SONA
ASSET MANAGEMENT

PRIVATE CREDIT: AN HONEST ASSESSMENT

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FOREWORD: CUTTING THROUGH THE NOISE IN PRIVATE CREDIT

In recent weeks, credit markets - and private credit in particular - have found themselves under heightened scrutiny. As the asset class has grown in scale and prominence, so too has the debate around its structure, transparency, and resilience.

This paper is not intended to add another speculative or contentious voice to that debate. Rather, our aim is to step back from the noise, address the issues we believe matter most, and offer a balanced perspective from an active credit investor.

In recent years we have witnessed first-hand the increasing convergence between public and private credit, and we firmly believe they will continue to coexist and evolve together, fulfilling complementary roles in a growing global credit ecosystem.

For participants in credit markets, this is a potentially pivotal moment. The questions currently being asked around liquidity, underwriting discipline, valuation practices, and market structure, will likely shape how the asset class develops in the years ahead.

We hope this paper contributes constructively to that discussion.

KEY POINTS

- **The good**. Private credit, which rose to prominence as banks retreated from corporate lending, today plays an increasingly important role in global financing markets, as well as filling the void when public markets pull back. Borrowers benefit from flexibility and certainty of execution, while creditors can access attractive risk-adjusted returns. Fund structures - especially redemption terms - are designed to safeguard investor capital.

- **The bad**. In an asset class which lacks convexity, upside from AI disruption is limited, but downside could potentially be significant. Private credit appears particularly exposed: approximately 60% of the market is asset-light. The pro-cyclicality of the model - exacerbated by large inflows of insurance capital compressing spreads - is beginning to reveal structural weaknesses. Anecdotal evidence of poor underwriting standards is becoming more common, while payment-in-kind (PIK) usage is rising.

- **The ugly**. Prior assumptions around default and recovery rates are outdated, in our view. Higher losses should be expected, and potentially sustained. Duration worries exacerbate these challenges and have been widely underestimated. Exiting positions will become more difficult, and recent vintages will struggle to meet their distributed-to-paid-in (DPI) benchmarks.

- **We may already be at a tipping point**. The magnitude of redemptions from semi-liquid vehicles is hard to ignore. The risk is a cascading effect, where we see spill over into other corners of private credit down the line such as more traditional drawdown vehicles, but also into public markets and especially the leveraged loan market, given the sizeable holdings in BDCs.

- **If you don't do both, you should not do either**. Investors should not abandon private credit - far from it. However, those who treat public and private credit as separate asset classes are structurally ill-equipped for the environment ahead. The managers most likely to succeed will combine strict underwriting discipline with the flexibility to react to pricing dislocations between public and private credit markets.

INTRODUCTION

Public scrutiny of private credit is now in full force and has almost certainly never been greater. Negative headlines are dominating the narrative: heavy exposure to software companies, redemptions and gating, criticism of portfolio marks, and banks marking down collateral posted by private credit firms. Confidence in the asset class has been severely and quickly eroded as a result. Perhaps most strikingly, the opacity once valued by investors as a source of volatility suppression is increasingly being viewed as a liability.

With limited transparency, it is difficult to distinguish between isolated problems and systemic ones, and fear of the unknown is starting to dominate sentiment. Not all the criticism is justified. Some of it veers into hyperbole. However, enough of it reflects genuine concerns and the repricing now underway. It is therefore no surprise to us that Business Development Companies (BDCs), which have in effect become the public proxy for private credit, have underperformed to the extent that they have this year.

BDCs, as a proxy for private credit, have underperformed public credit meaningfully

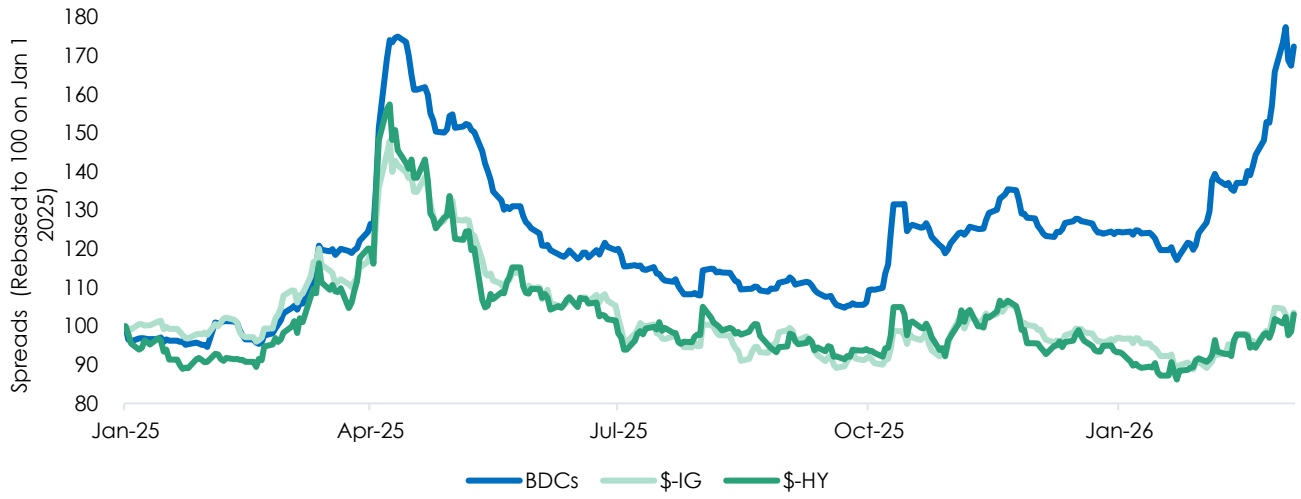

Figure 1: BDC vs. $-BBBs vs. $-BBs (Spreads, Rebased to 100 on 1 January 2025)
Source: Bloomberg

Many of the negative stories share a common denominator: software. However, we would argue that software has simply opened a can of worms, exposing a broader set of worries around private credit, most of which stem from structural differences between private and public markets. These structural issues form the core focus of this paper.

To be clear, we believe this is a healthy debate. It has the potential to realign incentives among borrowers, creditors, general partners, and limited partners. And, as in any good cycle shakeout, dispersion in returns will reveal a great deal about the skill and credibility of private credit managers. Over time, some will thrive, some will survive, and some may no longer be active. However, the market itself will likely emerge stronger as a result once the excesses of past cycles have washed away.

Whatever the outcome, we feel most strongly about one thing: successfully navigating the current environment requires expertise across the entire credit ecosystem. The lines between markets are increasingly blurring. In the case of public and private credit in particular, focusing on only one risks leaving managers at an information disadvantage.

In our view, if you don't do both, you should not do either.

Just as importantly, one should not let a good crisis go to waste. The current environment for active credit investing, while remarkably complex and fast-moving, is also rich with opportunity. Capturing those opportunities, however,

increasingly requires both the expertise and the flexibility to move across the full credit spectrum as dislocations emerge between public and private markets.

