Credit Market Conditions

Muted M&A Activity and Significant Lending Dry Powder Expected to Perpetuate Borrower-Friendly Market in 2026

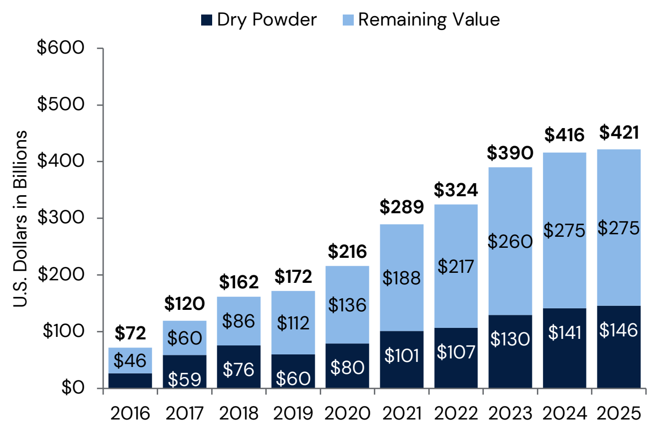
Adam Morris,
Senior Director
Debt Capital Advisory Group

Private Credit Fundraising & Dry Powder. The last decade has witnessed a substantial amount of investment capital flowing into the Private Credit/Direct Lending market. However, the quantum of capital raised has consistently exceeded funds deployed, which has led to a continued increase in competition among lenders, a reduction of secured overnight financing rate (SOFR) spreads throughout the market, and a buildup of dry powder available for new lending opportunities. Dry powder within U.S. direct lending funds hit a new record of $146 billion at the end of 2025 (compared to $141 billion at the end of 2024) despite declines in private credit fundraising during the year, according to PitchBook LCD.[1]

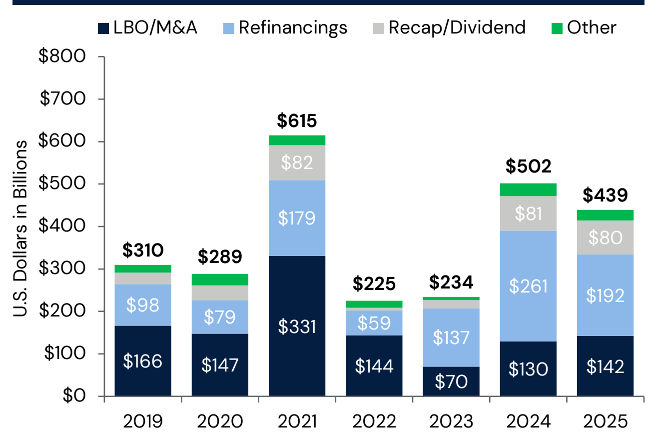
2025 Year in Review. Institutional merger and acquisition (M&A)-related loan volume (excluding repricings and extensions) declined by 12.5% year-over-year (YOY) to ~$439 billion in 2025, according to PitchBook LCD.[2] New deployments were difficult to come by given a still subdued M&A environment. Refinancing and recapitalization transactions drove the majority of loan activity, collectively representing 61.9% of total institutional loan volume in 2025. As refinancings are typically a dollar-for-dollar replacement of outstanding loans, this activity resulted in almost no change to private credit dry powder, which has remained at record levels heading into 2026.

M&A Loan Activity. Hopes that 2025 would finally be the year that private equity (PE) M&A activity fully resurged never quite materialized despite minor gains in a still-subdued market. Shifts in U.S. trade policy, continued inflation, and only modest interest rate cuts put a full M&A volume recovery on hold. While M&A financing volume grew slightly in 2025 (+9.9% YOY), it remained below 2019-2022 levels. Further, sponsored middle market loan activity, while resilient during the past year, continued to be heavily supported by demand for incremental or add-on financings, which

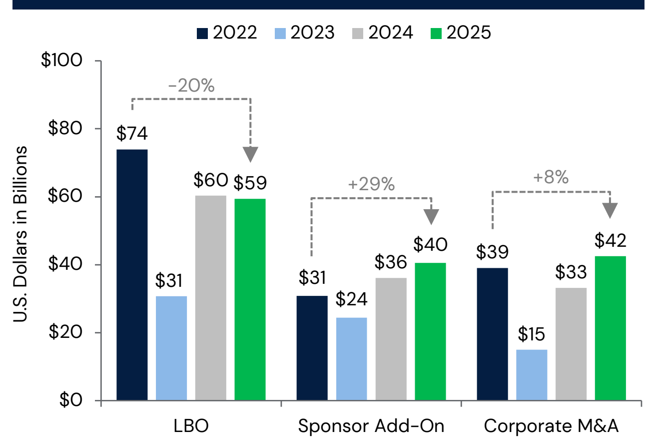
U.S. Private Credit Assets Under Management



