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Why Private Credit Stress Shows Up in Valuations Before Defaults

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As private credit has grown into a significant source of financing, assessing the value of these instruments has become increasingly important, despite the lack of transparent market pricing. Private credit generally refers to loans made outside traditional lending channels, often to private equity-backed and middle-market companies, and can range from senior secured debt to more complex financing structures. Because they rarely trade publicly, determining their fair value requires a closer look at the borrower's financial health, credit risk, and current market conditions.

A borrower does not need to miss an interest payment or breach a covenant for its debt value to change. That distinction increasingly matters more in private credit, where valuation shifts can begin well before a visible, discrete event like a default.

Deteriorating credit quality is usually more gradual. It may first appear in weaker operating results, declining liquidity, reduced covenant headroom, or lower enterprise values. By the time a borrower formally defaults, several of the assumptions supporting its previous valuation may already have changed.

For valuation professionals, the question is, therefore, not simply whether a loan is still performing. It is whether the assumptions supporting the prior-period mark remain appropriate at the current measurement date. Fair value requires a market-participant perspective and consideration of current information, including credit risk, interest rates, and other capital markets conditions. For investments with limited observable trading data, that often means determining whether changes in the borrower or the market warrant changes to unobservable inputs rather than simply carrying forward the prior quarter's assumptions.

A Performing Loan Can Still Be Worth Less Than Par

One of the easiest traps in private credit valuation is allowing contractual performance to stand in for fair value. A loan can remain current on principal and interest while its risk profile deteriorates. Suppose a lender originally provides $40 million of debt to a company with an enterprise value of $100 million. At origination, the loan-to-value ratio (LTV) is 40%, providing a substantial equity cushion.

A year later, the company is still making its payments, but its earnings outlook has weakened and comparable-company multiples have declined. If the enterprise value falls to $70 million while debt remains approximately unchanged, LTV has increased to roughly 57%.

Nothing has defaulted. The borrower may still follow every covenant. But the lender's downside protection has changed considerably.

That does not automatically dictate a particular markdown. It should, however, trigger a

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reassessment of the inputs supporting the valuation. Is the original credit rating still appropriate? Would a market participant require a higher yield today? Has expected recovery changed? Is the borrower still likely to refinance the debt on acceptable terms at maturity? If the answer to those questions has changed, the valuation may need to change as well.

Look for Deterioration Before the Credit Event

Valuation professionals should avoid treating a missed payment or covenant breach as the starting point for credit analysis. Those events can confirm a problem that has been developing for several quarters. A more useful exercise is to identify what has changed since the previous valuation date and determine whether those changes would affect a market participant's assumptions.

Some of the earliest indicators may appear in operating performance. Revenue growth may be slowing relative to underwriting expectations. EBITDA may be missing budget. Customer churn may be increasing, margins compressing, or working-capital requirements consuming more cash than projected.

In other cases, deterioration is more visible in the capital structure through declining interest coverage, increased revolver usage, shrinking liquidity, or reduced covenant headroom.

None of these factors should be evaluated mechanically. A temporary earnings miss is different from a change in the borrower's competitive position. An increase in leverage from a planned acquisition differs from leverage rising because EBITDA has declined. The valuation analysis should distinguish between volatility that does not materially change credit risk and developments that alter the expected return or recovery available to the lender.

Market information can provide another important check. Even when a private loan itself does not trade, valuation professionals may have access to pricing on comparable loans, broadly syndicated credit, recent private debt originations, or other instruments with

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similar risk characteristics. Changes in public-company valuations and sector transaction multiples can also affect the enterprise-value cushion supporting a loan.

The objective is not to force private assets to move in lock-step with public markets. It is to determine whether observable market changes provide information that a market participant would consider when pricing the private instrument.

An Unchanged Mark Is Still a Valuation Conclusion

A stable valuation may be entirely appropriate. But it should result from updated analysis rather than the absence of a formal negative (or positive) event.

This becomes especially important when surrounding market conditions have changed significantly. If spreads have widened for comparable credits, the borrower's earnings have weakened, or the relevant sector has been repriced, an unchanged valuation deserves the same level of support as a markdown.

A useful question for the practitioner is: Why would a market participant still require the same return for this credit today?

There may be a strong answer. The borrower may have substantial liquidity, low leverage, recurring revenue, a defensible competitive position, or significant covenant protection. A sponsor may have demonstrated both the capacity and willingness to contribute additional capital. The debt may sit high enough in the capital structure that changes in enterprise value have little effect on expected recovery.

