AVISTA GROUP 艾华迪集团

Valuation in Private Credit Instruments

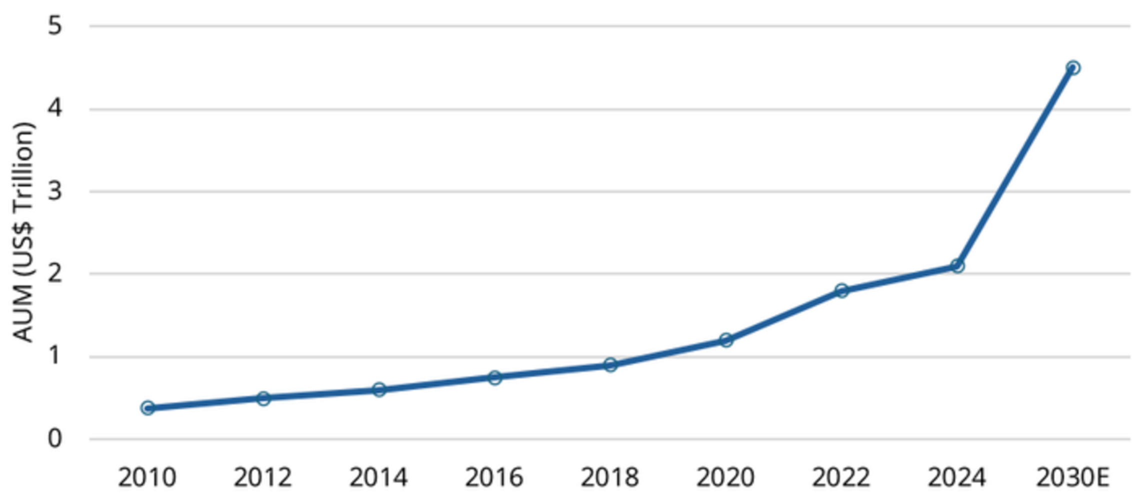
Marking a $2 Trillion Asset Class in the Dark: Why Fair Value, Not Spread, Is Now Private Credit's Most Important Metric

1. The Asset Class at an Inflection Point

A Decade of Compounding Growth

Over the past decade, private credit has evolved from a niche alternative into a cornerstone asset class within global finance. According to Preqin and the Financial Times, the global private credit market surpassed $2 trillion in assets under management (AUM) in 2025, up from approximately $380 billion in 2010, and is projected to expand at a compound annual growth rate (CAGR) of 13%, reaching $4.5 trillion by 2030.

Exhibit 1: Global private credit assets under management, 2010–2030E



Source: Preqin (2025) and Financial Times

The rise of private lending can be traced back to the aftermath of the Global Financial Crisis. Stricter regulatory frameworks imposed on traditional banking institutions severely constrained their ability to provide capital to middle-market enterprises. This retrenchment created a substantial liquidity gap, which increased demand from businesses for alternative financing sources outside traditional borrowing and lending channels, a gap agile non-bank direct lenders quickly moved to fill.

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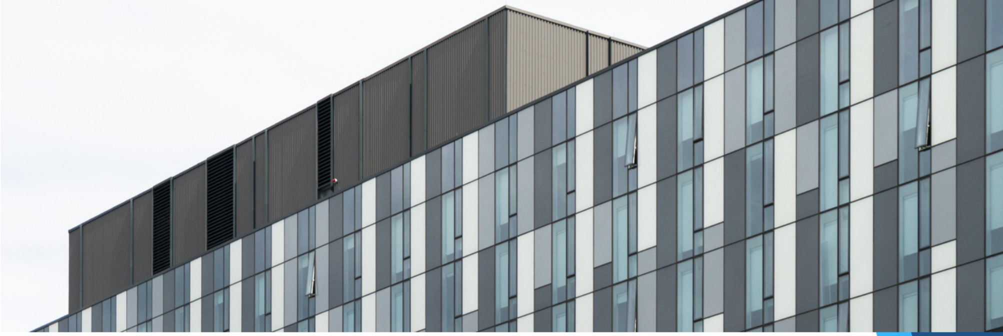

Private credit offers distinct advantages to both borrowers and investors:

- **For Borrowers:** Direct lenders provide tailored terms, structural flexibility, rapid execution, and certainty of closing.
- **For Investors:** Asset managers benefit from portfolio diversification, appealing risk-adjusted returns, and reliable yield premiums relative to public fixed income.

