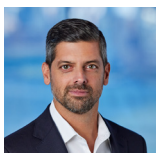




The Investment Conversation: Current Perspectives on Private Credit



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In this podcast, Lord Abbett Head of Private Investments Steve Kuppenheimer discusses today's environment for private credit and direct lending—and how recent developments may result in more favorable conditions for investors going forward.

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ANDY D'SOUZA: Welcome to *The Investment Conversation*. I'm Andy D'Souza, chief marketing officer here at Lord Abbett. Today we're talking about private credit, its rapid growth, potential pockets of pressure, and what investors should be watching as the market matures. Joining me is our Head of Private Investments, Steve Kuppenheimer. Steve, happy to have you again.

STEVE KUPPENHEIMER: Always good to be here, Andy.

D'SOUZA: Love having you. Let's go. All right, Steve, private credit, it continues to grow in the marketplace and evolve. A lot of headlines today around this asset class. It's very popular to talk about now with investors. One of the headlines we're seeing again is some of the stress on the asset class. We've talked about that last year, early this year with you as well. What are you seeing? How is that evolving overall in the marketplace?

KUPPENHEIMER: I definitely think the market sentiment has gotten a little bit ahead of what you're seeing in the portfolios. And I think that's come from a concern around software exposure in particular. And you do see some of that as a concentration in some BDCs [business development companies].

And I think that's drawn some attention along with not just in private credit but kind of the impact of AI [generative artificial intelligence] generally on the markets. And so, I do think that there's definitely pressures to talk about. And we can do deeper on software. I know we will, later in the conversation.

But I would add some context that I don't think is always talked about, which is we're in a bit of a heightened default environment right now. So, if historically the default rate for senior secured lending in the U.S. is about 2% a year, for the last 18 months or so the default rate's been about 5% a year [based on data from Cliffwater].

So, you're already seeing a little bit of stress in leveraged finance generally, even before we start just narrowing that down to private credit. And that's to be expected in market cycles from time to time. But you're not seeing that all coming from just software for example.

So, one of the things we try to focus on as a portfolio management team is finding the stress anywhere that it is. And I do think some of the market focus has been almost exclusively about software exposure, which in my opinion maybe is a little bit overdone. Even though I do think there's things to be concerned about there, and then maybe not as much focus as I would have expected on the broader market.

D'SOUZA: In software, I guess, I've read a lot about that as well. Go back to the why. Why is software so prevalent in the market? I think it's somewhere around a quarter of BDCs have exposure to software. Why is that?

KUPPENHEIMER: So, I think a quarter, that would be on the higher end for a given BDC. And I do think you see significant differences between portfolios on software exposure. But where it's come from, I'd go back in time a bit. I think private credit in general, as we've talked about before, Andy, likes to avoid cyclical industries.

Because we are long and illiquid. So, we have to assume that there will be an economic cycle during the hold period of the loans that we make. So, the more cyclical industries, things like parts of financial services, or energy, or parts of consumer discretionary products, tend not to do well in heavy[economic] cycle downturns.

So those tend to get avoided. And if we look at energy as just an example, let's say that's 16% of the leveraged finance market is the energy industry. And if you're going to avoid that in your private credit portfolio and you want to be diversified, what are you replacing that with?



Are you going heavier into some of the other industries? Are you replacing it with a different industry? And I think that some managers leaned into software. Maybe that was part of the mindset. It was a combination of: We want to stay away from the some of the more cyclical stuff; we believe software is less cyclical. So, we're going to lean more into that. And that combined with a significant increase in capital formation around software companies in the immediate post-COVID era. And so I think that led some portfolios to get a little bit more concentrated in it than I think people are comfortable with.

D'SOUZA: And I guess timing-wise, let's talk about vintage. Does that play a role here as well?

KUPPENHEIMER: Absolutely. Vintage is an important concept in credit investing in general. And what people mean by that is loans originated at approximately the same time or approximately the same year. And why it gets talked about is the lending conditions at a confined amount of time are going to be similar.

You might have low base rates or less fear in the market. And so that will lead to more aggressive lending practices in that type of environment versus you might get to another time when there's concerns about recession or rates are high. And that leads to a different discipline in the lending market.

So, vintage definitely plays a role, I would say, in credit investing generally of all kinds and in all different products. How it relates to software, to your question, is in that year and a half, two years immediately post-COVID, you had a confluence of a couple things.

