



# A Focus on Valuation: Private Credit vs. Public Credit

## INTRODUCTION

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Private credit and public credit are often viewed as similar asset classes, yet they have distinct characteristics and differences resulting in unique valuation considerations. Direct lending, arguably the fastest-growing form of private credit, involves non-bank lenders that originate private bilateral loans directly with issuers rather than through a traditional syndication process. These loans are typically not publicly traded and are classified as level 3 investments in the fair value hierarchy. In contrast, public credit, such as broadly syndicated loans or bonds, often trade on public markets and have observable prices. Understanding the differences between private credit and public credit is crucial when valuing these securities. In this publication, we discuss certain valuation considerations specific to private credit. We will use the terms private credit and direct lending interchangeably.

## THE RISE OF DIRECT LENDING

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The rise of direct lending started after heightened regulations brought on by the Global Financial Crisis caused banks to withdraw from the middle-market lending industry. The increased regulations made it challenging for banks to lend to middle-market companies, leaving a funding gap that was filled by direct lenders. In recent years, the rise of direct lending has accelerated due to its greater certainty of execution and speed of close compared to a traditional bank process and macroeconomic events, such as the aftershock of the COVID-19 pandemic and the U.S. Federal Reserve's ongoing rate hikes, which have resulted in higher borrowing costs, with base rates like SOFR increasing from approximately 0.8% to 4.6% in 2022 alone. These macroeconomic shocks have impacted nearly every asset class, causing some to underperform and others, like private credit, to be resilient.

## DIRECT LENDING FEATURES

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Direct lending offers many benefits over public credit, which we will define as broadly syndicated loans and corporate bonds. Some of the key features and distinctions of direct lending include:

- 1. Floating Rates, Base Rate Floors, Pricing Grids:** Unlike public corporate bonds, floating rate loans benefit lenders in rising rate environments. These loans often have an interest rate composed of a floating rate (typically tied to a base rate such as SOFR, often with base rate floors) and a fixed margin rate. Many loans also have variable interest rate grids, which allows the "fixed" component of the interest rate to change based on pre-defined thresholds such as leverage ratio. This is attractive to both borrowers and lenders as it allows the interest rate to adjust to changing credit risk profiles of the borrower without the need for renegotiations.
- 2. Seniority:** These loans are typically first lien or have high attachment points. Additionally, they are frequently secured by underlying assets of the borrower. These loans often have covenants that provide greater structural protections to the lenders compared to covenant-lite, broadly syndicated loans or unsecured high-yield bonds. Private credit loan covenants typically provide lenders with protection when a borrower begins to experience financial difficulties. This can result in lenders having a greater say in the company's affairs and being in a better position to protect their returns on the loans during periods of declining performance for the borrowers.
- 3. Shorter Maturities, Lower Duration:** Direct loans typically have contractual maturities of five to seven years, which is shorter than long-dated corporate bonds. Direct loans are frequently repaid, restructured, refinanced, or amended prior to contractual maturity, which often leads to lenders earning additional returns in the form of call protection or amendment fees and can also result in an expedited accounting recognition of upfront OIDs rather than through full contractual maturity date.
- 4. Held for Investment:** Direct loans are usually held for investment and are not frequently traded, unlike broadly syndicated loans and corporate bonds. As a result, private credit is also generally perceived to be less affected by public market price volatility.

**5. Closely Held:** Direct loans are often closely held by a small group of lenders. Broadly syndicated loans are often held by tens or hundreds of different lenders. Smaller lending groups allow direct lenders to be more nimble in closing deals and responding to the needs of the borrowers or sponsors. As a result, private equity sponsors are increasingly turning to direct lenders to finance buyouts due to the certainty of execution, speed of close, and flexibility should issues arise.

## VALUATION CONSIDERATIONS FOR PRIVATE CREDIT

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It is important to consider all of the terms and features when valuing a loan. It is also important to take into consideration any fundamental differences between the subject security being valued and the public comparable benchmark being used. Typically, loans are valued via a discounted cash flow analysis whereby expected future cash flows are present valued at a risk-adjusted discount rate. Estimating the fair value of a loan typically involves calculating the implied spread and yield at the time of purchase or underwriting (i.e., calibrating) and then adjusting that yield or spread at the valuation date by taking into account various qualitative and quantitative factors. These factors could include changes to the financial performance, changes in credit metrics and credit profile of the borrower, and changes in observed market spreads and yields.

