



Private Credit

Challenges and Opportunities

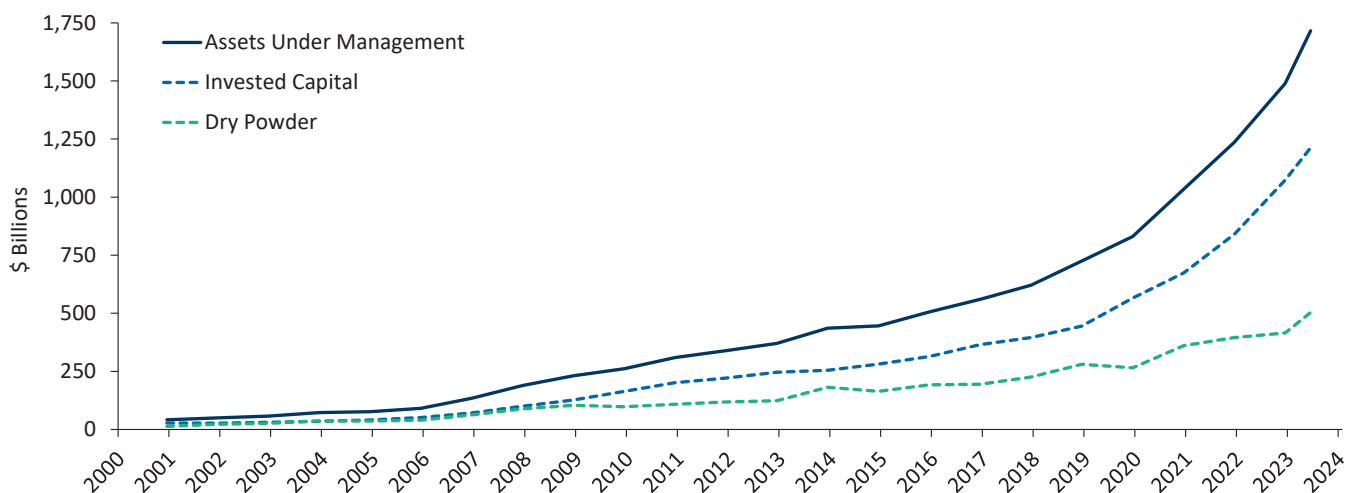
October 17, 2024

Private credit's rapid expansion and impressive returns over the past two decades have transformed it into a critical asset class for investors, borrowers, and lenders. However, transparency concerns, particularly in loan valuation and return volatility, have fueled skepticism about its long-term viability. To address these concerns, rigorous independent validation is essential for boosting transparency and fostering sustainable growth in the private credit market.

The Meteoric Rise of Private Credit

Over the past two decades, private credit has grown exponentially, expanding from a \$50 billion market to a \$1.7 trillion market (see Figure 1),¹ exceeding those of leveraged loans and high-yield bonds (approximately \$1.4 trillion and \$1.3 trillion, respectively).²

