

Our take on the public pillorying of private credit



Wealth Management
Dominion Securities

A challenging environment presents an opportunity for skilled private credit managers to distinguish themselves

Everything in moderation: Private credit returns and fund flows

Investor enthusiasm for private credit has moderated alongside returns, negatively impacting fund flows. Mounting concerns about the AI-induced upheaval in the software industry and some notable non-investment-grade bankruptcies have clouded investor sentiment. The moderation in private credit returns to high single-digits in 2025 from low teens during the prior two years has been primarily driven by declines in base rates and credit spreads on new deals rather than credit losses.

Disparate times: Growing signs of performance dispersion

While credit stress broadly appears contained so far, there are growing signs of performance dispersion—both in terms of portfolio returns and in some of the credit metrics that we monitor as a part of our due diligence process. Within the private markets generally, but also specifically within private credit, manager dispersion—the performance gap between top- and bottom-quartile managers—is wide. During periods of stress, this dispersion can widen further. As a part of both our initial and ongoing due diligence, we are attentive to the level and trend in defaults/non-accruals, increases in payment-in-kind (PIK) income, and closely track the proportion of loans at stressed prices.

Liquid scourge: Redemptions from many private credit funds

The current environment reflects a liquidity squeeze, more than a systemic credit shock, in our view. Investor redemptions from private credit funds began increasing in the second half of 2025 and have climbed higher through the first quarter of 2026, in many cases resulting in net outflows and funds enforcing their redemption limits. Redemption limits (i.e., restrictions placed by fund managers on the amount of capital that investors can

withdraw during a specific period) can be uncomfortable for investors, but they are a common feature of products within the alternative asset class (which includes private credit). Fundamentally, this restriction is in place to protect all unitholders, particularly during periods of stress given the limited market to trade the underlying investments. We believe this marks the first time many of the largest open-end structures in private credit are facing outflows—and in some cases it is the first time investment managers in the space are confronting net outflows. Managers with disciplined leverage profiles and conservative positioning are better suited to navigate the current liquidity-constrained environment and potentially capitalize on emerging opportunities, in our opinion.

Re-visiting the value proposition: Higher returns (if losses are minimized)

We acknowledge the near-term headwinds but continue to view private credit as a useful tool for income generation. The higher yield that private credit offers, in exchange for credit and illiquidity risk, positions it to be among the highest-returning segments of the fixed income market. It is incumbent on managers to be disciplined and effectively manage these risks to ensure losses do not overwhelm the premium yield. In an AI-disrupted environment, we believe cycle-tested managers with proven risk management processes are better positioned to succeed.

A potential exchange traded opportunity to fade the negative headlines

Negative sentiment can create opportunities for value-oriented investors. The sell-off in exchange-traded private credit (often referred to as listed business development companies or BDCs for short) may be overdone and potentially represents a buying opportunity for nimble investors as many of these funds trade at sizable (in excess of 20%) discounts to their reported net asset value (NAV).

All values in Canadian dollars and priced as of March 31, 2026, market close, unless otherwise noted.

Past performance does not guarantee future results.

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For important disclosures and author's contact information, see [page 13](#).

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RBC Dominion Securities Inc.

Key topics in this piece:

- Background on the private credit market and linkage to broader financial system,
- Moderation in absolute and relative returns have dampened enthusiasm for private credit,
- Modest deterioration—not a collapse—in the key credit metrics we follow,
- Software as a disservice: private credit has outsized exposure to a sector facing challenges,
- Waning enthusiasm for private credit has hurt fund flows, and
- Potential opportunity in exchange-traded private credit funds.

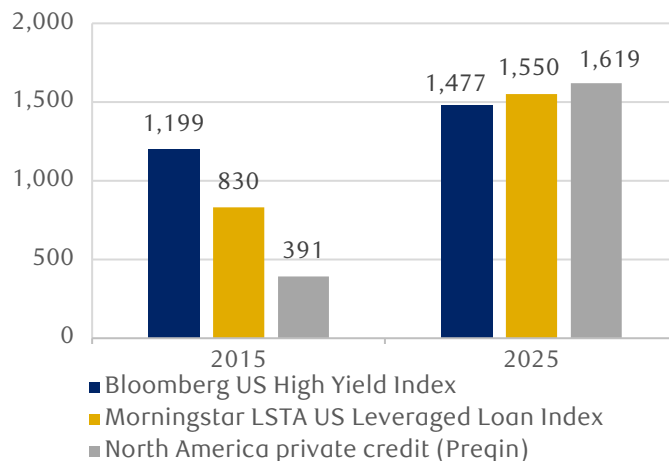
Background on the private credit market

The fastest-growing segment of the non-investment-grade lending market

Private credit refers to loans that do not actively trade like bonds or broadly syndicated leveraged loans. These are typically five- to seven-year floating loans that are priced at a credit spread over a variable base interest rate (typically the Secured Overnight Financing Rate, referred to as SOFR, on USD-denominated loans). The universe of private credit is broad, spanning both corporate direct lending and asset-backed credit (which includes loans secured against real estate and infrastructure assets). Corporate direct lending is the most prominent segment of the market and refers to loans extended to privately owned companies, at varying stages of their lifecycle. It is a category that has seen particularly strong growth over the last decade, nearly quadrupling in size since 2015 and meaningfully gaining market share as a provider of capital to non-investment-grade borrowers. As it took market

U.S. leveraged finance market

(US\$ billions)



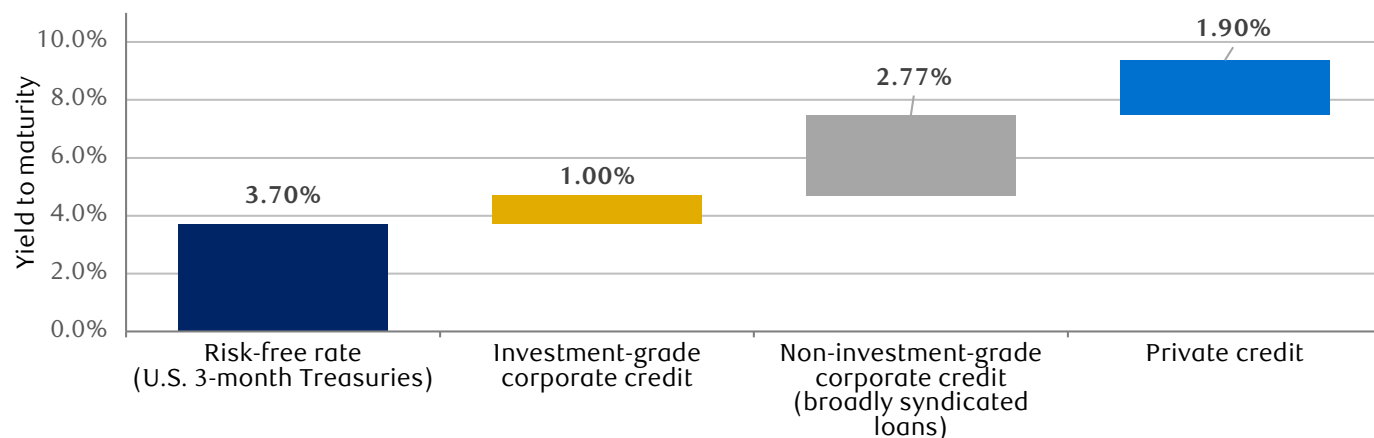
Source - Bloomberg, Preqin, and LSTA

share away from the high yield bond and leveraged loan markets, direct lending went from representing roughly 15% of the U.S. leveraged finance market in 2015 to approximately 35% in 2025. When we refer to private credit in the remainder of the publication, we are specifically referring to corporate direct lending.

