FEBRUARY 2024 | ISSUE 5

TPG INSIGHTS

Private Credit: Opportunity & Innovation

> **Private credit has historically provided low-to-mid-teen returns, which is fairly comparable to equities but with less volatility.**
> - Josh Baumgarten

> **The historical pattern has shown that private credit loss rates compare favorably to their public market peers, and we expect that to hold true in this cycle.**
> *- Amanda Lynam*

> **Direct lending isn't a one-size fits-all market.**
> *- Trevor Clark*

> **Non-corporate credit provides a diversifier that's incredibly core to the market.**
> *- T.J. Durkin*

> **We're just at the beginning of what we expect will be a multi-year private credit cycle.**
> *- Ryan Mollett*

The rapid rise of private credit has been nothing short of astonishing. More than a decade in the making, the seismic forces contributing to private credit's ascent, including pricey public market valuations, investors' desire for structure and control, and continued bank deleveraging, only look set to deepen ahead. Add to that the prospect of structurally higher interest rates, and we believe private credit is poised to play an outsized role in portfolios and the market in the coming years. With this in mind, we sit down with **Josh Baumgarten**, Co-Managing Partner & Head of Credit at TPG Angelo Gordon, and **Amanda Lynam**, Head of Macro Credit Research at BlackRock, to discuss the outlook for public and private credit in 2024, what's driving private credit AUM growth, and the portfolio benefits of private credit allocations. Both Baumgarten and Lynam agree that credit markets have yet to fully adjust to the higher cost of capital, but they see more room to run for private credit AUM. Lynam, for her part, believes her forecast for $3.5T in global private credit AUM by 2028—from around $1.7T today—is achievable considering the asset class's historical growth and relative size. We then turn to **Trevor Clark**, Founder of TPG AG's middle market direct lending business, TPG Twin Brook, **T.J. Durkin**, Head of TPG AG's Credit & Specialty Finance business, and **Ryan Mollett**, TPG AG's Global Head of Credit Solutions, for deeper discussions on what they see as the biggest pockets of opportunity and innovation in private credit today.

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GABE LIPTON GALBRAITH ggalbraith@advisorstpg.com

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Interview with Josh Baumgarten

Josh Baumgarten is **co-Managing Partner** of TPG Angelo Gordon and a member of the TPG board of directors. He **leads TPG's Credit business** and is **co-portfolio manager** for AG Super Fund and multi-strategy portfolios. TPG Angelo Gordon manages a variety of private credit strategies, including TPG Twin Brook Capital Partners, its middle market lending platform, TPG Angelo Gordon Credit Solutions, and TPG Angelo Gordon Structured Credit & Specialty Finance. Below, Baumgarten discusses the rapid rise of private credit, the portfolio benefits of private credit allocations, and what he's most excited about for the asset class looking ahead.

Q: We hear a lot about this being the "golden age of private credit". What's fueling the boom?

Josh Baumgarten: The market dynamic today is more than a decade in the making. It was really borne out of the aftermath of the Global Financial Crisis (GFC), when the world's largest banks were forced via regulation to de-lever. These banks represented some of the largest balance sheets in the world, incorporating a substantial amount of leverage. As they began to exit corporate lending to reduce their balance sheets, there emerged a significant need for new sources of debt financing.

What we've seen since is the growth of a roughly $1.7T private credit market. In the first phase of this capital shift, corporate credit lending shifted away from the banks at a rapid pace, and private lenders stepped in to fill the void—with bigger and more stable pools of capital, appropriate investment structures, and reduced asset volatility profiles. It was this combination of attributes that first sparked strong interest in private credit.

Today, we believe a gigantic supply-demand imbalance in the market is compounding the attractiveness of the private credit opportunity. Simply put, the available supply of capital is dwarfed by the demand for corporate lending. Factor in now the significant amount of consumer-related assets that also need to be transitioned off banks' balance sheets—we're talking volume in the trillions of dollars—and we see a whole new asset class of non-corporate private credit emerging to further drive demand.

This growth in the consumer part of the private credit ecosystem is being fueled by the increased regulation that has come for the smaller banks with sub-$250B in assets following the regional banking crisis of March 2023. These banks are now being forced to reduce their balance sheets, bring down risk-weighted assets, and curtail new risk capital investments all at the same time.

Big picture, the supply deficit in the market today allows private lenders to charge more for the capital that they are ready and willing to provide–it's not a premium for risk, but there's simply a lack of available capital to supply markets. We believe it's a dynamic that is driving enormous opportunity.

Q: Is the growth of private credit sustainable?

Josh Baumgarten: Yes. Only part of the market has been tapped so far. If you think about the roughly $1.7T already in private credit, that compares to a universe of high yield and leveraged loans that's still about $3.5T. Many investors in traditional high yield funds, separate accounts, or leveraged loan funds don't need their money on a daily basis, yet they allocate towards these markets in structures that offer that type of liquidity, exposing themselves to greater volatility than necessary. As the private credit market matures, I'm confident that more fixed income investors will come to recognize the potential for better risk-adjusted returns, lower volatility, and a better asset-liability match in this market and allocate accordingly.

For investors who recognize the opportunity in private credit, it's not so easy to increase or rotate your allocation towards it. Many investors are locked up in other illiquid strategies that are neither calling capital nor returning it, which makes it challenging to allocate capital towards private markets in the near term. That's become a blessing and a curse for private credit managers. On the one hand, it makes it challenging to raise capital. On the other, it ensures that the premium lenders can charge on capital remains well in excess of the underlying risk of those assets. Without capital available to freely flow towards this opportunity, the supply side of the imbalance is going to be very hard to solve in the short term.

From a demand perspective, issuers are truly still in the early stages of getting comfortable with private debt. Historically, borrowers accessing capital in the private versus public markets were considered adversely selected. But that paradigm has turned entirely on its head. Today, accessing capital in the private debt market may actually be a sign of a better borrower. We also believe issuers have become more comfortable accessing private

> **"Private credit has historically provided low-to-mid-teen returns, which is fairly comparable to equities but with less volatility. This powerful combination of both higher returns and downside risk protection is prompting a growing number of investors–both institutional and retail–to rethink private credit.**

rather than public credit, as they've come to appreciate the ease of execution, greater flexibility tailored to meet borrowers' needs, improved time to market, larger pools of capital, and frankly some advantages from having fewer existing lenders to deal with to get something done.

I think there's plenty more room to grow on the corporate side, and I believe the more nascent consumer side could be just as big as the corporate private credit market. While the corporate market has taken 15 years to develop to where we are today, it's unlikely regulation will wait that long on the consumer side. They want these assets in the hands of stable pools of capital that are not exposed to an asset-liability mismatch, as we saw in March 2023. This will happen much more quickly if capital can rotate to this market.

Q: What are the attractions of private credit to investors as an asset class?

Josh Baumgarten: Private credit strategies maintain an appropriate and compelling investment structure that limits the likelihood of an unnecessary need for liquidity as illiquid originated assets are matched against a similarly illiquid liability structure. With solid fundamental underwriting and the benefit of control premium at the time of origination, typically including covenants, the asset class is also able to maintain an illiquidity and complexity premium that compensates investors well in excess of the embedded risk in the asset class. Private credit has historically provided low-to-mid-teen returns, which is fairly comparable to equities but with less volatility.

This powerful combination of both higher return potential and downside risk protection is prompting a growing number of investors–both institutional and retail–to rethink private credit. I strongly believe that income-oriented products like private credit are going to be a portfolio staple moving forward, particularly in the environment of more normalized interest rates we're seeing today after more than a decade of rock-bottom risk-free yields.

Q: Do you worry about the near-term outlook for private credit given elevated rates and the prospect for a period of softer growth in coming years?