In those cases, maintaining the prior mark can be reasonable. What becomes difficult to support is stability by inertia. A prior-period yield, credit rating, or enterprise-value assumption should not remain unchanged simply because the loan continues to pay according to its contractual terms.

The 2025 International Private Equity and Venture Capital Valuation Guidelines similarly emphasize calibration at subsequent measurement dates and the need for valuation assumptions to evolve as company performance and market conditions change.

Pressure-Test the Assumptions, Not Just the Output

When early signs of deterioration appear, valuation professionals can gain more from pressure-testing the underlying assumptions than from debating a single point estimate.

A practical review should address five areas:

1. *The underwriting thesis.* Is the borrower performing against the assumptions made when the loan was originated? Identify which parts of the original thesis have changed rather than relying solely on current compliance with loan terms.

2. *Credit quality.* Revisit the borrower's internal or "shadow" credit rating using current leverage, coverage, liquidity, and operating performance. Even a modest deterioration in credit quality can affect the market yield appropriate for the instrument.

3. *Market yield.* Consider whether current pricing for comparable risk indicates that market participants would demand a different return. A loan will decline in value when its required market yield increases, even if the borrower continues to make all contractual payments.

4. *Enterprise value and recovery.* Reassess the value supporting the debt and calculate the resulting LTV. Then test recovery under downside scenarios rather than assuming the current enterprise value remains available if performance deteriorates further.

5. *Refinancing risk.* Evaluate whether the borrower could refinance the instrument under current market conditions. A loan that appears manageable based on current cash interest may present significantly greater risk if repayment at maturity

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depends on refinancing at materially higher rates or leverage levels.

The purpose is not to manufacture volatility in the valuation. It is to understand which assumptions would have to remain true for the existing mark to remain supportable.

Use Downside Scenarios Before They Become the Base Case

Scenario analysis is particularly useful because private credit deterioration rarely happens all at once.

Consider a borrower with adequate coverage today but little room for further earnings deterioration. The base case may still support repayment at par. A moderate downside case, however, could produce materially higher leverage, lower coverage, and a refinancing requirement that the borrower would struggle to meet.

That downside case should not automatically replace the base case. It should inform the risk assessment.

Valuation professionals can test changes in EBITDA, market multiples, interest expense, and refinancing costs individually and in combination. They can also examine the amount of equity cushion remaining at different enterprise values and estimate recovery across potential restructuring outcomes.

This exercise can reveal sensitivities that are not obvious from current payment status alone. Two loans carrying the same valuation mark may have very different risk profiles if one has substantial downside protection while the other requires nearly every base-case assumption to hold.

Scenario analysis can also help distinguish a temporary performance problem from a valuation issue. If reasonable downside scenarios continue to show strong debt coverage and recovery, a stable mark may be supported even amid broader market weakness. If modest changes in assumptions materially impair recovery, the valuation should reflect that increased risk before a default makes the conclusion obvious.

Documentation Should Explain What Changed

For Level 3 investments, where significant valuation inputs are unobservable, documentation becomes particularly important.

A strong valuation file should do more than state that the borrower remains current or that no covenant breach occurred. It should explain what information was considered, what changed since the previous measurement date, and why those developments did or did not affect the conclusion. If the valuation remains unchanged despite weaker performance, the analysis should explain why. If an internal credit rating was maintained, the file should demonstrate how current operating and leverage metrics support it. If the selected market yield remains constant despite wider market spreads, the analysis should explain why.

The same discipline applies when a mark changes. The valuation should clearly bridge changes in company performance, market conditions, or credit risk to the assumptions used in the model.

Calibration and backtesting can strengthen that process. Calibration connects the valuation methodology and inputs to the economics of the original transaction and provides a framework for assessing subsequent changes. Calibration should consider both company-specific developments and broader changes in economic and capital market conditions. Backtesting compares actual outcomes with prior valuation assumptions and can help identify areas where the process consistently overestimates or underestimates risk. Both are emphasized in the AICPA's guidance for valuing portfolio-company investments.

Valuation Should Lead, Not Follow, the Default

Private credit valuations should not be expected to predict every default. They should, however, respond to information before a default becomes the only evidence that credit quality has changed.

For the valuation practitioner, that means looking beyond whether the borrower made its most recent payment. Operating performance, leverage, liquidity, market yields, enterprise value, refinancing capacity,

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and expected recovery should be reassessed as conditions change. An unchanged mark can be every bit as defensible as a markdown, but it should be supported by current evidence.

The strongest private credit valuation processes do not wait for a formal impairment event to begin asking difficult questions. They identify where assumptions are changing, test whether the lender's economics have changed with them, and document the conclusion before the credit event arrives. ◆

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