

View from the Outer: Private Credit in Context

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Private Credit in Context

Private credit has attracted significant scrutiny in recent weeks as concerns around software exposure and potential AI disruption have prompted volatility across asset managers and banks with meaningful private credit franchises. Software represents approximately 20% of total global private credit debt exposure, with concentration elevated by the surge in software buyouts completed at peak valuations in 2020-2021. The vintage problem is compounded by payment-in-kind (PIK) loan structures, where software companies account for the largest share of borrowers deferring cash interest payments. Headlines have focused on Blue Owl's gating of redemptions and volatility in publicly traded private credit vehicles, with some commentary bordering on sensationalism/doomerism about potential contagion risks.

While these risks warrant ongoing monitoring, much of the recent market reaction reflects overblown concerns rather than fundamental credit deterioration. Actual default rates remain well below levels implied by equity market selloffs, and private credit continues to offer compelling risk-adjusted returns with 3-4% yield premiums over public high yield bonds. Critically, private credit occupies a senior secured position in capital structures with first-line claims on assets, providing meaningful protection compared to private equity's first-loss exposure at the bottom of the capital structure. If AI disruption materialises in software companies, private equity investors will be far more exposed, absorbing valuation compression and business deterioration before debt investors face any principal impairment.

Manager quality and portfolio diversification provide critical insulation. Our preferred managers maintain exposure across hundreds to nearly a thousand underlying loans, meaning individual software defaults represent less than 0.1-0.2% of total portfolio exposure. The macro backdrop remains highly supportive, with above-trend US GDP growth, Federal Reserve rate cuts, and expansionary fiscal policy underpinning borrower cash flows. Systemic risks remain low, as explicitly noted by the Federal Reserve, given private credit's modest size relative to broader credit markets and contained leverage ratios.

Recommendation

We recommend maintaining strategic positions in carefully selected managers (Churchill, Ares) that demonstrate disciplined underwriting and strong diversification. For clients seeking additional comfort, asset-backed finance strategies eliminate software exposure entirely.

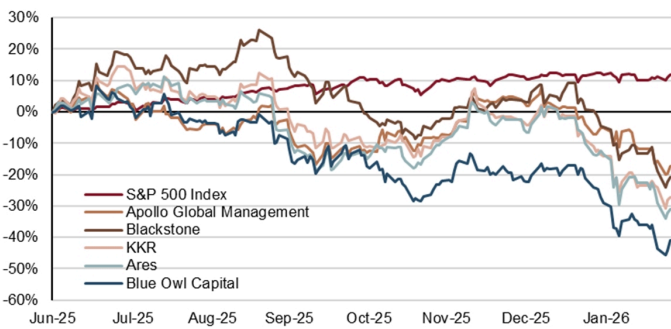
We continue to recommend 6-10% exposure to private credit within balanced portfolios, with approximately 60-70% in corporate direct lending and 30-40% in asset-backed finance (Apollo ABC, JPMorgan Global Transport, Qualitas).

When private markets met software

Private credit remains firmly in the headlines. Recent volatility has been driven by concerns around software-related concentration risks across private credit portfolios. Fears that rapidly advancing AI could disrupt traditional software-as-a-service (SaaS) business models have prompted anxiety about potential defaults cascading through the sector. Asset managers with significant private credit franchises have experienced sharp equity price declines as investors fret about the durability of software borrowers' cash flows and their ability to service debt obligations.

