BDC growing pains: Navigating the next phase of private credit

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Overview

- BDCs have expanded rapidly post-COVID, as investors have sought yield, but rising skepticism of underlying credit quality has led to weaker flows, testing sector resilience.
- Negative sentiment, slowing flows and valuation pressures drive our underweight stance, as limited catalysts and asset quality dispersion challenge performance.
- As sector dislocation intensifies, Invesco Fixed Income remains tactical, opportunistic and value-oriented, in search of attractive risk-adjusted investment opportunities across the US investment grade BDC space.

Business development companies (BDCs) are funds that operate as specialty lenders and primarily provide debt financing to private middle-market companies. Interest in BDCs gained momentum after the global financial crisis (GFC), as banks' leveraged lending capabilities became more strictly regulated. While growth was steady early on, the post-COVID period saw a boom, as investors sought higher yielding products in the low-interest rate environment. This surge in demand gave rise to perpetual non-traded (PNT) vehicles, which are not listed on public exchanges and operate indefinitely without a fixed termination date. These vehicles have since attracted substantial retail inflows

Recent events have raised concerns about BDCs

In September 2025, two private companies, automotive parts company First Brands and sub-prime auto-lender and used car retailer Tricolor, filed for bankruptcy amid allegations of fraud. Although BDC exposure to these companies was small, skeptics felt this could be a sign of systemic stress in the private credit industry, and investor sentiment soured across the sector (Figure 1).

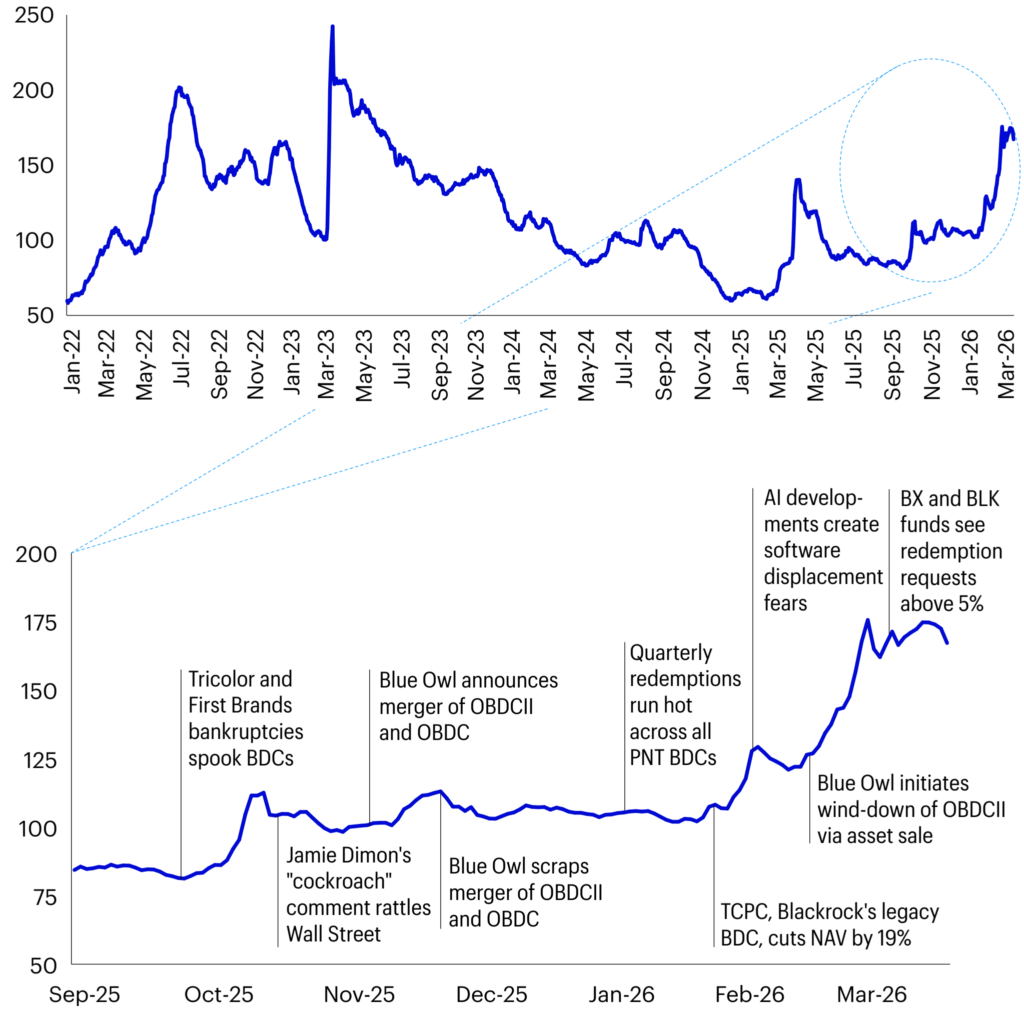
Figure 1: BDC spreads have widened this year, led by negative sentiment
Basis points