PART 1. THE GOOD.

For all the negativity surrounding private credit today, it's important to remember that the asset class plays a critical role in the global financing ecosystem, not only for corporates, but increasingly across a broader set of markets, including the growth of private credit asset-based finance (ABF). We don't expect this role to diminish. Quite the opposite. The scale of capital required across the economy is expanding rapidly, and private credit will play an increasingly important role in meeting that demand over the medium to long term.

A MARKET BORN OF NECESSITY

Private credit did not emerge from nowhere. In many respects, it was summoned into existence following the Global Financial Crisis (GFC) by the retreat of banks from middle-market lending. Post-GFC regulatory reforms (most notably Basel III and its successors) imposed significantly higher capital requirements on leveraged and sub-investment-grade lending. For banks whose cost of equity had permanently increased, lending to smaller, unrated, or below-investment-grade borrowers was no longer economically rational on balance sheet.

HOW PRIVATE CREDIT EVOLVED

Three distinct phases broadly characterise the market's development:

Phase 1: The Middle Market Foundation (2010–2016)

In the immediate aftermath of the GFC, private credit was primarily a middle-market direct lending phenomenon. Lenders focused on companies typically financed at mid-single-digit leverage. Returns compensated investors for illiquidity, with spreads of 600–800 basis points over base rates, and deal sizes rarely exceeding $500m.

Phase 2: The Institutionalisation (2016–2021)

As performance data accumulated and institutional capital sought alternatives to low-yielding public markets, private credit moved from niche to mainstream. Insurance companies, seeking duration and yield, became structural buyers, while sovereign wealth funds committed capital at scale. Deal sizes increased, and documentation began to loosen.

Phase 3: The Mass Market Era (2021–Present)

The rate reset of 2022 made private credit acutely attractive to yield-hungry capital. BDC structures opened the asset class to retail investors, while ELTIF 2.0 and semi-liquid fund vehicles did the same in Europe. Non-traded perpetual BDCs grew from zero in 2021 to more than $200bn in AUM.[1] Semi-liquid vehicles now represent almost a third of the $1tn US direct lending market.[2] At the same time, scale has become increasingly concentrated: the five largest private credit managers grew AUM by 174% between 2020 and 2025 to more than $2tn, commanding a significant share of the market.[3]

[1] Source: S&P Global, Jan-26

[2] Source: US Alternatives Investments, Dec-24

[3] Source: S&P Global, Feb-26

The private credit market in Europe is now the same size as the high yield and leveraged loan markets

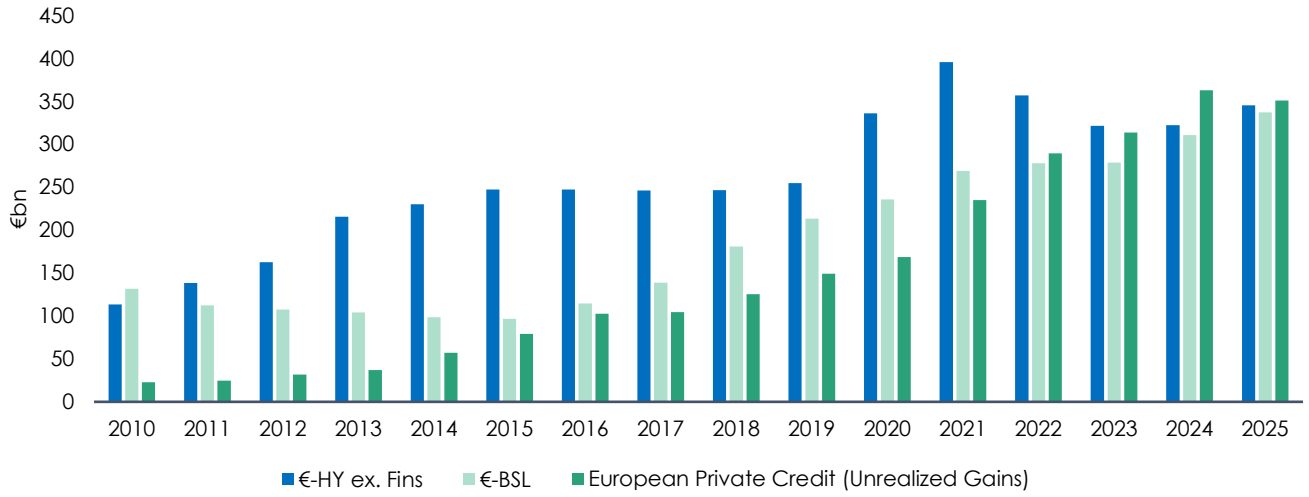

Figure 2: Notional Size of European Private Credit Market (Excluding Dry Powder) vs. European HY and BSL Markets
Source: Bloomberg, PitchBook, Preqin

FROM THE PERSPECTIVE OF BORROWERS

Private credit offers numerous advantages for borrowers.

- **Certainty of execution.** Public syndication processes are inherently uncertain; market conditions can shift between mandate and close. Private credit provides committed capital from a small group of lenders, largely eliminating syndication risk.

- **Confidentiality.** Public bond issuance requires disclosure of financial results, business strategy, and risk factors to a broad market audience. Private credit requires no such disclosure - a significant benefit for private equity-backed firms navigating competitive dynamics or preparing for potential IPOs.

- **Structural flexibility.** Public markets demand standardised instruments. Private credit can instead be structured around the specific cash-flow dynamics of a business, including PIK options for capital-light growth companies, covenant packages tailored to operating model, and amend-and-extend provisions negotiated bilaterally without coordinating across a diffuse bondholder base.

- **Relationship-based workouts.** A company with a single lender group can negotiate an amendment or waiver in days or weeks; equivalent processes in public markets may take months and can ultimately damage enterprise value.

FROM THE PERSPECTIVE OF CREDITORS

There are also numerous positive features for creditors.

- **Spread premium.** While not completely like-for-like given different risk characteristics, direct lending has historically offered a spread premium of roughly 150–250 basis points over equivalently rated public debt.[4]
- **Structural seniority with stronger protections.** Most – though not all - of the private credit market is first-lien and senior secured. Relative to public credit, bilateral negotiation can enable stronger financial covenants, more robust security documentation, and more granular reporting requirements.
- **Lower reported volatility and lower correlated returns.** Because private credit is not continuously marked to market, it exhibits lower reported volatility than public credit. For institutional investors managing liability-matching frameworks or regulatory capital requirements, this characteristic can be genuinely valuable. The asset class also exhibits low correlation with public equities and bonds, offering diversification benefits.
- **Higher Sharpe ratios.** As an extension of the above, higher returns and lower reported volatility translate to higher Sharpe ratios. Over the period of 2015 to 2025, private credit produced a Sharpe ratio of 1.23.[5] That compares with 1.01 for private equity and 0.57 for real estate. This also compares favourably with public markets: 0.68 for high yield, for example.
- **A growing opportunity set.** As the private credit market has expanded, so too has the opportunity set. What began largely as a middle-market direct lending strategy now spans much of the leveraged credit universe, - and increasingly extends beyond it, including into areas such as asset-backed finance.