You had base rates being very, very low. So that meant people were searching for yield and trying to find yield from spread rather than yield from base rates. And that usually leads to some more aggressive mindsets. You also did not have concern about recession.

You're coming out of COVID. So, there's a lot of optimism in the market. You also had a number of these software transactions coming to the market. And that preceded COVID a little bit. But it carried through COVID. I would say it started maybe 2019, something like that.

But on the back end of COVID, they had a strong resurgence. And then the final thing I'll say that came in that time period was there wasn't really concern about AI's impact on software at that time. So, you saw a bit of leaning in in that 2021-22 vintage. One is probably more aggressive vintage in general in terms of lending. And then specifically with software, there's a lot of those deals.

D'SOUZA: And with underwriting, you mentioned with the software companies I think one of the metrics people point to there is this idea of annual recurring revenue, or ARR.

KUPPENHEIMER: Yes.

D'SOUZA: How do you guys think about software companies and using that metric when you analyze companies?

KUPPENHEIMER: Yeah, so maybe we'll talk about just what ARR is. And before I get to that, we need to put it in context. For private credit, what are we generally doing? What are we generally lending against? And these are generally called cash flow loans.

And that means we're lending against two different things: 1) the borrower's profitability or their ability to generate free cash flow, and then 2) their enterprise value. So, if we lend a company four times leverage and they're worth 10 times, then that's a 40% loan to value.

And you're looking at that often as how you're going to get paid back at the end. And then their ability to generate profits or free cash flow during the life of the loan is how you're going to get paid your interest as you go. And that's the typical very basic approach of what we're lending against as compared to hard core asset-based lending where you're just looking at a given hard asset of a company and lending against that. These loans tend to be cash flow loans.

So, the concept of ARR really came up for software lending in particular because you might see some very strong software companies, if I rewind the clock a number of years, that would have great customer bases, a terrific product that was growing very nicely.

Maybe the company's sponsored or owned by a who's who of Silicon Valley venture companies or investors. And so, they'd have very nice revenue. But they may not have profitability yet because they were taking that revenue and reinvesting it in customer acquisition or additional programming, things like that.

And so, if you don't have profitability, so you start thinking, "Can I lend against revenue and feel comfortable there?" So that's where the concept came from. As you can tell, it's a bit of an aggressive concept just in what it is. Because this is a company not generating free cash flow.

So, in general, we are pretty skeptical about ARR lending because it by definition means there's not profitability. So, the bar is very high for us to look at an ARR loan. And we've done virtually none of it in our portfolio. But in the market, that was a common way some of these loans in the 2021-22 vintage in the software sector were executed.

And what I just laid out in terms of a profile of a company that may borrow that way, it can be compelling. But I think what you've seen is two things happen to some of those loans. 1) When rates shot up at the end of 2022, so now, let's say, a software company that was valued at, let's say, 25 times [enterprise value], when rates go up by 500 basis points, just from the discount rate, that may now only be worth in the high teens.

And then you layer on that the more recent impact of concerns about AI and how disruptive that could be to software, that further erodes that enterprise value. And what that means is that loan to value keeps going up. So that dynamic I think is there and we're talking about.



At the same time, I do think if we talk about AI now just for a moment, because this is where we may have a little bit a different view than at least some of the stories we read about in the market or what we hear in the market. AI in general is a tailwind.

It's going to increase efficiency, increase productivity. The issue with it is that it has an uncertain impact. It's hard to know which companies are going to be the winners, which companies are going to be maybe obsolete. But I think if you look at the software industry as a whole, I certainly don't think it's all going to go away.

And some of what you hear almost makes you think that that's some sentiment out there. And even though we are very underweight to software in ARR [based loans], I do believe that that's a little bit overdone. I think you will have some software companies that are doing great.

By the way, many of them aren't ARR borrowers. Many of them are materially profitable and have been around for a long time. And that's a very different dynamic than someone who's pre-profitability and still establishing themselves. And some of those will wind up being big winners with AI.

And some of them may be made obsolete. But I think right now what the market's reacting to is it's hard to pick which one's which. So even if the market would agree, it's not going to be a uniform negative impact on software. I think that uncertainty is what's leading to some of the concern.

