Private credit fault lines

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How private credit breaks

Summary

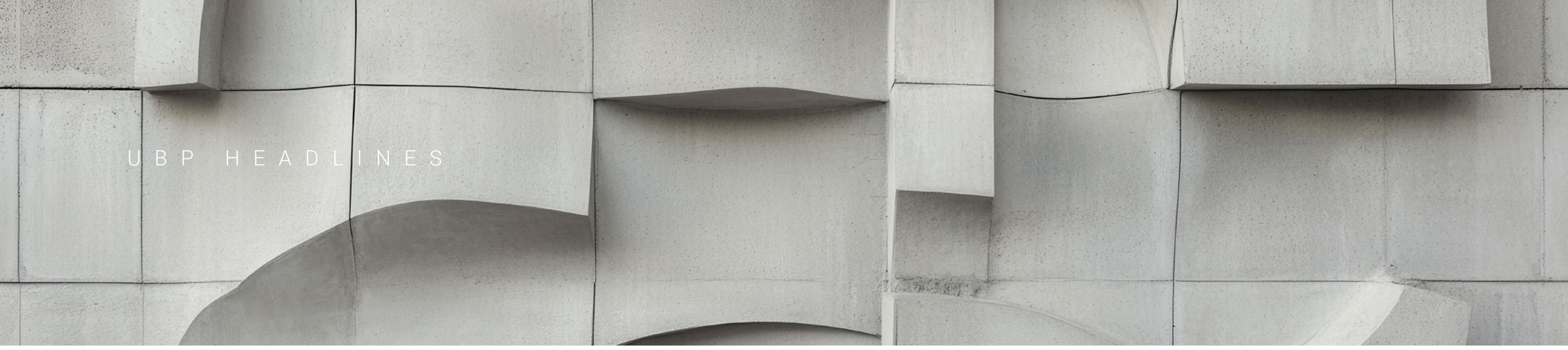
The consensus view of private credit risk begins with this observation: credit sits above equity in the capital structure. For a loan to be impaired, the equity cushion must first be eroded, and that erosion must originate from deteriorating fundamentals, margins and cash flows at the enterprise level. Under this framework, private credit cannot implode in isolation. It can only break if equity breaks first. This is mostly correct, but in the context of private credit, there are some nuances that must be explained.

This framework is incomplete. It describes one transmission channel while ignoring three others that may be equally capable of transmitting stress through the private credit system in the current cycle.

In this UBP Headlines, we identify four structural fault lines through which private credit can experience impairment, each representing a fundamentally different risk layer:

Fault line	Risk layer	Core mechanism
The Phantom Cushion	Valuation Risk	Model-based equity valuations disguise breached attachment points
Sponsor Optionality	Sponsor Behaviour Risk	Private Equity (PE) sponsors exercise a put option on portfolio companies, creating discontinuous impairment
Rate-Driven Impairment	Macro Mechanical Risk	Floating-rate debt erodes coverage ratios independently of enterprise fundamentals
Vehicle Feedback Loops	Market-Structure Risk	Business Development Companies (BDC) equity sell-offs constrain lending capacity and generate endogenous credit stress

Only the first of these follows the conventional equity-first pathway. The other three exploit structural features unique to today's private credit ecosystem: opaque marks, sponsor optionality, floating-rate mechanics without borrower protection, and vehicle-level feedback loops driven by regulatory leverage constraints.



The Phantom Cushion: When equity beneath you is an illusion

How does it work?

This pattern of breaking rests on a precise claim: for a senior secured loan to be impaired, enterprise value must decline below the par value of the debt. This is classic corporate finance textbook. In a typical PE-backed middle market deal, the equity cushion at entry is 30 to 40% of enterprise value. This buffer should, in theory, absorb meaningful deterioration before the credit is threatened.

Why does it not always work?

The problem is not the logic but the inputs. Unlike public markets, where enterprise value is continuously evaluated by market pricing, private equity valuations are updated infrequently and rely heavily on model-based assumptions.

This creates what we are calling the phantom cushion problem. The equity is not absent from the capital structure, but it is not measured. And the difference between those two things is the difference between a portfolio that is well protected and one that is already breached without anyone knowing it.

Why does it matter in our context?

The vintage concentration of private credit amplifies this risk. The majority of capital deployed in today's BDC and private wealth vehicles was committed between 2020 and 2023, at entry multiples that have since compressed materially in public markets. If private company valuations have followed a comparable trajectory the effective equity cushion in many deals may have evaporated.