Josh Baumgarten: I don't. Yes, we expect default rates are going to pick up, particularly since we're coming out of an unnatural period of near-zero rates and abundant liquidity. This led to many borrowers being financed that may have had no good reason to exist except that risk-free rates were tethered to the floor and the return hurdle for capital was almost non-existent. Now, with the cost of capital moving higher and its availability that much more limited, those who can access it will likely be regarded as some of the better credits, as I said earlier. Some of those who find accessing capital more challenging maybe shouldn't have had it in the first place.

It's going to take time, but the economy will eventually feel the reality of the return to a more normal interest rate policy. Some of these borrowers may come to represent the beginnings of the first distressed credit cycle since the GFC.

I would suggest being defensive, making sure to have plenty of liquidity in your portfolio, and maintaining the flexibility to go where opportunity presents itself.

Q: How much differentiation is there within private credit as an asset class?

Josh Baumgarten: A good deal. As the private credit market matures, we continue to see growing differentiation in terms of the ways in which you can access the opportunity set. On the corporate side, post-GFC, the market started out focused fairly narrowly on middle market direct lending, as the mid-to-larger capitalization companies could readily meet their capital needs via traditional public markets. Now, borrowers of all types have begun to feel more confident in accessing private markets, and we're seeing managers differentiating their efforts by company size, geographic focus, and even sector specificity. While the consumer or specialty finance private credit market is still in its infancy, we are already beginning to see more specialization as the market continues to evolve and grow.

Q: How do you reduce risk in your private credit portfolio?

Josh Baumgarten: It's all about structure and control. As a private credit lender, you always aim to have control of the pen. You want to be the one at the table structuring the financing opportunity, picking the collateral, and selecting and crafting the covenants. Over the financing lifecycle, you want to continue to be in front of that borrower making sure that their performance is tracking to plan. If it's not on track, you want to have the means to proactively address the issue with the borrower and/or the sponsor to mitigate adverse issues that may come up. The best way to address a problem is to hit it quickly. The ability to address these issues as a sole lender, or with a small group, typically allows you to do so more quickly and with greater efficiency and flexibility.

From a structure perspective, you want to make sure there is always the right asset-liability match on the leverage side. That means ensuring that your liabilities are long-term in nature and do not have mark-to-market triggers. And from a capital structure perspective, you want to make sure your LPs are locked up for the duration of your assets. Given these are private markets, you certainly cannot expect liquidity to be available at all times. Lastly, like any portfolio, you also want to seek diversification in terms of borrowers and end markets.

Q: Looking ahead, what are you most excited about in private credit?

Josh Baumgarten: There's still so much growth opportunity. This isn't just a moment in time. It isn't one of those market dislocations that appears and if you were unable to raise capital in the short term then the opportunity is gone. The supply-demand imbalance in credit markets is not going anywhere.

This mismatch is in the trillions of dollars, and not every GP has the scale, team, and resources to penetrate the market. It's going to take a while for capital to come in. I would advise LPs to pick their partners carefully and stick with them. The market is inundated with opportunity right now, and it's going to be that way for a while.

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Interview with Amanda Lynam

Amanda Lynam, CPA, is **Head of Macro Credit Research** at **BlackRock**. In this capacity, Amanda leads original market research across a range of asset classes, including global corporate debt markets as well as private debt, real estate and infrastructure lending. Prior to joining BlackRock, Amanda spent 16 years at Goldman Sachs, where she was previously **Managing Director** and **Senior Credit Strategist** in **Global Credit Strategy**, within the **Global Investment Research Division**. Below, she discusses her expectations for the public and private credit markets in 2024 and why she expects global private credit AUM to grow to $3.5T by 2028.

The views stated herein are those of the interviewee and do not necessarily reflect those of TPG.

Q: What do you expect for credit markets in 2024?

Amanda Lynam: In a sentence: the adjustment to a higher cost of capital environment is not yet complete. That said, we view this as a catalyst for dispersion across and within asset classes, as opposed to a catalyst for widespread market disruption. Over the next few quarters, we expect some modest, additional increases in loss rates in both the public and private credit markets–extending the trend in place for much of 2023. In aggregate, we're calling for 50-100bp of additional credit losses in coming quarters, which represents a normalization (higher) from the historically low loss rates of late 2021 and early 2022.

If you were to isolate the leveraged finance portion of the public (syndicated) credit market, which refers to high yield (HY) bonds and leveraged loans, what you'd see is that the higher cost of capital has been a headwind to fundamentals, but it's generally been well-managed. For the BB-rated portion of the HY market, which is roughly half of the index eligible universe, companies still have solid interest coverage metrics. It's at the lower end of the ratings/quality spectrum—in the B- and CCC buckets—where we're expecting more meaningful headwinds in 2024.

Given significant pre-funding and liquidity raising in 2020-21, many leveraged finance issuers have had the luxury to be patient about refinancing, and they didn't have to tap the debt markets to a large extent in 2022-23. That's going to change this year as maturity walls get closer. If you look at implied refinancing costs, which we think about by taking the fixed coupon and comparing it to the current yield-to-worst, that differential is more than 600bp for the CCC cohort.[i] The average interest coverage ratio for CCCs is already low, at 1x.[ii] So, there's very little flexibility for higher interest costs at the lower end of the quality spectrum.

Q: What does this mean for the private credit market?

Amanda Lynam: Private credit markets are also navigating a higher cost of capital. But the historical pattern has shown that private credit loss rates compare favorably to their public market peers, and we expect that to hold true in this cycle. In large part, this is a byproduct of the flexibility inherent in the longer-term relationships between borrowers and lenders in private credit.

Two stats are powerful here. The first utilizes the Cliffwater Direct Lending Index (CDLI), which is an asset-weighted index of approximately 14K directly originated US middle market loans totaling $295B as of September 2023. We use the index as a proxy for US direct lending, which is the largest of the private credit strategies. The loss rates of the CDLI have been similar to–or better than–those of HY and leveraged loans in most years since 2005.[iii] Second, based on the Lincoln International Senior Debt Index (LSDI), which tracks 4.5K US portfolio companies across 150 sponsors, the rate of covenant defaults has been declining since Q1 2023. That's striking, considering the cost of capital has remained high throughout this period.

Notably, 15% of the LSDI universe obtained a covenant amendment in the first 9 months of 2023. That speaks to the flexibility inherent in private credit, where borrowers have long-term relationships with their lenders (either one lender, or just a few) and can often proactively address headwinds to covenants. This can be a more efficient process than in the public market, where a syndicated leveraged loan issuer, for example, might need to coordinate with dozens of lenders to obtain covenant relief. That's not to mention that roughly 90% of the US syndicated leveraged loan market is actually "covenant lite".[iv]

Q: Given the macro backdrop, what do you think about valuations across public and private credit today?

Amanda Lynam: In general, in the USD and EUR public corporate credit markets and across most rating categories, valuations are attractive from an all-in yield perspective, driven by the increase in risk-free rates, but somewhat tight from a credit spread perspective.

"Private credit markets are also navigating a higher cost of capital. But the historical pattern has shown that private credit loss rates compare favorably to their public market peers, and we expect that to hold true in this cycle.

i. As of December 7, 2023, using the Bloomberg Barclays USD HY CCC rated Corporate Index (par weighted coupon vs. yield-to-worst).
ii. Trimmed mean interest coverage ratio as of 3Q2023, using Bloomberg data for the Bloomberg USD HY CCC rated Corporate Index.
iii. Using realized losses (as reported) for the CDLI and our estimates of loss-given-default, using Moody's issuer-weighted default data for the HY and leveraged loan universes.
iv. 89% of the Morningstar/LSTA USD Leveraged Loan Index was "covenant lite" as of November 2023, per Pitchbook LCD.
V. Per Dealogic, as of October 2023.
Vi. Per Pitchbook LCD.
Vii. Notional value of the Bloomberg Global Corporate Credit Index, the Bloomberg Global HY Index, and the Morningstar Global Leveraged Loan Index – all as of November 2023. Excludes index-ineligible debt.

