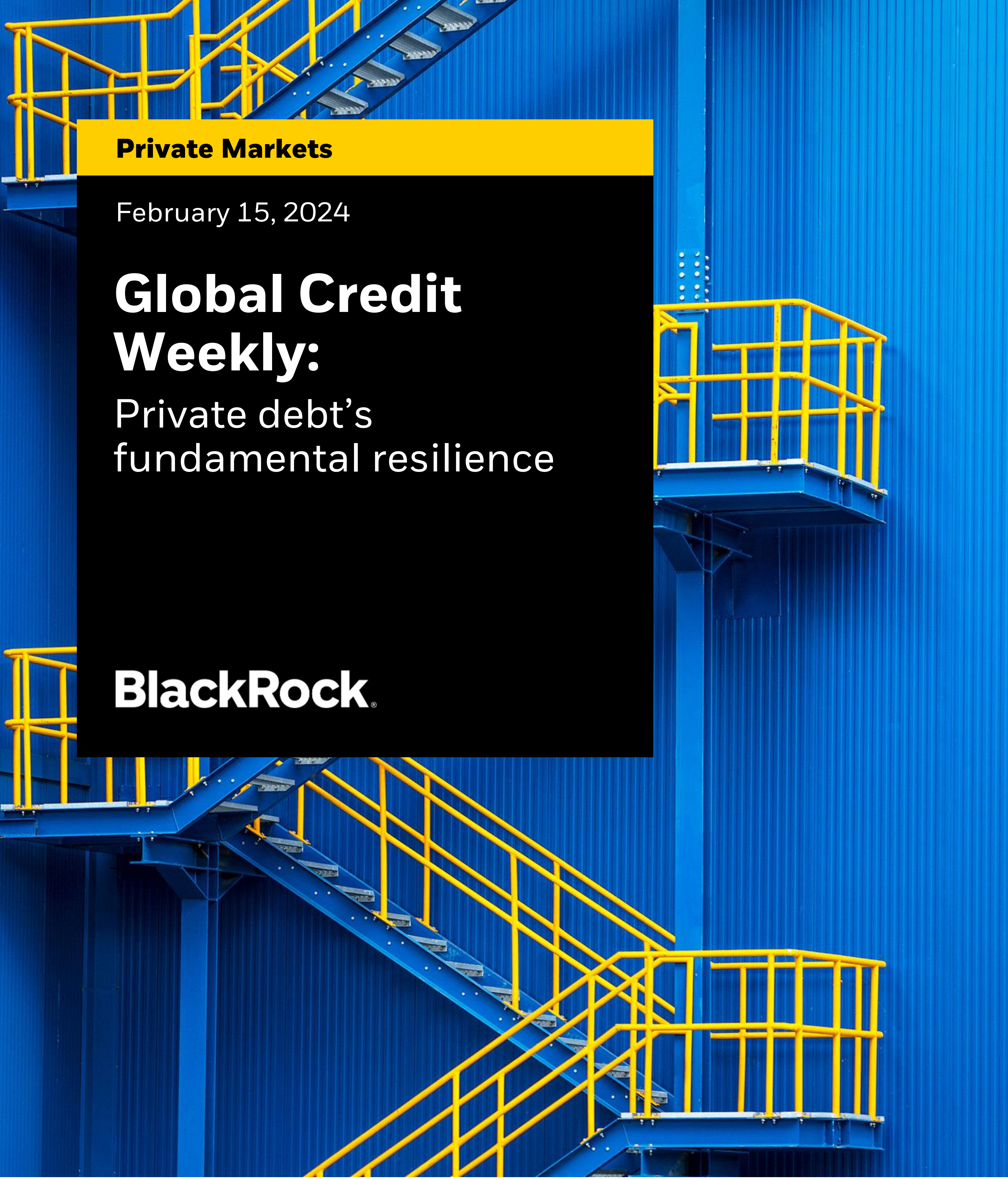

Private Markets

February 15, 2024

Global Credit Weekly:

