Navigating Private Credit Uncertainty With **Asset-Based Lending**

Alex Preobrazenski

Cortland Credit Group
Managing Director & Portfolio Manager

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How Is Private Credit Defined?

Provision of non-traded credit by non-bank lenders to operating or non-operating corporate borrowers.

Given that sponsor-backed direct lending dominated private credit during its rise in popularity, most associate private credit with just this vertical.

- Private credit was historically dominated by private lenders providing mezzanine financing (behind banks) and loans to distressed corporates
- Private lenders began to structure club unitranche transactions
- Regulatory pressure post-GFC cuts out banks from ‘riskier’ credit holds, private credit fills the gap
- Private credit fundraising and deployment dominated by sponsor-backed direct lending (1st lien + unitranche) as managers chase scale
- Previously ‘esoteric’ credit strategies become investable through new private credit structures

Private Credit Strategies

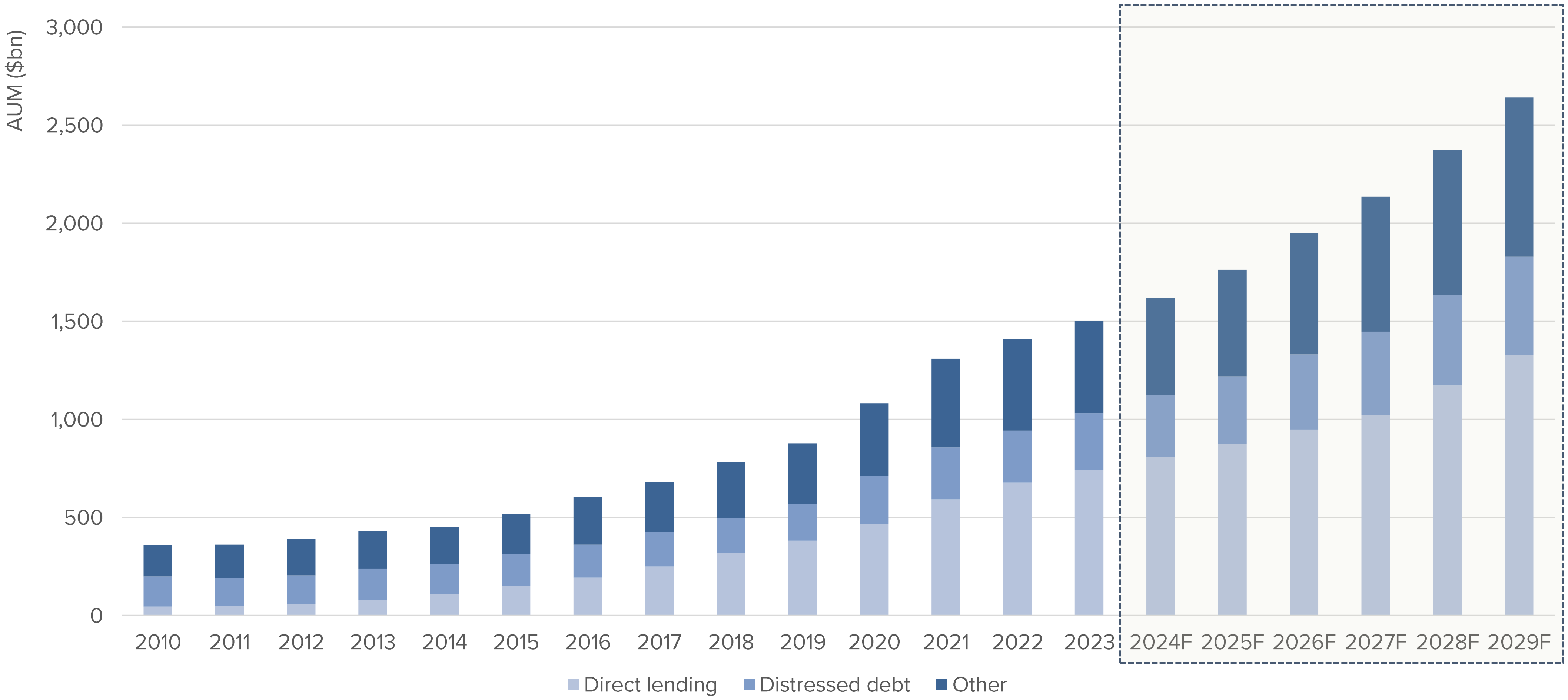
We break down private credit into three main verticals:

- **Direct Lending**
  - Generally characterized as loans made to private equity-sponsored corporate borrowers in the context of primary LBOs or add-on acquisitions, and refinancings related to the same
  - Scalable, DSCR / FCCR / leverage levels are core focus
  - Competes with banks and the BSL market for deployment
- **Asset-Backed Finance**
  - Financing diversified pools of contractually cash-flowing assets (consumer loan pools, BNPL, leases, etc.)
  - Each pool has distinct risk drivers; mitigate through tranches
  - Focus on expected cumulative loss curves and SMM, factors stressed by severity and timing
- **Asset-Based Lending**
  - Loans to corporate borrowers based on tangible collateral support (accounts receivable, inventory, equipment etc.)
  - Diversified collateral base, relatively liquid underlying assets
  - Specialized structuring and monitoring required

Private Credit Strategies Compared

	ABL	ABF	Direct Lending
Structure & Collateral	Revolver, Term Working Capital and Hard Assets	Revolver (Warehouse), Term Asset Pools (Loans, Leases, etc.)	Revolver, Term EV
Loan to Value Basis	Net Orderly Liquidation Value of specific assets	Collateral Value (par, discounted, fair value)	Enterprise Value
Rank	1^{st} Lien on all assets, or limited to specific assets	Tranche-dependent	1^{st} lien to structured equity
Liquidity	Moderate	Low-Moderate	Low
Portfolio Role	Core; principal protection + income	Core to Opportunistic; risk and tranche-dependent	Core to Opportunistic;