This has enabled investors to deploy capital into the public credit market at attractive all-in yields relative to history, even though the compensation for credit spread risk hasn't been particularly robust.

In the private credit market, again using the CDLI index as a proxy for US middle market direct lending, the yield as of September 2023 was 12.3%. This compares to an 8.9% yield-to-worst for the Bloomberg USD HY Index and a 10.3% yield-to-maturity for the Morningstar/LSTA USD Leveraged Loan Index, as of that same timeframe.

Q: Why are capital allocators increasingly attracted to private credit as an asset class?

Amanda Lynam: The narrative has shifted over the past decade. For several years, investors were focused on the opportunity to capture incremental yield in private credit. This was especially prevalent in the low-rate environment prior to the pandemic. In essence, investors that had long-term capital (i.e., pension funds, endowments, and life insurance companies) decided to commit some of that capital for a longer period (often many years) in exchange for capturing an "illiquidity premium".

In the post-pandemic period, the dialogue has evolved somewhat. In our conversations, there's much more focus today on the opportunity to introduce diversification, granular credit selection and structural protections (depending on the private credit strategy) amidst a backdrop of higher financing costs for companies and potential downside economic risks.

In a June 2023 Preqin survey, investors cited the following as among the most common reasons for increasing their allocation to private credit: diversification, the desire for an ongoing income stream, reduced portfolio volatility, and its limited correlation with other assets.

> "There's much more focus today on the opportunity to introduce diversification, granular credit selection and structural protections amidst higher financing costs and potential downside economic risks.

Q: What's behind your bullish call that private credit will grow to around $3.5T by 2028?

Amanda Lynam: As private credit has become a sizeable and scalable asset class on a standalone basis, it is no longer reserved for niche pockets of the lending market. There are four main drivers of our growth forecast–some of which have been in place for a while.

First is investors' preference for portfolio diversification. We see room for investors to continue to increase their allocations to private credit, whether within their broader alternative asset allocation, or increasingly as a fixed income substitute.

Second is borrowers' desire for certainty and ease of execution when seeking financing, as well as the flexibility inherent in a long-term lending relationship. Some companies may also prefer to stay private for longer, while they execute on their growth initiatives.

Third is the structural shift in the public debt markets, which are serving larger and larger borrowers (and can therefore render modest-sized debt financings illiquid). For context, the average deal size in the USD HY market has been over $700M since 2020[v], and it has averaged over $450M in the syndicated leveraged loan market over that same timeframe.[vi] These "average" deal sizes would be extremely large for most middle market firms. The private markets, by contrast, can often provide a more tailored financing solution for smaller companies.

And fourth is the well telegraphed tightening in bank lending standards–a trend which was in place even before the March 2023 disruption among some US regional banks. We do see opportunity for more partnerships between banks and non-bank lenders to provide financing into the broader ecosystem. But potential changes to bank capital and liquidity rules, if they materialize, would further amplify the trend in the growth of private credit.

On net, these factors should all allow for a further expansion of private debt's "addressable market" of borrowers.

> "Private credit satisfies investors' desire for portfolio diversification and borrowers' desire for certainty and ease of execution.

Q: Do you think the growth in private credit is sustainable?

Amanda Lynam: Yes. Overall, our forecast implies a 15% CAGR in global private credit AUM from now until year-end 2028, and that's for a market that has been growing by roughly 20% per year over the last few years. The forecast we describe isn't outsized relative to other parts of the financial ecosystem, or even the alternatives market.

For example, the global corporate credit market (investment grade, HY, and leveraged loans) is more than $17T.[vii] And at $1.7T of AUM (inclusive of dry powder), private credit still represents a relatively small percentage of the broader alternative asset investing universe, which totaled more than $13T as of March 2023, according to Preqin, and is dominated by private equity.

One thing to watch out for is a flurry of new entrants into this market. Managers with less experience are likely to be challenged now that the cost of capital is elevated. And in private credit, an experienced manager with workout and restructuring expertise is critical if or when companies face financial pressure.

We expect private lenders will remain selective as they deploy "dry powder" available for investment. Indeed, private credit dry powder is approximately $445B as of December 2023, according to Preqin, which suggests that players have capital to deploy but are being disciplined in putting it to work.

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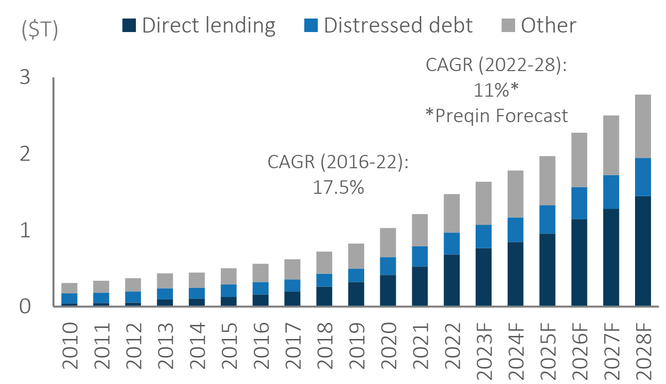
Private Credit: AUM & Performance

Global Private Credit AUM On Track to Reach ~$2.8T by 2028*

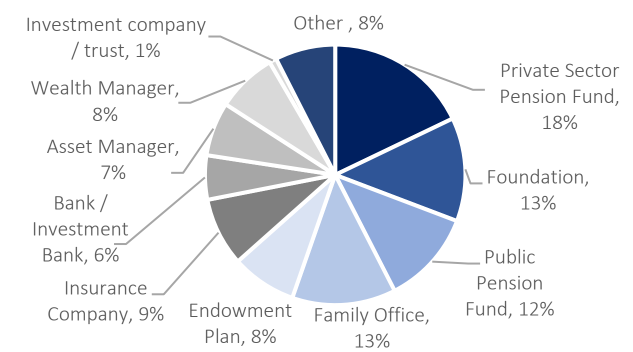
Private Credit AUM by Strategy, $T



Note: *AUM growth based on Preqin estimate.
Source: Preqin, TPG.

Private Credit Ownership Is "Buy-and-Hold" Oriented

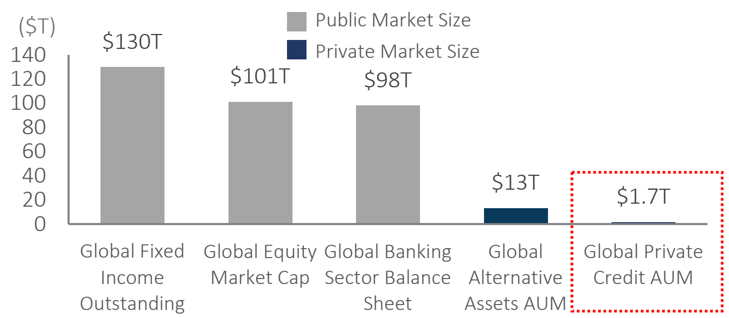
Ownership of Global Private Debt AUM, By Investor Type



Note: As of YE 2022. The "Other" category includes Corporate Investor, Government Agency, Sovereign Wealth Fund, and Superannuation Scheme.
Source: BlackRock, Preqin.

The Size of Private Credit Remains Modest Relative to Public Markets

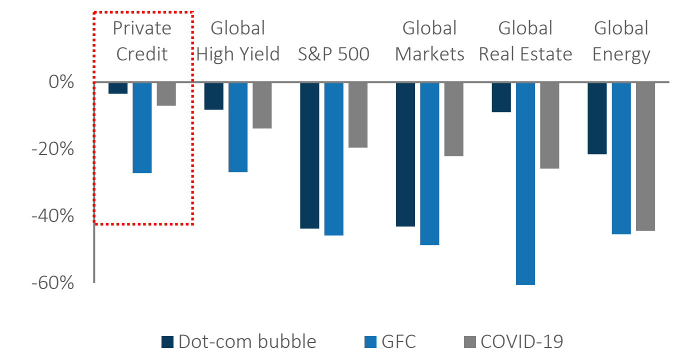
Size, $T



Note: SIFMA data as of Q2 2023, Preqin data as of June 2023, private asset AUM includes dry powder.
Source: SIFMA, BIS, Pitchbook, TPG.

