



## Credit Unbound: Capitalizing on a Shifting Opportunity Set

August 2025

### Part I: The Road from Boom to Stress – Credit Quality in Decline

In this Insight Series, we're sharing a short set of perspectives on the evolving credit landscape and how it is shaping today's investment opportunity set for Axar. In this first piece, we focus on the dramatic growth in credit markets over the past decade – a foundational shift that has expanded the universe of potential investments across both liquid and illiquid strategies, especially in the middle market.

At Axar, we are currently seeing dramatic growth in our pipeline of investment opportunities, driven by the repetition of a familiar pattern / cycle in credit markets:

Significant growth → reversal of the factors underpinning that growth → erosion of credit quality → increased defaults.

Between 2015 and 2021, the high-yield credit markets ballooned, driven by easy-money policies including generationally low interest rates, an extended economic expansion, and insatiable demand by private equity for leveraged buyouts. Consequently, the U.S. Leveraged Loan market experienced 75% growth in the U.S., growing from ~\$800bn to \$1.4tn.<sup>(i)</sup> During this time period, private equity transaction volume skyrocketed, fueled by lenders, primarily CLOs, whose fundraising benefitted from the aforementioned market growth and who aggressively competed with each other to deploy greater sums of capital to a universe of companies that remained roughly flat over the same 2015 to 2021 period. The result is that lenders eagerly provided more debt to financial sponsor-backed companies, which increased company-level leverage levels on generous terms. This reached its apex during the post-COVID period of 2020-2022, with middle market private equity deal volume exceeding 10,000 transactions, nearly 75% of all private equity deals.<sup>(ii)</sup> These lenders were able to take comfort in record equity valuations, strong free cash flow, sponsor “relationships” and a benign macro picture supporting growth.

**The tide has shifted. The past three years have seen an erosion of the factors underpinning that impressive growth, most notably significantly higher interest rates. This has caused financial conditions to tighten for highly levered businesses, resulting in growing distress in the middle market and a marked increase in defaults.**

While well understood today, inflation, driven by supply disruptions, global leverage, and unprecedented fiscal stimulus, prompted the Federal

Reserve to tighten policy aggressively starting in late 2022. Approximately 90% of the leveraged loan

### Middle Market PE Activity <sup>(iii)</sup>



**Figure 1: Middle Market Private Equity Activity, Sub \$1BN transactions, peaking in 2021.**

market is floating rate and base rates (SOFR) have increased significantly from ~0% at the end of 2021 to ~4.3% as of 2Q25. The corresponding ~75% increase in total borrowing costs for companies was expected to be “transitory” (much like the inflation that precipitated the rapid increase in rates). However, the Fed has since been forced to maintain its “elevated for longer” regime as elements of sticky inflation persist. Executive branch tariff policy variability complicates this already difficult operating environment, notwithstanding growing concerns about weaker longer-term consumer demand trends and potential softening in the labor markets.

This new paradigm has led to a significant deterioration in the overall credit quality of the institutional loan market. As evidence, over the period from January 2022 to June 2025, \$427 billion in loans held by CLOs have been downgraded, compared to just \$265 billion upgraded — a 1.7:1 downgrade-to-

upgrade ratio (see Figure 2 below). This imbalance isn't a short-term blip: downgrades have outpaced upgrades in 36 of the last 37 months (March 2025 being the only outlier, with equal upgrades and downgrades). According to Moody's, the downgrades have been driven by weaker operating performance across issuers facing reduced interest coverage, high leverage, and margin pressure from inflation, supply chain dislocations, and now renewed interest rate policy uncertainty. Base rates have not come down, and middle market companies – particularly those backed by private equity – which were purchased at peak multiples, using peak COVID-era EBITDA, with peak leverage levels at historically low interest rates (together, a staggering number of macroeconomic and credit market factors converging during one 2-year period), were never underwritten to service persistent interest costs not seen since the early 2000's. This pre-GFC period of elevated interest rates was far before private equity became the dominant asset class it was during COVID-19 and during a period when private equity purchase multiples were ~33% lower than the 2020-2022 average (~8x in 2007 compared to ~12x from 2020-2022) <sup>(iv)</sup>.

