Of Principle Interest

Credit Market Insights by Antares

Off the Mark: Are Private Credit Valuations "Flawed"?

Recently, some skeptics have suggested that loan valuations ("marks") within private credit portfolios are potentially flawed and could pose a threat to the asset class's surge in popularity among investors.[1]

Variance among lenders' marks is to be expected.

Most loans in a typical private credit portfolio are not publicly traded and require the manager or General Partner ("GP") to fair value or "mark" assets based on various estimates and assumptions. Valuation variances across managers for the same loan tend to be lower for performing loans but increase for underperforming loans. Such variance is to be expected given a lack of observable market pricing data and does not necessarily suggest that direct loans are systemically over or under valued. In stressed situations, the valuation ranges on private loans tend to widen because the range of assumptions, implied outcomes, and probability weighting of those outcomes tend to vary based on managers' views. When looking across a broad universe of loans, empirical evidence suggests that median pricing in private and public markets has been relatively comparable over the long-term when adjusting for Original Issue Discount (OID).[2] Furthermore, research indicates minimal evidence of serial correlation, suggesting that managers do not commonly adjust reported asset values to conceal the full range of valuation fluctuations over brief periods, also known as "valuation smoothing."[2]

Of course, if one identifies a clear pattern of materially higher valuations by a GP vs. peer marks, then there may be a cause for further diligence. Additionally, if it's observed that the adjustments made for credits that default in a GP's portfolio are consistently drastic just before or at the moment of default rather than a more gradual acknowledgment of emerging issues, this could indicate that the GP is slow to recognize problems until they have no choice.

> *To ensure objectivity, it is best for GPs to engage independent, experienced third-party experts to value credits that are underperforming expectations and, in particular, for stressed and distressed credits.*

Lower volatility is attractive and not just due to lower frequency of marks.

Publicly traded loans offer liquidity that comes with a cost, typically both in the form of lower spread and greater volatility. Those are the costs of being able to get in or out of a position on demand. However, many investors have concluded that this cost of liquidity isn't worth the benefit – at least for a portion of their portfolio - especially since liquidity tends to diminish in times of stress when it is most valued. Additionally, investors generally value reduced volatility within their portfolios.

Some argue that failing to lower an asset's reported value doesn't mean its "real" market value isn't actually lower – and certainly there can be some truth to this.

However, valuing a loan based on market supply/demand at any given instance in time may not reflect the underlying fundamental value of the long-term cash flows of an asset for those willing to hold the asset to maturity - a fundamental tenet of long-term investing. Additionally, there are attributes of direct loans that make them fundamentally less volatile than publicly traded loans. This includes generally tighter documentation, covenants and typically a more solutions-oriented approach to stressed situations (often involving sponsor equity infusions) and workouts with higher ultimate recovery rates.

Protecting against concerns over inaccurate valuations.

To ensure objectivity, it is best for GPs to engage independent, experienced third-party experts to value credits that are underperforming expectations and, in particular, for stressed and distressed credits. This is less critical for performing loans where there is greater clarity around a borrower's financial health and the prospects for a loan's full repayment. Other important GP considerations include:

1. Strong alignment of incentives and clear and objective valuation practices
2. Experience across industries and cycles
3. A deep understanding of the dynamics of workout to inform more accurate valuation assessments in times of stress.

Finally, interim loan valuations are somewhat meaningless in a "buy and hold" portfolio if the end result is a full return of principal and interest. Therefore, partnering with a GP that is skilled at minimizing realized losses is really what is most critical.

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1 "Flawed Valuations Threaten $1.7 Trillion Private Credit Boom", Bloomberg, February 27, 2024.

2 Cliffwater Research "Valuation and Private Debt" Feb 29, 2024 and Forecasting Risk for Illiquid Asset Classes" October 2019.

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