Private debt’s fundamental resilience

BlackRock

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GPDM0324E/M-3422705-1/12

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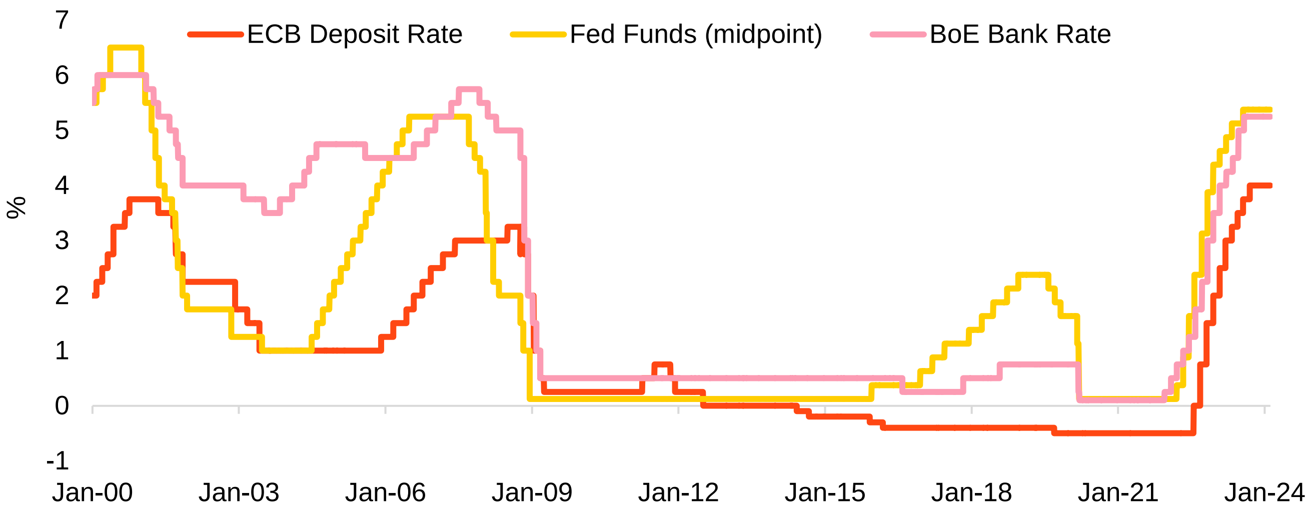
Key takeaways

- The January U.S. CPI data (released February 13th) – which illustrated increases in certain components of inflation – will likely embolden the Federal Reserve's (Fed) patient approach towards the start of the next monetary policy easing cycle. Our base case remains for a 2H2024 start for Fed rate cuts, with the risks skewed earlier within that timeframe.
- As we have emphasized previously, the key for corporate credit investors is the Fed's willingness to (eventually) cut interest rates *proactively*, in response to improving inflation – as opposed to waiting for evidence of a growth downturn to begin normalizing monetary policy. With U.S. economic growth still solid and unemployment remaining low by historical standards, we do not see an obvious sense of urgency for near-term rate cuts by the Fed. A *sustained* reacceleration in inflation, while not our base case, is a risk to closely monitor.
- A key near-term implication for corporate credit investors (from "delayed" rate cuts) is how floating rate borrowers will continue to navigate this (prolonged) high cost of capital environment. For the U.S. private debt market, the most recent signaling is encouraging. Using the widely tracked Lincoln International Proprietary Private Markets Database, 4Q2023 data highlighted the third consecutive quarter of *declining* covenant defaults.
- The flexibility inherent in long-term private debt relationships has likely been a key driver of this declining default rate, as borrowers proactively worked with their lenders to address headwinds from higher interest costs. For this reason, we expect realized losses in the private debt market will continue to compare favorably to those in the public (syndicated) leveraged finance market – although both should remain modest by historical standards, given the supportive growth-inflation mix (especially in the U.S.). Additionally, we believe the bulk of the financial strain for floating rate borrowers is likely in the rear-view mirror at this point, given the vast majority of the policy rate hikes occurred in 2022 and 1H2023 (Exhibit 1).

Exhibit 1: We do not expect significant policy rate cuts in the near term
Monetary policy rates for the European Central Bank, Federal Reserve, and Bank of England



Source: BlackRock, Federal Reserve, European Central Bank, Bank of England, Bloomberg. As of February 14, 2024.

Inflation data reinforces a later start to Fed rate cuts

The January 2024 U.S. CPI data (released February 13th), which was above Bloomberg consensus expectations (as well as December 2023 values) on both a headline and core basis, further dampened market pricing for Federal Reserve rate cuts in the next few months (particularly, in March 2024).