#### Credit Quality Deterioration: Downgrades vs. Upgrades<sup>(v)</sup>

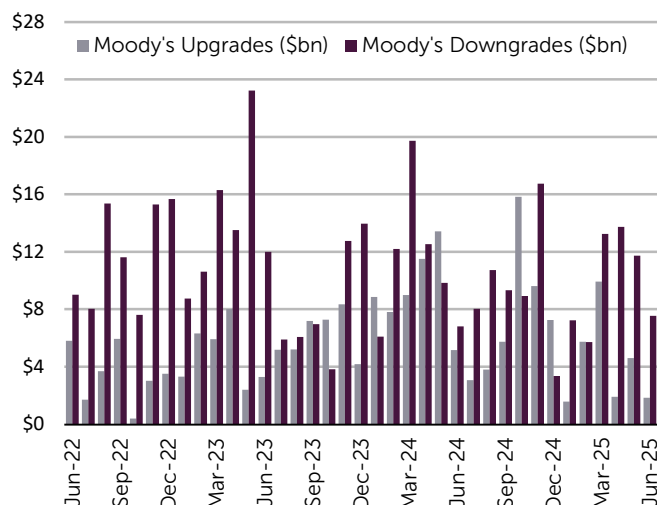


Figure 2: Credit quality erosion as downgrades outpacing upgrades within the Leveraged Loan market

As the toll of higher rates builds and credit quality deteriorates, we've seen the **Leveraged Loan default rate** – typically a lagging indicator of stress in the system – begin to grind higher. A key factor driving the growth in the overall default rate has been the increased prevalence of **Distressed Exchanges**, or, as they are now commonly referred to, **Liability Management Exercises (LMEs)**.

LMEs are voluntary defaults, initiated by financial sponsors responding to the following: (i) an inability to exit the portfolio company (despite current record equity valuations), (ii) an inability to refinance (despite credit spreads currently at the 99th percentile of tightness and historically high rates of high yield debt issuance) and / or (iii) balance sheet stress. (Note: We will take a deep dive into our approach to the LME-driven investment opportunity set in Part 3 of this series.)

As the chart in Figure 3 below shows, today's dual-track default rate, which includes traditional "hard" defaults + LMEs, reached nearly 8%, up from ~1% at YE2021. For some perspective, peak default rates in the 2009 Global Financial Crises reached 10% - although a key differentiator is that the last time we reached this level of defaults it was during a post-Lehman 100-year economic shock, and we are currently in a period of record equity markets, historically low unemployment and relatively strong GDP growth.

### Default Rates Rise <sup>(vi)</sup>

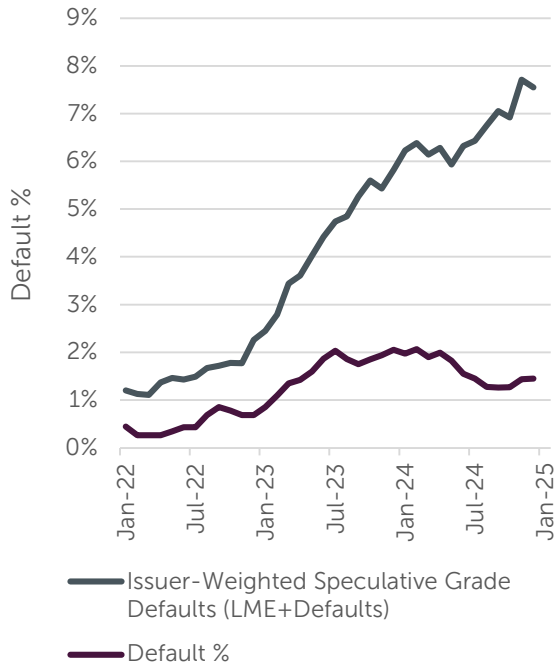


Figure 3: Moody's Issuer-Weighted Speculative Grade US Loan Default Rates, last three years, including LMEs vs. Hard Default Rate % (LCD)