Because private loans do not have readily observable market spreads and yields, it is common practice to consider public credit benchmarks such as broadly syndicated loans, loan indices, and high-yield bond indices. However, private loan spreads and yields do not always move in lockstep with that of public credit. There are many reasons for this. First, private credit loans do not trade and are generally perceived to be less affected by public price market volatility. Second, directly originated loans are structured with tighter, more lender-friendly terms and protections such as financial covenants as opposed to public market covenant-lite deals. Lastly, the competitive landscape of direct lending remains at record levels. The value for any asset is the price that would be received to sell that asset—so what better way to get a pulse on the market than to consider the current pipeline of deals as well as recent transaction precedents? Since both competition and dry powder remain at elevated levels, market spreads and yields for private credit have generally not witnessed the same level of volatility as observed in the public markets. At the end of the day, the valuation approach and assumptions regarding key inputs used in valuing private credit should generally be consistent and align with those observed in new investments. Using an experienced valuation professional with insight into private credit market trends and conditions can be key when estimating the fair value of private credit.

Houlihan Lokey has extensive relationships and has worked with some of the world's leading asset managers. Houlihan Lokey is the independent valuation provider for more than 35 BDCs and direct lending funds, spanning assets in excess of \$600 billion. At our firm, we obtain real-time market information from our leading debt capital markets team and conversations with numerous direct lending investors. Houlihan Lokey publishes its Private Performing Credit Index (PPCI),<sup>(1)</sup> which is drawn from the firm's extensive dataset of more than 7,200 private loan valuations. Nonetheless, a valuation is more than simply an output from a model and needs to undergo rigorous testing by fund managers and valuation professionals to ensure consistency across multiple factors. Additionally, backtesting data points from recently exited investments or secondary market transactions can help triangulate a valuation conclusion. The resulting valuation should be comparable on a risk-adjusted basis with both newly originated deals and existing investments within the given portfolio and should factor in the many differences between public and private market transactions.

*(1) The Houlihan Lokey Private Performing Credit Index is an aggregate view drawn from our extensive dataset of private credit valuations. The PPCI is intended primarily to provide a window to the universe of performing private credit loans, which is generally inaccessible, and to act as a basis for comparison to specific assets or other indices to inform discussions of market dynamics between ourselves and our clients. For more information regarding the PPCI, please visit the [Insights](#) section of [HL.com](#).*

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Advisor	Deals
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2 Rothschild & Co	369
3 JP Morgan	217
4 Lazard	206
5 Goldman Sachs & Co	203

Source: Refinitiv. Excludes accounting firms and brokers.

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5 Moelis & Co	21

Source: Refinitiv.

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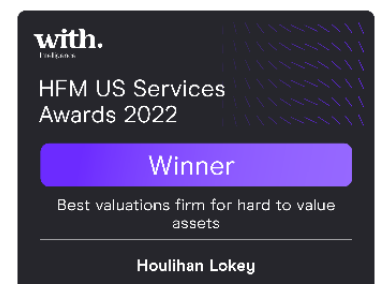
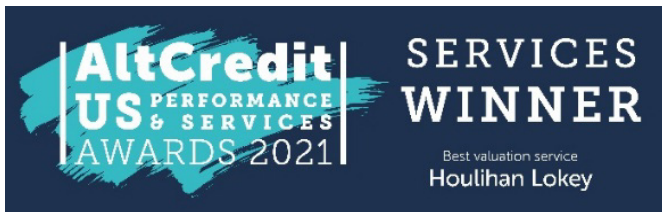
Advisor	Deals
<b>1 Houlihan Lokey</b>	<b>1,232</b>
2 JP Morgan	1,030
3 Duff & Phelps, A Kroll Business	938
4 Morgan Stanley	725
5 BofA Securities Inc	710

Source: Refinitiv. Announced or completed transactions.