The appeal to borrowers: Greater certainty and flexibility

Private credit managers highlight greater certainty, speed of execution, and flexibility as key benefits offered to borrowers. These benefits are a byproduct of a borrower working directly with a single private lender or a small group of private lenders rather than with a financial institution (or a syndicate comprised of many financial institutions) acting as an intermediary between a borrower and a larger group of investors. The non-intermediated process allows for greater customization

Building up to private credit’s premium yield



Note: Based on most recent data available. Investment grade corporate credit proxied by Vanguard Intermediate Corp. Bond ETF, non-investment-grade corporate credit proxied by Invesco Senior Loan ETF, private credit proxied by the 3-year takeout yield of the Cliffwater Direct Lending Index-Perpetual.

Source - U.S. Federal Reserve Bank of St. Louis, Vanguard, Invesco, and Cliffwater

for the borrower. A private lender can offer greater certainty of execution because they are speaking for their own capital, rather than acting as an agent for a different set of end investors.

What is appealing to investors: Higher yields

Borrowers are typically willing to pay lenders a premium in exchange for the attributes noted above, and the lender is internalizing the services that a syndicate of banks typically earn a fee for—so this translates into a higher yield for investors (chart bottom of previous page). Whereas loans sold via the syndicated loan market price regularly in an active secondary market, private credit does not. Some investors also prefer the smooth ride that is a function of private credit’s lower observed volatility. We would caution that lower observed volatility is largely a function of the appraisal process of the underlying loans, which is a monthly process reported with a lag (in contrast to the daily pricing of publicly-traded bonds).

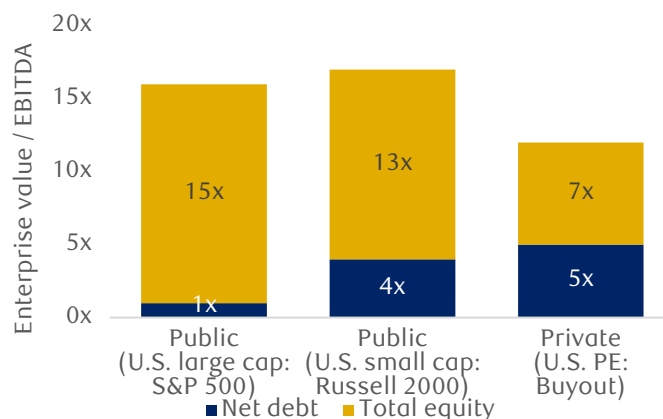
A higher yield is a form of compensation for both credit and liquidity risk

Private credit is one of the highest-yielding segments of the fixed income market because (1) investors are being paid a higher yield to hold less liquid assets and (2) many of these borrowers are more leveraged and/or smaller companies.

Credit risk: Private credit borrowers are typically smaller and more indebted

The assets held in a private credit fund are loans providing leverage for the operating businesses that they are financing. Some of the potential higher returns in private markets reflect compensation for the risk that is associated with the leverage profile of these investments. The top-right chart illustrates this dynamic by comparing the debt and equity components that constitute the enterprise value of public and private companies. Roughly half of the enterprise value of private companies is comprised of debt, compared to less than 25% for public companies.

Private equity companies trade at lower valuations but have higher leverage



Note: Estimated 5-year average from 2021 to 2025, based on last 12-month earnings.

Source - RBC Wealth Management and Bloomberg

investments in the portfolio. The semi-liquid label reflects that these vehicles were designed to provide investors the ability to sell (often up to a certain amount at regular intervals), by having funds repurchase units at NAV.

There are variants of these private credit products that are exchange-traded, often referred to as listed BDCs. These are perpetual vehicles, that are listed on public stock exchanges and traded daily. NAV tends to be a marker for where these funds trade, but at any given time these funds can trade at either a discount or premium to NAV. We refer to these as exchange-traded private credit funds in the remainder of the publication.

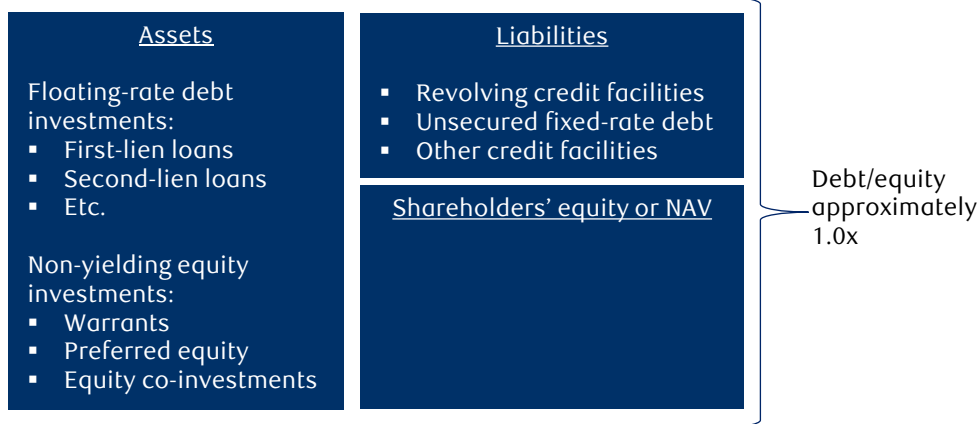
A levered structure

Most private credit funds incorporate leverage to increase their return prospects with the aim of enhancing returns. The chart below shows how a typical fund raises \$1 of equity from investors and another \$1 of debt from a collection of lenders to purchase \$2 of assets. In our view, the use of leverage needs to be evaluated in the context of the investment strategy. This is a way to drive enhanced

Balance sheet of a typical private credit fund

The structure of an open-end semi-liquid private credit fund

The fastest-growing part of the private credit market is open-end, semi-liquid funds that typically acquire floating-rate loans and are required to pay out the bulk of their earnings in the form of distributions to investors. Purchases and sales of these funds are done at NAV based on the appraised fair value of the underlying



Source - RBC Capital Markets

return as there is a positive net interest margin for these vehicles as the yield on their loans typically exceeds their cost of debt. However, this use of leverage also amplifies the impact of losses.

A higher fee structure

The chart below also shows a typical fee structure for a private credit fund. Private market investments tend to charge higher fees than traditional investments. In addition to a management fee, these funds often charge a performance fee. Additional fees are incurred to operate these funds and package them in a format that is suited to individual investors. We believe the higher investment management fees reflect the more involved investment due diligence that takes place with private companies, and the higher operating expenses reflect difficulties that clients may have investing at scale in the space on their own. Our due diligence process involves scrutinizing all fee and expense items to understand and be able to compare the fully loaded fee profile across products.