Private Credit Has Weathered Past Downturns Well

Peak Drawdown by Asset Class and Event, %



Source: Pitchbook, TPG.

Direct Lending Has a Strong Return Track Record

Total Returns, % (Green = Highest Total Return in Period. Red = Smallest Total Return in Period.)

	Cliffwater Direct Lending Index (CDLI)	Bloomberg USD HY Corp Bond Index	Morningstar LSTA USD Leveraged Loan Index
2007	10.2%	1.9%	2.0%
2008	-6.5%	-26.2%	-29.1%
2009	13.2%	58.2%	51.6%
2010	15.8%	15.1%	10.1%
2011	9.8%	5.0%	1.5%
2012	14.0%	15.8%	9.7%
2013	12.7%	7.5%	5.3%
2014	9.6%	2.5%	1.6%
2015	5.5%	-4.5%	-0.7%
2016	11.2%	17.1%	10.2%
2017	8.6%	7.5%	4.1%
2018	8.1%	-4.5%	0.4%
2019	9.0%	14.2%	8.6%
2020	5.5%	7.1%	3.1%
2021	12.8%	5.3%	5.2%
2022	6.3%	-11.2%	-0.8%
1Q2023	2.7%	3.6%	3.3%
2Q2023	2.8%	1.8%	3.2%
3Q2023	3.2%	0.5%	3.5%

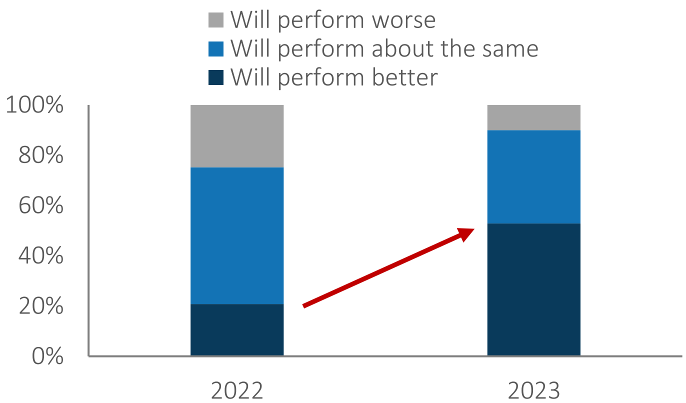
Note: As of 3Q2023 (most recent available for the CDLI), see here for more detail on the construction of the CDLI.
Source: BlackRock, Cliffwater, Bloomberg, Pitchbook LCD, Morningstar LSTA, TPG.

TPG INSIGHTS

Private Credit: Market Drivers

Investors Expect Strong Private Credit Performance

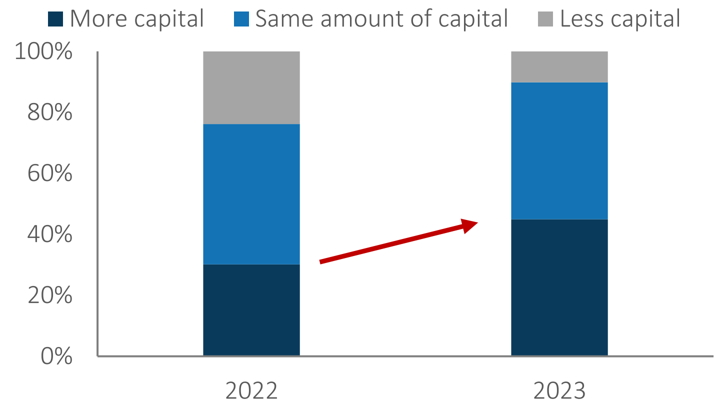
Preqin Investor Survey Responses To: 'How will next 12 months' performance for private debt compare to previous 12 months?'



Source: Preqin Investor Survey (June 2022 vs June 2023).

45% of Respondents Plan to Increase Their Private Credit Allocation

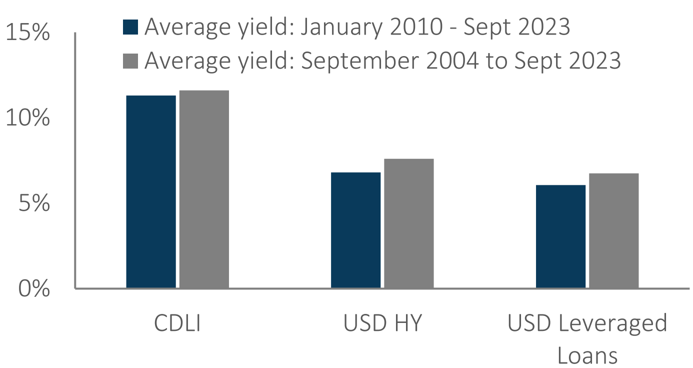
Preqin Investor Survey Responses To: 'How much capital will you commit to private debt in the next 12 months?"



Source: Preqin Investor Survey (June 2022 vs June 2023).

US Direct Lending Has Offered a Yield "Pick-Up" vs. Public Markets

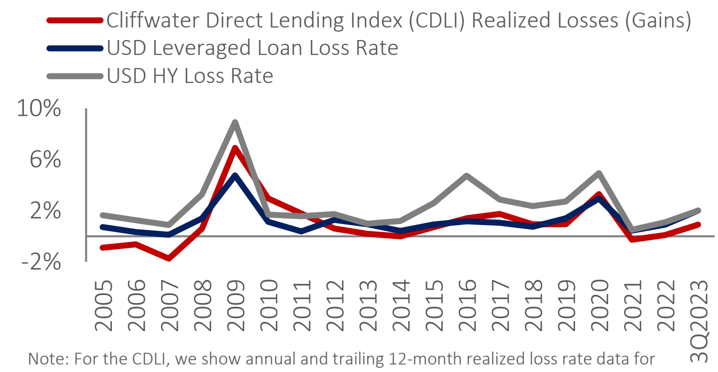
Average Yields for CDLI, Morningstar/LSTA USD Leveraged Loan Index, and BBG USD HY Corporate Index, %



Note: As of September 2023 (the latest available for the CDLI). Yields used: CDLI: 3-year takeout yield; HY: yield-to-worst; Loans: yield-to-maturity.
Source: BlackRock, Cliffwater, Bloomberg, Pitchbook LCD, TPG.

Private Credit Loss Rates Have Been More Muted So Far This Cycle

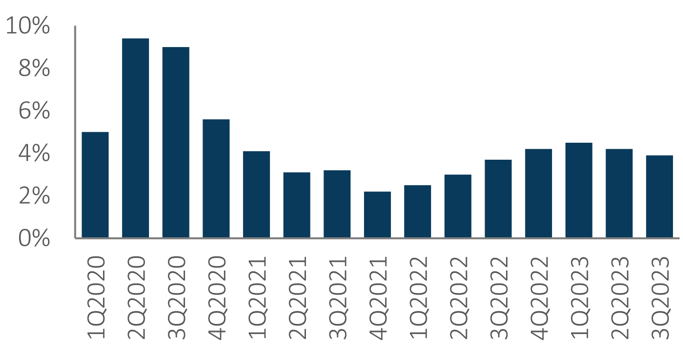
Historical Loss Rates (%) for the Cliffwater Direct Lending Index and the USD HY Bonds and Leveraged Loans Tracked by Moody's



Note: For the CDLI, we show annual and trailing 12-month realized loss rate data for 3Q2023. We assume a 40% recovery rate for HY and a 60% recovery rate for leveraged loans to arrive at estimated loss rates given the Moody's issuer-weighted, trailing 12-month default data. The HY and leveraged loan loss rates reflect the universe of HY bonds and leveraged loans tracked by Moody's. Source: BlackRock, Moody's, Cliffwater, TPG.