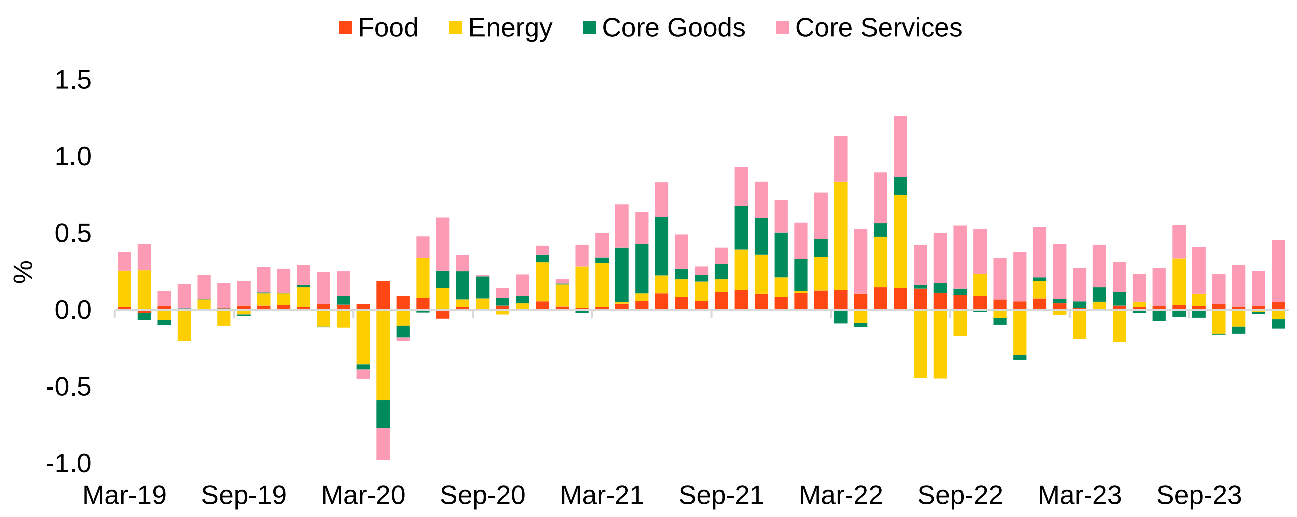
According to the Bureau of Labor Statistics release, shelter costs – which include owners' equivalent rent, rent, and hotels – were a large driver in the January 2024 data, as they rose 60bp during the month and contributed over two-thirds to the overall headline increase. Food costs (including the "at home" and "away from home" categories) also increased, alongside inflation rates for car insurance and medical care (hospital and physician services). By contrast, inflation rates for gasoline, used cars and trucks, and apparel decreased in January.

As has been widely discussed by market commentators[1], January inflation data is unique in that it can often include annual price adjustments across a range of categories (including those tied to labor or supplier agreements), which can lead to volatile prints. Nevertheless, we drew two key takeaways from the January data. First and foremost, the most recent inflation data will likely embolden the Fed to approach the start of a rate cutting cycle with patience. As a reminder, at the January 31st FOMC press conference, Chair Powell acknowledged that the Committee wanted to gain "greater confidence that inflation is moving sustainably toward 2%", prior to starting a rate cutting cycle.

Our baseline view remains for the start of the Fed's rate cutting cycle to begin in 2H2024, with the risks skewed earlier within that timeframe. With U.S. real GDP growth tracking at 3.3% (annualized) as of 4Q2023, and the labor market still tight, we see little urgency for the Fed to cut rates. As we have emphasized previously, the key for corporate credit investors is the Fed's willingness to cut interest rates proactively, in response to improving inflation – as opposed to waiting for evidence of a growth downturn to begin normalizing monetary policy.

Second, from a compositional perspective, services inflation will likely remain the category to watch for continued improvement in inflation. At the January 31st FOMC press conference, Chair Powell acknowledged that the deflation in the goods sector (Exhibit 2) was likely unsustainable, therefore requiring that "services sectors would have to contribute more" towards ongoing improvement in inflation. The strength in the U.S. labor market, where the unemployment rate has remained below 4% since February 2022, is likely one key contributor (as wages are a meaningful input to services costs). Indeed, in January, the services ex-housing inflation measure – widely referred to as "Supercore" increased by the most since April 2022 (Exhibit 3).