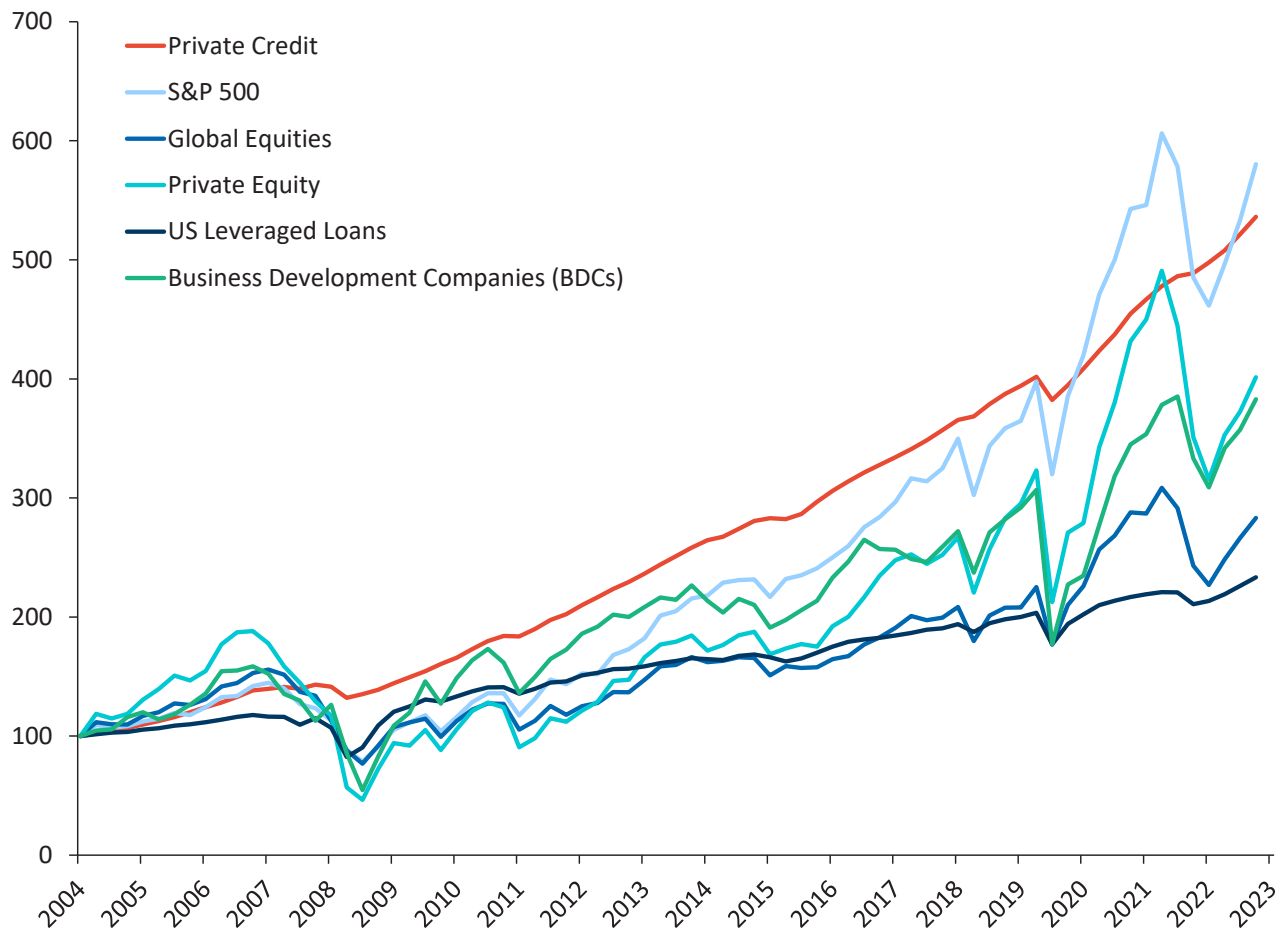
Figure 1. Private Credit Growth



A confluence of factors has driven the rise of private credit. Notably, the prolonged low interest rate environment following the Great Financial Crisis, coupled with stricter bank regulations, has spurred a shift in credit from banks to private lenders.³ Middle-market companies and those with higher risk profiles have found particular value in private credit's flexibility, enabling tailored loan structures that align with specific risk profiles and operational requirements. This customization is especially advantageous in complex financial situations, when traditional public credit options are limited or when the time to close the loan is critical.

Private credit offers investors actively managed, short-duration assets with rigorous due diligence and exclusive access to borrower information. Compared to syndicated loans, privately issued loans often feature stronger covenants and call protection terms, with the added advantage of confidentiality. These advantages contribute to private credit's ability to maintain stable returns across different economic conditions. Historically, private credit returns have rivaled and even outperformed some better-known alternatives, including the S&P500 and MSCI World Total Return indices, through periods including recessions (see Figure 2).

Figure 2. Returns on Private Credit and Other Asset Classes⁴



Challenges Faced by Private Credit

Despite rapid growth, the private credit market remains largely opaque to investors. Fund managers' quarterly reports often lack transparency, and the absence of active trading of private credit assets hinders accurate valuations and performance assessments. Specifically, some of the greatest challenges for this asset class often cited by investors concern the ability to evaluate the reasonableness of asset marks and volatility.

