Private debt

CIO View: Private debt

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- 2025 started with much positivity about the economy; however, recently announced tariffs by the US administration are likely to impact the operating environment for private lenders, particularly in import/export-sensitive sectors, while more domestic and non-cyclicals should be more shielded.
- Increased uncertainty and more cautious sponsor behavior has reduced lending activity. However, reduced bank lending appetite could create opportunities for alternative lenders, in our view.
- We recommend selectivity in the current environment and prefer sponsor-backed loans in the upper-middle market and large-cap deals, as well as areas more isolated from cyclical pressures.

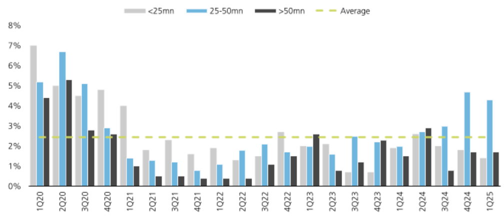
Source: Getty images

Private debt in the current environment

- 2025 started with much optimism about the economy. Constructive investor sentiment combined with high bank participation in the leveraged loan market further compressed private loan spreads. Banks for most of 1Q were willing to refinance private credit deals completed in 2022 and 2023, often against a spread advantage of near 200bps compared to the original direct loans (LCD). As of February 2025, private loan spreads stood at 500bps, compared to 525bps at the end of December 2024.
- Moving forward, however, recently announced tariffs by the US administration are likely to impact the operating environment for private lenders. We expect borrower credit risk to increase and spreads to widen from here. Tariffs are negative for profit margins and cash flows while broader economic weakness should reduce earnings growth. Debt servicing capacity will likely be challenged, albeit the potential for more rate cuts by the Federal Reserve should provide some support. We expect increased divergence across sectors. Companies in industries heavily reliant on imports/exports may face direct disruptions, notably those exposed to the auto industry and retail. More domestic and non-cyclical businesses should be better shielded and could even benefit from supply chain reshoring.
- Overall lending activity is likely to slow as broad market uncertainty starts affecting bank appetite to lend. Private equity (PE) LBO activity, an important source for direct lending deal sourcing, was already depressed in the first few months of 2025. Tariff uncertainty has resulted in more selective PE capital deployment and lengthier due diligence processes. For instance, sponsor-backed direct loan issuance count declined 23% in 1Q25 compared to 4Q24 and is down 20% year over year, according to PitchBook data. PE-sponsor caution could extend for a few more quarters until more clarity on the new operating regime or budget

Fig. 1: Default rates hover at historic averages as the rate-cutting cycle may provide a relief on debt servicing

Private loan default rates by company size (EBITDA)



Source: Proskauer 1Q25, UBS April 2025

reconciliation emerges, or deregulation combined with meaningful interest rates cuts incentivizes fresh capital deployment. Bank lending retrenchment, however, may provide an opportunity for alternative lenders to step in and capture a bigger share of overall lending volume.

- Risk metrics may deteriorate, especially in the weaker segments of the market. Entering 2025, direct lending benefited from low defaults, below average leverage levels, and moderate non-accrual rates. While we do not anticipate a surge in default activity as our revised GDP outlook continues to point to positive growth, we acknowledge that financial stress may increase—especially in the lower-middle market and for companies with limited pricing power, weak balance sheets, and those operating in tariff-sensitive sectors.

- In this environment, we recommend selectivity and an up-in-quality bias. Direct lending is short duration, generally senior, and less sensitive to market volatility given its non-listed nature. In turbulent times, lenders also have several strategies at their disposal to support borrowers and manage risk effectively. But the current environment is likely to exacerbate the dispersion of outcomes across borrowers and direct lenders. We retain a preference for managers with a focus on sponsor-backed, upper-middle-market and large-cap deals in sectors more isolated from cyclical pressure.

- Private market investors need to consider risk factors like leverage, potential defaults, and concentration risks. Investing in private market vehicles also requires a tolerance for illiquidity and comes with limited disclosure and control over holdings.

