

Private debt: outlook, risks and contagion

Over the past 18 months, the private debt market has continued to evolve. In this outlook, we primarily refer to corporate direct lending, which has become an established source of corporate financing and the main sub-asset class within private debt. Direct lending has attracted media scrutiny as it entered a more testing phase of the credit cycle. These concerns are understandable. Fundraising has broadened beyond large institutional investors, as semi-liquid wealth vehicles (particularly in the US) gained significant traction with retail investors, while mergers and acquisitions (M&A) and leveraged buyout activity have remained subdued. As a result, competition to deploy capital has intensified, compressing spreads and pushing documentation in borrowers' favour.

The software sector and AI disruption

A particular investor focus has been on the software sector and its potential business model vulnerability to generative artificial intelligence (AI). Direct lending portfolios typically have a meaningful exposure to the software sector, reflecting the composition of private equity-backed buyouts over the past decade. Investors are now questioning whether companies can still meet the initial growth assumptions embedded in underwriting models. We expect the impact to be uneven. Software businesses with strong market positions, high switching costs, proprietary data or vertically integrated business models should be better placed than more commoditised software providers.

In our view, underwriting discipline, documentation quality and portfolio construction will be the key differentiators between winners and losers.

Pressure points

At the same time, the growth of semi-liquid evergreen vehicles, particularly US business development companies (BDCs), has introduced a new technical pressure point. These vehicles' structures allowed affluent private investors to enter an asset class that has traditionally been reserved for institutional money. While they broadened the investor base, they also introduced a degree of liquidity mismatch by offering periodic redemptions against portfolios of fundamentally illiquid loans. With news of generative AI advances hitting the headlines earlier in 2026, many investors sought to redeem their investments in BDCs, forcing several to gate. We view this as sentiment-driven technical pressure, rather than evidence of a broad deterioration in credit fundamentals. However, it has exposed the importance of liquidity design and understanding the risks of private markets vehicles offering liquidity.

Spreads have compressed, particularly in larger transactions; however, higher base rates still support a reasonable absolute yield outlook. Moreover, recent market stresses may actually help reduce competitive pressures, which should modestly widen spreads and improve lender protections.

That said, we've seen broader deterioration in fundamentals and believe reported defaults are understated by amendments and liability management exercises. In our view, underwriting discipline, documentation quality and portfolio construction will be the key differentiators between winners and losers.

Selective opportunities

Overall, we retain a cautiously positive long-term view on direct lending. However, short-term conditions have proved more challenging than in the past decade. We anticipate a choppy path ahead and wider dispersion between managers. We remain selective within direct lending. We see greater relative value in Europe, which remains a more fragmented market versus the established US market. Meanwhile, intensified competition in the larger end of the market arguably favours the lower- and core-middle market direct lending, where conditions are more lender friendly.

We also see scope for diversification beyond direct lending in other areas of private debt, including asset-based finance, high-grade private credit, opportunistic credit, net asset value lending and credit secondaries. These markets have their own market drivers differentiated to direct lending.

Emerging reasons for caution

Direct lending has benefited from the benign conditions for much of the post-global financial crisis (GFC) period. However, with interest rates rising since the end of 2021, borrowers are now contending with higher financing costs for longer than anticipated, slower revenue growth in some sectors and a more uncertain exit environment. While this doesn't point to an imminent broad-based default cycle, the margin for error has narrowed.

Reported defaults by managers remain low, but they likely understate underlying stress. This can be seen by the increased use of LMEs, which help borrowers manage difficult periods, but also delay formal default recognition. These tools have been more prevalent in the US, where looser documentation has allowed borrowers to act with minimal lender consent.

The broader increase in payment-in-kind (PIK) interest is another warning sign. While PIK can be appropriate in some cases (eg a borrower preserving cash for a specific growth project), the widespread increase across senior secured lending suggests that more companies are struggling to service cash interest payments.