Example: Capital Structure Compression

A PE sponsor acquires a SaaS company at 15x Earnings before Interest, Taxes, Depreciation, and Amortisation (EBITDA) (USD 50 million EBITDA = USD 750 million Enterprise Value (EV)). The sponsor funds the acquisition with USD 475 million of first-lien debt (6.3x leverage) and USD 275 million of equity (37% cushion). Those metrics are stretched for illustrative purposes.

After a while, comparable public SaaS multiples have compressed from 15x to 11x. If the company's EBITDA is unchanged at USD 50 million, implied EV falls to USD 550 million. The equity cushion has shrunk from USD 275 million (37%) to USD 75 million (14%). At a 27% multiple compression, the first-lien loan's attachment point is nearly breached, although revenues are unchanged

Now, if we stress EBITDA with a theoretical of just 10% (USD 45 million at 11x = USD 495 million EV), the loan is now underwater.

The underlying reality is now a first-lien loan trading through its attachment point, with the only thing preventing recognition being the lag in the mark-to-model cycle. One could argue that this is a feature of private credit and there is nothing new here. Although we agree with this argument, the issue underlying this example is what we have seen with BlackRock TCPC marking loans to zero from 100, which is the jump-to-default risk (JTD). In public markets, JTD can be carefully estimated using rating transition matrices. In private markets, most recent historical data tends to show a pattern of cliff rather than slow burn.

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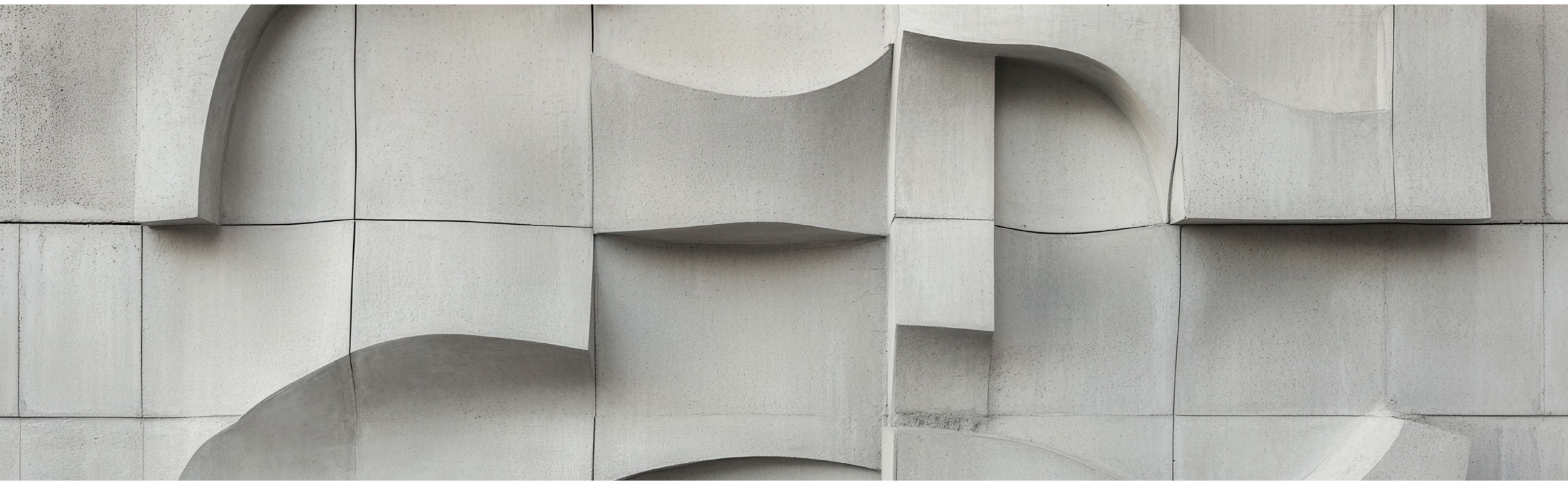

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Sponsor Optionality: The discontinuous break

The conventional expectation

Under the traditional credit equity relationship, credit impairment should arrive gradually. Revenues slow, margins compress, cash flows decline, coverage ratios tighten, and eventually the borrower breaches a covenant or misses a payment. The lender has time to see it coming, and to work the credit. The dynamic is well known and well documented.

