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But a market full of danger

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How to contact us

Senior Editor
Andy Thomson
andy.t@pei.group, +44 20 7566 5435

Head of Special Projects
Graeme Kerr
graeme.k@pei.group, +44 20 3862 7491

Americas Editor
Robin Blumenthal
robin.b@pei.group, +1 646 970 3804

News Editor
John Bakie
john.b@pei.group, +44 20 7566 5442

Reporters
Christopher Faille
christopher.f@pei.group, + 1 860 849 1808

Sergio Padilla
sergio.padilla@pei.group, +1 210 957 9307

Contributors: Claire Coe Smith, Tom Zimmermann

Managing Editor, Production: Mike Simlett

Production Manager: David Sharman

Senior Production Editors: Tim Kimber, Adam Koppeser

Production Editors: Helen Burch, Christine DeLuca, Nicholas Manderson, Jeff Perlah

Copy Editors: Khai Ojehomon, Louise Squire-Crawford

Art Director: Mike Scorer

Head of Design: Miriam Vysna

Art Editor: Lee Southey

Art Director – Americas: Allison Brown

Senior Visual Designer: Denise Berjak

New Media Designer: Ellie Dowsett

Designer: Shanzeh Adnan

Global Business Development Director – Private Debt: Beth Piercy
beth.p@pei.group, +44 20 7566 5464

Subscriptions and Reprints
subscriptions@pei.group

Customer Services
customerservices@pei.group

Editorial Director, US: Rich Melville

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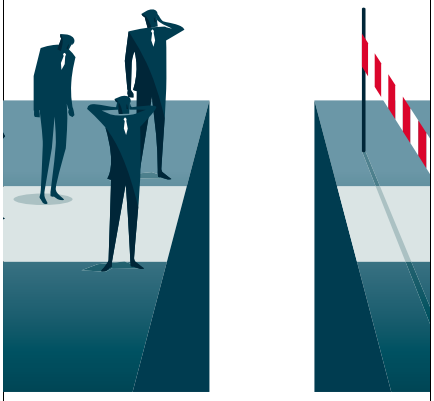
Insight



Cover story

Real Estate Debt 50

Analysis

Insight

Market conditions **Default picture lacks clarity**

Defaults may not provide a conclusive picture of the amount of stress in the private credit universe, but they're still one of the best – and most commonly referenced – measurements that the asset class has, ***writes Andy Thomson.***

So, what does the current default rate tell us about the state of the market today? According to a respected study from New York-based law firm Proskauer – whose *Private Credit Default Index* tracks senior-secured and unitranche loans in the US – there doesn't appear to be too much to worry about.

The index revealed a default rate of just 2.42 percent for the first quarter of 2025, which is slightly lower than the 2.67 percent figure from the fourth quarter of 2024. That's not the lowest the rate has ever been, but also far from the highest.

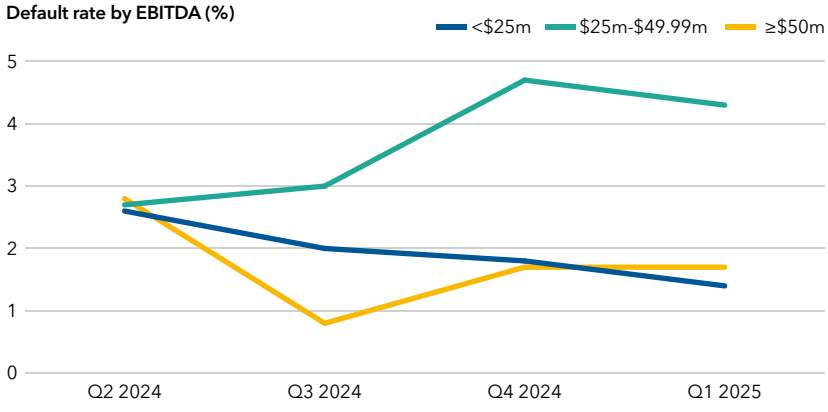
Stephen Boyko, partner and co-founder of Proskauer's private credit group, says: "The latest default rate continues to reflect a stable and resilient private credit market [because] credit fundamentals remain strong and lenders continue to show discipline in underwriting and portfolio management."

> "Is there nothing for borrowers and lenders to fear? That would be an assertion too far"

In the first quarter, the private credit default index encompassed 786 loans representing a principal amount of $148.6 billion, divided into three EBITDA categories (below $25 million, between $25 million-$50 million and equal to or above $50 million). Across all three bands, the default rate was less than or equal to that of the quarter before.

For the smallest EBITDA group, the rate has fallen quarter-on-quarter for the past three quarters.

Default rate by EBITDA (%)



Source: Proskauer

Tariff impact

So, nothing for borrowers and lenders to fear? With the tariff impact only just being felt, interest rates remaining high and the threat of possible recession on the horizon, that would be an assertion too far.

Patrick Warren, vice-president of research at MSCI, recently noted that loan valuations deteriorated further in 2024, with 50 percent write-downs becoming more common.

"These deeper write-downs suggest that a growing number of borrowers are really getting squeezed by a combination of sustained elevated interest rates and an uncertain growth outlook, and these are the types of loans at the greatest risk of sliding into restructuring, barring a turnaround."

Other respected authorities are also unnerved. European defaults are expected to rise this year, both by number and volume, according to KBRA Direct Lending Deals, part of ratings agency KBRA.

The default rate for the region is tipped to grow to 1.25 percent by volume and 2.25 percent by count, up from 0.4 percent and 1.0 percent respectively, among the 290 borrowers in KBRA DLD's Europe Index.

KBRA Default Radar up

KBRA DLD said it was seeing a growing numbers of issuers on its Default Radar as well as declining fair values. It added that the consumer sector was expected to drive default activity in the Index.

The organisation's US Index is tipped for the same outcome by volume at 1.25 percent but is higher by count at 3.0 percent based on around 2,500 companies in the index.

KBRA DLD also recorded a low implied recovery rate of around 40 percent based on fair value marks provided by business development companies, typically the quarter before a restructuring.

Average fair values for 12 companies with 'red' status on the Default Radar stands at less than 62 percent, down 24 points over the past year and 16 points in the last six months.

Thus, the default picture is mixed – no need for panic, perhaps, but every reason for a careful watching brief. ■

↑

"In an increasingly uncertain global environment, Europe stands out as a region where investors can still find consistency and returns"

*Taken from a **KKR paper**, European Credit's Underappreciated Resilience*

↑

Ups & downs

↓

"Bond markets have been in turmoil and failed to protect against volatility. Private debt has been calmer but the direct impact of tariffs, broader macro slowdown and reduced M&A will still affect many strategies"

*Taken from Private Credit After An Orange Swan Event, authored by **Reji Vettasseri** of Decalia Private Credit Strategies*

↓

The big numbers

New partnership for Mubadala, China's private debt decline, Apera's fundraising success

$1bn

Size of private debt investment partnership formed between Mubadala Investment Company and Fortress Investment Group

50%

Decline in the size of China's private debt market between 2017 and the end of 2024, according to S&P

6.9%

Average return delivered globally by private credit closed-end funds in 2024, beating private equity's 5.6%

$100bn

Size private debt evergreen funds could eventually reach, according to Jess Larsen of Briarcliffe Credit Partners

€2bn

Raised so far by Blackstone for its high-net-worth-focused European Private Credit Fund, according to public filings

$546bn

Ares Management's assets under management as of 31 March, 2025

€2.9bn

Raised by Apera for its third European mid-market fund, beating its hard-cap

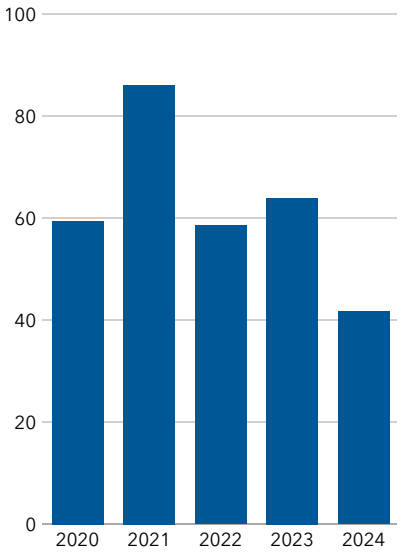
Trend Watch

Mubadala forms $1bn partnership with Fortress

Mubadala Investment Company announced it has entered into a $1 billion partnership with fund manager Fortress Investment Group. The move will see Mubadala commit to Fortress's direct lending, asset-based lending and real estate strategies, as well as co-investments.

In a statement announcing the partnership, Omar Eraiqat, Mubadala's deputy chief executive officer of credit and special situations, highlighted private debt's role in global capital markets, its risk-adjusted returns and ability to provide flexible capital for businesses. He added that the partnership leverages the complementary strengths of Mubadala and Fortress, providing access to a range of credit and real estate strategies.

European private debt fundraising ($bn)



Source: Private Debt Investor

The United Arab Emirates' sovereign wealth fund, with the equivalent of $330 billion in assets under management, already owns a significant portion of Fortress through its asset management subsidiary.

China private debt declines

Private debt typically makes headlines for its strong growth trajectory, with the rise of asset-backed finance creating a whole new – and very large – playing field to rival the established direct lending market.

It is unusual therefore to dwell on a private debt market in retreat, but that is the case in China, where an S&P report found that the asset class had shrunk nearly 50 percent between 2017 and the end of 2024.

The market, according to S&P, "lacks alternative investment funds and direct lending, is heavily regulated and banks remain key players". Explaining the decline over the past seven years, the report said strong competition from local bond markets has compressed margins and made the risk-reward ratio less appealing.

Europe sees capital drop, fund size growth

Fundraising levels continued to decline in 2024 (see chart), reaching the lowest levels since 2016, though average fund sizes reached an all-time high on $984 million, suggesting that investors are favouring larger managers. The outlook looks to be rosier for the remainder of 2025, according to market onlookers who say investors are increasingly recognising the myriad opportunities that Europe offers in terms of its relatively stable political and regulatory frameworks – particularly as the global markets grapple with uncertainty around US tariffs. ■

ALLOCATION • WATCH

■ Los Angeles Fire & Police Pension System

LAFPPS has approved a commitment of up to $30 million to Ares Management's Ares Special Opportunities Fund III. The vehicle follows a distressed debt strategy and will target the corporate sector in North America and Western Europe. The fund has a target size of $7 billion. Its predecessor fund held a final close on $7.1 billion in October 2022, which was above its target size of $4 billion.

■ New Mexico State Investment Council

NMSIC has approved two recommendations totalling $300 million to private debt funds.
It will commit $150 million to Evolution Credit Opportunity Fund III, managed by Evolution Credit Partners, which will invest in senior debt opportunities in the US.
The body will also commit $150 million to Ares Sports, Media & Entertainment Fund II, managed by Ares Management, which will invest in subordinated/mezzanine debt across the US.

■ Sacramento County Employees' Retirement System

SCERS has approved a $75 million commitment to NGP Royalty Partners III. The fund, managed by NGP Energy Capital Management, plans to invest in opportunities across North America within royalties in the corporate sector. The fund has a target size of $750 million and launched in January 2025. SCERS has also committed to other funds in this series, including $40 million to NGP Royalty Partners and $25 million to NGP Royalty Partners II. ■

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Strategy **Brookfield adds latest partnership**

Brookfield Asset Management, with a credit business amounting to a mammoth $317 billion, certainly boasts a very large internal private debt operation, ***writes Andy Thomson***. But what it has also done is take the partnership model and grown it into numerous corners of the private debt universe. Partnership arrangements are not uncommon in private debt these days – but few firms have embraced the approach with as much enthusiasm as Brookfield.

At the beginning of April, the latest new manager was ushered into the Brookfield stable with the acquisition of a majority stake in Angel Oak, a US firm specialising in US residential mortgage strategies, founded in 2008.

"The area of the market that Angel Oak focuses on requires a high degree of specialisation, says Craig Noble, chief executive officer of Brookfield's credit business. "We believe controlling the origination of these types of loans is very valuable and results in better investment outcomes than public securities in the same space. Our observation is that institutional investors including insurance companies have a significant appetite for these types of investments."

Angel Oak follows in the footsteps of fund managers such as Oaktree Capital Management, LCM Partners and Castlelake in joining forces with Brookfield. "By partnering with highly specialised managers, it's allowing us to cover the entire private markets spectrum," says Noble.

