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Notes from the Wharton Restructuring and Distressed Investing Conference

Fixed Income

February 26, 2026

The 22nd annual Wharton Restructuring and Distressed Investing Conference (WRDIC and wrdic.org) was held on February 20 in New York City. This was my first year attending. The focus of this year's conference was predominantly on the private credit market, which at an estimated \$1.8 trillion in size, is now larger than both the Broadly Syndicated Loan (BSL) market and the High Yield (HY) market, each of which are estimated at \$1.7 trillion.

Private credit has been a hot topic in the business media. Given the sector's rapid growth, some think it is now in a bubble. The panelists did not address the bubble issue directly in the sessions that I intended; but they did offer counterpoints to concerns raised in the media.

Among those concerns: Market opacity often makes it difficult for many institutional investors and the credit rating agencies to stay on top of borrower financial and operating trends. However, active market participants, especially giants like Apollo, Blackstone, KKR and ARES Management, say they have greater access to management, which facilitates credit monitoring.

Private credit lenders also say that they maintain close relationships with private equity sponsors. This makes it easier to adjust loan terms when needed. In cases where the borrowers are overleveraged, these close relationships facilitate out-of-court restructurings (a/k/a liability management exercises or LMEs). Where the required debt reductions are significant, private equity sponsors are now more willing to "hand over the keys" to private credit lenders.

Relationships between sponsors and investors may be a bit too close, according to lenders and other creditors who are not part of the club. In recent years, there are more instances of so-called "creditor-on-creditor violence," where a group of lenders holding a majority of the loans outstanding enter into a cooperation agreement with the intention to strip collateral away from smaller participants in the lending facility. The industry has responded by incorporating provisions against such tactics in new loan agreements, but many outstanding loans do not have such protections. Some disadvantaged lenders are also suing the cliques that take such actions, asserting violations of antitrust laws. A permanent resolution to this problem, if indeed one is possible, is still in process.

The terms of loans in the PC market are also more flexible. Covenants are usually not nearly as tight. About 14% of PC facilities now have payment-in-kind (PIK) options, which give borrowers the option of skipping interest payments (and adding them to principal). PIKs are often derided as merely delaying an inevitable restructuring or bankruptcy filing.

Yet PIKs are useful in certain situations. They can buy time to avoid near-term capital raises or to help ready a company for sale or better position a company for bankruptcy.

With these tools, critics point out that most LMEs prove to be only temporary fixes; so the borrowers usually end up in bankruptcy anyway. Even so, the proponents say that bankruptcy is expensive and time consuming; so any steps taken to keep a company out of bankruptcy may be justified.

Despite these advantages, PC borrowers are more highly leveraged, so defaults will certainly rise in the next economic downturn. Still, in the absence of a full blown recession, the WRDIC panelists believe that market will make the necessary adjustments to address problems as they arise. Consequently, they expect that growth of the private credit market will continue.

My notes are in outline form. If you have any trouble understanding them, please reach out to me for assistance.

KEY POINTS:

1. Growth of Private Credit (PC) followed the Great Financial Crisis (GFC) and increasingly stringent bank regulations.
 - a. Now \$2 trillion in size, growing at 15%/year. (A recent Bloomberg article pegged the size of the PC market at \$1.8 trillion.)
 - b. Either way, PC appears to be at least equal in size and probably larger than traditional High Yield and Basic Syndicated Loan (BSL) markets
 - i. HY and BSL markets pegged at \$1.7T each (No source cited.)
 - c. 70% U.S.; 30% Europe, Canada and Australia (No source cited.)
 - d. Banks expanding into the business
 - i. Recently announced PC capital commitments by BofA of \$25B and JPM of \$50B.
2. PC loans are usually higher risk, but the higher rates charged on those loans compensate for that risk. So investment returns should be on par with or modestly above those of BSL.
3. BSL advantages/disadvantages:
 - a. Advantages
 - i. Larger, generally more stable borrowers.
 - ii. Borrowers typically have access to diverse sources of capital
 - iii. Borrowers usually carry less leverage
 - b. Disadvantages
 - i. Less information available to monitor the performance of the borrower than PC

