



**Are the Private  
Credit Markets  
Under Stress?**  
PIK Usage & Covenant  
Erosion May Tell the Tale

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## EXECUTIVE SUMMARY:

Private credit markets are showing stress, with 11% of fourth-quarter borrowers paying interest in-kind (“PIK”) rather than cash, marking the third consecutive quarterly increase. More concerning, 58% of these PIK loans are classified as “bad PIK”, meaning borrowers began deferring payments mid-loan rather than at origination, typically due to liquidity constraints. This translates to 6.4% of all private loans now carrying bad PIK, nearly tripling from 2.5% in late 2021. Lincoln International views this as a “shadow default rate,” representing situations where defaults might have occurred absent PIK elections.

The deterioration is evident in leverage metrics: companies with bad PIK have seen their loan-to-value ratios surge from a healthy 39% at origination to 76% currently, representing a 37 percentage point increase. Ron Kahn of Lincoln International noted companies have been unable to organically deleverage amid slowing EBITDA growth.

**6.4%** of all private loans are now carrying bad PIK

Compounding this stress, covenant protections have eroded. As of year-end 2024, covenant-lite loans represented 91% of outstanding US leveraged loans – approximately \$1.3 trillion in total, while 70% of private credit loans in 2024 were covenant-lite. This dual degradation, rising PIK usage com-

combined with declining lender protections, creates risk as private credit faces its first real stress test.

## DETAILED FINDINGS:

PIK, operating performance and covenant erosion all point to changing credit dynamics in the private space.

- PIK Stress Indicators: Data from Lincoln International shows that 11% of Q4 2025 borrowers paid interest in-kind, with more than 58% of those loans featuring bad PIK. Bad PIK occurs when borrowers opt to delay interest payments during the life of the loan versus when the debt was originated, a clear sign of financial distress rather than strategic planning. Putting this together, 6.4% of the total population of loans in Lincoln’s proprietary private market database had bad PIK as of Q4 2025, an increase from 6.1% in Q3 and 2.5% in Q4 2021. This near-tripling represents what Lincoln characterizes as a shadow default rate – a proxy for situations where defaults would have occurred without PIK elections. Companies with bad PIK experienced an average increase in loan-to-value (LTV) of 37 percentage points, increasing from a healthy 39% at inception to 76% today. This represents a fundamental erosion of lender protection and equity cushion.

**70%** of private credit loans in 2024 were covenant-lite

**Table 1: PIK Interest Evolution (2021-2025)**

Metric	Q4 2021	Q2 2025	Q3 2025	Q4 2025	Change
Total PIK Usage (% of loans)	7%	11%	11%	11%	+4 pp
“Bad PIK” (% of PIK loans)	37%	~50%	57%	58%	+21 pp
“Bad PIK” (% of all loans)	3%	~6%	6%	6%	+3 pp
Bad PIK LTV at Inception	~47%	—	—	39.4%	—
Bad PIK LTV Current	—	83%	—	76.1%	+37 pp
Annual EBITDA Growth	—	7%	5%	5%	Declining trend
Fixed Charge Coverage Ratio	—	—	—	1.3x	Improved (aided by PIK)
Private Credit Default Rate	~0%	—	—	5.7%	+5.7 pp



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- **Operating Performance Deterioration:** The magnitude of EBITDA growth steadily slowed throughout 2025, declining from 6.5% in Q2 to 5.2% in Q3 and 4.7% in Q4. While EBITDA growth remains positive, this deceleration explains why Lincoln observed leverage increases of approximately 0.5x from a deal’s inception to today across all vintages, likely driven by a combination of lower realization of synergies and limited free cash flow generation due to years of high rates. Ron Kahn, Managing Director and Global Co-Head of Lincoln’s Valuations and Opinions Group, stated: “We have seen a steady slowing of EBITDA growth during 2025 and companies not being able to organically deleverage.”
- **Covenant Erosion:** While PIK stress has received attention, the simultaneous erosion of covenant protections amplifies the risk significantly. As of year-end 2024, covenant-lite loans represented 91% of outstanding US leveraged loans – approximately \$1.3 trillion in total, with 93% of all institutional leveraged loans issued in 2024 being covenant-lite. The private credit market shows bifurcation by deal size. In the lower-middle market, 20% of private credit loans cleared without maintenance financial tests in 2023, down from 30% in 2022 and a peak of 31% in 2021 – suggesting modest improvement for smaller deals. However, in the upper-middle market (companies with \$50 million or more in EBITDA), around 30% of recent deals are now covenant-lite, up from just 5% a decade ago. Most concerning, in mega-deals exceeding \$500 million, roughly half of new transactions lack financial maintenance covenants altogether. Fewer than 10% of loans above \$500 million include maintenance covenants, prompting industry observers to question whether the market has moved from “covenant-lite” to effectively “covenant-void.”

