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

Spotlight On: Private Credit

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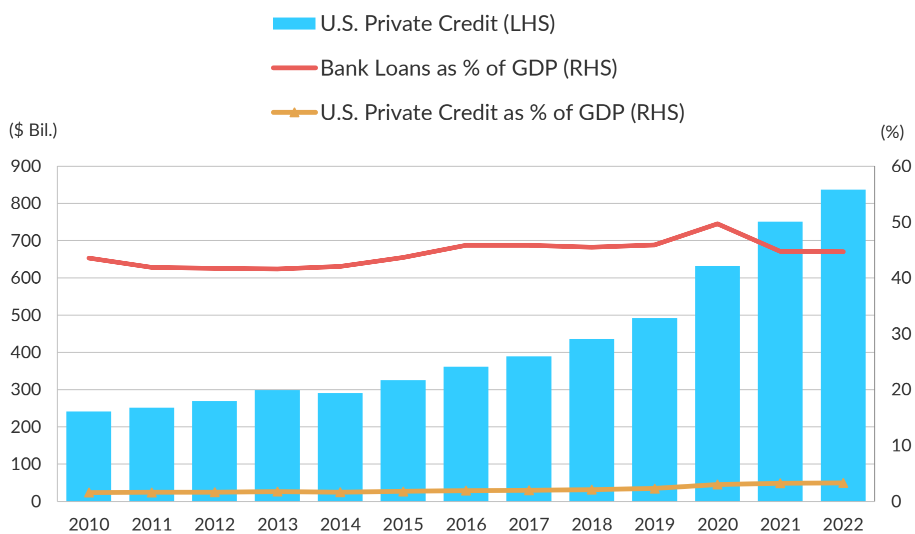
US/Canada Head of Non-Bank Financial Institutions
Fitch Ratings

May 16, 2023

Steady Expansion of U.S. Private Credit

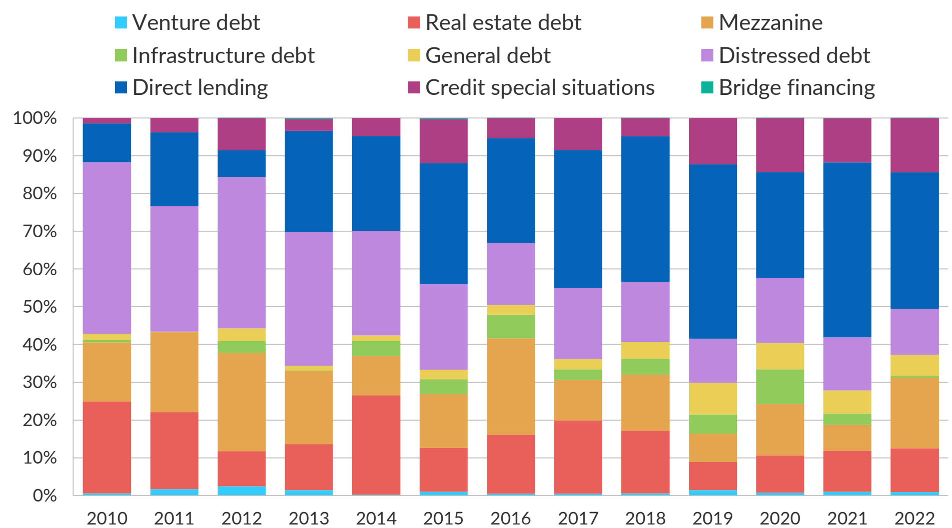
Private Credit Growth During Mostly Benign Economic Environment



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

Composition of the Private Credit Market

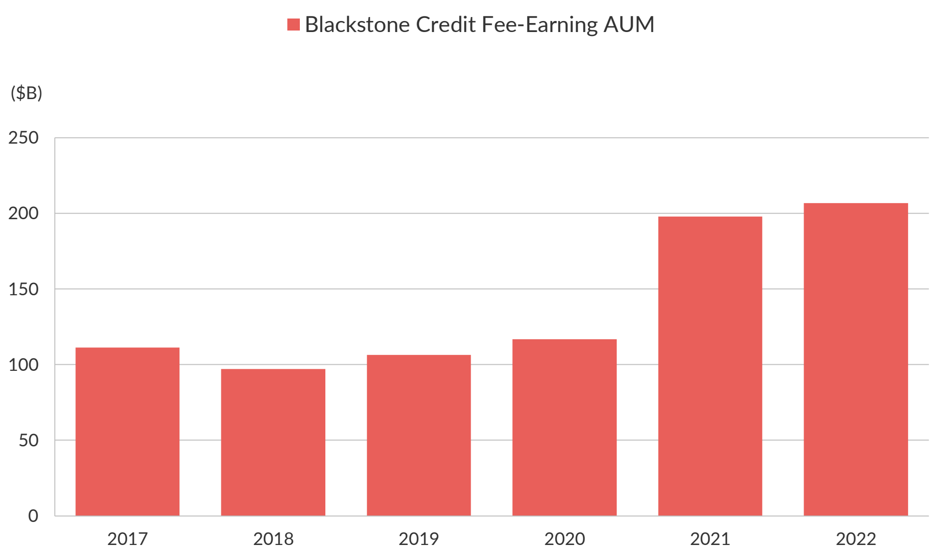
Share of Global Private Credit Capital Raised, by Type



