Audax Private Debt

AUDAX PRIVATE DEBT PRESENTS:

Is Your Private Credit Portfolio Ready for a Recession?

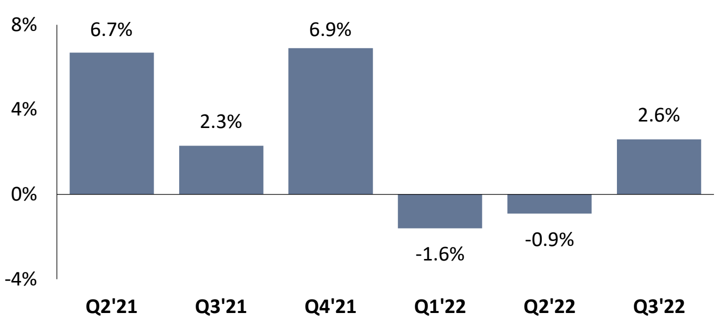
NOV 2022

Market volatility, high inflation, and rising rates have heightened concerns over the near-term economic outlook. With the possibility of a recession increasing, it is critical for managers to have robust risk and portfolio management practices to ensure that portfolios are well-positioned to weather a cycle.

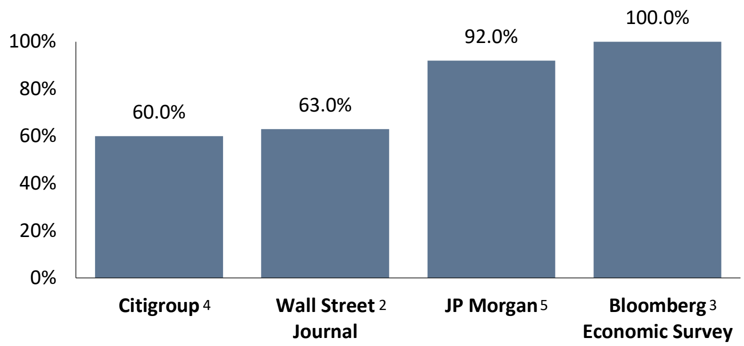
INCREASING PROBABILITY OF A RECESSION

Despite the modest growth of U.S. GDP in Q3 2022, fears of an impending recession continue to rise. A recent survey of economists by the Wall Street Journal has put the probability of a recession in the next 12 months at 63%,[2] while the Bloomberg Economics model projects a 100% probability of a recession.[3] At the same time, rising rates and elevated inflation levels are putting pressure on the financial health of borrowers. It is critical that managers and investors ensure their loan portfolios are well-positioned to navigate the environment ahead.

Quarterly U.S. GDP Growth[1]



Projected Probability of Recession in the Next 12 Months



SAFETY FROM SENIORITY WITHIN THE CAPITAL STRUCTURE

Middle market loans generally offer greater downside protection and resiliency relative to both broadly syndicated loans and high yield bonds, with lower historical defaults and losses, and higher historical recovery rates. Within the middle market, traditional first lien, senior secured loans provide the highest degree of structural protection for investors. These loans rank first in priority for interest payments and principal repayments and are typically secured by substantially all available collateral and equity pledges of the borrower, providing first claim on the value in the case of an out-of-court restructuring or bankruptcy. Moreover, when a borrower begins to face performance or liquidity challenges, protections and covenants within the senior debt holders' credit documents allow them to take corrective actions early. In such instances, sponsor equity and junior cash interest are typically the first levers utilized to solve for liquidity shortfalls, providing cushion for a continuation of senior debt principal and interest payments. Consequently, senior debt has demonstrated lower historical default rates and higher historical recovery rates relative to securities lower in the capital structure.

Traditional, First Lien, Senior Secured Debt Provides the Most Downside Protection within the Capital Structure

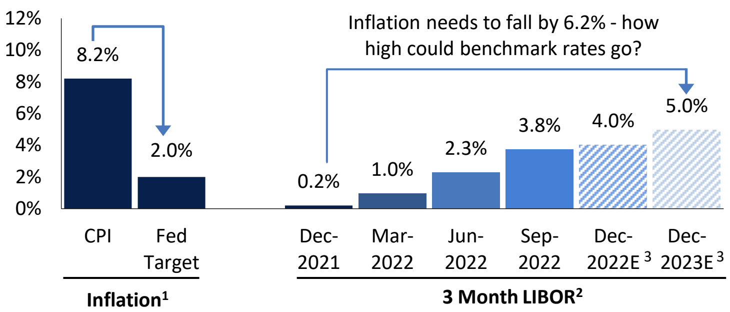
Lowest Risk	Traditional Senior Secured 1st Lien Debt	▸ Priority of payments ▸ Collateral: All assets and stock of borrower ▸ Modest Debt / EBITDA levels	▸ Lower LTV with junior debt & equity cushion ▸ Lower historical default rates ▸ Higher historical recovery rates (~75%)[6]
	Junior Debt	▸ Unsecured; No collateral ▸ Contractually subordinated ▸ Higher Debt / EBITDA levels	▸ Higher LTV with only equity cushion ▸ Higher historical default rates ▸ Lower historical recovery rates (~25-45%)[6]
Highest Risk	Equity	▸ Record high purchase price multiples	▸ Provides cushion for the debt

1) US Bureau of Economic Analysis. 2) The Wall Street Journal, "Economists Now Expect a Recession, Job Losses by Next Year", October 16, 2022. 3) Bloomberg, "Forecast for US Recession Within Year Hits 100% in Blow to Biden", October 17, 2022. 4) Barrons, "The Chance of a Recession Is Rising. Markets Are Shrugging", October 18, 2022. 5) Bloomberg, "JPMorgan Model Says Stocks in Free Fall Mean Recession Is a Lock", September 28, 2022. 6) Represents recovery data for the period 1987-2020 provided by S&P Global LossStats.