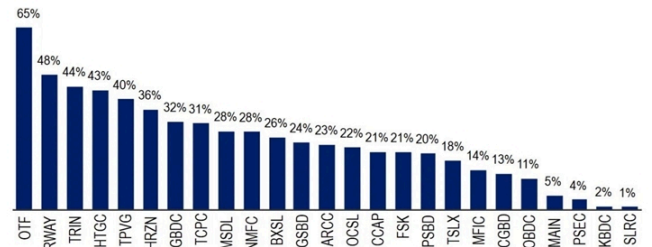
US private credit, in particular, is heavily exposed to software. Software represents approximately 22% of total private credit debt exposure - around \$224 billion in a \$3 trillion market - according to analysis from KBRA covering over 2,400 middle market borrowers. Software and services companies account for roughly 17% of US-listed business development company (BDC) investments by deal count, second only to commercial services. This concentration has emerged on the back of surging private equity activity in recent years, with software companies becoming favoured buyout targets at elevated valuations. Simultaneously, private credit fundraising has accelerated dramatically, growing from \$2 trillion in 2020 to \$3 trillion at the start of 2025, much of which has come from retail and wholesale investors seeking enhanced yields in a lower-return environment.

Private-credit fund managers stock performance



Source: Bloomberg, E&P Research.

Exhibit 2: Technology exposure - 25% of total exposure across BDCs, on average
Technology related exposure, % of total



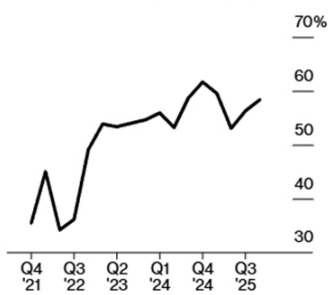
Source: Company filings and BDC Collateral. Note-standardized software disclosure for BDCs N/A. Assuming technology exposure is a rough proxy for software exposure

Compounding this is the vintage problem. Many software buyouts and the loans behind them were completed at peak technology valuations just after COVID in 2020-2021, with rising interest rates subsequently shutting down syndicated lending and pushing these deals into private credit at elevated leverage multiples. Software multiples paid by private equity have since compressed, eroding the equity cushion protecting debt investors.

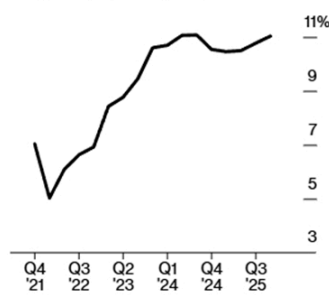
There's also a payment-in-kind (PIK) loan risk angle. Software and services companies account for the largest share of PIK loans, where borrowers defer cash interest payments by capitalising them into loan principal. While PIK structures can be appropriate for growth companies building scale, they mask deteriorating credit quality if revenues falter or business models face disruption.

Added to this, we have seen concerning headlines around the gating of private credit funds. Blue Owl permanently halted redemptions on one of its private credit funds - a non-traded term BDC with a finite life - after redemption requests exceeded the standard 5% quarterly cap. The fund was under sustained outflow pressure throughout 2025 and will now return capital to investors in episodic payments as it sells down assets over coming quarters and years.

% of PIK Investments with 'Bad PIK'



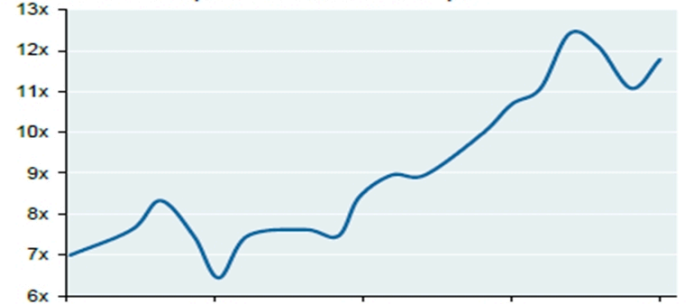
% of Investments with PIK



Source: Lincoln International

Note: "Bad" PIK is defined by Lincoln as PIK that was not elected or available at close but is now being utilized

