December 2025 Debt Market Update

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TABLE OF CONTENT

Overview

Direct lending issuance has experienced a slowdown in the latter half of 2025 and is anticipated to continue this trend into 2026 as the landscape gets increasingly saturated. Competition in direct lending remains intense, with new issuance spreads tightening to approximately S+4.5% in the last quarter of 2025.

Although M&A activity has seen increased volume in the fourth quarter, it is not at a level to offset demand for private credit. US companies are facing pressure on growth due to rising costs from tariffs, economic uncertainty, and cautious consumer spending. Companies are struggling to pass on higher input costs to consumers due to weaker demand and competitive pressures, which strain profit margins. This has also led to a more cautious approach to hiring and investment, contributing to slower job growth. Many companies across various sectors including technology, retail, logistics, media and healthcare are being impacted by AI through adoption, disruption and workplace changes. Market participants are having a reduced appetite for certain loans deemed as having AI displacement risk.

Sector Headwinds

Several sectors face headwinds driven by persistent inflation, high interest rates, slowing consumer spending, and geopolitical uncertainties such as trade tensions.

Auto / Auto components: Consumer defaults on auto loans have increased and new auto sales have slowed down due to lack of affordability, increased competition from China and tariffs. The auto sector also had a perfect storm of factors including difficult and expensive transition to EVs, rising costs, high interest rates, and supply chain issues.

Housing: Home sales have slowed as a result of high mortgage rates, low affordability, and broader economic uncertainties.

Construction: Construction has seen a slowdown due to economic factors like high interest rates and global tensions that have increased material costs. The sector faces a shortage of skilled labor, policy uncertainty regarding tariffs and immigration, and a shift in working expectations for better work-life balance and training.

Pet Veterinarian Clinics: Vet clinics are seeing a slowdown due to a combination of post-pandemic factors, including a decrease in the number of pet adoptions, and ongoing economic pressures like inflation and rising costs for both clinics and pet owners. This has led to fewer vet visits as pet owners cut back on discretionary spending and skip or delay routine care due to rising prices and economic uncertainty. Growth has also been challenged due to more entrants in the space which has created high competition which has put further pressure on growth and margins.

Transportation / Logistics: Transportation and logistics have slowed due to a combination of factors including labor shortages, port congestion, a global economic slowdown, and geopolitical issues. Other contributing elements include infrastructure problems, high operational costs, and disruptions from events like weather and trade tariffs.

Other affected sectors include commercial real estate, various parts of manufacturing, traditional retail, traditional information/media, and others.

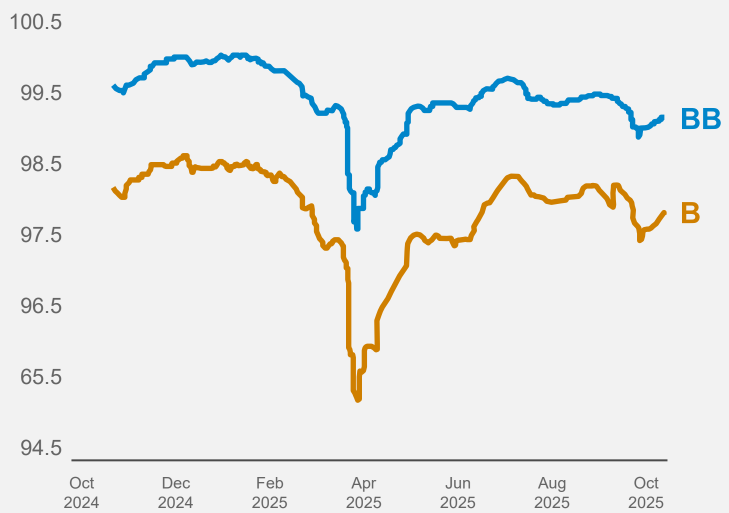
US Leveraged Loan Bids and Pricing

As a result of sector-specific headwinds, weakness in AI-exposed loans, and other issuer-specific problems, the average bid price for B rated loans in the LSTA US index decreased from 97.06 as of September 30th to 96.35 as of October 14th (the five month low) and then rebounded up to 96.67 by October 31st.

First Brands had an impact on the LSTA US leveraged loan index. It filed for Chapter 11 on September 29th. With $4 billion in outstanding leveraged loans, First Brands ranks 39th out of 1,130 names. Automotive Components was the worst performing sector followed by Chemicals. Macroeconomic drivers of sector weakness included soft end market demand particularly in housing and construction. Elevated energy costs, tariff uncertainty and increased import competition from Asia all added to pressure to bid prices.

