Research @ Citi Podcast Episode 76: Private Credit — What Goes Up, Must Come Down

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Rob Rowe (00:02)

Hi, everyone. I'm Rob Rowe, Acting Global Head of Research. Welcome to our Research @ Citi podcast. On the podcast with us today is Mike Anderson, our Head of Credit Strategy here at Citi.

Last October, we had a great conversation about the ins and outs of private credit, the developments in the market, how the market has been. And we're having a follow-up today in terms of where we are since last October.

Mike, one thing that I think has been of deep concern to clients, given remarks from people, from some competitors as well: What is the state of private credit right now? And what is the state of private markets in general?

We know that there's a lot of concerns around default potentially. There are situations in the Middle East, we have some geopolitical volatility as well. We have potentially higher rates. How is the market looking right now? How are the private credit markets looking?

Michael Anderson (00:51)

Yeah, by the way, I can't believe it's been six months since the last time we spoke. That flew by.

I still think we have two issues that people are grappling with. One is the idiosyncratic stories of borrower misrepresentation, that the growth of private credit was partially enabled by a loosening of lender protections, and that in the short run, you have potentially more of these situations. I still think that is fairly contained.

But especially over the last few months, starting in late January, there's a renewed focus on software and other sectors that might be disrupted by the AI buildout. These are situations that are going to take a while to play out. They're not going to play out over the next few weeks or the next few months — they're going to take a few quarters or a few years.

So what we saw in the broadly syndicated loan market, which trades every day, a lot of these loans sold off since the beginning of the year. They're probably off six, seven, eight points. Now they're priced at about 90 cents on the dollar, so clearly cheaper than the rest of the loan market, but not cheap that they're reflecting a lot of distress.

Right now investors are waiting for more clarity in the coming quarter as far as how these companies are performing. Now, sentiment remains very negative. We saw significant outflows from non-listed BDCs — these are the semi-liquid BDCs that generally have a 5% cap on outflows. So in general, we saw much larger than 5% outflow requests. Most of the managers stuck to 5%, although some have gone a little bit higher.

So now there's some concern around, OK, what's the liquidity profile of these funds? And also, what happens to financial conditions? If these BDCs are seeing outflows, they can't redeploy capital, they can't extend maturities, and that's another concern.

One thing about private credit vs. the broadly syndicated markets is that the maturity wall is a lot shorter. So some of this debt is going to need to be rolled over in fairly short order. Everyone's kind of figuring this out. Good thing is we've got the earning season coming up in the coming weeks, and we'll get some more color from managers in terms of how their portfolios are performing. And we're going to be looking at all sorts of metrics like non-accrual rates and pick utilizations and so on and so forth. So we should be entering a period of another flurry of headlines to digest.

Rob Rowe (03:19)

Looking at these, you mentioned liquidity conditions. How do you look at liquidity conditions?

And also within that question, I know that you've put together a metric to identify what you think is the potential default rate in the market. Maybe you could expound on both.

Michael Anderson (03;38)

Unfortunately, the market does have a bit of opaqueness to it. The rating agencies generally do not rate these loans, and so really what you're trying to figure out is, you're trying to get whatever public information that you can out.

So what we did is we developed a Stress Indicator, which takes the PIC utilization rate, adds the non-accrual percentage, and then actually compares — S&P has a default history of five years, actually probably closing on six years at this point — and we're able to look back historically at what that Stress Indicator leads to in terms of defaults over the medium term.

And then in addition, you could also look at another sentiment factor, because ultimately credit is about confidence. And when lenders lose confidence in a borrower, things can deteriorate fairly quickly. But back to a Stress Indicator looking at PIC utilization, non-accrual rates, and also where listed fund BDCs trade relative to their NAVs. And then you can kind of predict where default rates are going to go over the course of the next year or so.

Right now, we're in about the mid-4% range for defaults. We see it going up to 7%. So that is a meaningful increase. But the real question is going to be in the out years. Because remember, if you have a 2028 maturity that needs to be extended, you're going to need potentially a new lender or maybe even the existing lender to be comfortable extending that loan another three, five, seven years.

So even though the fundamentals of these software companies aren't necessarily deteriorating in the short run, when you're renewing a loan, you're taking a long-run view. And as we see internally in our day-to-day operations, the AI trade — or the AI expansion, the AI infiltration — is occurring at a rapid rate. And what that means is that you have a very wide range of outcomes for what AI means for all of these companies two or three years from now.

And so given that wide range of outcomes, you're ultimately lending money to these companies where everything goes great, you get par back; if things go poorly, then you have significant downside. So there's a mismatch between the level of volatility in the underlying operations and the solvency of these companies vs. the instrument, which is limited upside and significant downside.