Mark to Model

Compared to bank loans and broadly syndicated loans, which are subject to regulatory oversight and extensive disclosure requirements, private credit offers limited transparency. Unrated, rarely traded, and without standardized contract terms, these loans are often valued based on asset managers' internal models. This, combined with the opacity of private credit funds,⁵ makes accurate real-time pricing challenging. Some critics have derisively labeled this process as “marking to magic.”⁶

The challenges of accurately valuing private credit loans are increasingly evident (See *Table 1*). High-profile bankruptcies such as Hertz and Neiman Marcus demonstrate the critical role of asset valuation in these proceedings. The wide disparity in valuation estimates for another stressed loan, Pluralsight's debt — with March 2024 marks ranging from 83.5 to 97 cents on the dollar for its April 2027 term loan⁷ — highlights the significant valuation challenges inherent in the valuation of private credit assets. Skepticism surrounding the valuation of Blackstone Real Estate Income Trust (“BREIT”), a \$114 billion private real estate fund founded in 2017, further indicates a growing distrust about the opaque nature of private credit valuations.

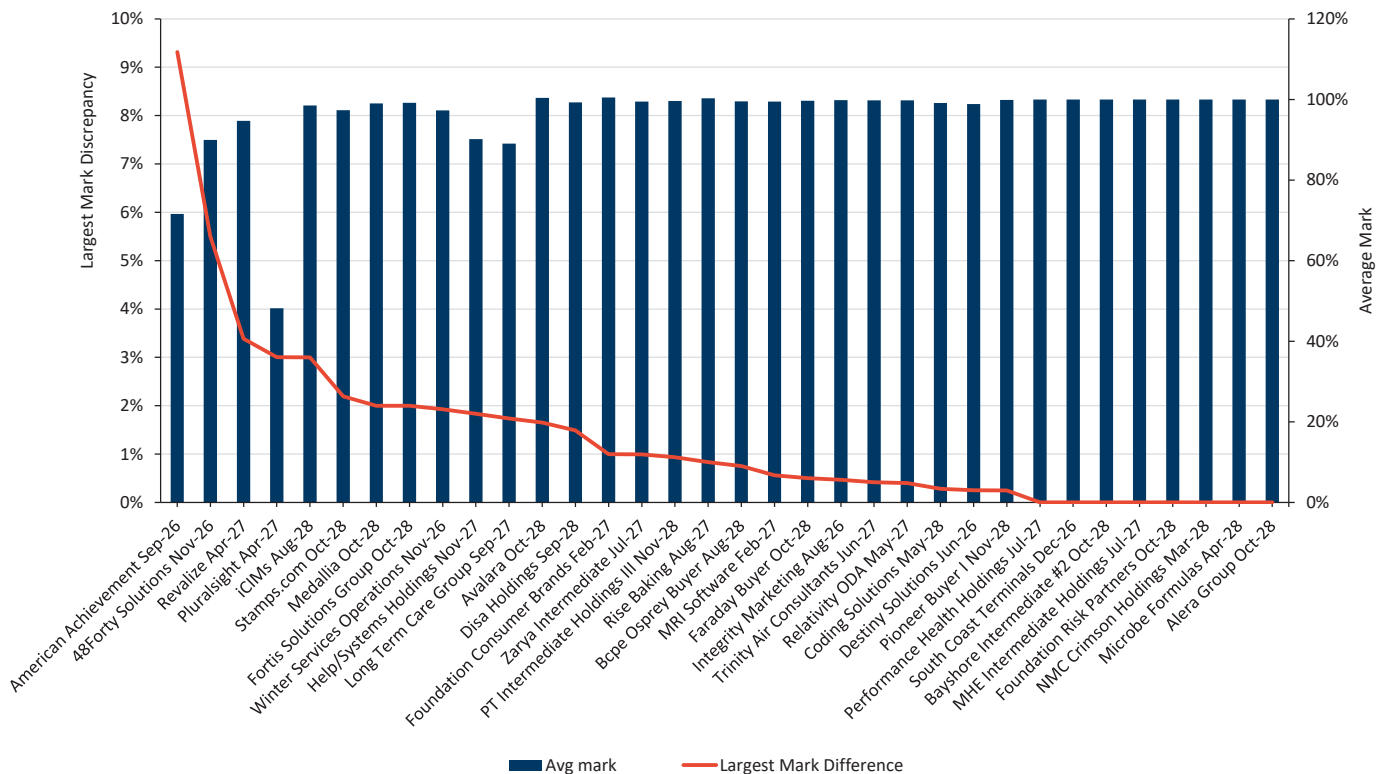
Table 1. Examples of Challenges in Private Credit Asset Valuation