U.S Institutional Loan Volume by Use of Proceeds



M&A-Related Loan Volume



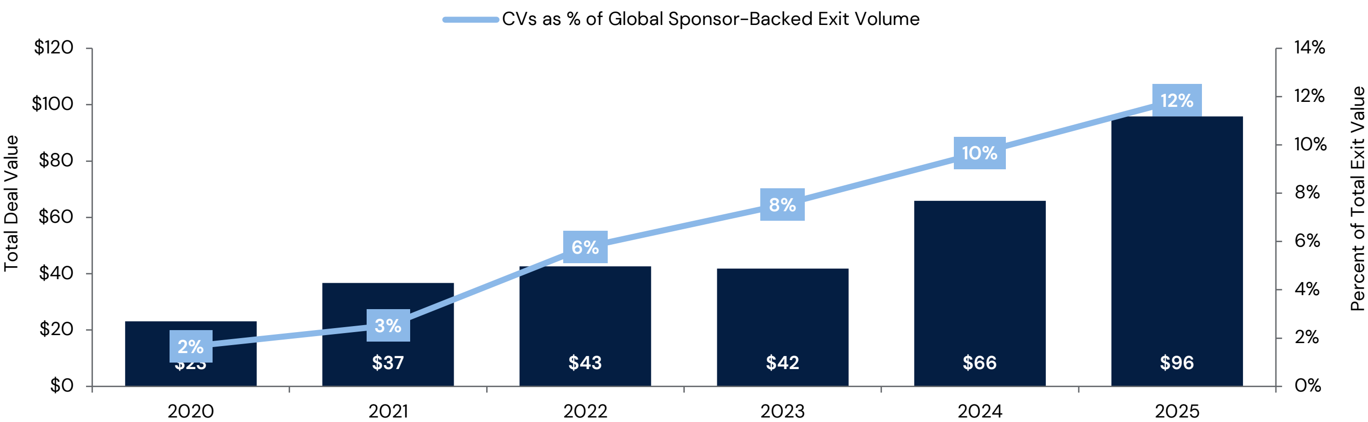
Source: PitchBook LCD and Capstone Partners represented a significant and growing portion of M&A financing activity over the past several years. PE leveraged buyout (LBO) financing activity declined slightly in 2025 (-1.5% YOY) and remained ~19.7% below 2022 levels and 59.3% below 2021, according to PitchBook LCD.

In response to this muted dealmaking environment, both PE and private debt investors have increasingly turned to Secondary markets, not just as a source of liquidity, but also as an area for new capital deployment.

Continuing Down a New Path? As investors navigate prolonged exit timelines, tepid M&A activity, and growing pressure to demonstrate liquidity from limited partners (LPs), continuation vehicles (CVs) have emerged as a critical component of the M&A and Financing markets. CVs are investment structures established by a general partner (GP) to transfer one or more portfolio assets from an older fund nearing maturity. These vehicles offer existing LPs the option to cash out or roll over their interest while bringing in new investors seeking exposure to high-quality assets. As traditional exit pathways from M&A remain constrained, CVs have grown in popularity, both benefiting the Refinance/Recapitalization market and dampening sponsor-to-sponsor LBO volume.

Total global secondary transaction volume, encompassing both LP- and GP-led deals, hit a record $408.8 billion in 2025, up 46.8% compared to 2024, according to PitchBook.[3,4] Historically, LP deals have dominated the Secondaries market. However, GP-led Secondary market volume increased 45.4% YOY in 2025 to $95.8 billion and represented 11.9% of all sponsor-backed exit volume (up from 2.5% in 2021), reflecting an immense shift in market dynamics.