Private credit has offered a 150-250bp spread pickup versus public markets

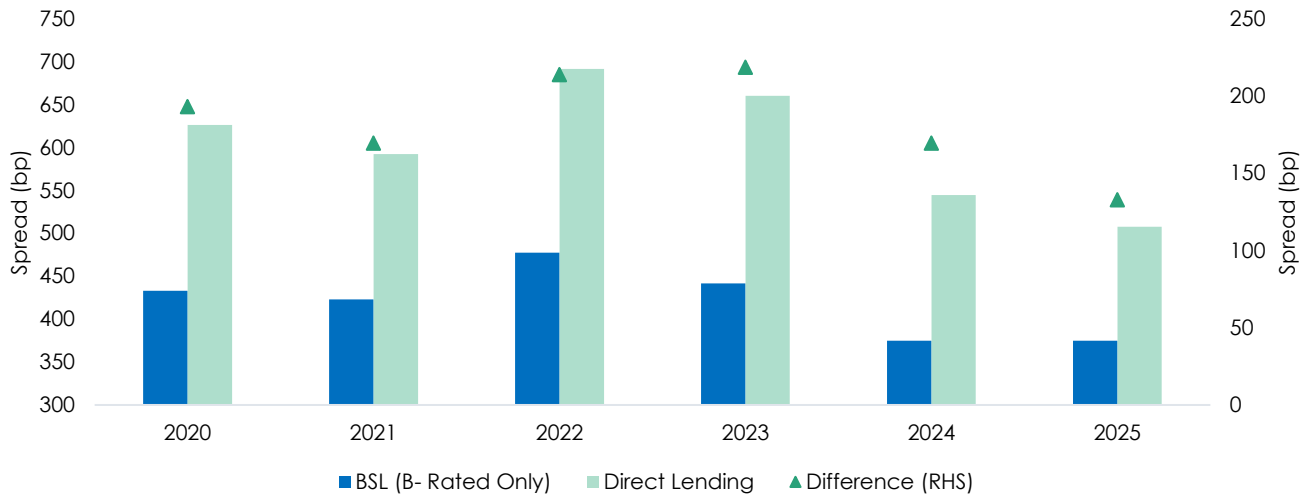

Figure 3: New Issue BSL vs. Direct Lending Spreads (US Only)
Source: PitchBook

[4] Source: PitchBook, Jan-26

[5] Source: Morgan Stanley, Oct-25

SEMI-LIQUID STRUCTURES EXIST FOR A REASON

The creation of semi-liquid private credit structures was an innovation which expanded the market. Fundamentally, they are built around a simple and transparent principle: periodic redemptions, typically quarterly, capped at a fixed percentage of NAV, often 5%. Gates limit the amount investors can redeem in any given period, set at a level designed to match the time it would ordinarily take for the underlying portfolio to run off. There is no ambiguity as investors allocate to these vehicles with full knowledge of the terms - both on the way in and, critically, on the way out.

The purpose of this structure is protective. It is fundamentally a risk management mechanism designed to prevent the wealth transfers that occur when funds are forced to meet redemptions by selling assets at fire-sale prices.

Much of the criticism implicitly compares these vehicles to public market liquidity - ETFs in particular. These comparison cuts both ways, though. During periods of market stress, bond ETFs can amplify price movements in their underlying markets through liquidity mismatches, the pressure of creation and redemption mechanisms, and the amplification of broader market volatility.

None of this makes the current moment comfortable for managers. Each redemption cap risks reinforcing a negative sentiment spiral at a time when the industry is already under scrutiny. There are also legitimate questions surrounding the handful of managers who have chosen to honour redemptions above the standard 5% threshold - arguably rewarding first-mover behaviour.

However, the recent examples of managers limiting withdrawals reflect the very reason these structures exist in the first place. Private credit is illiquid. That is known, priced, and agreed upon at the point of commitment. Sudden, large-scale withdrawals would compromise a fund's stability and potentially require premature liquidation of illiquid assets at a loss. Redemption gates are designed to prevent exactly that. They exist to protect the investors who stay just as much as they manage the investors who redeem.

PART 2. THE BAD.

The factors below are in our view negative for private credit – but not yet ugly. That still lies ahead.

AI AND PRIVATE CREDIT – LIMITED UPSIDE, REAL DOWNSIDE RISK

We don't doubt the productivity gains AI will deliver in the years ahead. Nor do we doubt that some companies, particularly from a margin perspective, will benefit. However, the lack of convexity in credit markets means the upside is capped, while lenders remain fully exposed to the downside. For private credit in particular, that exposure to disruption risk is substantial.

An Overexposed Market

The first concern is exposure. Private credit has a serious concentration problem in precisely the sectors AI is targeting most aggressively.

Software is the clearest example. Through the 2010s and into the early 2020s, SaaS companies became the darlings of private equity - and by extension, private credit. The logic was compelling: recurring revenues, high gross margins, low capital intensity, and sticky customers. These businesses were seen as predictable cash flow machines, and lenders piled in accordingly. Valuations reflected that enthusiasm, with median deal multiples reaching more than 15x annualised recurring revenue in 2021[6], layered with substantial debt. Those multiples have since collapsed to around 5x.

Now AI is beginning to dismantle the very thesis that made software such an attractive lending target. Exposure across leveraged finance markets is significant, though uneven. In high yield (HY), the damage is relatively

[6] Source: SaaS Capital, Jan-26

contained - software represents roughly 2% of the €-HY market and 4% of its $-equivalent. The broadly syndicated loan (BSL) market is more exposed, at around 10% and 17% respectively. Though it is private credit where the numbers become alarming. Estimates put average software exposure north of 20% of assets, with some funds potentially approaching 40%. Given the leverage in these structures, the exposure of a fund's equity is theoretically much higher; deploying 1x of leverage for example suggests average equity exposure to software is more like 40%.

The implications extend beyond software. Financial services, business process outsourcing, and a range of other asset-light industries face their own reckoning with AI-driven disruption. In theory, any company whose competitive advantage rests primarily on human capital rather than hard assets is vulnerable. The HY market, which is relatively asset-heavy, has roughly 15–25% exposure to asset-light businesses. In the BSL market, that figure rises to 40–45%. In private credit, it approaches an astonishing 60%, as shown in the figure below.

Research from UBS further sharpens the picture. Their analysis estimates that as much as 35% of the private credit market faces "high" disruption risk from AI - and critically, 92% of those companies are rated B- or below. The contrast with HY is stark: only around 12% of HY issuers face comparable risk, and fewer than 20% of those are low-quality borrowers.

The pattern is telling. If a company was creditworthy enough for the collateralised loan obligation (CLO) market, it went there. If it was not - if the deal only worked at inflated loan-to-value (LTV) ratios based on peak-cycle valuations - it often ended up in private credit, which was effectively lending against LTV rather than durable cash flow.