Source: Invesco Credit Research, Bloomberg L.P. Bloomberg US BDC Issued Debt Unh USD. Data from Jan. 3, 2025 to March 20, 2026.

Negative sentiment continued through the winter as BDC mergers were announced and then cancelled, redemptions from PNT vehicles increased, concerns about software exposure escalated, and scrutiny over the validity of loan marks intensified. We attribute much of the skepticism to the rapid growth of BDCs, coupled with the absence of a full credit-cycle track record for many of them. We believe the current environment provides a constructive test for of them: Asset quality and liquidity management should ultimately reveal differentiated performance across the sector.

Figure 2: Timeline of BDC headlines

Spread differential of BDCs vs US investment grade (basis points)



Source: Invesco Credit Research, Bloomberg L.P. Bloomberg US BDC Aggregate Eligible Index Unh USD and Bloomberg US Agg Credit Avg OAS. Data from Jan. 3, 2022, to March 20, 2026.

Market strategy

In November 2025, we favored an underweight position across all perpetual non-traded BDCs (PNTs) on the expectation of slower retail flows.1 Going into 2026, we reinforced our view by favoring an underweight position across the entire BDC sector as we expected the rising negative sentiment to continue, driving negative spread performance. Despite valuations looking attractive from an historical perspective, we continue to favor an underweight position in BDCs, as we anticipate few positive catalysts that could outweigh the negative sentiment in the near term. A shift in the narrative coupled with a normalization in flows are key indicators we are monitoring closely as we reassess our outlook. We view the current environment as a pivotal test for BDCs, one that should clearly separate winners from losers, as strong asset quality and liquidity management prove to be the true differentiators. With the narrative continuing to evolve, we remain tactical, selective and opportunistic, with a focus on the highest-quality names in the space

Trends in BDC fundamentals

Going forward, the fundamental backdrop for BDCs remains challenged, in our view. While BDCs continue to report improved average EBITDA growth and interest coverage ratios for their portfolio companies, we're beginning to see more asset quality dispersion. Lower base lending rates (typically SOFR) plus tight direct lending origination spreads have led to lower returns, implying unsustainable dividends. Public BDCs are trading at significant discounts to their net asset value (NAV) as investors question the validity of loan marks and

1. BDCs in this paper refer to BDCs with outstanding public unsecured bonds.

price in future dividend cuts. Net flows to BDCs are also slowing, as weakening fundamentals and persistent negative news weigh on investor sentiment.

How Invesco Fixed Income navigates the BDC sector

Our analysis takes a holistic approach to evaluating BDCs. We focus on both qualitative and quantitative factors to identify sector and name-specific risks. We consider many factors and trends, but we believe the key factors to monitor are portfolio construction, asset quality, manager selection and liquidity management.

- **Portfolio construction**

  BDCs differ in the size of the companies they lend to. Company sizes range from low middle market (<USD25 million EBITDA), to core middle market (USD25 million-USD100 million EBITDA), to upper middle market (USD100 million+ EBITDA). We assess a portfolio's sector concentration, its average position size and the weighted average life of its loans. We believe that diversification is crucial and consider outsized software exposures and large, concentrated positions as credit negatives in the current environment. We also identify the percentage of investments that are first lien senior secured, the average loan-to-value ratios of portfolio company loans and the percentage of loans to private equity-backed companies. We believe these metrics provide insight into the risk framework of the BDC, and trends show how that framework is evolving.

