# Private Debt Investor

June 2025 • privatedebtinvestor.com

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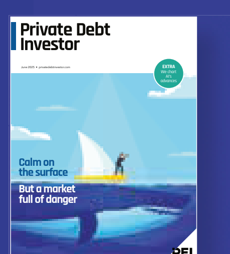
## Calm on the surface

## But a market full of danger

PEI

# The threats that lurk below the surface




Cover story

*With pressure rising on borrowers from outside forces, signs of danger are fast emerging. While not everyone agrees, some think a turn of the credit cycle is in the making.*

*By Robin Blumenthal*

A confluence of signals, coupled with the shock precipitated by the tariff drama and its attendant effects on the economy, is indicating a rough ride ahead for the credit markets, with some expressing deepening concern around private credit.

"We're at the early innings of a credit distress cycle," says Charles Peabody, a founding partner and president of independent bank research firm Portales Partners. "People have woken up to the fact that there's credit stress in private credit." He expects private equity and private credit "to be at the epicentre of any credit dislocations", even drawing parallels between the current situation and the Panic of 1907 (see panel, p. 16).

Andrew Milgram, chief investment officer and managing partner at Marblegate Asset Management, a restructuring manager, concurs. "We have this pandemic of over-indebtedness across the entire corporate landscape that is particularly acute in the mid-market," he says, noting that average payment-in-kind debt among public business development companies has risen to nearly 10 percent, a statistic he calls "profoundly disturbing".

At the same time, the data his firm uses to monitor the health of the mid-market points to "sharply negative" net profits after tax for the average mid-market company, with interest coverage on 20 percent of the data set below one times EBITDA.

According to the International Monetary Fund's *Global Financial Stability Report*, released at the end of April, more than 40 percent of companies that borrowed from private lenders had negative cashflow from their operations at the end of 2024. At the same time, debt maturity issues are building, with 40-60 percent of lower-rated borrowers facing debt maturities by the end of 2026, according to KBRA.

Concerns about credit quality pre-dated the hefty tariffs President Donald Trump imposed on more than 60 countries on 2 April. A week later, after an equity market rout, the administration reversed course and paused the tariff increases for 90 days on all countries save for China, before the two reached a deal in mid-May to roll back most of their retaliatory tariffs imposed in April.

Although markets were assuaged, uncertainty over the eventual outcome has undermined business confidence in an already lengthy credit cycle that has been marked by higher interest rates, continued inflation and now supply chain disruptions. The US economy, as measured by GDP contracted in the first quarter, as businesses stockpiled imports of goods in anticipation of higher tariff-related costs.

## Defaults on the rise

Signs of stress have been evident for some time. Last year, on average, one out of 20 businesses owned by a sponsor defaulted, notes Victor Khosla, founder and chief investment officer of Strategic Value Partners.

"Underneath the surface in the illiquid markets, the problems are much more extreme than the liquid markets," Khosla says, noting that SVP saw prices on senior debt on some secondaries deals compress from around 70 cents on the dollar to 50-55 cents in the space of just four weeks this year.

"There's a big rationalisation coming in private credit," partly evidenced by the rise in bankruptcy filings, says Dan Zwirn, chief executive and chief investment officer at fund manager Arena Investors. US corporate bankruptcies remained at a "historically high" level in April, with the number of filings in the first four months of the year by large public and private companies hitting 246, the highest since 2010, according to S&P Global Market Intelligence.

Zwirn says he's seen people sell distressed loans "at levels that imply the buyer of the loan needs to take over the business to make that make sense". Indeed, some of the recoveries in the public markets have been tiny, with bankrupt retailer Forever 21 proposing in May that senior lenders recover a

paltry maximum of three cents on the dollar.

David Breazzano, head of team for credit and portfolio manager at Polen Capital, believes "the risk has been pushed over to the private credit market", with second-lien loans often being refinanced with private credit. But the risk isn't as evident as in the syndicated market, because private credit managers can hide it by deferring coupons or using PIK interest.

"Managers oftentimes have the ability to value these assets at cost, so the investor doesn't know there's trouble in the portfolio," says Breazzano.

That cannot continue indefinitely, says Eric Newman, who sits on pension boards for the City of Stamford, Connecticut. "Like previous black swan cycles, at some point there will be write-downs, particularly for smaller and medium-sized companies that don't have liquidity or the support of a sponsor." Unlike prior cycles, where companies received government support, "there's not necessarily going to be bailouts across the board".