Private Credit AUM by Strategy



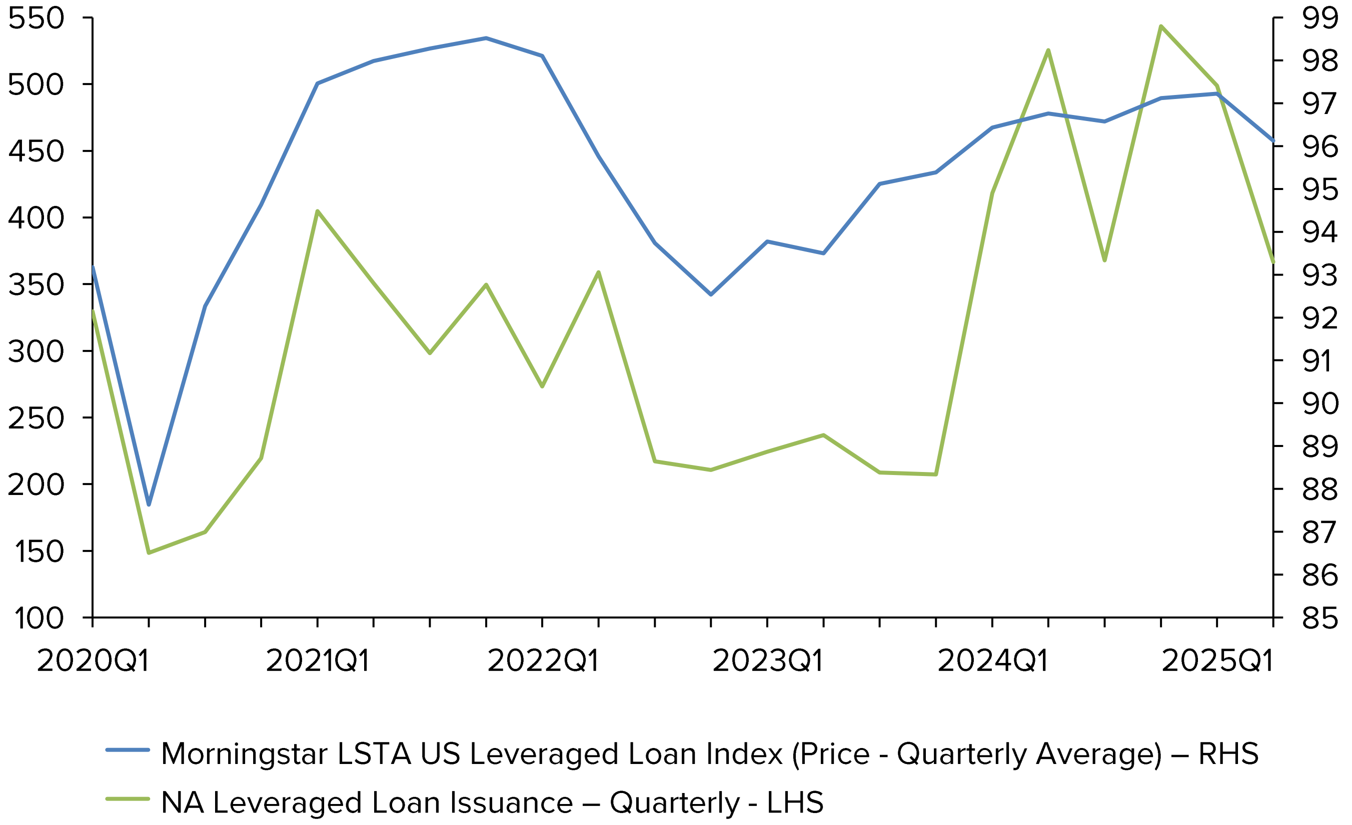
Source: Preqin, a part of BlackRock

Private Credit Drivers and Pressures

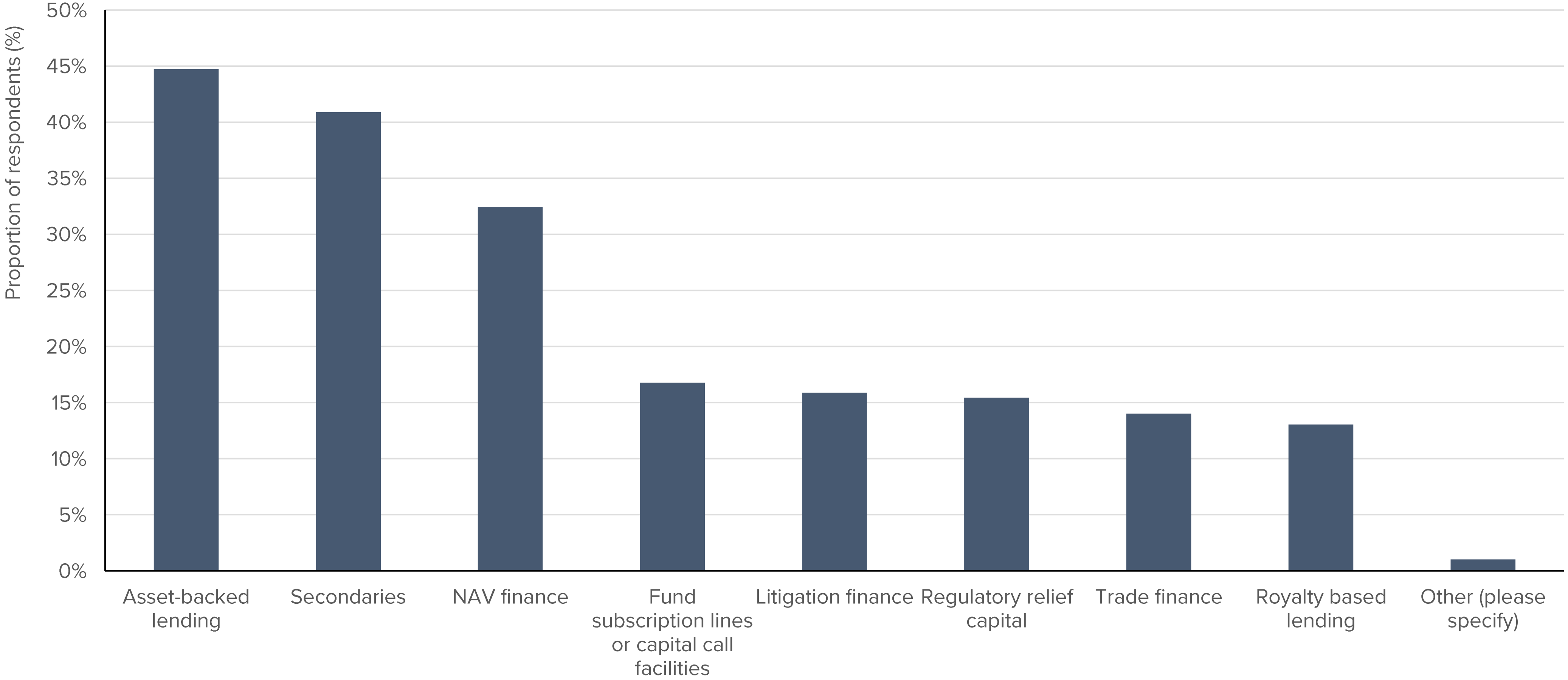
- M&A
- Policy shifts
- Credit market openness
- Interest rate environment
- Canadian market view

