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ZCGC Insights

The Coming Test for Private Credit: Concentration Risk, Illiquidity, and the Challenge of Exits

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Key Takeaways

- 1 Private credit has yet to be tested by a prolonged downturn. When the cycle turns, off-loading illiquid assets will become a central challenge. Firms with disciplined underwriting, realistic valuations, diversified LP bases, and strong secondary networks will be best positioned.
- 2 Insurance capital has fueled industry growth, but introduces regulatory risk. As borrower performance and valuations come under pressure, insurance regulators are likely to increase scrutiny of these exposures.
- 3 Continuation funds delay, not solve, off-loading challenges. Lenders must use this additional time to execute accelerated, value-creation initiatives in close partnership with borrowers.

The Expansion of Private Credit

The 2008 financial crisis significantly reduced the availability of corporate debt, with loan activity declining by approximately 80% in Q4 2008. According to Moody's, eighty-six issuers defaulted on approximately \$54.4 billion of syndicated bank loans in 2008, up sharply from twenty-six issuers that defaulted on roughly \$3.8 billion in 2008.¹ As the market gradually rebounded, the amount of outstanding loans held directly on commercial bank balance sheets experienced a noticeable decline due to the tightening of regulatory standards and oversight. The shift of outstanding loans away from banks provided the conditions that led to the rapid emergence of private credit.

Over the past 15 years, private credit has grown exponentially. The size of private credit at the start of 2025 was \$3 trillion, compared to about \$2 trillion in 2020, and it is estimated to grow to approximately \$5 trillion by 2029.² The USA market dominates private credit with estimates ranging from 2/3 to 3/4 of the total global market.

Tighter regulatory requirements on traditional banks accelerated the rise of non-bank lenders, including business development companies (BDCs), direct lending funds, and alternative asset managers. The low-interest rate environment also made the ~200 bps higher yield offered by private credit extremely attractive to investors. A second factor contributing to the rise in private credit was the significant cutback by traditional banks in lending to middle-market borrowers. As banks appear to have become less willing to lend to middle-market firms with riskier profiles in the United States and Europe, private credit has emerged as a key lender.³ This retraction created a significant opportunity for private credit due to the massive size and demand for middle-market lending.

In response to this opportunity, private credit has deployed large amounts of capital in sponsor-backed middle and upper-middle market companies. To keep pace with demand, leading firms have significantly expanded their origination and underwriting capabilities. The demand for private credit has also resulted in major players seeking stable sources of investment capital.

Accordingly, insurance company partnerships have become a major source of permanent capital. Firms such as Apollo, Ares, Blackstone, Blue Owl, Brookfield, and KKR have each developed affiliated insurance platforms. While these relationships provide stability, they shift risk toward insurers, who are subject to regulatory oversight. Increased scrutiny of asset valuations and portfolio performance may impact the level of future capital flows into private credit.

At the same time, pressure to deploy capital has intensified competition. As a result, many lenders have taken on larger hold positions rather than diversifying risk through syndication or participation. While this approach can enhance returns, it also increases concentration risk and complicates exits, particularly when borrowers face operational or industry headwinds.

The Challenge of Off-Loading Private Credit Loans

Private credit funds are structured to prioritize capital deployment and long-term hold strategies. While effective in stable environments, this model concentrates risk and limits flexibility during periods of stress or market uncertainty.

Off-loading challenges arise when illiquid or underperforming loans cannot be easily transferred or exited. Common drivers include:

1. Frequent Covenant Amendments and Incremental Financing: When a borrower's operating performance deteriorates, lenders often amend covenants or provide additional liquidity and rescue financing. These actions could weaken secondary market demand unless there is a successful performance improvement strategy or a willingness to sell the loan at a discount. Holding the position may avoid immediate write-downs but prolongs exposure to operational turnaround risk and increased debt leverage. Furthermore, multiple amendments and frequent waiving or reset of financial covenants results in additional professional fees and financing costs, which when combined with operational shortfalls, can collectively create challenges and significant hurdles in the ability to refinance by the maturity date.
2. Widespread Use of Pay-in-Kind (PIK) Interest: Private credit borrowers' who are not achieving their financial and liquidity projections are often utilizing PIK as a tool to manage their loan payment obligations. The variety of PIK arrangements provide both borrowers and lenders with flexibility in managing the credit. When used properly, PIK can provide an effective temporary solution to manage through a period of under-performance. PIK arrangements typically do not have a material impact on secondary pricing since the lender controls the negotiation process and passes those rights onto the secondary buyer(s).
3. Fund Life Constraints: With typical fund lives of 5–10 years and loan durations of 3–5 years, managers nearing the end of a fund's life shift focus from origination to portfolio management. Underperforming loans may need to be sold at a discount or transferred to continuation vehicles.
4. Capital Recycling Pressures: Raising new funds often depends on returning capital to existing LPs. Managers may face difficult decisions around liquidating assets—potentially at a loss—to support future fundraising efforts.

Methods to Facilitate Off-Loading

The most significant challenge in offloading private credit assets is the lack of a transparent market pricing of these investments. The process is time-consuming and often requires extensive negotiation to bridge the gap between where buyers and sellers are willing to transact. These negotiations can take weeks to complete in comparison to BSL and liquid credit sales which can be completed in minutes. Primary methods to reduce concentration and exposure include:

1. Secondary Market Sales: Selling positions in the secondary market can provide liquidity but often encounter pricing challenges. Bid-ask spreads can be wide, as buyers anticipate further deterioration while sellers seek to minimize losses and avoid negative signaling to LPs.
2. Transfers to Continuation Vehicles: The use of transfers to continuation vehicles is increasing in popularity for private credit loans that cannot be refinanced prior to maturity or that may not receive an acceptable price on the secondary market.
3. New Private Credit CLO: Movement of a loan or group of loans into a newly established CLO provide private credit firms with the opportunity to monetize and reduce their concentration risk without having to deal with the uncertainty of the secondary market or utilize continuation vehicle capital.

Off-Loading Valuation Differences

When loans are sold or securitized, there is often a gap between carrying value and market pricing. This reflects illiquidity discounts, differences in valuation methodologies and discretion utilized by managers in valuing level 3 assets due to the lack of observable market prices.

Looking Ahead: The ZCGC Perspective

Private credit volatility is expected to persist through 2026 and 2027. Traditional tools, such as covenant amendments and incremental liquidity, may be insufficient on their own. More proactive, operationally focused strategies will be critical.

ZCGC partners with management teams and lenders to align real estate strategy, working capital optimization, organizational design, technology enablement, and capital planning into a unified execution framework. This integrated approach aims to help stabilize balance sheets, unlock liquidity, and preserve flexibility, without defaulting to formal restructuring or additional external capital.

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You can also learn more about ZCGC, the business consulting services platform of ZCG, at www.zcgc.com, and explore ZCG's technology affiliate, Haptiq, at www.haptiq.com.

Sources

¹ Moody's Credit Policy, Syndicated Bank Loans 2008 Default Review and 2009 Outlook, March 2009.

² PitchBook. As of May 2025.

³ IMF eLibrary, The Rise and Risks of Private Credit, April 16, 2024.

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