The reality of sponsor-backed lending

Practically, and even almost by definition, credit borrowers present in the BDC space are backed by private equity sponsors. This is how direct lending is defined. Sponsors have various tools to mask deterioration and defer recognition, for a number of reasons. Subscription revenues in software companies can obscure customer churn for quarters. Sponsors can inject small equity cures to avoid covenant trips. Revolvers can be drawn to cover interest shortfalls. Management add-backs can inflate reported EBITDA well beyond economic reality.

The effect is that the credit appears to be performing, until it again meets the jump-to-default risk discussed previously. What is important to understand here is that this is not an irrational behaviour from the sponsor but is the optimal use of the embedded option in the credit as described by the Merton model.

Key Insight: The sponsor put option

The PE sponsor holds, in economic terms, a put option on each portfolio company which is effectively a strategic abandonment option. The mechanics behind it are as follows:

As long as the expected value of incremental capital injection exceeds its cost, the sponsor will continue to support the business by funding interest shortfalls, curing covenants, and maintaining the appearance of a performing credit. When this situation reverses, when the marginal dollar of support is worth less than one dollar in expected recovery, the sponsor exercises the put by walking away. Obviously, some strategic situations are different, but the theoretical framework holds.

And this is where the cliff effect, or jump-to-default effect discussed previously comes into play again. The lender's loss is not a continuous function of revenue decline, it is a non-linear function of the sponsor's support decision. The credit goes from "performing" to "non-accrual" in a single quarter, with the timing determined not by the macro cycle but by the sponsor's internal calculus: fund lifecycle,

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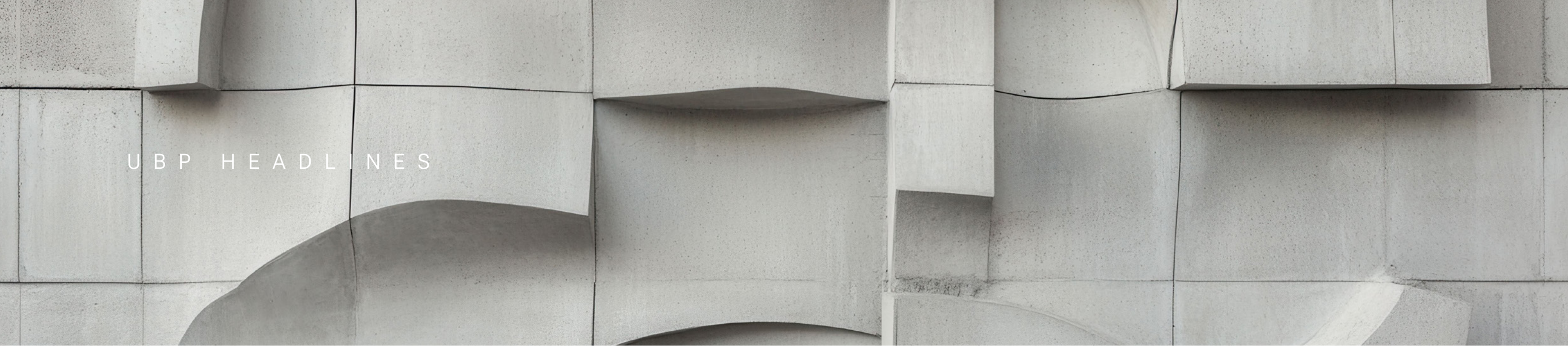


limited partner (LP) reporting pressures, opportunity cost of capital, and the relative priority of this portfolio company versus competing claims on the fund's reserves.

This dynamic has to do with how the sponsor behaves and not the credit, the credit is the output and not the input in the equation. Traditional credit monitoring tools like revenue trends, coverage ratios, covenant headroom track the underlying asset, not the option holder's decision function.

Example: The Support Withdrawal

A sponsor holds a healthcare services platform acquired for USD 400 million (10x EBITDA of USD 40 million), funded with USD 260 million of first-lien debt and USD 140 million of equity. Over 18 months, EBITDA drifts from USD 40 million to USD 36 million. The sponsor has already injected USD 15 million in equity cures and revolver draws to maintain covenant compliance.

At this point, the sponsor's total invested capital is USD 155 million. The implied equity value at a now-compressed 8x multiple on USD 36 million EBITDA (USD 288 million EV) minus USD 260 million debt is USD 28 million. Further support is economically irrational: the sponsor would be injecting capital to protect a residual equity claim of USD 28 million in a deteriorating business.

The loan moves to non-accrual in the following quarter. From the lender's perspective, the transition from "performing" to "impaired" happened in 90 days. In reality, the economic deterioration occurred over 18 months but was masked by sponsor support.