So that's something that the market's really got to struggle with. But yeah, the Stress Indicator is something that we found that's definitely given some use in terms of trying to predict defaults.

Rob Rowe (05:58)

It seems like it's a combination of things that could potentially be both fundamental but could also be a liquidity issue. They seem to feed off of each other, but sometimes it's just an old-fashioned bank run that's going on in markets, and sometimes it's a fundamental issue.

How are you looking at, for instance … you said the non-accrual rate, I would think that would be a fundamental indicator vs. where liquidity conditions are, where people just want to get out of something, even though the fundamentals, as you suggested, are not as severe as maybe people think.

Michael Anderson (06:29)

Yeah. Well, it goes back to credit being a confidence game and in the short run, when lenders lose confidence, then things can deteriorate.

But back to the original point around the original question, which was around the non-accrual rate. So, the non-accrual rate still remains fairly well-behaved, call it in the mid-2%, 3% range for most of the borrowers. But what we're going to be looking for is the trend in that non-accrual rate.

Again, those are problems that are existing in the portfolio. Those aren't really the AI disruption names. The AI disruption names, potentially you might see some PIC utilization there, because maybe you're seeing companies wanting to conserve their liquidity and their cash position to expand, or to do something to combat or to counter the AI infiltration. Many of these credit documents permit a PIC utilization.

So these may not be defaults in the classic sense that you've defaulted on the terms of your agreement, but it's clearly a sign of —

Rob Rowe (07:25)

Not a positive sign.

Michael Anderson (07:26)

It's not a positive sign. It's a sign of liquidity being at a premium for these companies that they have to make a decision between paying debt and interest and using it for whatever other purposes that they might need it for.

Rob Rowe (07:37)

And so from the fundamental side, you're saying things look still well-behaved. Does that include PIC utilization as well as non-accrual rate?

Michael Anderson (07:44)

Yeah. So there's really more in the non-accrual rate. The non-accrual rate remains well-behaved. As far as fundamentals go, when you listen to these earnings calls — and obviously we'll be watching this fairly carefully — the managers are still, for the most part, expressing confidence on a broad basis. They might talk about a couple of names here and there, but ultimately they will say that their portfolios and the companies in their portfolios are performing up to budget, they're performing up to their expectations.

And again, for the AI-disrupted names, it's not surprising because we haven't seen a lot of disruption. But that disruption could start to be apparent in the coming quarters.

Rob Rowe (08:18)

Mike, you mentioned the volatility of outcomes in regard to AI. And I imagine when you say that, you mean that there could also be positive outcomes for AI in terms of, say, productivity for some of these companies. So maybe you could delve a little more into the issues surrounding the software space and what happened there.

And also, are there other sectors? For instance, is private credit made up of a broad set of sectors, or is the sector concentration in private credit among more-sensitive tech names or healthcare names where there could be pressure?

Michael Anderson (08:52)

Yeah, it's a great question. Take a step back: What are the sort of companies that you like to lend to? You typically like to lend to companies that have robust free cash flow generation, but also visibility into that generation. So if the company has contracts that are multi-year, you're comfortable that those contracts aren't going to go away overnight. That's always a really good place to start. You also like to have assets that if things go wrong, you have assets that are worth something.

Now, if you think about some of these recurring revenue business models — and it doesn't have to be just software, but software is a classic one — the thought was historically that recovery rates would be very strong because you have an entrenched customer base, you have significant visibility into the performance of that company in out years. The problem is that AI has the potential to disrupt all of those assumptions.

And it's like the old saying, "it's not what you don't know that kills you, it's what you know for certain that could kill you." And so very often, there was such a great degree of comfort around these businesses that their enterprise multiples, their price tags rose, and made people more comfortable to provide leverage because you're saying, "oh, loan to value is 40%, it's 50%." You look at software companies in the public market and their enterprise multiples have come collapsing down. So now all of a sudden that 40% or 50% loan to value? It's a private company, so you don't get daily marks on what the equity is worth, but clearly that has compressed significantly. So the original loan to value isn't necessarily indicative of today's loan to value.

But you also asked the question, Rob, "Are there positive aspects?" And there's no doubt there are positive aspects. Because if you're a gaming company and you have a team of software engineers and they are coding for games, well, if they're going to be more productive, then you could create and customize your games to a much larger degree. So that's the upside on the change.

But again, as a lender, par is my upside. As a bondholder, maybe par plus my call price is upside. So if the upside plays out, great, but I don't participate in the upside to the same degree that equity holders do.

And then in the downside, the pain is shared across the capital structure — maybe a little less so for lenders, but they're participating in that pain as well. So again, it kind of goes back to that mismatch between the instrument, the upside/downside of the instrument, vs. the binary outcomes that could happen.