**Less than 10%**  
of loans above \$500 million include maintenance covenants

Market Segment	2007	2021	2023	2024	Trend
Leveraged Loans (Broadly Syndicated)	17%	86%	89%	91%	↑↑↑ Accelerating
Private Credit (Lower-Mid Market)	~2%	31%	20%	—	↓ Modest improvement
Private Credit (Upper-Mid, >\$50M EBITDA)	~5%	—	—	~30%	↑↑ Tripling
Private Credit (Mega-deals >\$500M)	Minimal	—	—	~50%	↑↑↑ Severe erosion
Overall Private Credit Average	—	—	—	70%	↑↑
Cov-Lite Premium (bps over covenanted)	50-75	0	0	0	↓↓↓ Premium eliminated

- **The Vanishing Risk Premium:** Perhaps most troubling, lenders are no longer compensated for accepting weaker protections – the historical 50-75 basis point premium for covenant-lite loans has essentially vanished since Q1 2017. Lenders now accept dramatically less protection for the same return, a striking departure from traditional risk-return relationships. The consequences are measurable: when covenant-lite loans default, lenders recover an average of just 57% on first-lien positions, compared to 66% recovery on covenanted loans – a 9-percentage point gap. Across a \$1.3 trillion covenant-lite market, this could translate to approximately \$117 billion in lost recovery value during a full default cycle.

**57%** recovery on first lien positions when cov-lite loans defaults

- **Market Context and Default Rates:** The U.S. private credit default rate climbed to 5.7% by early 2025, up from effectively 0% in 2022. Using bad PIK as a proxy for distress, shadow default rates are estimated closer to 6%, versus 2% in 2021. In 2022, covenant-lite loans made up 91% of all defaults, dropping to 54% in 2023, then rebounding to 85% in 2024. As these structures have come to dominate the market, they’re now dominating defaults proportionally. Covenant-lite loans lack the periodic financial tests that historically give lenders early warning and bargaining power when borrower performance deteriorates. Without these tripwires, lenders might only learn of trouble when a payment is missed or when liquidity is almost gone – by then, options can be limited.

**Table 3: Default Performance & Recovery Rates**

Metric	Cov-Lite Loans	Covenanted Loans	Impact
Average Recovery Rate (First Lien)	57%	66%	-9 pp
% of 2022 Defaults (by amount)	91%	9%	—
% of 2023 Defaults (by amount)	54%	46%	—
% of 2024 Defaults (by amount)	85%	15%	—
Potential Lost Recovery Value	—	—	~\$117B

**THE COMPOUNDING CRISIS: WHY PIK + COV-LITE MATTERS**

The convergence of rising bad PIK and eroding covenants creates a compounding risk scenario unique in private credit's modern history:

- **No Early Warning System:** Without maintenance covenants, lenders only learn of trouble when a payment is missed or liquidity is almost gone. Meanwhile, bad PIK masks deterioration by allowing borrowers to defer cash payments.
- **Accelerating Leverage Spiral:** Companies with bad PIK saw leverage increase from 39.4% to 76.1% while operating under covenant-lite structures that provide no mechanism for early intervention.
- **Delayed Recognition, Worse Outcomes:** When problems can no longer be deferred, the eventual defaults are more severe. Companies have accumulated debt via PIK for years without covenant-triggered restructurings, leaving lenders with deteriorated collateral and much higher debt loads.
- **Lower Recovery Expectations:** The 9 percentage point recovery gap between covenant-lite and covenanted loans becomes critical when 85% of 2024 defaults were covenant-lite loans.
- **Market Bifurcation Reality:** While lower-middle market deals (<\$50M EBITDA) retained stronger protections, the upper-middle market and mega-deals – which dominate by dollar volume – increasingly operate in covenant-void territory with cushions allowing 30-40% EBITDA decline before triggering any breach.