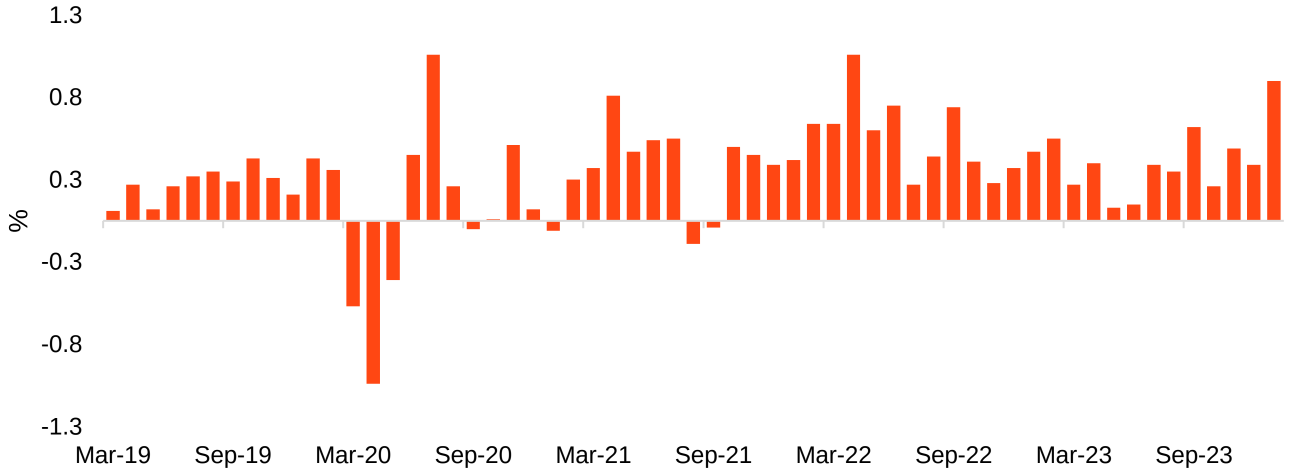
Exhibit 2: Services inflation will remain key for the Fed to have confidence to begin rate cuts
Contributions to month-over-month U.S. CPI (seasonally adjusted)



Source: BlackRock, Bloomberg, Bureau of Labor Statistics. As of January 31, 2024.

(1) "US Daily: A Smaller January Effect", Goldman Sachs Global Investment Research, January 17, 2024.

Exhibit 3: In January 2024, "Supercore" CPI increased the most since April 2022
Month-over-month change in CPI Core Services ex-Housing ("Supercore" CPI)



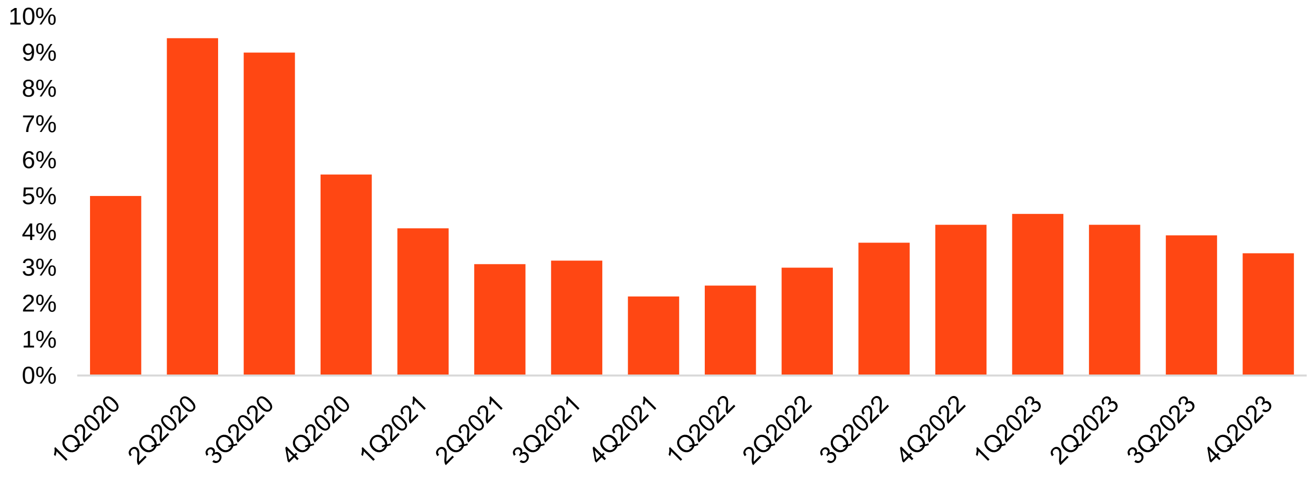
Source: BlackRock, Bureau of Labor Statistics, Bloomberg. As of January 31, 2024. Bloomberg estimate of "Supercore" CPI excludes Rent of Primary Residence and Owners Equivalent Rent of Residences from Services ex-Energy Services. Estimate reflects Bloomberg's calculations following consultation with the Bureau of Labor Statistics (BLS) https://www.bls.gov/opub/hom/cpi/calculation.htm.