Private credit has greater exposure to asset-light sectors than public credit

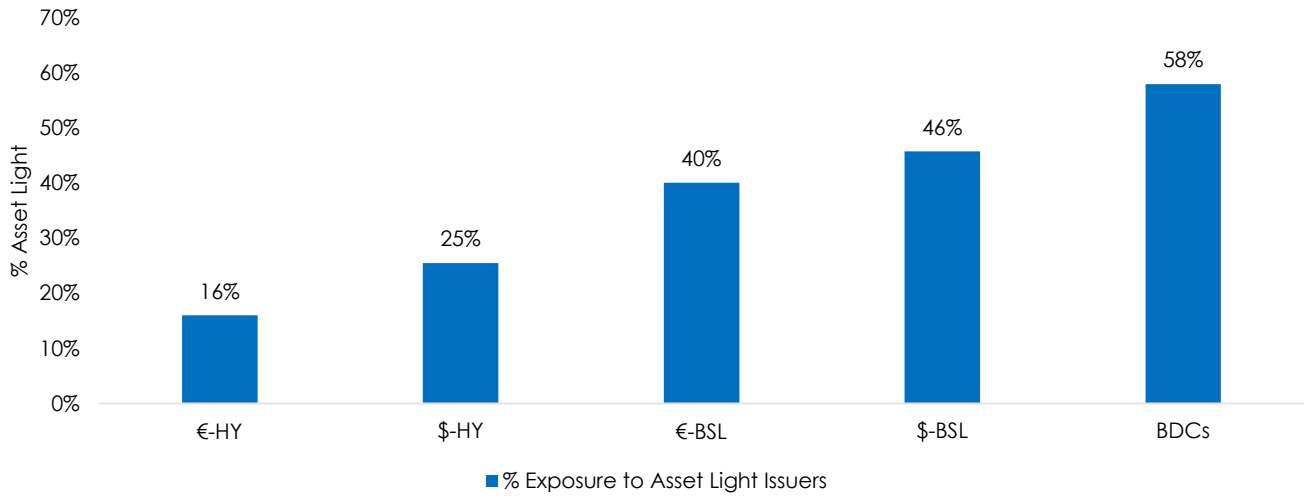

Figure 4: Exposure to Asset Light Sectors by Asset Class
Source: Bloomberg, JP Morgan

The Asymmetry Problem

The second issue is simple, structural, and it applies to all leveraged finance: convexity. Credit investing is inherently asymmetric. Like equities, the worst outcome is a total loss. Unlike equities, the best outcome is par – investors get their money back plus coupon income. There is no participation in the upside.

AN INDUSTRY BUILT TO ORIGINATE, NOT MANAGE

The private credit industry was designed to originate. Its fee structures, staffing models, GP incentives, and fundraising narratives are all oriented around deployment. The implicit assumption embedded in the business model is that the most important decisions are made at origination and that if underwriting is done correctly, monitoring and management can be largely mechanical. We believe this assumption is wrong.

As a result, many private credit portfolios are not constructed; rather, they emerge as the accumulation of individual deployments.

A genuine portfolio management culture requires continuous reassessment of underlying assumptions. It means regularly asking whether the thesis on which an investment was underwritten remains valid; whether the competitive position of the borrower has changed; and whether covenant levels still reflect the underlying risk. It requires the willingness to mark assets to economic reality, to initiate difficult conversations with sponsors, and - crucially – the willingness and ability to walk away from an investment when circumstances call for it.

This doesn't apply to all managers. However, there is clear evidence that portfolio management standards have deteriorated in parts of the market. Why would a well-managed portfolio manager tolerate 40–50% exposure to a single sector – software – that was already showing signs of strain and emerging AI-driven competitive pressure? The answer often lies in incentive structures: managers who deployed capital most aggressively were rewarded with the highest fees and the largest subsequent fundraises.

This contrasts with public markets, where we would argue there is far greater discipline in recognising and exiting a flawed underwriting decision. As the lines between public and private credit increasingly blur, the managers who succeed will be those able not only to originate investments, but also to construct portfolios and actively manage risk - including exiting bad positions when necessary.

Experience, or the lack of it, reinforces this problem. Private credit has long been perceived as operating in a "golden age", but cycles eventually turn. Managing a concentrated, illiquid portfolio through a credit cycle requires a fundamentally different skill set. The industry has scaled its origination infrastructure dramatically, and portfolio management capabilities, in many cases, have not kept pace.

Concentration Risk in Private Credit Software Today is Comparable to Telecoms in 2002 in $-HY

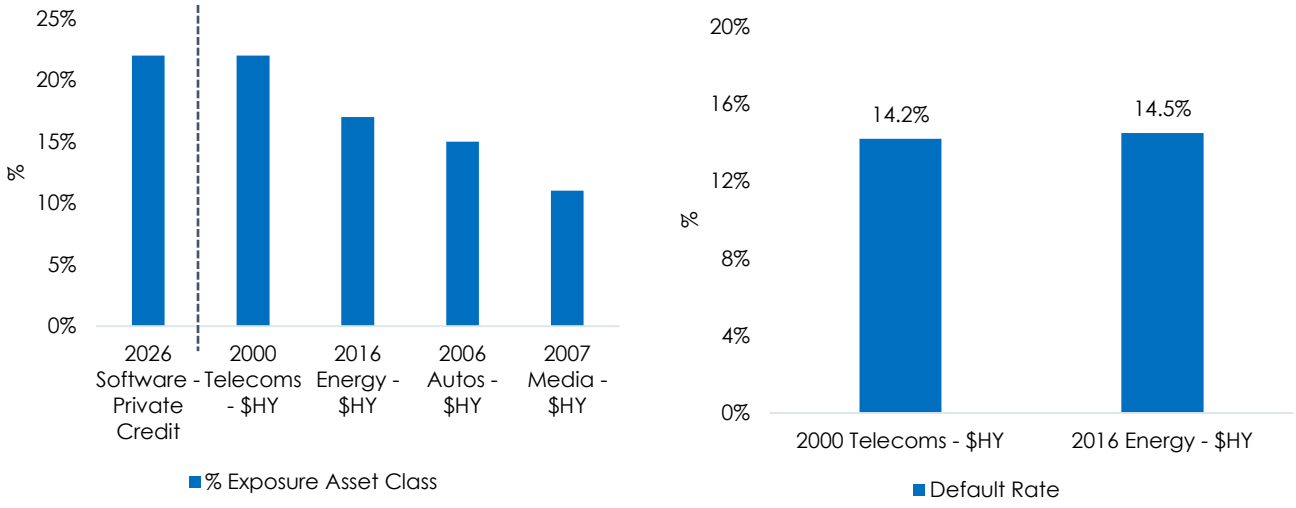

Figure 5: Sector Concentration: Software in Private Credit vs. Equivalent High Sector Exposure in Public Markets (LHS) and Default Rates in 2000 Telecoms & 2016 Energy
Source: Bloomberg, PitchBook, Moody's

THE PRO-CYCLICAL PROBLEM

Private credit's business model is inherently pro-cyclical, particularly when compared with public credit. In favourable markets, the incentives tend to align in a predictable way: fee income is generated on deployed assets, fundraising is driven by historical performance, and LP commitments create pressure to put capital to work. GPs with dry powder are therefore incentivised to find transactions even as the risk–reward balance deteriorates, while competition pushes documentation towards borrower-friendly terms and compresses spreads to levels that barely compensate for illiquidity.