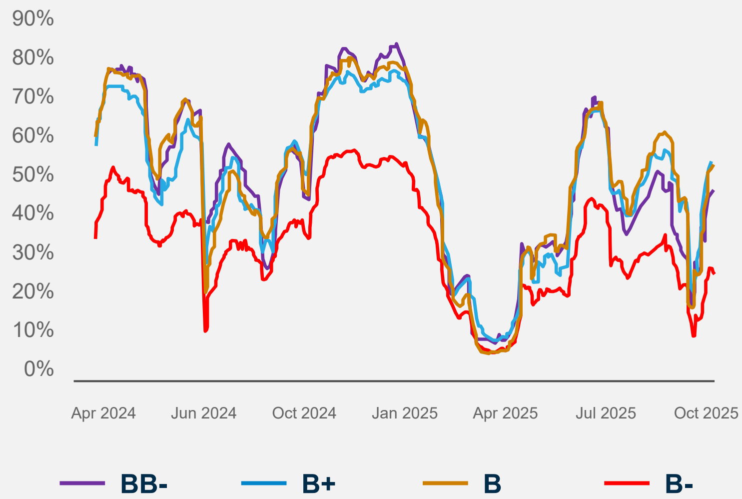
Roughly three-quarters of the market has been at 99 or above over the past few months. However, the lower end has not shown the same improvement — the share of loans priced below 90 continued to edge higher, to 9.2% on October 31, its highest level since early May. The bulk of this sub-90 cohort consists of borrowers rated B-minus (41%) or CCC plus (31%), while the most represented sectors are Software (21%) and Chemicals (11%).

Average bid of performing loans



Sources: Pitchbook | LCD; Morningstar LSTA US Leveraged Loan Index

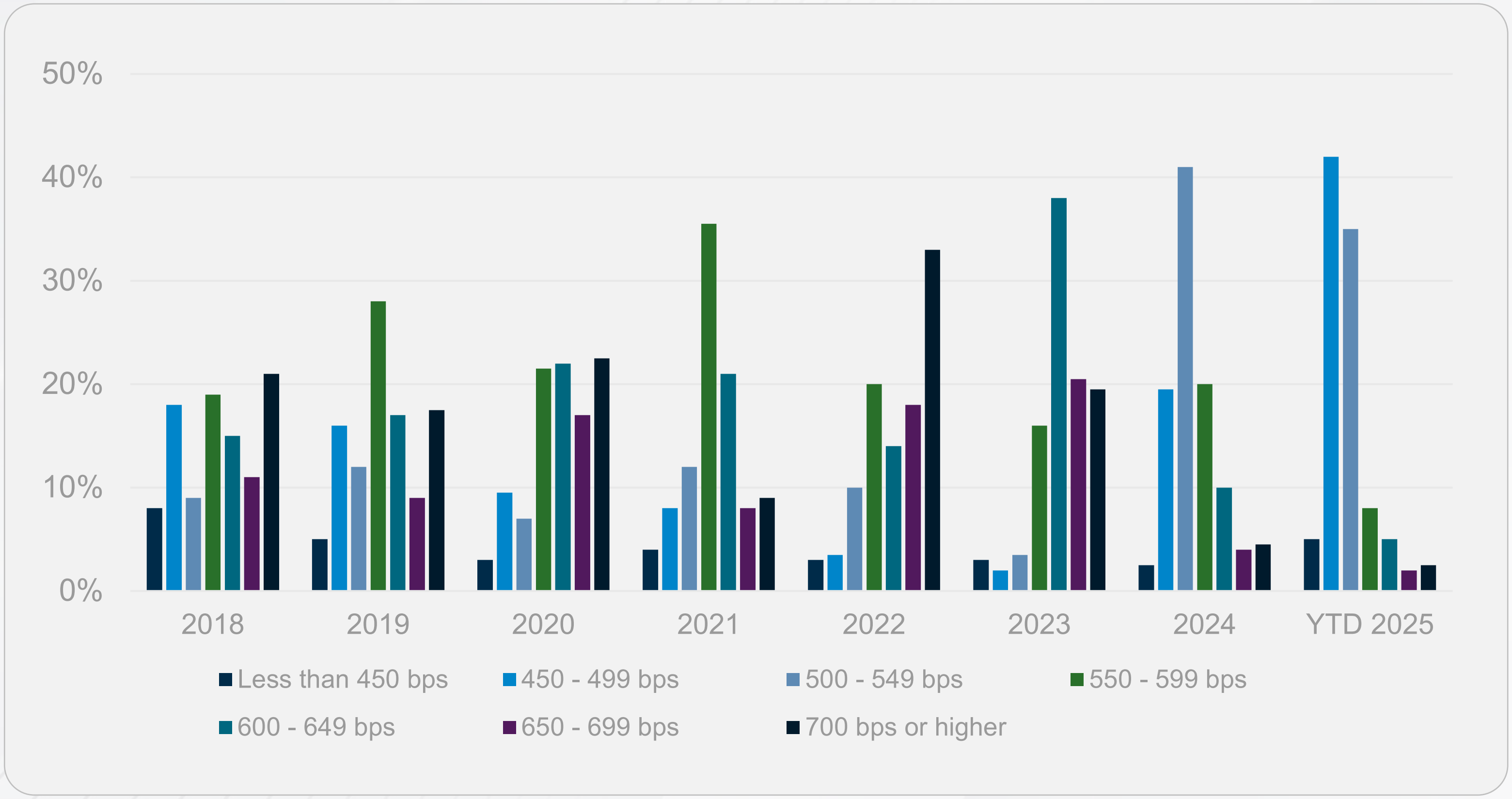
Loans priced at par and above by issuer rating