GP-Led Secondary Market Transaction Volume

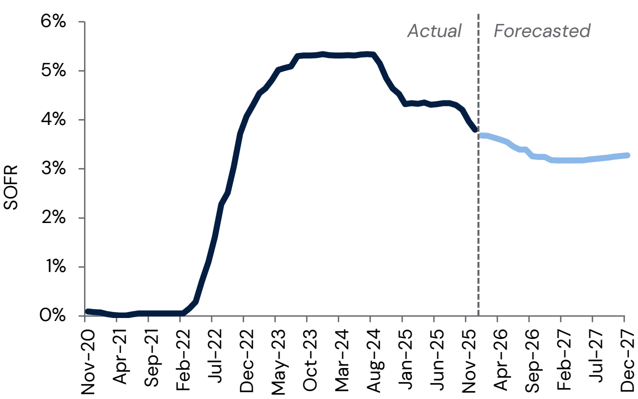


Source: PitchBook and Capstone Partners

Capstone Viewpoints. One consistent piece of feedback we have heard from lenders in the market over the last two years is the increasing prevalence of CV financing opportunities, which many lenders still view with caution. Generally, their emergence has been a positive development for direct lenders as they remain an ever-growing share of recapitalization pipelines. However, their hybrid nature—part recapitalization, part secondary sale—creates complexity, particularly for lenders with traditionally focused sponsor-owned investment mandates. Capstone believes the use of CVs will likely increase over the next two to three years. This would have a counterbalancing impact, simultaneously increasing refinance/recapitalization activity and dampening M&A activity volume. The lower middle market has typically lagged the adoption of more bespoke structures in the upper middle market by one to two years, but we expect adoption of smaller CV structures (less than $100 million single asset vehicles) to become more prevalent given widespread adoption in the upper middle market.

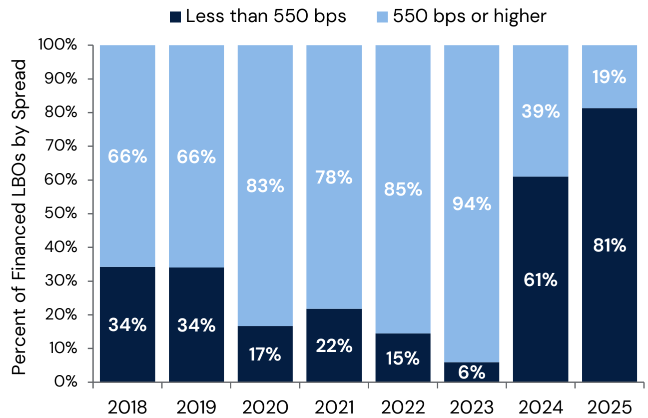
Loan Pricing. Borrowing rates on senior/unitranche loans continued to decline in 2025 based on the tandem impact of SOFR reductions and spread compression. Base three-month SOFR is expected to remain near ~3.25% through the end of 2027, according to Chatham Financial.[5] After peaking near 700 basis points (bps) in 2022, SOFR spreads compressed to the lowest average levels ever in 2025, driven by the ever-increasing competitive environment to deploy capital—best evidenced by the percentage of direct lending LBOs with a spread below 550 bps increasing to 81% in 2025, according to PitchBook LCD. While significant loan spread compression is unlikely in 2026 given the material compression that has already occurred, there does not seem to be any known catalyst on the horizon that would reverse these recent reductions to loan spreads.

Historical & Projected SOFR Curve



Source: Federal Reserve Bank of St. Louis, Chatham Financial, and Capstone Partners

