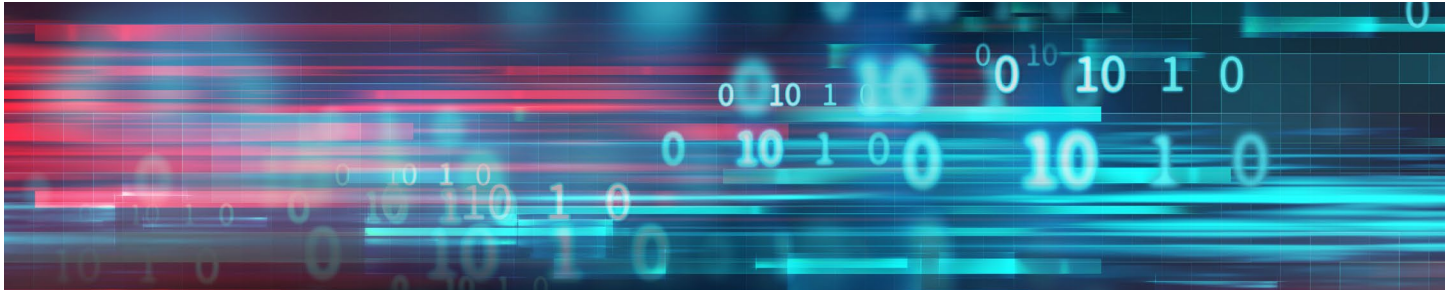


# Is Direct Lender Optimism Camouflaging Problem Loans?

**Jeffrey Diehl**

Managing Partner  
& Global Head  
of Investments

**Bill Sacher**

Partner & Head  
of Private Credit

**KEY TAKEAWAYS**

- Direct lenders' optimism or self-interest can camouflage problem loans, delaying defaults and inflating portfolio values, which can lead to overstated fund returns
- Investors should proactively apply five metrics: high loan-to-value (LTV), low interest coverage ratios (ICR), cash-to-PIK shifts, declining EBITDA/revenue, and material loan amendments, as they seek to accurately identify hidden loan risks
- Recent cases, such as Pluralsight, illustrate how quickly camouflaged loans can unravel, emphasizing the critical need for careful diligence beyond reported valuations and interim returns

The four most dangerous words in investing are “this time it’s different.”

History tells us that periods of inflation and rising rates are typically followed by a rise in defaults and bankruptcies of levered companies, which in turn widens return dispersion of direct lending funds. Over the past few years, we have witnessed the former without evidence of the latter. So, has something structurally changed to make default history a poor guide?

We don’t think so.

Indeed, there is substantial evidence that suggests direct lenders – through optimism and/or self-interest – are camouflaging problem loans, postponing defaults and bankruptcies, leading to potential over-statement of loan valuations, portfolio yields, and fund returns.

As a follow-up to our article [In Private Credit Manager Selection, the Devil is in the Diligence](#), we advise investors to systematically assess the left tail of lender loan books by examining individual loans rather than relying on headline fund returns and portfolio averages.

By applying five tests, investors can unmask potentially problematic loan portfolios that can help to differentiate top-tier direct lenders from marginal ones. We also offer a concrete example of a high-profile camouflaged problem loan that would have been spotted by these tests.

## Alpha in Direct Lending

Direct lenders seek to generate top-quartile returns by assembling portfolios of money-good loans that pay quarterly cash interest and repay principal at maturity. Direct lenders can't generate right-tail equity upside from their deals, they can only avoid left-tail losses.

Managers who have consistently produced top quartile results have done so by avoiding losses. This generally means they possess a valuable edge in originating, underwriting and winning loans with superior private companies. Lenders that lack an edge in any of these categories must compromise on company quality or price and terms as they look to deploy capital. While the latter sin is the lesser of the two evils, either approach creates a formidable challenge for producing top-tier results.

Unfortunately, it is typically hard for investors to assess the credit risk of direct lending portfolios until loan losses appear. This can take time and can be delayed by lender optimism. This article is designed to give investors numerous tools to spot problem loans that can lead to overstated returns.

## Interim Returns of Direct Lending Portfolios

On an interim basis, private credit returns derive from interest accruals and quarterly loan valuation marks. Direct lenders understandably accrue interest for companies making cash interest payments. However, they must make judgements about whether to accrue interest for companies that are not making cash interest payments but have flipped to paying some/all interest as payment-in-kind (PIK).

PIK interest is effectively additional debt that gets added to the existing stack of a borrower that may already be struggling to make cash interest payments. The rise in base rates from 0% in early 2022 to 5.5% by mid-2023<sup>1</sup> caused an uptick in PIK flips as more companies struggled to make interest payments on their floating rate debt.