The spectrum of strategies is vast—ranging from senior direct lending and mezzanine debt to distressed debt, special situations, and infrastructure credit—allowing institutional portfolios to customize risk/reward profiles.

Where the Cycle Has Turned

However, following years of rapid expansion, the market is facing heightened scrutiny regarding borrower credit quality. According to Fitch Ratings, the U.S. private credit default rate reached a record 6.0% for the twelve months ended May 2026.

Crucially, 52% of these defaults involved interest payment deferrals or conversions to payment-in-kind (PIK) arrangements, where unpaid interest is added to the principal balance rather than settled in cash. While PIK provisions offer borrowers temporary liquidity relief, they can obscure underlying financial distress and dramatically increase leverage over time. Analysts at Morgan Stanley warn that overall defaults could climb toward 8% in 2026.

Exhibit 2: Breakdown of Private Credit Default Event (TTM to May 2026)

Default Event Type	Share of Defaults
Interest payment deferral or PIK conversion	52%
Distressed maturity extension	36%
Uncured payment default	6%
Bankruptcy, liquidation, debt-for-equity swap, or out-of-court restructurings	6%

Source: Fitch Ratings

PIK usage is the clearest channel through which borrower stress permeates carrying values. Lincoln International, which values approximately one-third of U.S. private credit portfolios, reports that PIK-structured loans more than doubled from 5% of the market in early 2022 to 11% by year-end 2025. More critically, “bad PIK”—cash-pay loans converted to PIK terms under distress—rose from 2% to 6.4% over the same period. Public Business Development Companies (BDCs) now recognize roughly 8% of investment income in non-cash form.

> *For valuation professionals, every PIK conversion poses a core question: Has the instrument’s cash flow merely been rescheduled, or has its fundamental risk profile changed such that the discount rate must widen even as interest accrues on paper?*

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These concerns are magnified by the sector's concentrated exposure to software and technology borrowers, which account for an estimated 40% of all sponsor-backed private credit loans. The rapid acceleration of artificial intelligence is disrupting established business models, putting pressure on software borrowers that lag in adaptation and weakening their debt servicing capacity. Combined with rising default metrics, these structural shifts raise the prospect of spillover into broader financial markets and place valuation transparency firmly at centre stage.

Why Valuation Is Now the Binding Constraint

Unlike broadly syndicated loans or corporate bonds, private credit instruments are originated bilaterally. Because these loans do not trade publicly, they are classified as Level 3 investments under the fair value hierarchy, making them illiquid and highly dependent on model-driven valuation methodologies.

This classification has consequences far beyond compliance reporting. During Q1 2026, several prominent semi-liquid funds restricted investor redemptions:

- BlackRock’s HLEND gated redemptions after withdrawal requests (~$1.2 billion) outpaced new inflows ($840 million).
- Morgan Stanley capped redemptions on a private credit vehicle after requests reached 10.9% of net assets.
- Cliffwater capped redemptions on its $33 billion fund at 7% against withdrawal requests of 14%.

Where redemptions are struck at Net Asset Value (NAV) and that NAV is model-derived, the mark ceases to be an accounting exercise—it becomes the exact price at which capital transfers between exiting and remaining investors. Consequently, fair value discipline has shifted from a back-office compliance routine to a core fiduciary responsibility.
Furthermore, secondary markets do not yet offer reliable price discovery. At an estimated $18 billion in 2025, private credit secondary volume represents only ~1% of total market AUM (compared to 2–3% annual turnover in private equity). In the absence of observable exit transactions, the discount rate carries the entire burden of capturing credit deterioration.