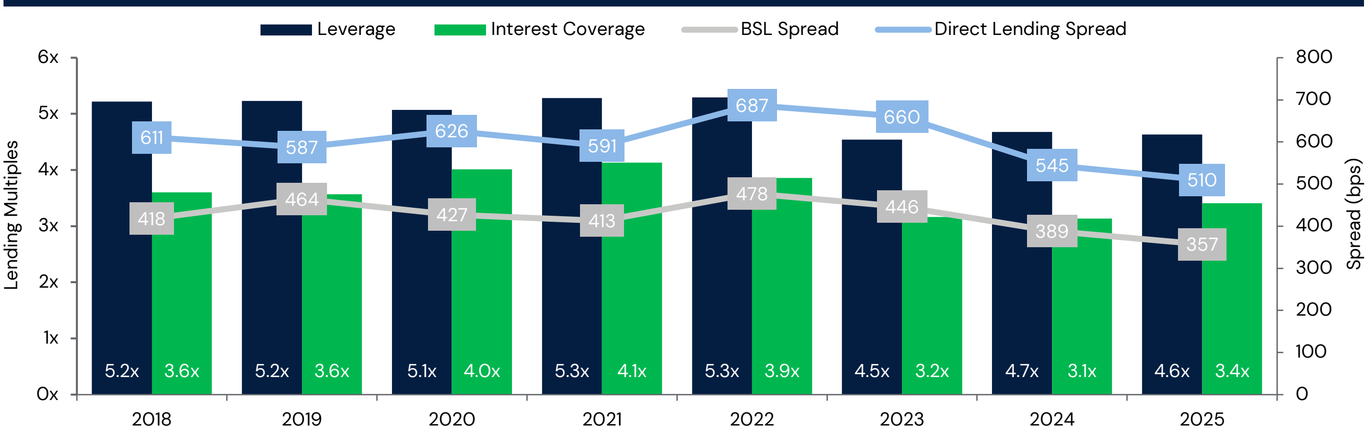
Direct Lending LBO SOFR Spreads



Source: PitchBook LCD and Capstone Partners

Leverage. While average leverage ratio levels have stayed below the 2021-2022 peak of ~5.3x, it is important to note that leverage ratios were forced to correct in 2023 to ~4.5x in direct reaction to the swift increases to all-in borrowing costs stemming from the dual impact of widening loan spreads and significantly increasing SOFR that year. In 2025, leverage ratio tolerances were effectively unchanged from 2024's levels. However, the outlook remains stable-to-growing for leverage tolerances in 2026 given projected reductions in all-in borrowing costs related to further telegraphed rate cuts.

Key Lending Metric Trends

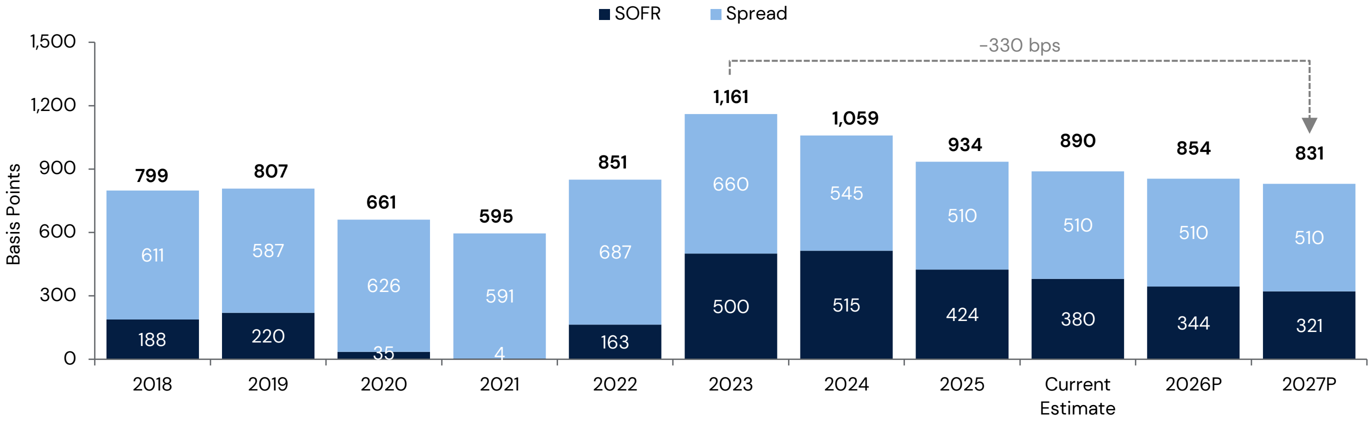


Source: PitchBook LCD and Capstone Partners

What Borrowers Can Expect Heading into 2026. The U.S. Leveraged Loan markets have been—and will likely continue to be—in borrower-friendly territory, underpinned by the loan supply/demand imbalance and significant borrowing cost compression. While only modest further declines to all-in borrowing costs can reasonably be expected for 2026, the significant declines in both SOFR and spread rates over the past 24 months have already made a positive impact to PE LBO models. In an attempt to illustrate this impact, Capstone anticipated future all-in average borrowing costs for 2026 and 2027 based on expected declines to the base three-month SOFR rate (while keeping average spread flat at 510 bps). Total average borrowing costs are expected to decline to ~850 bps for 2026 and 2027. While still significantly above 2021 levels (~595 bps when SOFR was effectively 0%), borrowing costs are projected to approach 2018/19 levels, when average leverage was 5.2x (more than 0.5x higher than current average levels) and interest coverage was 3.6x (in-line with current metrics).