Sources: Pitchbook | LCD; Morningstar LSTA US Leveraged Loan Index
• Data through Oct 31, 2025

New-Issue Spreads

The following shows the new-issue spread distribution of LBOs financed in the direct lending market. Per Pitchbook, spreads have decreased from their 2022 highs with many borrowers priced at approximately S+450. The main theme of 2024 and 2025 was significant spread repricings. The continued spread compression is a result of supply and demand imbalance continuing to persist as M&A remains below expectations. In the second quarter, the majority of spreads were in the S+500 range. As of September 2025, that has come down to S+450, representing 50 bps compression in six months. Nearly half of new issuances are below 500 bps spread as of September 2025.

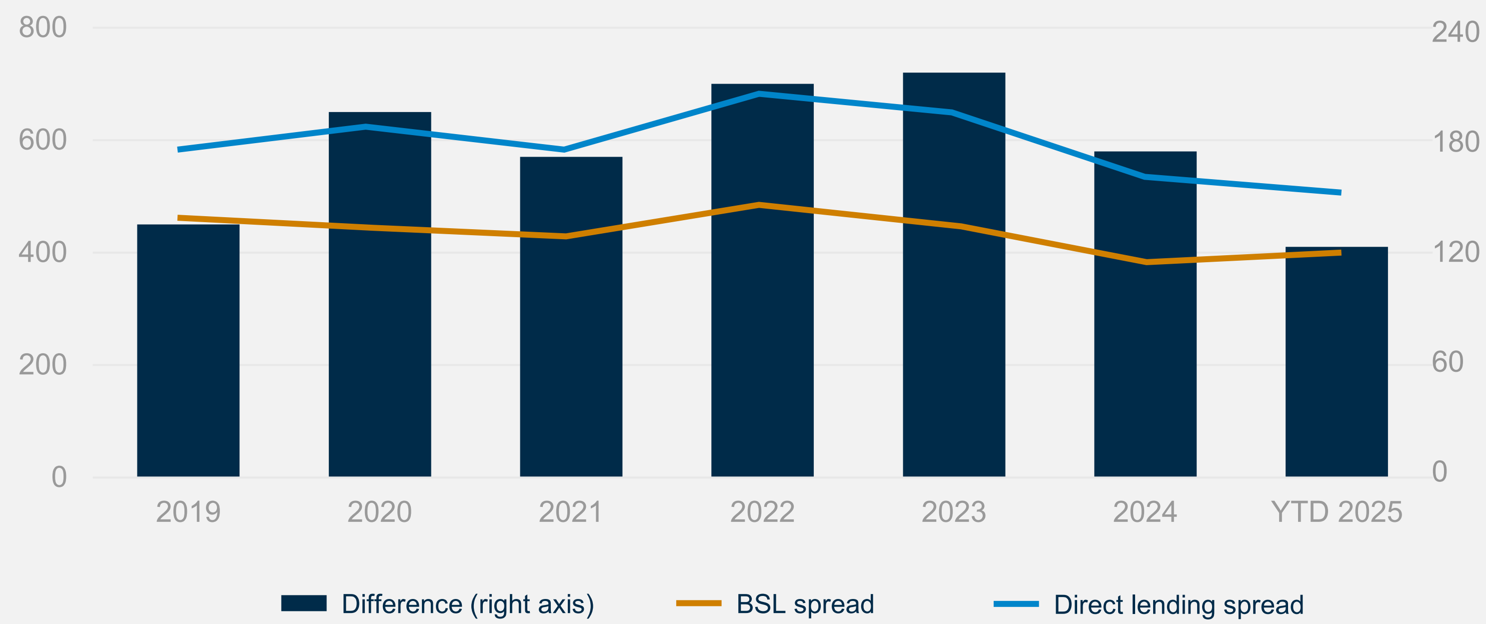


Sources: PitchBook | LCD • Geography: US • *As of Sep. 30, 2025

Spread Differential between Private Credit and BSLs

The gap between spreads for private direct credits and for BSLs is on track to narrow for the second straight year according to Pitchbook. This is indicative of the enormous investor demand for income. This is partially fueled by weak LBO activity in both the BSL and private credit markets. Given the dry power available in private credit with limited supply of deals, direct lending spreads in the upper middle market have become very competitive to BSL pricing. We have seen a number of BSL deals taken up by private credit and vice versa in 2024 and 2025. We expect the upper middle market to resemble the BSL market, particularly in terms of being covenant-lite and more susceptible to LMEs. As private credit funds have grown over time, direct lenders have also been able to provide large checks and execute large deals. The premium of private credit over BSL is currently 50 to 100 basis points.

