



Business Development Companies: Potential Opportunity Amid Private Credit's Stress Test

Private credit has remained one of the most closely watched asset classes in 2026, as investors reassess the outlook for an industry that benefited from significant capital inflows during the Federal Reserve's rate-hiking cycle from 2022 through 2024.

Several factors have weighed on sentiment. The Federal Reserve's rate-cutting cycle has reduced income generated by floating-rate loan portfolios, while increased competition among private credit managers has compressed lending spreads. At the same time, investors have become more focused on portfolio quality as non-accrual rates have risen and payment-in-kind (PIK) income has increased at some managers. More recently, rapid advances in artificial intelligence have prompted additional scrutiny of software and technology borrowers, which represent meaningful exposures for many private credit portfolios.

Pressure has also emerged in non-traded private credit vehicles. Several funds have experienced elevated redemption requests, and some have implemented redemption limits in accordance with their offering documents. These developments have contributed to broader caution across private credit markets and have weighed on valuations of publicly traded Business Development Companies (BDCs).

As a result, many publicly traded BDCs now trade at discounts to their most recently reported net asset values (NAVs). While these discounts reflect legitimate concerns about earnings, credit quality, and portfolio valuations, they may also provide opportunities for long-term investors to access diversified private credit portfolios below reported book value.

Understanding Business Development Companies

Congress created Business Development Companies in 1980 through amendments to the Investment Company Act of 1940 to increase the flow of capital to small and middle-market U.S. businesses. BDCs provide financing to privately held companies through senior secured loans, second-lien debt, subordinated debt, and, in some cases, equity investments.

Unlike most corporations, BDCs generally elect to be treated as regulated investment companies (RICs) for tax purposes. To maintain that status, they must satisfy certain distribution and qualification requirements, including distributing at least 90% of their taxable income to shareholders. BDCs are also subject to SEC oversight, leverage limitations, and diversification

requirements established under federal securities laws. Because publicly traded BDCs provide access to privately negotiated loans through liquid securities, they have become one of the primary vehicles through which retail investors can gain exposure to private credit.

Key Pressure Points

1. Net Investment Income Is Under Pressure

Net investment income (NII) is the primary source of cash available to support BDC distributions.

Most BDC loans carry floating interest rates tied to the Secured Overnight Financing Rate (SOFR) or other short-term benchmarks. As policy rates have declined, asset yields have generally fallen. At the same time, increased competition has narrowed spreads on newly originated loans, reducing the yields available on reinvested capital. Many BDCs also continue to finance portions of their balance sheets with fixed-rate debt issued when interest rates were materially higher, compressing net interest margins.

Collectively, these factors have reduced earnings for many BDCs, leading some managers to reduce or eliminate supplemental dividends and, in certain cases, lower regular distributions.

2. NAVs Face Valuation Pressure

BDC portfolios consist primarily of privately negotiated investments that are classified as Level 3 assets under U.S. GAAP. Because these investments do not have readily observable market prices, they are valued each quarter using internal valuation processes, often with support from independent valuation firms.

As credit conditions have softened and required market yields have increased for certain borrowers, many BDCs have reported lower portfolio valuations, resulting in declines in reported NAVs. Whether these unrealized markdowns ultimately prove temporary or become realized losses will depend on future credit performance and recovery values.

3. Non-Accruals Have Increased

Loans are placed on non-accrual status when management determines that contractual interest payments are no longer probable of collection. These investments cease generating interest income and often require valuation reductions.

Industry non-accrual rates increased during the first quarter of 2026, although credit deterioration has varied significantly across managers. The trend

reinforces the importance of manager selection, underwriting discipline, and portfolio construction.

4. PIK Income Warrants Monitoring

Payment-in-kind (PIK) interest allows borrowers to satisfy interest obligations by issuing additional debt rather than making cash payments.

While PIK income is recognized for accounting and tax purposes, it does not generate current cash flow. Increasing reliance on PIK income, particularly on loans that previously paid cash interest, may indicate borrower stress and can precede future restructurings or non-accruals. Investors should evaluate both the level and composition of PIK income when assessing portfolio quality.

Discounts Create Both Risk and Opportunity

The combination of lower earnings expectations, valuation pressure, and credit concerns has pushed many publicly traded BDCs from trading at premiums to NAV to trading at discounts.

A discount to NAV does not necessarily indicate that a BDC is undervalued. Reported NAVs themselves may continue to change as portfolio valuations evolve. However, when discounts become materially wider than long-term averages, investors may be able to purchase diversified private credit portfolios at prices below their reported intrinsic value.

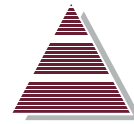
As the industry works through this phase of the credit cycle, differences among managers are becoming increasingly apparent. Firms with disciplined underwriting, conservative leverage, diversified portfolios, and strong sponsor relationships appear better positioned than those that relied on aggressive structures or higher-risk originations to support earnings during periods of intense competition.

For investors considering the sector today, manager selection may be more important than broad exposure to private credit itself.

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