- **Credit quality**

  BDC managers allow some of their portfolio companies to utilize payment-in-kind (PIK) interest.[2] While we consider deferring interest as a negative development, PIK optionality is often offered at loan origination to allow borrowers financial flexibility. Sometimes BDCs grant PIK optionality after origination when a company cannot meet its cash interest obligations. In our view, this masks underlying fundamental weakness, which is a credit negative. Regardless of the use, PIK is inherently negative, in our view, given that BDCs must distribute at least 90% of taxable income to shareholders.

  Another credit quality metric we monitor is when portfolio companies' loans are placed on "non-accrual status". This designation occurs when principal or interest payments are past due, typically 90 days, or when there is reasonable doubt about collecting principal or interest in full. Historically, non-accruals have represented around 2.5% of a BDC's loan book.[3] Post-COVID, lower interest rates, more recently formed portfolios and strong performance pushed the industry's average non-accrual rate below the historical norm, though recent increases have heightened investor concern.

  To identify credit quality issues before they show up in the form of PIK, non-accruals, or losses, we track the health of BDCs' underlying portfolio companies. We accomplish this by monitoring the average EBITDA and interest coverage growth of the portfolio companies and loan marks (fair value divided by cost). This allows us to get a sense of any potential credit issues on the horizon.

- **Management and BDC sponsors**

  As BDCs have become popular, many asset managers and banks have launched vehicles to capture flows into the asset class. Therefore, having a high degree of confidence in the management team, investment criteria process, and underlying platform is another crucial factor to consider when analyzing BDCs – especially since disclosures on portfolio companies themselves are limited.

  In the current volatile environment, we have more confidence in BDCs with long-track records that have experienced and survived credit cycles. While a majority of BDCs were formed post-GFC, many platforms did exist beforehand and survived the crisis. We generally view these BDCs more favorably than newer platforms that have not experienced a significant drawdown.

  The investment process is also a key consideration. Understanding how new loans are sourced and managed is critical in analyzing each BDC. We prefer BDCs managed by credit-focused platforms with deep, experienced teams that can deliver strong origination and actively manage credits through restructuring or remediation when needed.

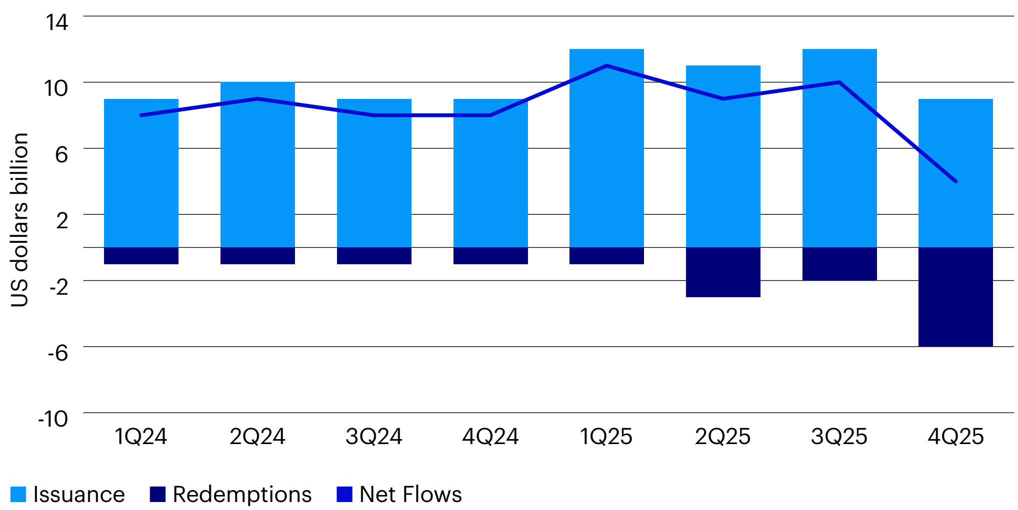
- **Liquidity and capital management**

  We believe liquidity and capital structure management are crucial to understanding a BDC's credit quality.

2. When a payment in kind is made, unpaid interest is added to the outstanding loan balance instead of being paid in cash.
3. Source: Barclays, Fitch, Dec. 31, 2025.

