LM CAPITAL GROUP
GLOBAL FIXED INCOME MANAGEMENT

Private Credit and Its Discontents

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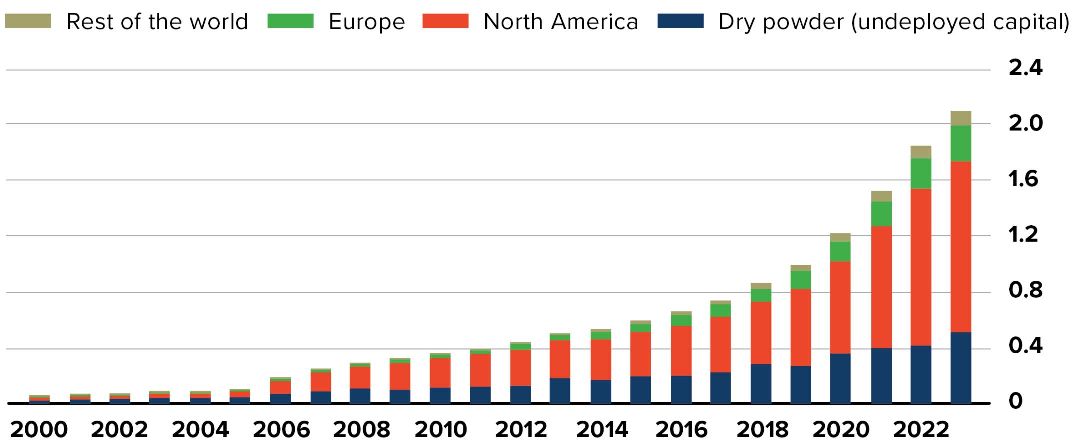
We find that the hullabaloo regarding the provision of private credit reflects the adage that ‘there is nothing new under the sun.’ The benefits of private credit for a potential borrower are clear and fall into three categories. The first is flexibility. Private credit providers can offer structures or terms that have fallen out of favor in the public markets due to regulatory strictures or otherwise (especially in the wake of the Great Financial Crisis of 2008), such as delayed-draw term loans or loans based on annual recurring revenue, a measure used by tech companies during periods of (hopefully) rapid growth. A second attraction of private credit is the speed of deployment. Deals come together very quickly, and it is argued that there is greater certainty of execution. The third benefit proponents usually tout is that private credit is less vulnerable to market dislocation. All these benefits, however, come at a cost, usually in the form of higher rates paid by the borrower.

The growth of private credit markets

Trillions of US dollars



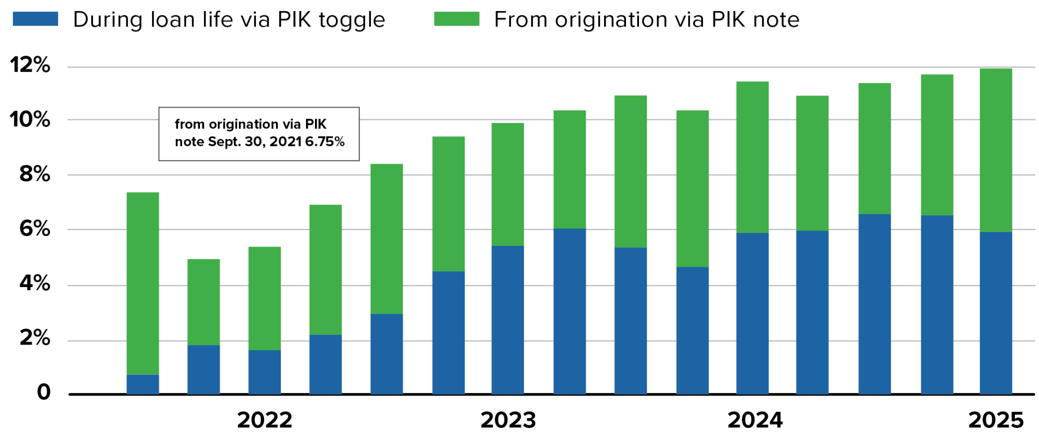
Source: IMF GFSR 2024

However, while the benefits for the borrower are clear we ask the question of whether the benefits outweigh the negatives for investors. To set the stage for this discussion, we note that non-bank financial institutions and the provision of private credit are nothing new.

While the concept of non-bank financial lending is not new, what is new is its explosive growth. Moreover, this growth has taken place without public oversight as represented by marking to market pricing. Not marking to market can lead to a misallocation of capital, as Citibank found in the early 1990s before having to ask Prince Alwaleed bin Talal to save the bank with an infusion of capital. Where other banks were packaging commercial real estate loans for resale, Citi’s bankers did not. This meant that as the bank suffered losses on its portfolio, Alwaleed’s capital injection became necessary.

