

Insights Engine | Private Credit

Yield Premium, Defensive Structuring, and a Re-Accelerating Deal Cycle

Executive Summary



Private credit enters 2026 with a compelling blend of elevated yields, controlled risk, and improving deployment conditions. After a muted mid-2025 pipeline, direct-lending activity re-accelerated into Q4 with \$63 bn of new issues, reflecting stronger M&A pipelines, rising recapitalization demand, and expanding borrower diversity. Leading managers such as Ares signal a material pickup in origination, supported by a \$3 bn backlog and rising first-time borrower activity—an indicator of broadening market depth as sponsors prepare for a rate-cutting cycle.

The asset class continues to deliver a meaningful yield premium over syndicated loans and high-yield bonds, underpinned by tighter covenants, bespoke structuring, and faster workout mechanics. Loss experience remains contained: long-term default and recovery patterns for senior direct lending compare favorably with public high-yield benchmarks, reinforcing the defensive character of the asset class.

Structural tailwinds remain intact: banks’ post-GFC retreat from middle-market lending, regulatory constraints, and the rise of private credit as a full-stack financing partner. For 2026, investors can benefit from 5–20 % allocations that blend yield enhancement, drawdown resilience, and low correlation to public markets—provided manager selection and covenant discipline remain front and center.



**Direct Lending Issuance in
3M Oct '25, Up From \$60B
in Q3 '25**

\$63B

\$2.5T

**Est. Global Private Credit AUM
by end of 2025**

**Ann. Private Credit Loss Rate
(2017-24)**

1.33%

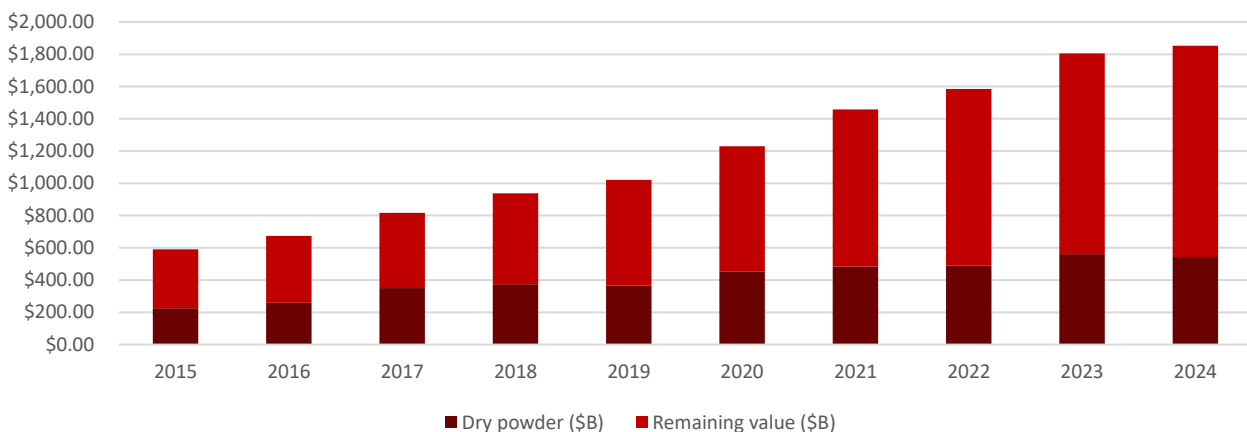
14.5%

**Private Credit Growth CAGR
over Last Decade**

A 300-500 BPS ILLIQUIDITY PREMIUM WITH LOWER LOSSES – PRIVATE CREDIT DELIVERS YIELD PREMIUM WITH CONTROLLED RISK

We believe the private-credit market is positioned for a material rebound in 2026 as the macro-environment normalizes and sponsors regain confidence in financing. Direct-lending new-issue volume rose to \$63 bn across 211 deals in Q4 2025, modestly above the \$60 bn/201-deal level in Q3, yet year-to-date volumes remain roughly 15 % below 2024. The short-term lag reflects a muted Q2-Q3 pipeline, but BDC earnings calls in the third quarter signal accelerating deal flow. Moreover, Ares reported a \$3 bn backlog as of 23 Oct 2025, with approximately 50 % of that pipeline tied to M&A-related originations and 60 % from new borrowers. This shift away from roll-up-only strategies suggests a broader base of credit demand that can sustain higher origination levels once rate cuts and confidence return. We note that refinancings and recapitalizations now represent about 30 % of new PE-backed deals in Q4, up from 25 % in the first three quarters, underscoring borrowers’ appetite to lock in tighter spreads ahead of a more active financing environment.