When identifying liquidity risks, we focus more on PNT vehicles, which typically offer periodic redemption windows that can strain liquidity. Publicly traded vehicles, on the other hand, do not face the same redemption risk since they trade on exchanges. Most PNTs offer liquidity to investors on a quarterly basis. Inflows to PNTs have been strong in seven of the past eight quarters with muted outflows, suggesting strong liquidity positions. The fourth quarter of 2025 displayed continued strong inflows, albeit at a slower pace, but also an uptick in redemptions, largely driven by negative market sentiment.

Figure 3: Aggregate quarterly flows to PNTs
US dollars billion



Source: Barclays Research. Data from March 2024 to Dec. 2025.

The market standard is for PNTs to cap redemptions at 5% of NAV to safeguard liquidity and avoid early asset liquidation. However, in the fourth quarter of 2025, the few BDCs that received redemption requests in excess of the 5% cap all honored redemptions in full.

In recent weeks, almost all PNT BDCs announced that redemption requests for the first quarter of 2026 were well above the 5% cap. These companies took different approaches. Two provided liquidity to all redemption requests while the others utilized the 5% cap and prorated redemptions. Combatting redemptions is a delicate balance as BDCs try to maintain adequate liquidity positions while satisfying equity investors, seeking to address their liquidity concerns and avoid elevated redemption requests in the future. We prefer BDCs that enforce the 5% cap, as it signals they are not willing to sacrifice liquidity based on fluctuating equity investor sentiment.

Another factor we watch is how BDCs manage their dividends. As base rates have declined, net investment income (NII) has been pressured, leading many BDCs to cut their dividends. We prefer when BDCs proactively reduce their dividends – it shows they are probably not reaching for yield through riskier investments to try to make up for lost NII. From a credit perspective, it concerns us when we see BDCs using leverage or earnings that could be put to better use to defend the dividend, as this sacrifices liquidity.

Where do we go from here?

Negative sentiment around private credit in general and specifically BDCs, remains elevated. Every new negative headline seems to weaken BDC bond performance. With media and investor focus likely to continue, we are monitoring its effect on redemption requests. Continued elevated requests will likely weaken BDC fundamentals, primarily by draining liquidity. AI-related software concerns have been challenging to discern, but portfolio markdowns will likely show signs of weaker underwriting and portfolio strain, if applicable. Pressure on the software sector and reduced capital inflows will potentially make asset-quality weaknesses more visible, distinguishing stronger managers as fundamentals normalize. As lower returns and potentially rising capital costs compress the margin for error, we expect greater dispersion across BDCs amid tighter liquidity for unfunded commitments, idiosyncratic credit stress, and additional workouts, particularly for newer funds. That said, Invesco Fixed Income remains tactical, opportunistic and value-oriented and we continue to monitor the space, seeking attractive risk-adjusted investment opportunities.

As the BDC landscape is likely to become more differentiated, we believe performance will be increasingly driven by portfolio construction, credit discipline, and liquidity management. Our approach focuses on identifying potential stress early by closely monitoring borrower fundamentals, valuation trends, and portfolio composition, allowing us to better assess how individual BDCs may perform as conditions evolve.

We also view manager experience and balance-sheet discipline as critical in navigating the current environment. Managers with established platforms and a track record across multiple market cycles may be better equipped to manage periods of volatility. From a liquidity perspective, we favor BDCs that maintain flexibility through measured leverage, disciplined redemption frameworks, and prudent dividend management. Overall, we believe this framework supports a selective approach focused on identifying BDCs capable of delivering more consistent outcomes over time.

Investment risks

The value of investments and any income will fluctuate (this may partly be the result of exchange rate fluctuations) and investors may not get back the full amount invested.

Fixed-income investments are subject to credit risk of the issuer and the effects of changing interest rates. Interest rate risk refers to the risk that bond prices generally fall as interest rates rise and vice versa. An issuer may be unable to meet interest and/or principal payments, thereby causing its instruments to decrease in value and lowering the issuer's credit rating.

Non-investment grade bonds, also called high yield bonds or junk bonds, pay higher yields but also carry more risk and a lower credit rating than an investment grade bond.

The risks of investing in securities of foreign issuers, including emerging market issuers, can include fluctuations in foreign currencies, political and economic instability, and foreign taxation issues.

The performance of an investment concentrated in issuers of a certain region or country is expected to be closely tied to conditions within that region and to be more volatile than more geographically diversified investments.

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