North American buyout multiples
Median total enterprise value/EBITDA multiple

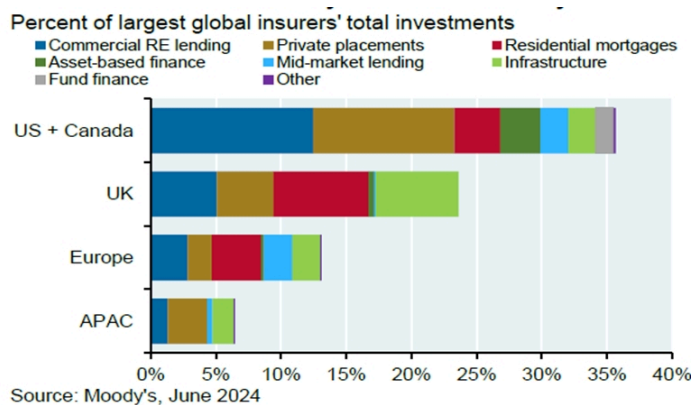
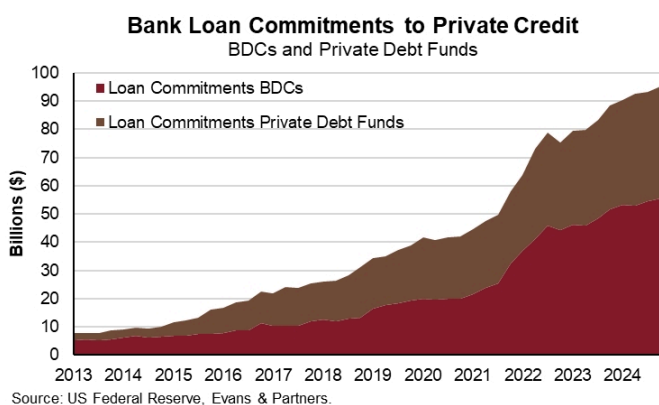


Source: "Global Private Equity Report 2025", Bain, September 30, 2024

The contagion question

Naturally, this has prompted some concern around potential spillover effects, should the asset class come under stress. Private credit has become increasingly interconnected with the traditional banking system and insurance companies through co-lending arrangements, warehouse facilities, and shared borrower relationships. This has prompted some volatility in the share prices of major US banks with meaningful exposure to private credit lending. Importantly, it is far more capital efficient for US banks to lend to private credit funds than to lend directly to private credit borrowers, as loans to funds attract lower regulatory capital requirements. Similarly, global insurers have become significant allocators to private credit to match long-duration liabilities, with some of the largest life insurers now holding material concentrations in their investment portfolios.

If private credit returns structurally decline or default rates rise meaningfully, these insurers may face pressure to rebalance portfolios, potentially transmitting stress from private to public markets. A recent Federal Reserve research paper ([Bank Lending to Private Credit, May 2025](#)) examining bank lending to private credit explicitly called out these interconnections, noting that in a stress scenario where multiple funds simultaneously draw credit lines, bank liquidity could be strained. However, the Federal Reserve paper ultimately concluded that risks remain contained at this point, given private credit's relatively modest size compared to the overall US credit market and the lower leverage employed by private credit funds compared to traditional banks.

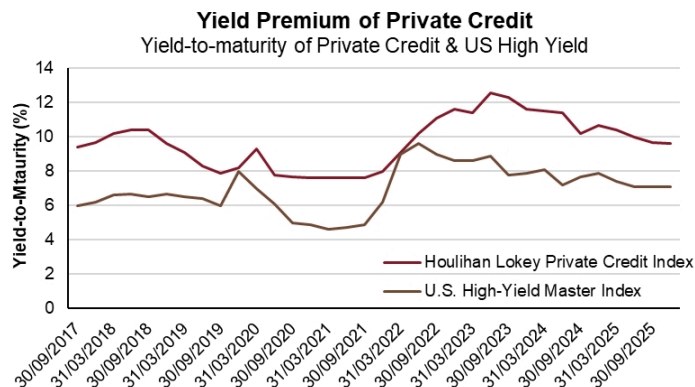
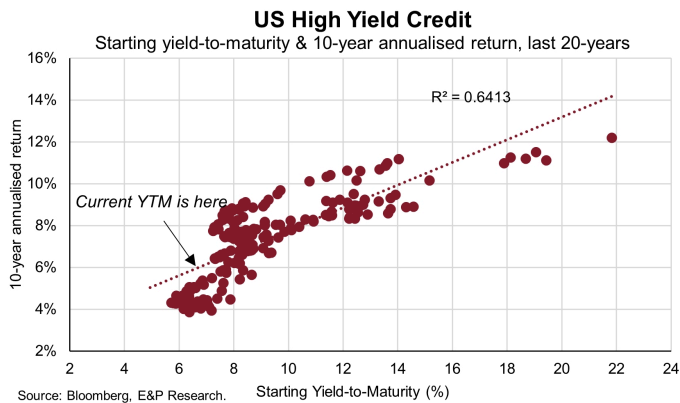