With around half of Brookfield's total credit AUM now accounted for by these partnerships, Noble thinks the approach may have reached its limit. "If there was an additional partnership that made sense, of course we would be open to it, but our view is that we've really got the spectrum filled," he says.

Noble is confident that Brookfield's private credit expansion is justified by the continuing positive sentiment around the asset class. Although there have been plenty of recent shocks to the economic and geopolitical system, most recently from the US government's approach to tariffs, he believes that these are merely short-term developments that shouldn't deflect from long-term strategy.

"We're observing a lot of volatility across different metrics in the public markets but our investment

Craig Noble: looking at long-term fundamentals

> "By partnering with highly specialised managers, it's allowing us to cover the entire private markets spectrum"

thesis – including anything we do in private credit – is about long-term fundamentals. We're making investments with the expectation of holding them for multiple years in the case of private debt, or multiple decades in the case of owning assets outright.

"Having that perspective allows us to still be open for business and active in the markets throughout an economic cycle. The shorter-term sentiment and volatility is just less relevant."

Mood vs commitment numbers

Where the volatility has been relevant is in helping to suppress fundraising levels for the asset class in general. While survey after survey has confirmed investors' positive sentiment towards private debt, actual commitment levels have fallen over the past few years. This, however, is the overall picture – larger managers with a wide variety of offerings have vacuumed up a disproportionate amount of fresh capital.

> "The last couple of years, we have experienced some of our best fundraising on record"

"The last couple of years, we have experienced some of our best fundraising on record, and that's in an environment where there has been some softness more broadly in the market," says Noble. "What we're experiencing first hand is that large institutional investors want to do more with a smaller number of strategic managers.

"They want their capital to be more strategic, they want more touchpoints in their relationships, more co-investments and partnerships, and that, I think, is one of the reasons that larger managers with global scale and a full breadth of offerings are doing well."

It is also worth considering, he says, that volatility is not necessarily a bad thing for private credit. Turbulence in the market can be a way of releasing opportunities that don't make it to the surface in calmer times. "In credit, there continues to be an opportunity for higher returns compared with the public markets for the same type of risk," he says.

"The volatility we've seen recently will probably add to that advantage because it will generate more opportunities for specialised investors. We're continuing to see a lot of demand for multi-strategy programmes with larger institutions which want broader strategic relationships with a fewer number of global managers."

While private debt may have struggled – with other alternative asset classes – to attract institutional capital over the past few years, Noble points out that Brookfield manages around $150 billion on behalf of insurance companies "but it's a highly specialised skill set required to do that properly, so there are relatively few managers focused on it".

With insurance one of the big talking points when it comes to the capital to fuel the asset class's future, another is wealth. Here, too, Noble expects managers like Brookfield to be well placed, given idiosyncratic structuring and liquidity requirements. ■

Three areas of focus for Brookfield

Craig Noble highlights where the firm's credit business is turning its attention

1 Real estate debt

"There's just not enough capital available relative to the opportunity set and there's some amazing top-quality assets across all parts of real estate where the capital structure needs to be addressed or there's a financing need. We think that the current vintage for real estate debt is going to be very interesting, with a lot of opportunities."

2 Infrastructure

"The quantum of capital needed is very large, in the trillions of dollars. A large part of that capital need is equity but an even larger part is on the debt side because of things like data centres, energy infrastructure and deglobalisation as supply chains are moved back onshore in so many countries."

3 Asset-based finance

"We're seeing a lot of interest within our Castlelake franchise, within our Oaktree franchise and within things that we're doing directly. There's a tremendous amount of demand and that's partially because the banks have pulled back over the last couple of years, and I think will continue pulling back significantly and not returning to the ABF part of the market."

Regulation **Securitisation and the need for clarity**

Expert analysis by **Jiří Krol**, global head of the Alternative Credit Council

European policymakers have made clear their ambition to strengthen the EU's capital markets and expand alternative financing channels for businesses. Nowhere is this more evident than in their approach to securitisation, which has been the subject of renewed focus over the past year. Multiple reports, speeches and consultations have emphasised the need for reform to support a more dynamic financial ecosystem.

Following a public consultation in 2023, the European Commission is expected to publish a proposal in June to revise the EU Securitisation Regulation. The ACC has long advocated for changes, highlighting how the current framework imposes unnecessary complexity and discourages investor participation. We remain hopeful that the forthcoming reforms will address these long-standing concerns.

However, the lead up to this proposal has revealed deeper structural issues in the EU's approach to securitisation policy, particularly around regulatory clarity. Recent developments have created confusion for market participants and raised questions about the stability of the policymaking process.

At the centre of this issue is the concept of the originator – an entity that creates or sources the underlying assets to be securitised. Under EU rules, originators play a key role in fulfilling the 5 percent risk retention requirement, which is designed to ensure alignment between issuers and investors. In the private credit and CLO markets, managers frequently use third-party originator entities to retain this exposure in a compliant and transparent manner.

Critically, the regulation states that an originator cannot exist solely for the purpose of holding the risk retention slice, as that would undermine the rationale of alignment. But how this "sole purpose" test should be applied has long been open to interpretation.

Detailed interpretation

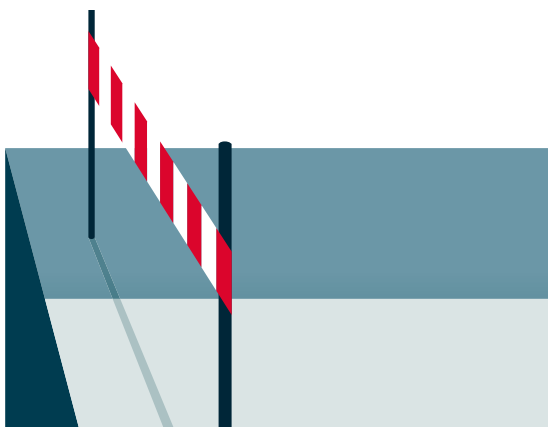
In March 2025, the Joint Committee of the European Supervisory Authorities (ESA) released a report on the implementation of the Securitisation Regulation. While intended as a review exercise, it introduced a more detailed interpretation of the sole purpose test, proposing that if more than 50 percent of an entity's income comes from securitised exposures, it should be deemed to exist solely for that purpose.

This was accompanied by a recommendation that supervisors and market participants begin applying it immediately, even though it still asked the European Commission to confirm its agreement. While focused on third-party CLO originators, it offered no guidance on other structures or practical questions – such as how income should be calculated, over what period or how retained positions should be treated.

The shift has caused disruption, with several CLO deals paused or cancelled, and uncertainty chilling new issuance. The CLO market – previously a more resilient area of European securitisation – is facing headwinds just as investors had begun to reallocate capital to the region.

There are encouraging signs in the ESA report, such as support for allowing alternative investment fund managers to act as sponsors, a long-standing proposal of ours. On this, ESMA rightly asks for a thorough cost-benefit analysis, so it is strange the originator definition discussion has not been subject to a similar process. Investors need a predictable regulatory environment. Abrupt changes in interpretation risk undermine confidence in EU policymaking.

Regulatory stability is not a luxury. It is the foundation on which confident, well-functioning capital markets are built. ■



PEI

New York
530 Fifth Avenue,
14th floor
New York,
NY 10036
T: +1 212 633 1919

London
100 Wood Street
London
EC2V 7AN
T: +44 20 7566 5445

Hong Kong
Room 1501-2, Level 15,
Nexxus Building,
No. 41 Connaught Road, Central,
Hong Kong
T: +852 3704 4635

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Editor's letter

Trouble looming?

Andy Thomson
andy.t@pei.group

"Politics is now driving the economics rather than the other way around," said Katharine Neiss, deputy head of global economics and chief European economist at PGIM Fixed Income, at the PDI Europe Summit in London in mid-May. "That's quite a different environment to the ones I grew up studying."

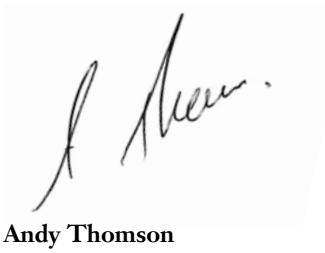
In the US, maximalist and chaotic policy announcements have not yet fed through to the economy in a significant way but "there could be lags as we're getting warning lights from soft indicators", said Neiss. The tariff uncertainty is "terrible for growth", she added. That's not an environment those in the audience (distressed specialists aside) would have relished, no matter how many times private debt's resilience was mentioned.

"There could be lags as we're getting warning lights from soft indicators"

If that's not sufficient reason for concern, Robin Blumenthal finds numerous others in this month's cover story (see p. 10) – adding up to a turning of the credit cycle. "People have woken up to the fact that there's credit stress in private credit," says Charles Peabody of Portales Partners. Using various metrics, the piece demonstrates the pressure that borrowers have come under.

Not everyone agrees that the asset class is about to drop off a cliff. Through Brexit, covid and, indeed, the current challenging backdrop up to now private debt has demonstrated that it can take a buffeting and still emerge with its reputation intact. There are those who think it well capable of pulling off the same trick again.

For further assessments of how private debt-backed businesses are likely to fare in the period ahead, look no further than our *Mid-Market Report*, which accompanies this issue.



Andy Thomson

The threats that lurk below the surface

Cover story

With pressure rising on borrowers from outside forces, signs of danger are fast emerging. While not everyone agrees, some think a turn of the credit cycle is in the making.

By Robin Blumenthal

A confluence of signals, coupled with the shock precipitated by the tariff drama and its attendant effects on the economy, is indicating a rough ride ahead for the credit markets, with some expressing deepening concern around private credit.

"We're at the early innings of a credit distress cycle," says Charles Peabody, a founding partner and president of independent bank research firm Portales Partners. "People have woken up to the fact that there's credit stress in private credit." He expects private equity and private credit "to be at the epicentre of any credit dislocations", even drawing parallels between the current situation and the Panic of 1907 (see panel, p. 16).

Andrew Milgram, chief investment officer and managing partner at Marblegate Asset Management, a restructuring manager, concurs. "We have this pandemic of over-indebtedness across the entire corporate landscape that is particularly acute in the mid-market," he says, noting that average payment-in-kind debt among public business development companies has risen to nearly 10 percent, a statistic he calls "profoundly disturbing".

At the same time, the data his firm uses to monitor the health of the mid-market points to "sharply negative" net profits after tax for the average mid-market company, with interest coverage on 20 percent of the data set below one times EBITDA.

According to the International Monetary Fund's *Global Financial Stability Report*, released at the end of April, more than 40 percent of companies that borrowed from private lenders had negative cashflow from their operations at the end of 2024. At the same time, debt maturity issues are building, with 40-60 percent of lower-rated borrowers facing debt maturities by the end of 2026, according to KBRA.

Concerns about credit quality pre-dated the hefty tariffs President Donald Trump imposed on more than 60 countries on 2 April. A week later, after an equity market rout, the administration reversed course and paused the tariff increases for 90 days on all countries save for China, before the two reached a deal in mid-May to roll back most of their retaliatory tariffs imposed in April.

Although markets were assuaged, uncertainty over the eventual outcome has undermined business confidence in an already lengthy credit cycle that has been marked by higher interest rates, continued inflation and now supply chain disruptions. The US economy, as measured by GDP contracted in the first quarter, as businesses stockpiled imports of goods in anticipation of higher tariff-related costs.

Defaults on the rise

Signs of stress have been evident for some time. Last year, on average, one out of 20 businesses owned by a sponsor defaulted, notes Victor Khosla, founder and chief investment officer of Strategic Value Partners.

"Underneath the surface in the illiquid markets, the problems are much more extreme than the liquid markets," Khosla says, noting that SVP saw prices on senior debt on some secondaries deals compress from around 70 cents on the dollar to 50-55 cents in the space of just four weeks this year.

"There's a big rationalisation coming in private credit," partly evidenced by the rise in bankruptcy filings, says Dan Zwirn, chief executive and chief investment officer at fund manager Arena Investors. US corporate bankruptcies remained at a "historically high" level in April, with the number of filings in the first four months of the year by large public and private companies hitting 246, the highest since 2010, according to S&P Global Market Intelligence.

Zwirn says he's seen people sell distressed loans "at levels that imply the buyer of the loan needs to take over the business to make that make sense". Indeed, some of the recoveries in the public markets have been tiny, with bankrupt retailer Forever 21 proposing in May that senior lenders recover a

paltry maximum of three cents on the dollar.