Rob Rowe (11:06)

And in terms of the software sector in particular, it did take a relatively large hit. Is it stabilizing now, or is that concern still around? And if it did stabilize, why did it stabilize then?

Michael Anderson (11:22)

You're absolutely right. And so there has been some stabilization. If you look at ETFs that track software? Big decline beginning of the year, and then over the last month or so, some stabilization. And we've seen that filter into the credit markets where software loans and software bonds have been performing a little more closely in line with the market.

Now, if you look under the surface, given the fact that some of these names are distressed, there's a wide range of performance. So on average, everything is kind of performing in line with the market. But under the surface, there are some loans that are up 10 points or some loans that are down 10 points.

Anytime you enter a distress scenario for a loan, there's going to be a lot of jockeying around amongst lenders and what the restructuring could look like on that front. So that certainly has helped stabilize the situation.

So why has that happened? It's sort of a million-dollar question. My interpretation is that this segment, whether you're looking at it in equities and high yield or in private credit, has cheapened enough that it really stands out vs. everything else. However, the triggers to that going a lot lower are going to take some time to materialize.

So we don't have enough information for the next step of broad price discovery. Now, maybe we get some headlines that show that the evolution of AI is slowing significantly and is not working in certain sub-segments in certain industries where software is used. That's certainly possible. Or it could be the other way around, that the adoption is a lot faster and the business intermediation is a lot faster.

But I think ultimately you cheapen up relative to the rest of the market. You're sort of standing out, but you're not cheap enough that you're reflecting distress and default. You're just sort of like, “Something is wrong.”

And this is sort of the way credit markets are, Rob. Credit markets are typically like in one of three states.

It's either in a euphoric state where spreads are really, really tight — people are throwing their hands up saying, spreads are so tight, what does it do with this?

On the other hand, you could be going through a cycle, at the bottom of the cycle, and spreads are extremely wide for whatever reason is driving spreads wide for that cycle.

And then usually you're kind of in no man's land, where you've widened out maybe for high yield instead of being 300 and really, really tight. Historically, you're at 450 or 500 and people are scratching their heads saying, “Uh-oh, is this November 2007 or July

2001 where we're about to go through a really, really big downturn?" Or is it the other dozen or so times that this has happened? And in 12 months or six months, we'll be back to 300.

And so that's sort of what's happening is with software. Software is kind of in that middle ground where everyone's kind of like, "I don't know, are we heading a lot wider or are we going to like normalize and come back in?" We just don't have enough information really to resolve that question.

Rob Rowe (13:52)

A lot of the times with private credit, we're obviously concentrated on fundamentals and we're concentrated, as you pointed out, you're going to be looking very closely at earnings.

How does a geopolitical event like the situation in Iran, closing of the Strait of Hormuz, affect private credit? And maybe it's just a question about how does it affect credit overall, but does it also have a more acute effect on credit itself?

Michael Anderson (14:17)

So my thought is that it definitely has an effect. It goes back to, "What's the duration of the conflict?" I think it's lingering out there in the headlines, and we certainly see in the markets on a day-to-day basis that it can influence valuations pretty significantly.

But how much does it affect private credit? Well, in the short run, we did have some tightening of financial conditions in March where spreads were widening. Obviously, Treasury yields rose materially, fed somewhat by inflation expectations, but also by real yields.

Then of course the Fed was expected to be cutting this year and now the markets are expecting a much more gradual cutting cycle or maybe no cutting cycle at all, maybe even a little bit of a chance of a rate hike.

So it does affect the markets in the short run. But ultimately these high-yield companies know that they cannot count on regular access to capital. So they set up their balance sheets so that they only tap the capital markets every three or five years.

It's sort of like a swimmer in the ocean taking a deep breath and going underwater as a wave is coming and the wave passes over them, then they come back up. If you need to come up for air at the wrong time, when the wave is there, you know that could be an issue. A three- or six-month shock should be OK for these companies, but if you need capital at the wrong time, it can be trouble.

Having said that, the market right now is functioning fairly well, Rob. I mean, last week, the week of April 13, we had the largest week for high-yield issuance since August of 2020. That was during the pandemic when companies were raising capital hand over fist. And there's a lot of AI issuance: We've had $13 billion of AI issuance this month already in terms of AI enablers, and that compares to $17 billion for all of 2025.

So for the most part, financial conditions are fairly loose. There's no doubt that the AI-disrupted names are still sort of on the outside looking in. But broadly, what we're seeing in the Middle East hasn't hampered companies' ability to raise capital.

Rob Rowe (16:13)

Got it. Mike, I could go on forever. This is highly insightful. Thanks so much for being on the podcast today.

Michael Anderson (16:20)

Thank you for having me.

Rob Rowe (16:22)

This podcast was recorded on April 24, 2026.

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Thank you so much, everyone.