Private debt: ongoing resilience in navigating high borrowing costs

The most obvious near-term implication (from delayed rate cuts) for corporate credit investors is how floating rate borrowers will continue to navigate this (prolonged) high cost of capital environment. For the U.S. private debt market, the most recent signaling is encouraging. Using the widely tracked Lincoln International Proprietary Private Markets Database, 4Q2023 data highlighted the third consecutive quarter of a *declining* covenant default rate (Exhibit 4).

For context, Lincoln International is an independent valuation advisor specializing in illiquid alternative investments. Lincoln's Valuations and Opinions Group Proprietary Private Markets Database included approximately 5,000 U.S. operating companies as of 4Q2023, representing over $175 billion of privately held principal and invested capital (primarily by private equity sponsors).

Exhibit 4: The private debt covenant default rate declined again in 4Q2023
Covenant default rate (size-weighted) for the U.S. operating companies in the Lincoln International Proprietary Private Markets Database



Source: BlackRock, Lincoln International Valuations & Opinions Group Proprietary Private Markets Database. As of 4Q2023. Note: A default is defined as a covenant default and not a monetary default. The analysis was performed based on a size-weighted approach, which considered the total net debt balance for each of the portfolio companies that had a defaulting security in the respective quarter.

The flexibility inherent in long-term private debt relationships has likely been a key driver of this declining default rate, as borrowers proactively worked with their lenders to address headwinds from higher interest costs.

In 2023, approximately 18% of the companies tracked by Lincoln International had executed at least one amendment. Of those companies that completed amendments in 2023, two themes stand out to us:

1) The majority of amendments were for deals originated in the low interest rate environment of 2021 (prior to the start of the Fed's rate hiking cycle, which began in March 2022). This underscores the importance of vintage selection, in our view. As Exhibit 5 illustrates, the macroeconomic backdrop (and specifically, the interest rate regime) can have a meaningful impact on fundamentals.

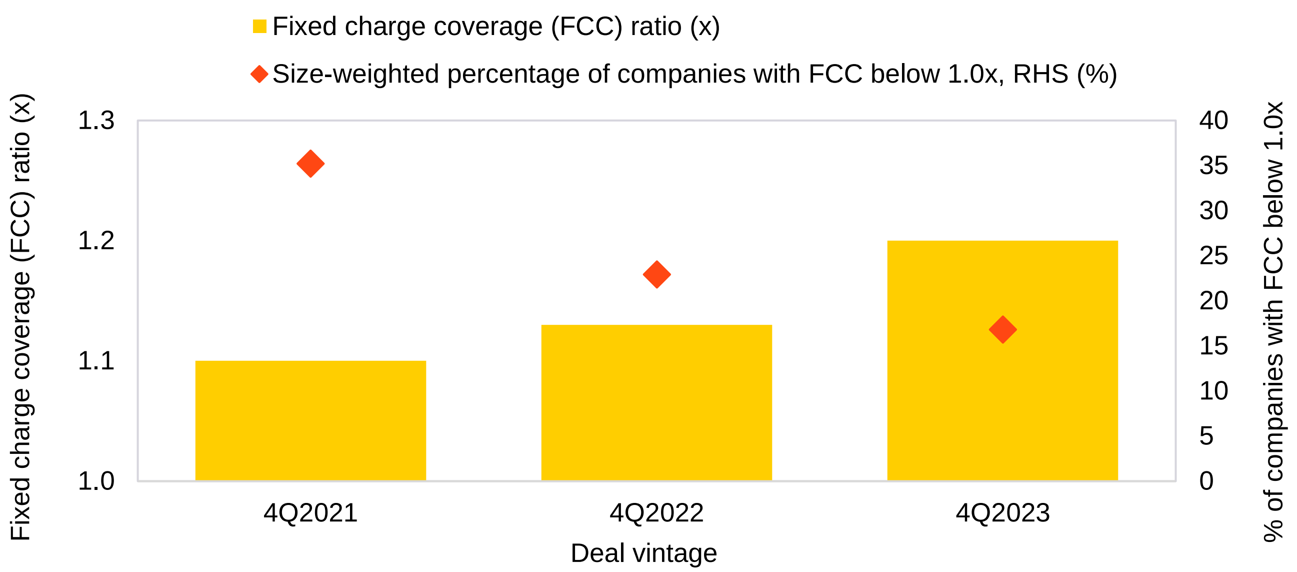
2) 12% of companies completed multiple amendments over 2023, and 33% of these firms were in the Business Services sector. In our view, this underscores the importance of credit and sector selection (i.e., avoiding borrowers that cannot grow in a capital efficient way, outside of ultra-low interest rate regimes, as well as avoiding sectors which may not have strong margins and pricing power).