Figure 01: Private Debt Institutional Fund AUM (\$B)



Source: PitchBook.

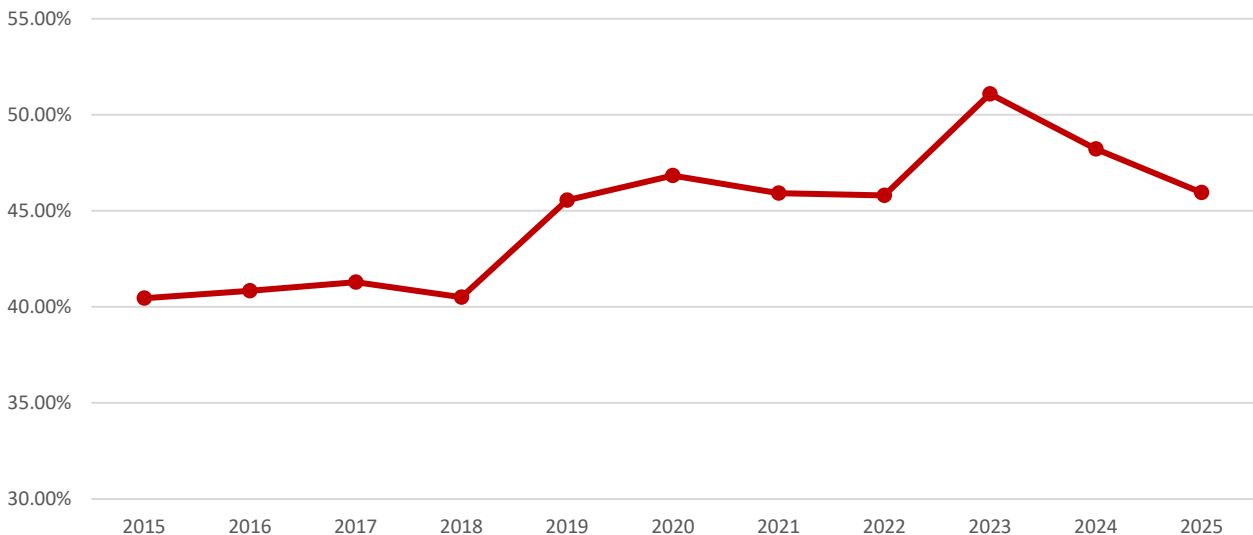
Opportunity in Private Credit: Yield Premium and Low Loss Ratios

We note that private credit historically outperforms comparable syndicated loans and high-yield bonds on a risk-adjusted basis. Cliffwater data shows a ten-year average spread advantage over the ICE BofA high-yield index, reflecting the bespoke structuring, speed of execution, and tighter covenant packages that private lenders can impose. At the same time, loss ratios for private-credit portfolios have remained below those of high-yield and in line with leveraged-loan benchmarks, a result of deeper due-diligence access and single-lender or small-group structures that enable faster workouts. The broader performance attribution is clear: higher yields combined with lower credit losses have delivered superior risk-adjusted returns versus public high-yield and leveraged-loan benchmarks. In a simple return model, a 10 % yield with 1× leverage would require defaults to exceed 6 % and recoveries to fall below 40 % to erode total returns – a scenario we view as unlikely for top-tier managers given the historical resilience of senior direct-lending assets, which have recorded only three negative-return years since 1992 in a syndicated-loan proxy.

Growth and Trends: Expanding Asset Base and Diversified Strategies

We believe the private-credit universe has expanded at a compound annual growth rate (CAGR) of roughly 14.5 % over the past decade, outpacing corporate borrowing (5.5 %) and bank loans (3 %). Total AUM reached approximately \$2.5 tn globally by mid-2025, with U.S. direct-lending assets alone at \$450 bn and a dry-powder level of \$1.05 tn in September 2024 – a 94 % increase since the end of 2019. The market now equals the public high-yield market and represents about 9 % of total corporate debt, yet the sector’s share remains modest, indicating ample headroom. The strategy set has broadened beyond floating-rate senior loans to include fixed-rate senior and mezzanine, distressed/opportunistic, hybrid equity-credit, and specialty asset-backed credit. This diversification enables investors to target specific risk-return profiles, from interest-rate insulated floating-rate exposure to counter-cyclical distressed playbooks. Moreover, middle-market private-debt CLO issuance remains robust, with cumulative issuance of roughly \$15 bn in 2025 and a healthy pipeline of new issues, further expanding the toolkit for capital-structure tailoring.