Morningstar LSTA US Leveraged Loan Index (Price) vs. N.A. Leveraged Loan Issuance - Quarterly

Source: Bloomberg, Morningstar, White & Case



Investor Outlook on Opportunities Within Private Credit



Source: Preqin, a part of BlackRock – Preqin Investor Survey, November 2024

Asset-Based Lending Overview

- Loans to corporate borrowers who use their assets to obtain credit rather than their cash flow
- Lender collateral is typically corporate accounts receivable, inventory, equipment etc., borrowers are typically more asset-heavy compared to DL borrowers, have a tighter margin profile and may be more seasonal in their cash flows
- Transactions are underwritten based on asset Net Orderly Liquidation Value (NOLV) – ABL prioritizes asset quality over total borrower leverage
- Diversified underlying collateral packages and second-order counterparty diversification
- Recovery in revolving 1st lien ABL is among the highest of all lending 'products'
- Considered uncorrelated to DL – deal flow not dependent on sponsor relationships or M&A activity
- High levels of natural liquidity through structural features and collateral
- Specialized structuring and monitoring required

ABL Structure

- Loans predominantly structured as revolvers (accounts receivable and inventory) with term structures provided for alternative assets (equipment, real estate)

- Generally rank 1st lien, sometimes split lien with other asset-based (separate assets financed - equipment) or cash flow lenders

- Blocked accounts are key components to an ABL's security package, risk management and liquidity
  - "Springing" vs full cash dominion

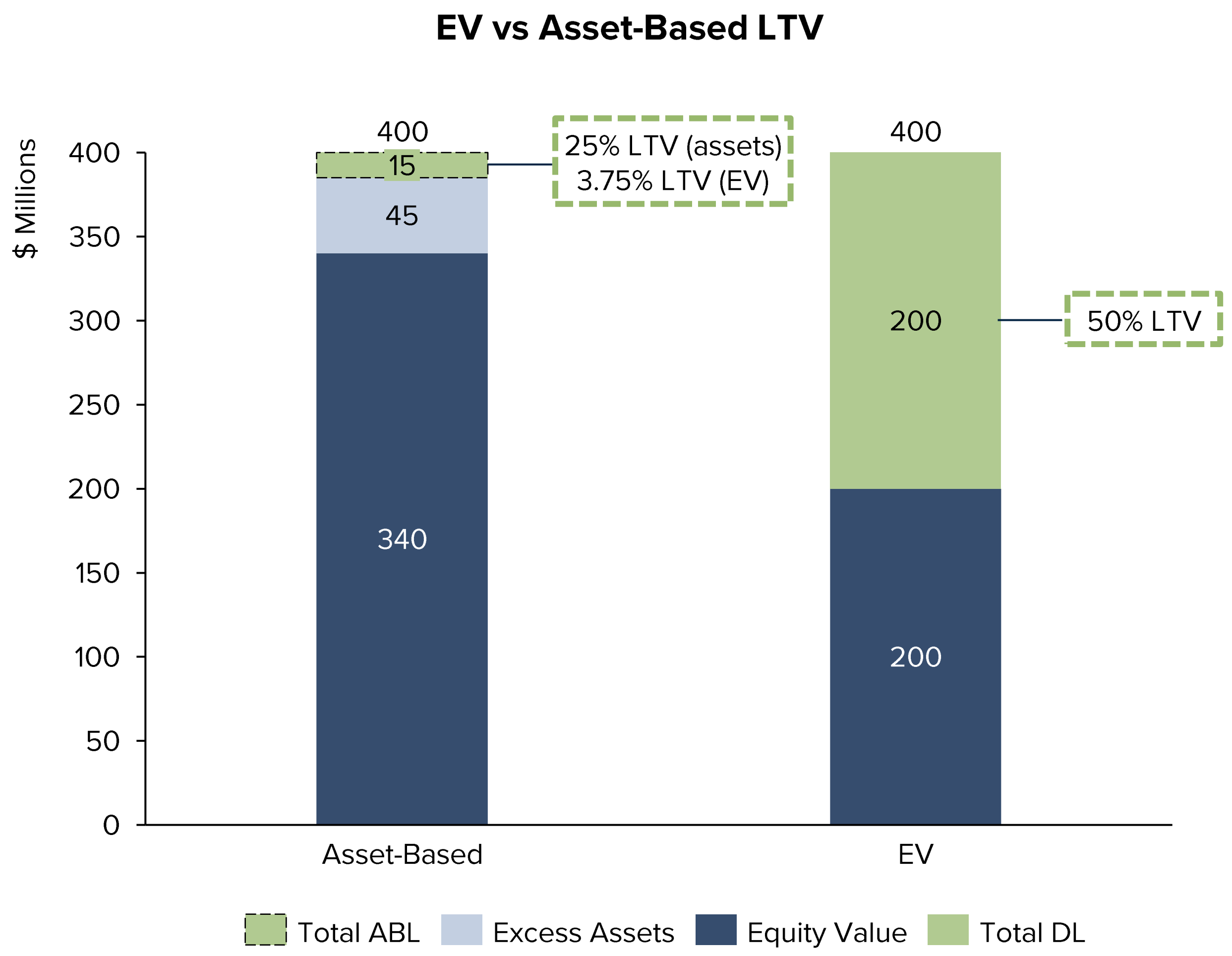
- Repayments occur daily/weekly, re-draws completed weekly or semi-weekly