The 2021 vintage clearly illustrates this dynamic. A period of ultra-low funding costs, inflated EBITDA, and massive M&A activity drove the industry to deploy capital at maximum pace. The consequences are now becoming visible: loans originated in 2021 have the highest level of non-accruals of any origination year by a wide margin - approximately $2.8bn across tracked BDC portfolios.[7]

This pro-cyclical nature of the private credit model presents a structural challenge. Deal flow tends to be strongest when spreads are tight, and creditors have less influence to dictate terms or insist on structural protections. For the most part, this dynamic has not yet been fully tested. The 2021 vintage is now five years old, and as the cycle turns, there is a rising probability that some funds will struggle to meet their hurdle rates.

THE RISE OF "BAD" PIK

Payment-in-kind (PIK) structures have long existed as a legitimate tool for borrowers managing short-term liquidity pressures. However, the data increasingly suggests they are being used to mask something more troubling. Lincoln International finds that 58% of companies currently using PIK had the provision inserted mid-deal – rather than agreed at the outset. In the lexicon of private credit, that is "bad PIK." And bad PIK has a more straightforward name: a shadow default.

Lincoln's shadow default rate has more than doubled in four years, rising from 2.5% of all deals in Q4 2021 to 6.4% by Q4 2025. The officially reported default rate, meanwhile, remains a comparatively benign 3.4%. The gap between those two figures is where the real risk sits.

Data from JP Morgan reinforces this point. Their analysis shows that once non-accrual loans (those where lenders already expect to incur losses) are included, the adjusted default rate rises to 5.4%. That puts private credit roughly in line with the broadly syndicated loan market it has long claimed to outperform.

The wider context makes this harder to dismiss. Large amounts of capital were raised in a short period, and the pressure to deploy it appears to have outpaced underwriting discipline in parts of the market.

[7] Source: Franklin Templeton, Aug-25

Percentage of "Bad" PIKs in Private Credit has Climbed

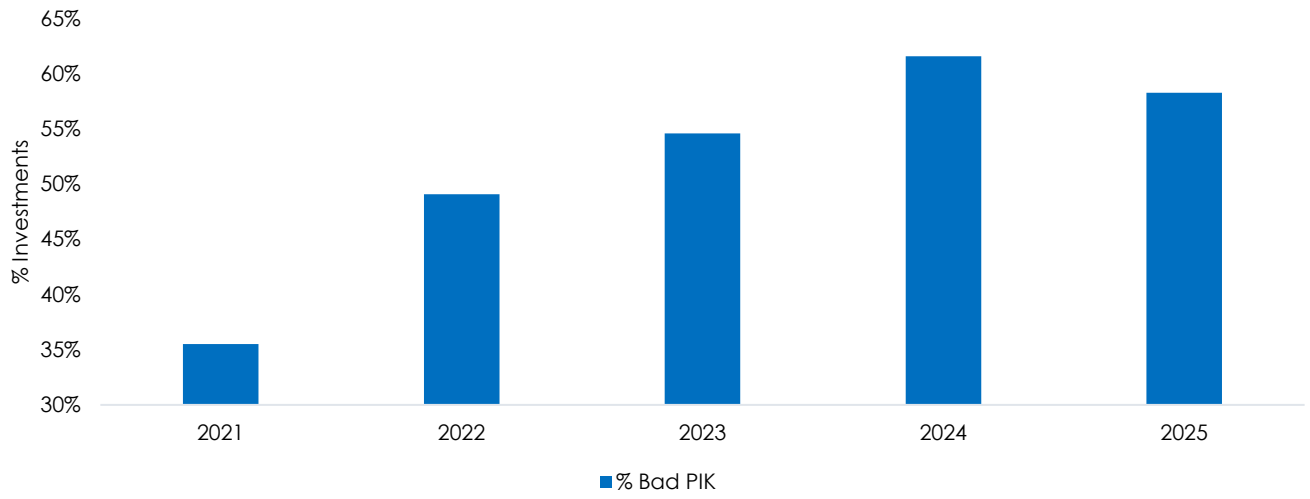

Figure 6: Bad PIK Exposure. "Bad" = Inserting PIK Provision Post Deal
Source: Bloomberg, Lincoln International

A FLOOD OF CAPITAL HAS COMPRESSED SPREADS

The most transformative structural development in private credit over the past five years has been the influx of insurance capital, and the implications for the risk-return profile of the asset class have been profound.

According to Barclays, US life insurers' overall general account investments are $6.1tn. They estimate that the sector's allocation to private letter ratings – the best proxy for private credit – is about 10% (this includes some rated middle market CLOs and other similar exposures in the alternatives bucket). Notably, they suggest that private credit assets in the US life insurance industry grew 21% in 2025, about the twice the rate of growth of the overall general account.

The problem is not that insurers invest in private credit. Rather, it's the capital dynamics they introduce. Insurance capital faces permanent deployment pressure - a liability structure that must continuously generate matching assets. This dynamic closely resembles the GP deployment incentive problem described earlier but operates at a scale that dwarfs any individual fund.

The result has been persistent spread compression precisely at a point in the cycle when spreads should be widening to reflect higher risk. Insurance capital has lowered the cost of private credit financing for borrowers at a time when credit quality, documentation standards, and macro uncertainty all point to the need for a greater risk premium.

POOR UNDERWRITING STANDARDS ARE BEING EXPOSED

For many of the above reasons, poor underwriting standards from prior vintages are now beginning to surface. It would be unfair to frame this solely as a private credit problem. The examples below sit at the intersection of private credit, ABF, and, in some cases, public credit. Even so, they illustrate a broader issue across credit - and private credit in particular: underwriting standards have not always been sufficiently robust, and the need for strong structural protections has become increasingly imperative.

First Brands and Tricolor

The failures of First Brands Group and Tricolor Holdings in September 2025 were textbook asset-based finance arrangements - receivables-backed lending in one case, auto collateral in the other - extended by sophisticated institutional lenders.

