



**Navigating the Risks
of Private Credit
Investing: Roadmap
for Allocators**

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EXECUTIVE SUMMARY:

The global private credit market has expanded dramatically over the past decade, now surpassing US \$2 trillion in assets under management, according to the International Monetary Fund. Pension funds and other institutional investors continue to increase allocations, motivated by attractive yield premiums of 200–400 bp relative to comparable public credit instruments. However, this expansion coincides with mounting vulnerabilities: structural illiquidity, weakening underwriting discipline, and increasing exposure to macroeconomic stress. Without robust governance and enhanced stress testing, private credit may pose hidden risks. This paper explores some core risk dimensions: liquidity, underwriting quality, market competition, macro dynamics and manager conflicts, and concludes with practical recommendations for institutional investors.

INTRODUCTION:

Private credit encompasses non-bank lending strategies, including direct lending, mezzanine debt, asset-backed lending, and distressed credit, positioned outside traditional capital markets. After the 2008 crisis, new regulations such as Basel III prompted banks to retreat from middle-market financing, spurring institutional capital inflows. According to Preqin, institutional allocations to private credit grew at a compound annual rate of ~17% between 2010 and 2023. North America remains the largest region, accounting for approximately 60% of activity, followed by Europe and Asia. Today, private credit offers borrowers non-bank financing solutions while earning investors a premium over public credit markets. Yet, this asset class remains less transparent and standardized, potentially increasing risk for investors unfamiliar with its nuances.



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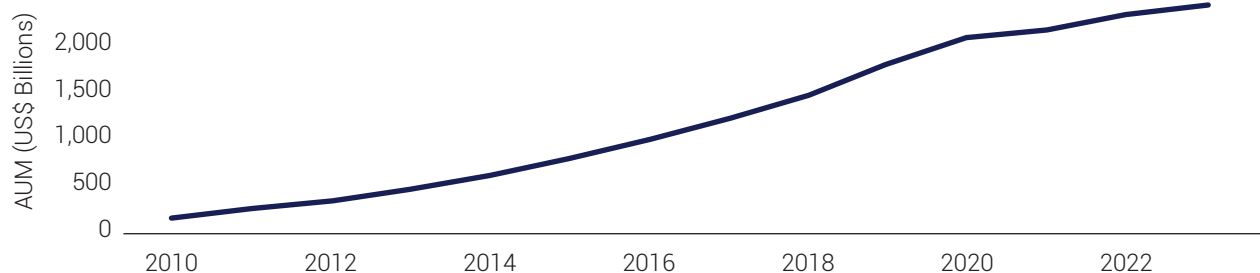
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Growth of Global Private Credit AUM (2010-2023)



VALUATIONS:

Private credit facilities typically mature over three to seven years and lack an active secondary market, meaning they are usually held to maturity. Valuation is therefore predominantly mark-to-model, relying on internal assumptions with limited third-party validation. This increases the risk of stale NAVs that fail to accurately reflect deteriorating borrower fundamentals, potentially leading to distorted portfolio perceptions and ill-advised allocation decisions.

UNDERWRITING AND CREDIT QUALITY:

Underwriting standards have loosened significantly amid aggressive capital competition. While specific middle-market data for covenant-lite loans is scarce, leveraged corporate loan markets, comparable in many respects, feature cov-lite structures in over 90% of new issuance, up from roughly 25% in the mid-2000s. Covenant-lite agreements often rely on incurrence covenants that only trigger upon specific borrower actions, removing early warning mechanisms. As such, covenant erosion is a material deterioration in protection for lenders. Simultaneously, leverage has increased. PitchBook reports show average

debt-to-EBITDA multiples of 6.4x in 2022, well above historic norms. Aggressive EBITDA “add-backs”, such as projected cost synergies or future revenue, further inflate leverage metrics and obscure true cash generation capacity. This creates a precarious financial cushion for borrowers, especially in an environment of rising rates and slowing growth.

MARKET SATURATION AND COMPETITIVE PRESSURES:

Private credit, once composed of a limited cohort of specialist managers, has grown increasingly crowded. The number of active private credit managers has doubled in the last five years, while fundraising for direct lending reached a record US \$228 billion in 2023 alone. This inflow has led to tighter spreads, earning unitranche yields around 10%-11%, just 150–200 bp above equivalent public high-yield bonds despite lower liquidity. Such margin compression pressures managers to deploy capital rapidly to avoid yield drag, resulting in compromised underwriting and diluted deal selection. Over 60% of institutional investors surveyed by Bain in late 2023 expressed concern that private credit was becoming commoditized and no longer compensating adequately for underlying risk.