**False optimism can cause lenders to delay markdowns and non-accruals in favor of offering loan modifications that buy time**

Direct lenders value loans quarterly based on an estimate of fair market value. Since private credit loans are floating rate, their valuations are more sensitive to idiosyncratic factors than to changes in base rates or credit spreads. Absent a major macroeconomic dislocation, direct loan values are primarily determined by the fundamental performance of the underlying company. If performance has been weak, lenders must decide whether to hold the loan at par or mark it down and if so, by how much.

Since direct lending alpha is eroded by left-tail loan losses, investors should pay close attention to companies paying PIK interest and/or those whose valuation marks seem inconsistent with business fundamentals. Lender valuations are a key driver of management/incentive fees, fund leverage covenants, and fund performance, so lenders are generally reluctant to book non-accruals, markdowns, defaults, and bankruptcies. False optimism can cause lenders to delay markdowns and non-accruals in favor of offering loan modifications that buy time, hoping company fundamental performance improves or base rates decline.



## Five Tests to Identify Problem Loans

How can investors determine if a direct lender is being too optimistic about problem loans through unrealistic interest accruals or valuation marks? No single measure provides a magic bullet. In fact, any single metric could lead to a false sense of comfort. However, we think investors can uncover most problem loans by analyzing the following five key metrics. We would encourage investors in direct lending funds to use these tests to dig into the details of a loan book before committing to a manager.

### **LOAN-TO-VALUE (LTV) ABOVE 60%**

Loans representing more than 60% of company enterprise value should be flagged for further analysis to ensure they are fairly marked and have a proper interest accrual status, especially if the LTV has risen over time.

While some exceptional businesses – those with predictable and growing, high margin revenue – can tolerate an LTV above 60%, we don't believe this high of an advance rate provides enough cushion to reliably avoid losses.

Our experience tells us that investors should typically be concerned if a loan book has more than 10% of the companies with greater than 60% LTVs. But this metric is not foolproof. For example, software company loans underwritten using annualized recurring revenue instead of cash flow often have very low LTVs. Don't worry – problem loans should get flagged by one or more of the other metrics below.

### **INTEREST COVERAGE RATIO (ICR) BELOW 1**

Companies with cash interest that exceeds their pre-tax earnings (EBITDA) should be a major flag, as this indicates an inability to service required cash interest from operating cash flow. These companies must use balance sheet cash to pay interest or seek lender relief by paying PIK interest.

A recent Kroll analysis indicates that 27% of leveraged loans have ICR below 1, largely due to the rapid rise in base rates during 2022-2023.<sup>2</sup> While some companies hedge a portion of their floating rate debt into fixed rate, those hedges ultimately expire leaving companies exposed to base rates. ICR below 1 should be a material cause for investor concern. Our rule of thumb is that a healthy loan book should have very few, if any, companies with an ICR below 1.

### **LOANS THAT FLIPPED TO PIK**

Loans that were issued assuming a borrower would pay cash interest but then subsequently flipped to PIK interest should be a cause for concern. These companies are struggling to service their existing debt, and PIK interest simply adds more debt causing LTV to rise.

We recently analyzed the four largest business development companies (BDCs),<sup>3</sup> direct lending funds registered with the US Securities and Exchange Commission. The average percentage of their total cost invested in loans paying some or all PIK interest is more than 21%, up substantially from a few years ago. A decent portion of these loans were not PIK by design, but rather cash-to-PIK flips, indicative of companies struggling to pay cash interest following the rise in base rates. Investors should understand if direct lenders are appropriately accruing interest for these loans. From our standpoint, a healthy loan book should have very few, if any, companies that have flipped from cash payer to PIK payer.

Lenders sometimes will avoid PIK amendments by employing two tactics, both of which can overstate yields/returns.

First, lenders may extend new PIK debt to a company (or the parent holding company) that is struggling to pay cash interest. This new debt can be used to pay cash interest of the current debt. These new loans often have high headline rates and seem attractive on the surface. However, investors should be sure to add this new obligation to LTV calculations because it makes a future default more likely.



**Loans that were issued assuming a borrower would pay cash interest but then subsequently flipped to PIK interest should be a cause for concern**

The second tactic is for lenders to offer to swap some existing debt for preferred equity with a high accruing interest rate or dividend. While these swaps seem attractive on the surface as they appear to reduce LTV, investors should include the new interest or dividends when calculating ICR.

The largest BDCs show evidence of both tactics as they are accruing high rates of dry income from new PIK debt and equity dividends.<sup>4</sup> In our view, these time-buying tactics likely do little or nothing to reduce the ultimate probability of default.

## **REVENUE OR EBITDA DECLINES FROM ENTRY TO CURRENT**

Loans extended to companies where revenue or EBITDA has declined from entry to current should be flagged for further analysis. Investors should also determine if adjustments to company EBITDA have increased from entry since this dynamic could mask declines in operating cash flow.

