

CHIEF INVESTMENT OFFICE

Investment Insights

Turbulence in Private Credit

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KEY TAKEAWAYS

- Direct Lending (DL) faces a new focal risk early in 2026: Artificial Intelligence (AI)-driven disruption of software businesses. While fundamentals remain broadly stable, investors are focused on whether Software-as-a-Service (SaaS) borrowers (around 20% of DL exposures versus 14% in broadly syndicated loans (BSL) and 4% in High Yield (HY))¹ may face pressure from emerging AI-native competitors.
- AI-disruption risk is real but not unique to DL, and the asset class may benefit from meaningful mitigants: first-lien seniority, security, and shorter durations.
- Expectations for DL need recalibration. Its history is attractive but relatively short and untested. While its structural features and track record are compelling, investors should be under no illusion that DL is immune to economic, credit, or innovation/creative-destruction cycles. Return profiles will vary with short-term rates, spreads, and realized losses (which are a function of defaults and recoveries).
- Liquidity optics—not widespread credit deterioration—sit at the center of today’s stress. Unlisted perpetual-life business development companies (BDC) have board-directed quarterly repurchase programs, typically up to 5%. Redemption queues are value-preserving by design; these structures are not forced sellers.
- Investment managers with robust sourcing, underwriting discipline, workout capabilities, and diversified liquidity sources should differentiate outcomes.
- The modern media cycle has amplified negative narratives and blurred distinctions between structural design features and fundamental performance. The industry must adapt by proactively rebutting misperceptions in scale across traditional and social media to keep sentiment tethered to reality.
- Private Credit (PC) should be allocated appropriately across a diversified portfolio consistent with risk and liquidity tolerance. Alternatives work best when investors remain committed through cycles.

WHAT WE BELIEVE IS DRIVING THE TURBULENCE

- A confluence of factors is shaping the current narrative, though not all reflect fundamental deterioration. AI-related uncertainty is real, but it is a broad, economy-wide theme, and is not unique to DL.
- Liquidity stress largely reflects semi-liquid fund mechanics interacting with a social-media-driven news cycle in which misunderstood structural features are misinterpreted as signs of fundamental distress.
- Post-2021, slower private market capital velocity (fewer exits/realizations) has reduced distributions and exacerbated liquidity optics even while loan performance has been steady. The recent sentiment reset has been sharp, but the underlying drivers are more nuanced than the “perfect storm” narrative suggests.

¹ BofA Global Research. As of February 2026.

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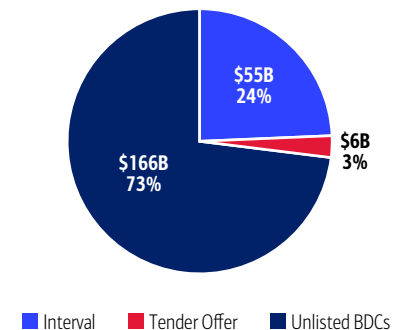
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DISSECTING STRUCTURE AND LIQUIDITY

- Evergreen and semi-liquid funds have emerged as a major structural shift as managers broaden access to PC/DL. DL assets under management (AUM) within evergreen funds are \$227 billion (B), around \$166B of which sits in unlisted perpetual life BDCs.² (Exhibit 1)
- Listed (publicly-traded) BDCs are distinct vehicles with permanent capital. Their shares are listed on major exchanges, and investors therefore have daily liquidity at market prices, which can trade at discounts or premiums to net asset value (NAV). Publicly traded BDC assets total \$179B.³
- PC managers are increasingly launching open-ended evergreen vehicles to match investor demand for simplified onboarding, lower minimums, NAV-based entry, and periodic redemption opportunities.
- Evergreen funds remove capital-call friction and long lockups characteristic of closed-end, drawdown PC funds. Instead, evergreen structures enable ongoing deployment, automatic reinvestment, and perpetual capital, giving investors a smoother and more flexible experience.
- Evergreen structures align well with DL, where recurring interest and shorter maturities support periodic liquidity. These features make DL one of the most popular strategy by AUM within evergreen funds, followed by real estate in real estate investment trusts (REIT).
- Evergreen structures can introduce liquidity-mismatch risk, since periodic redemption programs coexist with inherently illiquid private assets. The most relevant fund types in the current context include:

Exhibit 1: DL AUM in Evergreen Structures.