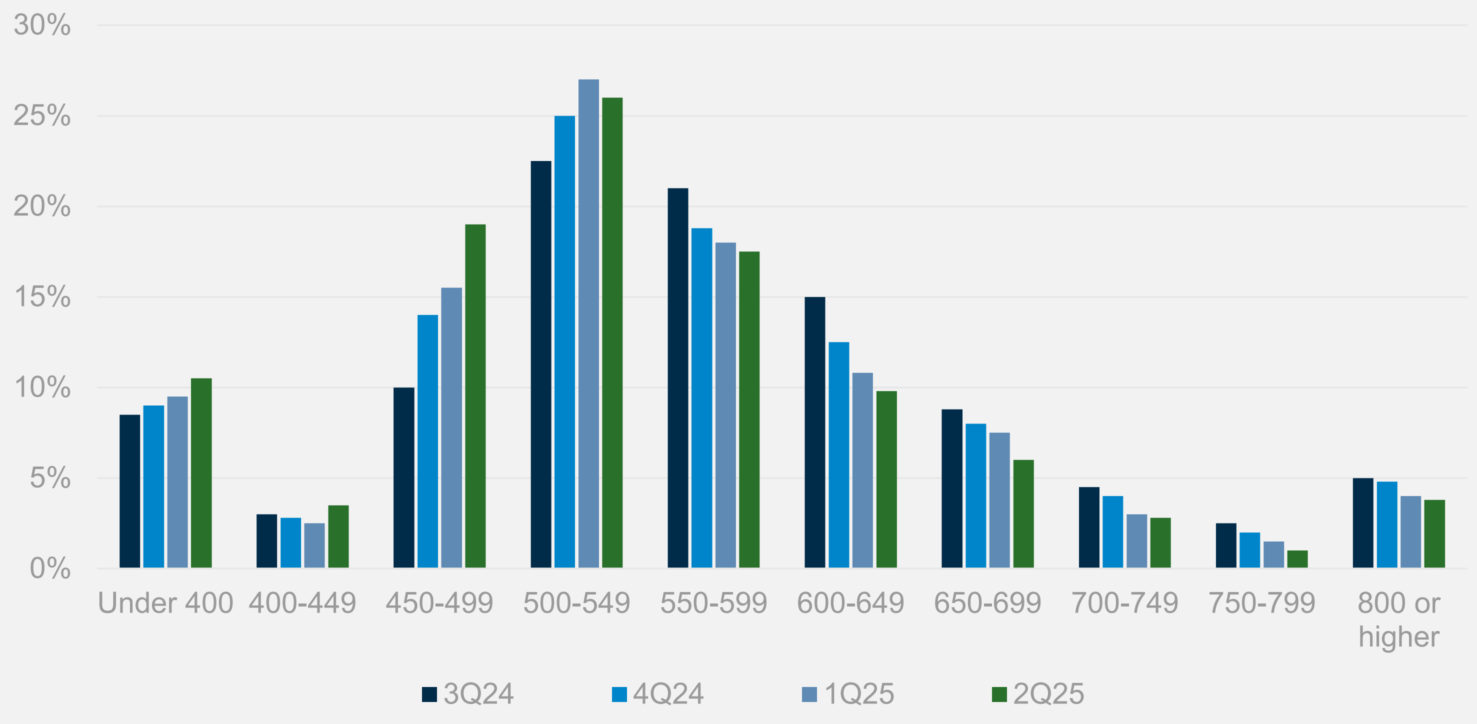
Spread of LBOs financed in BSL (B-minus borrowers) vs direct lending market



Sources: PitchBook | LCD • Geography: US • *As of Sep. 30, 2025

Spread Distribution of BDC Holdings

This chart represents the spread distribution ranges by share of portfolio based on count. This chart further illustrates spread compression as of June 2025.



