CARLYLE

Carlyle's four Cs of private credit underwriting

Four considerations for evaluating opportunities across a changing credit landscape

The significant financing needs associated with the buildout of AI infrastructure are creating opportunities for private credit investors across a broad ecosystem. At Carlyle, when we evaluate these opportunities, we use a framework focused on four considerations: counterparty, contract, compensation, and criticality.

While the four Cs help inform our approach to AI infrastructure-related lending, the principles behind them extend more broadly. Understanding who is responsible for repayment, the protections within a loan, the compensation for the risks being taken, and the importance of the asset being financed are considerations that can help inform underwriting and risk assessment across private credit.

For financial advisors, we believe that understanding these four considerations can provide useful context when discussing private credit with clients and evaluating how managers approach underwriting.

01

Counterparty

WHO IS GOING TO PAY YOU BACK?

Credit underwriting starts with the borrower. Lenders evaluate borrowers, who are responsible for paying interest and repaying principal, and whether each borrower can remain financially healthy throughout the life of the loan.

That means looking beyond where a company stands today to understand whether it can keep generating cash, managing its balance sheet, and meeting its obligations until the loan is repaid. The conditions under which a company originally borrowed can be an important part of that assessment. Companies that financed when interest rates were lower may face greater pressure from interest expense costs as base rates rise and borrowers need to refinance, while loans originated during higher rates are underwritten with those higher costs already reflected in their capital structures.

WHY IT MATTERS

Looking at the companies behind a private credit allocation can help advisors understand the sources of repayment and how well positioned borrowers may be to meet their obligations over time.

02

Contract

WHAT PROTECTIONS DOES THE LENDER HAVE?

The borrower is only part of the underwriting equation. Lenders also need to understand the terms of the loan and the protections built into the documentation.

Such protections can include financial covenants, liability management protections, and definitions used to calculate measures such as earnings before interest, taxes, depreciation, and amortization (EBITDA). The details in those definitions matter because financial covenants may be tested against a contractual definition of EBITDA, making the adjustments permitted within that definition an important part of assessing leverage and borrower compliance.

In our process, documentation can also be a measure of underwriting discipline. If a transaction does not provide the protections a lender believes are appropriate, having the ability to pass and move to another opportunity can be important.

WHY IT MATTERS

Similar yields do not necessarily mean similar loans. A private credit manager, in its role as a lender, must consider documentation and lender protections when evaluating an opportunity. Understanding the manager's approach to these protections, including its willingness to walk away from a transaction, can provide another lens to how it approaches risk.

03

Compensation

ARE YOU BEING APPROPRIATELY COMPENSATED?

A key part of underwriting is understanding the risks associated with an investment and assessing whether the potential compensation, including the interest income a lender may receive, appropriately reflects them.

That assessment includes an analysis of the underlying credit risks that could affect a borrower's ability to pay interest and repay the principal. Depending on the opportunity, that assessment can include factors such as illiquidity and tenor, as well as construction and technology risk in areas such as AI infrastructure. It also evolves with market conditions. Wider spreads, for example, may offer greater potential compensation, while lower leverage and loan-to-value ratios can provide a larger equity cushion beneath the debt. Loan documentation and lender protections are also part of that equation.

As market dynamics shift, so can the balance between risk and potential compensation. This can be particularly relevant in areas experiencing significant financing activity. Within parts of the AI infrastructure ecosystem, for example, greater availability of capital can compress the premium available to lenders. We believe that this makes selectivity important in determining whether a particular opportunity offers appropriate compensation.

WHY IT MATTERS

Yield is more meaningful when considered alongside the risks required to generate it. Looking at spread, leverage, loan-to-value, documentation, and investment-specific risks can help provide a more complete picture of the opportunity.

04

Criticality

HOW ESSENTIAL IS THE ASSET BEING FINANCED?

The final question looks beyond the borrower to what the capital is actually financing and the role that asset plays within the business or industry it supports. We believe that AI infrastructure provides a useful example. Financing opportunities can extend beyond data centers and GPUs to the equipment used to build those facilities and the energy and power assets required to operate them. That creates a broader opportunity set, but we believe that it also makes understanding the role and importance of the underlying asset an important part of underwriting.

While AI infrastructure illustrates the concept, criticality of an asset to the broader economy can also be considered more broadly when evaluating credit opportunities. A significant investment theme may create many financing opportunities, but those opportunities can carry different risks and economics depending on where they sit within the ecosystem.

WHY IT MATTERS

Exposure to a long-term theme tells only part of the story. In our opinion, understanding what is actually being financed, why that asset matters, and how the exposure fits within the broader portfolio can provide a more complete picture of the investment.

Bringing the four Cs into the client conversation

When discussing private credit with clients, financial advisors can use the four Cs to help explain why a manager's underwriting approach matters. Beyond yield, the framework provides four areas to consider when evaluating how a private credit manager selects and structures investments.

01

Counterparty

How does the manager assess who is responsible for repayment and their ability to pay over the life of the loan?

02

Contract

What lender protections does the manager seek, and when is it willing to walk away?

03

Compensation

How does the manager determine whether the potential compensation appropriately reflects the risks of the investment?

04

Criticality

How does the manager assess the importance of the asset being financed within the industry it supports?

For clients considering private credit, the four Cs can help make manager selection more tangible. They shift the conversation beyond what an allocation may yield to how a manager underwrites, structures, and selects the investments intended to generate that income.

For financial advisors, this may create an opportunity to help clients understand an important distinction: not all private credit portfolios are constructed the same way, and the approach a manager takes to underwriting can shape the characteristics of the resulting portfolio. The four Cs, while particularly relevant to how we evaluate AI-related financing opportunities, provide a useful lens for understanding those underwriting considerations more broadly.

Definitions

EBITDA: Earnings before interest, taxes, depreciation and amortization; a measure commonly used to assess a company's operating performance before the impact of financing, tax and certain non-cash expenses.

Tenor: The period of time from the origination or issuance of a debt instrument until its contractual maturity.

Spread: The incremental interest rate or yield on a debt instrument above a specified reference or benchmark rate, generally expressed in basis points.

Leverage: A measure of a company's indebtedness relative to its earnings or other financial metrics. Leverage is commonly expressed as a multiple of debt to EBITDA.

Loan-to-Value ("LTV"): The ratio of the amount of a loan or other debt investment to the value of the underlying asset or collateral, generally expressed as a percentage.

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