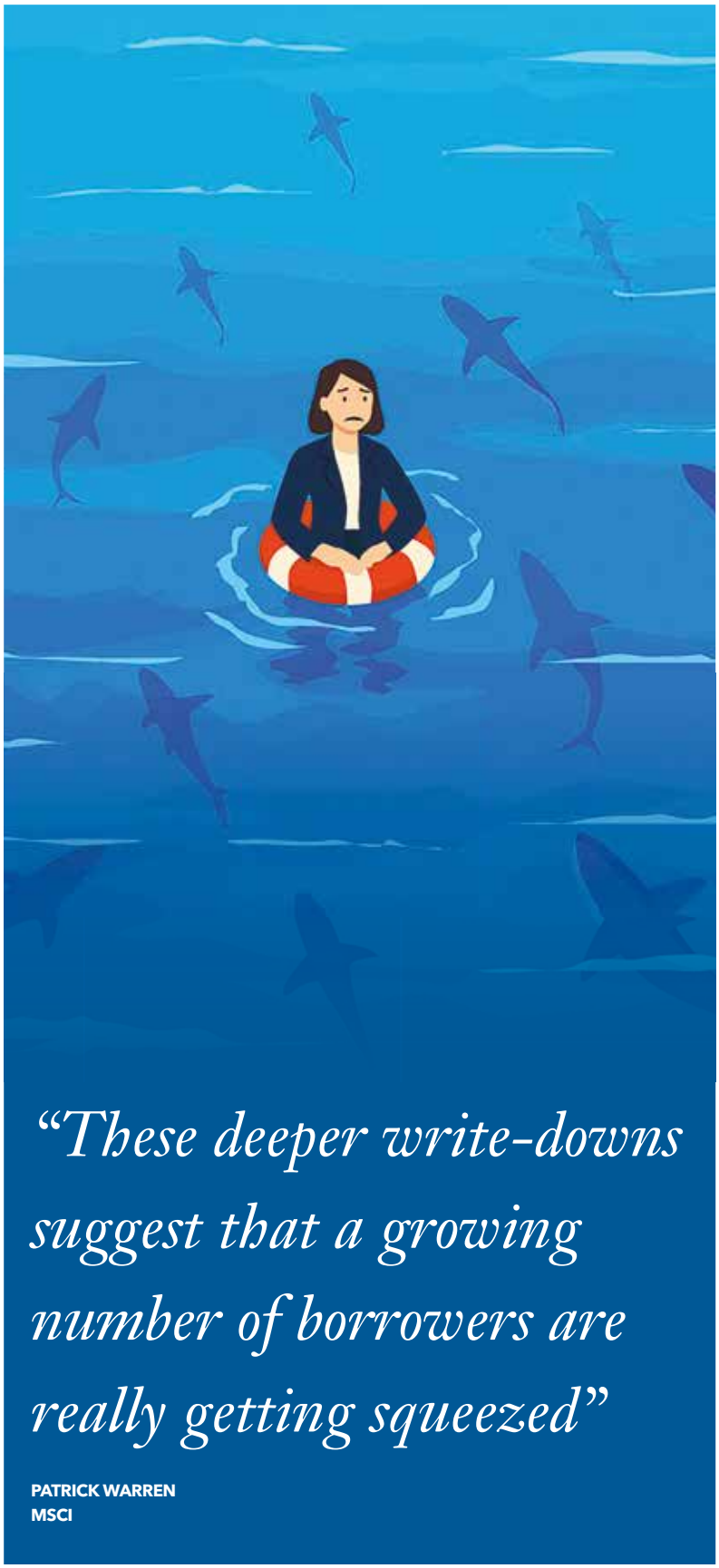
David Breazzano, head of team for credit and portfolio manager at Polen Capital, believes "the risk has been pushed over to the private credit market", with second-lien loans often being refinanced with private credit. But the risk isn't as evident as in the syndicated market, because private credit managers can hide it by deferring coupons or using PIK interest.

"Managers oftentimes have the ability to value these assets at cost, so the investor doesn't know there's trouble in the portfolio," says Breazzano.

That cannot continue indefinitely, says Eric Newman, who sits on pension boards for the City of Stamford, Connecticut. "Like previous black swan cycles, at some point there will be write-downs, particularly for smaller and medium-sized companies that don't have liquidity or the support of a sponsor." Unlike prior cycles, where companies received government support, "there's not necessarily going to be bailouts across the board".

Milgram believes a protracted credit distress cycle is inevitable. "Valuations suggest that much of the sponsor-backed PE world is severely out of the money," with a big disconnect between the marks and the valuations, he says. "We're moving into a period where the problems are now broad-based enough that large parts of lenders' portfolios will become troubled."

Private Debt Investor raised the prospect of credit stress in our October story, 'Are we nearing a credit cycle downturn?' and MSCI has been sounding



"These deeper write-downs suggest that a growing number of borrowers are really getting squeezed"

PATRICK WARREN
MSCI

the alarm since at least September. In a December note, MSCI said "private credit as a strategy is experiencing its first real rate cycle, and investors who hoped those loans would be light on credit risk may be disappointed".

Concern over valuations

More recently, at the request of *PDI*, MSCI found that loan valuations sharply deteriorated in 2024, with write-downs spiking from the 20 percent level that generally indicates distress to a lofty 50 percent, even on some vaunted senior loans. "The haircuts on distressed loans have snowballed," says Patrick Warren, vice-president of research at MSCI, with valuations getting sliced in half on about 5 percent of senior loans and 12 percent of mezzanine debt.

"It's more alarming than if transaction values were being cut, because it's against GPs' interest to volunteer that information," Warren says. "These deeper write-downs suggest that a growing number of borrowers are really getting squeezed by a combination of sustained elevated interest rates and an uncertain growth outlook, and these are the types of loans at the greatest risk of sliding into restructuring, barring a turnaround."

Moreover, Warren notes that dry powder for senior private credit reached "multi-year lows" relative to committed capital in early 2024. Despite a small uptick as the year went on, at year-end just 14.5 percent of such commitments were uncalled, compared with 22 percent on average since 2009. The last time that ratio fell to such lows was 2013, he says, noting that the decline is "largely due to a slowdown in private credit fundraising, which has meant that younger funds with capital to deploy have not materialised to fill the gap".

To be sure, the severity and breadth of any crisis remains to be seen, given the uncertainty around tariffs and their effects. Indeed, concerns about the credit picture are not uniform.

Richard Wheelahan III, co-founder of Fund Finance Partners, a capital markets advisory firm for sponsors, believes it is "premature" to sound the alarm for a credit crisis. He notes that borrowers "are not clamouring for any rainy-day liquidity" by calling for outsized borrowings on revolvers and delayed-draw term loans, as they did in 2020. "It's right to raise the degree of scrutiny, but I wouldn't say things are really bad."

No cushion

Those arguably facing the greatest risk are smaller managers, which lack restructuring teams or advanced technology to navigate a deep dislocation, as well as industrial and consumer-facing companies.

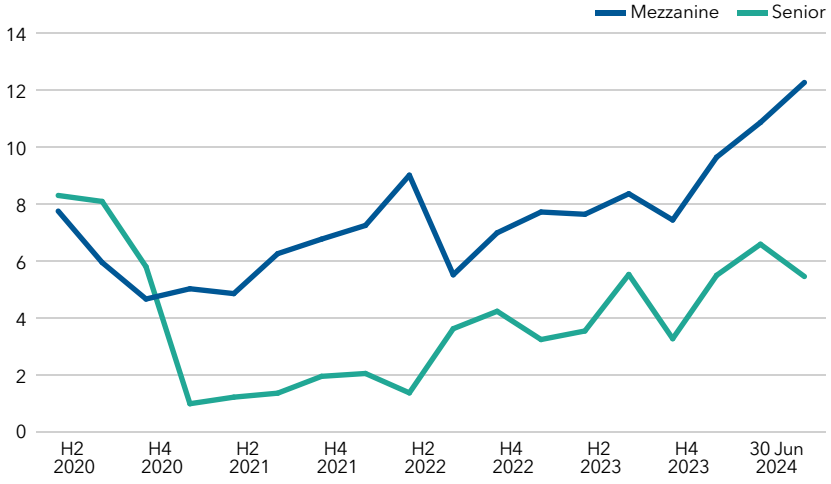
"There will be some dispersion between public and private markets, and big managers and small managers," says Brad Marshall, global head of private market strategies at Blackstone. He notes that the portfolios of most larger managers like Blackstone are geared to sectors such as tech, software and business services, which he believes will outperform other sectors.

Mark Jenkins, head of global credit at Carlyle, points to the significant resources his firm and other large managers have that can be used to address and head off problems. Even before the US administration changed, he says his team was managing out of "any legacy positions or credits that probably had no right to survive in a normalised environment but were suffering from the 550-point base rate rise".

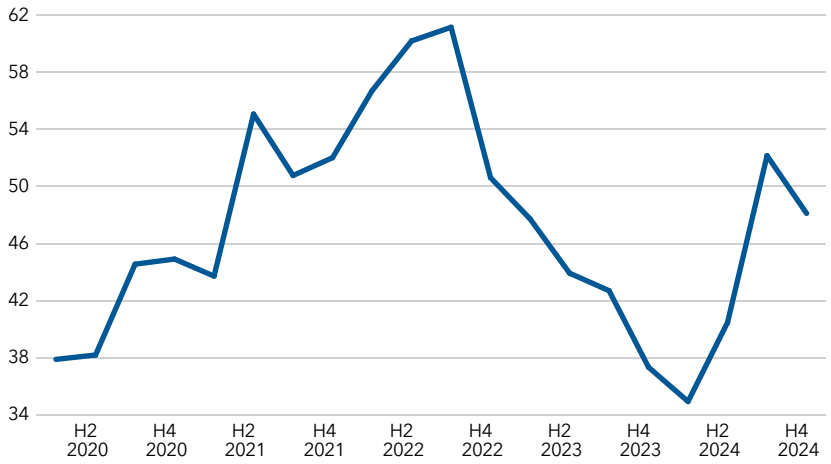
The vintage matters as well. "The cohort that is most susceptible to issues is the period from the end of 2020 to the beginning of 2023," Jenkins says.

David Conrod, co-founder and chief executive officer of capital raising and advisory firm FocusPoint Private Capital Group, doesn't believe a credit distress cycle is imminent. But he says that it "would also be suspect if, say, 2021-vintage private credit funds were all marked at par".

Percentage of private credit loans with 50% write-downs



Dry powder in the senior private credit sector ($bn)



Source: MSCI

A number of the private debt capital structures were put together post-covid, "when base rates were at zero", says Bryan High, head of global private finance at Barings. "There will likely be issues among some of these companies, and not a lot of cushion to deal with problems in those instances. We seek to underwrite our investments to protect for that downside risk."

Matt Douglass, chief executive officer of PGIM Private Capital, is confident about the manager's prospects, given its focus on the terms and structures of its loan agreements. "The way to outperform as a credit manager is by avoiding losses," he says. Moreover, given that PGIM is often the only lender to its mid-market borrowers, "if trouble comes, we have to be able to work constructively through challenges with borrowers, and we have the experience to do so".

If a distress cycle is indeed coming, it will arrive amid a major push by private credit into the retail market, including the launch earlier this year of a private credit ETF by Apollo and State Street. That instrument gives investors access to daily liquidity in a vehicle that contains an inherently illiquid investment.

In times of stress, individual investors are often the first to run for the exits. Soon after the initial tariffs were announced, outflows of loan ETFs hit a daily record of $1.3 billion, while the Janus Henderson Triple A CLO ETF saw nearly $600 million of withdrawals

in one day, pushing its share price 1.1 percent below the value of the CLOs in its portfolio.

Nor are institutional investors immune. "When we have an inflection point or a downturn, some of these institutions are going to be shocked that they don't have the liquidity they expected," Polen's Breazzano says. "There will be a rude awakening there." In such instances, "many institutional investors are tempted to do things that a rational person wouldn't do".

In recent months, several big institutional investors, including Yale University, Kaiser Permanente and Norinchukin Bank, have sold or are seeking to sell multibillion-dollar private asset portfolios, some including private credit, although not necessarily because of market volatility or tariffs.