Deteriorating company fundamentals typically lead to declining enterprise value, rising LTV, and challenges paying cash interest. Any company with eroding fundamentals is more likely to experience a markdown in its EBITDA multiple given the correlation between multiples and growth rates.

In cases with declining fundamentals, investors should determine whether lenders have taken a haircut to the entry EBITDA multiple and a resulting loan markdown. A recent Kroll analysis indicates that about 21% of leveraged loans have declining EBITDA and about 16% have declining revenue.<sup>5</sup> In our view, a healthy loan book has very few, if any, companies with declining fundamentals.

## **MATERIAL LOAN AMENDMENTS**

Direct lenders typically charge management fees based on the value of the underlying assets, so they have an incentive to avoid shifting loans to non-accrual and/or having companies default on a payment.

When companies are at risk of defaulting, lenders often agree to material loan amendments to avoid default. Investors should determine what percentage of a loan book has had a material amendment. We think a healthy loan book has very few, if any, material loan amendments designed to avoid a default.

## Putting it Together

Identifying loans that meet these criteria can help investors assess the overall percentage of a portfolio that has potentially invested in problem loans.

It's a truism that smoke is usually accompanied by fire. For example, lenders who deceive themselves about problem loans may also be using highly adjusted EBITDA to support their carrying values and accrual policies. If investors aren't convinced of a loan book's quality using the tests above, it may suggest the portfolio won't pass the smoke test.

## High-Profile Camouflaged Problem Loan

In mid-2024, the Financial Times<sup>6</sup> reported the details of a high-profile take-private buyout deal that became a camouflaged problem loan and ultimately a default.

In 2021, a prominent private equity firm bought Pluralsight, an education software company, and subsequently combined it with another business. In total, the private equity firm and its co-investors infused \$4 billion of equity and a group of seven prominent direct lenders extended \$1.7 billion in debt.

Pluralsight's fundamentals started to deteriorate as it experienced end-market challenges. At year-end 2023, six of the seven direct lenders valued the loan at 95-99 cents, while another firm had marked it in the high 80s. As of March 31, 2024, lenders valued the loan between 84-97 cents.<sup>7</sup>



**While it is possible company fundamentals eroded massively in April and May before the June 2 private equity write-off, the first quarter lender valuations seem optimistic in hindsight**

In late May and early June 2024, media reports said the private equity firm had written its entire \$4 billion equity stake to zero.<sup>8</sup> On June 30, 2024, the lending group marked the loan down to 45-50 cents.<sup>9</sup> Late the following month, the lenders took control of the business, extinguishing 71% of their \$1.7 billion in debt while infusing several hundred million dollars in equity.

The original loans were marked to 29 cents in the third quarter of 2024. It is difficult to comprehend how lenders marked the loan at more than three times this value in the first quarter. While it is possible company fundamentals eroded massively in April and May before the June 2 private equity write-off, the first quarter lender valuations seem optimistic in hindsight.

Based on our observations as an active investor in private companies and funds over five decades, we expect more situations like Pluralsight to unfold in coming quarters as high debt loads and/or higher base rates for longer create stress at companies with challenged fundamentals.

## In Summary

Despite rising rates and a slowing economy, defaults and bankruptcies of levered companies have remained benign. As a result, interim direct lender return dispersion has been low. We believe this is due to some lenders optimistically camouflaging problem loans. Investors who want to protect against left-tail risk would be well served by digging into the key metrics that we believe distinguish top-tier direct lenders from those that camouflage problem loans. ■

1. [FOMC's target range for the federal funds rate](#)
2. [Private Credit: Q4 2024 Middle Market Borrower Surveillance Compendium—5% at Risk](#), KBRA, February 4, 2025
3. Public company data available via the SEC's Electronic Data Gathering, Analysis, and Retrieval ("EDGAR") system. Most recent company information as of June 30, 2024. The four largest BDCs by assets as of such date included: Ares Capital Corp (ARCC), Blue Owl Capital Corp (OBDC), FS KKR Capital Corp (FSK), Blackstone Private Credit Fund: BCRED. For statements of comparison to earlier periods, Adams Street has reviewed historical information through December 31, 2021. There can be no guarantee that analysis of other BDCs would have produced similar results.
4. Ibid
5. Ibid
6. [Vista and co-investors lose \\$4bn in Pluralsight restructuring](#), Financial Times, August 22, 2024
7. [A borrower's struggles highlight risk lurking in a surging corner of finance](#), Financial Times, July 10, 2024
8. [Vista Equity writes off PluralSight value, after \\$3.5 billion buyout](#), Axios, May 31, 2024
9. [Vista Equity's Pluralsight to Cede Control to Private Lenders](#), Wall Street Journal, July 29, 2024

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