Milgram believes a protracted credit distress cycle is inevitable. "Valuations suggest that much of the sponsor-backed PE world is severely out of the money," with a big disconnect between the marks and the valuations, he says. "We're moving into a period where the problems are now broad-based enough that large parts of lenders' portfolios will become troubled."

*Private Debt Investor* raised the prospect of credit stress in our October story, 'Are we nearing a credit cycle downturn?' and MSCI has been sounding

*"These deeper write-downs suggest that a growing number of borrowers are really getting squeezed"*

**PATRICK WARREN**
**MSCI**

the alarm since at least September. In a December note, MSCI said "private credit as a strategy is experiencing its first real rate cycle, and investors who hoped those loans would be light on credit risk may be disappointed".

### Concern over valuations

More recently, at the request of *PDI*, MSCI found that loan valuations sharply deteriorated in 2024, with write-downs spiking from the 20 percent level that generally indicates distress to a lofty 50 percent, even on some vaunted senior loans. "The haircuts on distressed loans have snowballed," says Patrick Warren, vice-president of research at MSCI, with valuations getting sliced in half on about 5 percent of senior loans and 12 percent of mezzanine debt.

"It's more alarming than if transaction values were being cut, because it's against GPs' interest to volunteer that information," Warren says. "These deeper write-downs suggest that a growing number of borrowers are really getting squeezed by a combination of sustained elevated interest rates and an uncertain growth outlook, and these are the types of loans at the greatest risk of sliding into restructuring, barring a turnaround."

Moreover, Warren notes that dry powder for senior private credit reached "multi-year lows" relative to committed capital in early 2024. Despite a small uptick as the year went on, at year-end just 14.5 percent of such commitments were uncalled, compared with 22 percent on average since 2009. The last time that ratio fell to such lows was 2013, he says, noting that the decline is "largely due to a slowdown in private credit fundraising, which has meant that younger funds with capital to deploy have not materialised to fill the gap".

To be sure, the severity and breadth of any crisis remains to be seen, given the uncertainty around tariffs and their effects. Indeed, concerns about the credit picture are not uniform.

Richard Wheelahan III, co-founder of Fund Finance Partners, a capital markets advisory firm for sponsors, believes it is "premature" to sound the alarm for a credit crisis. He notes that borrowers "are not clamouring for any rainy-day liquidity" by calling for outsized borrowings on revolvers and delayed-draw term loans, as they did in 2020. "It's right to raise the degree of scrutiny, but I wouldn't say things are really bad."

### No cushion

Those arguably facing the greatest risk are smaller managers, which lack restructuring teams or advanced technology to navigate a deep dislocation, as well as industrial and consumer-facing companies.

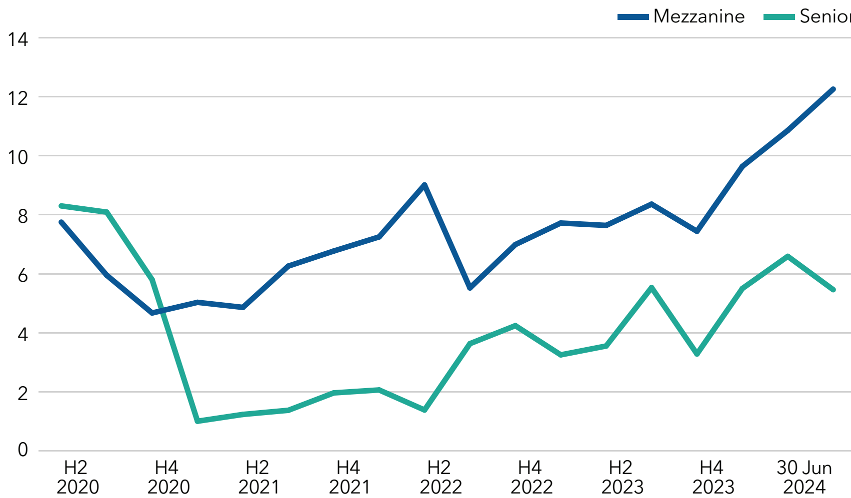
"There will be some dispersion between public and private markets, and big managers and small managers," says Brad Marshall, global head of private market strategies at Blackstone. He notes that the portfolios of most larger managers like Blackstone are geared to sectors such as tech, software and business services, which he believes will outperform other sectors.