Some market participants are betting that a dislocation will cause widespread pain, with short sellers at one point targeting big publicly traded asset managers.

> *"We're at the early innings of a credit distress cycle"*
>
> **CHARLES PEABODY**
> **Portales Partners**

Consumers on the run

Although the tariff agreement between the US and China steadied markets and eased some uncertainty, and economists tempered their recession forecasts, consumer confidence plunged to a four-year low in March and credit card delinquency rates have risen above pre-pandemic levels. Automotive repossessions reportedly surged last year to the highest level since 2009, a 16 percent jump from 2023.

First-quarter earnings exhibited signs of stress, with some business development companies reporting restructurings and asset markdowns. Sumitomo Mitsui Banking Corp reportedly sold at least $3 billion of credit lines it had provided to BDCs to Apollo, Carlyle and Ares in the form of significant risk transfers (SRT), the first known instance of such securities being sold to transfer the risk of banks' lending to BDCs.

Distressed or opportunistic managers such as Oaktree Capital Management, which earlier this year closed the largest distressed fund ever at $16 billion, are likely licking their chops, with one manager quipping that for managers like Oaktree, "it's going to be a Christmas bonanza".

According to Moody's "the probability of default of US corporates hit a post-financial crisis high of 9.2 percent" – double that of 2021 – at the end of last year, and "there are no signs of a clear peak approaching". Distressed debt funds pose the greatest concern, with distressed companies rated B3 negative or lower constituting 16 percent of Moody's total rated debt. PE firms own approximately 75 percent of those companies by issuer count.

Senior loans aren't immune, with their distress rates approximately tripling over the past few years, according to MSCI's Warren. He also found that nearly 40 percent of assets in mezzanine and generalist private credit funds are equity instruments. "The surprising thing is if you think you're investing in a private credit fund… actually a lot of what you're investing in is equity," he says. That is problematic because if a borrower defaults or goes bankrupt, equity holders get paid last or not at all.

Lyle Margolis, head of private credit at Fitch, says defaults reached an

Shades of crises past?

Although this black swan event may feel unprecedented, industry figures think there are parallels with other times of extreme stress

Private credit came into its own in the aftermath of the global financial crisis of 2008, and the illiquid nature of the asset class and its premium returns have since largely shielded it from market volatility and stress. But April's equity market rout put into stark relief how a shock such as 'Liberation Day' could spark mayhem in the private credit universe, especially the more visible, public parts.

Ted Koenig, chairman and CEO of Monroe Capital, was worried that Liberation Day "could be a seminal moment like 2008, and the start of something we're going to be reading about for years to come". It seems the initial shock of the tariffs has abated and we are getting back to some state of normalcy, but Koenig still thinks there should be a heightened state of awareness and

inflection point in 2024, when bankruptcies increased by a factor of five, from the single default recorded the previous year. "We are seeing a change in the way sponsors react to these things," he says. "Because the cost of capital is so high, it doesn't make sense to continue to throw good money after bad with some of these companies." And when sponsors cede control, recoveries continue to be weak and often total just 25 percent of the principal or less, Fitch says.

According to Portales' Peabody, private organisations have some of the riskiest junk bond/leveraged loan exposures. He cited the Shared National Credit exam for 2024, which found that non-banks still hold a disproportionate share of loan commitments rated special mention and classified – an eye-popping 26.8 percent, compared with only 4.7 percent and 4.6 percent for US banks and foreign banking organisations, respectively. These classifications signal potential weakness in loan quality.

He points to the lack of M&A and IPOs that are preventing managers from monetising their investments. At the same time, many stocks and select industries are repricing at much lower levels, sometimes as much as 30-40 percent. The upshot, says Peabody, is this: "Any inability to monetise/liquify these holdings will be the undoing of private equity and private credit." ■

preparedness for portfolio management. Private credit platforms that have deep asset management expertise will have an advantage and should drive excess alpha.

Charles Peabody, founding partner at independent research firm Portales Partners, is drawing parallels between private credit and the trust companies of the early 20th century, whose undoing led to the 'Panic of 1907' – the first worldwide financial crisis.

Peabody likens the shadow banking system populated by private credit managers, hedge funds and others to those trust companies, which were largely unregulated institutions that competed with banks, but unlike them lacked membership in the New York Clearinghouse – the predecessor to the New York Fed – and were thus unable to access liquidity from the lender of last resort in a crisis.

In a note subtitled, 'Why Private Capital is the Likely Source of the Next Credit Cycle Problem', Peabody points to the rapid, largely unconstrained growth of private capital since 2010. "The structure of the PC world is diffuse, its managers are both smart and powerful, and the discovery process is slow." He worries that "the spillover into the real economy will likely occur when some of these companies attempt to refinance 2021-era loans at 2025-2026 interest rates, or in a hostile equity environment".

EXPERT Q&A

The role of local scale, vertical integration and platform control in sourcing and managing mid-market opportunities, by Enrico Sanna, CEO of Platforms at Arrow Global

How to build a vertically integrated pan-European investment model

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Q The European market is often described as highly fragmented. Just how fragmented is it, and what does that mean for private credit strategies?

It is certainly true that the European market is highly fragmented – structurally, legally and operationally. Despite more than 50 years of the EU and multiple efforts to create a unified financial market, it remains highly diverse.

Across the continent, 82-85 percent of lending occurs within national borders, with minimal cross-border activity, according to the European Central Bank. Additionally, there are 44 countries, more than 7,000 banks and a wide array of regulatory regimes and local supervisory bodies. It is certainly not a single, unified market in the way the US is.

This fragmentation presents challenges and significant opportunities for private credit. We see a particular opportunity in the mid-market. As European banks and governments prioritise the development of both European and nationally local champions, their focus tends to shift toward servicing large corporate clients, leaving mid-market companies underserved.

There is an estimated €14 trillion in local, asset-backed mid-market lending opportunities across Europe. This represents a vast investable asset class, what we refer to as the 'last mile' of lending. These mid-sized, often non-core or distressed assets, typically too small for institutional capital, are exactly where we see the greatest asymmetry between risk and return.

We also see the ability to lend across geographies. As a pan-European manager, we can cross-collateralise a client's assets, enabling us to pursue cross-border transactions. As banks continue to retrench from many of these markets, private credit is well positioned to step in. While fragmentation is seen as a bad thing for many lenders, we see it as a real opportunity.

Q What are the advantages and challenges associated with building a vertically integrated investment platform across Europe?

If you accept the view that Europe's fragmented market presents an opportunity, particularly in the mid-market, then it follows that you need to be deeply embedded in that segment and close to individual assets.

Securing off-market, bilateral opportunities requires 'boots on the ground'. You're not going to find a €30 million distressed opportunity in the middle of France if you're based in London or New York. Yes, you might see the €100 million-€200 million deals from a distance, but in the mid-market, everything is local. That's why vertical integration is essential. It means having a deep local presence, coupled with operational control to manage assets and credit effectively.

Another key element of our model is institutional-grade execution. As a fund manager, we are responsible for delivering returns to our institutional investors, which means we must operate with the same level of execution quality as a much larger global player. Our investors benefit from the combination of local reach and institutional-level underwriting and investment process.

You also need a clear understanding of where investment opportunities exist across your geographies. That requires rigorous collaboration between platforms and funds. We follow a highly specific, country-by-country approach to evaluating investment opportunities.

The next challenge is how to build the full suite of capabilities including origination, execution, asset management and servicing across multiple markets. That can be done either organically or inorganically. Much of our business has been built inorganically, simply because it allows us to scale more quickly. Moreover, because we hold our platforms on balance sheet, this structure gives us the flexibility to adapt our capital strategy. We retain platforms when they are strategically aligned and divest them selectively when they no longer fit our focus.

Q How important is local presence when it comes to competing in fragmented markets?

If you're making an investment in a municipality in southern Spain, and you don't understand the regulatory landscape, pricing dynamics, or the local competitive environment, there's a high probability you'll get it wrong.

Having a local presence is critical to navigating these nuances. Across our platform, for example, Zenith Global is a leading master servicer in Italy, giving us visibility into nearly everything happening in the non-performing loan market there. Sagitta manages our funds in Italy, while Europa Investimenti handles underwriting, together forming a deep local footprint.

That embedded presence allows us to access genuine opportunities across the Italian mid-market. Without it, we'd most likely be limited to Milan, which is the easiest market to access and understand. Instead, we're actively investing in Turin, Florence, Pisa, Rome, and beyond.

In all, we operate through 24 platforms and have 4,000 employees across eight Western European geographies. Approximately 85 percent of the deals we execute are bilateral and off-market, deals we can uncover precisely because of our strong local presence. Many of our platforms began as joint ventures or long-term partnerships, which helped us ensure operational and cultural alignment well before full integration, something that is important in relationship-driven markets.

Q You've talked about seeking to control the entire investment lifecycle in-house. Why is that operational control so critical, and how does it work in practice?

At its core, the role of a fund manager is to identify a position, underwrite it, and ultimately recover it for a return. We believe the most effective way to do that is by maintaining operational control across the entire value chain.

In every country where we operate, we have dedicated teams that source deals, originate, underwrite, asset manage, and service the loans. We also have specialists who understand the recovery process when a deal goes off track. We literally control the value chain from origination through to exit.

This model is strengthened by our ability to underwrite positions at an

institutional level, drawing on data from our €110 billion portfolio of assets under management. This allows us to monitor default rates, recovery performance and credit risk with exceptional accuracy.

That insight helps us not only choose the right investments but also manage them smartly through to exit. We're able to identify the right time to sell a position well before it becomes obvious to others who may be operating from a distance.

We also approach operational control with a cross-border mindset. We have in-country expertise tailored to different asset classes and investment types, and we actively share that knowledge across geographies. For example, our Italian bankruptcy experts may not be familiar with every local regulation, that's where local teams step in, but they can still share their experience across markets.

Q Where do you see attractive opportunities to invest, in terms of both geographies and sectors?

We invest thematically across Europe, and one area where we have strong conviction is Southern European hospitality. It's a strategic theme that we have been very active in.

For example, we own a hotel operator in Portugal. If we identify a new hotel investment opportunity in Sicily, or Majorca, that same Portuguese team becomes directly involved. They manage the development process and collaborate with the local operator to ensure the asset performs to the standards outlined in our business plan.

We apply this same model to other sectors, including multifamily residential real estate and student accommodation, where we see strong demand. We don't view these opportunities purely through a national lens, we leverage our sector specialisations across borders. While some opportunities are country-specific, wherever possible, we bring a cross-border perspective to how we underwrite and manage investments.

"As European banks and governments prioritise the development of both European and local champions, their focus tends to shift toward servicing large corporate clients"

Q What about underwriting risk across such a complex and varied market landscape – how does that work?

It's a balance between local insight and centralised, institutional discipline. When we underwrite, we heavily rely on local knowledge and proprietary data, we have a deep understanding of what's happening on the ground. But we also integrate this with the perspective of our central teams, who have experience with deals across European markets and bring a broader institutional risk lens.

Our servicing platforms play a crucial role in this process. They enable us to monitor default behaviours, refine risk models, and assess recovery rates across multiple geographies at a granular level. That detailed, data-driven view allows us to make more informed and confident decisions when it comes to underwriting risk.

Q How do you ensure your servicing operations and asset management strategies are aligned?

That alignment is a fundamental part of our approach. Around 90 percent of our fund investments are serviced on our platform, giving us a high level of control and ensuring strong alignment between our fund strategy and asset management execution.

While servicing involves significant complexity and a large operational footprint, it also provides a valuable source of opportunity. We see a vast array of assets, allowing us to cherry-pick those that align with our fund strategy. And because we manage those assets directly, we have complete visibility into every aspect of the credit positions, offering us a unique and informed perspective.

It's true that servicing adds complexity, but the returns and opportunities it provides more than justify that complexity. Many of our competitors avoid this complexity and, as a result, miss the €14 trillion opportunity we see in the mid-market. While they're chasing a handful of large deals, we're consistently generating dozens of solid mid-market transactions every quarter.

From a risk management standpoint, we prefer a diversified portfolio of hundreds of mid-market positions over a handful of large ones, where a single underperformance could adversely affect returns. Diversification builds resilience and reduces vulnerability to macroeconomic disruption.