D'SOUZA: Makes sense. Thank you for that. You mentioned defaults have been elevated a bit recently compared to historical numbers, 5% or so recently. We talked about the concept of PIK in the past, payment in kind interest. Can you talk about how is that playing out? Are you seeing more PIK? Because in [a January 2026 podcast] you said elevated PIK in a portfolio can predict potentially stress in the future.

KUPPENHEIMER: Yes.

D'SOUZA: We're seeing that come true now, it feels like.

KUPPENHEIMER: I like your question because it combines enhanced observed increased defaults and then how PIK can maybe be a precursor to that. And I do think, directionally, if you're seeing stress in the market, even before a company defaults, it very well might PIK [utilize the payment-in-kind feature of the loan] a little bit before it actually defaults.

So, I think that's a fair correlation to point out. And we talked about a little bit of this before, but it's good to revisit. PIK comes in two forms. So, one is negotiated for up-front at the time of the loan. I usually call that intentional PIK where you're underwriting the company and you know that part of their expected business plan may result in them electing to partially pay interest for a short period of time. So, think this could be a company that's like a roll-up strategy where you invest in one health care company. And their business plan is to acquire other health care companies.

And as they acquire other competitors, they might get tight on cash for a bit of time while they integrate them. And so that can be part of a regular company's business plan. You still prefer to see a company that can afford to do that without "PIK-ing," of course.

But that's the kind of intentional PIK that might be part of your underwriting case of the loan.

D'SOUZA: Got it.

KUPPENHEIMER: And then of course there's the other type, which is probably the more intuitive type, which is, it wasn't expected. You make a loan. Company's doing great. And then sometime after you make the loan, they start to struggle. And in other words, their business plan has turned out not to be as good as they hoped. And now they can't afford to pay all the interest. And that is where it comes from. So those two types are good to keep in mind. But in general, if you see increasing PIK in a portfolio, it is probably indicative of growing stress in general.

But that's my view on PIK. And then combining that with your question about vintage or industry, I do think, 1) it was a more common feature to allow in that 2021-2022 vintage, and 2) it was more commonly present in some of those software deals.

D'SOUZA: So, as we're seeing some of the hiccups maybe with some of the elevated default rates or some increase in PIK, are spreads following along yet? In other words, have spreads widened again? We talked about this before where you said a lot of forces in the market in the last nine months or so would lead you to believe spreads should be widening, but they weren't. Are they yet?

KUPPENHEIMER: They're starting to, still early days. I would say they're modestly wider now, Andy. Because the last time we spoke, I think we were seeing all that spread widening pressure. But they were frustratingly tight. And now I think they're wider.

I couldn't put an exact number on it, but maybe 25 to 35 basis points wider or something like that. But before you see material spread widening, and this we are seeing more regularly, which is you get what I call better defense. So, less requests for PIK, less requests for super aggressive leverage, more covenants, things of that nature. And those types of features, that type of defense is far more prevalent in the middle market than in the large market. But that's been improving now for the last couple of months.

D'SOUZA: Do you mind again just for everyone recapping how you define the middle market?

KUPPENHEIMER: So, everyone wants a number about what is an EBITDA [earnings before interest, taxes, depreciation & amortization] that makes it middle market or not. And I can certainly estimate that. And I'd put that at, just to get that out of the way, probably about \$100 million of [annual] EBITDA is a good estimate to keep in mind.

The reason why I call it an estimate is really the defining feature for me is: Does this borrower have access to the liquid markets or not? That's really the critical point. Private credit as an asset class has shown outstanding relative performance to other credit products for decades in my mind for a very simple reason.

That is, it's built on the premise that you're lending money to companies that don't have access to the liquid markets. And when you do that, you get more spread against less leverage, more covenants. And no surprise, through cycles that formula outperforms.



What you've seen post-COVID is really the advent of what gets called "the upper middle market" or the large private market where these are borrowers that have access to the liquid markets. And why that matters, just to put a finer point on it--obviously it matters that you're competing with the liquid markets--but the liquid markets price risk, depending on the year, 150 to 250 basis points tighter than the private markets. So, you as a private lender need to convince a borrower to pay you 150 to 250 more basis points per year for your borrowing. And that leads to a lot of pressure on those defensive points. Not only does it lead to tighter spreads in the middle market, but it leads to giving things like PIK more frequently, giving up covenants frequently, more leverage and more loose documents in general.