Sources: PitchBook, Morningstar, BofA Global Research. Interval fund DL AUM include \$41B from exclusively DL strategies and an estimated \$14B from "alternative credit" strategies (around 1/3 of the total \$43B), which include a mix of private and public credit investments. Data spanning June 30 to September 30, 2025 based on disclosure document filings.

Unlisted perpetual life BDCs (aka, unlisted BDCs)

- Regulated under the 1940 Act, continuously offered, and evergreen in structure. Unlisted BDCs have recently shifted to the perpetual life structure, away from the legacy private structure (unlisted "private" BDCs) offered via private placements with limited liquidity and defined terms.
- These vehicles invest in portfolios of income-generating loans with around 5 to 7 year tenors and shorter average lives (around 3 to 4 years), supporting liquidity.
- They provide limited quarterly liquidity via repurchase/tender programs, typically up to 5% of NAV, similar to the interval-fund range but implemented differently.
- Repurchase programs are not mandated; they are board-directed and can be modified, suspended, or gated.
- Oversubscribed redemption cycles may take multiple quarters to clear, but these structures avoid forced selling scenarios.

Interval funds

- Registered closed-end funds under the 1940 Act, but unlike traditional closed-end funds they generally do not trade on an exchange.
- They operate as a hybrid between open-end and closed-end structures, allowing continuous offering of shares at NAV while holding illiquid alternative assets.
- Intervals are designed to provide access to less-liquid alternatives but are often mixed with public market investments as well.
- Intervals have mandated periodic liquidity (quarterly, semi-annual, annual), with 5% to 25% repurchase offers. Investors can only exit during pre-designated windows and may receive pro-rata fills.
- While interval funds can prorate redemptions if oversubscribed, they cannot simply opt out of making a periodic repurchase, raising liquidity-mismatch risk.

DL FUNDAMENTALS, RISKS, AND POTENTIAL MITIGANTS

- DL software exposure is around 20%,³ reflecting historical Private Equity (PE) dealmaking trends. Underwriting since 2022 (the year OpenAI publicly released ChatGPT) increasingly embeds AI risk. Vulnerability is highest where software features can be commoditized and data moats are weak; SaaS incumbents with deep workflow integration and high switching costs are better positioned, in our view.
- To date, borrower fundamentals have been stable, with revenue, operating profits, margins, and coverage ratios steady or modestly improving.⁴

² PitchBook, BofA Global Research.

³ BofA Global Research. As of February 2026.

⁴ SEC filings, BofA Global Research, Lincoln International (Lincoln U.S. Senior Debt Index), Cliffwater LLC (Cliffwater Direct Lending Index), as of March 2026.

- Nevertheless, DL borrowers are not riskless credits. The capacity of smaller DL companies to maneuver is arguably more limited than larger BSL and HY peers. Lenders in this space have a well-deserved reputation for partnering with strained borrowers to find mutually beneficial outcomes (which can include payments-in-kind, higher interest rates, equity injections, and more); however, this constructive and non-antagonistic historical relationship may turn contentious in a deep credit crunch.
- To date, defaults have been in line with expectations. Conservative estimates for DL, inclusive of non-accruals, have shown default rates climbing steadily since 2022 (Exhibit 2). As of January 2026, default rates stand at around 4.7%, above BSL (3.5%) and HY (1.4%).⁵ Q3 and Q4 2025 shows modest improvements driven by declines in short-term rates. Notably, performance has been consistent from Q1 2022 through Q3 2025, in the high-single-digit, low-double-digit range.⁶
- While many SaaS borrowers may prove insulated in the current cycle, there is historical precedent for higher-than-expected default rates in single sectors (e.g., HY energy in 2015 to 2016). Structural DL features may help mitigate this risk. In general, these private loans are first-lien, senior secured, with moderate loan-to-value (LTV) ratios and sizable equity cushions. Additionally, one-third of DL portfolios turn over annually given around 3-year average lives, helping reduce longer-term AI risks.
- Managers also have access to credit facilities and “liquidity sleeves” (cash, cash alternatives, or marketable securities) that can cushion redemption waves.