- The "Borrowing Base" is the most critical piece of an ABL. The amount of capital a borrower can access at any given time is based on a semi-formulaic structure which starts at total asset values, with deductions applied for ineligible assets and other reserves taken for conservatism.

- Advance rates are applied to the resulting net amount for each asset category – advance rates are higher on assets that are closer to cash conversion: Accounts Receivable > Inventory > Equipment, etc.

Loan to Value

- Apples to Oranges
- Direct Loan's LTV calculated based on implied Enterprise Value
- Asset-Based Loan LTV based on specific asset liquidation value
- Example
  - Direct Loan given to corporate with $400MM EV - $200MM 1st lien loan provided to facilitate acquisition = 50% LTV
  - Pre-Acquisition ABL of $15MM vs $60MM assets = 25% LTV based on assets
  - Apples-to-apples LTV for the ABL is 3.75% (15mm/400mm)



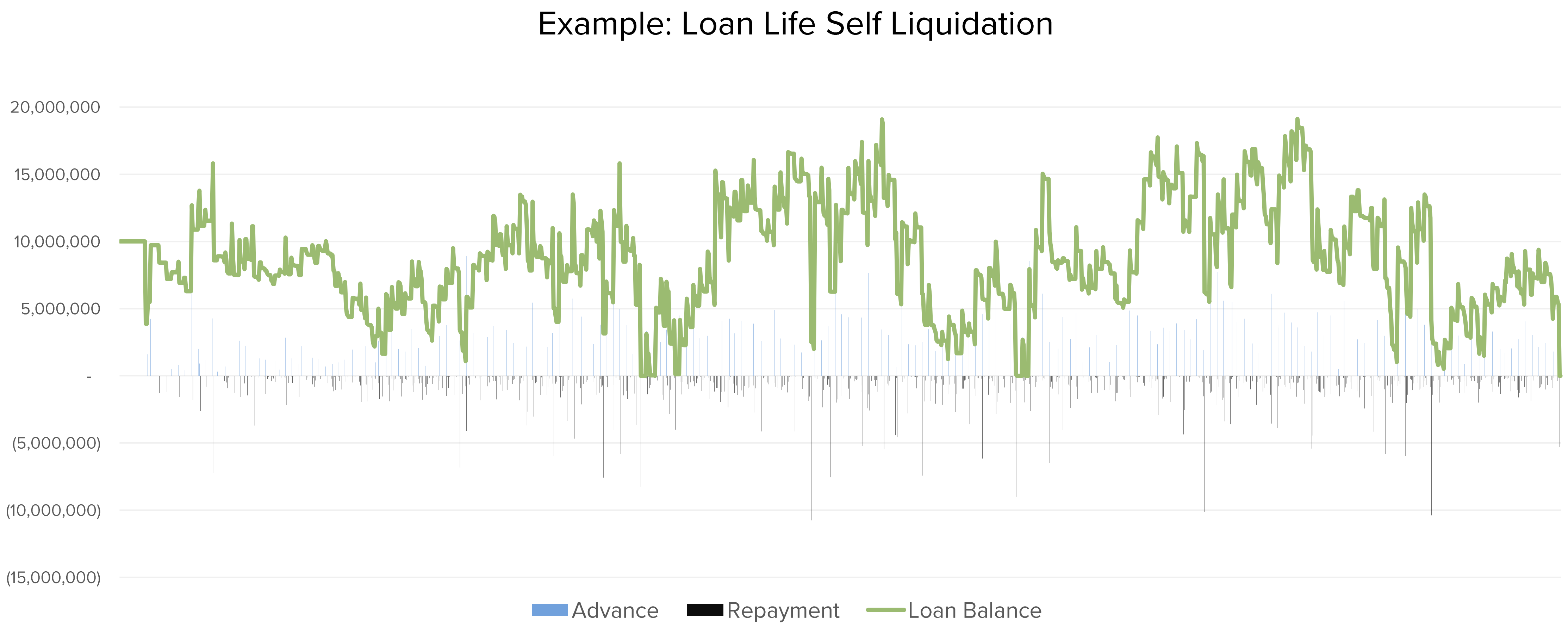
ABL Monitoring

- High-touch relationship with the borrower's management team – weekly or semi-weekly borrowing base reviews and reconciliation
- Analyst teams reconcile all cash received by the borrower to interim reduction in loan balance through blocked account sweeps
- Specialized interim diligence – third-party appraisals and field exams

Abridged Monitoring/Funding Process

1. Borrower submits borrowing request with borrowing base and supporting documents
2. Analyst team reviews materials including bank statements, flagging inconsistencies or errors for correction
3. Collateral Analyst prepares summary and recommendation
4. Approval received, funds released to borrower
5. Daily or weekly repayments from blocked accounts reduces facility balance until next draw

Natural Liquidity Within ABL



ABL Realization Example

- Cortland Credit established a credit facility with a Canadian corporate borrower that with an initial commitment of CAD $15MM to fund the company's growth.

- The credit facility was repaid almost exactly 3 years after its initial funding. At its peak, Cortland committed $23MM to the credit facility (through two accordions). Assets margined were eligible loans receivable and a small amount of cash float.

- The facility was opportunistically priced with a floored floating coupon, structured with full blocks on collection accounts and had daily sweeps applied as repayments against the facility balance. The facility carried a standard unused line fee and IRR on exit was in the high-teens. Over the life of the facility, Cortland advanced and was repaid ~$880MM cumulatively.

- Over the life of the loan, the borrower increased revenue by ~2.5x, EBITDA by ~5x and TNW by ~3.5x