Liquidity risk: Redemption restrictions exist given illiquidity of underlying loans

Private credit funds are vehicles that generally accept monthly subscriptions and allow for quarterly redemptions. Redemptions are typically subject to a cap of 5% of a fund’s NAV and are prorated if this figure is exceeded (i.e., an investor attempting to redeem 100 units would have 50 units accepted if there were \$1 billion of redemption requests on a fund with a \$10 billion net asset value). Liquidity refers to the ease with which an asset can be converted into cash without affecting its market price. By definition, private assets do not benefit from the price discovery or liquidity of the public markets. Each investment is privately negotiated, and there may be limited alternative buyers with the means and expertise to purchase any given asset. Even if a fund offers regular redemptions or has been held for years, investors might not be able to cash out when they wish. As a rule of

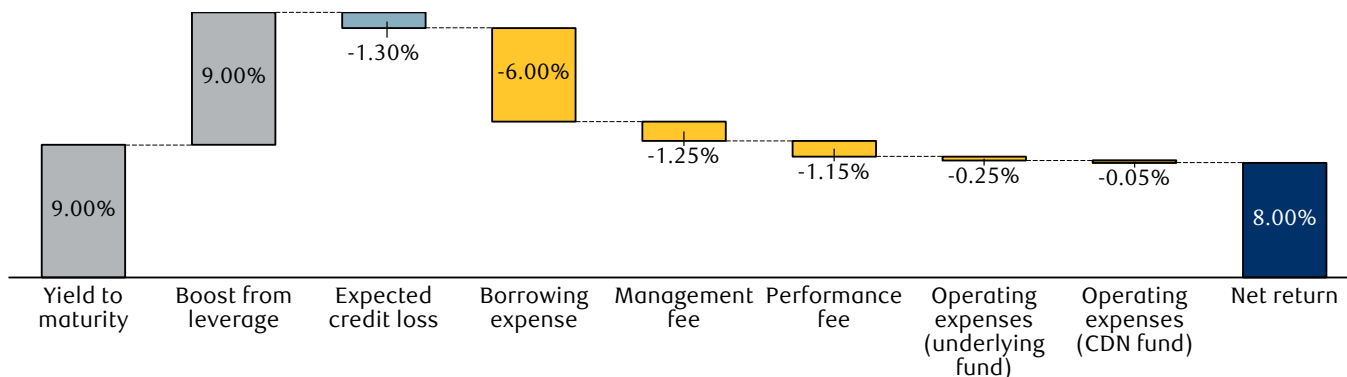
thumb, investors should expect a holding period of five to ten years or longer depending on the structure.

As part of our due diligence, we assess whether the redemption frequency and limits are set appropriately based on the sources of liquidity that a fund has at its disposal. We prefer investment managers that have demonstrated success in managing a semi-liquid structure through downturns and periods of elevated redemptions. Credit has a natural structural advantage versus other private market categories in that loan maturities and refinancings are a recurring source of liquidity that typically amounts to 15%–40% of a portfolio per year.

Valuation risk: An inherent challenge given the lack of trading activity

Open-end semi-liquid private credit funds are marked-to-model, meaning the underlying loans are valued using a financial (discounted cash flow) model given that they do not trade regularly. Loans are typically valued at their face value (par) at origination but can fall meaningfully below par to the extent that the probability of repayment becomes less certain. Given there is a level of subjectivity around valuation model assumptions and investment managers earn fee income tied to the valuations, we prefer valuation procedures that involve independent oversight and where the frequency is aligned with the timing of subscriptions and redemptions. In our ongoing monitoring of these vehicles, we seek to identify loans that have fallen in value below 90% of par that to us suggest material underperformance and a potential early indicator of a default. As part of the publicly available disclosures many of these funds are required to make through the U.S. Securities and Exchange Commission (SEC), details about each underlying loan in the portfolio including where it is valued are typically available quarterly.

Expected return decomposition of a typical private credit fund



Note: Based on estimates of market conditions as of Dec. 31, 2025
 Source - RBC Wealth Management

A systemic shock: What to watch

As headlines have grown increasingly negative, commentary about private credit has increasingly bled into overall macro economic analytical commentary. We acknowledge the current slowdown in private credit could have broader implications, but we see a number of mitigating factors at the moment when we assess some of the key linkages between private credit and the broader financial system.

Does the public credit market remain open for business?

In our view, what we are seeing is a slowdown in the fastest-growing segment of the non-investment-grade credit market. Within this segment, public market options—such as the broadly syndicated loan market and high yield bond market—are equipped to provide financing for many private credit borrowers, and there is recent evidence of those markets re-gaining some of the market share lost over the last decade. If the public market is able to provide borrowers with capital to refinance debt or fund business expansion plans, this minimizes the macroeconomic impact of the slowdown in private credit.

What to watch at banks and insurance companies

From a liquidity perspective, most private credit is held in funds that either restrict (normally at 5% per quarter) the amount of the fund available to meet redemptions or via closed-end structures that return capital to investors as loans are repaid. Given the inherent illiquidity of the underlying loans, these are appropriate guardrails. There is exposure within the financial system at banks and insurance companies that are worth watching, in our view. Banks lend money to private credit funds, but this is done with a priority claim on assets, so banks are less exposed to this market segment than in prior cycles when banks were the ones directly originating these loans. The insurance industry is one of the largest buyers of private credit, and we believe this merits paying attention to; however, these positions are matched against very long-term liabilities.

Returns and relative appeal of private credit

Moderation in absolute returns as both base rates and credit spreads have fallen

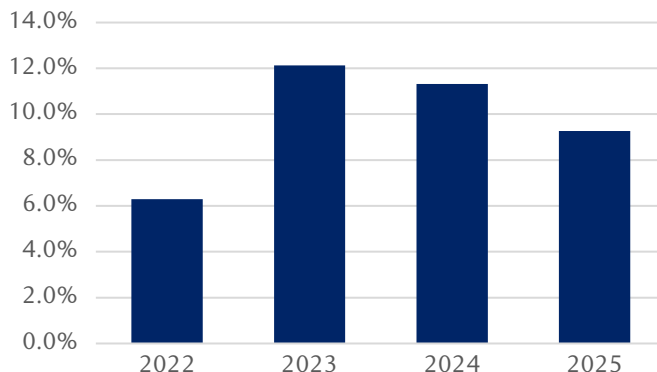
Private credit returns have normalized to high single digits in 2025 versus the low teen returns that the asset class generated in 2023–2024, and returns have hovered near flat through the first two months of 2026 (these funds typically report results with a one-month delay).

According to Cliffwater, the lower private credit returns in 2025 were not driven by credit losses. Realized losses modestly declined to 0.64% in 2025 versus 0.86% in

2023 and remain below the average loss rate of 0.99% since 2005 based on the Cliffwater Direct Lending Index (covering over 21,000 directly originated middle market loans in the U.S. totalling \$549 billion).

Cliffwater Direct Lending Index

Calendar year net returns

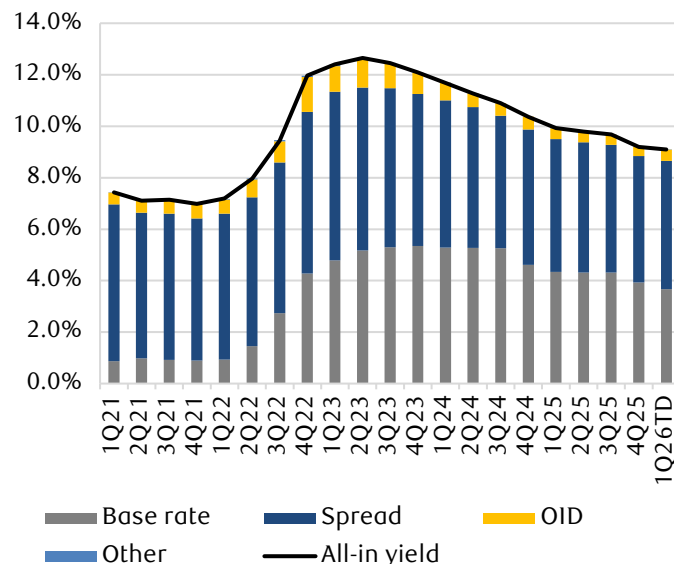


Note: Cliffwater Direct Lending Index-Perpetual refers to the levered net of fee return of private loans in perpetual non-traded BDCs (open-end semi-liquid private credit funds).