EXAMPLE	CHALLENGES
Hertz's Private Credit Facility	Hertz's 2020 bankruptcy involved complex negotiations with creditors over collateral valuation during restructuring, highlighting challenges in valuing distressed assets within private credit portfolios.
Neiman Marcus Bankruptcy	Neiman Marcus, a luxury retailer, filed for bankruptcy in 2020 with significant private credit involvement. Challenges in valuing inventory and real estate assets, coupled with the lack of transparency, led to disputes among creditors regarding the recovery values. ⁸
Pluralsight Restructuring	The Pluralsight restructuring underscores the significant valuation challenges in private credit: In March 2024, seven lenders reported wildly divergent valuations for Pluralsight debt, with marks ranging from 83.5 to 97 cents on the dollar. ⁹
BREIT (Blackstone Real Estate Income Trust)	BREIT is a \$114 billion private real estate fund established in 2017. Despite outperforming public REITs, it has faced substantial redemption requests and skepticism over its valuation, including allegations that its net asset value (NAV) is inflated by over 55%. ¹⁰

Outside the sharing of proprietary information by private credit funds, the only window into the asset valuation (*i.e.*, marks) of private credit loans is through the quarterly reporting of public business development companies (“BDCs”), which hold “an estimated 40% of the private credit market's invested assets.”¹¹ To illustrate the challenges associated with private credit valuation, we analyze the marks on loan investments held by two or more BDCs.¹² Our illustrative sample of BDC loan investments comprises the top 50 holdings for each of the largest 20 BDCs.¹³ From this sample, we identified 34 loan investments with matching terms simultaneously held by two or more BDCs.¹⁴

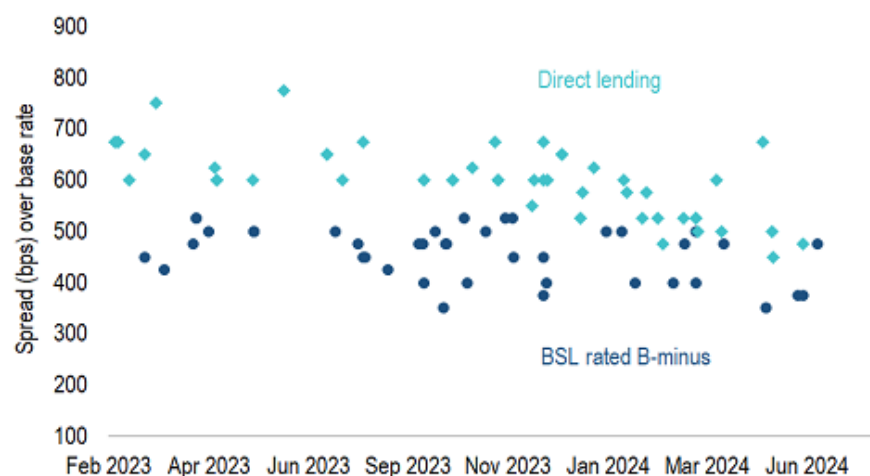
For each loan, we compare the fair value marks reported by each BDC investor.¹⁵ We observe 21 loans with mark discrepancies of less than 1 percentage point, 9 loans with mark discrepancies between 1 and 3 percentage points, with the remaining 4 loans having mark discrepancies in a range of 3 to 9.3 percentage points. Typically, mark discrepancies are larger when the loan price drops well below par. *Figure 3* below plots average marks and their discrepancies across BDC investors for each of the 34 overlapping loan investments.

Figure 3. Mark Discrepancies for Selected BDC Loan Investments¹⁶



Historically, private credit investors received higher returns to offset transparency risks. However, this premium has recently eroded, in some cases vanishing entirely (see *Figure 4*). Without adequate compensation for the lack of transparency, the appeal of private credit over more liquid, transparent public markets would likely diminish.