Sources: PitchBook | LCD • Geography: US • *As of Sep. 30, 2025

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Middle Market Yield Matrix

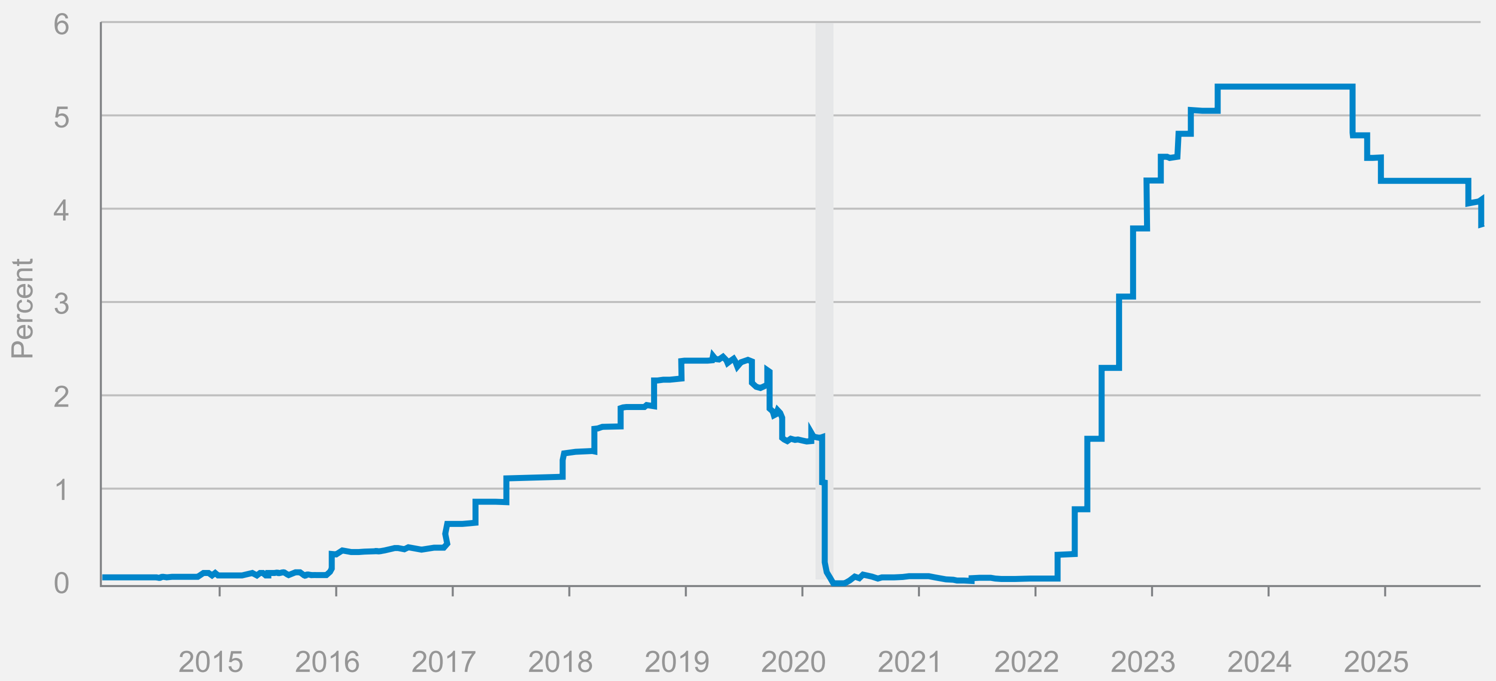
The new normal is now around S+4.50% given the volume of repricings in 2024 and 2025 as well as a number of credits that have been repriced more than once since 2024. The premium for direct lending spread over broadly syndicated loans is around 50 to 100 basis points as of October 2025. Increased competition and market convergence have caused private credit spreads to compress. Upper middle market private credit and the BSL market continue to compete. Pricing is far less differentiated and nuanced in today's market. Better deals are priced at around S+4.50% while lower quality credits are priced higher.

Security	Small Cap	Lower Middle Market	Traditional Middle Market	Upper Middle Market
EBITDA	$3.0MM to $7.0MM	$3.0MM to $15MM	$15MM to $75MM	$75MM to $150MM
# Lenders	1 to 2	1 to 5	3 to 5	10 to 25
Liquidity	Illiquid	Illiquid	Relatively Illiquid	Partially Illiquid
Borrower Compliance	Traditional Covenants	Traditional Covenants	Traditional Covenants	Traditional/Cov-Lite
1st Lien	S + 4.75% to S + 5.50%	S + 4.50% to S +5.25%	S + 4.25% to S + 5.00%	S + 4.00% to S + 4.75%

Sources: Based on conversations with market participants as well as a review of multiple sources such as: (i) Pitchbook (LCD), (ii) SPP Capital, (iii) TheLeadLeft (Churchill Asset Management), (iv) public BDC filings; (v) PitchBook; and (vi) other research.

Fed Funds Rate with Market Expectations

There was a rate cut in September of 25 bps and another rate cut in October of another 25 bps. This brought the federal funds target range to 3.75% - 4.00% as of October 2025 and represents a total rate cut of 1.5% since 2024. The Fed has indicated that there is no definitive outlook on rate changes for December due to differing opinions among board members. Inflation remains elevated at 3%, the unemployment rate has creeped up to 4.4% as of September and the labor market remains cool. The median investor estimate is for a target rate of 300 to 350 bps by the end of 2026. The shaded area below indicates U.S. recession.