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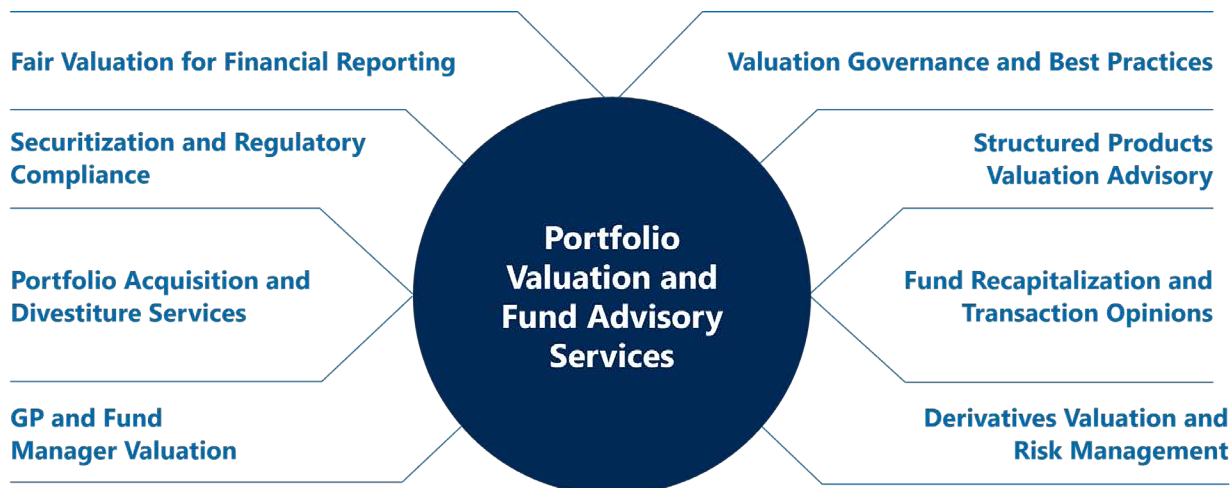
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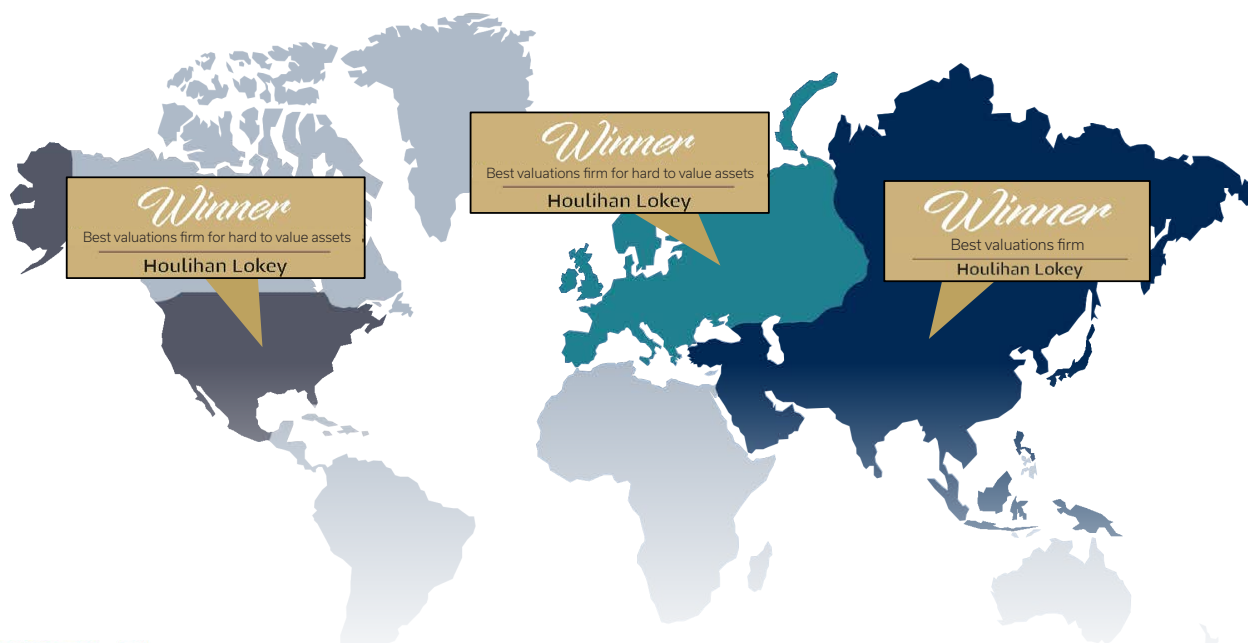
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The HFM Services Awards named Houlihan Lokey "Best Valuations Firm for Hard to Value Assets" in the U.S. in 2018–2022 and in Europe in 2020–2022, and it was named "Best Valuations Firm" in Asia in 2020–2022. Houlihan Lokey has now won these awards in all three geographic regions for three consecutive years!



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