Source - Cliffwater

Given the floating rate nature of the loans, private credit yields have fallen by nearly 350 basis points (bps) since peaking in 2Q23. This decline was driven in almost equal measure by Fed rate cuts and credit spread tightening on new loans added to portfolios. Commensurate with the reduction in portfolio yields, most managers have lowered their distribution rates from the 2023–2024 peak levels.

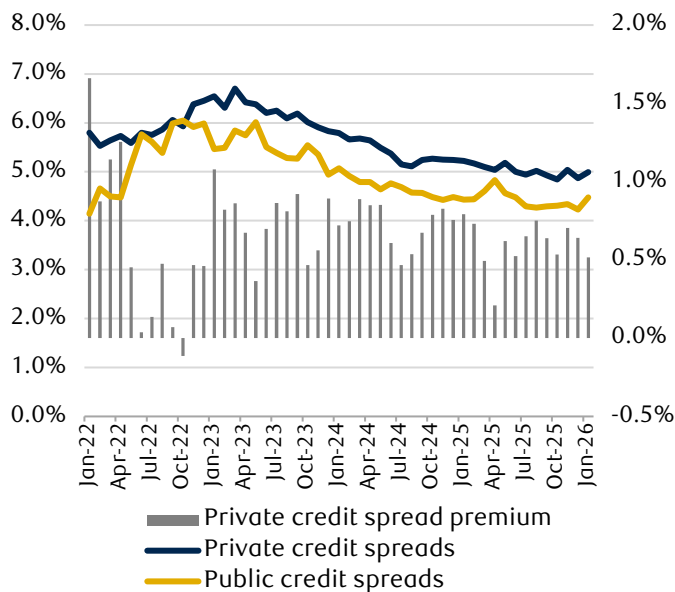
Private credit yields



Note: Private credit yields proxied by new issue first lien all-in yields of private equity owned company loans. OID refers to a small original issue discount that private lenders commonly obtain.

Source - Cliffwater

Comparing spreads of similar credit quality private and public loans



Note: Private credit spreads proxied by Cliffwater new issue first lien sponsor (private equity owned company) loan spreads. Public credit spreads proxied by the Bloomberg US Leveraged Loan Index (B1/B2 rated loans).

Source - Cliffwater and Bloomberg

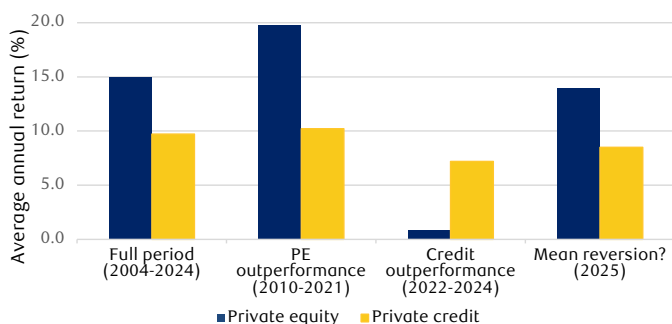
Moderation in excess yield versus public credit (leveraged loans)

Private credit’s spread premium over leveraged loans (floating rate bank loans) has modestly declined since spreads in both markets peaked in early 2023. The spread premium appears to sit currently just shy of the average over the last three years.

Underperformance versus private equity: An end to the anomalous period of outperformance

Private credit has underperformed private equity by over 5% annualized since 2004 based on data from MSCI. This

Private equity versus private credit (2004–2025)



Note: Private equity proxied by MSCI US Private Equity Closed-End Fund Index (gross return). Private credit proxied by MSCI US Private Credit Closed-End Fund Index (gross return). 2025 returns include an estimate for calendar 4Q25.

Source - RBC Wealth Management and MSCI

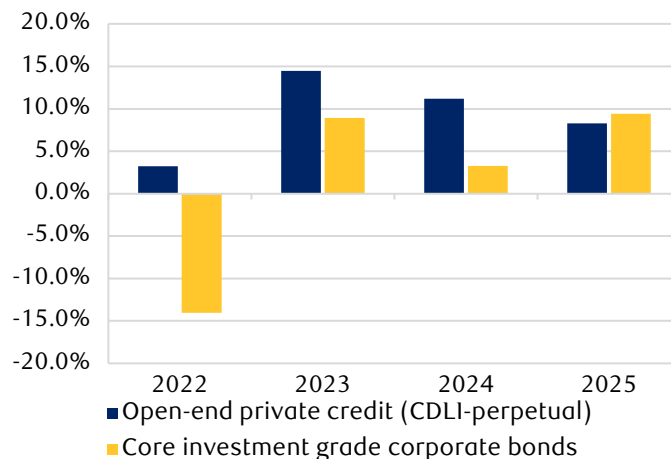
is unsurprising to us given the different positions in the capital structure, as private credit is typically a senior-ranking asset used to finance private equity transactions. However, private credit has outperformed private equity (cumulatively and each individual year) from 2022–2024. This anomalous period appears to be subsiding, as relative performance in 2025 was more in line with long-term averages.

Underperformance versus public fixed income: Unwinding some of the outperformance

Private credit has historically outperformed public fixed income given the illiquidity and credit risk premiums that investors could potentially earn in private credit. The Cliffwater Direct Lending Index has generated 10.3% and 9.4% over the last five and ten years respectively, outperforming floating rate public credit (Morningstar LSTA US Leveraged Loan Index) by approximately 3.5%–4.0% over this period. It has also outperformed fixed rate high yield debt (Bloomberg High Yield Bond Index) by nearly 6.0% over the last five years and by almost 3.0% over the last ten years.

Mean reversion in returns for private credit against public investment grade fixed income

Calendar year performance (2022–2025)



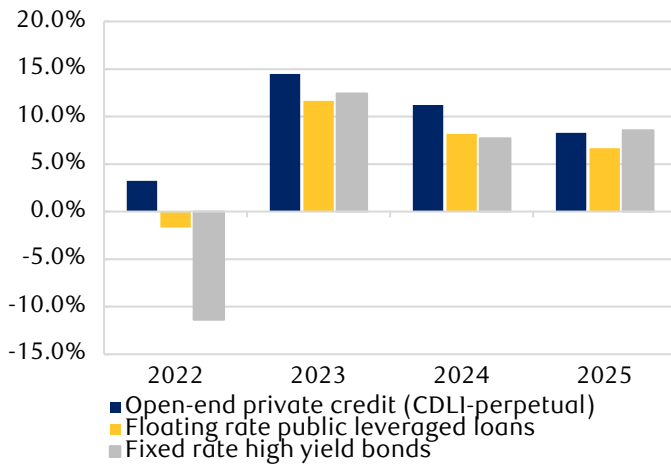
Note: Core investment grade corporate bonds proxied by Vanguard Intermediate Corp. Bond ETF. Open-end private credit proxied by Cliffwater Direct Lending Index-Perpetual (levered net of fee return of perpetual non-traded BDCs).

Source - Cliffwater and Vanguard

While floating rate private credit continued to outperform floating rate public credit (leveraged loans) in 2025, another anomaly was that private credit underperformed both investment grade (chart above) and high yield fixed income in 2025 (chart on next page). Rates declining since 2024 have provided a tailwind for fixed rate debt, which outperformed over this period (conversely, this was a headwind in 2022 when rates spiked and fixed rate debt significantly underperformed).

Mean reversion in returns for private credit against public high yield fixed income

Calendar year performance (2022–2025)



Note: Fixed rate high yield bonds proxied by the iShares iBoxx \$ High Yield Corporate Bond ETF. Floating rate public leveraged loans proxied by Invesco Senior Loan ETF. Open-end private credit proxied by Cliffwater Direct Lending Index-Perpetual (levered net of fee return of perpetual non-traded BDCs).