Sources: Federal Reserve Bank of New York via FRED®

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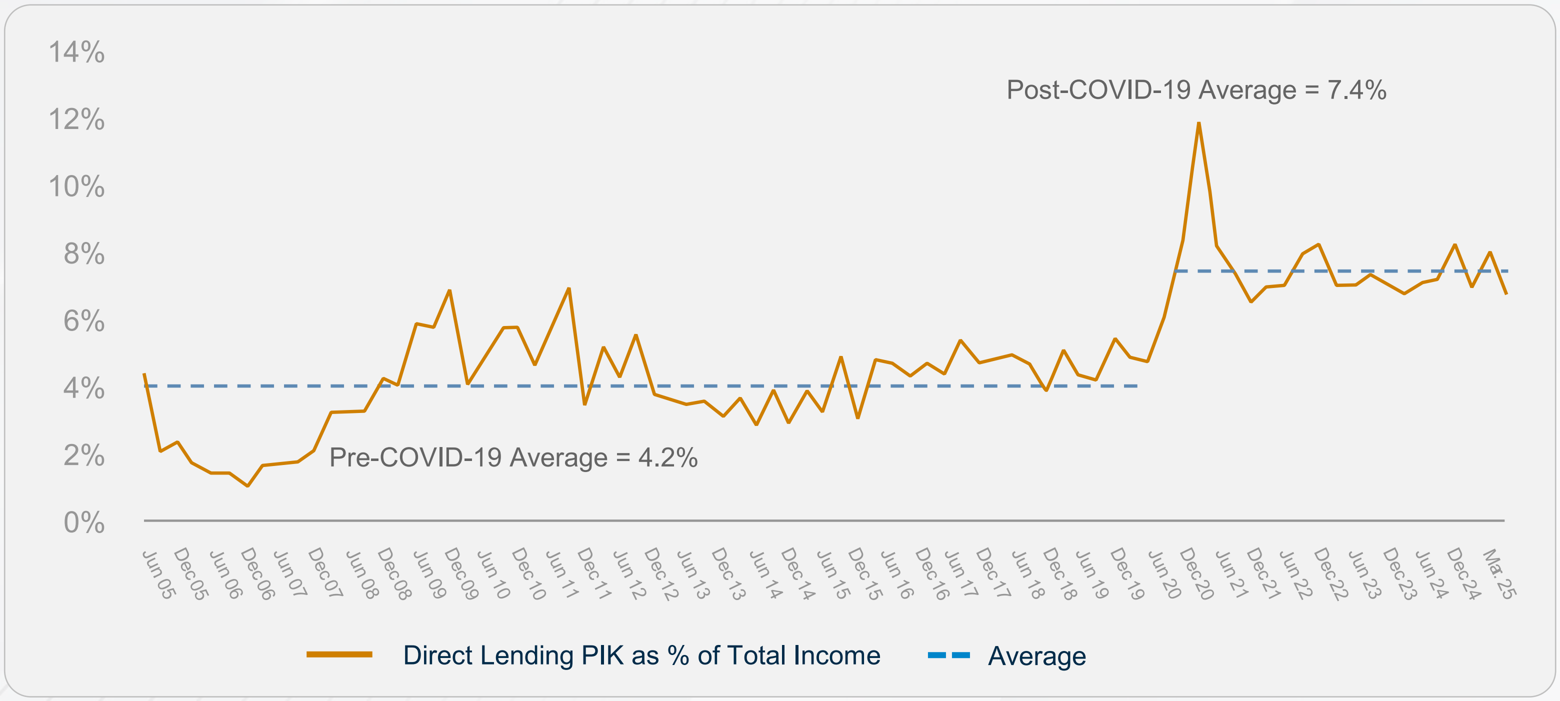
PIK Feature Increase & Future Default Risk Concerns

According to BofA, approximately 30% of private credit loans with PIK terms are estimated to come due in two years. The growing prevalence of PIK interest is raising concerns that private credit funds may be using it to mask deteriorating loan quality and prevent actual defaults. The market has bifurcated PIK loans into “good PIK” and “bad PIK”. “Bad PIK” is defined as loans that were originally issued as all cash pay and over the life of the loan have converted to partial or full PIK. In other words, unplanned PIK. “Good PIK” is defined as credits originated with some PIK feature included.

Deferred interest can also be problematic if growth slows. Based on a review of quarterly credits, a key trend in the September 2025 quarter was a challenge with top line growth. In addition, the 2019 to 2022 vintages continue to be problematic as these were originated at peak fundraising levels with rates near zero. These vintages saw high valuations with aggressive leverage. As a result of the continued rise in PIK along with growth challenges, market sentiment believes default rates will rise in 2026.



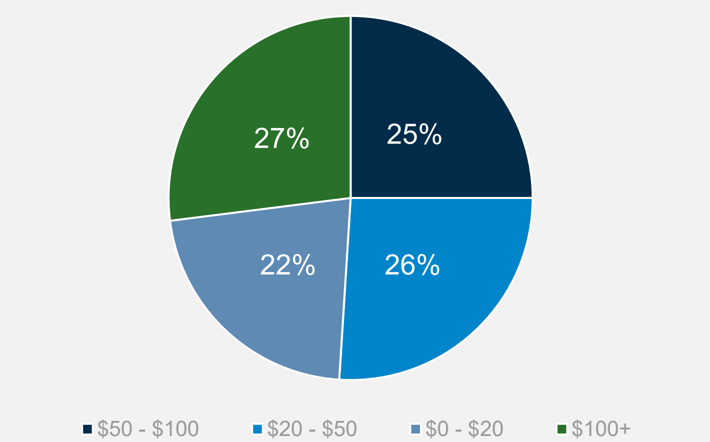
Sources: Golub Capital, Credit Stress Toolkit, November 2025

Default Rate

Published default rates can vary widely from different sources such as rating agencies, legal groups and valuation firms. Establishing true default rates for private credit is challenging due to limited available information and limited tracking of issuers. Based on Fitch's definition and data reach, it tends to report a higher default rate than other sources such as Proskauer and Lincoln.