Figure 02: Average Equity Contribution to BSL-financed LBOs Easing Back to 46% of Deal Value



Source: PitchBook. BSL = Broadly Syndicated Loan.

Structural Drivers: Bank Retreat, Regulatory Pull-Through, and Customization

We note that the retreat of banks from middle-market lending after the Global Financial Crisis (GFC) created a durable financing gap that private credit has systematically filled. Post-GFC regulatory constraints, including Basel III/IV capital requirements and Dodd-Frank leveraged-loan rules, have reduced banks’ appetite for bespoke mid-size exposures, while the “gravitational pull” toward non-bank lenders has intensified. Private-credit managers act as “matchmakers,” consolidating origination, underwriting, structuring, placement, and distribution through a single lending committee, thereby reducing friction relative to bank syndication or public issuance. The ability to embed payment-in-kind (PIK) features, equity kickers, and bespoke covenants differentiates private credit from regulated bank lending and enables faster, more tailored financing. In addition, the benchmark-free mandate of private-credit funds allows opportunistic allocation and risk-adjusted return enhancements that are not constrained by public index tracking. This structural

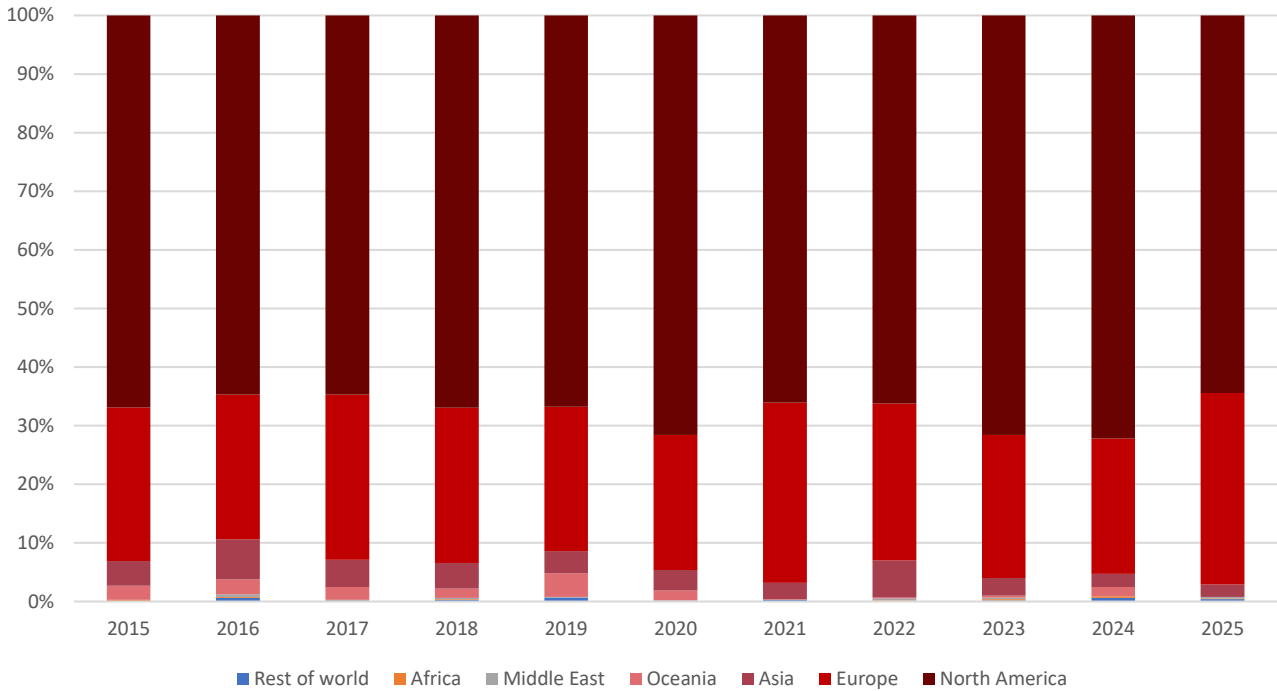
flexibility has translated into a pricing advantage: recent syndicated refinancings of direct-lending debt have produced spreads up to 200 bps tighter when borrowers transition to the public market, highlighting the cost-efficiency of private credit origination.