Source - BlackRock, Cliffwater, and Invesco

A modest deterioration—not a collapse—in credit metrics

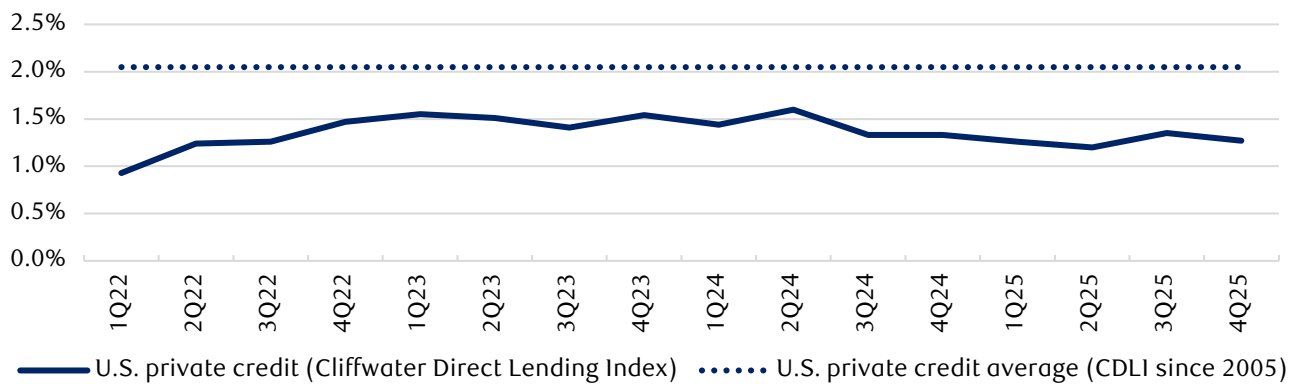
Over the last few years, there has been some deterioration in credit metrics. It is worth acknowledging that most direct lending borrowers in the private credit market, if rated, would be considered below investment grade; therefore, a certain level of defaults is to be expected given a long-term default rate of 3%–4% in public non-investment-grade markets.

Although private credit defaults/non-accruals have ticked up since early 2022, they are running at 1.3%, which remains below their 2.1% 19-year historical average (as per Cliffwater Direct Lending Index).

In part, credit defaults/non-accruals are likely understated because of the prevalence of payment-in-kind income (referred to as PIK throughout this piece). PIK defers cash interest on a loan to the maturity date. An increase in PIK income is a risk we monitor, as it could suggest lenders are postponing defaults by offering interest rate relief. We are particularly attentive to an increase in PIK driven by cash to PIK loan amendments. In contrast, some lenders offer PIK at the outset of a loan for a temporary period in exchange for a higher spread and may not necessarily

Private credit non-accruals remain contained and below historical averages

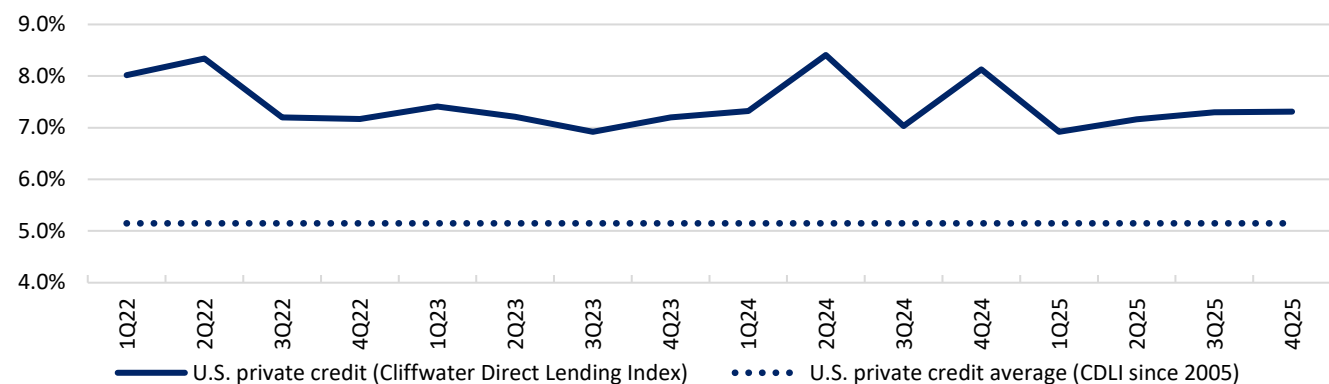
(% portfolio at cost)



Source - RBC Wealth Management and Cliffwater

PIK income above historical average

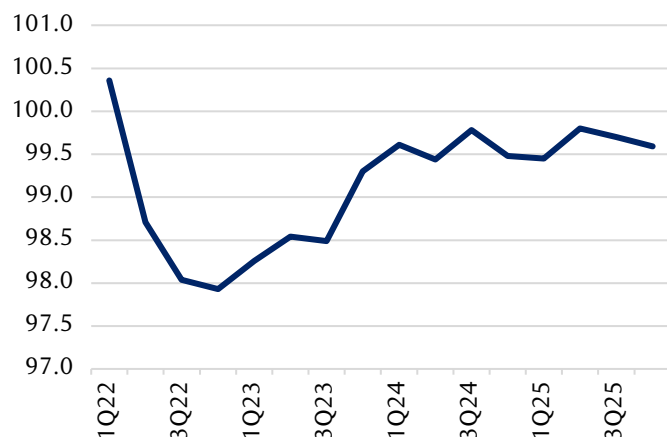
(% total investment income)



Source - RBC Wealth Management and Cliffwater

U.S. private credit

Fair value/cost



Note: U.S. private credit proxied by Cliffwater Direct Lending Index. Source - Cliffwater

reflect a struggling borrower. To the extent this dynamic extends the financial life of a borrower, it can reduce the ultimate recovery value lenders recoup in the event of default.

PIK income for the broader market represents approximately 7.3% of total investment income, above the 19-year average of nearly 5.2%.

A rise in performance dispersion across underlying loans

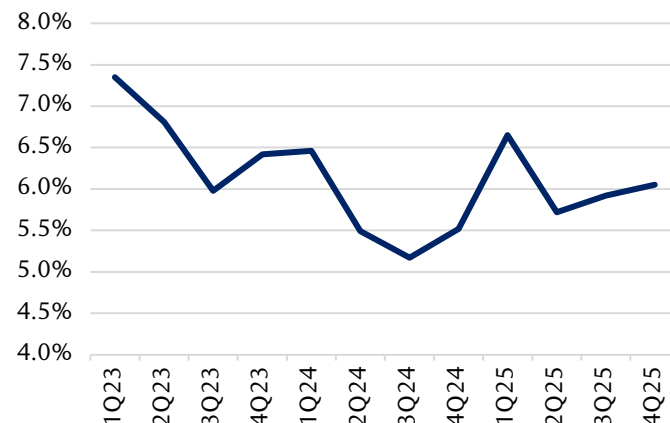
Private credit portfolios are valued near par today (chart above), which is generally indicative of a low level of distress. However, portfolios valued near par may be more susceptible to unrealized losses arising from spread widening events, such as what we are witnessing through the first three months of 2026. Performance for the space has generally been flat as unrealized losses have offset income.

Underneath the surface, there has been dispersion in performance across underlying loans. On average, around 6% of private credit portfolios are valued at stressed levels below 90% of par (top-right chart). This figure has ticked up over the last year. Sectors that accounted for the largest fraction of these stressed loans in 2025 included: consumer exposed retail and automotive sectors, technology (including software), transportation, and general manufacturing and construction.