Rate-driven Impairment: Credit breaks without equity breaking

The mechanical vulnerability

This is perhaps the most direct challenge to the equity-first thesis. The vast majority of private credit is floating rate, typically Secured Overnight Financing Rate (SOFR) +500 to 600 basis points.

A critical structural asymmetry makes this exposure more dangerous than it appears at first glance. Most private credit loans include SOFR floors at around 75 to 100 basis points (bps) to protect the lender from rate decline. But, this protection does not exist in the form of a cap to protect the borrower from a rate increase. This asymmetry means borrowers absorb the full impact of monetary tightening: when SOFR moved from near-zero to above 5%, borrowers experienced the entire 400 to 500 basis point increase in their cost of capital, with no contractual cap to limit the damage.

The broken causal chain

When base rates rise materially, the total debt service cost of a leveraged borrower can increase by 25-30%, even if the company generates similar revenues, the same margins, and the same customer base. At no point in this scenario does the equity-level story break. The business model remains intact. The enterprise may still have positive equity value in an unlevered context. But the credit is impaired because the debt contract became unsustainable at the new rate environment. And in this particular scenario, the stress experienced by the credit is endogenous.

Example: Coverage Collapse at Constant Revenue

	SOFR at 1%	SOFR at 5%
EBITDA	USD 50 million	USD 50 million
First-Lien Debt (S+500bps)	USD 275 million	USD 275 million
Total Interest Cost	USD 16.5 million	USD 27.5 million
Interest Coverage Ratio	3.0x	1.8x
With 10% Margin Pressure	2.7x	1.6x

Coverage falls from a comfortable 3.0x to a stressed 1.6x with no change in the underlying business. Many private credit covenants trigger below 1.6x. The credit impairs through a rate transmission mechanism and not via the equity.

Why this channel is underappreciated

Most credit analysis in private markets focuses on enterprise value and multiple coverage. Rate sensitivity is modelled, but often as a secondary risk factor. In reality, for a borrower at 5–7x leverage on floating-rate paper with no rate cap, interest rate movements can dominate the coverage equation more than modest revenue fluctuations. This makes the private credit book vulnerable to monetary policy, which has nothing to do with the health of the underlying equity.

Vehicle feedback loops: The endogenous credit crisis

The modern private credit ecosystem has a feature that allows it to generate stress endogenously: the publicly traded BDC.

BDCs have been discussed extensively recently with clients and advisors. They are equity vehicles that hold private credit. Their capacity to originate new loans and roll maturing positions depends on their ability to issue equity at or above NAV. When BDC equities sell- off, the equity issuance channel closes. The BDC can no longer grow its balance sheet.

What are the mechanics?

The feedback loop is amplified by a hard regulatory constraint. Under the Investment Company Act, BDCs must maintain a minimum asset coverage ratio of 150%, which is equivalent to a max debt to equity ratio of 2 to 1. When net asset value (NAV) declines due to portfolio mark-downs or non-accruals, the BDC faces a binding leverage ceiling that can force asset sales, constrain new origination, and trigger covenant breaches on the BDC's own credit facilities, creating a form of negative spiral.

Any BDC that breaches 150% asset coverage cannot pay dividends, cannot incur new debt, and cannot make new investments until the ratio is restored. The only options are to sell assets or to raise equity at a deep discount to NAV, diluting existing shareholders and confirming the market's negative signal. Additionally, equity investors into BDC are dividend-seeking investors so removing the dividend generally worsens the sell off.