Private Credit's Long-Term Lender-Borrower Relationships May Help Contain Defaults During Difficult Periods…

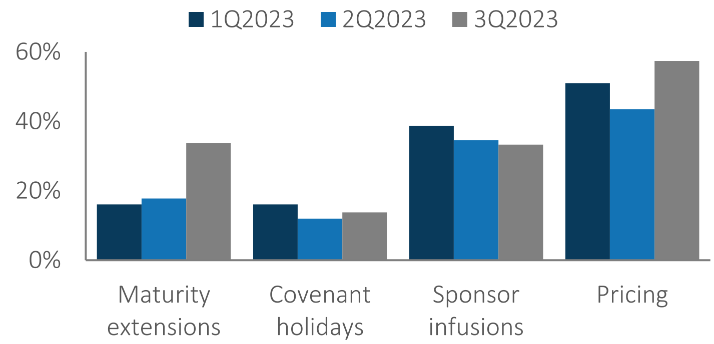
Covenant Default Rate for Lincoln International Senior Debt Index, %



Note: Size-weighted default rate for 4.5K+ portfolio companies tracked by the Lincoln International Senior Debt Index; data as of Q3 2023.
Source: Lincoln VOG Proprietary Private Market Database, BlackRock, TPG.

… And Covenant Amendments May Help Too

Allocation of Amendments in the First 9 Months of 2023, % Total



Note: Data as of Q3 2023.
Source: Lincoln VOG Proprietary Private Market Database, BlackRock, TPG.

Disclaimer: Past performance is not a reliable indicator of current or future results. Index performance returns do not reflect any management fees, transaction costs or expenses. The figures shown relate to past performance. Past performance is not a reliable indicator of current or future results. Index performance returns do not reflect any management fees, transaction costs or expenses. Indices are unmanaged and one cannot invest directly in an index.:

TPG INSIGHTS

Interview with Trevor Clark

Trevor Clark is **Founder** and **Managing Partner** of TPG Angelo Gordon's middle market direct lending business, Twin Brook Capital Partners, where he's been responsible for overall operations of the business since its inception in 2014. Twin Brook Capital Partners is a leading senior secured direct lender to private equity sponsored lower middle market companies. Below, he discusses asset allocators' increased interest in middle market direct lending, the unique opportunity set in the lower middle market, and the outlook for direct lending in 2024 and beyond.

Q: What's the attraction of middle market direct lending?

Trevor Clark: Direct lending has many valuable facets, though the importance of each depends somewhat on the investor. For traditional public credit market investors, middle market direct lending has offered a significant yield premium, less mark-to-market pricing volatility, and better loss-adjusted returns over an extended period of time.

These facts have contributed to an explosion in the popularity of direct lending since the Global Financial Crisis (GFC), when fixed income allocators woke up to the idea that bilaterally negotiated loans to smaller companies can be quite attractive and less risky than they'd thought.

At the same time, there's a second group of yield-driven investors who're increasingly allocating to direct lending from other asset classes because of its potential to provide attractive net returns alongside a steady cash component that's incredibly compelling on a standalone basis. There are a variety of broader benefits of middle market direct lending, including the fact that lenders have the opportunity to be the first dollar in the capital stack, have direct interaction with borrowers, and insist on strong lender protections.

That said, direct lending isn't a one-size-fits-all market. A last-out loan to a highly cyclical company without private equity backing has a far different risk profile than a first lien, directly originated loan to a low-levered, high-performing company. As an investor, you can access direct lending in either fashion. But the return profile and stability of those returns is going to be very different.

Q: What differentiates middle market direct lending from the broadly syndicated loan (BSL) market?

Trevor Clark: We believe the broadly syndicated loan (BSL) market is a lowest common denominator type of lending environment where the borrower maintains most of the negotiating power. Typically, the borrower wants the lowest cost, highest leverage, and the least constraints from their lender group. By its very nature, it's the lowest bid that often clears the market. You also see much larger bank groups associated with this market, which leads to lenders selling in and out of positions and therefore much more volatility.

In contrast, direct lending deals are bilaterally negotiated. As a direct lender, it's common to be the only capital provider in a credit facility. In the lower middle market, there are often smaller lender facilities and much better lender protections even compared to the upper middle market.

In the BSL and upper middle markets, you often don't have financial covenants, have lower pricing power, and are commonly working with higher leverage. That's not to say there aren't good credits in this part of the market, but just that these market segments offer a different risk-return profile than lower middle market direct lending.

Q: What's the outlook for middle market direct lending in 2024?

Trevor Clark: Some cracks will start to show in parts of the market. There's a narrative out there that the default picture has been quite benign given the sharp rise in interest rates, especially since many companies put structures in place that assumed sizable cashflows that didn't occur. That's true to some degree.

But the recent default picture ignores the fact that the lenders who closed transactions without covenants were in some cases able to avoid instances of default by waiving required payments or taking PIK interest instead of cash interest. These actions would indicate that there was portfolio stress, but it hasn't yet manifest itself in an uptick in defaults.

As for the market as a whole, we expect investor demand should only continue to grow. Direct lending returns compare well to those of private equity and distressed investing when interest rates are elevated. From a deployment standpoint, the ongoing retrenchment

"Direct lending isn't a one-size-fits-all market. A last-out loan to a highly cyclical company without private equity backing has a far different risk profile than a first lien, directly originated loan to a low-levered, high-performing company.

of the commercial banks and their surrendering market share to non-bank lenders should continue to drive increasing loan demand.

The last thing to keep an eye on is the explosion in the number of direct lenders because of the attractive return environment. A natural question is whether this competitive environment will diminish returns over time.

We don't believe that's the case because what we've seen in recent years, as was the case following the GFC, is that during periods of economic and market disruption allocators' focus shifts to the most reliable, consistent, and scaled providers of direct lending capital. We believe these are the groups that will continue to benefit from industry-wide tailwinds.

Q: But won't borrowers seek out more favorable terms given increased lender competition?

Trevor Clark: No, at least not in the lower middle market. Some groups have tried to penetrate this part of the marketplace by giving away terms, but they haven't been particularly successful. The reason is that if you're a lower middle market private equity firm, you probably aren't pursuing a strategy focused on financial engineering or multiple arbitrage in order to generate returns. Instead, you're focused on transforming and growing companies, which requires significant lender collaboration.

There are a few ways to accomplish that as a sponsor. You can pursue a roll-up strategy by acquiring competitors. You can expand the company's footprint by building a new factory, creating new product lines, or venturing into new geographies. But the common theme for any of these strategies is that you need a lender with experience, consistency, and reliability to support you along the way.

The close relationship between borrower and lender is particularly important in the lower middle market (in contrast to the BSL and upper middle markets). It's frankly a much higher priority for sponsors than a small pricing concession or receiving additional leverage, in my experience.

> "The close relationship between borrower and lender is particularly important in the lower middle market (in contrast to the BSL and upper middle markets).

Q: How do direct lenders diligence new opportunities?

Trevor Clark: Cashflow is always king. It's critical that a business has produced the consistent cashflows required to support the interest payments and debt levels being requested. That's quite different from enterprise value lending based on a percentage of a company's valuation at a point in time.

Second, there's an intensive borrower selection process where hundreds if not thousands of companies are reviewed annually and only those with proven cashflow profiles pass an initial screen.

Third, once a company has demonstrated the required cashflow profile, there's going to be multiple months of due diligence that involves combing through earnings quality reports, market studies, background checks, and environmental and insurance reviews before a loan is issued.