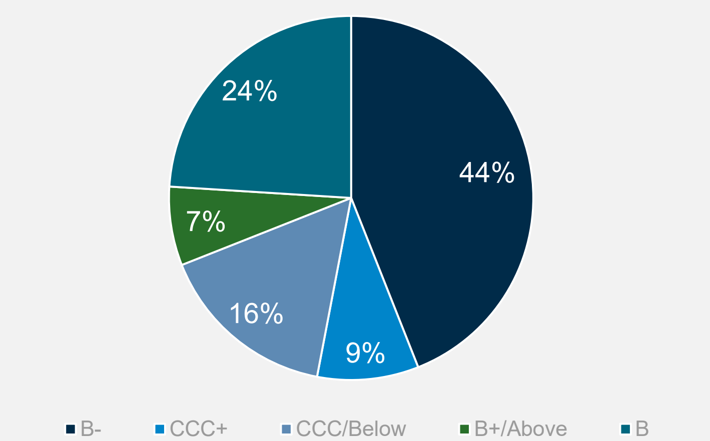
Fitch Rating's private-credit default rate was 5.2% as of August, unchanged from the prior month and expected to remain flat for September. Approximately 40% of defaults in 2024 were for issuers with EBITDA under $25mm. That trend continued in 2025, but actual data will not be available until early 2026. According to Fitch, smaller issuers with EBITDA below $25mm for the August 2025 TTM period had more than double the default rate at 10.1% compared to mid-size peers with EBITDA between $25mm to $50mm at 3.9%.

PMR Portfolio Breakdown by EBITDA ($ mil)



Sources: Fitch Ratings

Portfolio - Breakdown by Rating



Sources: Fitch Ratings

Two recent bankruptcies, TriColor Holdings and First Brands Group, have exposed alleged collateral fraud across multiple institutions. In each case creditors were blindsided by opaque private structured financing arrangements. The structures involved were nontraditional loans: trade finance funds, supply-chain financing vehicles, and warehouse lines linked to securitizations. The non-transparency of these structures led to the lenders failing to verify the underlying collateral. The lenders involved included JPMorgan, Fifth Third, UBS and Jeffries. These credits were erroneously linked to private credit in the media. Both TriColor and First Brands were bank-led with no sponsor backing.

Private Credit Key Trends

Subordination Protection

Since 2023, there has been a significant trend by lenders to close off liability management loopholes. Classic examples of LMTs included J. Crew, Serta, PetSmart, Chewy, and iHeart Radio. In the last quarter, lenders shifted their focus from simply closing LMT loopholes to securing lien subordination protection. According to the WSJ, terms that require unanimous lender consent before any lien subordination increased 23% in Q3 2025 and appears in over 84% of all credit deals. That is the sharpest quarterly increase ever recorded for a protective covenant. The following represents Fitch Rating's Privately Monitored Ratings as of 3Q 2025.

Focus on Retail Investors

Besides the launch of new ETFs, private credit is now targeting 401(k)s. President Trump signed an executive order in August to speed up the process. The executive order directed the Labor Department and the SEC to issue regulations making it easier for employers to include nontraditional offerings in 401(k) plans. However, the government shutdown has delayed this process.

Growth of Private Credit Internationally

Private credit is expected to grow significantly in emerging markets such as Africa and Asia as well as the Middle East. As the US and Europe get saturated with competition driving down spreads, international markets have bankable projects keen for cash and offer more upside. In the UAE alone, estimates run as high as $30 trillion due to the size of private companies that are family owned.

Growth in Secondary Strategies

Many asset managers are creating in-house groups to capitalize on the influx of demand for credit secondaries. According to Campbell Lutyens, private credit secondary deals increased from $7 billion in 2022 to $9.8 billion in 2023 to over $12 billion in 2024 and are expected to exceed $14 billion in 2025. Muted exit activity and the resulting liquidity constraints have put pressure on both fund sponsors and their institutional investors. Meanwhile, the rapid and steady growth in primary private-credit markets over the past decade has created a deep pipeline of secondary supply, particularly as more institutional investors look to rebalance or consolidate their holdings. Pantheon Ventures has deployed $3 billion in 2024 and over $3.5 billion in 2025. Coller Capital raised $6.8 billion in July, which is four times the size of previous fund-raising efforts.

Bank partnerships:

Partnerships with banks and consolidation is expected to continue in 2026. These partnerships have been found to be far more challenging to execute. Regardless, these partnerships continue to proliferate. A BlackRock report classified partnerships between banks and private credit lenders into four categories (with examples):

1. Banks making loans directly from their own balance sheets (JPMorgan)
2. Origination partnerships with private credit lenders (Apollo/Citigroup)
3. Extending direct loans through asset management arms using LP capital (GSAM)
4. Sales of loan blocks to private credit lenders (PacWest Bancorp sale to Ares)

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Economic Trends

Increase in High-Risk Consumer Borrowers

According to a TransUnion report released on November 3rd, the share of consumers in the subprime credit risk category has reached levels not seen since 2019. The shift comes as consumer debt balances grow across the board. About 25% of the US population has a FICO score below 660, which is subprime. The share of consumers taking on subprime loans accounted for 14.4% of borrowers as of 3Q 2025, up from 13.9% for the same period in 2024 and the highest since 2019.

