

Private Credit Update – Beyond the Headlines

Quick Take:

- Private credit markets have matured over the past decade, with asset growth driven by the retrenchment of traditional banks and increased demand for customized financing.
- More recently investors have been spooked by media headlines we believe were in some cases misleading and did not accurately portray credit and liquidity risks.
- Direct Lending fundamentals remain broadly stable particularly for late credit cycle. Credit challenges have generally been idiosyncratic rather than systemic, reinforcing the importance of diversification and underwriting discipline.
- Direct Lending investments continue to play an important role in diversified portfolios, particularly in an environment marked by tighter financial conditions, elevated volatility, and liquidity shortages.
- We view Direct Lending as particularly well-suited for semi-liquid vehicles offering measured liquidity through contractual cash flows and relatively steady valuations.

Private credit markets have matured over the past decade, with asset growth driven by the retrenchment of traditional banks and increased demand for timely customized financing. Today, private credit assets are over \$3 trillion including direct lending to corporate borrowers, the largest and fastest growing segment. Most private credit assets are held by institutional investors, but above-average yields and appetite for income-producing strategies led to strong demand from retail and high-net worth investors over the past few years. Evergreen or semi-liquid structures that provide periodic liquidity up to a set limit and simplified tax reporting have proliferated with the most successful funds experiencing rapid asset growth.

After a period of elevated returns, some investors in Direct Lending funds have headed to the exits now that lower short-term interest rates and a recovery in bank loan activity have pushed yields lower. Investors have also been spooked by media headlines critical of the semi-liquid fund structure, exposure to vulnerable software companies and deteriorating lending standards. We believe media headlines were in some cases misleading and did not accurately portray credit and liquidity risks. We continue to view private credit as a core asset class that provides a steady yield premium over public fixed income but favor experienced, high-quality asset managers with the skill set to navigate the late credit cycle environment.

Direct Lending Liquidity and Fund Redemptions

Semi-liquid vehicles such as Business Development Companies (BDCs) and Interval Funds provide access to illiquid private corporate loans while offering ongoing subscriptions and redemptions in perpetuity but limit the frequency and size of repurchases. These structures balance investor access to private debt with the long-term nature of the assets held, protecting investors from forced selling during difficult market conditions.

After a period of strong inflows, redemptions for Direct Lending funds have risen over the past two quarters, in many cases exceeding the typical 5% fund level cap. As a result, redemptions for some funds have been pro-rated with investors receiving a portion of the requested amount. Redemption demand may remain elevated as ongoing redemption requests are met over the coming quarters. Net inflows remain positive for most managers, but some funds may enter a period of negative net flows before Investor demand stabilizes.

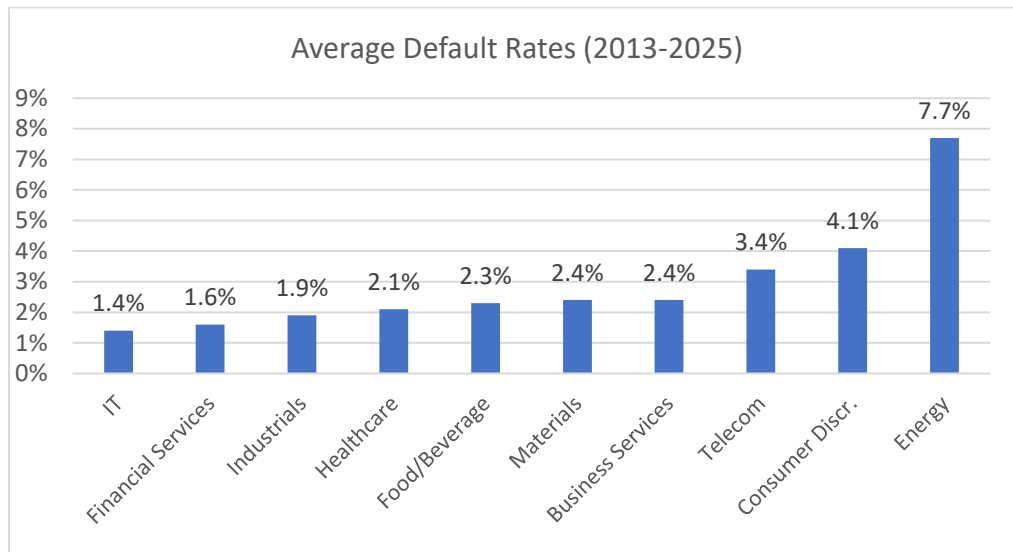
Most funds maintain ample liquidity to meet redemption demand. A Direct Lending fund has multiple sources of liquidity including cash flows from interest payments, maturing loans and repayments due to M&A activity and refinancing. In addition, a portion of fund assets are held in liquid public securities to prepare for redemption needs. A line of credit and other leverage techniques provide additional liquidity. Most managers typically maintain modest leverage which is limited by regulatory guidelines. Many managers entered this period with conservative leverage and defensive positioning, providing flexibility to adjust balance sheets if needed.

A clear understanding of these structural features is essential when allocating to any private asset class through a semi-liquid vehicle. Investors should align capital committed to these strategies with long-term objectives and liquidity needs, viewing periodic liquidity as a feature—not a guarantee. Investors in funds with liquidity limits should have a long-term investment horizon and be prepared to wait out periods when distributions are limited.