REGIONAL LANDSCAPE: U.S. DOMINANCE, EUROPEAN UPSIDE, ASIAN EMERGENCE

We believe the United States remains the anchor of private-credit activity, with AUM of roughly \$2.1 trn and a market share of about 75 % of global private-credit transactions. The U.S. market is characterized by a high concentration of senior direct-lending assets, a robust pipeline of M&A-driven originations, and a growing presence of Business Development Companies (BDCs) that provide semi-liquid exposure. However, Europe offers a compelling upside narrative. Private-credit assets in Europe grew at an 18 % CAGR between 2008 and 2024, outpacing the U.S. at 11 % CAGR, and now represent roughly \$500 bn (30 % of global private credit). European deal sizes are shifting upward, with 47 % of transactions in 2024 exceeding €350 m, and “jumbo” unitranche volumes in the €1-2.5 bn range emerging in 2025.

The region benefits from a fragmented banking landscape, higher equity cushions (57 % equity contribution versus 47 % in the U.S.), and slightly higher first-lien recovery rates (≈ 73 % versus 71 %). For USD-based investors, currency hedging can capture the roughly 100 bps spread advantage that European private credit enjoys over comparable U.S. deals, while EUR-based investors can mitigate USD depreciation risk. In Asia, private-credit assets surged from \$58.2 bn in 2020 to \$99.3 bn in 2023, driven largely by India, Japan, and Southeast Asia where banks have retreated from mid-market and structured lending. Institutional allocators are attracted by higher yields, lower correlation to bonds, and the nascent credit penetration in markets such as India, Indonesia, and Thailand. The Asian expansion aligns with rising corporate M&A and private-equity activity, suggesting sustained demand for flexible, sponsor-friendly capital.

Figure 03: Debt Capital Raised by Region (%)



Source: PitchBook.

Regional Risk Differentials and Systemic Links

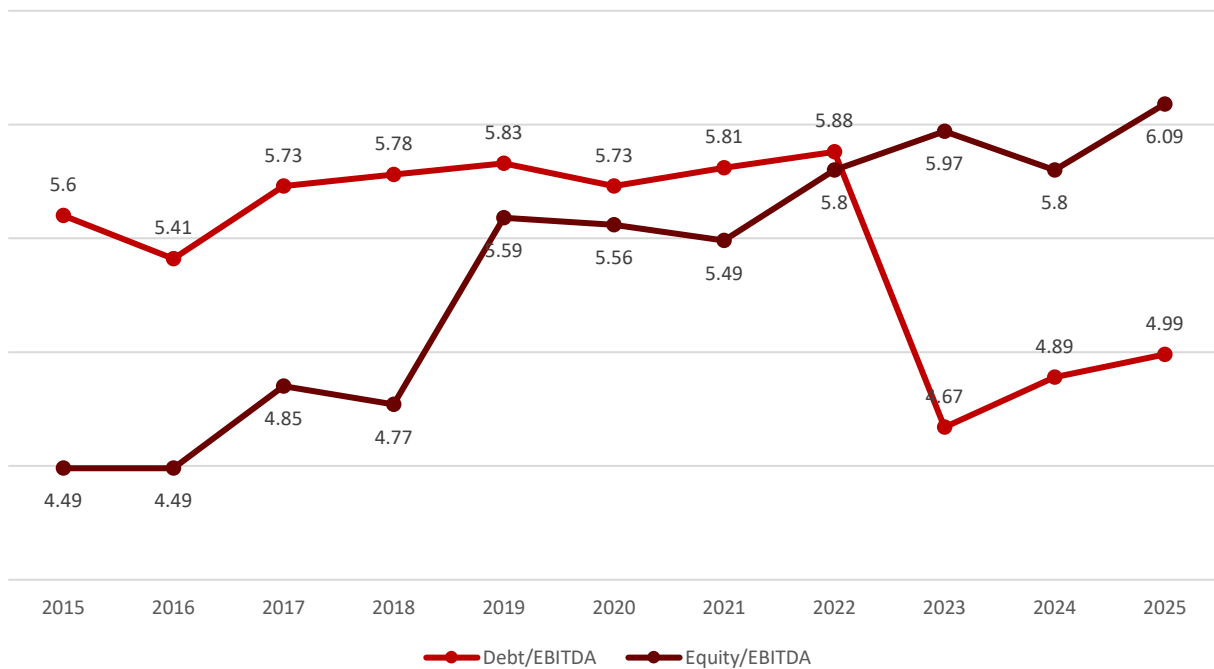
We believe that while the U.S. market offers scale and depth, it also exhibits heightened concentration in BDCs, which account for approximately 20 % of the private-credit market and rely heavily on bank lines for liquidity (5-10 % of total private debt). These lines create a conduit for credit-risk contagion: adverse shocks in private-credit portfolios can transmit to banks via loan and line-of-credit relationships, a systemic-risk flag highlighted by the IMF in its October 2025 Global Financial Stability Report. European private-credit exposure, by contrast, benefits from lower average leverage and higher equity cushions, which provide an additional buffer against default cascades. Asian private-credit markets, while still nascent, have demonstrated low default incidence (zero defaults reported in India over the past decade) but face macro-economic volatility that could test covenant structures. Across all regions, the opacity of private-credit transactions—limited disclosure, minimal regulatory oversight, and heterogeneous reporting standards—complicates macro-prudential monitoring. We therefore recommend heightened diligence on leverage ratios, covenant quality, and the extent of bank-fund interconnections when evaluating regional allocations.

