

## On Wall Street

# Separating the signal from the noise in private credit

## What matters most is how capital was deployed and underwritten



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Investors are justifiably concerned about some of the issues that have been raised about private credit in recent months. Rising impairments, questions over valuations, the use of leverage, liquidity mismatches, software exposure in an AI-driven world, and refinancing risks are all real issues.

But the current debate risks conflating multiple factors to reach overly broad conclusions. It's worth separating the fundamentally sound concept of private credit – tailored, non-bank lending – from specific challenges. Direct lending, or the making of private loans to finance mid-size buyouts, isn't inherently flawed. The issue is lax underwriting standards during a period of favourable conditions and abundant capital.

In the years leading up to and during the pandemic, capital flowed rapidly into direct lending. Interest rates were ultra-low, valuation multiples were high, and competition to deploy capital intensified. In that environment, some loans were structured with higher leverage, more optimistic assumptions and features such as payment-in-kind structures that deferred cash payment obligations. Software was a favoured sector for private equity and direct lenders alike yet many of the pre-ChatGPT deals could not have accounted fully for the potential impact of AI.

Those loans now face a different reality. Interest rates are higher, valuation multiples have come down, AI is a real and growing threat to some legacy software businesses, and in some cases, business conditions are more challenging. Many of these loans will need to be refinanced in the coming years, and investors are right-

ly focused on whether that will be possible given lower valuations.

A significant portion of private credit portfolios, however, has been built more recently, in a higher-rate environment where underwriting standards have generally been more conservative. These loans typically carry lower leverage, stronger structures and assumptions that reflect today's conditions rather than those of a previous cycle. These deals certainly won't be perfect, but a tougher environment should encourage more disciplined lending.

The distinction between these vintages helps explain several apparent contradictions in the market. Publicly traded investment funds known as Business Development Companies, which tend to have greater exposure to pandemic-era loans, are trading at meaningful discounts to their reported net asset values. They also show higher levels of loans that exhibit signs of stress. By contrast, non-traded BDCs, which have grown more rapidly in recent years, often have greater exposure to newer vintages and are showing lower levels of stress.

This helps explain why market sentiment may appear more negative than borrower performance alone would suggest, as concerns about pandemic-era loans weigh on the asset class as a whole. More broadly, it's also a question of confidence. When concerns around valuations, sector exposure and refinancing begin to pile up, they can have an impact on broad sentiment.

None of this means concerns should be dismissed. Investors are right to scrutinise how different managers approached underwriting

during periods of abundant capital and demand. But we appear to be seeing a correction and recalibration on the part of fund investors rather than a systemic issue for the asset class – that is, there's nothing fundamentally wrong with most of the underlying loans.

What matters most is not the asset class in the abstract, but how capital was deployed and individual investments underwritten within it. In more accommodating environments, there can be a tendency for capital to be put to work at a faster pace than would otherwise be prudent, for underwriting assumptions to become more optimistic, or for more leverage to be used. Likewise, competitive conditions can encourage promises of liquidity in investments in ways that are not fully aligned with the illiquid nature of the assets. Risk often builds up in good times and only becomes apparent when conditions deteriorate. That's why sound underwriting discipline, careful risk management and deliberate portfolio construction matter.

For investors, the question is not whether private credit will experience stress. Like any market, it will whenever the cycle turns down. The more important question is how it performs through that stress and how different approaches shape outcomes. We can't judge the merit of an investor or an investment until we've seen how they perform in bad times as well as good. That disclosure lies ahead for private credit.

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