What Opportunities and Risks for Financial Markets Accompany the Growing Role of Non-Bank Financial Institutions?

Spotlight On: Private Credit

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US/Canada Head of Non-Bank Financial Institutions
Fitch Ratings

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Steady Expansion of U.S. Private Credit

Private Credit Growth During Mostly Benign Economic Environment

Composition of the Private Credit Market
Share of Global Private Credit Capital Raised, by Type

Source: Preqin, the Fed, FDIC. Note: Preqin data as of June 2022, estimate for NAMER AUM.

Source: IMF April 2023 Global Financial Stability Report
Alternative Investment Managers and Business Development Companies Benefiting from Private Debt Expansion

Credit Arms Expand at Investment Firms

- Blackstone Credit Fee-Earning AUM

Business Development Companies Gain Significant Scale

- Blackstone Private Credit
- Ares Capital
- Owl Rock Capital

Source: Fitch Ratings, Blackstone Inc.

Source: Fitch Ratings, Company Filings.
Private Credit Has Moved Up-Market; Competition Drove Weaker Terms

Ares Capital Underlying Portfolio Company Trends

- Weighted Average EBITDA (LHS)
- Weighted Average Net Leverage (RHS)

Covenant-Lite Deals More Prevalent in Broadly Syndicated Loan Space

- Broadly Syndicated Large Cap Deals
- Middle Market Club Deals

Source: Covenant Review, a FitchSolutions Company

Source: Fitch Ratings, Ares Capital.
How Durable is Private Credit Through a Recession?
### Pre- and Post-Global Financial Crisis BDC Comparison

<table>
<thead>
<tr>
<th></th>
<th>BDC 1.0&lt;sup&gt;a&lt;/sup&gt;</th>
<th>BDC 2.0&lt;sup&gt;b&lt;/sup&gt;</th>
<th>Improved?</th>
</tr>
</thead>
<tbody>
<tr>
<td>% of Portfolio Non-Debt Investments</td>
<td>34.5%</td>
<td>15.3%</td>
<td>✓</td>
</tr>
<tr>
<td>Control Investments</td>
<td>39.5%</td>
<td>10.2%</td>
<td>✓</td>
</tr>
<tr>
<td>Non-Accrual at Value</td>
<td>3.89%</td>
<td>1.0%</td>
<td>✓</td>
</tr>
<tr>
<td>Aggregate Net Realized Gains&lt;sup&gt;c&lt;/sup&gt;</td>
<td>$1.7bn</td>
<td>($0.5mn)</td>
<td>×</td>
</tr>
<tr>
<td>Duration of Bank Facility</td>
<td>1-3 years</td>
<td>4-5 years</td>
<td>✓</td>
</tr>
<tr>
<td>% of Debt Unsecured</td>
<td>53.1%</td>
<td>51.5%</td>
<td>-</td>
</tr>
<tr>
<td>Average Leverage</td>
<td>0.80x</td>
<td>1.17x</td>
<td>×</td>
</tr>
<tr>
<td>Asset Coverage Cushion</td>
<td>11.6%</td>
<td>19.2%</td>
<td>✓</td>
</tr>
<tr>
<td>Paid-in-Kind/Investment Income</td>
<td>16.0%</td>
<td>8.9%</td>
<td>✓</td>
</tr>
<tr>
<td>Net Investment Income/Dividends</td>
<td>67.2%</td>
<td>113.2%</td>
<td>✓</td>
</tr>
</tbody>
</table>

<sup>a</sup>Average of American Capital, Ltd., Allied Capital Corporation, and MCG Capital Corporation, as of June 30, 2008.  
<sup>b</sup>Average of 19 Fitch-rated BDCs as of Dec. 31, 2022.  
<sup>c</sup>Data represents 2003 through June 2008 for BDC 1.0 and 2010 through December 2022 for BDC 2.0. Source: Fitch Ratings, Company Filings.
Initial COVID Pandemic Valuation Hit More Meaningful for Liquid Investments

Spread Widening in 1Q20 Drove Unrealized Losses

Aggregate 2020 BDC Valuation Trends

Source: Fitch Ratings, Company Filings.

Note: Net unrealized loss rate calculated as net unrealized losses divided by beginning portfolio at fair value.