VALUATION & RISK: SPREAD COMPRESSION, ILLIQUIDITY PREMIUM, AND LEVERAGE CONCERNS

We note that direct-lending spreads have compressed in recent quarters, with unitranche pricing clustering around SOFR + 450-500 bps. In Q4 2025, 45 % of buyout deals fell within this band, compared with only 18 % in 2024, indicating a narrowing of pricing dispersion. Concurrently, BDC portfolio spreads have continued to compress; as of 30 Jun 2025, roughly 30 % of unitranche holdings trade below S + 500 bps, up from 17 % at the end of 2024. This compression reflects heightened competition for deals and the influx of cheaper capital, yet the illiquidity premium remains a key component

of total return. Private-credit investments are ill-traded, requiring longer lock-ups and limiting secondary market exit options. Leveraged-fund structures further amplify risk: many private-credit funds employ leverage, and some pursue speculative structures that could magnify losses under stress. Nevertheless, structural protections—granular covenants, seniority positions, and robust collateral packages—support higher recovery rates in defaults. The private-credit loss experience from 2017-2024, derived from the Cliffwater Direct Lending Index (senior + non-senior), suggests an estimated annualized loss of 1.33 %, well below the leveraged-loan and high-yield loss rates for the same period.

Figure 04: Valuation Multiples for BSL-financed LBOs



Source: PitchBook

Portfolio Implications: Allocation Ranges, Manager Selection, and Diversification

We believe a calibrated allocation of 5-20 % of total assets to private credit can enhance portfolio yield while providing diversification benefits, given the sector’s low correlation to public markets and its defensive characteristics. Senior direct-lending assets retain strong defensive traits: high starting yields (~10 %), senior capital-structure position, and diversified loan portfolios; only three negative-return years have been recorded since 1992 in a syndicated-loan proxy. However, diversification across sub-segments is critical. Direct lending offers sector-wide exposure with higher yields; GP/LP solutions provide capital-call financing for private-equity GPs and secondary liquidity for LPs; asset-backed credit delivers collateralized cash-flow streams (projected TAM \$12-20 tn over ten years, with private credit holding ~5 % market share); and opportunistic credit captures value from distressed dislocations. Manager dispersion is expected to widen, making manager selection a primary alpha source. High-quality managers differentiate via sector diversification, covenant strength, seniority, and robust stress-testing frameworks. The data show that 84 % of 2024 capital was

allocated to managers established pre-2008, underscoring investor preference for “safe pair of hands” amid expectations of a credit-cycle downturn.

FORWARD-LOOKING SCENARIOS: SOFT LANDING, CREDIT CRUNCH, SYSTEMIC SHOCK

We outline three forward-looking scenarios to frame risk management. In a soft-landing environment, modest spread widening and orderly funding would limit impact on banks and investors, preserving the current yield premium. A localized credit crunch—triggered by clustered defaults—could tighten wholesale funding, increase borrowing costs, and prompt regulatory tightening, especially for funds with high leverage or opaque structures. A systemic crisis scenario, though less probable, would involve large-scale fund or bank failures, liquidity freezes, sharp equity and bond market sell-offs, and a global dollar squeeze, potentially requiring sovereign intervention. In each scenario, the resilience of private-credit portfolios hinges on covenant quality, equity cushions, and the ability of sponsors to inject equity or restructure via debt-for-equity swaps. Our stress-testing framework, which strips expected loss (EL) into default risk (SD) and private-credit risk (SL) components, indicates that under severe macro shocks PD-LGD correlations rise sharply, eroding the illiquidity premium. Accordingly, we recommend monitoring covenant erosion (the shift toward “Cov-Lite” structures), PIK usage (up to 11.7 % of BDC portfolios in Q2-24), and the health of bank-fund credit lines (approximately \$95 bn committed, 56 % utilization as of Q4-24).