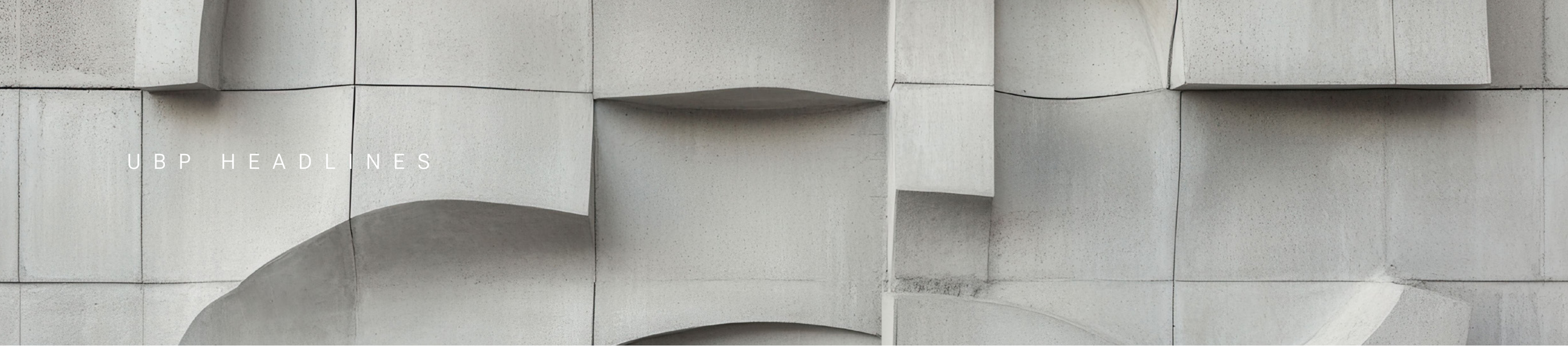
Example: The BDC Deleveraging Trap

A BDC with USD 5 billion in total assets, USD 3B in debt, and USD 2 billion in equity (NAV) operates at an asset coverage ratio of 167% (well above the 150% minimum). Its leverage is 1.5x.

A series of non-accruals and mark-downs reduce total assets to USD 4.5 billion. NAV falls to USD 1.5 billion. Asset coverage drops to 150%, exactly at the regulatory floor. The BDC can no longer originate new loans, issue new debt, or pay dividends.

If just one more position is marked down, a further USD 50 million loss, the BDC breaches the coverage test. It must sell assets to de-lever. But selling private credit at par in a stressed market is impossible; realised bids might be 85–90 cents, crystallising further losses and driving NAV lower still. Each forced sale worsens the ratio it was meant to repair. Additionally, in such a situation the market would identify immediately this BDC as a forced seller and bid accordingly.

The borrowers in the BDC's portfolio that need refinancing now face a lender that is a forced seller, not a willing counterparty. Credit availability contracts not because borrower revenues declined, but because the lending vehicle's own capital structure failed.



The broader implication

This channel is entirely endogenous to the private credit ecosystem. It does not require a recession, a revenue decline, or an equity market crash at the borrower level. Loss of confidence is a sufficient condition to trigger outflows in private wealth vehicles. Those vehicles have been sold on the premise that losses were close to non-existent. A few visible credit events could impair confidence quickly.

The equity-credit nexus here runs through the financing vehicle, not through the borrower. The BDC's equity is the credit's oxygen supply.

The feedback loop extends beyond publicly traded BDCs into the non-traded evergreen credit space. These vehicles mirror the 5% quarterly fund-level gate and therefore will likely mimic the flows too. Additionally, when a vehicle is gated, subscriptions are at risk of coming to a halt as it is not economically appealing to invest in a gated fund unless it is to acquire quality assets at a stressed price, which is not the case in private wealth vehicles, quite the opposite.

A precedent exists: in real estate, Blackstone's BREIT experienced cumulative net outflows of 27% of NAV over a 2-year period following gating. While aggregate industry liquidity buffers of roughly USD 87bn (from liquid holdings and maturing loans) should be sufficient at the system level, there is meaningful dispersion at the fund level, with some vehicles holding over 20% of their portfolios in liquid assets and others holding as little as 1%. The risk is not a systemic liquidity crisis but a concentrated one, where a handful of vehicles under redemption pressure are forced to sell illiquid assets into a market with punitive bids, crystallising the very losses the marks have been deferring.

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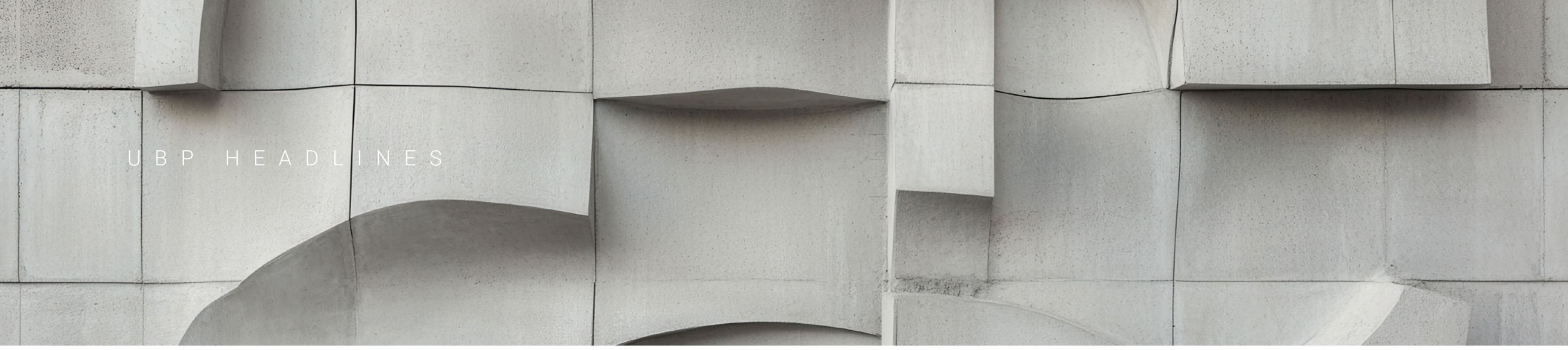