To evaluate and compare the credit health of portfolios, we track a more encompassing metric that we call at-risk-loans. These include loans currently on non-accrual, loans formerly on non-accrual and restructured, as well as all other loans valued at less than 90% of par.

An uptick in stressed loans since 3Q24

Stressed loans - U.S. private credit (% portfolio marked <90% of par)



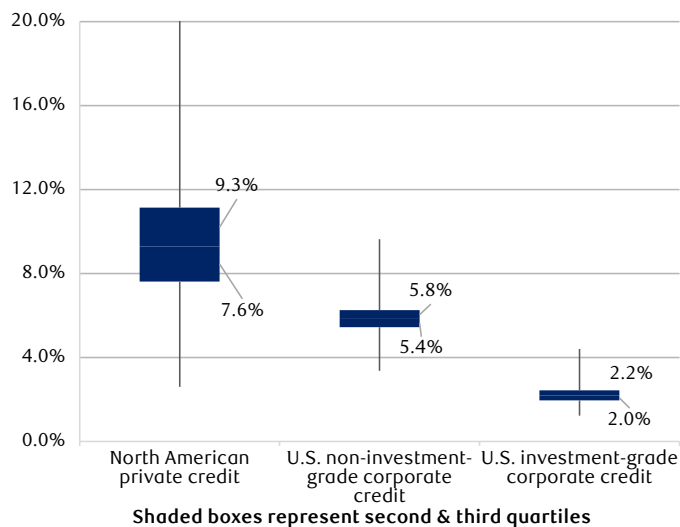
Note: U.S. private credit proxied by Cliffwater Direct Lending Index. Source - Cliffwater

A rise in performance dispersion across managers

This dispersion in loan performance appears to be translating to dispersion in manager performance. While some funds have posted only modest NAV declines, others have recognized meaningful markdowns in 4Q25,

Significantly greater dispersion of outcomes in private credit than traditional fixed income

Comparing dispersion in returns - private credit versus traditional fixed income (2016–2025)



Note: North American Private Credit proxied by average performance of six North American Direct Lending closed-end fund vintages (2015-2020) based on data from Preqin. US Non-Investment Grade Corporate Credit proxied by ten-year annualized return as of Dec. 31, 2025 of Morningstar's US Fund High Yield Bond Category. US Investment Grade Corporate Credit proxied by ten-year annualized return as of Dec. 31, 2025 of Morningstar's US Fund Intermediate Core Bond Category.

Source - RBC Wealth Management

including one fund that saw a nearly-20% NAV decline. Manager dispersion tends to be higher across alternative investments, including private credit, versus traditional stock and bond investments. The dispersion may also widen in more challenging environments. In our view, this highlights the importance of prudent due diligence and investment manager selection. We believe that portfolios that are more diversified, employ less leverage, and those that lend senior in the capital structure (first in priority for repayment) to larger companies may experience less downside risk. While use of fund leverage could enhance return in a normal market when defaults are low, it could also mean larger losses in the event of credit impairments, in our opinion.

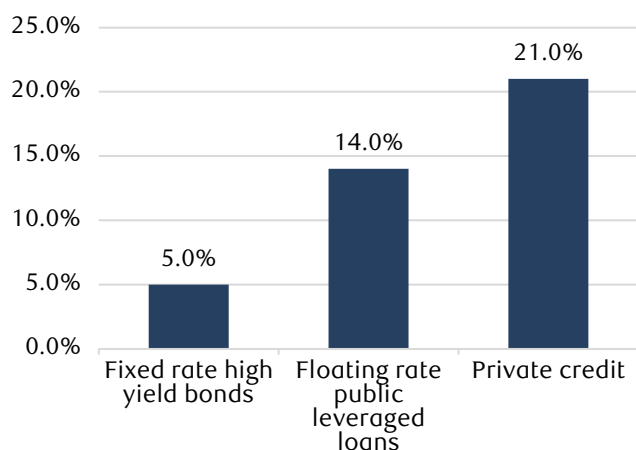
The latest concern is that software could contain a virus

Many public software equities were down more than 20% in the first three months of 2026. Investors appear concerned about the potential for AI to threaten competitive moats and future cash flows. Public software loans have dropped in value approximately 7% during the first two months of the year. Software loans accounted for the largest share of loans priced below 80% of par in the leveraged loan market.

Notably, private credit is more exposed to software companies than other parts of the credit market, including leveraged loans and high yield bonds. We estimate that software loans on average represent roughly 20% of private credit portfolios.

Software

(% of market in the U.S.)



Source - RBC Wealth Management and Bloomberg

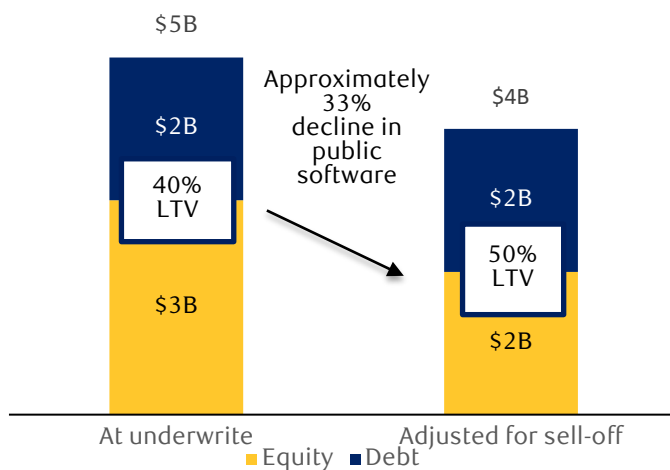
It may be a mistake to paint software with such a broad brush, as there are likely to be winners and losers. We believe the winners will likely be able to leverage AI to improve the value proposition delivered to customers, and the losers would be at risk of being disintermediated

from their customers by AI. Also, many potential outcomes exist for companies facing headwinds from AI, and a lower equity valuation applied to a still viable business does not necessarily mean a bad outcome for a lender, in our view.

Importantly, private software loans tend to be underwritten at low loan-to-value (LTV) ratios (approximately 40%), which means there is a significant equity cushion beneath that helps protect loan value. A drawdown of the magnitude experienced by public software stocks may drive LTV higher (approximately 50%) but not necessarily result in greater defaults/loan impairments. Equity owners have the first dollar at risk, so we believe it is likely that losses will appear here first and in the largest quantity.