US Manufacturing Declines

US factory activity shrank in October for an eighth consecutive month driven by pullback in production and tepid demand. The Institute for Supply Management's manufacturing index eased 0.4 points to 48.7. Readings below 50 indicate contraction which has been the case for most of 2025. Manufacturers are still concerned about lack of clarity behind trade policy. Top declines are from textiles, apparel and furniture.

Increase in US Layoffs / Low Job Growth

Several companies, including Starbucks, Target, Amazon, Paramount, Molson Coors, and others, have laid off many employees. According to Challenger, Gray & Christmas, almost 950,000 US jobs were cut through September, the highest year-to-date total since 2020. The government sector has been hit the most with almost 300,000 cuts. Earlier this year, more than 60% of executives surveyed on LinkedIn said AI would eventually take over some of the tasks now done by entry-level employees. At the same time, instead of passing full tariff costs along to consumers in the form of higher prices, many big companies have absorbed the added levies and have chosen to trim their labor costs to protect their profits. Federal Reserve Chair Jerome Powell said he sees "very gradual cooling" in the labor market "but nothing more than that." However, other market perspectives continue to keep a watchful eye for signs of further deterioration. The unemployment rate was 4.3% as of August 2025, up from 4.2% in July and 4.0% as of January.

Inflation

According to the US Bureau of Labor Statistics, on October 24, 2025, the inflation rate was at 3% which is above the Fed's target of 2%. Although substantially below 8% as of 2022, the inflation rate has remained elevated for a stubbornly long period of time. Trump's tariff policies are expected to continue to keep inflation above 2%.

Summary

Key themes for 2025 and the outlook for 2026 include:

1. Consumers are feeling the pressure with fewer employment openings and inflationary pressures, with more consumers classified as subprime. Labor softness is also partially due to the rising use of AI for entry-level positions. Trump's tariff policies continue to have an impact on inflation as well as uncertainty which has impacted growth for businesses.
2. The 2026 outlook is that the fed rate will normalize to about 3% to 3.5%. With lower base rates and spreads tightening, BDCs will continue to see pressure on their weighted average yield on assets.
3. Spreads for new issuances have continued to compress throughout 2025. At the end of 2025, the majority of new issuances were priced at S+4.50%.
4. Continued convergence of the BSL and private credit markets as competition remains fierce. BSL terms are expected to infiltrate into private credit, potentially creating room for LMEs in private credit.
5. Secondaries are expected to see much higher volumes as investors enter the growing asset class. Several institutions have successfully raised significant capital to continue to invest in secondaries.
6. The rise of partial PIK or full PIK features in private credit continues to grow as lenders cooperate with sponsors to provide necessary liquidity relief. The increase in PIK features has also been driven by intense competition to secure new deals.
7. LMEs are top of mind for investors but given the expectation of potential issues with recovery given default, investors are now pushing hard for subordination protections.
8. The size and scope of the global private credit markets will continue to grow rapidly in the next few years as the asset class enters into new strategies such as infrastructure funds, asset financing, aircraft leasing, auto loans, and other areas.
9. M&A is expected to pick up in 2026 due to lower interest rates, greater clarity on tariffs, increased private equity sponsor confidence in the macro environment and pent-up demand for attractive investments.
10. Dividend recaps are expected to decline due to expanded exit opportunities.
11. Refinancing activity has most likely peaked.

Melissa Brady

- Melissa Brady brings more than fifteen years of experience providing valuation services across multiple asset classes, including fixed and floating rate debt, unitranche loans, convertible debt, preferred equity, common equity, warrants and options. She has worked with business development companies (BDCs), private equity, credit opportunity funds and venture capital funds.
- Melissa is an expert in the assessment and valuation of illiquid debt and equity securities that fulfill management's fiduciary duties, mitigate risk of fraudulent conveyance, enhance the credibility and transparency of investor reporting, protect shareholder value and provide benchmarks and support for fund raising and management fees.
- She has presented on the topic of middle market leveraged loans, broadly syndicated loans (BSLs) and bonds at several conferences, webinars and other industry-focused groups. Ms. Brady has been a contributing author and presenter on valuation best practices topics for the AICPA's valuation best practices guide and a working member on the Alternative Investment Management Association's 2018 Guide to Sound Practices for the Valuation of Investments.
- Prior to joining A&M, Ms. Brady spent eight years with RSM US LLP in New York, where she most recently served as the valuation industry leader for the financial services. Prior to that, Ms. Brady spent seven years with Houlihan Lokey focused on alternative investments.
- Ms. Brady earned a bachelor's degree in economics from Occidental College. She is a Chartered Financial Analyst (CFA) Charterholder and a member of CFA Society New York.

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