Source: IMF April 2023 Global Financial Stability Report

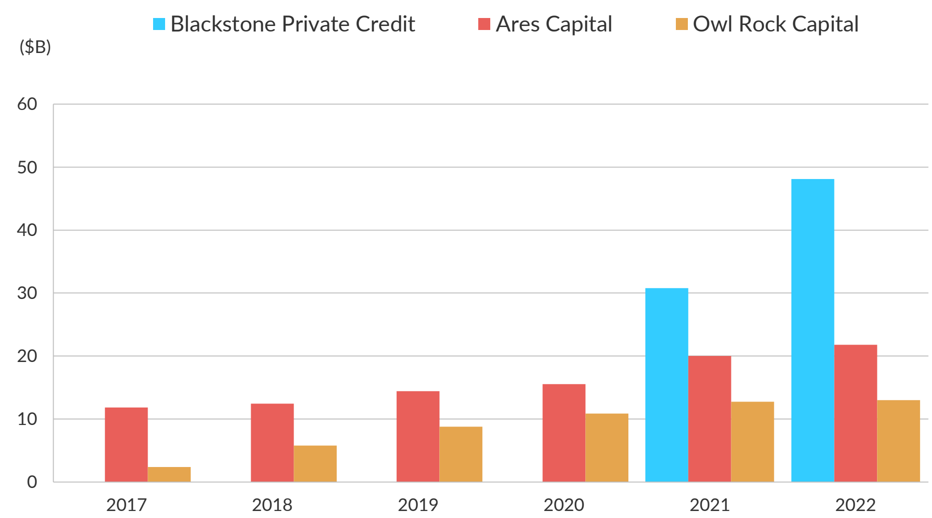
Alternative Investment Managers and Business Development Companies Benefiting from Private Debt Expansion

Credit Arms Expand at Investment Firms



Source: Fitch Ratings, Blackstone Inc.

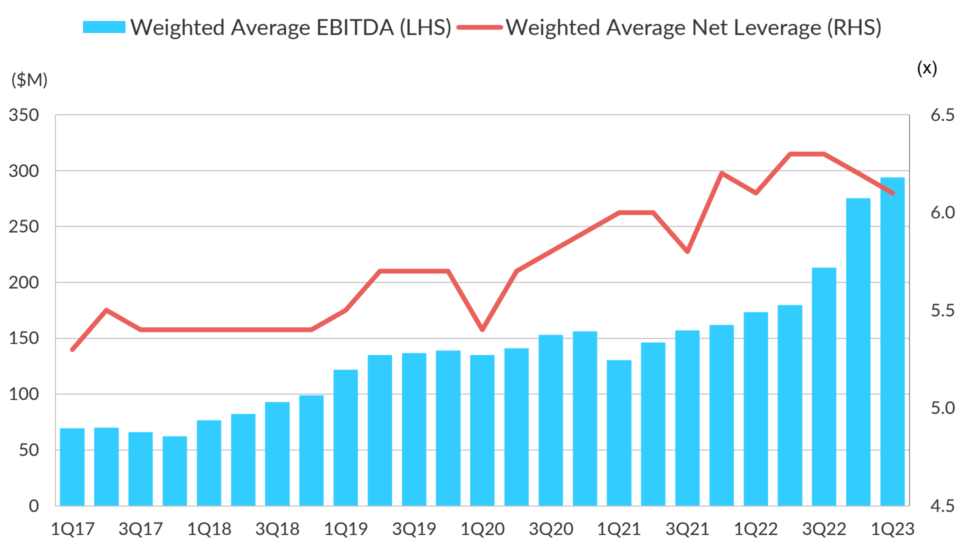
Business Development Companies Gain Significant Scale



Source: Fitch Ratings, Company Filings.

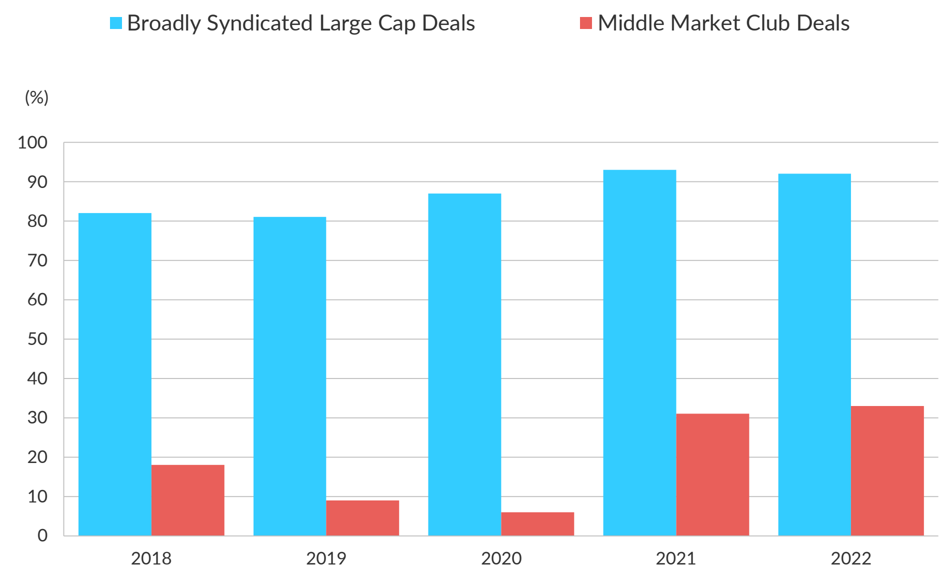
Private Credit Has Moved Up-Market; Competition Drove Weaker Terms

Ares Capital Underlying Portfolio Company Trends



Source: Fitch Ratings, Ares Capital.

Covenant-Lite Deals More Prevalent in Broadly Syndicated Loan Space



Source: Covenant Review, a FitchSolutions Company

How Durable is Private Credit Through a Recession?