CONCLUSION

- DL is experiencing turbulence, but the drivers are varied and often misunderstood. Structural liquidity mechanics, AI-driven uncertainty, slower capital velocity, and narrative overshoot have contributed to volatility. Fundamentals remain broadly stable, particularly across well-managed DL platforms.
- Several unlisted perpetual-life BDCs have approached or exceeded 5% repurchase, and others may follow suit. Gating is a contractual design feature that is meant to help protect portfolios. Investor discomfort with queues is understandable, but these features have repeatedly enabled asset managers to navigate elevated redemptions while preserving value.
- The recent real estate cycle (2022 to present) illustrates how time can be a key resource. In certain instances, redemption queues for unlisted perpetual-life REITs cleared after around 5 quarters—and with hands-on operational involvement, demonstrations of liquidity, and strong performance, outflows ultimately flipped to inflows. In other instances, redemptions have yet to clear due to poor performance. The range of outcomes in DL could therefore vary greatly, driven by the quality of the manager’s investment process.
- While listed BDCs have traded off significantly to around 20%⁷ discounts to NAV in public markets, history has shown no meaningful relationship to future returns of the underlying loans. In fact, DL indexes to date have demonstrated consistent positive performance over the subsequent year following meaningful drawdowns.⁸
- Bottom line: while credit concerns are rising, stronger economic growth and a transparent outlook on rates should help alleviate uncertainty over time. Systemic PC/DL risks are thus far contained, though AI-disruption remains a wildcard. DL has higher software exposure than public leveraged credit, but DL managers have greater underwriting control and tighter documentation. Quality lenders will likely manage elevated redemption queues, though negative sentiment and media noise could continue in the short run.

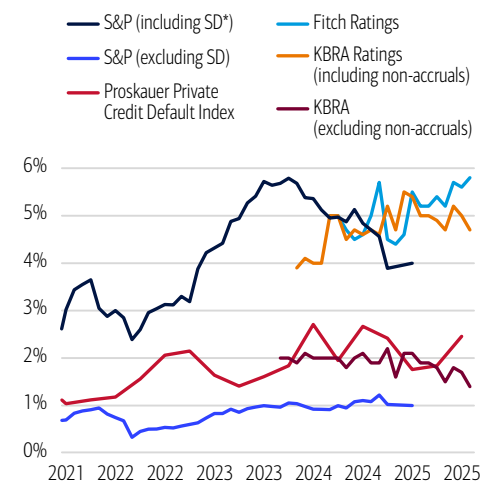
⁵ BofA Global Research.

⁶ Cambridge Associates, LSEG, PitchBook, Preqin.

⁷ Bloomberg, BofA Global Research. As of March 2026.

⁸ Cliffwater LLC, “New Private Credit Data Contradicts the Recent Risk Narrative,” February 23, 2026.

Exhibit 2: DL Default Rates.



Source: BofA Global Research. *SD = selective defaults. Latest data available. As of March 2026. **Past performance is no guarantee of future results.** Please refer to index definitions at the end of this report. It is not possible to invest directly in an index.

Index Definitions

The indices defined below are unmanaged, include the reinvestment of dividends when applicable, do not reflect the impact of transaction fees, management fees, or incentive compensation, and are not available for investment. They are included here for illustrative purposes.

Lincoln U.S. Senior Debt Index is a quarterly index that tracks the fair market value of 1,600 middle market, direct lending credit investments every quarter across approximately 175+ fund clients in the U.S. and in Europe.

Cliffwater Direct Lending Index is an asset-weighted index of directly originated middle market loans that was created to help investors better understand direct lending characteristics and benchmark manager performance.

Proskauer Index tracks senior-secured and unitranche loans in the United States.

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