D'SOUZA: Got it. And you mentioned the syndicated market. So maybe the cousin of direct lending private credit is the broadly syndicated loan space, the BSLs, as they say. Those seem to be, I don't know if they're more prevalent. But they seem to be prevalent these days in some of the vehicles that are out there where people are managing private credit loans. They're also employing [these loans]. And they always have. But I'd love to hear your thoughts on this. How do BSLs play a role in a private credit portfolio?

KUPPENHEIMER: I think really, we're talking specifically about BDCs.

D'SOUZA: Yes.

KUPPENHEIMER: And maybe I'll draw that distinction. Because if you're looking at just a regular drawdown fund, then you really won't see many BSLs there. And that maybe highlights the point I would make. Because I do think they get misunderstood a bit. They're really there because you have a little bit of a mismatch in your fundraising rhythm and your ability to deploy into private assets.

So BDCs are raising money on a monthly basis, the non-traded or private BDCs are. So, they're closing on cash the first of every month, basically. Yet it could take you six to 12 weeks to close a given private investment. So, at any given time, when you close on cash on the first of the month, you may or may not have the exact right amount of private loans available to close on for that cash.

And so BSLs get in those portfolios originally intended to be a placeholder to put that cash in while you then deploy the private loans over the coming weeks or months. And that's really why they're there in BDCs. I think sometimes it gets misunderstood that they're there to meet the tender features [to meet investor requests for share repurchases] of the BDCs, which isn't really how we view that.

We view the way you're going to meet the tenders is either through the natural cash flow of the portfolios, because the portfolios tend to repay you 25% to 35% of the loans that tend to mature every year. Or you're going to be able to use a modest amount of your undrawn leverage to meet the tender.

And those are both much better ways to do it because usually there's a correlation between investors wanting to take more advantage of the tender and there being pricing pressure on liquid loans. You don't really want to be selling a risky asset to meet liquidity. And that's why I draw that distinction.

D'SOUZA: One more part here. It might be a little too in the weeds, but a curious question on the BDCs, mechanically speaking. What do the BSLs do for a portfolio? Or what's the challenge there?

KUPPENHEIMER: Yeah, so why do investors prefer not to see a lot of them? Maybe I'll answer it that way, is they tend to add volatility and decrease yield because they are more volatile from a price perspective. And their spreads are tighter. And they're also just kind of easier to get.

So, investors that are looking for exposure to private credit from a given manager, they're usually looking for the origination of that manager into their version of private assets and their specific advantages. And so, it's viewed a little bit as mandate drift [variation from a private credit manager's stated investment focus], if there's too much of it. I think investors understand that there'll be some BSLs. It's a matter of degree.

D'SOUZA: Got it. We've talked about industry concerns on software today. We talked about vintages. We talked about PIK, the use of BSLs in the BDC portfolios at large, underwriting standards, spreads. A lot here today. I guess it seems there's a lot of maybe just noise out there right now. Why would someone invest in private credit today? Why would it be a good time in your mind?

KUPPENHEIMER: So, we like markets like this. And maybe I'll start with comparing it to where the market was a year, a year and a half ago, where there was really no concern. And when the markets are like that in any asset class for an extended period of time, you start to see 1) that asset class starting to get priced cheaper as if it is less risky and 2) you start to see less discipline on some of these defensive things like covenants or PIK. And so having a little bit of chop in the market just reminds everyone that this is a risky asset class. And that's good as an investor because of all the things you asked me about earlier.

So, we're starting to see spread widening. We're starting to see improving fundamentals of loan covenants and documentation. That's a more attractive environment for us to invest in where we can continue to [potentially] outperform. And for us, a material amount of our capital is dry powder.

So, we're able to look very selectively at a market like this. And I'd add to that, when you see a little bit of a pullback, that also means there's less capital chasing that strategy as well. So, a little bit less competition, wider spreads, better documents. So, we actually like markets like this.

D'SOUZA: Sounds great. Steve, for your time today, I really appreciate it.

KUPPENHEIMER: Thank you, Andy.

D'SOUZA: Thank you for listening to *The Investment Conversation*. Find more episodes wherever you get your podcasts or at Lordabbett.com. And follow us on LinkedIn, Instagram, and YouTube for more perspectives from across the firm.