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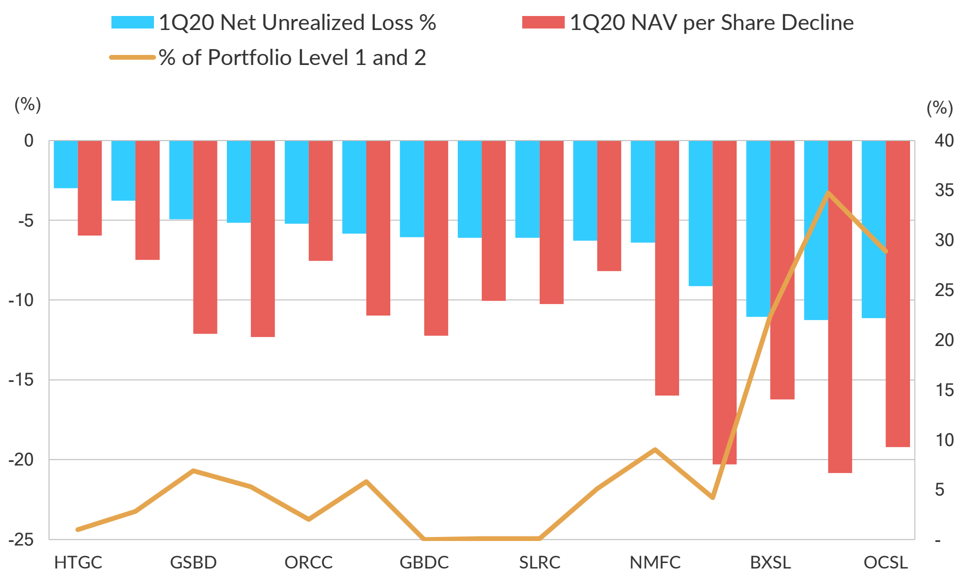
Pre- and Post-Global Financial Crisis BDC Comparison

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

[a]Average of American Capital, Ltd., Allied Capital Corporation, and MCG Capital Corporation, as of June 30, 2008. [b]Average of 19 Fitch-rated BDCs as of Dec. 31, 2022. [c]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

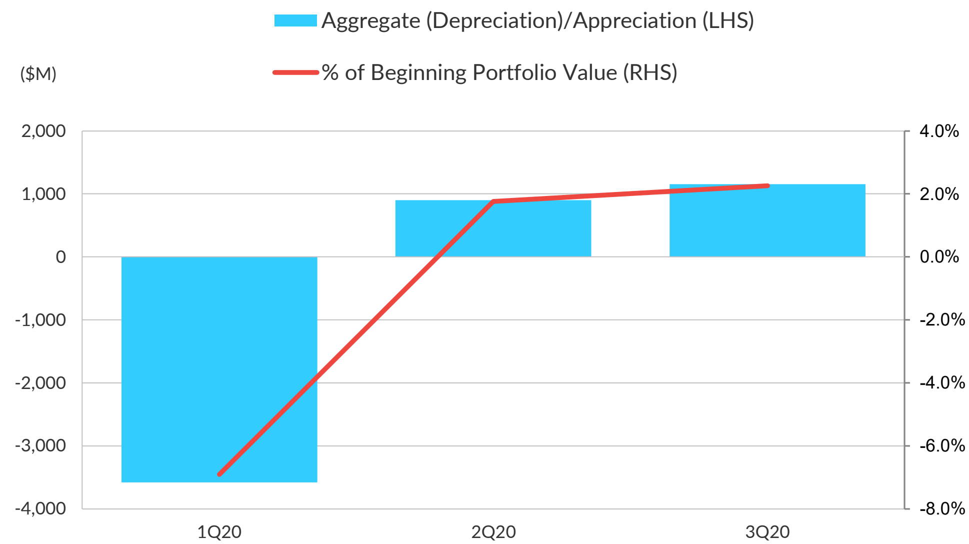
Spread Widening in 1Q20 Drove Unrealized Losses



Source: Fitch Ratings, Company Filings.

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

Aggregate 2020 BDC Valuation Trends



Note: Includes 13 rated BDCs. Source: Fitch Ratings, Company Filings.

Note: Net unrealized loss rate calculated as net unrealized losses divided by beginning portfolio at fair value. Source: Fitch Ratings. ARCC – Ares Capital Corporation. BGSL – Blackstone/GSO Secured Lending Fund. BKCC – BlackRock Capital Investment Corp. FSK – FS KKR Capital Corp. GBDC – Golub Capital BDC Inc. GSBD – Goldman Sachs BDC, Inc. NMFC – New Mountain Finance Corp. OCSL – Oaktree Specialty Lending Corp. ORCC – Owl Rock Capital Corp. ORCC II – Owl Rock Capital Corp. II. SLRC – Solar Capital Ltd. TSLX – Sixth Street Specialty Lending, Inc.