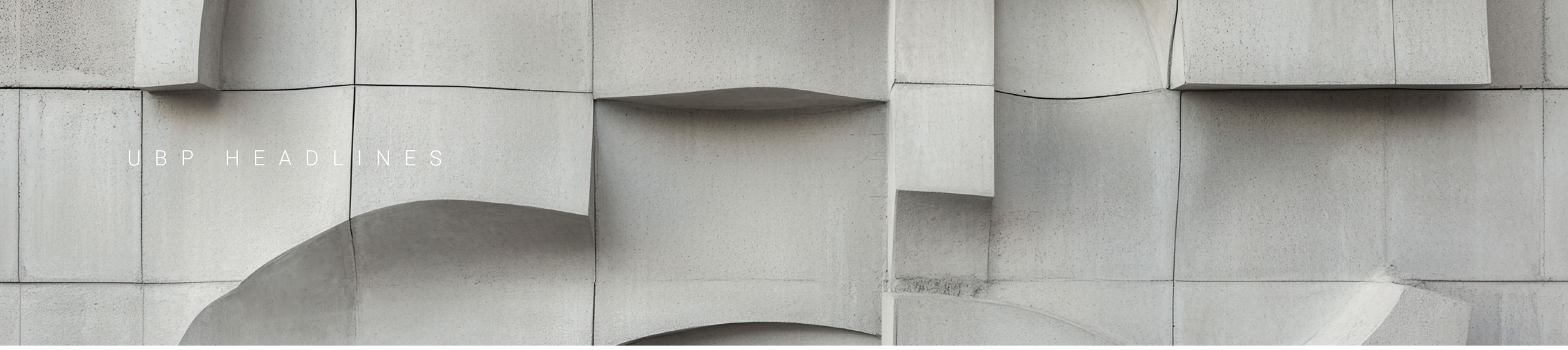
Extend-and-pretend as deferred amplification

Running beneath all four fault lines discussed here is a common mechanism that postpones their activation while amplifying their eventual impact: the extend-and-pretend dynamic.

When a private credit borrower approaches distress, the standard playbook is not to recognise the impairment but to defer it. Maturity extensions push the refinancing wall further out. Payment-in-kind (PIK) toggles convert cash interest into additional principal, relieving near-term coverage pressure while increasing the terminal debt burden. Covenant resets widen the definitions of compliance, allowing loans to remain classified as performing despite material deterioration in underlying economics.

Those tools are not inherently problematic, and they do exist for a reason. In some cases, they provide breathing room for a business experiencing temporary difficulty due to micro or macro reasons, but when deployed systematically across a portfolio, they serve a different function: they hold together the phantom cushion by avoiding marks that would reveal breached attachment points. They extend the sponsor’s option exercise window, allowing support to continue past its economic expiry. They mask rate-driven coverage stress by reducing the cash burden today in exchange for a larger claim tomorrow. And they maintain the appearance of portfolio health at the BDC level, preventing the NAV declines that would trigger the vehicle feedback loop.

The result is a system in which the four fault lines are not independent risks but interconnected vulnerabilities held in suspension by a shared set of deferral mechanisms. When those mechanisms exhaust themselves: maturities can no longer be extended, payment-in-kind burdens become too large to service, or covenant resets lose credibility with auditors, then the accumulated stress does not materialise gradually. It arrives in a compressed window, with multiple fault lines activating simultaneously. Jump-to-default risk again.