Artificial Intelligence (IA) and Software Exposure Risks

Software companies have long been considered strong borrowers due to recurring revenue, healthy margins and asset-light structures. Defaults over the past decade have been concentrated in cyclical sectors like consumer and energy. However, AI is widening the gap between companies in the sector. While the overall level of credit stress and defaults in the software sector is rising, there likely will be a wide range of outcomes over time. AI disruption is a risk that requires rigorous due diligence and borrower underwriting and not all asset managers have the needed expertise and deal sourcing.

Historical Defaults Concentrated in Consumer and Energy



Source: Cliffwater, "Private Markets in the Age of AI: Balancing Risk and Opportunity", 02/12/26

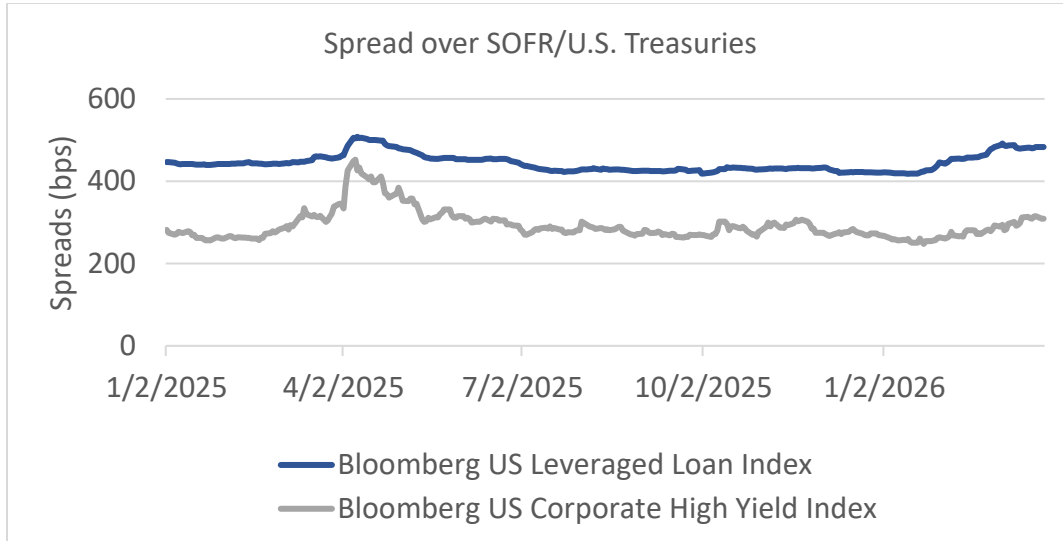
Software exposure in core Direct Lending portfolios is generally modest, with most managers keeping single-digit to low-20% exposure at the fund level, and much lower exposure to higher-risk software subsegments. Software exposure is very diversified in terms of end user and the demand dynamics across companies varies widely. Many managers have shifted toward companies with highly customized software that are leveraging AI capabilities. These companies are well positioned to provide durable cash-flows and strong structural protections mitigating downside risks.

Private Credit Market Conditions

Credit fundamentals remain broadly stable particularly for late in the credit cycle. Industry earnings and profitability growth remain positive. Deal flow has rebounded alongside improved M&A activity. Credit challenges that have emerged have generally been idiosyncratic rather than systemic, reinforcing the importance of diversification, underwriting discipline, and active portfolio monitoring. Defaults and non-accruals have edged modestly higher in certain cyclical sectors, consistent with a later-stage credit environment, but there is no evidence of widespread stress across corporate borrowers. Most BDC credit ratings remain stable at Investment Grade.

Loan spreads have widened slightly reflecting heightened credit risks and investor concerns over recent headlines. This has resulted in lower valuations for existing loans although the impact so far has been modest. The ramifications of the Iran conflict and rising recession and inflation fears may also put upward pressure on credit spreads and defaults.

Corporate Credit Spreads Have Widened



Source: Bloomberg

Manager dispersion in private assets is much wider than in public strategies. Although the widest dispersion is in Private Equity and Venture Capital, Private Credit managers also exhibit a wider range of outcomes versus benchmark-focused public bond managers. Dispersion across managers is increasing as lower quality loans deteriorate and secular trends such as AI become more difficult to navigate. High-quality deals have become more competitive. Asset managers with large, experienced deal sourcing, structuring and workout teams are best positioned to capitalize on these challenges.

Impact on Investment Portfolios

Private Credit continues to play an important role in diversified portfolios, particularly in an environment marked by tighter financial conditions, elevated volatility, and liquidity shortages. In fact, flows from institutional investors remain robust and show signs of trending upward. Direct Lending strategies offer the potential for enhancing income, diversification, and attractive risk-adjusted returns when sized appropriately to limit manager and liquidity risks. We view Direct Lending as particularly well-suited for semi-liquid vehicles offering measured liquidity through contractual cash flows and relatively steady valuations.

Portfolio construction and manager selection remain critical with a careful evaluation of liquidity needs and access to capital. We are focusing on well diversified portfolios invested in secured loans at the top of the capital structure with a material equity cushion. The Summit Investment Team continues to monitor market conditions, manager activity and fund liquidity to ensure these strategies are positioned to navigate the evolving market environment.

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The Bloomberg U.S. Corporate High-Yield Index measures the U.S. dollar-denominated, high yield, fixed-rate corporate bond market. Securities are classified as high yield if the middle rating of Moody’s, Fitch, and S&P is Ba1/BB+/BB+ or below. Bonds from issuers with an emerging markets country of risk, based on Barclays EM country definition, are excluded.

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