Private Credit Market Risks and Mitigants

Key Rating Driver	Risks	Mitgants
Asset Quality	- Outsized growth in an untested period - Lack of through-the-cycle track record for many private credit lenders - Deterioration in lending terms - Borrower credit risk rising - Higher loan concentrations within lender portfolios/funds	- Lenders primarily focus on secured lending, with increasing equity cushions - Recent reported gains by Fitch-rated BDC lenders - Lenders typically exhibit good alignment of interests
Earnings & Profitability	- Rising rates represent higher debt service burdens for borrowers	- Rising rates increase lenders' net interest income (absent AQ deterioration)
Funding, Liquidity and Coverage	- Borrowers face looming maturity walls (2024-2025)	- Lenders exhibit solid asset coverage cushions and low leverage
Capitalization & Leverage	- Borrower-level leverage continues to climb	- Lenders exhibit solid asset coverage cushions and low leverage
Systemic Implications	- Private credit lending exhibits relatively less transparency and regulation versus bank lending - Banks are often lenders to NBFIs creating second-order exposure to private credit markets	- Small market potentially insulates wider system - Bank lending to NBFIs average 5.8% for Fitch-rated institutions

Deteriorating BDC Sector Outlook in 2023

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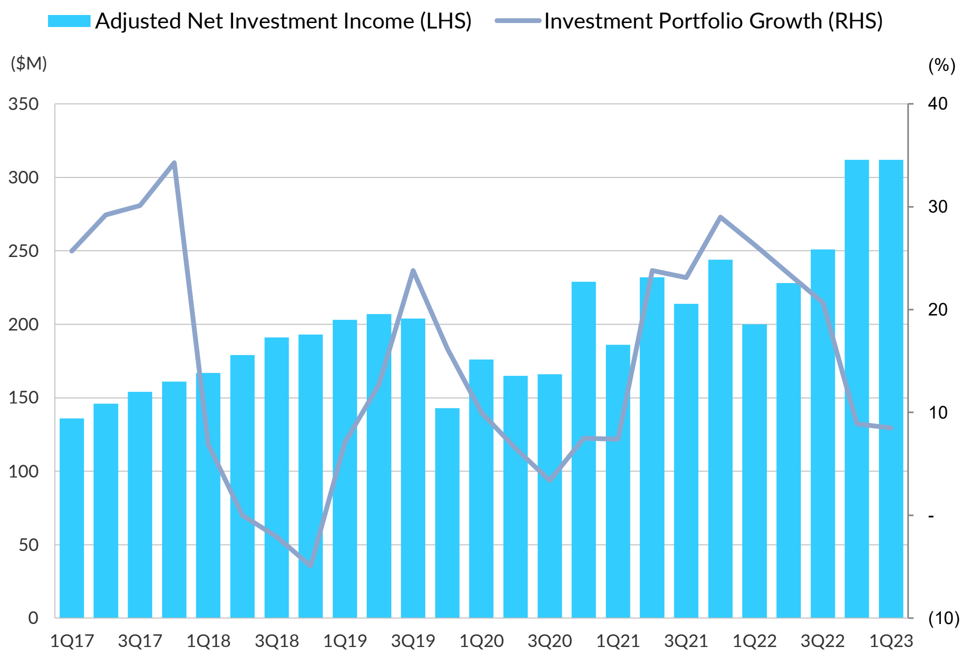
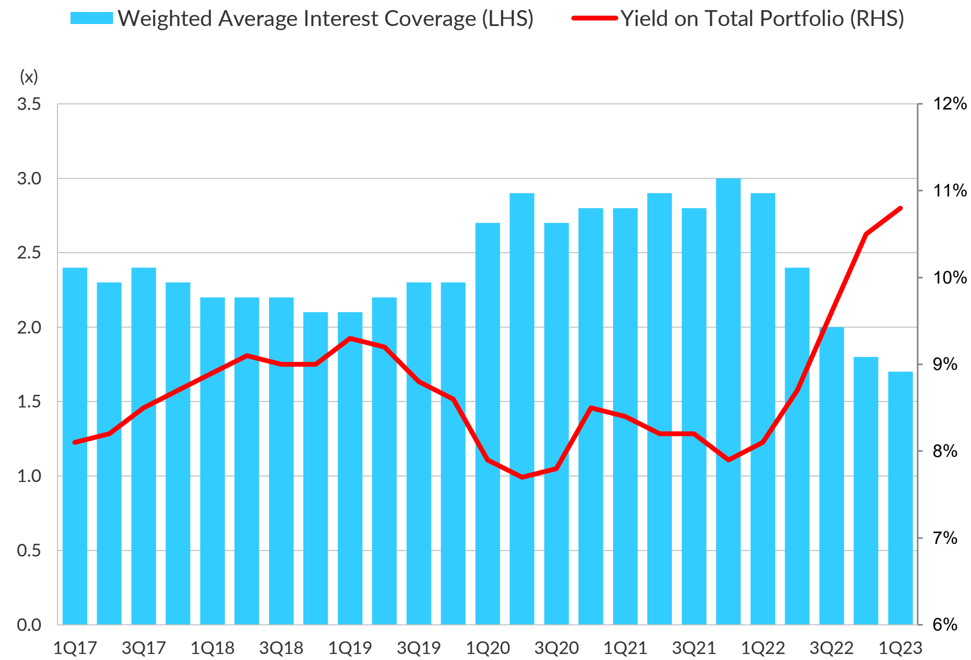
Rising Rates: Net Investment Income Up; Interest Coverage Down