While the situation then with Citi and today with private credit are not likely to be entirely comparable, we think investors have flooded private lenders with funds to chase ever-shrinking spreads or riskier credits in their pursuit of value, just as Citi retained assets on its balance sheet rather than sell them because its bankers knew where the value lay. Citi's travails provide a blueprint for diagnosing a potential issue. First, there is a rapid rise in lending and asset accumulation. Second, refinancing for the sake of fees takes precedence over repayment. Third, asset-liability mismatches may grow. Finally, leverage increases. We have already pointed to the growth in the market size. What of the focus on lending rather than repayment? Indeed, we believe that the use of PIK (pay-in-kind) interest exacerbates this issue by increasing the nominal debt load.

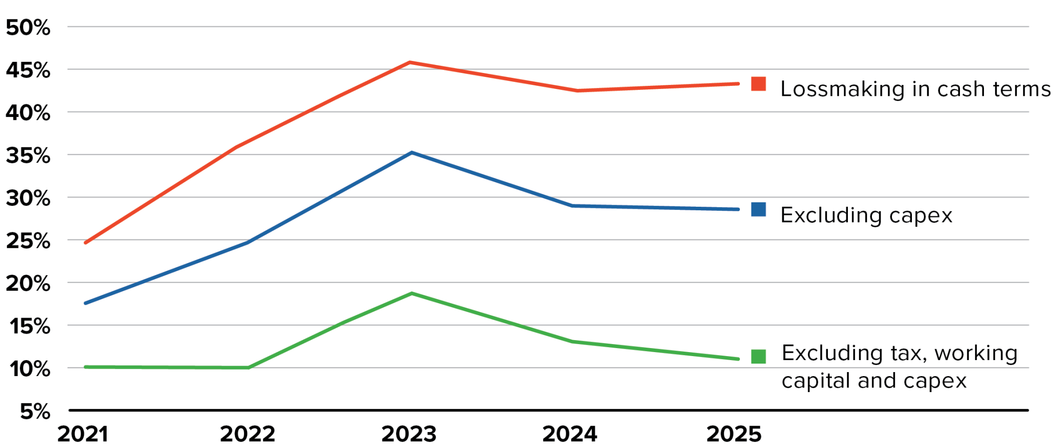
Share of private loans paying with extra debt



Source: Financial Stability Board

As for asset-liability mismatches, consider the following:

Share of holdings of private CLOs* making cash losses



*Middle-market collateralized loan obligations; 2025 is through Q3
Source: S&P via Financial Stability Board

We would argue that the funding gaps shown above are more likely to be filled with additional debt rather than equity, which would lead to higher leverage and thereby increase the asset-liability mismatch.

What of returns, though? Spreads are typically thought to include an intrinsic calculation of loss and recovery in the event of default. We understand that spreads for investment-grade borrowers have compressed to public market levels. This implies that any excess spreads will come from reaching down the credit curve.

In that regard, we note that even though deal activity surged in the fourth quarter of 2025, lenders still reported under-deployment of capital due to limited higher-quality supply and heightened competition. This translated into tighter pricing and a higher tolerance for leverage. Note that this more competitive environment does not preclude borrower demands for minimal amortization and structural flexibility.

But expected returns are one thing; actual returns are another. Our best guide to what is happening to returns is to look at the ratio of price to net asset value (P/NAV) for some of the publicly traded private debt vehicles. Here, we can see that this ratio has declined over the last several quarters.

	Mar-26	Dec-25	Jun-25	Dec-24
P/Nav Median	73%	84%	93%	99%
P/Nav (Mkt Cap)	89%	101%	108%	113%
Area Cap Corp	90%	101%	110%	110%
BlackRock TCP	51%	77%	88%	94%
Blue Owl Capital	75%	84%	95%	99%
Carlyle Secured	67%	77%	83%	107%

Source: S&P Global Market Intelligence

Not only have values declined, but funds have also limited withdrawals. Most notably, this phenomenon began with Blue Owl and has now spread to credit funds affiliated with Apollo, BlackRock, Blackstone, and KKR.

So, what are our takeaways? We believe that, like most financial markets, private credit once provided potential significant risk-adjusted excess returns. But like any financial market offering above-market returns, it has become saturated with investor capital. This means that borrowers at the top of the credit spectrum pay much less now, and lenders have sought riskier borrowers to enhance returns. Structural accommodations, such as PIK features, attenuate returns. Fund strictures have also limited investor withdrawals in many cases.

Note that this differs broadly from public market practice. Price transparency is a prerequisite, and holdings are marked to market daily. This makes assessing returns much easier, albeit potentially more volatile. The offset is that the published return is actually that. Further, there are typically no limitations on fund withdrawals. As private credit spreads continue to compress toward public spreads and the potential for loss increases, we believe this highlights the attractions of public credit by comparison.

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