Q: How do you protect yourself from losses as a lender?

Trevor Clark: The key is being proactive. In the lower middle market, there's typically a 2-3 month window to diligence a company, which enables investors to apply the proper scrutiny before investing. That compares to only 2-3 weeks of diligence in the upper middle market.

There's also the opportunity to do revolving credit facilities, which around two-thirds of direct lenders forgo because they're perceived as inefficient or human capital intensive to manage. But the benefit of being the first dollar (revolving lender) in the capital stack is that it provides a daily snapshot of companies' performance. Whereas a lender in the term debt may only be getting financials 30 days after month-end or as long as 90 days after quarter-end in the upper middle market, which is often far too late for a meaningful course correction.

> "The benefit of being the first dollar in the capital stack is that you get a daily snapshot of companies' performance.

Financial covenants also play an important role in protecting returns. While financial covenants won't make a "bad" company "good", they are an important tool in addressing any performance issues with a borrower. Financial covenants also serve as an effective tool in giving a lender the ability to reprice risk in the event of a downside scenario.

Another more subtle form of protection comes from working with financial sponsors. The presence of a sponsor provides operational oversight and capital support in the event that a borrower faces distress. It can also be beneficial to be the only direct lender in a facility, which helps to avoid the issue often found in larger credit facilities that can include over 50 lending parties where building lender consensus can be a challenge, especially during periods of economic stress.

Lastly, it's critical to be consistent in your credit philosophy across different economic cycles to avoid introducing investors to significant vintage risk. There were a number of direct lenders that entered the market prior to 2020 during a period of benign economic conditions, and many of them were less disciplined in their underwriting and structuring of credits.

While this lack of discipline didn't have an immediate impact on returns, you're now seeing greater downside volatility for some lenders as the cost of capital of these higher risk strategies becomes clearer.

TPG INSIGHTS

Interview with T.J. Durkin

Thomas (T.J.) Durkin is a **Managing Director** and **Head of the TPG AG Structured Credit & Specialty Finance** business. Mr. Durkin also serves as co-Portfolio Manager of TPG Angelo Gordon's structured credit securities and private credit portfolios. Below, he discusses the outlook for "specialty" or "asset-based" private credit, which he argues will make up a larger portion of institutional private credit allocations in the years to come.

Q: What parts of the credit market are you focused on in structured credit and specialty finance?

T.J. Durkin: Everything that's non-corporate, non-EBITDA-based lending. According to the Fed, less than 1/3 of the $38T stock of non-financial US credit is comprised of corporate business credit. That other 2/3 includes a large addressable market of things like consumer credit, residential and commercial real estate credit, and specialty lending markets.

For our part, we're focused on three broad segments, each of which involves some underlying financial or hard asset. The first is consumer assets like auto, credit card, student, and consumer loans. The second would be hard assets such as residential and commercial mortgages or financing for builders as they're developing lots for single family housing.

Finally, the third is what we call specialty credit that consists of things like equipment leasing, small business lending, and other more specialized forms of financing. All of these provide investors with a much more comprehensive exposure to the US economy than they might otherwise get in a traditional, corporate-only private credit portfolio.

Q: Are you seeing increased interest from asset allocators to put capital to work in non-corporate credit?

T.J. Durkin: The inbound interest we're observing in the market is the highest I've ever experienced, driven by a few critical tailwinds. The bank deleveraging trade picked up speed following last year's regional banking crisis. US banks don't typically own much corporate credit. They're far more exposed to the types of non-corporate assets that are in our wheelhouse, which make up roughly 75% and 80% of large and regional US banks' balance sheets, respectively.

But they're pulling back more and more across these markets. Looking ahead, there are more bank regulations in the pipeline, like the so-called "Basel III Endgame", that could see seasoned loans continuing to move off banks' balance sheets and finding their way into private credit funds.

The relative expensiveness of corporate credit today has also left investors looking for other pockets of value. Structured credit looks somewhat cheap in the public market, and you can add a substantial illiquidity and complexity premium to that on the private side and potentially provide an attractive relative and all-in return. Notably, that premium in our market tends to be larger than what our colleagues in middle market lending observe.

Non-corporate credit provides a diversifier that's incredibly core to the market. Only about 1/3 of the economically productive lending in the US involves operating companies, and so investors are way underweight non-corporate credit relative to its share of the economy.

There are some issues at play in allocating to below investment grade, non-corporate credit, including the lack of a benchmark, which leaves most private credit programs benchmarked to a mix of high yield and bank loans. But we expect a continued recalibration over time and think specialty private credit will eventually have a standard weight of somewhere between 10-40% in institutional private credit portfolio allocations.

Lastly, beyond diversification, there's a lot of alpha in this part of the credit market because of its size, complexity, and relative inefficiency.

Q: What's the investor base for specialty private credit?

T.J. Durkin: It's two-fold. Insurers are a sizable participant because they're generally investing in these asset classes in the IG part of the public market directly. So, they understand these assets well, but they perhaps don't have a big enough team to source, underwrite, and asset manage on the private side in-house. Another group is the earlier adopters of direct lending from the pension world. This group has already had a compelling run in direct lending, and they're now looking for the next thing to say ahead of the curve.

> **Non-corporate credit provides a diversifier that's incredibly core to the market. Only about 1/3 of economically productive lending in the US involves operating companies, and so investors are way underweight non-corporate credit relative to its share of the economy.**

More broadly, private credit in general reflects pensions and other large pools of institutional capital stepping into the shoes of the banking system. What allocators are beginning to understand is that there is no benefit to concentration in performing lending strategies, which is a key difference from private equity.

All things equal, we believe you should always choose a portfolio of 1,000 loans over one with 100 loans. And if you can identify intrinsically different sources of cash flow, that can be very valuable in terms of the risk profile of your private credit program in aggregate, which informs why the life insurance industry buys a lot of securitized products.

> "What allocators are beginning to understand is that there is no benefit to concentration in performing lending strategies.

Q: How do you build diversification into your portfolio construction process?

T.J. Durkin: At a deal level, it's all about the law of large numbers. If you're financing a consumer loan originator, it's going to have thousands if not tens of thousands of underlying loans to support the lending facility. We assume implicitly that some of those loans will have issues. There's no such thing as zero defaults in a specialty finance company loan book. But there's far less cliff risk relative to direct lending because of the potential diversification benefits of pooling so many loans. If a direct lending counterparty defaults, there's going to be a big dip in terms of pricing, and as a lender you start thinking about recovery rates.

> "There's no such thing as zero defaults in a specialty finance loan book. But there's far less cliff risk relative to direct lending because of the potential diversification benefits of pooling so many loans.

That's not the case though if only a few of the underlying loans in a pool gets into trouble. Of course, you need to be careful about structuring your facility to manage downside risk, but the nature of risk diversification is somewhat different in our space. From a portfolio level, we get further diversification in terms of the different assets classes we touch on, whether it's consumer loans, hard assets, or specialty credit, once a portfolio is fully ramped.

Q: What do you expect for structured credit and specialty finance in 2024?

T.J. Durkin: There's admittedly been a big move in the expected path of Fed policy, but the long-term story hasn't changed much, in my view. The process of bank deleveraging is still in the early innings. It's possible that there will be a bit less pain in the system now that rates have peaked. But we're not going back to February 2023 prior to the US regional banking crisis. In fact, the reality of lower possible losses may actually push banks to accelerate some dispositions because it won't be as painful.

It's important to keep in mind that the regional banks that are the biggest lenders to specialty finance companies have been locked into the facilities that they extended in 2021 and 2022. These are typically three-year facilities, and so we expect these companies are going to hear one of two things when these revolvers reach the end of their lives in the coming years. The banks will either be willing to extend them but with a new cost of capital that's 200-300bp higher, or they will simply say they're not interested in dedicating additional capital.