Valuation Insights and Benchmark-Free Flexibility

We note that private credit’s benchmark-free mandate permits opportunistic allocation and risk-adjusted return enhancements that public-market funds cannot achieve. The lack of a public index also means that performance attribution is driven by manager skill rather than index tracking error. Historical data from the PitchBook Private Debt Index (closed-end fund returns, unsmoothed, annualized) show that private credit has delivered 8-10 % annualized net returns over the long term, with a short-term peak of ~12 % during the 2022 rate spikes. As base rates fall and competition intensifies, we expect a normalization toward the 8-10 % band. The “give-and-take” flow—\$5.8 bn of direct-lending loans refinanced into the syndicated market in Q4 (down from \$10.2 bn in Q3) and a total YTD flow of ~\$29 bn both ways—demonstrates fluidity between private and public loan markets, reinforcing the pricing advantage of private credit while providing an exit pathway for investors.

Structural Resilience and Systemic Implications for Banks

We believe private credit’s illiquid capital base aligns with long-duration investors (pensions, insurers) and helps address asset-liability mismatches in the banking system. The sector’s growth has eroded traditional banks’ share of mid-market and larger corporate lending, with U.S. and European banks collectively holding about \$4.5 trn of exposure to non-bank financial institutions (NBFIs) as of October 2025. Large banks have originated roughly \$300 bn of loans to private-equity and private-credit funds in 2025, effectively financing the leverage that fuels higher-value deals. While this creates a strategic partnership—banks earn fee income and retain senior exposure—the interconnection also raises systemic-risk concerns. The IMF flags credit-risk contagion and liquidity stress as primary risks: adverse shocks in private-credit portfolios can transmit to banks via loan and line-of-credit relationships, and non-banks may draw on bank credit lines during market turmoil, straining bank liquidity. Consequently, macro-prudential monitoring of bank-private-credit

exposures, granular mapping of loan terms, and stress-testing of senior-leverage positions are essential to mitigate potential spillovers.

Emerging Themes: ESG, Specialty Finance, and Co-Investments

We note that “significant risk-transfer” (SRT) and specialty-finance vehicles are gaining traction, delivering uncorrelated, inflation-hedged returns through asset-backed structures. Evergreen vehicles now hold over \$500 bn AUM, and perpetual-life BDCs and interval funds are attracting high-net-worth investors seeking rapid deployment and liquidity. ESG considerations are increasingly integrated into manager selection, especially in Southern Europe where ESG, operational maturity, and co-investment capability rank as top criteria. Co-investment activity remains on an upward trajectory, driven by LP demand for fee-efficient exposure to diversified, high-quality private-equity portfolios. Near-record dry-powder levels and robust credit markets position sponsors to capitalize on emerging opportunities, particularly in the small- to mid-market segment, reinforcing the need for diversified co-investment portfolios across sector, geography, vintage, and GP relationship.

STRATEGIC TAKEAWAY AND RECOMMENDATIONS

We conclude that private credit has transitioned from a niche lender to a core component of the corporate-finance value chain, reshaping capital markets and drawing capital away from traditional banks and public markets. The sector offers a compelling blend of premium yields, lower loss ratios, and structural protections that together deliver superior risk-adjusted returns. However, the upside is contingent on disciplined manager selection, vigilant monitoring of leverage and covenant quality, and an appreciation of regional risk differentials. For investors seeking to enhance yield, diversify credit exposure, and capture the illiquidity premium, we recommend a core allocation of 5-20 % to private credit, with a balanced mix across direct lending, GP/LP solutions, asset-backed credit, and opportunistic strategies. Allocation should be tilted toward managers with proven underwriting discipline, robust stress-testing frameworks, and deep sector expertise—particularly in defensive sectors such as technology, healthcare, and business services. Continuous scenario analysis, including the soft-landing, localized-crunch, and systemic-crisis frameworks outlined above, will be essential to preserve capital and sustain the attractive risk-adjusted return profile that private credit has historically offered.



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