Additionally, our servicing platform covers 35 million individual credits and assets across the European banking system. That scale gives us real-time performance insights and enables us to engage banks in discussions about acquiring positions they're winding down. Our granular approach and established relationships make it easy for banks to transfer positions to us, giving our servicing capabilities a real edge in the market. ■

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How AI gives underwriting a boost

The latest technology is allowing managers to streamline their operations when planning and executing transactions, finds Sergio Padilla

Private credit underwriting is becoming more streamlined at some of the largest firms as managers adopt artificial intelligence to simplify workflows throughout the deal process and beyond.

Origination, due diligence, negotiation, deal closing and portfolio monitoring are exhaustive processes, but absolutely necessary to ensure adequate returns on invested capital, especially when LPs are hungry for distributions from their private markets portfolios.

Several platforms have launched to address the issue of time-related bottlenecks in dealmaking, such as Vienna-based Valutico – with its Done Diligence, an AI-powered platform designed to streamline due diligence – and Intapp, through its partnership with Alphastream.ai.

Alphastream, a due diligence, portfolio monitoring and data synthesis platform, was founded in 2019 with anchor clients including HSBC Bank and CreditSights (now owned by Fitch Group). Alphastream helped to build a covenant review process for CreditSights and worked with HSBC's credit research team to create a financial data extraction system. By 2021, its products matured, helping gain more clients and grow teams in engineering, data science and product in the US and India.

According to chief executive Vijay Gudipalli, Alphastream boasts a team of nearly 200 across the US and India, as well as relationships with three of the top five largest private credit firms. "When it comes to product, we build a system that can read unstructured data – reading the information from hundreds of pages – and create a crisp summary," says Gudipalli.

Gudipalli says Alphastream's models and AI engines are built using historical private credit data from both public and private sources. Alphastream's software works alongside lenders through the complete credit life cycle, "from deal sourcing and origination to the due diligence process and negotiation and the deal closing process. And then post-closing and deal monitoring".

Gudipalli says Alphastream helps solve two problems: creating structured data sets around legal data and financial status. He says it can process large amounts of legal data in several minutes, turn unstructured data into two-page summaries and allows lawyers or legal experts to provide opinions on top of the data.

Financial data, he says, utilises every document, from marketing decks to product decks, investment bank reports, valuation reports, financial reports and anything else from a company's data room, and can help create a standardised credit model. Users are able to see

PGIM's early-stage AI adoption

It's not about replacing humans, but the firm is finding AI can have plenty of benefits

According to Gabe Rivera, PGIM Fixed Income's co-head of securitised products, his team is leveraging AI frequently. An example in everyday work is examining residential home loans, particularly when viewing images of the homes themselves.

"It turns out there's a tonne of statistics on every home, but nothing is good as actually looking at the property and [asking] if this is a nice home or not, that you'd want to buy – and we're thinking internally that we can feed this into AI and have this score the property," he says.

Rivera adds there are numerous other potential capabilities for AI adoption, especially in underwriting.

Phil Waldeck, PGIM's CEO of multi-asset solutions, says the firm is in the early days of adopting AI, using it more tactically across certain units of the business. Underwriting of corporate credits and getting in front of companies PGIM wants to target for investment are areas that could be made more efficient through the application of AI and could potentially be used to cut down on costs, according to Matt Douglass, CEO and senior managing director for PGIM Private Capital. "It's an expensive delivery system, finding investment opportunities, and you could make that more efficient for those 8,000 calls made if you could get the same amount of money deployed on 6,000 calls," he says.

For PGIM, adoption of AI is meant to augment the work deal teams do rather than replace roles or tasks.

"You'll never replace it and you wouldn't want to, that human decision-making process of 'is this a good investment decision or not', and I don't think AI will ever have that intuition, but there is a lot of work that can be put together that I think could be where AI could significantly allow us to scale and improve underwriting processes," says Rivera.

exactly where the programme sourced a piece of information.

One issue that users of AI-powered tools like ChatGPT or various large language model competitors have is the ability for the software to "hallucinate" or create phoney information from non-existent sources. Gudipalli says Alphastream's software uses natural language processing, machine learning and large language processing models as part of its data pipeline, but this is built on top of exhaustive taxonomies that address legal and financial data-related standardisation issues.

"Whatever the output system is going to generate, it is controlled by our taxonomy," he says. "We are not 100 percent relying on large language models… we are utilising large language models in only a few places where we are very confident about what kind of output we are generating."

How Carlyle does it

One example of a leading manager launching AI initiatives is Carlyle. In 2023, the firm launched a programme to put AI tools on every desktop, meaning applications like ChatGPT and other non-proprietary AI software. In 2024, it began to lean into developing custom applications with an in-house team of full-stack developers for tasks that required the assistance of tools not available in the market, according to Lucia Soares, Carlyle's chief information officer and head of technology transformation.

Soares was one of chief executive officer Harvey Schwartz's first promotions upon heading the firm, formerly a managing director and head chief information officer of global portfolio solutions. She has been tasked with spearheading the initiative of increasing productivity through technology.

She says roughly 90 percent of Carlyle's employees are using tools like ChatGPT and enterprise co-pilots to streamline their daily tasks. In private credit, the way Carlyle utilises AI is through synthesising large volumes of unstructured data, using information from earnings calls, financial statements and data rooms among other sources.

"For example, in due diligence, we'll use AI tools to summarise information on targets and use that in templates that we have for our analysts to be able to quickly create differentiated points of views on our investments – we do that to extract insights and then we look at our own internal research," she says.

Carlyle has created digital chat tools on top of where it stores internal research, so that analysts have full access to internal insights as well as publicly available information to get differentiated insights. Soares adds that Carlyle also uses AI in navigating deal rooms, downloading data from data rooms and drafting internal materials quickly. It uses AI in a variety of forms post-investment for portfolio optimisation, accelerating trade execution, improving reinvestment rates and ESG analysis through proprietary tools that draft assessments using company documentation and regulatory standards.

"It's like creating more of an egalitarian, supreme-talent workforce because now AI helps to gather information more quickly and it allows all of our employees to be able to spot those patterns and pressure-test assumptions in a supercharged manner," says Soares. ■

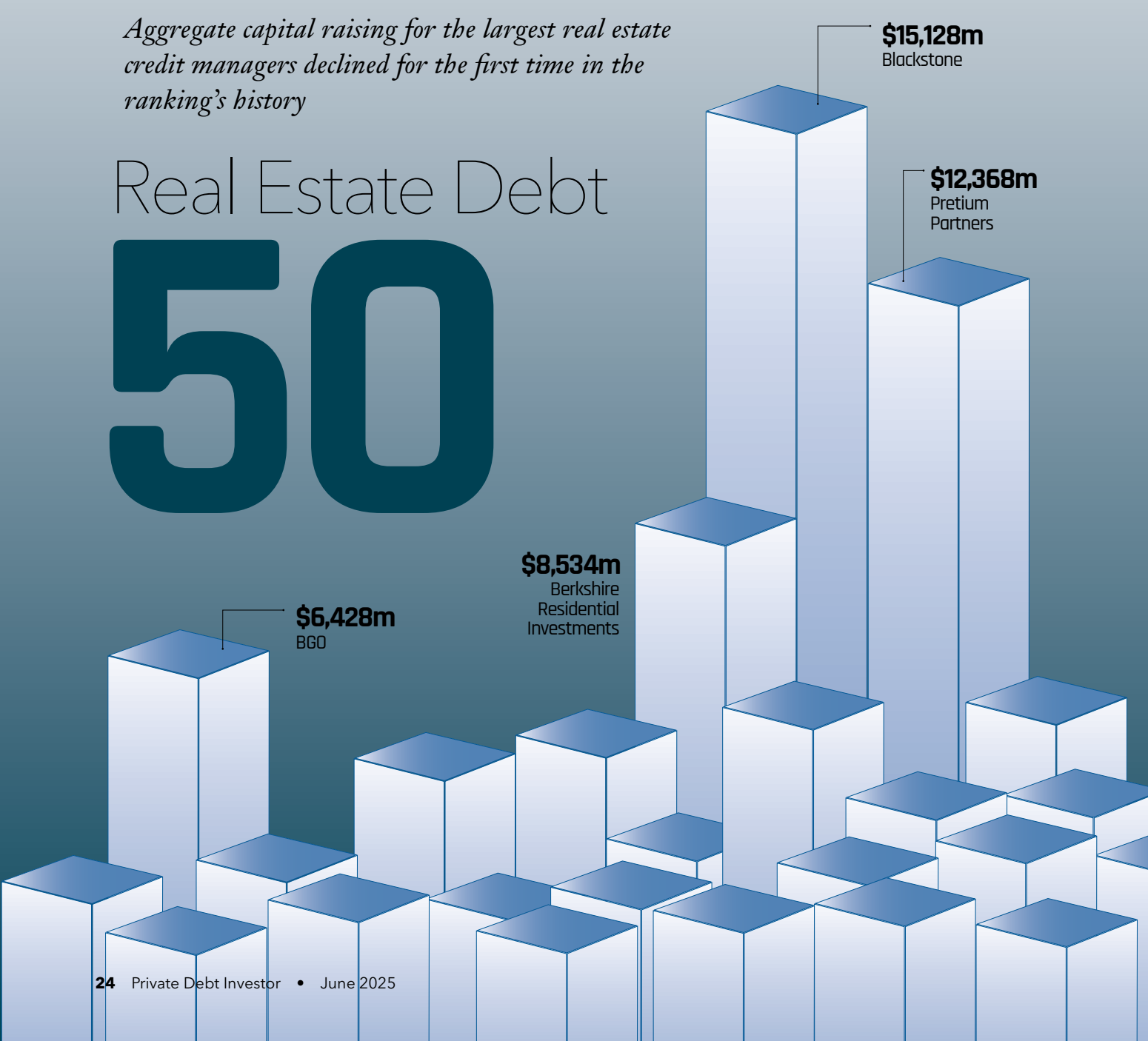
Private debt continued its emergence as a major focus of real estate fundraising last year, accounting for 24.3 percent of all capital raised for private real estate vehicles that closed in 2024 – the greatest share of annual fundraising in at least seven years.

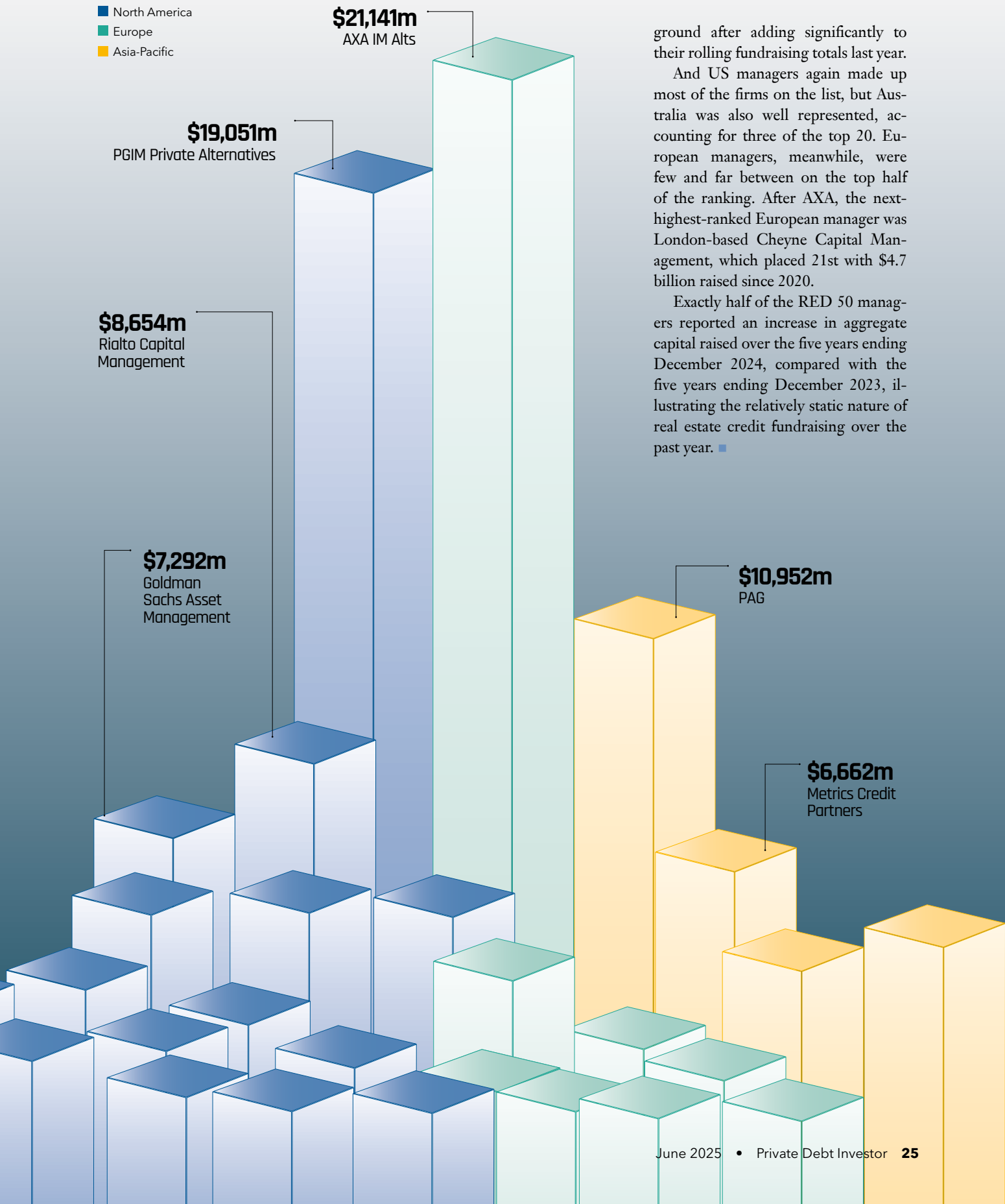
But amid an overall downturn in private real estate capital allocations generally, the rolling fundraising total for real estate's largest credit managers, as measured by affiliate title *PERE*'s Real Estate Debt 50, fell slightly compared with last year's amount for the first time since *PERE* began compiling the ranking in 2019.

