

Nicholas Marshi BDC Credit Reporter: Sourced by SOLVE

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OPINION: Does Private Credit - and the BDC sector - have a valuation problem?

There's been a lot written in the financial press of late about Private Credit - which includes BDCs - and some very controversial views are being thrown out which could have real-life consequences. One of them is that private credit loans are being improperly priced. We address the issue head on.

November 25, 2025

Doubt

Bloomberg has [reported](#) that the "de facto sheriff of Wall Street" and former **Apollo Global** senior executive **Jay Clayton** has questioned the veracity of private credit loan valuations and promised to do something about it should misbehavior be found. This has come out in an interview - presumably with Bloomberg itself -

Stark divergences in how competing firms value private assets in their portfolios are drawing increasing attention from market participants, academics — and now, the Department of Justice, according to Jay Clayton, the head of its Manhattan outpost.

"There are definitely some areas of concern for me in private markets," Clayton said in an interview. "People should know that the financial regulators and the department are looking at those."

Clayton says what he won't stand for is money managers cherry-picking prices that let them reap higher fees at the expense of their clients.

The public will "want to know that private marks, where there's liquidity offered or an asset value-based fee to be paid, are good marks," he said. "I expect we will have more to do in areas of our private markets."

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Clayton, 59, took over the DOJ's office for the Southern District of New York after President Donald Trump announced shortly after last year's election that he intended to make him the de facto sheriff of Wall Street. At the time, Clayton was chairman of [Apollo Global Management Inc.](#), one of the most dominant players in private markets. He previously led the Securities and Exchange Commission during Trump's first term.

Redux

Both the government and Bloomberg have been here before. A year and a half ago - at a time when **UBS Group AG chairman Colm Kelleher** warned of a [dangerous bubble](#) in private credit - it caused Bloomberg to undertake its own research - with the help of Solve's data - into the subject and the SEC to require more regulation, "rushing in rules to force private-fund advisers to allow external audits as an ["important check"](#) on asset values".

Greed Is Not Good

The "smoking gun" in all this - in the eyes of the critics - is that different lenders value the same loans differently - sometimes widely so. To some, this seems to signify that some of the players are essentially cheating, presumably for the lending firm to show a better net asset value than otherwise and for its professionals to book higher compensation. We all know how the wrong incentives can mis-shape markets.

Our Hand Is Up

Clearly this is not an issue that is not going away and is popular with both the press and the authorities - a dangerous combination - and a likely precursor to new regulations. Given that we literally review thousands of loan valuations every year as a by-product of our work on the **BDC Credit Reporter**, we thought we'd contribute to what has been so far a mostly one-sided debate. The private credit lenders and their advocates tend to get out only a cursory contrary view in these discussions.

Where To Start

There is a misconception at the heart of the subject that there's a "right" price for these tens of thousands of non-traded leveraged loans to non-investment-grade borrowers. Given that the

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loans don't trade like stocks - and never will - there is no centralized market that can give us a value whenever needed- like a stock exchange. Instead, the lenders - and the valuation firms they hire to independently assess their loans on a periodic basis - assign a value on a specific day - typically the end of a quarter.

Modeling

To do so, **GAAP** requires BDCs not to "mark to market" but "mark to model". The BDC managers all have to apply the [rules laid out in ASC 820](#). There are a host of rules about how these valuations are calculated - and a great cost involved, paid for by the shareholders. This ensures consistency of approach. Each loan is valued according to a financial model built on a series of inputs.

Here's the rub though. There are many assumptions that need to be made and - as anyone knows who has ever run a financial model - just a few changes in assumptions can result in very different results. Even with all the good will in the world different lenders will likely come out with different numbers.

Unequal

Then there are the subtleties. Not every loan was originated at the same cost and at the same time by these different lenders. Moreover, some of the loans are subject to "first out" or "last out" arrangements between lenders where risk has been shifted around amongst market participants. That will result in different values being applied. Who - besides us - is bothering to read all the footnotes in BDC filings identifying these arrangements, which can cause stark differentials in values?