The flexibility inherent in long-term private lending is a key reason why we expect realized losses in the private debt market will continue to compare favorably to those in the public (syndicated) leveraged finance market – a theme we outlined in our Private Debt Primer.

That said, as we highlighted in our 1Q2024 Global Credit Outlook, default and loss rates in both markets should remain modest by historical standards, given the supportive growth-inflation mix (especially in the U.S.). Additionally, we believe the bulk of the financial strain for floating rate borrowers is likely in the rear-view mirror at this point, given that most of the policy rate hikes occurred in 2022 and 1H2023 (again, Exhibit 1).

Exhibit 5: Fundamentals for deals underwritten in the ultra low-rate environment of late 2021 are more strained, relative to newer vintages

For firms in the Lincoln International Proprietary Private Markets Database: Fixed charge coverage ratios and the percentage of companies with ratios below 1.0x, by deal vintage.

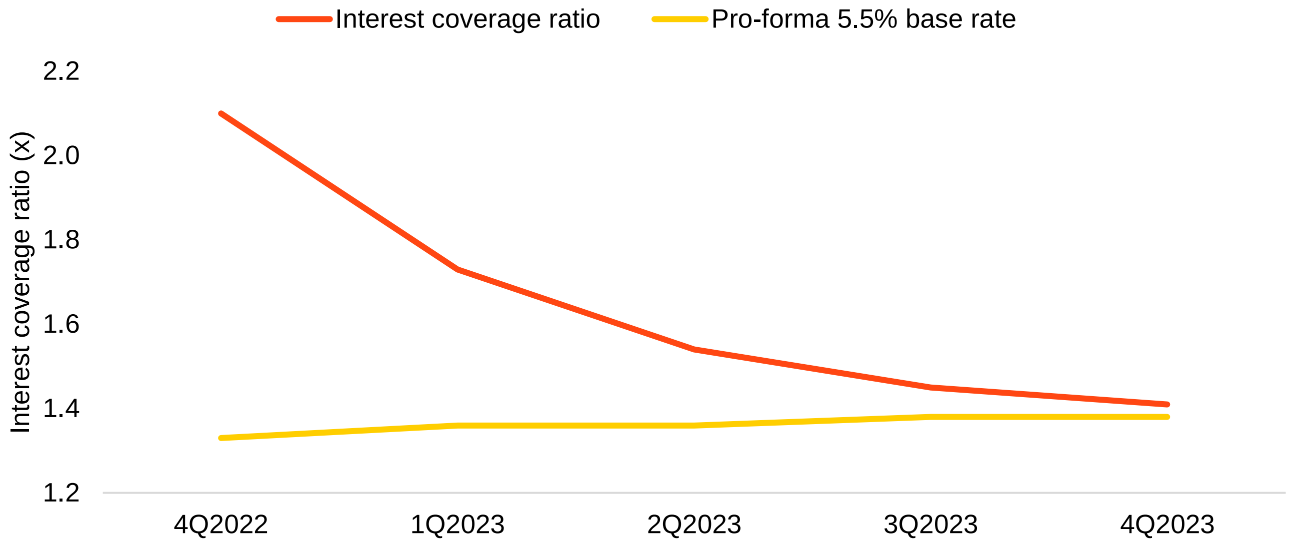


Source: BlackRock, Lincoln International Valuations & Opinions Group Proprietary Private Markets Database. Captures data as of 4Q2023. Fixed Charge Coverage Ratio = (LTM EBITDA – Taxes – Capex) / (LTM Interest Expense + (1% * Total Debt)).

