

BOARDROOM INTELLIGENCE

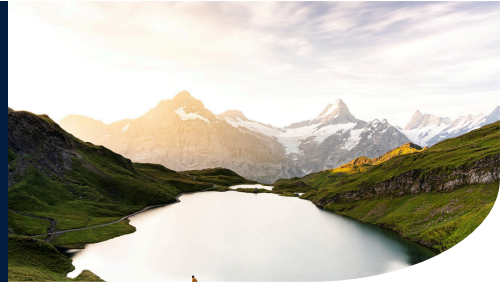
In Direct Lending, Cash Flow (Coverage) is King

October 22, 2025

Jefferies
Credit Partners

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Private credit has rapidly evolved from a niche asset class into a significant force in the global lending landscape. It has grown at a rate of 15.6% per year between 2018 – 2024 and is projected to grow from a \$2.1 trillion sector at 2024-end to an estimated \$4.5 trillion by 2030¹.

Private credit may offer superior yields, bespoke deal structures, and a favorable risk-return profile, having delivered an annualized return of 9-10% with low standard deviation over the last two decades as measured by Cliffwater Direct Lending Index ². Across several different credit cycles, sponsor-backed loans have maintained lower default rates than non-sponsor-backed loans³.

As investor interest in private credits grows, so too does the imperative of selecting the right manager, with the right process, to evaluate a potential borrower's strengths and weaknesses.

One common way that many direct lenders run unnecessary risk is when they are overly reliant on EBITDA measures that don't provide a clear view into a business's cash flow or creditworthiness. In the process, they are exposing credit investors to more risk than they bargained for, especially amid rising global geopolitical and economic risks.

At issue is the Interest Coverage Ratio (ICR), which, like a P/E ratio, has the virtue of simplicity, and is commonly referenced as a predictor of a company's creditworthiness.

Interest Coverage Ratio = Adjusted EBITDA / Interest Expense

Interest Coverage Ratio is a widely marketed metric in presentations, loan tapes, and diligence files for investors. However, the real standard that most lenders focus on, and investors should direct their attention to, is the Fixed Charge Coverage Ratio (FCCR). While being a useful proxy, we note that ICR can obscure more than it illuminates, by relying on an Adjusted EBITDA figure that does not answer the most critical question for every credit investor: Is this company generating enough free cash flow to service its debt?

EBITDA is increasingly subject to manipulation with companies adjusting it higher by, among other factors:

- Including pro forma cost savings or synergies
- Making run-rate or ramp adjustments – for example, including new stores or products that are not yet operational or profitable, or pulling forward revenue from contracts
- Classifying expenses such as recruiting, growth marketing spends, restructuring, and other employee costs (e.g., severance, legal, etc.) as ‘one-time costs’

Many leveraged loan credit agreements have an EBITDA definition that includes several pages of addbacks and adjustments, resulting in a materially higher “Adjusted EBITDA.” Interest coverage also does not account for capital expenditures, cash taxes, sponsor management fees, and other “below the line” cash costs that do not hit EBITDA, the sum of which can be material.

This is why lenders like Jefferies Credit Partners (“JCP”) rely on a measure called the Fixed Charge Coverage Ratio (FCCR), which they believe makes it more difficult for a company to engineer its way to creditworthiness.

Before delving into the details of FCCR, it’s worth reminding ourselves that credit has an asymmetric return profile, where a good outcome features capped upside (earning your coupon and recovering your principal) and a bad outcome is losing 100% of your principal. Unlike equity investments, credit does not offer winners with outsized returns to offset mistakes. Therefore, our view is that a good credit partner should focus on downside protection, with a disciplined and repeatable underwriting process.

Unpacking the Fixed Charge Coverage Ratio

FCCR is a key tool that is used to judge a company's free cash flow. Here is how it is measured:

FCCR =

$$\frac{(\text{Adjusted EBITDA} - \text{Cash Addbacks} - \text{Capex} - \text{Cash Taxes} - \text{Sponsor Fees} - \text{Other Below the Line Cash Costs})}{(\text{Interest Expense} + \text{Required Principal Amortization})}$$

Note that the denominator in this equation also includes principal payments for the simple reason that this is cash a company does not have available to operate or invest in the business.

Fixed Charge Coverage Ratio (FCCR) vs. Interest Coverage Ratio (ICR)

FCCR often paints a different picture of a company's creditworthiness than ICR. Consider the following illustrative example of two similarly situated companies, both generating \$ 125M of adjusted EBITDA, levered at 5x debt-to-EBITDA with the same interest rate and required amortization schedule. Both have the same Interest Coverage Ratio of 2.2x, while Investment A has a 0.3x higher FCCR due to lower capex requirements and fewer EBITDA adjustments.

	Investment A	Investment B
Adjusted EBITDA	125	125
Less: EBITDA Adjustments	5	10
Capital Structure		
Cost of Debt	S + 500bps	S + 500bps
CapEx	30.0	45.0
Less Cash Taxes	3.0	3.0
Sponsor Fees	2.0	2.0
Free Cash Flow	85.0	65.0
Required Amort	6.3	6.3
Cash Interest	58.0	58.0
Fixed Charges	64.3	64.3
Interest Coverage	2.2x	2.2x
Fixed Charge Coverage	1.3x	1.0x

If an investor were presented with these two credit opportunities, it would make sense, all things considered, for them to pursue Investment A over Investment B.

A Metric Credit Investors Need to Know

In recent years, the private credit market has become deeper and more diverse as investors have embraced a growing array of creative debt instruments.

Amid this growing complexity, straightforward and dependable measures of whether a company has the cash to cover its debt are essential. FCCR meets this test and remains a key tool for investors when assessing creditworthiness.

Endnotes:

1. Source: Preqin – Private Credit Forecast 2030; Total AuM values relate to year-end figures and are referenced as calculated by Preqin for Global Private Credit (including Direct Lending, Distressed Debt, Other and BDCs, excluding all other semi-liquid funds). AuM figures exclude funds denominated in yuan renminbi.
2. Source: Cliffwater 2025 Asset Allocation Report – referencing the Cliffwater Direct Lending Index which represents the actual historical asset class return for the 20 years ending September 30, 2024; gross of fees, on an unlevered basis.
3. Source: LCD – US Leveraged Loan Default Rates (Period reviewed: Jan 2020 to Jul 2025)

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