U.S. Private Credit Exposure Rising in Sectors with Stretched Valuations

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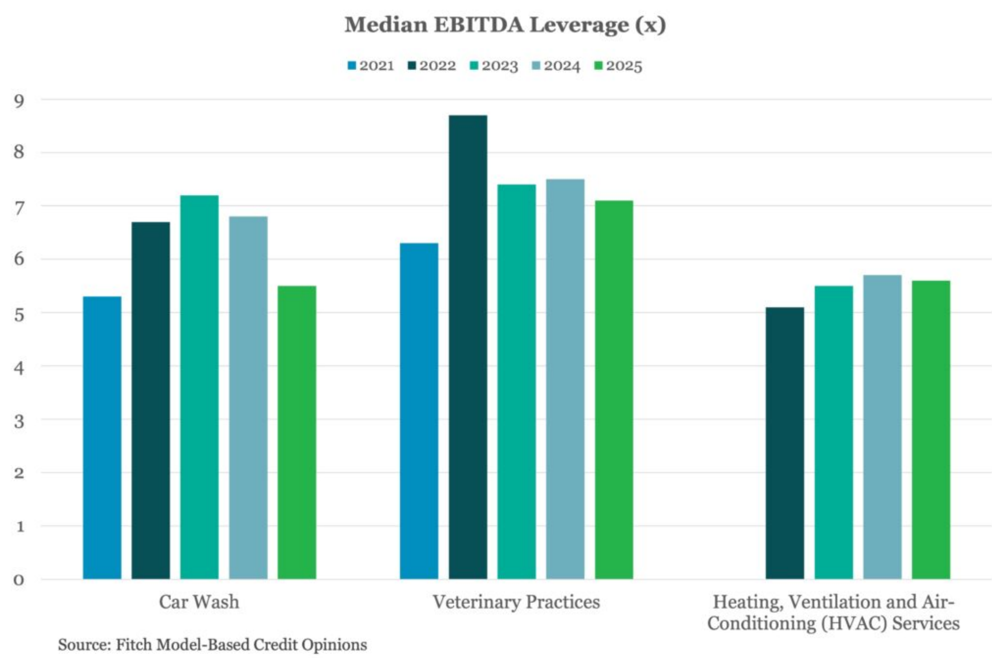

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Direct lenders' preference for non-cyclical, stable recurring cash flows has increased their exposure to corporate sectors with higher EV/EBITDA multiples, which could exacerbate credit risks in a market downturn. Private equity sponsors are more likely to walk away from a struggling company when equity cushions shrink, while a potential reset in valuation multiples will negatively affect creditor recovery prospects in case of distress.

Direct lenders tend to favor issuers in non-cyclical sectors with predictable cash flow, such as software, healthcare and services businesses, given a lack of secondary market loan liquidity that limits exit options in the event of cyclical stresses. Within Fitch's model-based credit opinion (MCO) portfolio, which consists largely of middle-market direct lending loans, the combined weight by issuer count of cyclical sectors (including Chemicals, Energy, Metals & Mining, Transportation and Building & Materials) is only 9.2%, compared to 18.4% in Fitch's U.S. Institutional Leveraged Loan Universe (excluding Financials).

Since 2021, Fitch has observed outsized investment activity in certain sub-sectors including car washes, veterinary practices, and heating, ventilation and air-conditioning (HVAC) services. Representation of these sub-sectors in Fitch's MCO portfolio has grown 100%, 200%, and 1,050%, respectively compared to total portfolio growth of around 45%.