Our conviction in credit

Despite these legitimate concerns, we remain convicted in carefully selected private credit allocations. Private credit continues to offer a healthy yield differential compared to listed equivalents, with direct lending currently generating returns of 9-11% (SOFR + 450-650 bps) compared to 5-7% for US high yield bonds, which are trading at historically tight spreads. This 3-4% premium compensates investors for illiquidity while providing enhanced structural protections through tighter covenants, direct borrower relationships, and active monitoring that public bondholders cannot access.

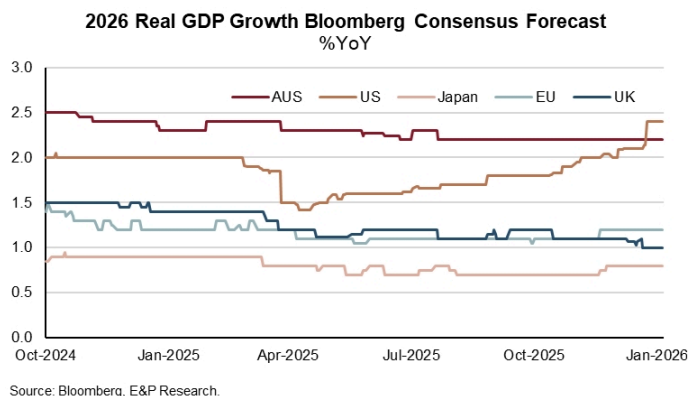
Critically, private credit occupies a senior secured position in the capital structure with first-lien claims on assets - a material advantage over private equity investors who sit at the bottom of the capital structure bearing first-loss exposure. These structural protections translate into meaningfully higher recovery rates: private credit has historically achieved 70-80% recovery rates in default scenarios, compared to 40-50% for high yield bonds. If AI disruption materialises in software companies, equity holders will absorb the full impact before debt investors face any principal impairment, **meaning private equity is far more at risk than private credit in a sustained software downturn.**

Manager quality reinforces this conviction and provides the critical differentiator between winners and losers in the current environment. Our preferred managers maintain highly diversified portfolios across both sectors and individual credits, with exposure across hundreds to nearly a thousand individual borrowers. This provides genuine diversification across healthcare, business services, industrials, consumer, and technology. Even if a handful of software companies face severe stress, a single default represents less than 0.1-0.2% of total portfolio exposure. We do expect broader dispersion in returns across the private credit peer group as managers with concentrated software exposure or aggressive underwriting face elevated default rates, while disciplined managers with diversified portfolios continue to perform well.



The macro backdrop remains highly supportive of private credit fundamentals. The US economy continues to demonstrate above-trend GDP growth and strong corporate profitability, with healthy balance sheet strength following post-COVID deleveraging. The Federal Reserve has resumed cutting rates, providing monetary policy support that eases borrower debt servicing costs on floating rate loans. Fiscal policy remains expansionary through personal and corporate tax cuts, investment incentives, and infrastructure spending, underpinning corporate cash flows and economic momentum. This constructive environment is reflected in actual credit performance - default rates in private credit remain below 3-5%, well below levels implied by recent equity market volatility.