Positive drivers

- **Dry powder:** Still-elevated dry powder means managers have the capital to take advantage of dislocations and liquidity stress.

- **Deal activity:** Slowing bank lending activity could provide an opportunity for alternative lenders to step in and capture a larger share of overall lending volume.

- **Pricing environment:** Managers are negotiating better spreads, lower leverage, and seeking stronger covenants. The floating-rate structure of loans suggests higher returns as long as rates are higher, but if rates begin to decline, returns would be lower.

Negative drivers

- **Negative economic pressure:** Slower economic growth can pose a risk to borrowers' ability to pay back loans.

- **Political environment:** Tariffs could negatively impact borrower credit quality, compress profit margins, and challenge debt servicing capacity, particularly in more import-/export-sensitive sectors.

- **Defaults:** Financial stress caused by elevated rates and tariff pressures could mean default rates may rise, particularly in the lower-middle market, while interest coverage ratios could weaken.

Considerations before investing

- When investing in alternative investments, investors must always be aware of the risks inherent to the asset class, such as a lack of liquidity, lack of control, limited disclosure, blind pool risk, uncertain cash flows, and the use of leverage.

Non-Traditional Assets

Non-traditional asset classes are alternative investments that include hedge funds, private equity, real estate, and managed futures (collectively, alternative investments). Interests of alternative investment funds are sold only to qualified investors, and only by means of offering documents that include information about the risks, performance and expenses of alternative investment funds, and which clients are urged to read carefully before subscribing and retain. An investment in an alternative investment fund is speculative and involves significant risks. Specifically, these investments (1) are not mutual funds and are not subject to the same regulatory requirements as mutual funds; (2) may have performance that is volatile, and investors may lose all or a substantial amount of their investment; (3) may engage in leverage and other speculative investment practices that may increase the risk of investment loss; (4) are long-term, illiquid investments, there is generally no secondary market for the interests of a fund, and none is expected to develop; (5) interests of alternative investment funds typically will be illiquid and subject to restrictions on transfer; (6) may not be required to provide periodic pricing or valuation information to investors; (7) generally involve complex tax strategies and there may be delays in distributing tax information to investors; (8) are subject to high fees, including management fees and other fees and expenses, all of which will reduce profits.

Interests in alternative investment funds are not deposits or obligations of, or guaranteed or endorsed by, any bank or other insured depository institution, and are not federally insured by the Federal Deposit Insurance Corporation, the Federal Reserve Board, or any other governmental agency. Prospective investors should understand these risks and have the financial ability and willingness to accept them for an extended period of time before making an investment in an alternative investment fund and should consider an alternative investment fund as a supplement to an overall investment program.

In addition to the risks that apply to alternative investments generally, the following are additional risks related to an investment in these strategies:

- Hedge Fund Risk: There are risks specifically associated with investing in hedge funds, which may include risks associated with investing in short sales, options, small-cap stocks, "junk bonds," derivatives, distressed securities, non-U.S. securities and illiquid investments.
- Managed Futures: There are risks specifically associated with investing in managed futures programs. For example, not all managers focus on all strategies at all times, and managed futures strategies may have material directional elements.
- Real Estate: There are risks specifically associated with investing in real estate products and real estate investment trusts. They involve risks associated with debt, adverse changes in general economic or local market conditions, changes in governmental, tax, real estate and zoning laws or regulations, risks associated with capital calls and, for some real estate products, the risks associated with the ability to qualify for favorable treatment under the federal tax laws.
- Private Equity: There are risks specifically associated with investing in private equity. Capital calls can be made on short notice, and the failure to meet capital calls can result in significant adverse consequences including, but not limited to, a total loss of investment.
- Foreign Exchange/Currency Risk: Investors in securities of issuers located outside of the United States should be aware that even for securities denominated in U.S. dollars, changes in the exchange rate between the U.S. dollar and the issuer's "home" currency can have unexpected effects on the market value and liquidity of those securities. Those securities may also be affected by other risks (such as political, economic or regulatory changes) that may not be readily known to a U.S. investor.

Appendix

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