Figure 4. New-Issue Spread of Acquisition-Related Deals, PE-Backed Companies¹⁷



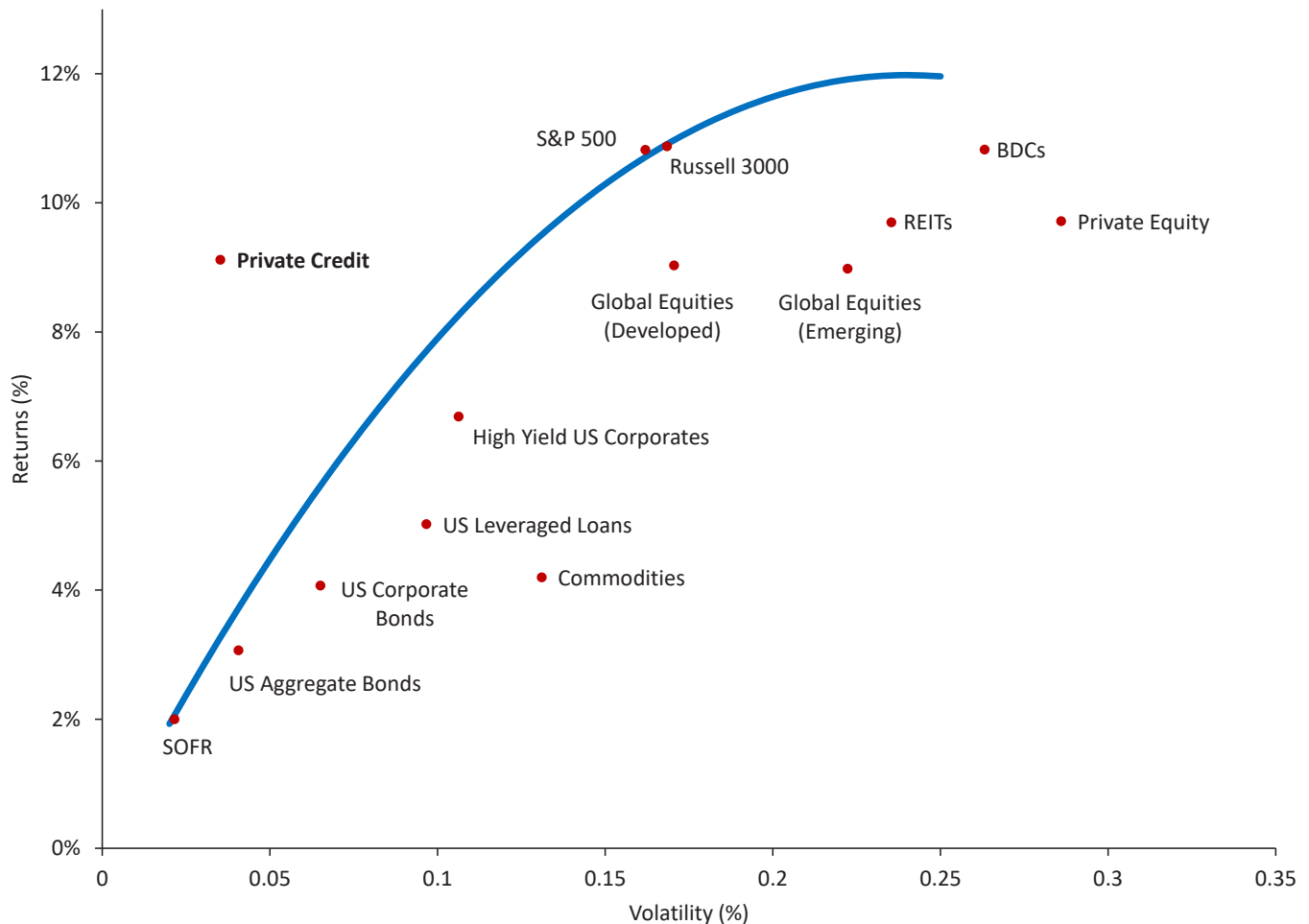
Source: Pitchbook LCD

Hidden Volatility

The opacity of private credit, coupled with proprietary data held by asset managers, necessitates a strong reliance on their expertise. While private credit fund managers typically report quarterly performance metrics, these metrics, such as internal rate of return (IRR),¹⁸ are tailored for the illiquid and irregular cash flows of this asset class. Such return measures do not fully capture the underlying risk.¹⁹ Infrequent pricing and potential asset price smoothing can further distort the perception of risk, as they may underestimate return volatility.

A cross-asset class comparison clearly illustrates the perceived low volatility of private credit. *Figure 5* below shows historical annualized returns and volatility across asset classes between 2004 and 2023.²⁰ The blue parabolic line connecting the risk-free rate (SOFR) and U.S. stocks illustrates the efficient frontier, representing the historical tradeoff between return and risk. While most asset classes fall on or below this frontier, private credit is a notable exception, realizing higher returns than most asset classes with a risk profile similar to that of U.S. Bonds.²¹ Specifically, private credit has realized annualized returns of over 9% since 2004, ranking sixth among the 14 asset classes, with an annualized volatility of 3.5% over the same period, the lowest across all asset classes except SOFR.