GLOSSARY OF TERMS USED IN THIS BROADCAST

Annual recurring revenue (ARR) measures the predictable recurring revenue a subscription business expects to generate in a year, excluding one-time fees.

A **basis point** is equal to one one-hundredth of a percentage point.

Base rate: Variable interest rates fluctuate in line with a base rate which, typically, shifts in reaction to market factors.

Broadly syndicated loans are floating-rate loans made to corporate borrowers with generally greater than \$50 million in EBITDA and in most cases, at least \$100 million. They are senior in the capital structure and have a first claim on the assets of the borrower.

A **business development company (“BDC”)** is a domestic, closed-end investment companies¹ that are operated for the purpose of making investments in small and developing businesses and financially troubled businesses.

Debt covenants are restrictions that lenders (creditors, debt holders, investors) put on lending agreements to limit the actions of the borrower (debtor).

Direct lending is a private debt strategy where non-bank lenders provide loans directly to private companies, bypassing traditional intermediaries like banks. These loans are typically senior secured, privately negotiated, and often backed by covenants that can protect the interests of a lender.

A **discount rate** is the rate of return used to discount future cash flows back to their present value.

A **drawdown fund**, also known as closed-end or finite-life fund, is the standard investment vehicle used in private equity and venture capital. Unlike typical public-market funds, drawdown vehicles don’t immediately invest all funds. Instead, investors commit a specified amount of capital upfront. Then, throughout the fund’s initial investment period, the fund manager issues “capital calls” to investors, gradually deploying their commitments into targeted investments.

Dry powder refers to readily available cash or liquid assets that investors, companies, or funds hold in reserve for strategic deployment. It represents capital that is not currently invested but is poised for immediate use. In both private credit and private equity, dry powder refers to committed but unallocated capital that may be pledged by investors that have not yet been deployed by fund managers.

EBITDA refers to a company’s earnings before interest, taxes, depreciation, and amortization.

Enterprise value (EV) measures a company’s total value by combining its market capitalization with debt and subtracting cash.

Evergreen funds are perpetual investment vehicles in private markets. They allow investors to buy and sell periodically under certain conditions, offering more flexibility than traditional private equity funds. Investors contribute capital, which is then invested in private companies or assets. Profits from these investments are either distributed to exiting investors or reinvested.

Free cash flow (FCF) represents the amount of cash generated by a company, after accounting for reinvestment in non-current capital assets.

Normalized free cash flow attempts to smooth out a company’s FCF by excluding non-core operations and one-time items.

Loan-to-value (LTV) is a metric that compares the amount of a loan to the appraised value of the asset being financed, which is usually real estate or other collateral.

Middle market lending: The middle market segment is typically considered to be credit for firms larger than small businesses but too small for large-scale commercial lending or syndicated credit.

Payment-in-kind (PIK) bonds are a type of debt instrument where the interest payments are made in the form of additional bonds rather than cash. This allows the issuer to defer cash interest payments, which can be attractive for companies in a cash-constrained situation.

Private credit refers to loans and debt financing provided by non-bank lenders to businesses, typically outside of public markets. A **private credit sponsor** is typically a manager or general partner of a private equity or venture capital investment fund. The sponsor is typically run by one or more private equity or venture capital investment professionals.

Spread is the percentage difference in current yields of various classes of fixed-income securities versus Treasury bonds or another benchmark bond measure. A bond spread is often expressed as a difference in percentage points or basis points (which equal one-one hundredth of a percentage point). The option-adjusted spread (OAS) is the measurement of the spread of a fixed-income security rate and the risk-free rate of return, which is adjusted to take into account an embedded option. Typically, an analyst uses the Treasury securities yield for the risk-free rate.

Underwriting is the process by which the lender decides whether an applicant is creditworthy and should receive a loan.

Vintage refers to the specific time period during which a set of loans or investments were originated or issued.

A **workout** is a mutual agreement negotiated between a debtor and creditor to manage and resolve a debt without resorting to formal bankruptcy proceedings.

Yield is the income returned on an investment, such as the interest received from holding a security. The yield is usually expressed as an annual percentage rate based on the investment’s cost, current market value, or face value. The **gross yield** of an investment is its profit before taxes and expenses are deducted.



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