Private Funds Finance: Big cushions offer protection against defaults

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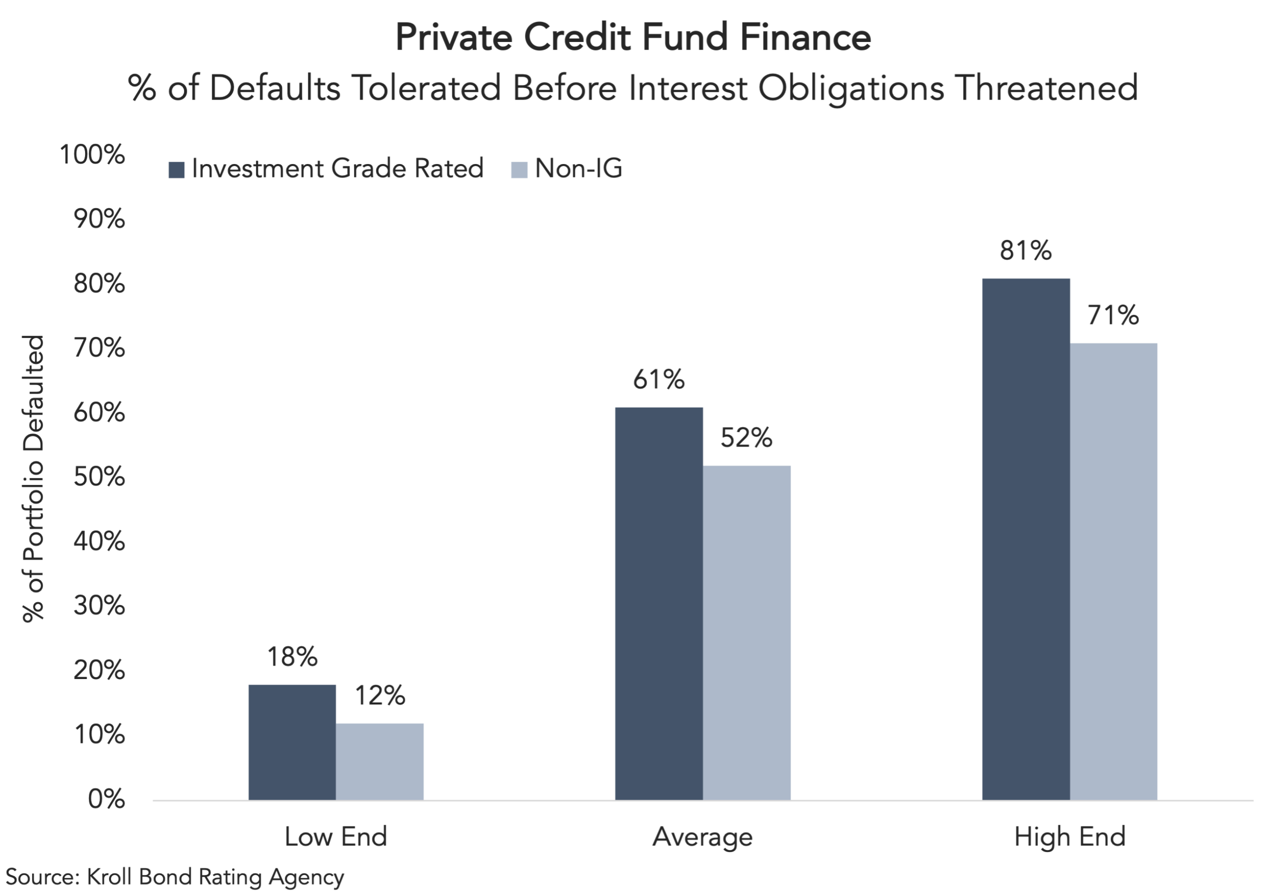

The private credit market is about to face its biggest stress test yet: Borrowing costs have more than doubled in the past 12 months for portfolio companies, and the Fed signaled last week that additional rate hikes were in the works for 2023. *KBRA DLD*'s parent, **Kroll Bond Rating Agency** (KBRA), recently analyzed the effects of 12% interest on middle market borrowers and reported that managers are staring at a 16% increase in the number of companies that can't generate enough cash flows to service interest.

What does this mean for the lenders backing the private credit funds that lend to portfolio companies? For the $14.5 billion of fund financing rated by the agency, there's actually considerable breathing room.

In an analysis this month, KBRA found that fund financing rated investment grade — about 90% of the $14.5 billion — would be able to, on average, withstand a cumulative default rate of 61% and still meet interest obligations. Default scenarios for portfolio companies ranged from a low of 18%, to a high of 81%.

To put the low end of that range into context: the **Cliffwater Direct Lending Index** has reported a cumulative net loss of just 1.34% (of which 1.06% was realized) in the 18 years spanning September 2004 to June 30, 2022. During Covid, **Proskauer's Private Credit Default Index** reported an average quarterly default rate of 2.9% from 1Q20 to 3Q22.

Meanwhile, non-investment grade fund financing could withstand portfolio default rates ranging from 12% to 71%, with an average of 52%, and still meet interest payments.

The investment grade and non-IG scenarios assume average recovery rates of 58% and 57%, respectively, as determined by KBRA.

The KBRA cohort includes 25 unique managers, for an average facility size of $580 million, and comprises a mix of credit facilities and rated notes for feeder funds.

The structural subordination and terms of the fund financings rated by KBRA insulate the lenders from individual underlying loans. In the case of credit facilities, losses would be first absorbed by the borrower (manager), and for rated notes, losses would be absorbed by more junior tranches of the capital structure. The rated notes generally include financial covenants or other structural features that accelerate the repayment of the rated debt to the extent the portfolio of middle market loans underperforms or becomes more concentrated, similar to the way CLO tranches are structured.

The rated notes portfolio — which accounts for $10.4 billion of the $14.5 billion — largely consists of ratings assigned between 2021 and 2022. With some exception, the associated master funds are generally early in their fund lives and actively investing. KBRA's rated portfolio has 39 remaining months left in the investment period, on average, and has fewer legacy loans that may be experiencing valuation stress.

As a result, managers will have the capability to deploy capital in the coming years and take advantage of more favorable credit terms. As reported in *KBRA DLD's* latest monthly report, leverage is swaying to lower multiples, and yields are rising.