Mark Jenkins, head of global credit at Carlyle, points to the significant resources his firm and other large managers have that can be used to address and head off problems. Even before the US administration changed, he says his team was managing out of "any legacy positions or credits that probably had no right to survive in a normalised environment but were suffering from the 550-point base rate rise".

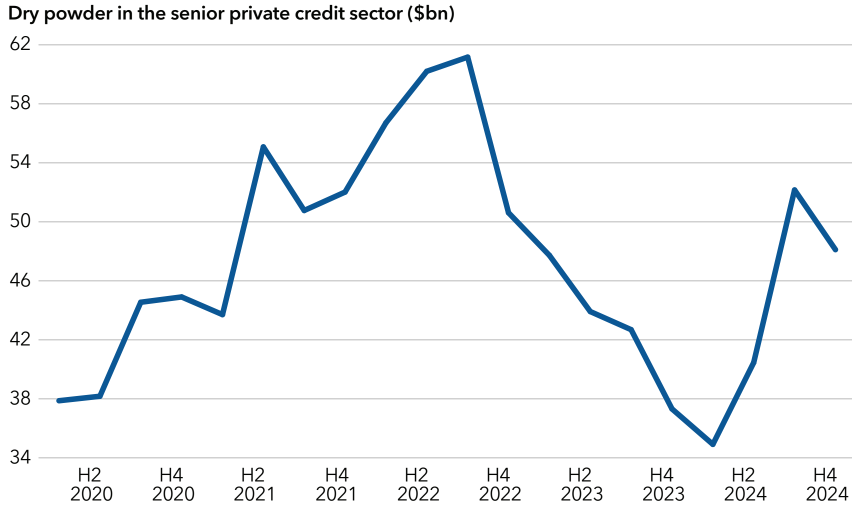
The vintage matters as well. "The cohort that is most susceptible to issues is the period from the end of 2020 to the beginning of 2023," Jenkins says.

David Conrod, co-founder and chief executive officer of capital raising and advisory firm FocusPoint Private Capital Group, doesn't believe a credit distress cycle is imminent. But he says that it "would also be suspect if, say, 2021-vintage private credit funds were all marked at par".

**Percentage of private credit loans with 50% write-downs**




**Dry powder in the senior private credit sector ($bn)**




Source: MSCI

A number of the private debt capital structures were put together post-covid, "when base rates were at zero", says Bryan High, head of global private finance at Barings. "There will likely be issues among some of these companies, and not a lot of cushion to deal with problems in those instances. We seek to underwrite our investments to protect for that downside risk."

Matt Douglass, chief executive officer of PGIM Private Capital, is confident about the manager's prospects, given its focus on the terms and structures of its loan agreements. "The way to outperform as a credit manager is by avoiding losses," he says. Moreover, given that PGIM is often the only lender to its mid-market borrowers, "if trouble comes, we have to be able to work constructively through challenges with borrowers, and we have the experience to do so".

If a distress cycle is indeed coming, it will arrive amid a major push by private credit into the retail market, including the launch earlier this year of a private credit ETF by Apollo and State Street. That instrument gives investors access to daily liquidity in a vehicle that contains an inherently illiquid investment.

In times of stress, individual investors are often the first to run for the exits. Soon after the initial tariffs were announced, outflows of loan ETFs hit a daily record of $1.3 billion, while the Janus Henderson Triple A CLO ETF saw nearly $600 million of withdrawals in one day, pushing its share price 1.1 percent below the value of the CLOs in its portfolio.

Nor are institutional investors immune. "When we have an inflection point or a downturn, some of these institutions are going to be shocked that they don't have the liquidity they expected," Polen's Breazzano says. "There will be a rude awakening there." In such instances, "many institutional investors are tempted to do things that a rational person wouldn't do".

In recent months, several big institutional investors, including Yale University, Kaiser Permanente and Norinchukin Bank, have sold or are seeking to sell multibillion-dollar private asset portfolios, some including private credit, although not necessarily because of market volatility or tariffs.

Some market participants are betting that a dislocation will cause widespread pain, with short sellers at one point targeting big publicly traded asset managers.

> *"We're at the early innings of a credit distress cycle"*
>
> **CHARLES PEABODY**
> **Portales Partners**

### Consumers on the run

Although the tariff agreement between the US and China steadied markets and eased some uncertainty, and economists tempered their recession forecasts, consumer confidence plunged to a four-year low in March and credit card delinquency rates have risen above pre-pandemic levels. Automotive repossessions reportedly surged last year to the highest level since 2009, a 16 percent jump from 2023.