Ares Capital Earnings and Portfolio Growth



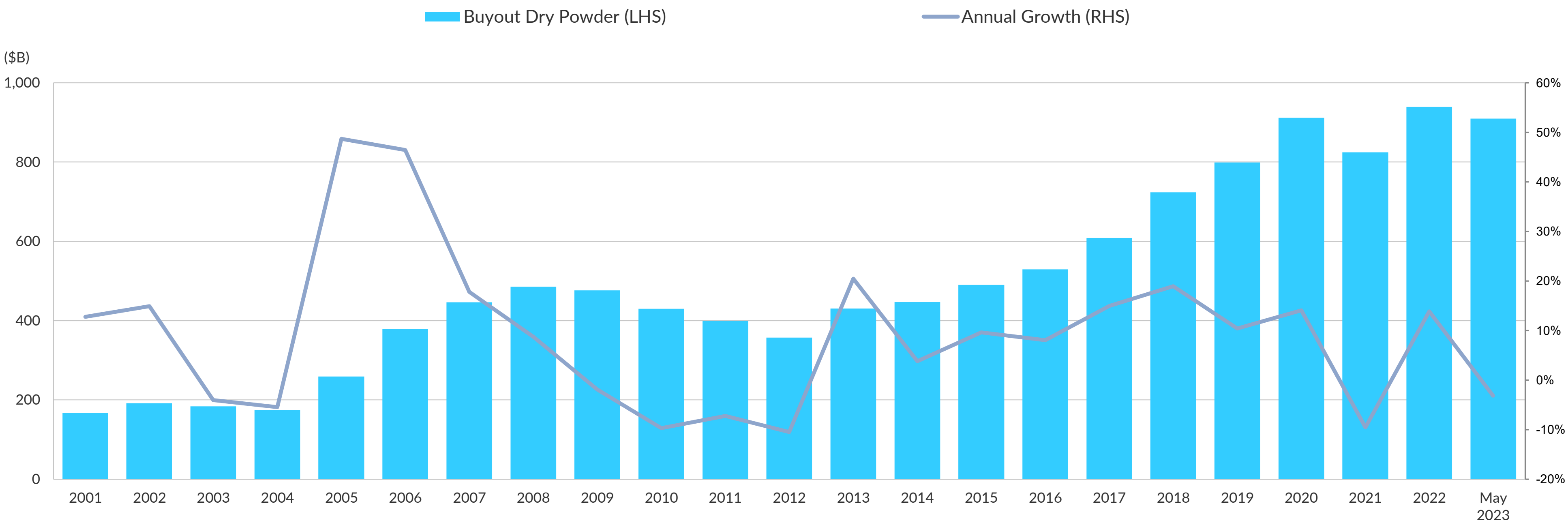
Note: Adjusted for capital gains incentive accrual not currently payable in cash. Source: Fitch Ratings, Ares Capital.

Ares Capital Portfolio Trends



Source: Fitch Ratings, Ares Capital.

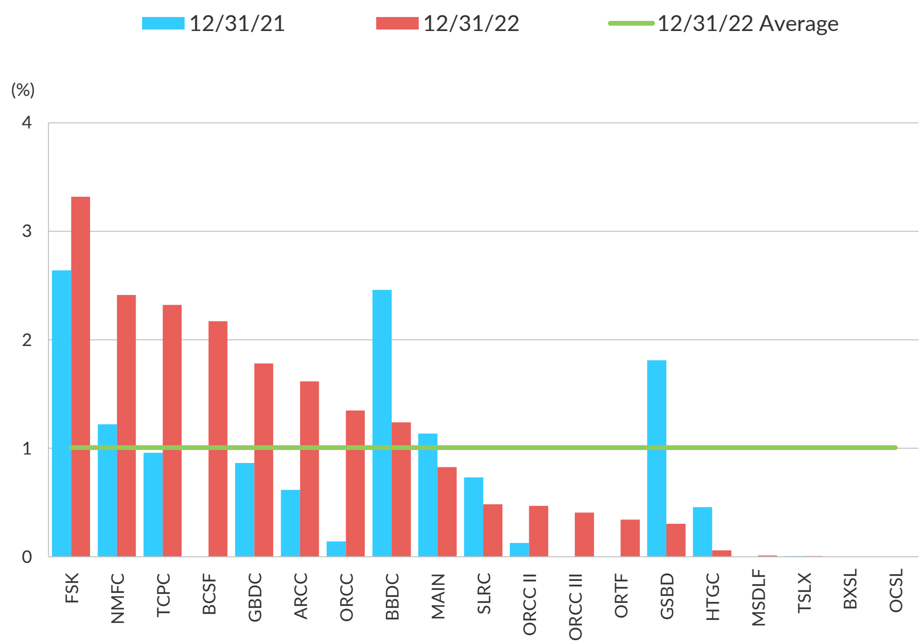
Private Equity: Ample Dry Powder to Support Portfolio Investments



Source: Fitch Ratings, Preqin.

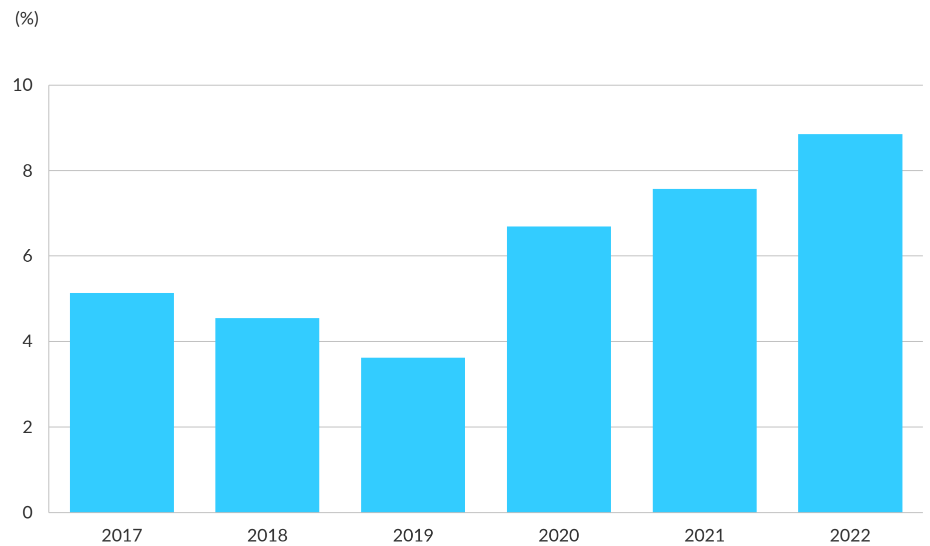
Credit Trends Stable, but Deterioration Expected