Fundamentals remain stable on a pro-forma basis

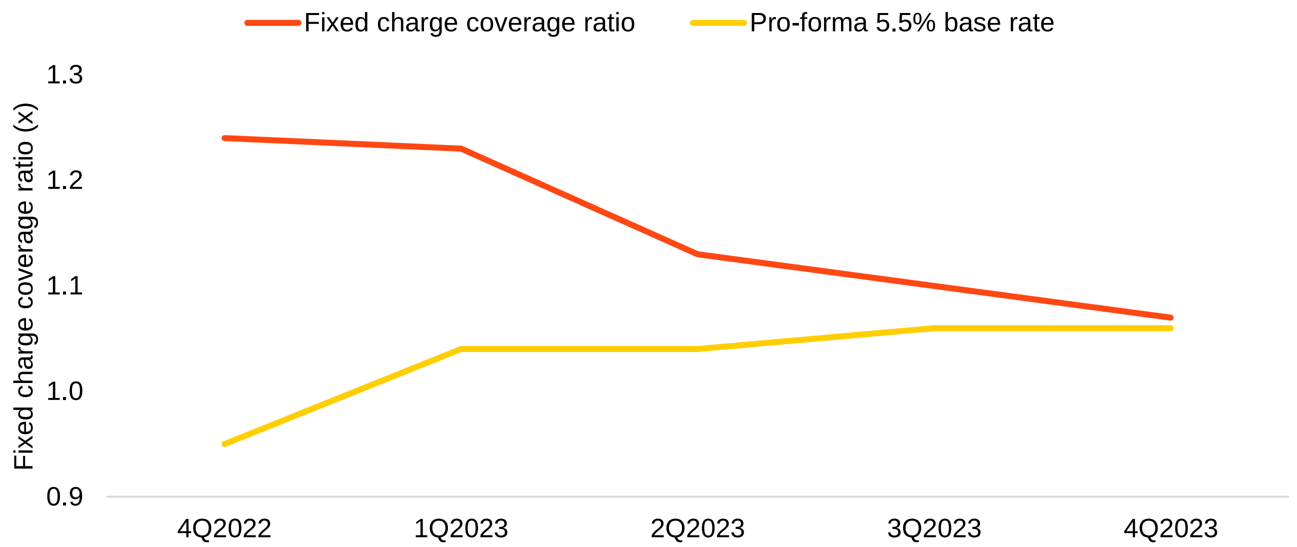
Beyond amendment activity, ongoing fundamentals are also holding in relatively well (i.e., not deteriorating) despite the persistently high cost of capital. For example, average (last twelve months) EBITDA growth for the companies in Lincoln's Database was 4.8% as of 4Q2023. This has helped keep interest coverage (Exhibit 6) and fixed charge coverage (Exhibit 7) ratios in a narrow range on a pro-forma basis, despite no relief (yet) in the form of interest rate cuts.

Exhibit 6: Interest coverage metrics have remained in a narrow range, on a pro-forma basis
Size-weighted actual and pro-forma (using a 5.5% base rate) interest coverage ratio for the portfolio companies in the Lincoln International Proprietary Private Markets Database



Source: BlackRock, Lincoln International Valuations and Opinions Group Proprietary Private Markets Database. Captures data through 4Q2023. Interest Coverage Ratio = LTM EBITDA / Interest.

Exhibit 7: Pro-forma fixed charge coverage ratios have improved slightly vs. year-end 2022
Size-weighted actual and pro-forma (using a 5.5% base rate) fixed charge coverage ratio for the portfolio companies in the Lincoln International Proprietary Private Markets Database



Source: BlackRock, Lincoln International Valuations and Opinions Group Proprietary Private Markets Database. Captures data through 4Q2023. Fixed Charge Coverage Ratio = (LTM EBITDA - Taxes - CapEx) / (Interest Expense + (1% * Total Debt)).

Unless otherwise stated, all reference to $ are in USD.

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