Large equity cushion helps protect loan value

Illustrative impact of software company sell-off



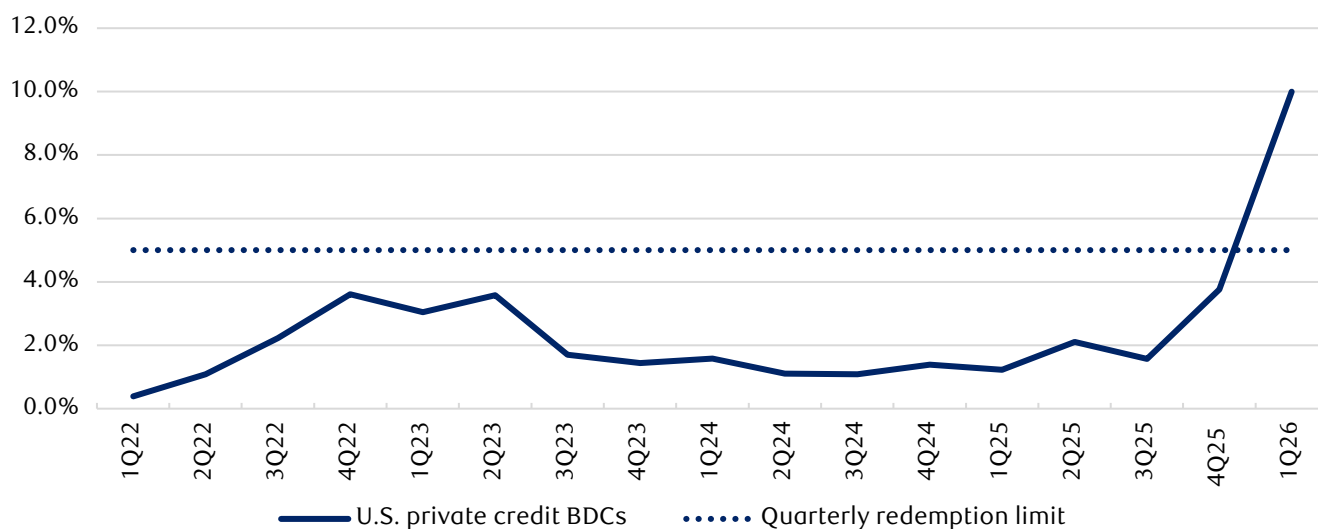
Source - RBC Wealth Management

This equity cushion mitigates losses for lenders in a world that grows increasingly bifurcated between winners and losers, but the asymmetry of returns is flipped the wrong way for credit investors versus equity investors. The best-case outcome for credit investors associated with the winners is repayment plus coupon income, whereas equity investors have unconstrained upside, which means a large winner can offset many losing investments.

In an AI-disrupted environment, we believe cycle-tested managers with proven risk management processes are better positioned to succeed. We prefer investment managers that have demonstrated low credit losses through multiple cycles, both in terms of minimizing defaults, as well as maximizing recoveries when defaults occur.

Redemption requests exceeded limits in 1Q26, prompting redemption restrictions

Private credit fund redemptions (% of NAV)



Source - Cliffwater and Robert A. Stanger & Co.

Waning enthusiasm for private credit has hurt fund flows

Surge in redemption requests likely leading to net outflows

Redemptions from semi-liquid private credit funds increased in late 2025 and climbed higher through 1Q26, above the typical 5% of NAV quarterly limits these funds have in place. Most funds have enforced their redemption limits, which we think is a sensible approach that attempts to balance the interests of all investors and mitigates the risk of fire sales of portfolio investments. Notable exceptions of managers exceeding the limits and meeting 100% of redemptions did so by adding firm or employee capital to plug the gap; we applaud the alignment of interests this demonstrates but do not expect this to be a recurring source of liquidity to fund redemptions. New subscriptions have meaningfully declined to start 2026, leaving most funds in the category facing net outflows—in many cases the first time they have encountered that. The largest fund in the space saw roughly \$2 billion in new subscriptions versus approximately \$4 billion in redemption requests in 1Q26 (the fund has a nearly \$50 billion net asset value).

We believe concerns around software exposures, moderating returns including rising dispersion in credit performance, the negative news cycle, and the significant sell-off in exchange-traded private credit funds are contributing to rising redemptions.

Redemption restrictions exist for a reason

Redemption limits exist to balance the interests of all unitholders, both redeeming and remaining investors. Given the less liquid nature of the underlying investments, redemption limits help mitigate the risk of managers needing to fire sell assets to meet redemptions. Failure to meet redemptions in full when they exceed the stated limit is not a scandal, and investors in open-ended private market funds should expect periods when redemptions are prorated. Redemption proration occurred in the U.S. real estate category from late 2022 to 2024.

Self-liquidating nature of loan portfolios is a plus

Among the various asset classes within private markets (e.g., private equity, real estate, infrastructure, and private credit), we believe private credit is likely best positioned to meet investor distributions and redemptions owing to natural liquidity from the loan portfolio. Private credit loans typically have a five- to seven-year underwritten tenor but a shorter three- to four-year average duration, as loans often are refinanced prior to maturity. Cliffwater estimates that cash inflows from maturing loans, prepayments, and sales have been approximately 3.5%–7.0% of portfolios per quarter over the last three years; furthermore, this source of liquidity may in some cases be sufficient for managers to satisfy up to 5% of NAV in redemptions without relying on new subscriptions or borrowing. In our view, most of the cash interest private lenders earn is likely used to maintain investor distributions and so that is not considered in the analysis above.

Watch unfunded commitments

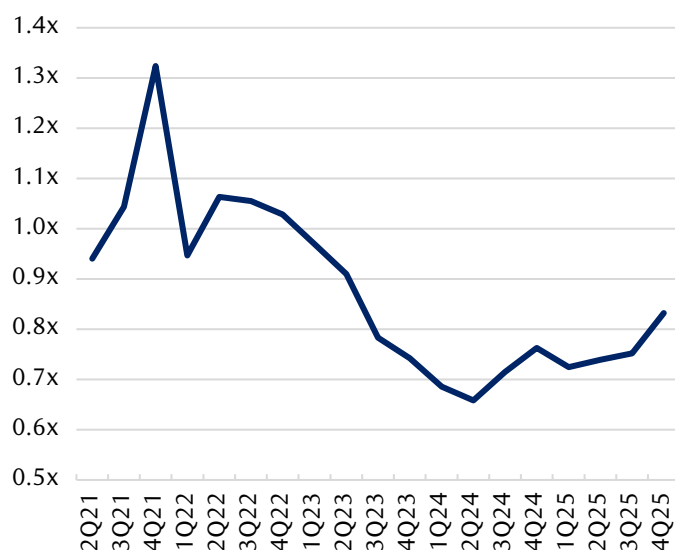
Private lenders often offer borrowers revolving credit facilities (such as a line of credit) and delayed draw term loans that allow borrowers the ability to call capital at a future date. We monitor these funding obligations, as they reduce the amount of liquidity funds have available.

Fund level leverage generally sits at low-end of the range

Investors can take some comfort from the deleveraging that has occurred across most funds in the space since 2022, with many funds operating below their target leverage, meaning potentially greater borrowing capacity available for short-term liquidity purposes. In our opinion, fund managers with more stable and diversified sources of funding can better rely on that borrowing capacity being available during periods of market stress when lenders retrench.

Fund leverage has declined materially from 2021 peak

Private credit fund leverage CDLI-Perpetual (debt-to-equity)



Source - Cliffwater

Something up their sleeve

Many semi-liquid private credit funds also have liquidity sleeves composed mostly of below-investment-grade traded credit. In an environment where public credit markets are trading reasonably well, this is a viable source of liquidity. In environments such as 2008, 2016, or 2020, these loans traded down sharply, and it would have been a less viable source of liquidity.

A silver lining

We believe a rebalancing in capital flows could be healthy for the asset class longer term. Strong fundraising from 2023–2025 coupled with a decline in transaction activity

from peak market in 2021–2022 likely contributed to a gradual decline in credit spreads. Less supply of capital today coinciding with a potential rebound in demand for capital from M&A, in our opinion, could lead to private lenders being in a better position to negotiate higher spreads on new deals, improving forward returns.

We believe managers sitting on the low end of the leverage spectrum and with public credit that they have been able to sell are best positioned to fulfill the up to 5% quarterly redemptions they have committed to their investors, while also being positioned to take advantage of new opportunities to deploy capital into potentially more attractively priced investments.

Exchange-traded private credit has sold off and may represent better value

Exchange-traded private credit funds are down almost 15% over the past year and are trading on average at approximately 20% discounts to their NAV, potentially representing an attractive entry point for opportunistic investors able to withstand equity-like volatility (chart on following page).

According to Cliffwater, exchange-traded private credit funds have historically traded below their NAV (approximately 5% discounts to NAV on average over the last ten years). We believe they also charge nearly 150 bps in higher fees and expenses on average than the semi-liquid private funds that are valued at NAV. As a result, investors may desire a sufficiently large discount to NAV as compensation for these shortcomings.