Non-Accruals as % of Debt Portfolio at Fair Value



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

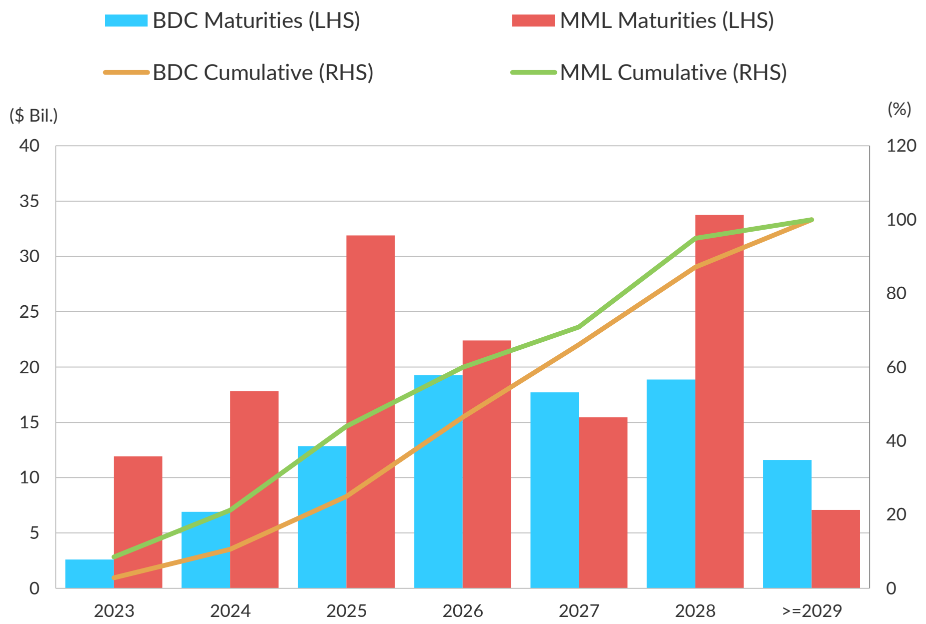
Paid-In-Kind/Interest and Dividend Income



Note: Metrics based on 19 Fitch-rated BDCs. Source: Fitch Ratings, Company Filngs.

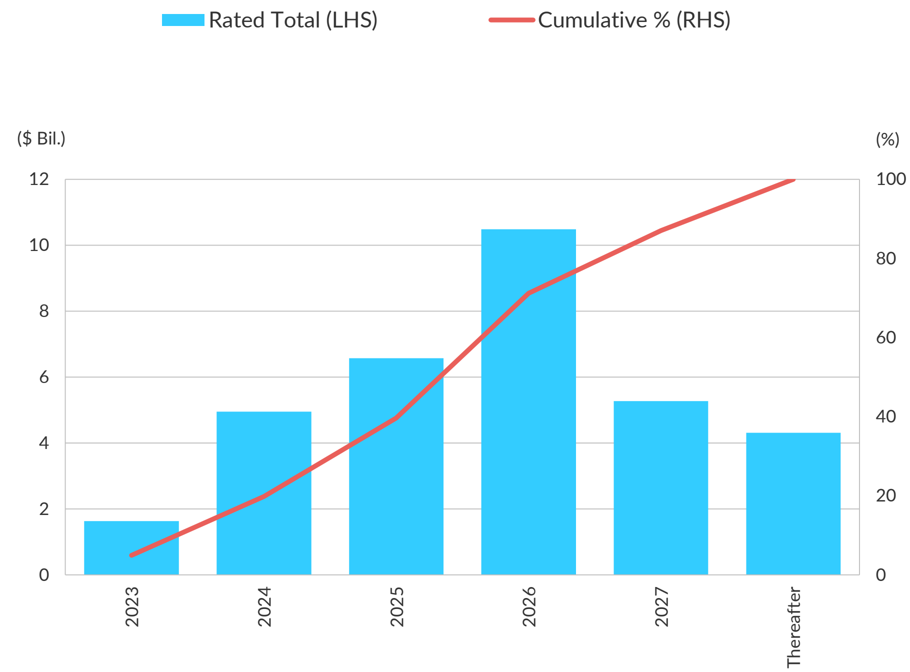
Maturity Walls Emerge in 2025-2026

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)



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

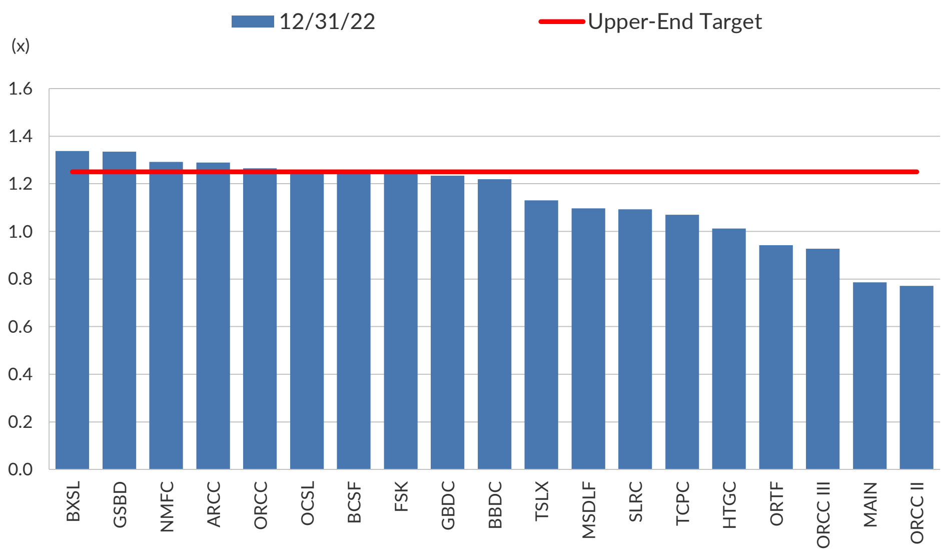
BDC Unsecured Debt Maturities
As of Dec. 31, 2022