Some things did not change. French manager AXA IM Alts retained its perch atop the ranking for a sixth consecutive year, having raised $21 billion for real estate debt since 2020. But it was followed closely by New Jersey-based PGIM Real Estate, while third- and fourth-ranked Blackstone and Pretium Partners both gained

Aggregate capital raising for the largest real estate credit managers declined for the first time in the ranking's history

Real Estate Debt 50





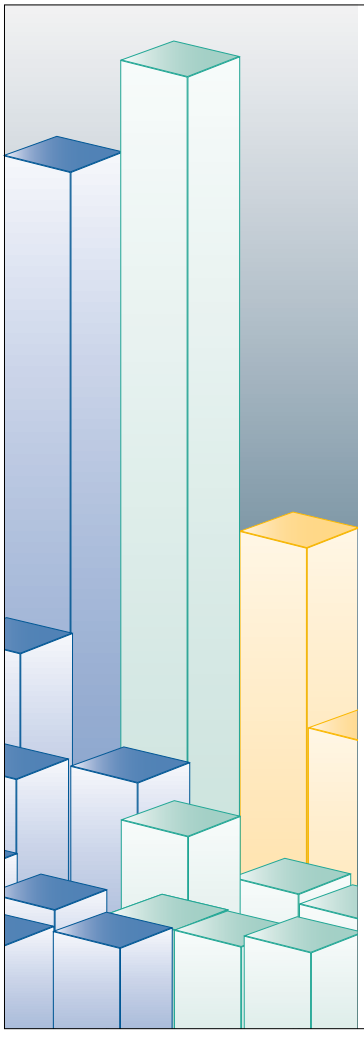
ground after adding significantly to their rolling fundraising totals last year.

And US managers again made up most of the firms on the list, but Australia was also well represented, accounting for three of the top 20. European managers, meanwhile, were few and far between on the top half of the ranking. After AXA, the next-highest-ranked European manager was London-based Cheyne Capital Management, which placed 21st with $4.7 billion raised since 2020.

Exactly half of the RED 50 managers reported an increase in aggregate capital raised over the five years ending December 2024, compared with the five years ending December 2023, illustrating the relatively static nature of real estate credit fundraising over the past year. ■

PERE 2025 Real Estate Debt 50 ranking

2025		2024	Manager	Capital raised ($m)	Headquarters
1	◁▷	1	AXA IM Alts	21,141	Paris
2	◁▷	2	PGIM Private Alternatives	19,051	Newark
3	▲	4	Blackstone	15,128	New York
4	▲	9	Pretium Partners	12,368	New York
5	▼	3	PAG	10,952	Hong Kong
6	▲	10	Rialto Capital Management	8,654	Miami
7	▲	13	Berkshire Residential Investments	8,534	Boston
8	▼	5	Goldman Sachs Asset Management	7,292	New York
9	▲	20	Metrics Credit Partners	6,662	Sydney
10	▲	19	BGO	6,428	New York



Methodology

The 2025 Real Estate Debt 50 ranking is based on the amount of capital raised for the purpose of real estate debt issuance by firms between 1 January 2020 and 31 December 2024, as well as capital raised for funds that were actively fundraising at the end of the counting period.

For the purpose of the rankings, we only count closed-end funds for which the fund manager has full discretion over the investment process, from selection over management to exit. As a consequence, we only accept blind-pool funds in which LPs cannot exercise investment decisions and have no liquidity options before the end of the (multiple years long but finite) fund life, without approval from the GP. Funds must invest solely into private real estate debt assets and GP commitments (for interest alignment only) can be included, too. Capital committed by affiliated entities as well as fund leverage is not eligible. Finally, we do not count funds of funds as well as recycled or rolled-over capital from previous fundraises.

We also count capital raised for co-investments and separately managed accounts, as long as they either fulfil the above criteria, or serve as an "extension" of the main funds' fundraise, even if the above criteria is not fully met. "Extension" is here defined as vehicles that invest alongside a selection of the portfolio assets of their respective main funds. We do not accept deal-by-deal fundraises.

For funds in market, capital raised via actual LP commitments that were made before the end of the counting period can be included, too. We cannot include commitments made after the end of the counting period, nor do we accept targets or expected commitments. For open-end funds that launched prior to the beginning of the counting period, we only count capital raised entirely within the five-year counting period.

▲Up ▼Down ◁▷No change ★ New entry

North America Europe Asia-Pacific

2025		2024	Manager	Capital raised ($m)	Headquarters
11	▼	6	PIMCO	5,934	Newport Beach
12	▼	8	AllianceBernstein	5,912	Nashville
13	▲	25	Prime Finance Advisors	5,873	San Francisco
14	★	-	Balbec Capital	5,659	Scottsdale
15	◁▷	15	Bridge Investment Group	5,613	Salt Lake City
16	▼	14	Qualitas	5,305	Melbourne
17	▲	18	Madison Realty Capital	5,144	New York
18	▼	12	Brookfield Asset Management	5,111	Toronto
19	▲	22	MaxCap Group	4,857	Melbourne
20	▲	26	BDT & MSD Partners	4,765	Chicago
21	▲	29	Cheyne Capital Management	4,685	London
22	▲	28	Oaktree Capital Management	4,537	Los Angeles
23	▲	47	KSL Capital Partners	4,184	Denver
24	▲	48	Silverstein Properties	4,158	New York
25	▲	39	Nuveen	3,845	New York
26	▲	38	Barings	3,468	Charlotte
27	▲	30	AgFe	3,449	London
28	▲	32	Rockwood Capital	3,435	New York
29	▼	23	Torchlight Investors	3,413	New York
30	★	-	400 Capital Management	3,219	New York
31	▼	37	BlackRock	3,167	New York
32	▲	44*	TPG	3,135	San Francisco
33	▼	31	Heitman	3,079	Chicago
34	▼	24	ICG	2,874	London
35	▲	43	AEW	2,800	Boston
36	▼	35	Harbor Group International	2,727	Norfolk
37	▼	17	M&G Investments	2,660	London
38	▼	36	PCCP	2,606	Los Angeles
39	▼	33	KKR	2,538	New York
40	★	-	Related Fund Management	2,517	New York
41	▼	21	Ares Management	2,464	Los Angeles
42	▼	11	Kayne Anderson Capital Advisors	2,372	Los Angeles
43	★	-	Angel Oak Commercial Lending	2,326	Atlanta
44	▲	49	TCI Fund Management	2,300	London
45	★	-	Starwood Capital Group	2,289	Miami Beach
46	◁▷	46	Caerus Debt Investments	2,181	Dusseldorf
47	★	-	CBRE Investment Management	2,137	New York
48	▼	41	DRC Savills Investment Management	2,118	London
49	★	-	Walton Street Capital	2,022	Chicago
50	▼	16	ACORE Capital	2,010	Larkspur

Source: PERE

*As Angelo Gordon

The modelling challenge facing CMBS

The commercial mortgage-backed securities market is seeking ways to adapt the use of AI to its requirements. By Christopher Faille

A fund manager active in the market for commercial mortgage-backed securities, and intent on bringing to bear cutting-edge technology, should bear in mind the folk story of Goldilocks and the Three Bears, and the title character's insistence on eating porridge that is 'just right', neither too hot nor too cold.

At the moment, CMBS issuance looks pretty hot. In 2024, it was $115 billion, according to KBRA, representing a 150 percent increase from 2023. The momentum continued through the first quarter of 2025, which saw a 110 percent year-on-year increase.

In contrast with other boom periods for these instruments, investor demand for securitised loans now turns chiefly on single-asset, single-borrower deals, which made up 45 percent of CMBS volume in 2024.

> *"A new wave of tech is coming to the commercial real estate debt space: it will be impactful in origination, revenue and value creation"*
>
> **MATT WEINSTEIN**
> **Axonic Capital**

There is no real mystery as to why. Investors want high-quality assets with cashflow. Multifamily, industrial and Class A office properties meet those demands. Furthermore, activity is being generated as property owners move towards five-year loans rather than the traditional 10-year periods. Industry website CRE Daily notes that nearly 70 percent of conduit deals in 2024 were for five-year periods.

'Fundamental to resilience'

Consider, too, that this boom is underway during the enthusiastic adoption of AI by financial institutions. In the words of Ziad Chalhoub, chief financial officer of Dubai-based holding company Majid Al Futtaim, AI and automation "are no longer just efficiency tools – they are

fundamental to financial resilience, operational agility and customer-centric innovation". They harness data, automate decision-making and (perhaps paradoxically) personalise experiences, making them "a key differentiator in today's landscape".

Accordingly, this is a good time to look at the intersection of these two phenomena. What, if anything, is AI doing to or for the CMBS market?

Irene Aldridge, chief executive officer of data firm AbleMarkets, says: "The world of mortgages and mortgage derivatives has long been notoriously very opaque, full of Byzantine processes and a lot of human labour." AI, including large language models, excels at bringing transparency and efficiency into areas like that.

Aldridge, a visiting professor at Cornell University who also teaches at the University of Cambridge, believes there is lots of room for AI to add value but that it comes with costs and risks.

Asked about the valuation of the underlying properties in a CMBS portfolio, Matt Weinstein, who oversees the investment team at Axonic Capital, says: "As long as you are feeding AI the right questions, it can help with valuations, but you do need human judgement grounding this assessment."

Getting inside the black box

One of the standard approaches to asking these questions has been the use of 'Monte Carlo simulations'. These are computer calculations that use randomness to solve problems that don't have deterministic solutions. How might one know whether a coin is unevenly weighted so as to bias it toward a 'heads' result when flipped?

There is at least one simple answer: flip it a lot of times and see if that bias manifests itself. Monte Carlo simulations do that virtually. They simulate thousands or even millions of possible future scenarios based on historical data and probabilistic assumptions and add up the results.

Such simulations gained traction in financial modelling late in the 20th century. In 2003, Paul Glasserman of Columbia Business School gave the subject textbook treatment: *Monte Carlo Methods in Financial Engineering*.

The use of randomness à la Monte Carlo has been integral to the subsequent development of AI. Indeed, this is why AI is error-prone and remains very much in need of human supervision.

Aldridge says: "For many people, AI is still a black box. But the source of the innovation, and of the resulting errors, is in principle simple: a random number generator. This is attached to a machine-learning system that reins in that randomness according to a model of what is realistic and what is not."

Since the global financial crisis, triggered in substantial measure by a failure of banks' risk management, there has been a tightening of standards and accounting in the mortgage derivatives world. Relatedly, the randomness that remains part of algorithmic models is reined in by datasets designed for a specific task – aptly called "fine-tuned parameters".