- Exit was via a refinance from a large US ABL who provided a significantly upsized asset-based credit facility.

Recovery Rates

- Recovery rates are seen falling in 2024 for first lien leveraged loans, private credit 1st lien loans still maintain recovery expectations of 70-75%

- S&P estimated that first lien recoveries for US-issuers was 39% in 2024 vs 51% in 2023.

    - LMEs seem to be driving lower recovery rates – weighted average recovery for issuers emerging from bankruptcy after undergoing an LME was 23% versus 53% for issuers that had not undergone an LME
    - Not as relevant for 1st lien private credit structures as it is for BSLs, however Pluralsight tested the private credit market with the industry's landmark LME

- Fitch notes that revolvers, and specifically ABL structures, tend to recover in line with Fitch's highest recovery rating category's recovery levels

    - In 2024, 411 revolver facilities in Fitch's case study dataset were studied for utilization and recoveries, split by structure and collateral.
    - Overall average recovery was 87%; 96% for asset-based loans and 80% for cash flow revolvers.
    - Recovery distributions were primarily cash for revolvers captured in the study

Sources: Private Debt Investor, Fitch Ratings

Private Credit Primary Risk Considerations

- Spread compression in the upper middle market and within large cap transactions
- Covenant loosening
- Liability management exercises / DQ lists in the context of competition and supply/demand imbalance
- How is ABL insulated from such exercises and pressures/risks?
    - Specifically in the lower middle market, ABL is less scalable for larger managers
    - Less competition, longer diligence cycles, relatively diversified origination funnel
    - Non-sponsored borrower facility structures contain more lender-friendly terms
    - All contribute to maintenance of the loans’ structural integrity

Benefits of ABL in Private Credit Sleeves

- Depending on the quality of structuring and monitoring, expect lower loss given default with asset-based revolvers than 1st lien term debt

- Especially in times of stress or uncertainty, ABL exposures supplement DL given focus on capital preservation.
    - Self-liquidating collateral allows ABL managers to make frequent credit decisions and reduce risk ahead of restructuring in times of stress.

- Focus on lower-middle market and non-sponsored borrowers reduces competition leading to healthier spreads and tighter documents, however, scale of deployment may be sacrificed.

- Seeks to add an uncorrelated return set to overall private credit allocation

Cortland Credit