What direct lenders are saying

Direct lenders have been vocal in saying that realised loss rates in private credit remain historically low, sponsor support has been robust, secondary market activity is growing, and manager selection mitigates these structural risks. We do not dismiss those. At the aggregate level, the system does have buffers: non-accrual rates at non-traded BDCs remain below 1%, well under their five-year average, and industry-wide liquid holdings should cover projected outflows. But aggregate sufficiency masks fund-level fragility. The dispersion in liquidity profiles across evergreen credit vehicles is extreme, and the dispersion in credit quality metrics across the BDC universe is widening. Software exposure alone represents roughly 25% of BDC loan portfolios, and watch list loans have been trending upward. The relevant question is not whether the average fund can manage through the cycle but whether the most exposed vehicles can avoid triggering the feedback loops described above.

The fault lines describe structural vulnerabilities embedded in how direct lending works, not predictions of imminent crisis. Low realised losses in a benign credit cycle tell us nothing about the resilience of the system under stress, particularly when the mechanisms described above are specifically designed to suppress loss recognition in the early and middle stages of deterioration.

The question is not whether private credit is in crisis today. The question is whether the tools currently used to monitor it would detect a crisis before it materialises.

What we are monitoring: a diagnostic framework

The below table shows how the theoretical fault lines are being measured in real life and their current readings.

Signal	Fault Line	Threshold	Frequency	Current Reading (Q1 2026)
Gross quarterly redemption rate	Vehicle Feedback	>5% for 2 consecutive quarters	Quarterly (SC TO-I filings)	BCRED at 7.9%, triggering threshold. Not yet systemic but inching towards
Subscription-to-redemption ratio	Vehicle Feedback	<1.0x for 2 consecutive quarters	Quarterly	Below 1.0x at several major platforms. March subscriptions running >50% below 2025 monthly average.
PIK as a percentage of NII	Extend-and-Pretend	>20% of portfolio NII	Quarterly (10-Q)	Several platforms above 20% but overall manageable.
Non-accruals at cost	Phantom Cushion / Sponsor Optionality	>3% of portfolio at cost	Quarterly (10-Q / 10-K)	Below 1% industry average for non-traded BDCs, but rising. Some platforms at 3–5%. Dispersion is the key metric between weak and strong platforms.
Public-to-private valuation gap	Phantom Cushion	>20% sector-level divergence	Monthly (internal)	SaaS and healthcare services multiples compressed 25–30% from peaks while private marks have adjusted only partially. This is the elephant in the room.
SOFR / EURIBOR trajectory	Rate-Driven Impairment	Upward surprise or sustained elevation vs. origination assumptions	Continuous	SOFR stable at approximately 3.65%. EURIBOR at approximately 2.5%. No immediate pressure but significantly above origination-era assumptions for most outstanding loans.
Software sector concentration	Hidden Correlation	>30% of portfolio	Quarterly	Approximately 25% across major BDC platforms. Approaching threshold but most platforms are derisking.
BDC discount to NAV	Vehicle Feedback	>10% for 3+ quarters across >50% of listed BDCs	Quarterly	Approximately 80% of listed BDCs trading at discount. Several at 25-30% discount or worse.

A simultaneous deterioration across multiple signals would suggest that the deferral mechanisms holding the system together are approaching exhaustion.

Where are we now: A diagnostic as of Q1 2026

The next natural question for any investor is: which of these fault lines are currently active? Each is showing early-stage signals that warrant close attention, but none is clearly flashing “imminent crisis”, which supports our messaging “this is not systemic but”.

Fault Line	Status	What data tells us
Phantom Cushion	Early signal	Public SaaS and healthcare services multiples have compressed materially from 2021–2022 peaks. Private marks have adjusted slowly and partially. Across the BDC industry, the weighted average mark on PIK debt investments stood at 98.3% as of 3Q25, but dispersion is significant: several portfolios marked their PIK books at 93 to 95c. The share of PIK debt marked below 90 cents has risen from approximately 7.5% in 3Q24 to nearly 13% a quarter later. Attachment point erosion is not hypothetical; it is observable in the marks themselves, but it is not widespread.
Sponsor Optionality	Pre-signal	Sponsors continue to support portfolio companies, but the nature of that support is shifting. PIK loans across the BDC industry rose from USD 33.6 billion (14.9% of debt portfolios) in 3Q24 to USD 48.5 billion (17%) by 3Q25. PIK-by-amendment has risen from 2.6% of direct lending investments in 2021 to approximately 6%. The support machinery is still running, but it is running materially harder than a year ago.
Rate-Driven Impairment	Stable	SOFR sits at approximately 3.65% as of March 2026, materially above the near-zero environment in which most outstanding private credit originated. Borrowers have absorbed the full rate shock given the absence of contractual caps. The Fitch private credit default rate has risen to 5.8% through January 2026, with 60% of default events driven by PIK conversions and interest deferrals rather than traditional missed payments. Non-accrual counts have increased across several major BDCs, with some platforms reporting portfolio-at-cost non-accrual rates of 3 to 5%. The rate-driven damage has been absorbed but not yet resolved. Future refinancings will be key.
Vehicle Feedback Loops	Early activation	Approximately 80% of publicly listed BDCs are trading at a discount to NAV. Several major vehicles trade at very large discounts of 50%, effectively shutting their equity issuance channels. In the non-traded space, the redemption dynamic has accelerated sharply in 1Q26: gross redemption rates at major vehicles have risen to 8–9%, March subscriptions are running over 50% below 2025 levels, and the industry is expected to see net outflows for the first time. Estimates point to USD 45–70 billion in cumulative net outflows over the next two years, with most managers likely to cap redemptions at the 5% structural minimum. Aggregate liquidity buffers appear sufficient at the industry level, but dispersion is wide: some funds hold over 20% in liquid assets while others hold as little as 1%. The feedback loop is in early activation for a concentrated subset of vehicles, not yet systemic but no longer hypothetical.