- ii. A \$50-\$75 million loan trade can often move the price in a multi-billion dollar loan facility.
- 4. PC market advantages:
 - a. Unregulated, so borrowers and lenders have more options in managing loans
 - i. Relationships among lenders and private equity sponsors are often deeper and more collaborative
 - 1. Negotiations are usually smoother.
 - ii. Less stringent terms; fewer and looser covenants.
 - iii. Lenders generally have access to more information.
 - 1. Opportunity for deeper understanding of the business.
 - iv. Loans trade less frequently.
 - 1. Reduced insider trading risks.
 - v. Lenders are more likely to have similar incentives.
 - 1. Everyone is a par lender.
 - 2. Fewer short-term investors with low cost basis.
 - 3. Tougher to "divide and conquer."
 - vi. Smaller loans, so fewer lenders in a credit facility
 - 1. Easier to renegotiate terms and execute restructurings.
 - 2. Ability to move more quickly.
- 5. PE sponsors more willing to "hand over the keys" to a business in a restructuring.
 - a. This action often raises the probability that the business will be sold.
 - b. Key entry point for investment bankers as financial advisors.
 - c. Still, there is a barrier to handover because of the stigma of having failed.
- 6. As growth in the private credit markets has continued, credits have become larger, leading to some convergence with BSL market.
 - a. Traditionally, less competition in PC has resulted in wider spreads on average.
 - b. Yet convergence with BSL market has caused relative spread compression in recent years.
 - i. More recently, spreads are widening in the current economic environment.
 - c. In normal times (and in the absence of financial distress), there is often less of a rush to get deals done, so they can be shopped more widely.
- 7. PC firms raise capital through PC funds.
 - a. PC funds typically utilize drawdowns of commitments over time.
 - b. Now, more funds are taking all commitments up front.

- c. Lock-ups have traditionally been 10-15 years.
 - i. Now more often incorporating terms for takeouts/redemptions.
 - 1. Could lead to more market volatility over time.
 - d. Need to diversify funding sources.
 - i. Retail funding is pro cyclical.
 - ii. Approaching 2027-2028 maturity wall.
 - e. More funds are allowing sponsors to fix problems by stepping in with debt financing.
8. Recent themes/trends:
- a. Size matters.
 - i. Quest for size driving PC market growth, greater convergence/competition with BSLs.
 - b. More distress in software loans.
 - i. Fears about AI, but sector was not doing so well before AI showed up.
 - ii. Shorter visibility into prospects – 3-5 years.
 - c. PC increasingly seeking investment grade assets.
 - i. Insurance companies, pension funds moving more into PC, but still focus on higher quality names.
9. Liability Management Exercises (LMEs).
- a. LMEs are still mostly in purview of the public markets.
 - b. Although viewed by many as bad for the system, they are not likely to go away.
 - i. Most LME's end up in bankruptcy anyway.
 - ii. Bankruptcy viewed as costly, so it is best to avoid it, if possible.
 - 1. Prepacks are less costly than Ch. 11, but more costly than LMEs.
 - iii. Some view PC restructurings as more efficient.
 - 1. Sponsors often get to keep 2%-5% of equity.
 - a. More if willing to commit more capital.
 - 2. Sponsors often get releases from liability.
 - c. More new PC deals incorporate covenants to protect creditors against Liability Management Exercises (LMEs)
 - i. Drop down risks:
 - 1. a/k/a "creditor-on-creditor violence."
 - 2. Small group of lenders enter into cooperation agreement.
 - 3. Assets dropped down into unrestricted subsidiary.

4. Certain lenders get pledge of collateral in that subsidiary for their loans.
 5. Other lenders effectively have collateral stripped away.
 6. Some within the legal community see this practice as a violation of antitrust laws, so the practice may be curbed over time.
- ii. Confluence with BSL.
 - iii. Serta decision.
- d. PC market participants increasingly realize the importance of structuring loans properly on the front end of the deal.
 - i. Try to assess where the axis of power will be when trouble hits.
 - ii. Negotiation of standstills.
 - iii. Increasingly standardized documentation.
10. Increasing prevalence of PIK financing.
- a. 14% of PC loans include PIK option.
 - b. Uses:
 - i. Amend to extend – kicking the can down the road.
 1. Hope and denial.
 2. Official default rate for PC is 2%. (No source given for this estimate.).
 3. Shadow default rate – considering increased utilization of PIK options – is 7.5%. (No source given for this estimate.).
 - ii. Used where lenders do not want to take responsibility for owning/managing the business.
 1. Corporate governance as a barrier.
 2. Hedge funds more willing to take the keys.
 3. Often used as a bridge to a sale of the company.
 - iii. Sometimes used to get companies over a temporary squeeze in liquidity or period of increased capital expenditures to help avoid raising new capital.
 1. Also, time to stabilize business before considering other options.
 2. Let company keep the cash now. Lender expects to get it back on the back end when the loan matures.
 - iv. When PIKs are used to delay addressing capital structure or operating issues, the delay often results in a decline in the value of the business.
 1. Often, the longer the delay, the worse the outcome.

Conflicts of Interest Disclosure:

There are no publicly traded securities mentioned in this report.

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