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

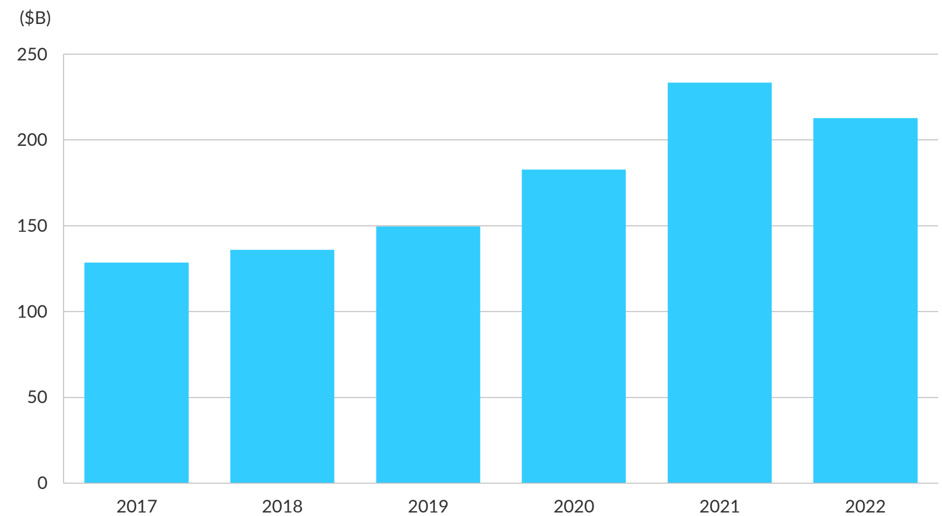
Many BDCs Capacity Constrained; But Solid Private Credit Fundraising

BDC Regulatory Leverage
Par Debt Excl. SBA Borrowings/Equity



Source: Fitch Ratings, Company Filings.

Global Private Debt Fundraising



Source: Fitch Ratings, Preqin.

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

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Cross-Sector
Nonbank Financial Institutions, Banks
U.S.A.

U.S. Private Credit Risks Rising but Contained

Private Credit Growth During Mostly Benign Economic Environment
(But Still Relatively Small Compared to GDP)

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

The U.S. commercial credit market has grown significantly since the global financial crisis (GFC), particularly in pockets outside of the more heavily regulated U.S. banking sector, including the private credit segment.

While the contagion risks and interconnectedness to the broader economy are difficult to identify given a high degree of opacity in the non-bank financial intermediation (NBFI) sector, Fitch Ratings believes a credit cycle downturn in private credit will not have widescale financial stability implications given the limited liquidity transformation risks, since private credit is typically held in closed-end funds with committed capital for extended periods.

Further, while growth in private credit has been strong, it still represents a modest portion of the overall U.S. commercial credit market at approximately 12%, and a small portion of the US economy, at just 3% of GDP. That said, to the extent any recession is deeper and/or longer than anticipated this would pressure market access, particularly for weaker credits, at a time when financial market conditions are likely to further tighten following several bank failures in the U.S. in mid-March. While we believe the risks are sufficiently mitigated and that any deterioration in the private credit sector will not in itself cause systemic issues in the financial sector, the opacity in the overall NBFI market make it more challenging to have a great deal of visibility into expected outcomes.

In response to these uncertainties and dynamics, this report outlines a subsector of the NBFI sector: the private credit market (or nontraded debt provided by NBFIs), explains why it has grown, frames risks and mitigants, highlights potential financial stability implications and addresses rating impacts.

Asset Quality, Refinancing Risks Increasing

Historically, private credit terms were more conservative than those of bank syndicated loans. However, there has been some convergence in recent years due to the competitive lending market. While underwriting terms improved in 2022 and early 2023, there is still significant exposure to pre-2022 vintages.

Asset quality deterioration amid rising rates and slowing economic growth is a key risk facing borrowers, lenders and investors in both private and public markets. As the prospects of a credit cycle downturn loom, Fitch expects that economic growth will deteriorate, funding pressures will further increase, banks will tighten lending standards, asset prices will decline and defaults will rise. This also raises the likelihood that certain portfolio/fund managers may need to cut holdings to maintain leverage within acceptable limits.

But Ratings Stable

Notwithstanding Fitch's expectations that business development companies (BDCs), other nonbank commercial lenders and alternative investment managers (Alt-IMs) will face challenges in 2023, Rating Outlooks for issuers in these sectors remain largely Stable.