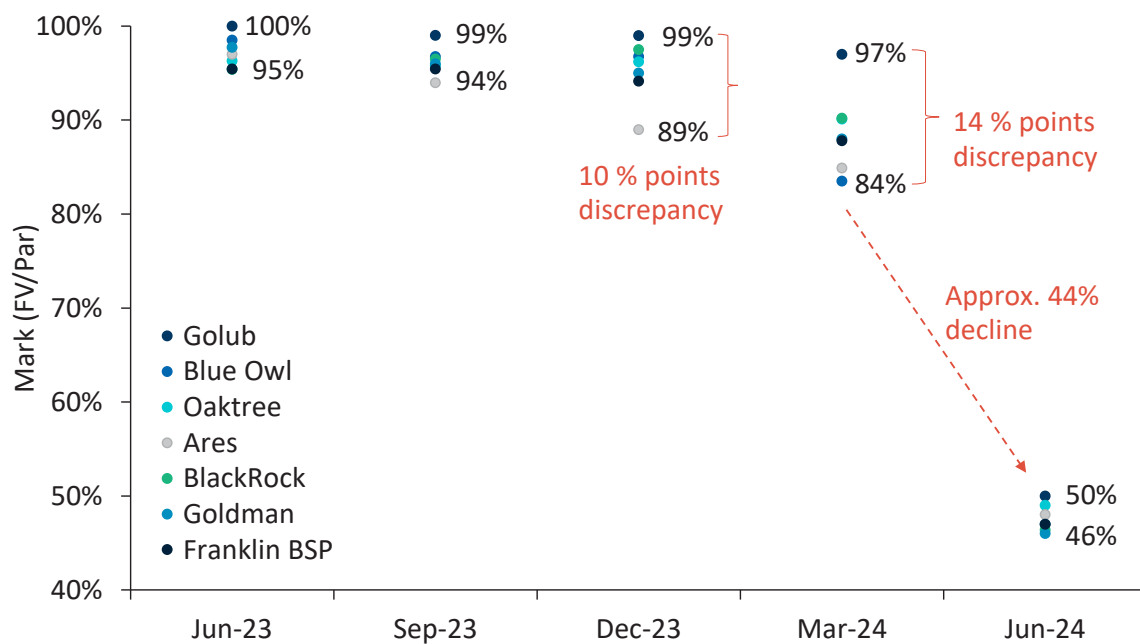
Figure 5. Historical Risk vs. Return by Asset Class²²



The higher returns for private credit relative to its risk are partly attributable to an illiquidity premium stemming from long-term capital commitments and the lack of liquid secondary markets. Still, this premium alone does not fully explain the observed returns. Compared to similarly illiquid private market investments, such as private equity, private credit has yielded a significantly higher premium. A lack of clarity surrounding the true volatility of private credit likely hinders investor confidence.

To illustrate the challenges faced by private credit, we show in *Figure 6* Pluralsight's term loan marks reported by BDCs. At year-end 2023, these marks ranged from 89-99% (fair value over par). At year-end 2023, the majority of BDCs with exposure to this loan were marking it at or above 95 cents on the dollar. This divergence widened to 14 percentage points in March 2024. By June 2024, as Pluralsight approached restructuring, the marks plummeted to 46-50 cents on the dollar.²³ This significant disparity highlights the inherent challenges in accurately pricing these illiquid instruments. The 44% drop in the average marks between March and June 2024 further underscores the limitations of quarterly reporting, as the decline likely occurred well before the reporting date. Investors, typically only privy to quarterly marks, may face challenges in assessing their investment risks in a timely manner.

Figure 6. BDC Marks for Pluralsight Term Loan²⁴



In summary, private credit's allure lies in its potential for attractive risk-adjusted returns. Yet, doubts persist about whether this performance is a byproduct of infrequent and delayed valuation, or a reflection of the asset class's true low volatility. The lack of transparency makes it challenging to answer this question definitively.

Importance of Independent Verification

Private credit has evolved into a significant market segment, offering attractive yields for investors and emerging as a serious competitor to traditional lending options like bank loans. However, a lack of transparency and the potential for underestimated volatility present significant challenges. Without accurate and timely pricing information, investors may question the reliability of the valuations provided by the managers. This skepticism can deter potential investors, limiting the market's growth and accessibility to capital, especially as base interest rates decline and high returns become harder to achieve.