First Brands entered 2025 carrying more than $10bn in total debt and roughly $900m in annual interest obligations, the legacy of an aggressive roll-up strategy in aftermarket auto parts. When tariff headwinds compressed operating cash flow, the capital structure quickly unravelled. Beneath the liquidity crisis lay something more troubling: allegations that roughly $2.3bn in receivables had effectively vanished through commingling and diversion of customer payments across overlapping facilities, with a Department of Justice inquiry reportedly focused on duplicate pledging and the accuracy of CEO-signed borrowing-base certificates. In many programmes, retailers continued remitting payments into accounts controlled by the company rather than into accounts governed by Deposit Account Control Agreements (DACAs); lenders owned receivables on paper but did not control the incoming cash.

Tricolor's collapse followed a different technical path to a similar outcome. The company operated as a vertically integrated used-car dealer and subprime auto lender, funding itself through warehouse lines, floorplan facilities, and asset-backed securitisations. The underlying vulnerability was the fragmentation of state-level vehicle title infrastructure. Within that framework, Tricolor pledged the same consumer auto-loan portfolios to multiple financing partners while maintaining internal ledgers that could not be reconciled across facilities - creating a collateral position that existed in documentation but not in practice. The company ultimately filed directly for Chapter 7, bypassing reorganisation altogether.

The common thread is control - or the absence of it. In both cases, the borrower acted as its own servicer, controlled the collection accounts, and provided the data on which lenders relied to assess their own exposure. Facilities that appeared secured and self-liquidating on paper depended in practice on the integrity of the party under the greatest financial stress. Building genuine control infrastructure requires meaningful operational effort. Though relying on trust where control is possible carries a cost that is now becoming very clear.

Market Financial Solutions (MFS)

MFS entered administration in February 2026, having built a £2.4bn loan book over nearly two decades of specialist property finance, and having received a clean audit as recently as March 2025. The immediate trigger was a collateral crisis: across loans totalling £1.2bn, only £230m of verified collateral could be identified - a shortfall of more than 80% of the debt outstanding. The alleged mechanism was double-pledging: the same properties were used to secure multiple separate loans from different lenders, each of which believed it held exclusive security over the collateral.

What makes this case structurally distinct from simple fraud is the architecture that enabled it. MFS operated ten warehouse facilities simultaneously, with each lender managing a purely bilateral relationship with MFS as servicer, with no visibility across the wider structure. Each institution saw only its own collateral position - self-reported by MFS. No independent party monitored aggregate exposure across all ten facilities, making overlap not just possible, but undetectable by design. MFS also controlled all collection accounts as central servicer, with no automatic mechanism to transfer control following a trigger event - allowing £238m in collections to be diverted before the issue surfaced through the administration process. Critically, no institution held registered security over MFS Ltd itself, leaving the central entity's balance sheet entirely unmonitored.

The collapse of MFS exposed some of the structural weaknesses present in parts of the private credit market - in this case, specifically within ABF - as well as poor structuring and weak internal controls that, taken together, can help facilitate fraud through the repeated pledging of the same collateral.

While we agree this was a complex situation, from an underwriting perspective, it was avoidable. One of the core advantages of private credit is the ability to impose structural protections that strengthen a lender's position. In this case, origination exclusivity, a single unified collateral pool, and control of the servicing function are just some examples of measures that could have helped mitigate the risks.

PART 3. THE UGLY.

This brings us to the two factors that, in our view, best capture the "ugly" side of private credit: losses and the duration trap.

THE LOSS CYCLE BEGINS

There is plenty of data suggesting that payment defaults in private credit have remained relatively contained since 2021, barely eclipsing 2%.[8] While that might be true, we suspect there may be a degree of creative accountancy at work. Covenant breaches and liability management exercises (LMEs) appear to be far more prevalent, particularly given the trajectory seen recently in public credit markets.

Regardless, what matters is that default rates are going to rise. Disruption from AI is the obvious reason and barely needs repeating. Timing is harder to forecast, and we have sympathy with the argument that defaults may be spread over several years. However, that misses the bigger point: we are moving into an environment of much higher cumulative defaults. The UBS tail scenario of "rapid, severe AI disruption" projects private credit defaults of 14–15%.

That scenario may prove overly pessimistic, but the direction of travel is clear: private credit needs to adjust to a higher level of defaults. Some of those restructurings will likely involve debt being converted into equity, which brings its own complications - not least changing the fundamental composition of private credit portfolios.

Defaults, however, are only part of the story. The bigger issue is loss severity. Recovery rates in private credit - particularly in software and other asset-light sectors - are likely to prove materially worse than historical statistics imply.

Recovery metrics across leveraged credit are already deteriorating, and the headline figures likely understate the true decline. The explosion of LMEs has created a reporting distortion: published recovery data often fails to capture post-restructuring trading performance. In addition, more defaults are now repeat credit events. In Europe last year, for example, 30% of all defaults in public markets were repeats[9], up from 15% in 2024 and 13% in 2023.

For asset-light businesses, the divergence between going-concern and liquidation value is extreme. A software company's enterprise value in a normal sale process is driven by recurring revenue multiples, customer retention rates, and the value of its technology platform. In a forced sale following default, those valuations compress dramatically. PIK structures only compound the problem.

Loss-rate assumptions therefore need to be reassessed. And to be clear, this applies to public credit also – CLOs in particular are still relying on outdated historical loss rate assumptions. Losses are heading higher, and there is a very real risk that they remain elevated for an extended period.

The 2021 leveraged buyout (LBO) vintage is particularly vulnerable in this regard. We've already seen rising credit events from this cohort, not least because many of the now-problematic software companies were financed during this period - when abundant capital met ultra-low funding costs and underwriting discipline was often far too loose. Research from Goldman Sachs underscores this: 2021-vintage deals have seen the steepest increase in credit events during the first three years after origination.

The read-through from this is straightforward: lower returns and lower Sharpe ratios for private credit going forward.