Systemic risks also remain low, as explicitly noted by the Federal Reserve in its recent analysis. Private credit benefits from significant dry powder and maintains liquidity through revolving bank credit facilities that provide capital to manage redemptions and fund new opportunities. Leverage is also well-contained within the sector. While BDCs do employ leverage to enhance returns, their typical 1-2x debt-to-equity ratios remain very low compared to banks' 10x+ leverage or the 30x+ leverage that characterised structured finance vehicles during the Global Financial Crisis.



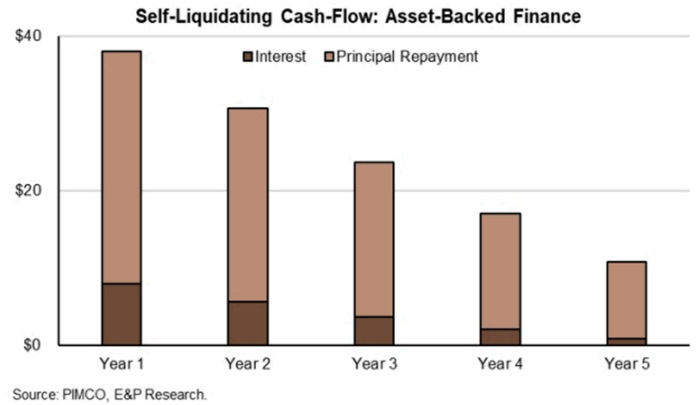
Taking stock

Recent events reinforce the importance of thoughtful manager selection and portfolio construction in private credit, as with any asset class. Understanding underlying portfolio compositions, structural features of investment vehicles, and manager quality remains essential to capturing the attractive risk-adjusted returns on offer. We continue to recommend 6-10% exposure to private credit within balanced portfolios, with the position sizing reflecting investors' risk tolerance, liquidity needs, and overall asset allocation framework - positioning toward the lower end for more conservative investors and the higher end for those with longer investment horizons and greater conviction in manager quality.

The current environment also highlights the importance of alternative lending strategies such as asset-backed finance. Unlike corporate direct lending, which relies on a borrower's operating performance, asset-backed strategies are secured against hard assets - physical equipment, aircraft, real estate, or contractual cash flows. This tangible collateral backing provides insulation from business model disruption. These loans amortise over time as borrowers make repayments, naturally reducing risk. Performance depends on asset-level factors like delinquency rates and property values rather than corporate profitability. We discussed these strategies in detail in our June 2025 [View from the Outer: Giving Credit Where it's Due](#).

Examples of Asset Backed Finance (Apollo)

	Consumer Finance	Financing consumers' lives, including their cars, recreational vehicles, or student loans
	Residential Mortgage	Financing homeownership and the development of housing stock
	Commercial Mortgage	Financing ownership and leasing of commercial real estate properties
	Hard Assets	Financing ownership and leasing of planes, automobiles, heavy equipment or digital infrastructure
	Financial Assets	Financing ownership of financial assets, including sports related revenue streams, music royalties, media rights and corporate loans
	Capital Solutions	Financing ownership of capital solutions, such as NAV lending, GP solutions and bank regulatory relief



Recommendation

Our recommendation is to maintain strategic positions in the private credit asset class rather than capitulating during a period of elevated concern. The recent market reaction reflects a re-rating of future risk rather than realised losses, with actual default rates remaining well below levels implied by equity market selloffs. We recommend:

- Maintain positions in carefully selected managers (Churchill, Ares) that demonstrate disciplined underwriting, strong diversification across sectors and individual credits, and conservative capital structures.
- Consider alternative strategies for portfolio diversification, particularly asset-backed finance (Apollo ABC, JPMorgan Global Transport, Qualitas), which reduce or eliminate software exposure while maintaining attractive risk-adjusted returns.
- Adopt a blended approach within private credit allocations, targeting approximately 60-70% in corporate direct lending and 30-40% in asset-backed finance, with total private credit position sizing of 6-10% of balanced portfolios depending on risk tolerance and liquidity requirements.

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