

Private credit today: Why approach and structure drive outcomes



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The private credit market has undergone its first meaningful sentiment test of the current cycle. The catalysts have been twofold:

- Growing concern around the potential impact of artificial intelligence (AI) on software and technology enabled services, historically among the largest sector exposures within direct lending.
- Increased scrutiny of liquidity dynamics in certain private credit vehicles, most notably publicly listed business development companies (BDCs) and the expansion of semi liquid perpetual BDC structures.

These developments, alongside recent headlines in other areas of public and private credit, including First Brands in the broadly syndicated loan market and Tricolor in asset based lending, have prompted broader questions about the overall health of private credit as an asset class and the rigor of underwriting standards across the market. In periods like this, it is important to differentiate among private credit strategies.



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Direct lending portfolios and software companies

Direct lending portfolios are predominantly composed of first lien, senior secured loans, typically representing approximately 90% of capital invested,¹ while other forms of private lending may lack comparable levels of collateral coverage, structural protections, or seniority in the capital structure.

Software has long been viewed as one of the more attractive sectors in private markets, often accounting for 20% or more of industry commitments (Figure 1). The rapid advancement of generative AI, however, has complicated that narrative. In certain cases, AI has raised legitimate questions around the durability of specific products and services, particularly where business models, such as software as a service (SaaS), could be replicated, automated, or meaningfully disrupted by increasingly capable AI tools, agents, and workflows.

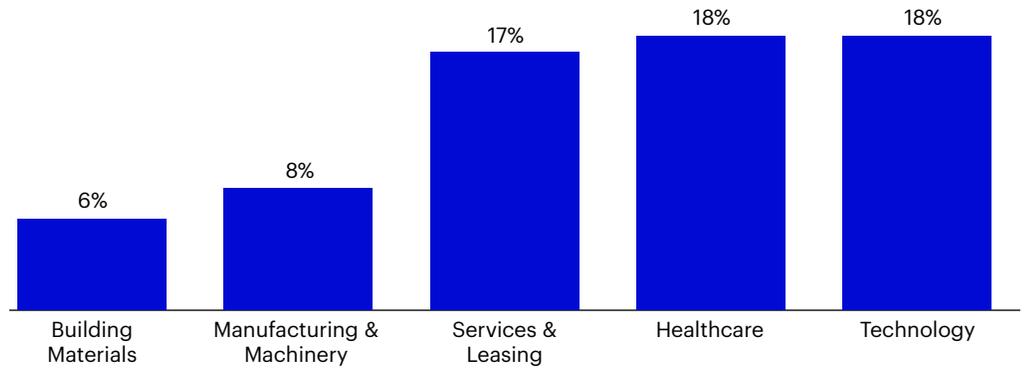
While software businesses have historically benefited from recurring contractual revenue, attractive margins, and strong free cash flow generation, these characteristics have also driven elevated valuation multiples and higher leverage levels. In our view, this combination has increasingly skewed the risk reward profile unfavorably for credit investors, particularly when assessed through the lens of downside risk mitigation and recovery outcomes.

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1. Source: Cliffwater, as of Sept. 30, 2025.

Figure 1: Software is the largest sector of direct lending new-issues

New-issue direct lending top 5 sectors



Source: KBRA DLD Research. PitchBook LCD, data through December 31, 2025. Direct lending analysis is based on transactions covered by LCD News.

Redemption pressure puts a focus on liquidity

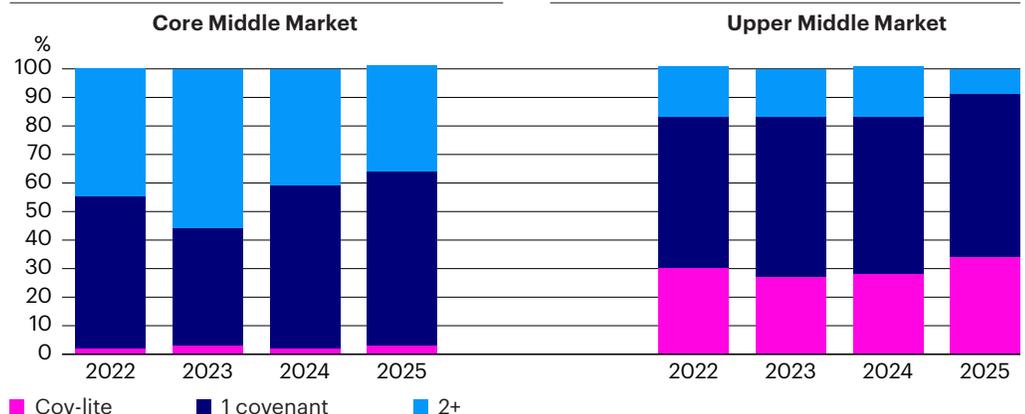
At the same time, several large public BDCs and semi liquid private credit vehicles have experienced redemption pressure. This has drawn increased attention to the structural mismatch inherent in offering periodic liquidity against portfolios of fundamentally illiquid loans, an imbalance that can become more visible during periods of market uncertainty. In publicly listed BDCs, this dynamic has manifested in meaningful discounts to net asset value. In newer, private semi liquid vehicles, it has led to elevated repurchase requests and heightened investor scrutiny.

As private credit has expanded into a market approaching \$2 trillion in size,² with a growing share of capital allocated to semi liquid structures, fundraising has increasingly concentrated among a smaller number of large platforms. With scale has come pressure to deploy capital consistently in order to manage cash drag. In some cases, this has coincided with a relaxation of underwriting discipline and a reduction in traditional creditor protections, including maintenance covenants.

While recent headlines have often treated private credit as a monolithic asset class, frequently conflating distinct strategies, vehicle structures, and liquidity profiles, we view the current environment differently. In our assessment, recent stress reflects a combination of vehicle level liquidity dynamics and sector specific challenges, rather than a systemic deterioration in middle market credit quality. This distinction is particularly important in the core middle market, where lending structures continue to emphasize seniority, collateral coverage, and contractual credit protections (Figure 2).

Figure 2: Core middle market deals tend to have significantly more covenant protections than larger deals

Covenants per deal by market size (%)



Source: KBRA DLD Research, as of Dec. 31, 2025.

2. Source: Pitchbook, as of Dec. 31, 2025.

Market dislocations can create compelling opportunities

We do not believe the opportunity set in private credit has fundamentally changed. Middle market companies and their private equity sponsors continue to require financing, and direct lenders remain essential in filling the gap created by the secular retrenchment of traditional bank lending. As portfolios are tested, however, differences in approach are becoming more apparent. Managers that have emphasized discipline and downside risk mitigation are likely to experience different outcomes than those that leaned more heavily into momentum and growth. For managers with dry powder, experience, and a consistent approach, periods of volatility may ultimately prove attractive.

As the credit cycle evolves, market dislocations can create compelling opportunities to finance high quality businesses in need of capital. Shifts in the balance between private credit supply and demand may alleviate pressure on spreads, while risk off environments typically bring tighter underwriting standards and improved transaction structures. Historically, these conditions have supported attractive risk adjusted returns and strong outcomes for vintages formed during periods of dislocation.

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