Too much, too little and a bottom line

There are at least two ways AI can go wrong: too much randomness or too little. Here we return to Goldilocks and porridge. Too much randomness, and a fantasy element creeps into the calculations. The inventiveness of AI becomes 'too hot'. Too little randomness (too much tuning of the parameters) and one encounters the problem of overfitting. Too slavish an obedience to historic trends leaves the algorithm blind to the possibility of the unexpected – too cold.

The search for the perfect porridge will continue. Modelling will refine itself and its parameters. The impact of all this on the CMBS market is only beginning to make itself felt.

To give Weinstein, of Axonic, the last word: "A new wave of tech is coming to the commercial real estate debt space: it will be impactful in origination, revenue and value creation." ■

The rise of data centres as collateral

As AI demands more infrastructure, a consequence is the growth of bonds issued against it

Aside from the question of what artificial intelligence can do to assist fund managers, there is the question of what AI contributes to the underlying asset base for the asset-backed securities world.

Given existing limits, AI advances require more data centres. That requirement has led to more construction, and to a boom in the issuance of bonds backed by those centres.

T Rowe Price posted a piece on this subject on its website in September 2024. It maintained that "most data centre tenants are highly creditworthy or rely on the data center for essential tasks", and that this makes ABS and CMBS deals on that underlying collateral very resilient. In February 2025, CBRE noted a surge in North American data centre leasing activity with a record-low vacancy rate.

Viral Patel, managing director of advisory firm Prime Lead Partners, discussed ongoing activity in this area recently. "There has been a miniboom already," he said. "The question is whether this is a 'build it and they will come' situation or will something like advanced AI with less computing needs and a shortage of natural resources to power and sustain these assets impact investor appetite in the long run."

EXPERT COMMENTARY

The Chinese debt market may have been around for two decades, but there are still many misconceptions around private credit in the world's second-largest economy, says Benjamin Fanger of ShoreVest Partners

The case for China

The US has long been seen as the primary safe harbour for private credit. But with an overabundance of dry powder in the market, on top of a rapidly changing regulatory and economic environment, global allocators have begun looking elsewhere to see where they can find uncorrelated returns in private credit. Could China be one of the options?

Chinese private credit is a strategy that has been in place for more than two decades, but is very often unfamiliar to global allocators. It's a large uncorrelated market that warrants consideration.

Q What strategies have been used to get credit exposure in China?

International investors have sought credit exposure in China through a variety of approaches, some unsuccessful. One approach has been offshore unsecured debt in Hong Kong (such as high-yield bonds), but this typically suffers from no directly enforceable collateral (as was the case with China Evergrande Group, the property giant that defaulted in 2021).

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Another approach has been lending to property developers onshore on the China mainland, but this has suffered from collateral with questionable marketability (eg, land or incomplete buildings). Because of these higher risks, our experience suggests these two strategies should be avoided.

Onshore first-lien asset-backed private credit to corporations in a variety of industries – other than property development – has had much better outcomes, and is where ShoreVest has focused for more than 20 years. Within this approach, we pursue three sub-strategies: performing asset-based corporate lending, asset restructuring (good asset/bad balance sheet clean-up), and purchasing loans at deep discounts from banks (non-performing loans). In all three cases, the common theme is first-liens on enforceable collateral, where the loan amount leaves a significant margin of safety. For example, ShoreVest's typical loan-to-value is 30-60 percent.

Q Does China private credit provide a return premium or more security?

If done with an experienced manager, returns on Chinese private credit are typically meaningfully higher than more mature markets. But more importantly, lenders are able to negotiate significant downside protection. Because they lack options, Chinese corporate borrowers in need of credit not only pay a premium to returns found in mature markets, but also grant more first-lien collateral coverage, together with personal guarantees and other protections.

Another salient characteristic of ShoreVest's experience has been the exceptionally high distributions to paid-in capital. Contrary to some foreign perceptions, Chinese private credit can be faster at returning capital. For instance, across the last 20 deals we invested in, the weighted average life of the transactions was about 18 months to exit.

Q What are the market conditions, and who are the players?

In China, a company has limited options for obtaining credit, the primary source being commercial bank loans, which are extremely rigid in their underwriting. Historically, China's shadow banking sector was a significant source of non-bank lending, but Beijing essentially shut down the shadow bankers around 2018 because most of the capital came from retail investors. So today, because of the government's efforts to de-risk and de-lever, there is a multi-trillion-dollar vacuum of private credit in China.

As the manufacturing hub of the world, China presents a vast array of private credit opportunities in traditional industrial spaces. But beyond that, China's growing leadership in green technologies, high-value manufacturing and AI, in its bid to re-orient its economy away from domestic property development, also presents a constant flow of asset-based lending opportunities in such sectors.

Even though there is strong demand for private credit, there are very few lenders in the space. Global players have yet to successfully establish any meaningful presence (much less experience) in mainland China. At the same time, domestic Chinese providers of private credit are still immature, and few raise institutional long-term capital.

Q But does China's legal system work for enforcing credit?

Yes. For over 20 years now, we have been enforcing credit investments and recovering cash in China. In the early days, it could take quite a long time – often four to five years – to enforce credit. Today enforcement usually takes 18 to 24 months. The improvements have been actively driven by the government; for example, in 2017, China's government began requiring courts to finish most credit enforcement cases within 18 months.

Not all cases proceed through the courts so quickly. For example, cases involving unsecured offshore credit carry significant legal uncertainty, as do situations where the enforcement of collateral would cause social unrest risk because they involve evicting people from homes or mass layoffs. An experienced local manager will avoid such kinds of credit.

ShoreVest has seen many situations where foreign investors parachute into China without fully understanding the legal system, resulting in unfavourable outcomes that are more a result of the investor's lack of experience than the shortcomings of the court system. Assuming such situations are avoided, China's legal system for enforcing credit can be quite predictable.

Importantly, because Chinese corporate borrowers are aware of the protections afforded by China's legal system, repayment under the terms of a loan are the norm, whereas a need for enforcement is more rare.

Q Even if you can enforce, with China's real estate malaise, will anyone buy the collateral?

Beijing has pulled the rug from under developers imprudently building homes nobody would ever buy, and as a result the residential real estate market has suffered. But in the second-largest economy in the world, certain types of commercial real estate in certain locations are in high demand (as seen from the fact that Shanghai saw a higher volume of commercial real estate transactions last year than any US city apart from New York).

Of course, investors that acquired any type of property at the market's pre-pandemic peak will have a tough time liquidating their positions at a profit. But our experience is that properly priced assets, of the right type and location, can be sold quite quickly.

Q But can you get money out of China?

ShoreVest has never had an issue getting exits turned back into USD and distributed to investors overseas. This is because we obtain proper government approval on every deal and have experience with repatriation of capital.

Conclusion

China is the second-largest credit market in the world and could, in coming decades, become the largest economy. With private credit becoming a flooded space in more mature markets, and China's market in need of experienced credit solutions providers, now is an ideal time to begin to explore this uncorrelated opportunity that, at least for experienced investors with strong local experience, has generated consistent returns and cashflow for more than 20 years. ■

Benjamin Fanger is managing partner and founder of ShoreVest Partners, a private credit firm focused on China

Direct lending at a crossroads

Guest comment by **Matthias Kirchgaessner**

Hidden fragilities may emerge amid persistent macroeconomic headwinds, suggests the managing partner at PLEXUS Research

Direct lending has grown to become a trillion-dollar asset class, largely driven by institutional investors that view it as a stable and accessible entry point into private debt. Beneath that veneer of stability, however, lie structural and behavioural dynamics that could trigger significant stress, especially if expected tailwinds such as a robust M&A cycle and lower financing costs in the US in 2025 fail to materialise.

A combination of increased payment-in-kind usage, liability management exercises, opaque valuation practices and high leverage levels in a high-rate environment could set the stage for a delayed but, for many direct lending investors, unexpected higher default rate, consequently delivering lower returns and potential losses.

Debt repayments postponed, not resolved

According to iCapital's February 2025 report *Painting a PIKture*, PIK toggles, where borrowers can elect to defer cash interest and capitalise it onto the loan principal, are on the rise. This helps companies facing liquidity stress avoid default in the short term but often results in higher total leverage. According to Morgan Stanley's Q1 2025 analysis, PIK income as a share of business development company interest income climbed from 6.3 percent to 7.4 percent year-on-year, with more than 20 percent of BDCs reporting more than 10 percent PIK income.

While not all PIK income should be directly viewed as toxic, the increase should at least be questioned, especially since PIK utilisation is typically executed by borrowers under liquidity stress. As Danny Moses (a credit veteran on Wall Street who shorted the US housing market in 2008) bluntly noted in a recent interview: "If your cashflow can't support your interest burden, and you PIK it, you're just kicking the can down the road and hoping for a better tomorrow that might not come."

This is also closely linked to the rise in LMEs, which are increasingly being orchestrated quite aggressively by PE sponsors not only in the broadly syndicated loan markets but also in private markets these days as well, often at the expense of legacy lenders. Law firm Gibson Dunn's Scott Greenberg, a key player in the LME space, described the current wave as one of the most active since early covid-19.

While such exercises may buy time and appear to be one of the last straws for PE sponsors to save their equity position, they often mask deeper financial stress situations. The April 2025 research note by Adams Street Partners (*Default Camouflaging*) discusses how LMEs are used not to truly de-risk a company, but to amend covenants, extend maturities, and avoid formal defaults – essentially allowing distressed borrowers to linger in 'zombie' status.

Recent studies by investment banks confirm that more than 60 percent of LME restructurings need a second restructuring within two years, particularly as often underlying operational issues went unaddressed.

Valuation practices: underappreciated risk

One of the other most hidden risks in direct lending today is the opaque valuation methodology used by many private lenders. Unlike public credit markets, which benefit from continuous price discovery, private debt valuations are often based on infrequent marks and subjective models.

Additionally, the inherent illiquidity of these loans and lack of public comparables exacerbate valuation risks. In March, the UK Financial Conduct Authority reiterated its concerns on valuation risks in private markets, calling for "robust valuation practices" amid a lack of standardisation that provides fund managers significant discretion, potentially overstating asset quality or masking deterioration to avoid markdowns.

Investors are often reassured by net asset values that appear stable, but these figures may not reflect the underlying health of borrowers. As Adams Streets notes: "Valuations are backward-looking and tend to rely heavily on last-12-months EBITDA, which is meaningless if revenue is cratering and debt has increased through PIK or LMEs."

This problem is exacerbated by the fact that many private debt funds are closed-end structures where managers have every incentive to avoid writing down positions until absolutely necessary. Without transparent market pricing or consistent third-party valuation and independent advisory board oversight, this creates a 'mark-to-myth' environment.

"The described dynamics suggest a systemic problem: direct lending is structured in a way that delays the recognition of risk"

Direct lending managers have so far relied on an arsenal of tools – structuring flexibility, negotiated amendments and internal valuation discretion – to navigate a challenging credit landscape. These mechanisms, largely within their control, have allowed them to defer defaults and preserve marks.

The potential macro test ahead

But with many of these levers already pulled, attention must now turn to the broader macro conditions that they cannot influence. The macroeconomic backdrop, marked by potential persistent inflation, geopolitical uncertainty, and a stalled M&A cycle, presents a far less forgiving terrain.

In the US, interest rates remain elevated, with the US Federal Reserve signalling there will be no imminent cuts amid potential inflation and tariff-driven cost pressures. Without rate relief or a rebound in M&A activity, many leveraged companies may be stranded with few refinancing options. Despite a headline median leverage of 5.4x for top-tier managers, a growing tail of borrowers is in much weaker shape.

According to Morgan Stanley, 16 percent of companies tracked by Lincoln International have interest coverage below 1x, and 40 percent of mid-market firms tracked by S&P report negative free operating cashflow. A fair question, and perhaps an overdue reality check, is to ask what is truly happening under the hood of direct lending managers today.

The long-promised M&A boom has yet to materialise. Capital recycling is stalled, and cracks are surfacing, particularly in the sponsor-backed lending space. As we hear from distressed managers: "Everyone's counting on the M&A boom to bail them out." If it doesn't come, defaults may rise faster – and earlier – than expected.

Time for higher standards in direct lending

To sum it up, the described dynamics suggest a systemic problem: direct lending is structured in a way that delays the recognition of risk. The current environment in direct lending reflects a precarious mix of financial engineering, valuation opacity, and over-optimism on the lending side, mirrored by a worrying degree of complacency among investors.