> "While we were in a borrower's market for a decade-plus, that's now flipped 180 degrees. But the repricing of capital has yet to fully play out across the market.

The overarching point is that while we were in a borrower's market for a decade-plus, that's now flipped 180 degrees. But the repricing of capital has yet to fully play out across the market. Asset sales will continue apace, and there are going to continue to be high-quality lending opportunities as banks continue to de-lever their balance sheets.

Q: Do you worry about increased competition across structured credit and specialty finance?

T.J. Durkin: No, because this is a lending market with real moat and complexity. While this area of private credit is in vogue, you need a lot of infrastructure as a lender to make it work. Managing pools of 10K underlying loans requires extensive data analytics, asset management tools, and proprietary software.

> "This is a lending market with real moat and complexity. While this area of private credit is in vogue, you need a lot of infrastructure as a lender to make it work.

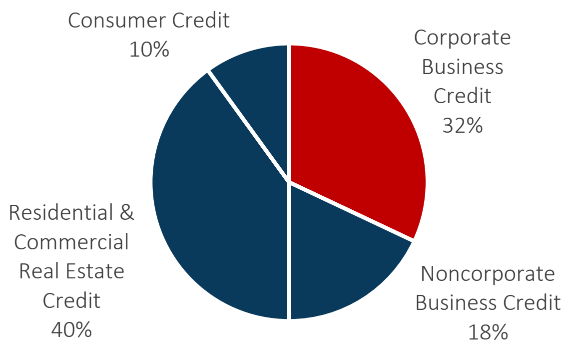
It's not as simple as looking at a company's finances in Excel, doing a few tweaks to EBITDA, and applying a multiple. As a result, we don't expect a proliferation of new players anytime soon. We think it pays to be an incumbent because you have the proper infrastructure, team, and data to potentially take advantage of what's a once-in-a-lifetime disruption of the financial industry as banks continue to shrink their balance sheets.

TPG INSIGHTS

Snapshot: Specialty & Asset-Based Private Credit

Less than 1/3 Of The Credit Market Is Corporate Business Credit

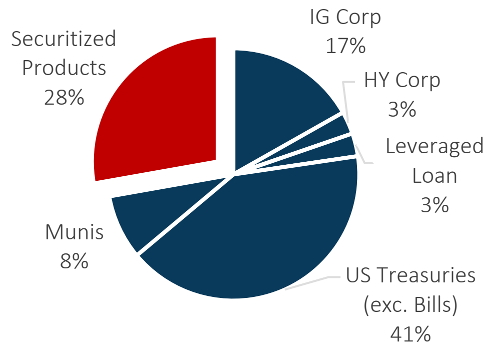
US Nonfinancial Credit, %



Source: Federal Reserve as of December 31, 2021.

Structured Credit Is ~$13.5T+ Of The ~$48.6T In U.S. Fixed Income

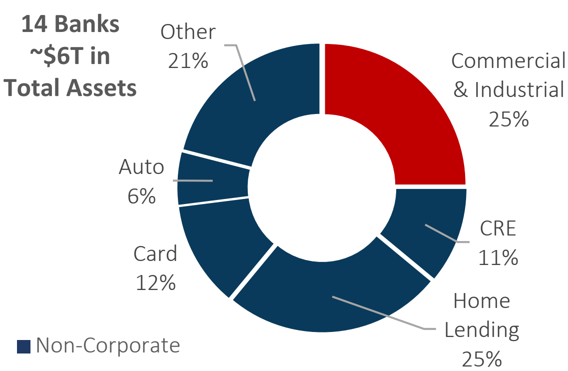
Total US Fixed Income Assets, % by Type



Source: BofA Global Research, Intex, FN, FH, GN, Bloomberg as of September 30, 2022

Large Banks Are Highly Exposed to Non-Corporate Credit…

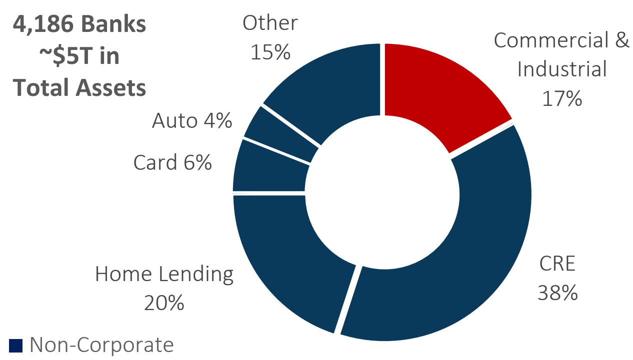
Laon Holdings of Largest Banks (>$250B), % Total



Source: SNL Financial as of September 30, 2023.

…As Are The Small US Regional Banks

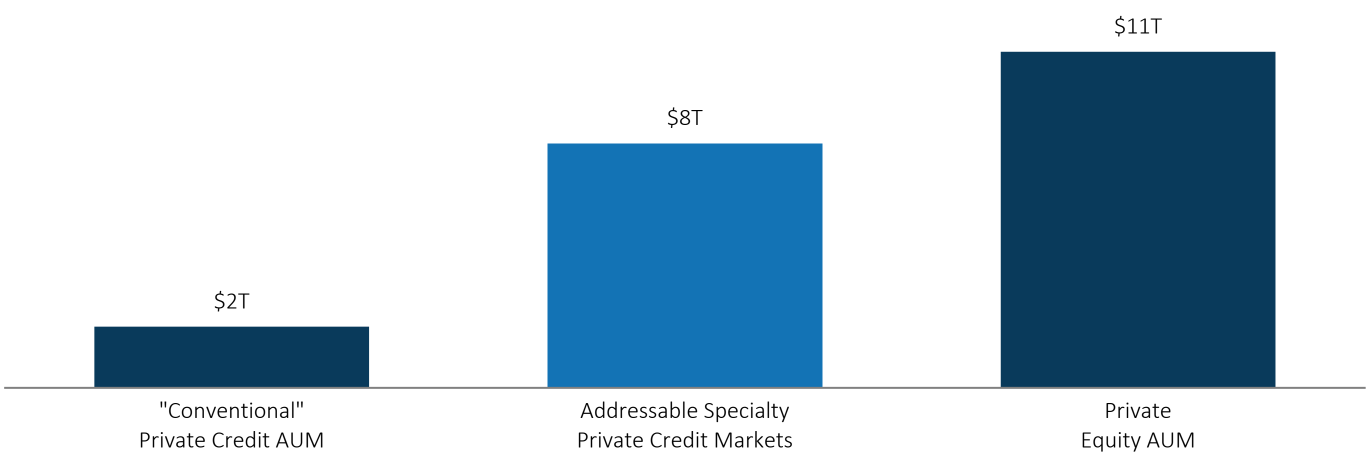
Loan Holdings of Small & Regional Banks (<$250B), % Total



Source: SNL Financial as of September 30, 2023.

Specialty Private Credit Represents A Sizable Addressable Market Opportunity

Private Equity and Private Credit AUM, $T; Estimate of Addressable Specialty Private Credit AUM, $T



Note: Per Preqin, defined as: Direct Lending, Distressed Debt, Mezzanine, Private Debt FOF, Special Situations, Venture Debt. Includes dry powder. "Addressable Specialty Private Credit Markets" reflects aggregate market size of various asset based or other non-corporate cashflow based lending markets which TPG Angelo Gordon judges to be reasonable proxies for the forms of credit Based on TPG Angelo Gordon's subjective view of the addressable market and there is no assurance a third party would have a similar view.
Source: Private credit and equity market size data per Preqin as of June 2023.