[8] Source: S&P, Feb-26

[9] Source: Fitch, Jan-26

The 2021 LBO vintage is a problem

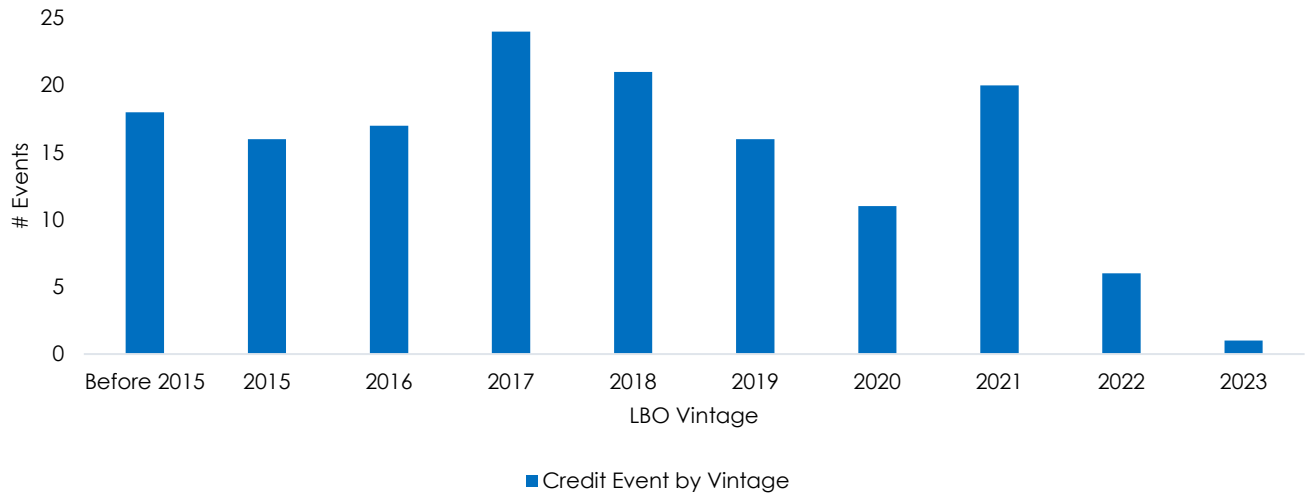

Figure 7: European Credit Events by LBO Vintage
Source: Goldman Sachs

THE DURATION TRAP

Private markets - and by extension private credit - face a duration problem. There is no shortage of data validating this point for the private equity market. For example, Bain's *Global Private Equity Report,* published earlier this year, shows that global buyout distributions (as a percentage of NAV), over the past four years have fallen to their lowest level since the GFC, at roughly 14%.

Recent fund vintages illustrate this point. In aggregate, private equity cohorts from 2017 to 2021 have underperformed relative to their historical performance. While equivalent data for private credit is less standardised, and the dynamics differ from private equity, the same broad trends appear to hold true.

The original investment thesis was built on a liquidity premium: investors accepted illiquidity in exchange for higher returns, on the assumption that capital would be returned over a three-to-five-year fund life.

The reality has been very different. Exiting positions has often proven difficult, while problems that emerge during the life of a deal frequently extend holding periods. The secondary market for private credit remains extremely limited. Despite growing interest, less than 1% of private credit AUM trades annually.[10]

And the duration trap interacts directly with AI disruption risk. A private credit investor exposed to a deteriorating software company has very few obvious exit routes. Investors may find themselves watching NAV drift further from economic reality while hoping that a restructuring ultimately preserves some value. More often than not, however, losses become the end result.

Put simply, the longer capital remains tied up, the greater the left-tail risk - a vulnerability that is further amplified by weaker documentation and structures that are economically subordinated.

In the past, rapid growth in private credit helped mask these duration issues. That dynamic will be harder to sustain as fundraising faces headwinds. Early data suggests this is already happening: just 93 private credit vehicles were launched across North America and Europe in the second half of 2025[11] - the lowest figure for any second half of the calendar year since records began in 2013.

[10] Source: CAIA, Dec-25

[11] Source: Preqin, Mar-26

Recent private equity vintages are underperforming their benchmarks in terms of DPI

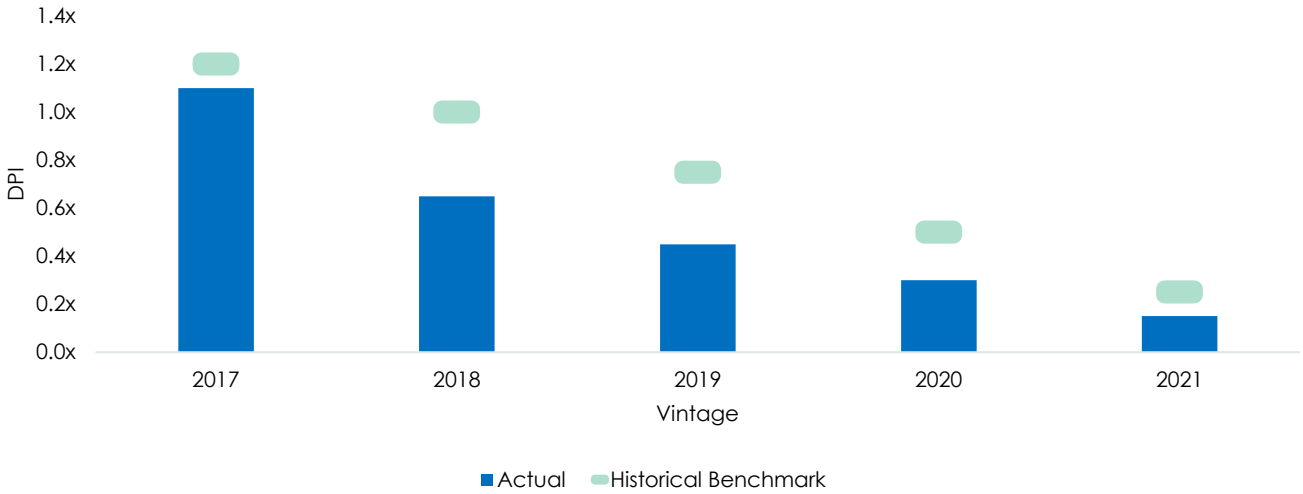

Figure 8: US and European Median Buyout DPI by Vintage.
Note, Historical benchmarks defined as the average of the median DPI for 2010-17 vintages
Source: Bain, 2026 Global Private Equity Report

WE MAY ALREADY BE AT A TIPPING POINT

For all the risks discussed above, there is a compelling case that the private credit market is already approaching a tipping point. The scale of recent redemptions from non-traded and perpetual BDCs is difficult to ignore. For now, those redemptions have largely been honoured, in some cases even exceeding the standard 5% of NAV cap, but the risk of a cascading effect is real. There may be contagion not only to other parts of private credit, such as more traditional drawdown funds with locked-up capital, but into public credit markets as well. It is hard to predict how consequential this ultimately proves to be; what looks orderly today can quickly become disorderly tomorrow.

Semi-liquid structures exist for a reason, and their architecture is deliberately protective. The mechanisms available to meet redemptions include revolving credit facilities from banks: a typical non-traded BDC, for example, will hold a senior secured revolving credit facility pledged against its loan portfolio, which can serve as a liquidity backstop. But BDCs also carry leverage limits. At the regulatory level, the ceiling is 2x; most BDCs, however, operate with internal limits of between 1.0x and 1.25x. Breaching those thresholds risks a ratings downgrade and would further constrain their ability to borrow from banks.

These vehicles can also sell Level 2 assets to meet redemptions — in most cases, broadly syndicated leveraged loans. Across the BDC universe, estimates suggest holdings of as much as $140 billion[12] in US broadly syndicated loans, equivalent to roughly 10% of the entire US BSL market. Should redemption pressure persist, forcing BDCs to liquidate those positions, the cascading effect shifts into the BSL market and, by extension, into CLOs.

Insurance companies represent another layer of exposure. Of the US life insurance industry's aggregate general account investments totalling $6.1 trillion[13], approximately 8% sits in private credit, rising to around 10% when middle market CLOs and similar alternatives are included. A common counterargument holds that direct exposure to middle market loans is limited, with private credit concentrations skewed toward investment-grade rated assets. However, insurance companies increasingly access private credit through rated feeders, which typically take a vertical slice of the capital structure and, in doing so, retain direct middle market loan exposure.