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Structural risk mapping across vehicle types

The fault lines described above do not affect all private credit vehicles uniformly; the characteristics of the wrapper are equally important. The following diagnostic maps each structural risk layer against representative vehicle types across US non-traded BDCs and European private wealth direct lending structures.

Fault Line	US Non-Traded BDC and feeders (BCRED, Apollo ADS)	US Feeder Structures (Apollo USPC)	European Private Wealth Direct Lending (Ares AESIF)
Phantom Cushion	Elevated. Heavy vintage 2020–2023 exposure at peak multiples. Mark-to-model lag is structural.	Transmitted. Risk inherited from underlying vehicle, typically at a 1:1 ratio for high-allocation feeders.	Lower. Fresher vintage (2024+). European mid-market operates at lower entry multiples (8–10x vs 12–15x).
Sponsor Optionality	Directly exposed. Multi-sponsor portfolios with limited visibility on sponsor decision calculus.	Transmitted via underlying BDC. No additional mitigation at feeder level.	Different dynamic. European sponsors operate under different LP pressure cycles and exit environments, but the risk exists too.
Rate-Driven Impairment	Elevated. SOFR at 3.65%, no borrower caps. Full rate shock absorbed since 2022.	Transmitted. SOFR-denominated exposure fully passed through.	Structurally lower. EURIBOR at approximately 2.5% reduces the mechanical pressure on coverage ratios.
Vehicle Feedback Loop	Directly tested. 150% asset coverage constraint (1940 Act). Redemption pressure visible in 1Q26 at 7.9% gross rates (BCRED data, ADS still pending)	Double-layer liquidity risk. Feeder liquidity depends on underlying vehicle's tender offers. If the BDC gates, the feeder gates.	Different framework. Luxembourg Part II UCI structure. Monthly redemptions capped at 2%, quarterly at 5%. 18-month early redemption penalty (5%) acts as built-in stabiliser. No 1940 Act constraints.
Hidden Correlation	High. Software concentration at 25–29% of BDC portfolios. >60% overlap across largest platforms.	Magnified. Concentrated feeder allocations reduce diversification.	Lower. European mid-market skews toward healthcare, industrials, business services. Different sector mix.

European semi-liquid vehicles operating under the Luxembourg Part II UCI or ELTIF 2.0 frameworks face their own set of risks, including untested liquidity mechanisms in stress environments and a smaller, less mature secondary market. However, they do not carry the same regulatory feedback loop that makes US BDCs uniquely vulnerable to self-reinforcing deleveraging cycles.

Conclusion

Private credit is not in crisis, but the margin for error has narrowed considerably.

The system is being sustained by a combination of residual sponsor support, deferral mechanisms operating at elevated capacity, and a rate environment that, while easing, remains well above the origination assumptions embedded in most outstanding loan books. The granular data tells a more nuanced story than the headline metrics suggest: BDC-level PIK portfolios have grown by nearly 30% in a year, bad PIK is concentrating in specific vehicles and sectors, and the gap between reported performance and underlying cash generation is widening. The fault lines we discuss here are designed to be early stage warning signs. Investors should be aware that those vulnerabilities do exist.

The commonly accepted construct that equity needs to break to break credit is accurate although incomplete. The more dangerous possibility is that credit breaks while equity is still being told everything is fine, because in private credit, the absence of losses is not evidence of safety, it is evidence of deferral.

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