Our "house" view is that even without a major macro shock or steep recession, we expect the default rate to remain elevated. This is due, in part, to (i) the severity of the upcoming maturity wall into 2028 (see Figure 5), which suggests a sustained supply of situations likely to be downgraded or default and (ii) the inability of financial sponsors to monetize investments. The private equity DPI, a measure of capital returned to investors, is at a historic low of below 0.05x for the last several vintage years, (see Figure 4 below), over 90% less than the average over the last 15 years. Furthermore, as we examine forward indicators of future LME activity—including (i) Octus data on lender co-op agreements executed, (ii) financial advisors hired and (iii) the continued historically low level of DPI and exit activity of private equity backed companies — we believe LME activity will continue at its recent pace, if not intensify.

### Private Equity DPI – By Vintage <sup>(vii)</sup>

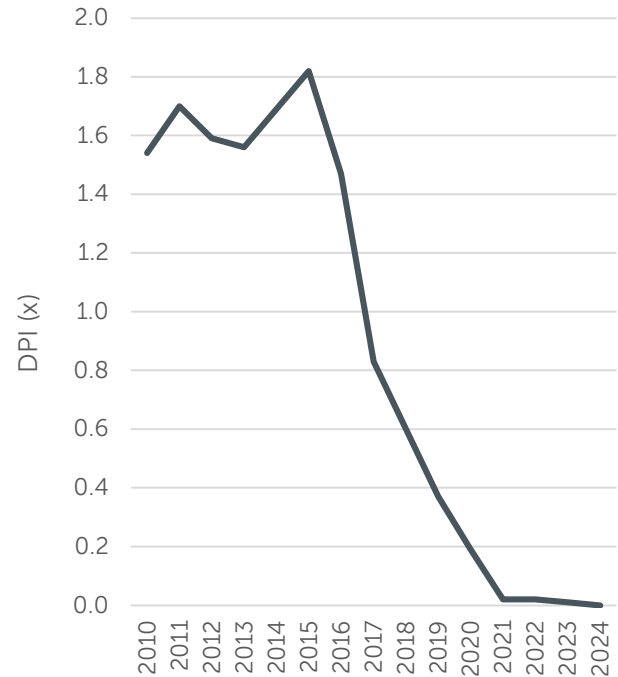


Figure 4: Distributions to Paid-In Capital (DPI) for Private Equity, by Vintage Year