[12] Source: Deutsche Bank, Nov-25

[13] Source: Barclays, Mar-26

The cascading dynamic can also reach the more traditional corners of private credit, including institutional drawdown structures. Even where these vehicles differ materially from BDCs or interval funds in terms of liquidity profile, they are not immune, particularly in their harvesting phase, where duration risk becomes acute. In a stressed environment, especially one in which fundraising headwinds intensify, the ability to exit the least liquid positions will only become harder.

It is easy to envisage a scenario where the stress spreads. The unknown is whether it can be managed, and whether it is ultimately orderly or ends up being disorderly.

CLOSING REMARKS

A MOMENT OF RECKONING

Let us be clear about what this paper is - and is not - arguing. While private credit is going through, and will continue to go through, significant challenges for reasons discussed, we do not believe the private credit market is on the brink of systemic collapse. The asset class is large, structurally embedded across institutional portfolios, and (in its better-managed corners) continues to offer attractive risk-adjusted returns.

Capital is largely locked up, avoiding, or at least delaying, the kind of forced liquidation dynamics that accelerated the GFC. Many of the structural features of semi-liquid vehicles are functioning as intended, with redemption limits designed to protect the interests of long-term investors.

Our argument is more specific. A significant portion of private credit portfolios is likely to face a prolonged period of weaker outcomes. The reason is not a single catalyst, but the convergence of several structural forces - rising disruption risk, weaker underwriting from recent vintages, and capital that is harder to exit. Each of these pressures might be manageable on its own. Taken together, they create an environment of far greater uncertainty.

For the private credit market, that may well mark a moment of reckoning.

PUBLIC CREDIT SHOULD NOT GET OFF EASILY

While this paper has focused primarily on private credit, it would be a mistake to assume that public markets are in materially better shape. They face their own structural pressures - and these are far from trivial.

The most immediate is the looming maturity wall in leveraged finance, particularly in Europe. We estimate more than €140bn of bonds and loans due to mature in 2028, nearly three times the volume due in 2026 and 2027 combined. The BSL market now faces the steepest maturity wall on record. Much of that debt is also low quality, with more than 40% of bonds and loans rated B3 or below.

As we have discussed previously (see here), 70% of debt is held by CLOs, which in our view are structurally unsuitable for dealing with par-loss restructurings. At the same time, whitelists (common pre-approved lender lists) have created limitations by concentrating creditor bases and reducing flexibility in restructuring situations. It would not be surprising if many of the solutions for the 2028 maturity wall ultimately emerge in private form.

The evolution of LMEs is another source of strain. The increasing use of third-party new money - often deployed to influence the pricing of existing capital structures and capture distressed discounts - has pushed the market back towards a far more hostile environment. Asset layering, where creditors lose access to collateral they once expected to rely upon, is becoming increasingly common.

Put simply, today's LME environment is intense, with borrowers, sponsors, holdouts, third parties, and ad hoc creditor groups all competing for position. The distressed public credit landscape is becoming more complex - and considerably less forgiving.

Public credit has its own challenges, and they will not be resolved overnight. As private credit valuations begin to adjust, it is only a matter of time before those changes start to filter through public credit spreads as well.

The 2028 maturity wall is near

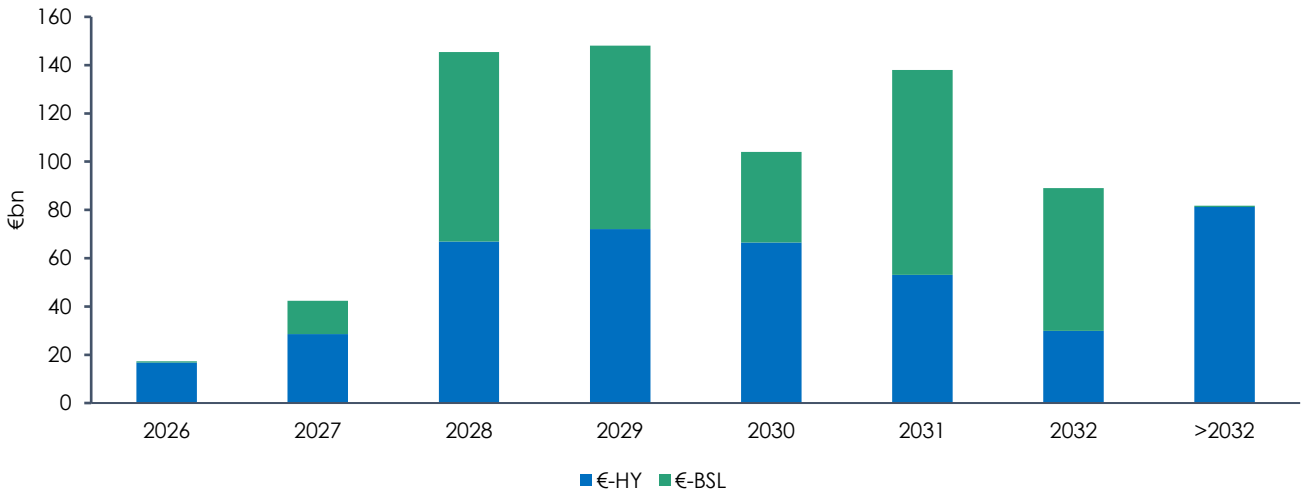

Figure 9: European HY and BSL Maturity Wall
Source: Bloomberg, PitchBook

IF YOU DON'T DO BOTH, YOU SHOULD NOT DO EITHER

The conclusion that follows from this analysis is not that investors should abandon private credit. Far from it. It is that credit managers who treat public and private credit as separate asset classes - managed by separate teams, governed by different mandates, and evaluated against individual benchmarks - are increasingly ill-equipped for the environment ahead.

Information asymmetry now flows in both directions. The traditional view was that private credit managers possessed superior insight through bilateral relationships and monthly reporting. Today, public market price discovery - particularly in sectors such as software, where loans and bonds of comparable companies trade continuously - provides information that private credit managers can and should use to stress-test their own assumptions. A private credit manager who ignores public market signals when assessing private portfolios is effectively operating with a self-imposed information disadvantage.

The investors best positioned for the period ahead are those who combine the origination capabilities, relationships, and structural creativity of leading private credit managers with the liquidity, hedging tools, and real-time price discovery available in public markets. This is not a hybrid strategy in the sense of simply owning both. It is a genuinely integrated credit philosophy - one that continually asks a simple question: where is risk most attractively priced, and where does the structure around it create or destroy value?

This paper has deliberately focused on the downside risks. Those challenges are real, and they deserve the frank assessment we have tried to provide. However, the conclusion is not pessimism about private credit as an asset class. It is a call for discipline, flexibility, and genuine portfolio management - the qualities that have always defined the best credit investors, and that the industry's most recent phase of growth has too often allowed to drift.

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