**39% to 76%**  
increase in leverage in  
companies with bad PIK

**Table 4: Combined Risk Metrics (Q4 2025)**

Risk Factor		
Bad PIK Rate	6.4% of all loans	156% increase from 2.5% (2021)
Cov-Lite Prevalence (Overall)	70% of private credit	No risk premium compensation
Cov-Lite Prevalence (Mega-deals)	~50% of deals >\$500M	Was ~5% a decade ago
Shadow Default Rate	~6%	vs. 2% in 2021
Official Default Rate	5.7%	vs. ~0% in 2022
LTV Deterioration (Bad PIK)	76%	From 39% at inception
Recovery Rate Gap	9 pp lower for cov-lite	57% vs 66% on first lien
EBITDA Growth Trajectory	4.7% (Q4 2025)	Down from 6.5% (Q2 2025)

**INDUSTRY PERSPECTIVES:**

Ron Kahn of Lincoln International summarized the situation: “We have seen a steady slowing of EBITDA growth during 2025 and companies not being able to organically deleverage.” He noted that approximately 30 to 40% of the deals maturing in the next two years have already extended their maturity once, meaning that lenders either need to provide an incremental extension or potentially explore a restructuring if these deals cannot otherwise be refinanced.

Kahn also observed: “Throughout 2024 we have observed lenders affording sponsors and portfolio companies flexibility in the form of PIK interest, covenant waivers, maturity extensions, and other borrower-favorable amendments. However, private companies can only kick the can down the road for so long. The slowing growth trends we have observed coupled with the continued use of PIK in distressed situations could spell trouble for some private companies.”

Brian Garfield, Lincoln's managing director, acknowledged: "There's cracks in the private markets. There are observable cracks because you're seeing the fact that there's a lot more PIKS, and that just presents a crack in itself." Len Tannenbaum, founder of Tannenbaum Capital Group, suggested Lincoln's PIK estimates may be conservative: "I think 10% probably is a low number. I don't have the data to support it, but I'm sure that I've heard 12% to 15% is the number."

### MARKET CONTEXT AND IMPLICATIONS:

While the private credit market is approximately \$3 trillion and many companies continue to grow, the combination of rising PIK usage, covenant erosion, and overall slowing growth presents significant challenges. At first glance 2025 does have signs of improvement, size-weighted fixed charge coverage ratios improved from 1.1x to 1.3x, and the weighted average percentage of companies with coverage below 1.0x decreased to 21%, the lowest level since 2022. However, Lincoln notes this improvement may be partly attributable to increased PIK usage rather than genuine operational improvement.

**3 quarters**  
of rising PIK usage

The lack of transparency remains concerning. Private credit lacks daily price discovery, public filings, or transparent headlines about stress. Amendment activity increased 13% quarter-over-quarter in Q4, with maturity extensions and covenant holiday activity both up 14%, and sponsor infusions up 31% – all signs of increasing stress that remain largely invisible to the broader market.

### CONCLUSION: EARLY WARNING SIGN OR TEMPORARY BLIP?

The evidence strongly suggests that recent changes in the private credit markets represent an early warning sign rather than a temporary blip:

- Three consecutive quarters of rising PIK usage indicates persistent, not temporary, pressure
- The shift from 37% to 58% bad PIK shows fundamental credit quality deterioration
- Covenant-lite structures now represent 91% of the leveraged loan market, eliminating traditional early-warning mechanisms
- Companies moving from 40/60 debt-to-equity to 76% debt represents equity cushion erosion
- Declining EBITDA growth amid persistently high rates means companies lack organic de-leveraging capacity
- 30-40% of deals maturing in the next two years have already extended maturity once

**30-40%** of deals maturing in next 2 years have already extended maturity

Private credit has yet to weather a full credit cycle. The market has boomed during an era of ultra-low interest rates when defaults were scarce. It's now facing its first significant stress test with dramatically fewer protections than historical lending cycles. Lenders have also been accepting weaker protections without additional compensation just as borrowers are beginning to experience liquidity stress. The combination of PIK masking stress and covenant-lite loans eliminating early intervention tools means problems may be accumulating quietly, until they appear suddenly, to paraphrase Ernest Hemingway.

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