Our Best Analogies

In any case, any valuation is like fresh bread - it quickly goes stale. By the time investors, analysts and journalists see any loan's valuation 30 days or more have passed since all those ASC 820 calculations have been performed. By then - especially where the sometimes fast-moving state of affairs of troubled loans is concerned - much has changed, including the likely value of the debt. Even if you knew the value of a given loan as it first came out of the valuation oven it would still be an illusion because the final value won't be crystallized till the completion of a "realization event" - a restructuring, bankruptcy or other settlement. For example, even

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now - months after its Chapter 11 filing - we have no idea what the "real value" of every **First Brands** loan might be. Troubled loan valuations are like fast moving trains headed to an unknown destination on no fixed schedule. Any value given is an only a signpost along the way.

The Forgotten

Pity the lender or credit valuation professional. He/she has to determine a value based only on the information available at the time prepared and only based on what "the market" believes - a very squishy factor. (See [this explanation](#)). Unlike bankers who can assess a loan's likely value down the road when all is said and done - and can "reserve" for that loss - the BDC valuation's expert view of what MIGHT happen in the future to the credit is not supposed to be factored into ASC 820.

While valuation professionals can and must exercise judgment when developing unobservable inputs (Level 3 inputs), this judgment cannot reflect management's personal views about what will happen to the company. Instead, the judgment must estimate what hypothetical market participants would assume when pricing that asset

Good For Us

Fundamentally, this is why we launched the BDC Credit Reporter in the first place because we recognized that there was a wide gap between the valuations of troubled loans offered by the BDCs themselves and their likely final value. This was not a matter of the lenders being biased and untruthful and us being independent and fair minded (although we like to think we are) but derives from the nature of the valuation system. Unlike the BDCs themselves, we can look down the road and assess how we think each loan will end up - the likely recovery and loss - which we include in every Company File for every Important Underperformer.

Fuller Picture

In a sense, we are calculating - like a bank - the "reserves" that observers should apply to the cost of the loans. Add these all together for a given portfolio - as we do in our database - and you have an estimate of the eventual impact on a BDC's capital and income. It's only an estimate but better than the hodgepodge of BDC valuation snapshots being taken at different stages of loans "going bad".

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Don't Do It

Would we all better served if Private Credit valuations were done on the same basis with every lender estimating its final loss experience, and each loan could be fully "reserved for" whenever its performance began to stumble? We think not, and not because we'd be worried about being made redundant. Such a system - when several lenders were involved in a single loan - could result in even wider variations in value than we occasionally get today. Throw out the tried and true "mark to model" and everybody becomes the BDC Credit Reporter, and each with a singular view. The variance in loan valuations would increase under such a scenario.

Not Good

Finally, we fear what might happen if the government intervenes and tries to regulate loan values and valuations. Typically, this will increase costs, all of which will be borne by the shareholders - not the managers. Also, we question what government can do to improve on what the accountants have concocted for what is a very slippery, protean subject.

Acceptance

Investors in Private Credit, journalists who cover the subject and the regulators need to accept that the valuation snapshots they receive from private credit lenders are just that: snapshots with only limited value and prepared with the best of intentions by the parties involved. Strung together the valuations do offer some sense of a trend about a loan's ultimate destiny and batch a full portfolio together and you get an idea of what any ultimate damage might to the BDC itself. String all the BDCs together and one can see roughly work out how segments or sectors of the lending landscape are performing versus others. However, to turn the individual loan valuations into something one can really depend on is like trying to catch a snowflake in your hand and take it home for further contemplation.

Answering The Question

So, to directly address the question in the headline: No, Private Credit - and especially public BDCs - do not have a valuation problem and have functioned very nicely - thank you very much - for several decades with the current system. Any attempt to solve this non-problem will achieve nothing, likely make matters worse and cost BDC shareholders more. Everyone has to be more

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accepting and understanding of the limitations inherent in valuing these sorts of loans. If at any time the expression "perfection is the enemy of the good" was appropriate, it's in this context.

Up Next

We're in an opinionated mode because we're reading a lot of tosh - as the English say - about Private Credit and BDCs, and we're not sure why that's the case. One reason may be that generalists in journalism, banking and investing don't properly understand how the sausage is made where leveraged loans are concerned. (We've been in the factory for thirty years and still have a difficult time finding our way around at times). So, we're going to write more articles like this one on occasion. Next up, we're going to tackle that popular shibboleth we hear over and over again: that BDCs are opaque in their disclosures - black boxes which nobody but the insiders know what is going on. We won't spoil your reading by saying too much, but we can promise that we have chapter and verse to say on this subject.