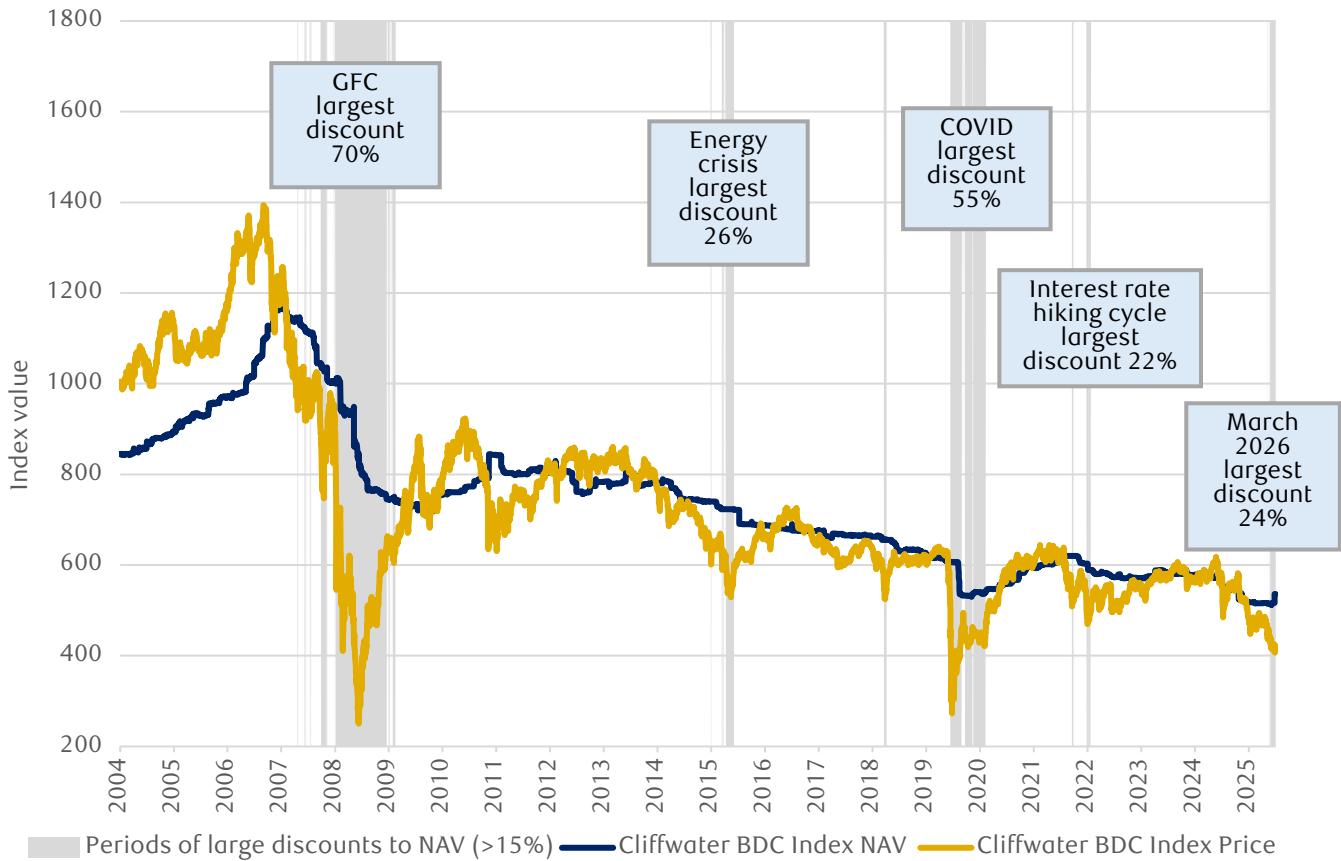
A public problem for private credit

Large discounts to NAV on exchange-traded funds may dampen the appeal of the private funds valued at NAV, particularly in cases where fund managers offer both an exchange-traded and private vehicle where there is significant portfolio overlap. While exchange-traded funds may be more attractive for new money in these cases, attempting a tactical trade to redeem holdings in a private fund to buy a listed vehicle is challenging. Investors would need to source cash initially from elsewhere to purchase the discounted exchange-traded fund, magnifying their exposure to the asset class until redemption proceeds from the private fund are received. The amount of the redemption proceeds is also not known in advance. Conversely, an investor waiting for the redemption proceeds risks seeing the discount disappear on the exchange-traded products.

The wider discounts to NAV on exchange-traded funds today may be explained in part due to these vehicles having on average lower credit quality portfolios than the broader market. Average exchange-traded fund non-accruals/defaults of nearly 2%–3% are approximately double the non-accrual rate of the broader market. Unlike

Exchange-traded private credit funds are trading at large discounts to their NAV

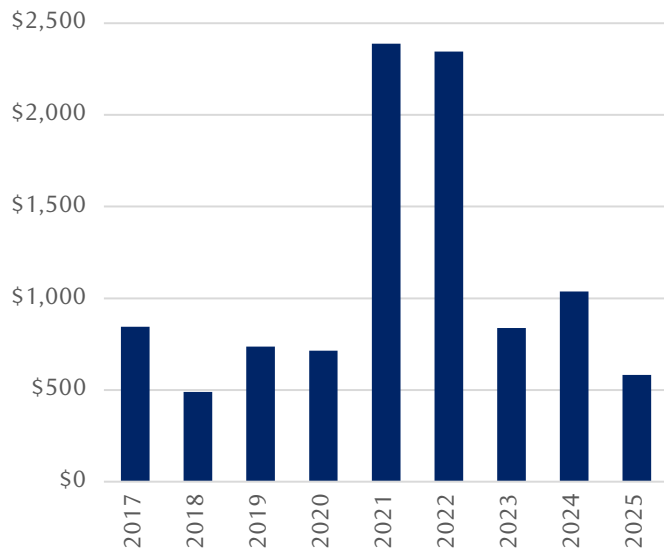
Comparing market prices and NAV



Source - Cliffwater

2025 Non-accruals by origination vintage

(Cost value, \$ millions)



Source - Cliffwater

many of the semi-liquid private funds that have raised and deployed most of their capital over the past two to three years, exchange-traded funds typically do not regularly issue stock. Consequently, they have relatively greater exposure to loans underwritten during the low-rate environment of 2021 and early 2022—a vintage of loans that appear to be exhibiting a greater share of credit issues (chart on left).

Another drawback that plagues exchange-traded private credit funds are that many of them are smaller (often sub-\$5 billion USD in size) and not overly liquid (many trade volumes are at less than \$20 million USD per day). This can make it challenging for larger allocators to establish and manage a position. However, tactical allocations to exchange-traded funds run by quality managers and trading at large discounts to NAV that are inconsistent with their fundamentals could be an attractive approach to investing in the space today.

A final word on the big picture

While private credit faces near-term headwinds from moderating returns, AI-related concerns, and redemption pressures, we continue to view private credit as a useful tool for income generation. Credit metrics, though deteriorating modestly, remain in reasonable shape with defaults/non-accruals and credit losses modestly below their historical averages. Private credit as an asset class is relatively well positioned to navigate elevated redemptions, although we expect managers to enforce their predefined redemption limits to protect their remaining investors.

In our opinion, we are in a part of the cycle that favours managers that have been more conservative, both in their underwriting and use of leverage, which puts them in a better position to capitalize on opportunities to deploy capital when others are pulling back. We believe that it is during challenging periods such as these when skilled managers can differentiate themselves and prudent manager selection is rewarded.

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