Related Research

U.S. Bank Fallout Extends to Various Non-Bank Financial Sectors (March 2023)
Liquidity Pressures Unfolding Rapidly For Some But Not All U.S. Banks (March 2023)
North American Non-Bank Financial Institution Refinancing Risk Report: 2023 (Aircraft Lessors Most Exposed to Near-Term Refinancing Risk) (February 2023)
Alt IMs Weather Financial and Headline Risks from Fund Redemptions (February 2023)
U.S. Middle Market Chart Book: Fourth-Quarter 2022 (Lighter MM Loan Issuance; MM LBO Activity Drops Sharply; LBO Equity Contributions Rise) (February 2023)
U.S. Banks: Sustained Period of Higher Rates Raises Liquidity Pressures (Large Unrealized Losses on Bond Portfolios May Cause Banks to Pursue Higher Cost Funding Options) (January 2023)
Global Non-Bank Financial Institutions 2023 Outlook Compendium (January 2023)
U.S. Bank Asset Quality, Operating Environment to Deteriorate in 2023 (November 2022)

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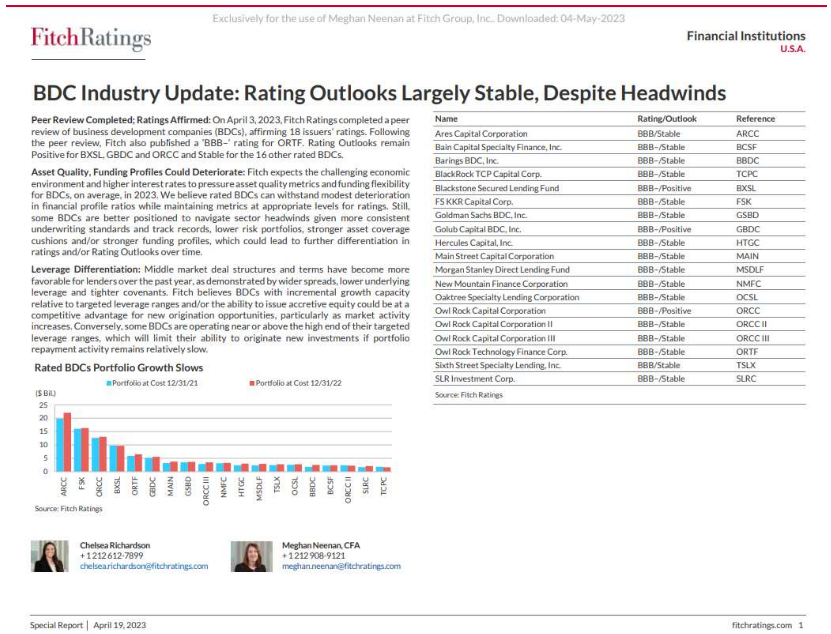

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Financial Institutions
U.S.A.

BDC Industry Update: Rating Outlooks Largely Stable, Despite Headwinds

Peer Review Completed; Ratings Affirmed: On April 3, 2023, Fitch Ratings completed a peer review of business development companies (BDCs), affirming 18 issuers' ratings. Following the peer review, Fitch also published a 'BBB–' rating for ORTF. Rating Outlooks remain Positive for BXSL, GBDC and ORCC and Stable for the 16 other rated BDCs.

Asset Quality, Funding Profiles Could Deteriorate: Fitch expects the challenging economic environment and higher interest rates to pressure asset quality metrics and funding flexibility for BDCs, on average, in 2023. We believe rated BDCs can withstand modest deterioration in financial profile ratios while maintaining metrics at appropriate levels for ratings. Still, some BDCs are better positioned to navigate sector headwinds given more consistent underwriting standards and track records, lower risk portfolios, stronger asset coverage cushions and/or stronger funding profiles, which could lead to further differentiation in ratings and/or Rating Outlooks over time.

Leverage Differentiation: Middle market deal structures and terms have become more favorable for lenders over the past year, as demonstrated by wider spreads, lower underlying leverage and tighter covenants. Fitch believes BDCs with incremental growth capacity relative to targeted leverage ranges and/or the ability to issue accretive equity could be at a competitive advantage for new origination opportunities, particularly as market activity increases. Conversely, some BDCs are operating near or above the high end of their targeted leverage ranges, which will limit their ability to originate new investments if portfolio repayment activity remains relatively slow.

Rated BDCs Portfolio Growth Slows

Source: Fitch Ratings

Name	Rating/Outlook	Reference
Ares Capital Corporation	BBB/Stable	ARCC
Bain Capital Specialty Finance, Inc.	BBB-/Stable	BCSF
Barings BDC, Inc.	BBB-/Stable	BBDC
BlackRock TCP Capital Corp.	BBB-/Stable	TCPC
Blackstone Secured Lending Fund	BBB-/Positive	BXSL
FS KKR Capital Corp.	BBB-/Stable	FSK
Goldman Sachs BDC, Inc.	BBB-/Stable	GSBD
Golub Capital BDC, Inc.	BBB-/Positive	GBDC
Hercules Capital, Inc.	BBB-/Stable	HTGC
Main Street Capital Corporation	BBB-/Stable	MAIN
Morgan Stanley Direct Lending Fund	BBB-/Stable	MSDLF
New Mountain Finance Corporation	BBB-/Stable	NMFC
Oaktree Specialty Lending Corporation	BBB-/Stable	OCSL
Owl Rock Capital Corporation	BBB-/Positive	ORCC
Owl Rock Capital Corporation II	BBB-/Stable	ORCC II
Owl Rock Capital Corporation III	BBB-/Stable	ORCC III
Owl Rock Technology Finance Corp.	BBB-/Stable	ORTF
Sixth Street Specialty Lending, Inc.	BBB/Stable	TSLX
SLR Investment Corp.	BBB-/Stable	SLRC

Source: Fitch Ratings

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