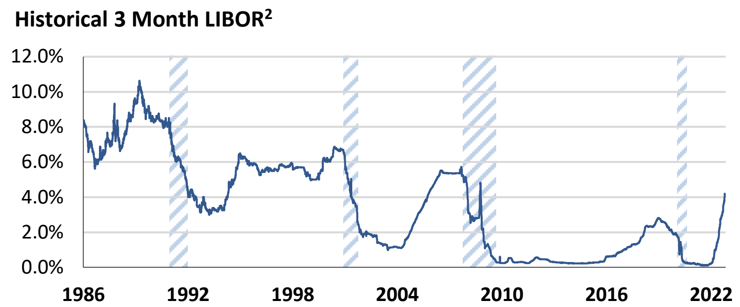
FLOATING RATE LOANS ARE DEFENSIVE IN A RISING RATE ENVIRONMENT

Despite recent Fed rate hikes, the U.S. inflation rate remained at a near-record high of 8.2% for September after hitting an over 40-year high of 9.1% in June.[1] Additional rate hikes will likely be needed to drive inflation down to the Fed's target of 2%. Lending benchmark rates (LIBOR, SOFR) have already increased by ~4% since 2021,[2] resulting in negative returns for fixed rate bonds while driving higher yields for floating rate loans. However, although higher yields generally drive higher returns for loan investors, portfolios must be closely monitored as rising rates and high inflation can put pressure on the financial health of borrowers.

How Far Will the Fed Go to Stave Inflation?



Recessions Have Historically Followed Periods of Rising Rates

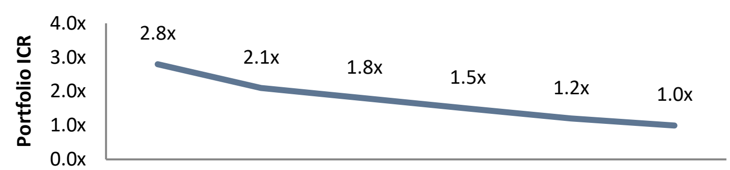


STRESS-TESTING TO ENSURE PORTFOLIO HEALTH & SAFETY

A critical metric that direct lenders often use to assess and stress-test the health of their portfolios is borrower interest coverage ratio (ICR = (EBITDA - CapEx) / Interest Expense). ICR is a profitability metric that measures a company's ability to pay the interest due on its outstanding debt. Managers should perform extensive stress testing on this metric, among others, to ensure that their portfolios remain well-positioned through a down cycle. Heading into this latest period of economic uncertainty and rising rates, we believe that a portfolio with an ICR of 2.75x+ has sufficient cushion to weather the environment ahead.

Stress-Testing Ensures a Well-Positioned Portfolio

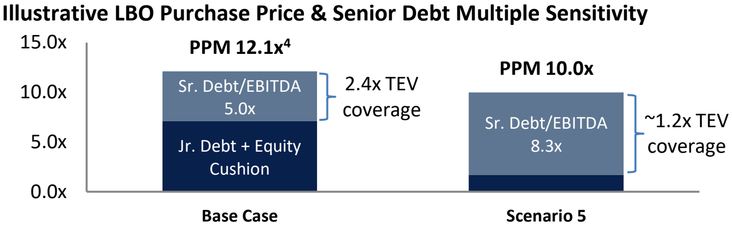
Illustrative Interest Coverage Ratio Sensitivity Analysis



	Base Case	Scenario 1	Scenario 2	Scenario 3	Scenario 4	Scenario 5
Base Rate:	-	4.25%	4.50%	4.75%	5.00%	5.25%
EBITDA Δ:	-	0.0%	(10.0)%	(20.0)%	(30.0)%	(40.0)%

Total Enterprise Value Coverage Provides Additional Cushion

Illustrative LBO Purchase Price & Senior Debt Multiple Sensitivity



	Base Case	Scenario 5
EBITDA Δ:	-	(40.0)%
PPM Δ:	-	(15.0)%

In the above illustrations, a portfolio with a base case ICR of 2.8x would maintain 1.0x interest coverage even under the severely stressed scenario with base rates rising to 5.25% and a (40)% decline in EBITDA. If junior debt interest payments were blocked, additional free cash flows could increase the portfolio's ICR by ~0.25x to 0.50x. Assuming a base case senior debt leverage multiple of 5.0x, a (40)% decline in EBITDA would cause leverage to rise to 8.3x; however, we still would expect enterprise valuation multiples to cover senior debt by ~1.2x, providing protection in a forced sale or restructuring.

CONCLUSION

Floating rate, senior secured first lien loans can offer structural protections for investors during periods of both rising rates and economic uncertainty, but robust risk and portfolio management practices are also critical to ensure that loan portfolios remain healthy and performing. In our experience, these are the key elements to preserving capital across cycles.

For illustration purposes only. 1) U.S. Bureau of Labor Statistics. 2) S&P Capital IQ as of November 4, 2022. 3) Projections based on latest forward curve data from Bloomberg as of November 3, 2022. 4) Pitchbook LCD Leveraged Buyout Review 2Q 2022.

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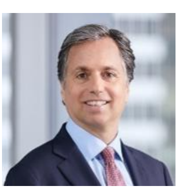
IMPORTANT NOTICES

AUDAX SENIOR DEBT LEADERSHIP



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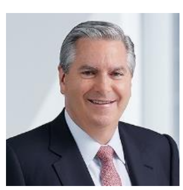

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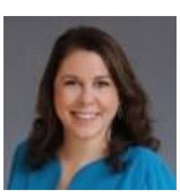

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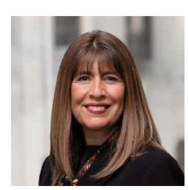

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