KBRA DLD Default Index: 2023 forecast is 2.5% for sponsored deals

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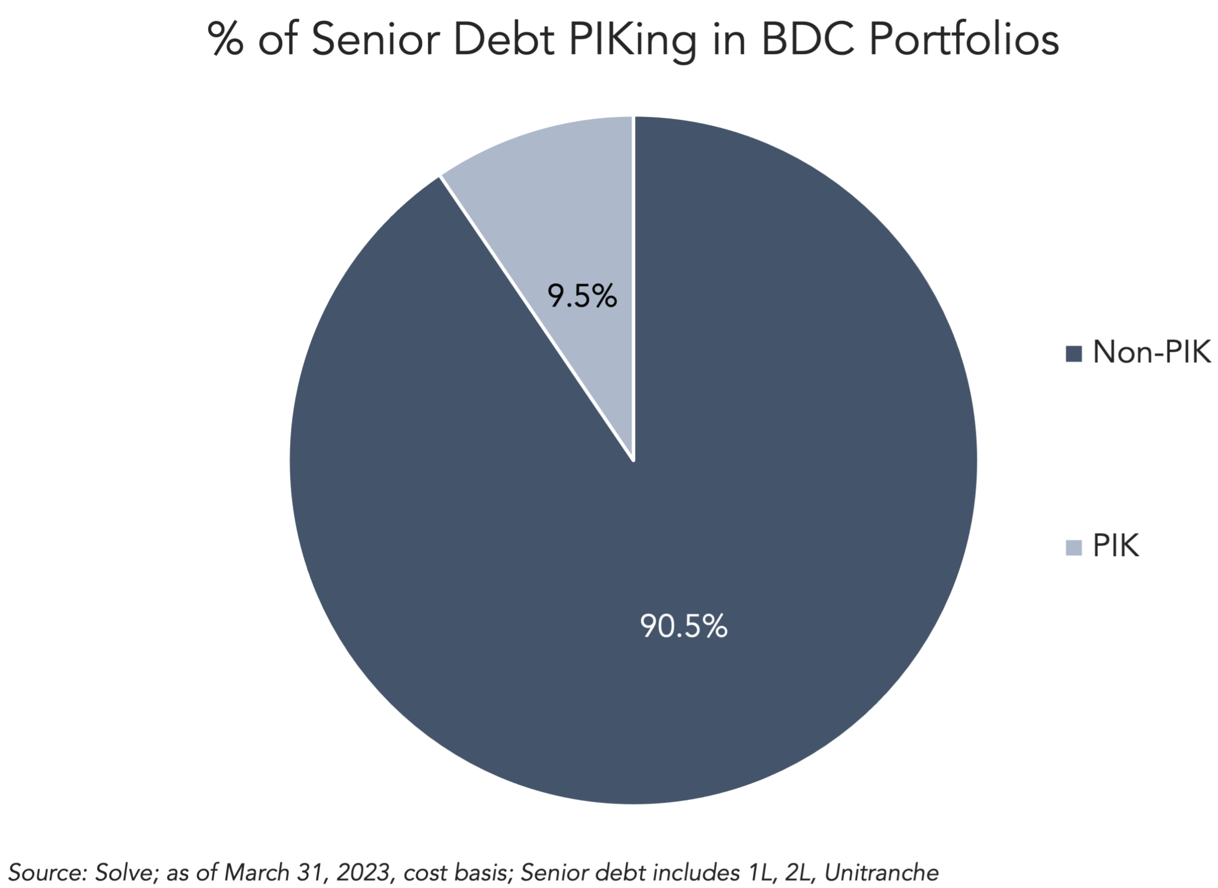
Table 1

KBRA DLD Default Index			
	All	**Sponsored**	**Non-Sponsored**
YTD	0.9%	1.2%	0.8%
2023 Forecast	2.5%	2.5%	2.3%

Chart 1



KBRA DLD's 2023 default forecast is 2.5% for sponsor-backed direct lending loans, equating to roughly 30 defaults against the roughly 1,200 sponsored borrowers in the **KBRA DLD Default Index**.

Table 1

The year-to-date (YTD) sponsored rate is 1.2%, which includes 14 defaults—mainly bankruptcies. **Searchlight Capital Partners**-backed **MediaMath** marked the most recent default at the end of June.

For non-sponsored direct lending, *DLD* projects a 2023 default rate of 2.25%. This segment has experienced 11 defaults so far this year against more than 1,400 non-sponsored issuers in the Index, translating to a 0.8% rate YTD.

For the overall Index, the 2023 forecast is 2.5% and stands at 0.9% YTD. The Index is curated by *DLD* and comprises private loans to more than 2,600 companies.

Interest threat

Swift and steep interest rate hikes over the last year have created the biggest danger to cash flows. Many issuers are now grappling with borrowing costs of roughly 12%, up from about 8% a year ago in the private market.

DLD's ratings parent, KBRA, published separate research last month highlighting movement across interest coverage ratios. In the rating agency's cohort of middle market corporate credit assessments, last October's 12% stress test pushed the percent of borrowers with coverage ratios <1.0x to 38% from 23%, according to the research.

Against an updated 13% stress test, the percent of borrowers with <1.0x ratios ticked up to 39%, while a 13.5% stress test increased the <1.0x group to 40% of the cohort. (Note that about 15-20% of the group comprises recurring revenue loans.) The message: The damage is already done.

The pressure of higher borrowing costs can also be seen in the form of PIK payments as borrowers flip to this option or some combination of PIK/Cash-Pay, as seen during the early days of the pandemic.

According to *Solve*, 9.5% of outstanding senior debt investments (1L, 2L, Unitranche) was PIKing across nearly $230 billion of senior assets across BDC portfolios in the first quarter on a cost basis. The likelihood of more companies emerging with PIK pricing in the quarters ahead is strong as base rates remain elevated. Unlike the relatively short-lived financial crunch during the pandemic, higher borrowing costs are here to stay for some time.

Chart 1

Private equity-backed companies typically have more aggressive capital structures and loan terms than non-sponsored borrowers, however PE firms have more resources in terms of access to capital, expertise and relationships to drive portfolio companies through rough patches.

During the Covid-era, direct lenders reined in terms, making the 2020-2023 class of sponsored loans one of the most conservative since the Global Financial Crisis. Leverage, a key measure of appetite for risk, has generally trended downward over the past 24 months, by roughly 1x, according to *DLD*. Moreover, vintages pre-dating 2020 were structured more conservatively relative to the aggressively arranged deals in the syndicated loan (where about 80% of volume is covenant-lite) and high yield markets.

One of the main tenets of the private market is the close-knit relationship sponsors enjoy with a smaller group of lending partners. The next several quarters will certainly test those bonds.