

The Rise of Private Credit in a High-Rate Environment: Opportunity or Risk?

After more than a decade of historically low interest rates, the financial landscape has entered a new era—one where the cost of borrowing is higher, credit markets are tighter, and traditional sources of capital are pulling back. In this environment, private credit is emerging as a major force, offering attractive returns and flexible capital solutions.

Projections suggest the industry could swell to \$2.8 trillion by 2028. But with elevated yields also come new risks.

So, is this the golden age for private credit? Or are we entering a riskier phase of the cycle?

I. WHY PRIVATE CREDIT IS THRIVING IN 2025

1. Yield Advantage

Private credit—especially in the form of direct lending—has been aided by its predominantly floating-rate nature. As base rates like SOFR have climbed, private credit funds are passing on higher interest income to investors. In some segments of the market, yields can be as high as 11–13%, with spreads supported by a pullback from traditional lenders.

This yield advantage has been a major draw for institutional allocators looking to outpace inflation and volatility in public markets.

2. Bank Retrenchment = More Deal Flow

Regulatory capital requirements and a renewed focus on risk have led banks to reduce their exposure to middle-market lending. This created an opportunity for private credit managers, who now serve as critical capital providers for a wide range of borrowers—from private equity-backed companies to family-owned businesses and real asset developers.

In many cases, these lenders offer more flexible, tailored terms than traditional banks can. Private credit managers are stepping into roles such as financing growth, M&A, and capital structure restructuring for middle-market borrowers.

3. Dislocation Premium

Intermittent dislocations in public credit markets have further fueled the momentum. As public bond and leveraged loan markets have faced volatility, borrowers sometimes prefer the certainty of execution and confidentiality that private deals provide.

For investors, this dislocation creates opportunities for enhanced spreads and better deal terms, notably in situations with potential for elevated credit risk.

MARKET COMMENT

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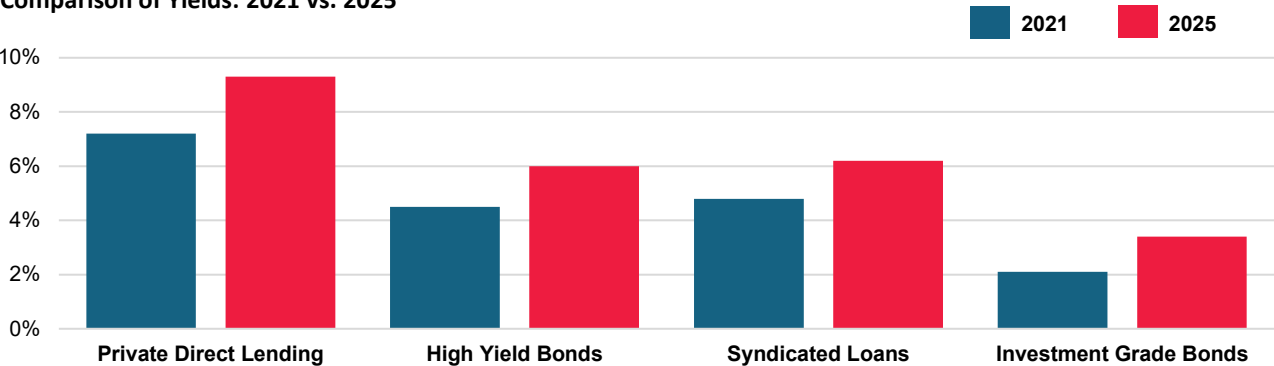
II. THE OPPORTUNITIES IN FOCUS

Senior Secured Lending: A core part of many private credit portfolios, these loans provide first-lien security and have performed well amid rising rates.

Asset-Based Lending: Gaining attention as a lower-risk strategy in uncertain environments, with loans backed by collateral such as receivables, inventory, or equipment.

Special Situations & Distressed Lending: As maturities stack up and refinancing costs rise, lenders with expertise in complex capital structures are finding opportunities in rescue financing and transitional lending.

Exhibit 1
Comparison of Yields: 2021 vs. 2025



III. BUT RISKS ARE RISING, TOO

1. Rising Borrower Stress

With high leverage levels, debt service burdens are meaningful for many middle-market companies. Even high-quality borrowers may struggle if earnings soften or margins compress. Amend-and-extend activity is increasing, and lenders must stay vigilant to signs of credit deterioration. Fitch, which tracks roughly 1,200 private borrowers, reported that the default rate climbed to 5.5% in Q2 2025, up from 4.5% in Q1.

2. Illiquidity Risk

Unlike public bonds or syndicated loans, private credit is inherently illiquid. While this can be a strength during stable periods, it becomes a challenge when market sentiment turns or when investors need liquidity.

For LPs, understanding the redemption mechanics and liquidity waterfalls of a private credit fund is more important than ever.

3. Valuation and Transparency

Valuing illiquid assets is complex, and in periods of volatility, reported NAVs can lag the market. Investors need to dig into the valuation methodologies used and understand how conservative—or aggressive—a manager may be in pricing their loans.

For private credit funds and their investors, elevated default rates can weigh on NAVs, force reserves, and restrict distributions. For pension funds and other institutional allocators, defaults may strain portfolio liquidity and impair long term return expectations. A wave of payment-in-kind conversions and maturity extensions—as seen in recent quarters—can mask underlying distress yet still erode credit quality and investor confidence.

IV. MANAGER STRATEGY IS THE DIFFERENTIATOR

In this environment, success may come down to:

- Strength of underwriting discipline
- Sector specialization and sourcing networks
- Experience managing through cycles
- Portfolio concentration and leverage levels
- Ability and willingness to enforce covenants and drive restructurings when necessary

V. LOOKING AHEAD

As of mid-2025, private credit remains resilient, supported by robust fundraising, steady deal flow, and elevated yields. The higher-for-longer interest rate environment has solidified private credit's role as a core component of institutional portfolios, while also drawing retail access through ETFs and other vehicles.

However, borrower refinancing pressure is building, particularly in leveraged sectors with upcoming maturity concentrations in 2026–2027. Defaults and restructurings may rise, with a bifurcation based on sectors and individual borrower credit strength.

Regulatory scrutiny is also intensifying, with greater attention on valuation practices, transparency, and fund liquidity structures. These shifts are likely to shape the industry's evolution, pushing it toward greater institutionalization and standardization.

Private credit is moving from an opportunistic play to a mainstream allocation, but its sustainability hinges on disciplined underwriting, strong structuring, and thoughtful manager strategy in a more complex market environment.

VI. BOTTOM LINE

The high-rate environment has given private credit a powerful tailwind. Investors are drawn to strong yields, innovative structures, and the chance to step into market opportunities. But as always, with greater return potential comes greater risk—especially for those chasing yield without sufficient discipline.

The winners in this new cycle will be the managers who combine opportunism with caution, and investors cognizant of complexity beneath the headline yields.