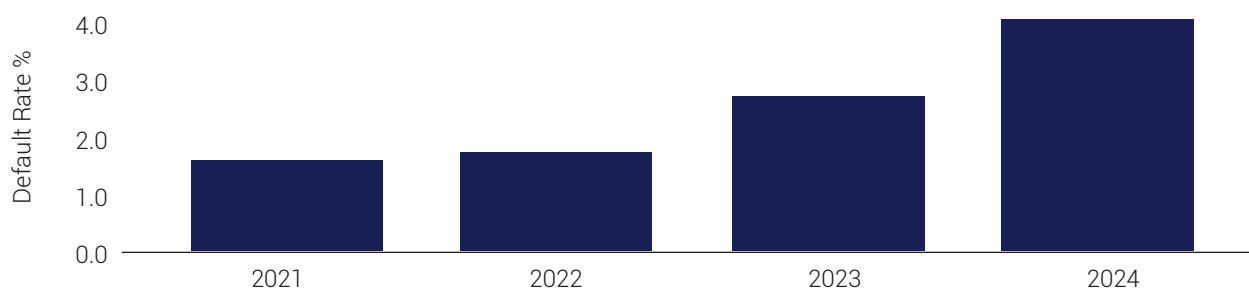
MACROECONOMIC AND SYSTEMIC RISKS:

Private credit has yet to face a broad economic downturn, having emerged during prolonged periods of low volatility. However, leading central banks have aggressively raised interest rates since 2022, pushing Fed funds from near zero to over 5%. LCD data reveals that interest coverage ratios for middle-market borrowers have dropped by more than 25% since 2021. While floating-rate structures benefit lenders, they also strain borrowers. Fitch estimates that a 100 bp rise in base rates increases default probability by approximately 0.4% for highly leveraged issuers.

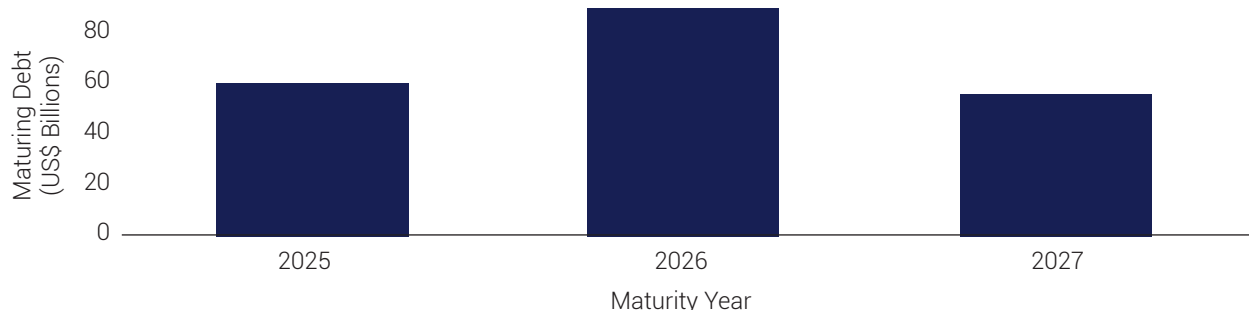
DEFAULT ACTIVITY IS RISING:

U.S. leveraged loan default rates reached 4.2% in Q1 2024, up from 1.7% in early 2022. Moreover, a growing wave of maturing private credit deals scheduled to refinance between 2025 and 2027 face elevated refinancing risk. Moody’s projects that over US \$200 billion in private credit and leveraged loan maturities are scheduled between 2025 and 2027, with a significant share concentrated in 2026. Many of these facilities were originated under low-rate conditions and feature aggressive leverage and weakened covenant structures, making them vulnerable to refinancing stress in today’s higher-rate environment. Refinancing risk is particularly acute among borrowers lacking access to capital markets or sponsor support, raising concerns about distressed exchanges, restructurings, or default spikes over the next 24 months.

US Leveraged Loan Default Rate (2021-2024)



Private Credit Maturities by Year (2025-2027)



MANAGER CONFLICTS:

Conflicts of interest across multi-platform asset managers are another concern. Increasingly, firms manage both private equity and private credit funds, sometimes backing the same portfolio company with both debt and equity. In stressed scenarios, decisions about enforcement, debt extension, or restructuring may be influenced by equity interests, potentially disadvantaging subordinated credit investors. Without clear governance and independent oversight, institutional investors face asymmetric downside exposure relative to potential equity upside.

CONCLUSION:

While private credit can offer compelling risk-adjusted returns, it also brings heightened vulnerability due to illiquidity, opaque valuation, weakened underwriting, competitive compression, macro sensitivity, and structural conflicts. To manage these risks effectively, institutional investors should:

- Demand granular transparency on defaults, NAV methodologies, covenant coverage, and add-back assumptions.
- Deep dive into underwriting practices, especially leverage metrics, covenant strength, and historical credit performance.
- Stress-test portfolios under adverse scenarios—rising rates, economic slowdown, refinancing stress, and NAV impairments.
- Strengthen governance and alignment, monitoring cross-platform conflicts and ensuring advisory committee oversight.

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