Heightened regulatory interest in recent years also underscores the industry's need to address these valuation challenges. In August 2023, the SEC adopted a new rule that would require, among other things, that SEC-registered fund advisors obtain a fairness or valuation opinion in connection with an adviser-led secondary transaction. The Fifth Circuit Court of Appeals overturned this rule in June 2024, and the SEC waived its right to appeal the following month. Financial market overseers, such as the IMF and Federal Reserve, have also recently published reports analyzing the private credit market and highlighting concerns of risk associated with this asset class and its limited transparency. To address these challenges, the private credit industry must practice independent verification and validation of asset valuations. This approach will bring multiple benefits:

- **Enhancing Transparency:** Independent verification ensures that private credit valuations accurately reflect true market conditions, adding a layer of transparency. For instance, the COVID-19 pandemic served as a catalyst for scrutinizing valuation practices in the private credit industry. During this period, some independent valuation firms employed diverse methodologies to provide more detailed assessments, revealing significant variations in how different managers marked similar assets.²⁵
- **Refining Valuation Policies:** Complementing the independent valuation process, fund managers can have their valuation policies explicitly defined and articulated to stakeholders, demonstrating that they are comprehensive and accurately reflective of the unique characteristics of their assets.
- **Enabling Accurate Volatility Assessment:** Regular and timely valuations provide more accurate volatility assessment and a realistic understanding of the risks involved. Expanded information on events like covenant breaches can allow for a more nuanced understanding of portfolio risk.
- **Fostering Investor Trust:** Independent valuations enhance the reliability of private credit assets' returns and foster investor trust by managing potential conflicts of interest.
- **Promoting Market Growth:** Increased transparency can attract more investors and promote the further growth of the private credit market.²⁶

As the market matures and faces increased scrutiny, the ability to provide transparent, reliable valuations may become a key differentiator for fund managers and a critical factor in attracting and retaining investor capital.

Conclusion

Challenges in private credit underscore the importance of independent verification of asset valuation. A timely, accurate asset value boosts investor confidence and provides a realistic understanding of return volatility. Enhanced transparency can also attract more investors to private credit markets, expanding the available capital pool and ultimately supporting the growth and stability of the market. As the private credit sector continues to grow, embracing transparency and rigorous validation practices would be essential for building a strong and healthy investment ecosystem.