TPG INSIGHTS

Interview with Ryan Mollett

Ryan Mollett is the **Global Head of Credit Solutions** at TPG Angelo Gordon. He is the **Portfolio Manager** of the **AG Credit Solutions** series of funds, the CSF Annex Dislocation Funds, the AG Corporate Credit Opportunities Fund, and the Essential Housing Funds, and oversees dedicated investment teams in the U.S. and Europe. Below, he argues that private credit markets look attractive relative to public credit and equities today, discusses the sizable coming maturity wall across credit markets, and details the biggest opportunities and risks over the next few years.

Q: How are you approaching credit markets in 2024?

Ryan Mollett: Following the tightening of public credit market spreads last year, there's much more of a focus on the private market in 2024. High yield credit spreads were wider than 600bp in the back half of 2022 after a fairly weak second quarter, which created a very attractive risk-reward in the public credit market. But spreads have since tightened quite a bit, as the growth and inflation outlooks have turned more constructive. While current all-in yields—hovering around 8% at year-end 2023—are attractive relative to the past decade, sub-400 bp spreads in the public high yield market mean investors are not being compensated much for taking additional risk.

In contrast, we believe the advantage of the private credit market right now is that you can move beyond the yield versus spread debate. Lenders can start with a base yield comparable to the public credit market, add some illiquidity and complexity premium, and have the potential to create mid-to-high-teen returns on securities with customized terms and structures. For this reason, we think deploying capital towards the private market looks attractive in the year ahead.

Q: How do you think about the relative value of private credit today versus both public credit and equities?

Ryan Mollett: There's positive asymmetry in private credit in terms of valuation and downside protection. In public equities, for example, the S&P 500 index ended 2023 trading at 4770. For the S&P 500 to provide a comparable 15% annualized return (or greater) to where many private credit deals are being priced today, the index would have to trade up to approximately 8350 over the next four years (assumed hold period), have a greater than 20x P/E multiple, and an EPS approaching $400 (from around $220 today). Public credit spreads, as we've discussed, are also quite tight. So, based on valuations alone, the opportunity set looks more favorable in private credit, particularly following the recent run-up in public equities.

We believe that as a private credit investor, you're also more protected on the downside since you're able to structure deals carefully, insist on maintenance covenants, and incorporate call protections. This combination of strong return potential with structures that provide downside protection creates a very attractive investment profile.

Q: What's driving the current "golden age" in private credit?

Ryan Mollett: The biggest factor, we believe, is that the broadly syndicated loan market doesn't handle complexity well. It is very difficult for companies with complex business models, substantial leverage, or that are undergoing a transition to issue new debt in the loan or high yield markets.

A company can end up working with 50-100 counterparties, all of whom have different constraints that need to be met. For example, some lenders won't be able to have maturities past a particular date, while others will require a higher coupon than the company would like to target. Others can't take equity, or they will need certain covenants. In the end, companies may be forced towards the lowest common denominator of all these factors and end up with a financing package that can be suboptimal—in many ways—for the ongoing needs of a business.

As a result, there has understandably been a movement toward working with a smaller set of private lenders who are more flexible and really understand companies' businesses back-to-front. These bespoke private capital providers are increasingly the first stop for many borrowers, particularly in an environment where it's already become more challenging to access capital in the public market through new issuance and companies cannot afford to take on excessive execution risk.

Q: But will the opportunity in private credit last if rates fall and lender competition rises?

Ryan Mollett: Absolutely, for a few reasons. We expect a strong outlook for private credit over the next few years given the

> **"We're just at the beginning of what we expect will be a multi-year private credit cycle. There will be a range of opportunities for lenders in coming years, especially for managers who have extensive experience working with borrowers to right-size their capital structures.**

combination of (i) the ongoing adjustment to the higher cost of capital environment and (ii) the sizable maturity walls coming due in the next five years. It's rare to see this volume of high yield and leveraged loan maturities that need to be addressed in the near-to-immediate-term. So, this will be a multi-year process.

The market has effectively been closed for CCC issuers since the back half of 2022, and companies are starting to face liquidity and working capital issues. There's also M&A that needs to take place following a sizable decline in transaction volumes, which only further increases the demand for capital.

> "It's rare to see this volume of high yield and leveraged loan maturities that need to be addressed in the near-to-immediate-term.

We expect more and more companies will have to come to the market for financing in the next few years, and they'll do so facing a cost of capital that is substantially higher than the low levels during and prior to the pandemic. We're going to see a lot of companies with capital structures that were designed for a zero-interest rate environment that suddenly look upside down.

Capital that previously would have been allocated to growth and expansion will increasingly be needed for interest payments, and many companies will struggle to grow into their existing capital structures. As the maturity wall gets closer, risk premia and therefore yields could rise further as investors start to worry about companies' ability to access capital markets, reinforcing the higher cost of capital.

The big picture is that there's inevitably going to need to be some de-leveraging. There's going to be a need for companies to proactively pursue discount capture and liability management exercises. But these and similar strategies will likely have to occur in the private market context, because these aren't processes that can be executed as effectively in the broadly syndicated public debt market.

This means that we're just at the beginning of what we expect will be a multi-year private credit cycle. There will be a range of opportunities for lenders in coming years, especially for managers who have extensive experience working with borrowers to right-size their capital structures given the new interest rate environment.

Q: Are you worried at all about an uptick in defaults and distress across credit markets?

Ryan Mollett: There's a running joke that distressed credit managers have correctly predicted fifteen out of the last three defaults cycles. There's a tendency towards pessimism that the next distress wave is always on the horizon. But more often than not it doesn't come, or at least to the magnitude many predicted. That said, while the high yield default rate has only been around 3% over the last 12 months—just below the long-term historical average—we've still had the fourth highest notional number of defaults in history because the size of the market has grown.

That means your capital as a lender is still in high demand even though the rate of defaults isn't particularly elevated. More broadly, we're likely to see the default rate tick up in the next few years because companies simply haven't been built for this higher cost of capital environment.

I also expect that the loss given default rate is going to be high in this cycle. We're currently at all-time lows in terms of recovery rates in the leveraged loan market, which has a lot to do with the weak documentation and capital structures of the companies that have brought loans to market in recent years.

If default rates do end up rising, my concern is that recoveries are going to be significantly lower than historical averages, particularly as companies move assets and pursue other liability management tactics, and the classic first lien that an investor thought it had isn't a first lien anymore.

> "I expect that the loss given default rate is going to be high in this cycle ... If default rates do end up rising, my concern is that recoveries are going to be significantly lower.

Q: What sectors are of the most interest to you right now?

Ryan Mollett: Not where you might expect. The common wisdom is that when there's increased risk of an economic slowdown, as some argue is the case today, you want to be more defensive and less cyclical. But perhaps counterintuitively, a lot of the stress in the system today is concentrated in the TMT and healthcare sectors, which aren't typically the most cyclical in nature.

What's unique about these two sectors is that there are a lot of great businesses, but with capital structures that were built for and financed in a different interest rate environment. That presents a massive opportunity to help these companies address their capital structures, and in doing so, better position them for the future. And there will be similar opportunities to work with individual businesses across nearly all other sectors.

Also, the persistent undersupply in residential housing across the U.S is a particularly interesting theme, which is a longer-term trend that isn't going to be solved anytime soon.

Q: What about the biggest risks?

Ryan Mollett: The lack of covenants and credit protections in the broadly syndicated market is one. These are going to be more acute issues over the next few years as companies reengineer their capital structures to align more closely with economic realities and business fundamentals.

If you're buying into public credit markets, you're accepting documents and terms that were negotiated several years ago, which could entail more risk than meets the eye. People have admittedly been talking about weak documents since the GFC, but I think the chicken is going to come home to roost in the next few years given the paradigm shift in the interest rate environment.

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[1] As of September 30, 2023, including AUM attributable to TPG Angelo Gordon on a pro forma basis.

www.tpg.com

GABE LIPTON GALBRAITH
ggalbraith@advisorstpg.com