First-quarter earnings exhibited signs of stress, with some business development companies reporting restructurings and asset markdowns. Sumitomo Mitsui Banking Corp reportedly sold at least $3 billion of credit lines it had provided to BDCs to Apollo, Carlyle and Ares in the form of significant risk transfers (SRT), the first known instance of such securities being sold to transfer the risk of banks' lending to BDCs.

Distressed or opportunistic managers such as Oaktree Capital Management, which earlier this year closed the largest distressed fund ever at $16 billion, are likely licking their chops, with one manager quipping that for managers like Oaktree, "it's going to be a Christmas bonanza".

According to Moody's "the probability of default of US corporates hit a post-financial crisis high of 9.2 percent" – double that of 2021 – at the end of last year, and "there are no signs of a clear peak approaching". Distressed debt funds pose the greatest concern, with distressed companies rated B3 negative or lower constituting 16 percent of Moody's total rated debt. PE firms own approximately 75 percent of those companies by issuer count.

Senior loans aren't immune, with their distress rates approximately tripling over the past few years, according to MSCI's Warren. He also found that nearly 40 percent of assets in mezzanine and generalist private credit funds are equity instruments. "The surprising thing is if you think you're investing in a private credit fund… actually a lot of what you're investing in is equity," he says. That is problematic because if a borrower defaults or goes bankrupt, equity holders get paid last or not at all.

Lyle Margolis, head of private credit at Fitch, says defaults reached an

## Shades of crises past?

**Although this black swan event may feel unprecedented, industry figures think there are parallels with other times of extreme stress**

Private credit came into its own in the aftermath of the global financial crisis of 2008, and the illiquid nature of the asset class and its premium returns have since largely shielded it from market volatility and stress. But April's equity market rout put into stark relief how a shock such as 'Liberation Day' could spark mayhem in the private credit universe, especially the more visible, public parts.

Ted Koenig, chairman and CEO of Monroe Capital, was worried that Liberation Day "could be a seminal moment like 2008, and the start of something we're going to be reading about for years to come". It seems the initial shock of the tariffs has abated and we are getting back to some state of normalcy, but Koenig still thinks there should be a heightened state of awareness and inflection point in 2024, when bankruptcies increased by a factor of five, from the single default recorded the previous year. "We are seeing a change in the way sponsors react to these things," he says. "Because the cost of capital is so high, it doesn't make sense to continue to throw good money after bad with some of these companies." And when sponsors cede control, recoveries continue to be weak and often total just 25 percent of the principal or less, Fitch says.

According to Portales' Peabody, private organisations have some of the riskiest junk bond/leveraged loan exposures. He cited the Shared National Credit exam for 2024, which found that non-banks still hold a disproportionate share of loan commitments rated special mention and classified – an eye-popping 26.8 percent, compared with only 4.7 percent and 4.6 percent for US banks and foreign banking organisations, respectively. These classifications signal potential weakness in loan quality.

He points to the lack of M&A and IPOs that are preventing managers from monetising their investments. At the same time, many stocks and select industries are repricing at much lower levels, sometimes as much as 30-40 percent. The upshot, says Peabody, is this: "Any inability to monetise/liquify these holdings will be the undoing of private equity and private credit." ■

preparedness for portfolio management. Private credit platforms that have deep asset management expertise will have an advantage and should drive excess alpha.

Charles Peabody, founding partner at independent research firm Portales Partners, is drawing parallels between private credit and the trust companies of the early 20th century, whose undoing led to the 'Panic of 1907' – the first worldwide financial crisis.

Peabody likens the shadow banking system populated by private credit managers, hedge funds and others to those trust companies, which were largely unregulated institutions that competed with banks, but unlike them lacked membership in the New York Clearinghouse – the predecessor to the New York Fed – and were thus unable to access liquidity from the lender of last resort in a crisis.

In a note subtitled, 'Why Private Capital is the Likely Source of the Next Credit Cycle Problem', Peabody points to the rapid, largely unconstrained growth of private capital since 2010. "The structure of the PC world is diffuse, its managers are both smart and powerful, and the discovery process is slow." He worries that "the spillover into the real economy will likely occur when some of these companies attempt to refinance 2021-era loans at 2025-2026 interest rates, or in a hostile equity environment".