"Investors are often reassured by net asset values that appear stable, but these figures may not reflect the real underlying health of borrowers"

Evaluating borrower credit quality in isolation is no longer sufficient: investors must also scrutinise the structures, incentives and valuation methodologies employed by their asset managers. The next phase of performance in private credit will hinge not on yield capture but on the ability to accurately recognise and price risks.

As the asset class matures, transparency and discipline are not just desirable, they are imperative. Without them, we risk a confidence crisis – not necessarily sparked by company defaults alone, but by the gradual and painful revelation of risks that were always present, merely hidden by the comforting illusion of stable marks. ■

Matthias Kirchgaessner is a managing partner at PLEXUS Research, where he specialises in due diligence in areas such as hedge funds and private debt

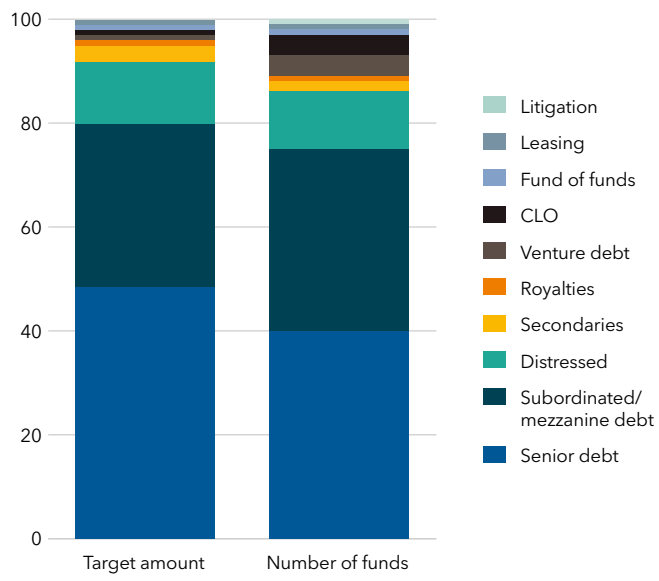
Funds in market

This month's measure of the pulling power of managers, regions and strategies in private credit

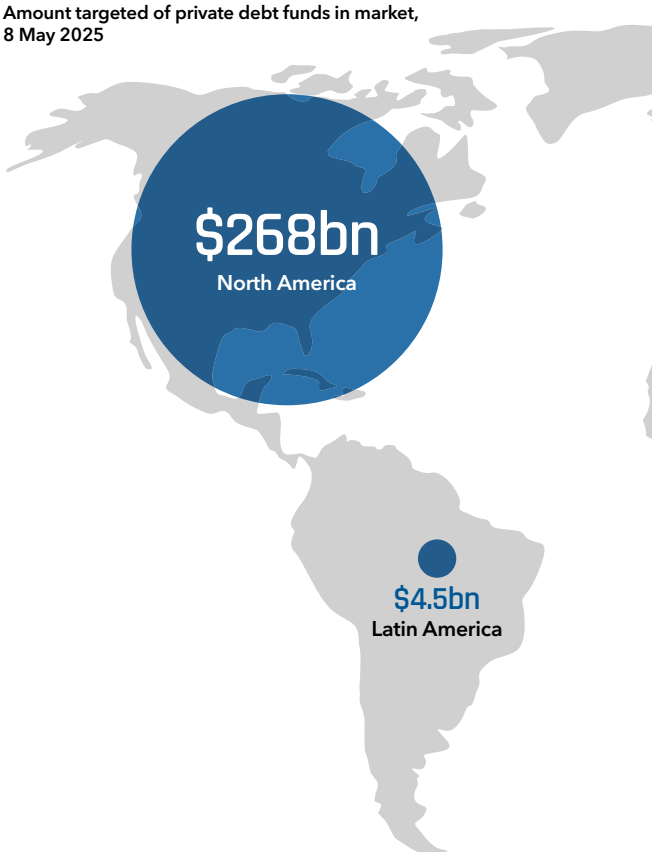
Top funds in market, 8 May 2025

Fund	Institution	Target ($bn)	Raised ($bn)	Launch year	Region	Strategy	Sector
Arcmont Direct Lending Fund V	Arcmont Asset Management	13.6	Undisclosed	2024	Europe	Senior debt	Corporate
Brookfield/Societe Generale Private Debt Fund	Brookfield Asset Management	11.3	2.8	2023	North America	Subordinated/ mezzanine debt	Diversified
ICG Europe Fund IX	Intermediate Capital Group	11.3	Undisclosed	2023	Europe	Subordinated/ mezzanine debt	Corporate
Oaktree Lending Partners	Oaktree Capital Management	10.0	0.5	2023	North America	Senior debt	Corporate
Stepstone Private Credit Fund	StepStone Group	10.0	0.1	2023	North America	Subordinated/ mezzanine debt	Corporate
Blackstone Capital Opportunities Fund V	Blackstone	10.0	3.3	2024	North America	Subordinated/ mezzanine debt	Corporate
HPS Strategic Investment Partners VI	HPS Investment Partners	10.0	0.8	2024	North America	Subordinated/ mezzanine debt	Corporate
Hayfin Direct Lending Fund V	Hayfin Capital Management	9.6	0.1	2024	Europe	Senior debt	Corporate
Fortress Credit Opportunities Fund VI	Fortress Investment Group	8.0	1.9	2023	Multiregional	Distressed	Corporate
CVC European Direct Lending IV	CVC Capital Partners	7.9	Undisclosed	2023	Europe	Senior debt	Corporate

Strategy focus of private debt funds in market, 8 May 2025 (%)

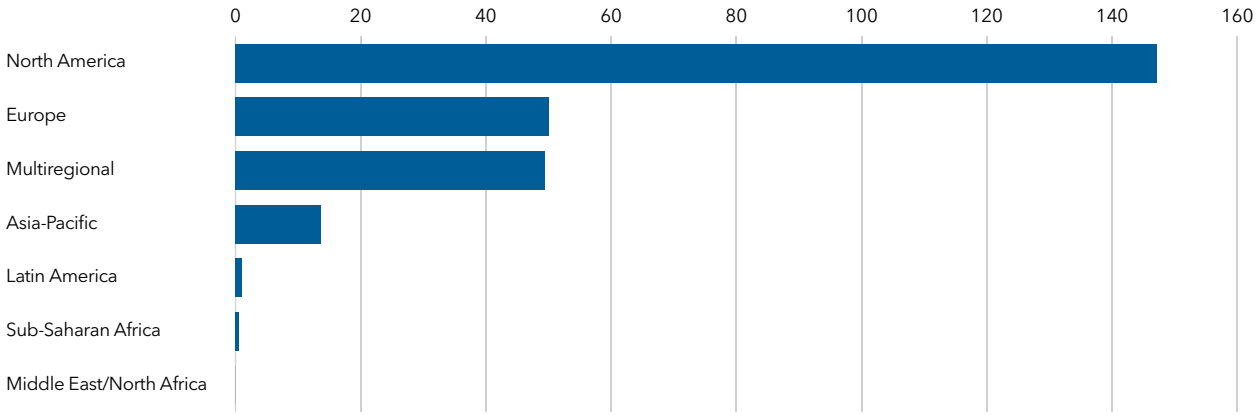


Amount targeted of private debt funds in market, 8 May 2025

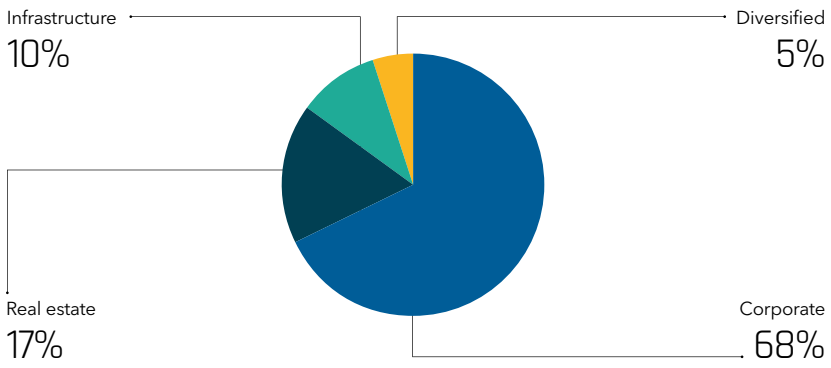


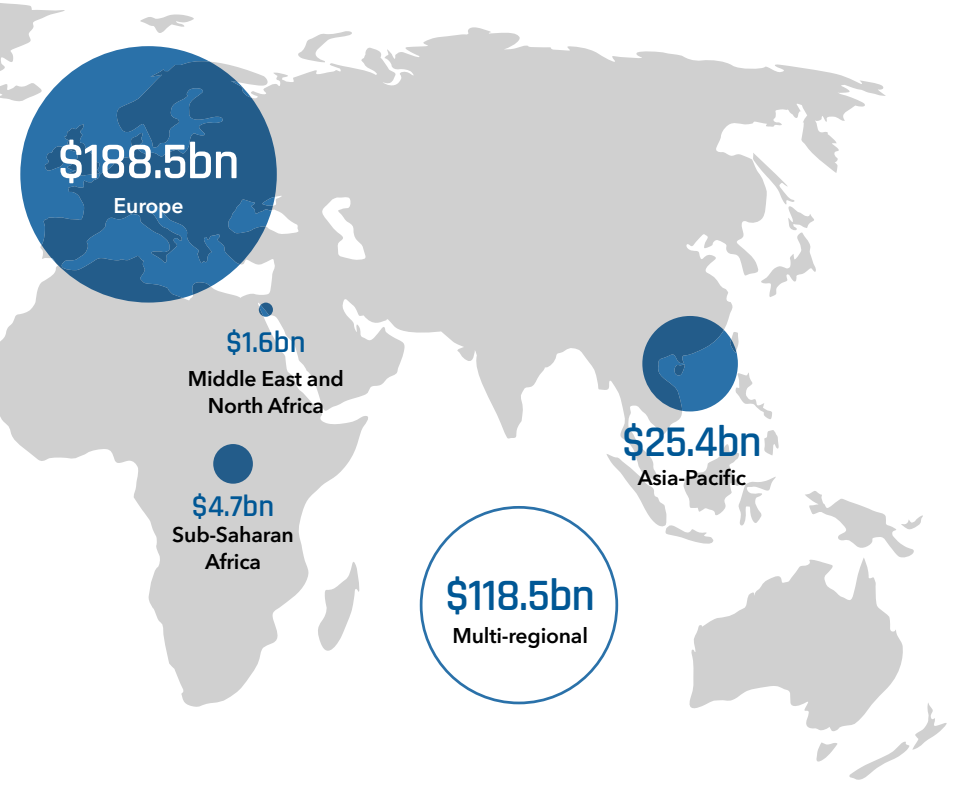
Source for all data: Private Debt Investor

Amount raised by private debt funds in market by region, 8 May 2025 ($bn)



Sector focus of private debt funds in market, 8 May 2025





$611bn
Total amount targeted by funds in market

1,492
Number of closed-end funds in market

918
Number of managers with funds in market

17%
Percentage of amount targeted by the 10 largest funds in market

172
Number of funds in market targeting $1bn or more

44%
Proportion of capital targeted by funds in market focused on North America

$262bn
Capital raised by funds in market through interim closes

The future of impact

Our next issue looks at opportunities and challenges within impact-focused credit

In March, we reported that Nuveen-owned Arcmont Asset Management had raised €475 million for its first private credit impact strategy following commitments from APG Asset Management and TIAA. This was close on the heels of news in February that Dutch sustainable specialist Colesco had raised €800 million for an impact fund with a target of up to €1.5 billion.

In Europe, it is clear, appetite for sustainability and impact – the main theme of our July/August 2025 issue – remains strong. At our PDI Europe Summit in mid-May, Menno van den Elsaker, head of alternative credit and mortgages at APG, made clear that his organisation is fully committed to impact strategies.

In the US, however, where the ESG backlash is in full swing, things are very different. While it would be wrong to assume all US states and US investors are uniform in their opposition to ESG-related strategies, the fact is that they are now a much harder sell on that side of the Atlantic.

Don't miss our July/August issue!

which will explore this Europe/US divide and reveal the implications for the future of sustainability and impact-focused credit fundraising and investing.

Private Debt Investor

PEI

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