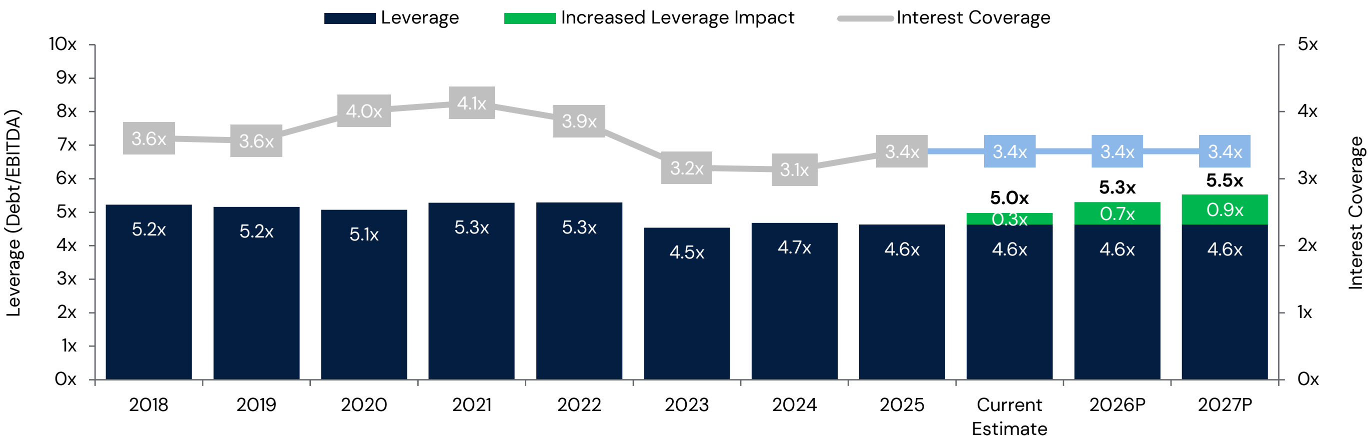
The impact on leverage from this reduction in borrowing costs could be significant, assuming lenders remain comfortable with current closing coverage metrics. Based solely on the anticipated rate reduction, average closing leverage could increase by 0.5x to 1.0x (and approach pre-2023 levels), while still maintaining the current 3.4x closing interest coverage levels. This increase in closing leverage would have a substantial impact on LBO valuations and potentially spur long-awaited increases in M&A activity.

Historical & Expected All-In Average Borrowing Costs



Source: PitchBook LCD, Federal Reserve Bank of St. Louis and Capstone Partners Analysis

Historical & Expected Key Lending Metrics

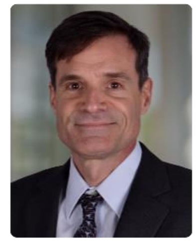


Source: PitchBook LCD and Capstone Partners Analysis

Debt Capital Advisory Team Leaders

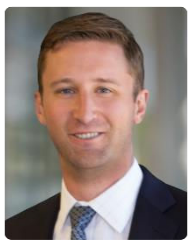
Kent Brown
Head of Debt Advisory
kbrown@capstonepartners.com
303-951-7127

Brent Krambeck
Managing Director
bkrambeck@capstonepartners.com
312-399-7977



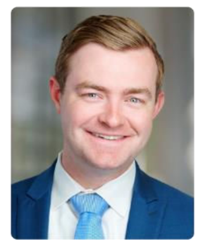
Brad Stewart
Managing Director
bstewart@capstonepartners.com
617-619-3334

Brad Harrop
Senior Director
bharrop@capstonepartners.com
303-531-5007



Adam Morris
Senior Director
amorris@capstonepartners.com
248-961-4557

Pierce Gascoigne
Vice President
pgascoigne@capstonepartners.com
303-531-4615



James Keefe
Vice President
jkeefe@capstonepartners.com
513-515-4651

Endnotes

1. PitchBook LCD, "December 2025 U.S. Private Credit Monitor," https://pitchbook.com/news/reports/december-2025-us-private-credit-monitor, accessed January 13, 2026.
2. PitchBook LCD, "U.S. Private Credit & Middle Market Quarterly Wrap," https://pitchbook.brightspotcdn.com/9d/8e/c2e5aaa54ba0a533858b0bff5d1f/q4-2025-us-private-credit-and-middle-market-quarterly-wrap.pdf, accessed January 13, 2026.
3. PitchBook, "2025 Annual U.S. PE Breakdown," https://pitchbook.com/news/reports/2025-annual-us-pe-breakdown, accessed January 27, 2026.
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5. Chatham Financial, "Term SOFR and Treasury Forward Curves," https://www.chathamfinancial.com/technology/us-forward-curves, accessed January 18, 2026