### Impending Loan Maturity Wall <sup>(viii)</sup>

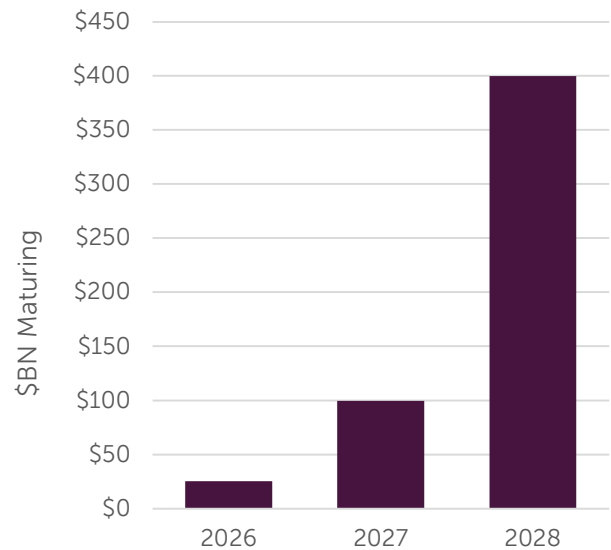
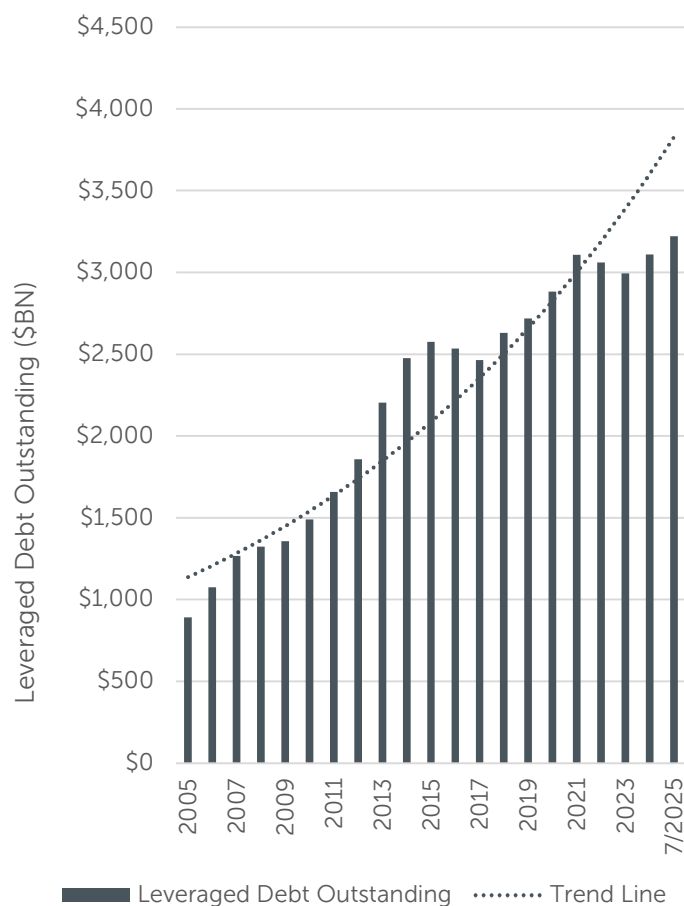


Figure 5: US LLI Loan Maturity Wall

While the current confluence of factors is contributing to an attractive opportunity set, we also recognize that the long-term trend of sub-investment grade debt outstanding balance has continued to grow over time, as seen in Figure 6. This secular reality, despite the higher interest rates in the last few years, suggests that a growing and substantial set of opportunities will persist well into the future.

#### Sub-Investment Grade Debt Outstanding <sup>(ix)</sup>



**Figure 6: US LL and HY Bond volumes – sub-investment grade debt – continue to grow, despite recent higher interest rates.**

In conclusion, Axar believes that the recently observed sequence—rapid expansion in credit availability chasing a steady number of companies, followed by a sustained erosion in the factors that underpinned that

growth and deployment—has led to significant deterioration in overall credit quality of the Leveraged Loan market. This market reality has led to innovations such as the LME, designed to extend the duration of private equity investment horizons, at the expense of credit quality. This weakening credit environment is now contributing to a sustained higher default rate paradigm, which now must be evaluated including both stated defaults and LMEs (a synthetic default), creating an attractive opportunity set for Axar’s opportunistic credit strategy. Moreover, when we look at the historical steady growth in the sub-investment grade debt market over the last 20+ years, growing at a ~6.4% CAGR, we are confident that opportunities will continue to present themselves in the future, in an environment where competition is likely to remain subdued.

In our second piece, we more closely examine how a decade of ultra-low rates, combined with idiosyncratic structural factors, has reshaped the distressed investor landscape—reducing competition for middle-market credit opportunities broadly and dislocating prices across our investment universe.

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## END NOTES / SOURCES

- (i) JP Morgan North American Credit Research
- (ii) Pitchbook
- (iii) Pitchbook, YTD 2025 through 6/30/25
- (iv) Pitchbook
- (v) Moody's, LCD
- (vi) BofA Global Research
- (vii) Pitchbook
- (viii) LCD
- (ix) Pitchbook, 2025 is based on actuals YTD through July 2025.