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- 1 “Private Credit: Characteristics and Risks, Accessible Data,” Board of Governors of the Federal Reserve System (February 2024), <https://www.federalreserve.gov/econres/notes/feds-notes/private-credit-characteristics-and-risks-accessible-20240223.htm#fig1>.
- 2 Cai, Fang and Sharjil Haque, “Private Credit: Characteristics and Risks,” FEDS Notes (February 2024), <https://www.federalreserve.gov/econres/notes/feds-notes/private-credit-characteristics-and-risks-20240223.html>.
- 3 The April 2024 Global Financial Stability Report shows that the ratio of U.S. private credit over bank credit increased from below one to over nine from 2001 to 2023. See Figure 2.2, Panel 4 of “Global Financial Stability Report: The Last Mile: Financial Vulnerabilities and Risks,” International Monetary Fund (April 2024), <https://www.imf.org/en/Publications/GFSR/Issues/2024/04/16/global-financial-stability-report-april-2024>.
- 4 Indices rebased to 100 as of September 2004. Index data from Bloomberg L.P.
- 5 The most common private credit investment vehicles are closed-end funds with a capital call structure and limited life cycle, similar to funds used for private equity. These funds account for approximately 81% of the total market, followed by business development companies (“BDCs,” approximately 14%) and collateralized debt obligations (“CDOs,” approximately 5%). See “Global Financial Stability Report: The Last Mile: Financial Vulnerabilities and Risks,” International Monetary Fund (April 2024), p. 56.
- 6 Bethany McLean, “Blackstone’s Big Gamble: Has the World’s Largest Private-Equity Firm Built a \$114 Billion House of Cards?” Business Insider, May 7, 2024.
- 7 See fair value marks reported by Golub Capital BDC, Inc. and Blue Owl Capital Corporation in their respective Form 10-Qs as of March 31, 2024, available at <https://www.sec.gov/search-filings>.
- 8 See, for example, “UCC, Neiman Sponsors File Dueling Reports Disputing Neiman Marcus, MyTheresa Valuations, Solvency, Strategic Rationale for MyTheresa Distribution,” Reorg, July 27, 2020.
- 9 Eric Platt and Amelia Pollard, “A Messy Loan Restructuring Highlights Risk Lurking in Private Credit,” Financial Times, July 10, 2024. Available at <https://www.ft.com/content/b10dbb08-c745-40d0-a7fc-9b4024f1fd10>.
- 10 See, for example, Bethany McLean, “Blackstone’s Big Gamble: Has the World’s Largest Private-Equity Firm Built a \$114 Billion House of Cards?” Business Insider, May 7, 2024.
- 11 Alexandra Scaggs, “A Window into Private Credit Marks,” Financial Times, January 11, 2024. Available at <https://www.ft.com/content/fe6b48e2-1850-4fdf-a122-014be411479e>.
- 12 A BDC is a publicly-traded investment vehicle, which primarily provides high-yield, floating-rate loans to small-to-mid-sized companies. The structure of loans provided by BDCs is often similar to those provided by private credit funds. See An Overview of Business Development Companies (BDCs), Guggenheim Investments, available at: <https://www.guggenheiminvestments.com/getattachment/Page-Types/UIT/BDCS010/An-Overview-of-Business-Development-Companies.pdf.aspx>.
- 13 BDC loan holdings data from Bloomberg as of March 31, 2024. Loan holdings limited to those with maturities between 2026 and 2028.
- 14 Note that we exclude 12 loan investments held only by Blue Owl Capital Corporation (OBDC) and Blue Owl Capital Corporation III (OBDE) which have identical marks.
- 15 Marks are measured as a fair value estimate as a percentage of the original principal amount. Marks are sourced from each BDC’s SEC filing as of June 30, 2024.
- 16 Fair value marks sourced from BDC Form 10-Qs as of June 30, 2024 (<https://www.sec.gov/search-filings>).
- 17 Abby Latour, “Q2 US Private Credit Wrap: Lenders strengthen defenses against refi, repricing wave,” PitchBook LCD, July 1, 2024. Available at <https://pitchbook.com/news/articles/q2-us-private-credit-wrap-lenders-strengthen-defenses-against-refi-repricing-wave>.
- 18 IRR measures the annualized effective compounded return rate over the duration of the fund.
- 19 For example, these measures often fail to account for the capital commitments required by the investors during extended periods.
- 20 Historical returns and volatility of SOFR measured between 2019 and 2023.
- 21 Based on Bloomberg US Aggregate Bond Total Return Index, which represents the investment grade, USD, fixed-rate taxable bond market. Bloomberg L.P.
- 22 Index data sourced from Bloomberg L.P. and covers the period between 2004 and 2023. Indices include S&P 500 Total Return Index, Russell 3000 Total Return Index, Bloomberg Commodity Index 3 Month Forward index, Morningstar LSTA US Leveraged Loan Total Return Index, MSCI World Total Return Index, MSCI Emerging Markets Total Return Index, Cliffwater Direct Lending Total Return Index, S&P Listed Private Equity Total Return Index, Bloomberg US Aggregate Bond Total Return Index, Bloomberg US Corporate Bond Total Return Index, Cliffwater BDC Total Return Index, Bloomberg US Corporate High Yield Total Return Index, Dow Jones US Select REIT Total Return Index, and CME Term SOFR 3 Month.
- 23 On August 28, 2024, Pluralsight announced that existing lenders including Blue Owl, Ares, GSAM, and Oaktree would own 100% of the company under a new recapitalization agreement. <https://www.pluralsight.com/newsroom/press-releases/pluralsight-announces-agreement-to-recapitalize-business>.
- 24 Data from each BDC’s Form 10-Qs and Form 10-Ks as of December 2023, March 2024, and June 2024.
- 25 Alternative Credit Council, Valuation Roundtable, December 8, 2020 (<https://acc.aima.org/article/acc-valuation-roundtable-summary-part-ii.html>).
- 26 “Transparency is key to sustainability.” See p. 5 of “Financing the Economy: The Future of Private Credit,” Dechert LLP and the Alternative Credit Council, November 20, 2019, available at <https://www.dechert.com/knowledge/publication/2019/11/financing-the-economy--the-future-of-private-credit.html>.