Note: Includes 13 rated BDCs. Source: Fitch Ratings, Company Filings.
<table>
<thead>
<tr>
<th>Key Rating Driver</th>
<th>Risks</th>
<th>Mitgants</th>
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<tbody>
<tr>
<td><strong>Asset Quality</strong></td>
<td>- Outsized growth in an untested period</td>
<td>- Lenders primarily focus on secured lending, with increasing equity cushions</td>
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<td>- Lack of through-the-cycle track record for many private credit lenders</td>
<td>- Recent reported gains by Fitch-rated BDC lenders</td>
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<td></td>
<td>- Deterioration in lending terms</td>
<td>- Lenders typically exhibit good alignment of interests</td>
</tr>
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<td>- Borrower credit risk rising</td>
<td></td>
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<td></td>
<td>- Higher loan concentrations within lender portfolios/funds</td>
<td></td>
</tr>
<tr>
<td><strong>Earnings &amp; Profitability</strong></td>
<td>- Rising rates represent higher debt service burdens for borrowers</td>
<td>- Rising rates increase lenders’ net interest income (absent AQ deterioration)</td>
</tr>
<tr>
<td><strong>Funding, Liquidity and Coverage</strong></td>
<td>- Borrowers face looming maturity walls (2024-2025)</td>
<td>- Lenders exhibit solid asset coverage cushions and low leverage</td>
</tr>
<tr>
<td><strong>Capitalization &amp; Leverage</strong></td>
<td>- Borrower-level leverage continues to climb</td>
<td>- Lenders exhibit solid asset coverage cushions and low leverage</td>
</tr>
<tr>
<td><strong>Systemic Implications</strong></td>
<td>- Private credit lending exhibits relatively less transparency and regulation versus bank lending</td>
<td>- Small market potentially insulates wider system</td>
</tr>
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<td></td>
<td>- Banks are often lenders to NBFIs creating second-order exposure to private credit markets</td>
<td>- Bank lending to NBFIs average 5.8% for Fitch-rated institutions</td>
</tr>
</tbody>
</table>
Deteriorating BDC Sector Outlook in 2023
Rising Rates: Net Investment Income Up; Interest Coverage Down

**Ares Capital Earnings and Portfolio Growth**

- **Adjusted Net Investment Income (LHS)**
- **Investment Portfolio Growth (RHS)**

**Ares Capital Portfolio Trends**

- **Weighted Average Interest Coverage (LHS)**
- **Yield on Total Portfolio (RHS)**

Note: Adjusted for capital gains incentive accrual not currently payable in cash. Source: Fitch Ratings, Ares Capital.

Source: Fitch Ratings, Ares Capital.
Private Equity: Ample Dry Powder to Support Portfolio Investments

Source: Fitch Ratings, Preqin.
Credit Trends Stable, but Deterioration Expected

Non-Accruals as % of Debt Portfolio at Fair Value

- 12/31/21
- 12/31/22
- 12/31/22 Average

Paid-In-Kind/Interest and Dividend Income

Note: Denominator includes any nondebt investments on non-accrual status.
Source: Fitch Ratings, Company Filings.

Note: Metrics based on 19 Fitch-rated BDCs. Source: Fitch Ratings, Company Filings.
Maturity Walls Emerge in 2025-2026

Fitch-Rated BDC Investment Maturities vs. Middle Market Loans by Maturity
(Loans Underlying Fitch-Rated BDCs Have a Smoother Maturity Wall Relative to Broader Middle Market)

BDC Unsecured Debt Maturities
As of Dec. 31, 2022

Note: Includes 19 BDCs rated by Fitch.
Source: Fitch Ratings

MML – Middle market loan. Note: BDC at fair value, includes 19 Fitch-rated BDCs.
Source: Fitch Ratings

BDC Maturities (LHS)  MML Maturities (LHS)
BDC Cumulative (RHS)  MML Cumulative (RHS)
Many BDCs Capacity Constrained; But Solid Private Credit Fundraising

BDC Regulatory Leverage
Par Debt Excl. SBA Borrowings/Equity

Global Private Debt Fundraising

Source: Fitch Ratings, Company Filings.

Source: Fitch Ratings, Prequin.
Fitch Publishes Recent Research on the Private Credit Market

- U.S. Private Credit Risks Rising but Contained (April 2023)
  - https://app.fitchconnect.com/search/research/article/RPT_10230351
- BDC Industry Update: Rating Outlooks Largely Stable Despite Headwinds (April 2023)
  - https://app.fitchconnect.com/search/research/article/RPT_10231347