

Direct Lending: Lower Rates Would Add Cushion to Metrics, but Growth Support More Significant

As potential actions by the FOMC to lower the federal funds target over the coming months and quarters would be a clear positive for private credit borrowers' credit profiles, a key question is magnitude of the likely effect in context of the credits and the macro environment. Lower rates would be welcome support for the market characterized by limited cash flow cushions and PIK conversions (which if involve amendment of original terms are deemed selective defaults). In this market comment, we estimate the magnitude of the effect on credit metrics and consider broader credit implications for the asset class.

The current forecast for SOFR troughs at about 3.1% at the end of 2026, a decline of about 120 basis points from the current level of 4.34%. We estimate the positive effect this decline would have on interest coverage, fixed charge coverage and free cash flow/debt ratios for a typical direct lending borrower profile at the higher end of the total leverage range. For the typical profile, we assume total leverage of 7.0x, spread vs. SOFR of 500 basis points, EBITDA margin of 15%, capital expenditures as a percentage of revenue of 1.5%, and working capital/other cash uses as a percentage of revenue of 1%.

The result indicates reduction in interest expense of about 13%, as interest amount is largely driven by the spread. As outlined in Exhibit 1, effect on the ratios is positive but not significant enough to materially enhance credit profiles. The key factor for credit strength and returns in direct lending continues to be top line growth of borrowers driving deleveraging. A macro environment supportive of growth in the middle market is important, and from this perspective the indirect effect of interest rate cuts stimulating demand may be more material than the direct effect of cushion to ratios.

Exhibit 1

Credit metric improvement from lower rates a positive but not large for typical direct lending credit profile

Typical direct lending borrower profile metrics assumed: total leverage of 7.0x, spread to SOFR of 500 bps, EBITDA margin of 15%, capital expenditures 1.5% of revenue, working capital/other cash uses 1% of revenue, and amortization of 1% of the debt amount