Lender protections have also weakened as intense competition for deals has compressed spreads and eroded documentation standards. Covenant-light structures remain prevalent in large transactions, but they have increasingly appeared in the core middle market. The increased use of aggressive earnings before interest, taxes, depreciation and amortisation adjustments and add-backs also understates true leverage levels. Together, these practices point to increased potential risks.

AI disruption in the software sector has further highlighted these vulnerabilities. We don't expect an immediate or uniform revenue collapse across software borrowers, and many continue to perform in line with expectations. But AI could challenge some horizontal software models, while also affecting adjacent sectors like business and financial services. Our immediate concern relates more to software companies with near-term debt maturities, especially as appetite for refinancing or buying software companies is greatly reduced in the current environment.

Valuations

Direct lending spreads compressed materially after a prolonged period of capital inflows. We consider a broad long-term reference point for senior direct lending spreads to be around 550 basis points over base rates in both the US and Europe. However, pricing has varied by borrower size, leverage, documentation and market conditions. Competition has been most acute in larger and upper middle-market transactions, where competition from large lenders, BDCs and syndicated markets has been the strongest.

Compressed spreads reduce expected excess returns and leave less compensation for weaker documentation or higher leverage. However, elevated base rates continue to support a reasonable all-in yield outlook. As a result, many senior direct lending strategies still offer gross yields that compare favourably with public credit markets and their own post-GFC history.

As mentioned, recent market volatility may be starting to reverse some of this pricing pressure. Redemption pressures and more cautious retail-channel demand have reduced a material source of deployment pressure in the US. Early indications from managers suggest spreads have widened modestly in parts of the market and lenders are regaining negotiating power over documentation. We wouldn't overstate this shift yet, but the direction of travel is more supportive than it was during the most competitive parts of 2024 and 2025.

Regionally, we continue to prefer Europe over the US on a risk-adjusted basis. The US direct lending market is larger, more standardised and more competitive. Europe remains fragmented, with differences across legal jurisdictions, sponsor relationships and bank retrenchment creating opportunities for managers with local origination networks. European documentation has also generally been more lender-friendly, offering investors better protections than comparable US deals. Importantly, the recent BDC-related technical pressure has been concentrated in the US and has not had the same direct impact in Europe.

Technicals

Technicals have become a more important driver of near-term returns in direct lending. The most visible pressure comes from retail channels in the US, where semi-liquid BDCs have faced elevated redemption requests. This has reduced one source of deployment pressure in the US, forcing some managers to focus on managing liquidity. Although it's created negative headlines, it may also improve investing conditions for patient capital by reducing competition and allowing new loans to price with wider spreads or stronger terms.

Private credit remains supported by structural demand from long-term investors. Institutional capital is still the dominant source of funding and closed-end structures are better aligned with the illiquidity of underlying loans. Managers have large amounts of dry powder, which provides a buffer for refinancing and new origination, even if fundraising is slower than the post-pandemic peak. This helps limit the temporary slowdown in retail demand.

However, the supply-demand balance is uneven. Subdued M&A and leverage buyout volumes have limited the flow of new direct lending opportunities, while managers still need to deploy capital raised in recent vintages. This is one reason why spreads and documentation have weakened. If M&A deal activity normalises, lenders should see a broader opportunity set, and we expect conditions to revert towards previous market norms – both in terms of pricing and documentation.

Summing up

Structural drivers continue to support the European direct lending market. Banks still account for a large share of corporate lending in Europe. However, with tighter regulation, we expect bank retrenchment to continue and direct lenders to gain more market share over the coming years.

The technical backdrop also supports diversification beyond traditional sponsor-backed direct lending. Asset-based finance, high-grade private credit, opportunistic credit and credit secondaries benefit from bank retrenchment, slower private equity exits and demand for liquidity. These areas offer a different risk-return profile and require specialist underwriting. Particularly at times of market stress within direct lending, they may offer better relative value than crowded upper middle-market direct lending.

If you'd like to discuss private debt in more detail, get in touch with the authors or your usual Hymans consultant.



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