Work It Out: Resilience Through Recovery

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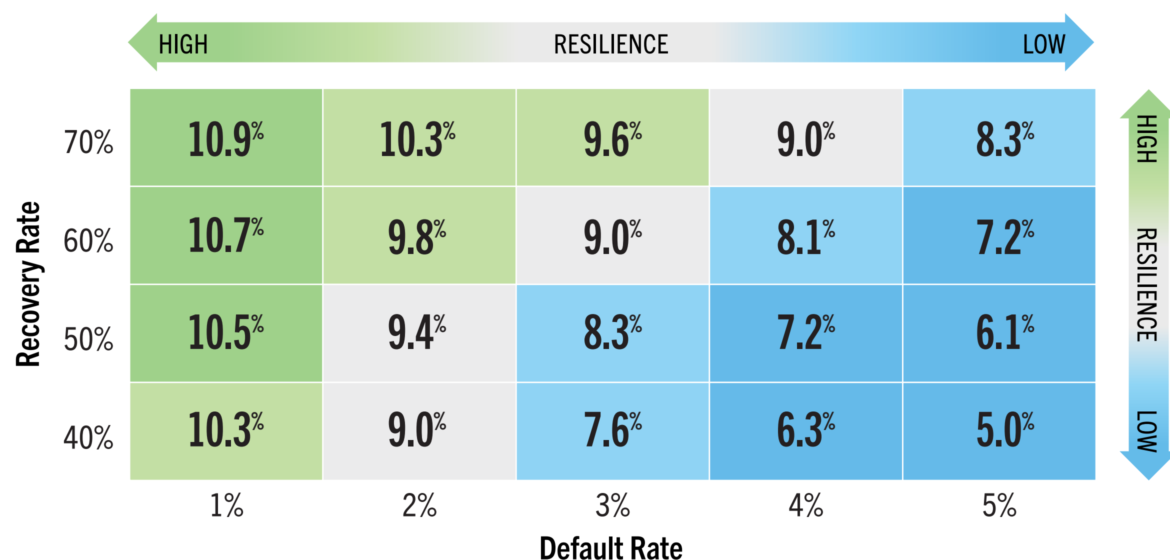
Higher recovery rates help mitigate losses and provide resilience in rising default rate environments

Recovery Rate: A Bulwark Against Default Rate in Managing Credit Portfolios

Net IRR under various default and recovery rate scenarios*



The average recovery rate for senior direct loans is ~60–70% versus ~40% for unsecured high yield bonds.

Recovery Limits Losses

- Recovery rates, alongside default rates, play a critical role in determining a manager's ability to deliver capital preservation and income stability.
- Unlike lenders in more liquid markets, direct lenders cannot trade in and out of positions to preserve value—they hold the debt on their balance sheet.
- To minimize loss in the case of default, lenders need to "work it out" through direct negotiation with borrowers, through operational and financial restructuring, or by "taking the keys."
- In a low–default rate environment, portfolios with poor recovery rates experience only modest return erosion, but as default rates rise, these managers' ability to navigate stressed credits becomes increasingly important.
- As default rates climb from 1% to 5%, managers with high (70%) recovery rates experience a modest reduction in IRR, from 10.9% to 8.3%, but managers with lower recovery rates (40%) see returns cut in half, from 10.3% to 5.0%.

Source: Golub Capital.

*Modeling represents a typical direct lending BDC operating with an 11.1% total interest income yield, a 5.6% borrowing cost, a 1.2x leverage (debt/equity), a 0.3% G&A expense (on assets), a 1.3% base management fee and a 17% incentive fee.

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