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2. Valuation Approach

Valuation Methodology

The Discounted Cash Flow (DCF) model serves as the foundational methodology for valuing private debt instruments. This approach is executed through two primary steps:

- **Projecting Cash Flows**: First, map out the loan's future contractual cash flows, including periodic cash interest payments, accumulated PIK interest, and the ultimate principal repayment at maturity.

- **Discounting to Present Value**: Next, discount these projected cash flows to present value using an appropriate discount rate. This discount rate is critical; it represents the current market yield an independent market participant would demand today to assume a loan with an identical risk profile, credit quality, and remaining maturity.

Discount Rate Derivation

The derivation of the discount rate begins with the yield of comparable public bonds that share similar credit ratings, terms to maturity, and trading characteristics with the subject instrument. This baseline yield is then adjusted for specific risk factors such as country risk and asset illiquidity.

Mathematically, the discount rate is constructed using the following build-up approach:

Exhibit 3: Illustrative Discount Rate Build-Up Framework

Component	Rate	Description
Yield on Comparable Public Bond	9.5%	Benchmark yield of public peers with similar credit ratings and terms
Less: Risk-Free Rate of Comparable Bond	4.0%	Deduct risk-free rate of the benchmark bond's currency/jurisdiction
= Implied Credit Spread	**5.5%**	**Derived credit risk premium over risk-free baseline**
Add: Risk-Free Rate for Subject Instrument	3.2%	Add risk-free rate matching the target loan's currency and maturity
= Proxy Baseline Yield	**8.7%**	**Adjusted benchmark yield**
Add: Country Risk Premium	1.1%	Adjust for geopolitical or economic risks of borrower's jurisdiction
Add: Illiquidity Premium	1.5%	Premium charged for the lack of secondary market liquidity
= Concluded Discount Rate	**11.3%**	**Discount rate applied to projected cash flows**

Note: The practical derivation of the discount rate may vary depending on transaction-specific facts, data availability, and instrument structures. The framework above is provided for illustrative purposes.

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3. Key Valuation Considerations for Private Credit

Determining the fair value of private credit requires evaluating both quantitative credit metrics and qualitative structural features. Because these assets are illiquid and do not trade on public exchanges, the gap between observable market data and the unique characteristics of the subject loan must be carefully bridged.

The table below highlights key valuation considerations within a comprehensive private credit valuation framework:

Exhibit 4: Private credit valuation considerations framework

Consideration Dimension	Description & Methodology
Market Calibration	Valuation begins by calculating the loan's implied yield and spread at the time of purchase or underwriting to establish an empirical baseline. Subsequent valuations require adjusting these inputs based on changes in the borrower's credit profile, financial performance, and prevailing market spreads.
Credit Risk Assessment	Monitoring quantitative shifts in the borrower's profile by tracking key performance indicators, credit metrics, and underlying financial performance. Any changes to the borrower's credit rating must be incorporated into the discount rate in subsequent valuation.
Liquidity & Country Risk Premium Adjustments	Apply an illiquidity premium to the discount rate to account for the loan's lack of secondary market trading liquidity. Where applicable, incorporate a country risk premium to reflect structural, political, and economic risks inherent when the operating country of the borrower differs from that of its public benchmark peers.
Structural Protections	Assess the value impact of loan-specific structural terms, including senior collateral backing (such as first-lien security), financial covenant compliance/leeway, and embedded options or special features (such as equity warrants or call protection).
PIK, Amendment & Covenant Overlay	Evaluate whether PIK conversions or covenant waivers reflect routine liquidity management or credit deterioration. Restructurings agreed under stress require immediate spread adjustments, even if interest accrues on schedule.
Governance, Calibration Cadence & Back-testing	Maintain a formal valuation policy with set revaluation cadences, independent Level 3 reviews, and systematic back-testing of marks against realized exits (repayments, refinancings, sales).

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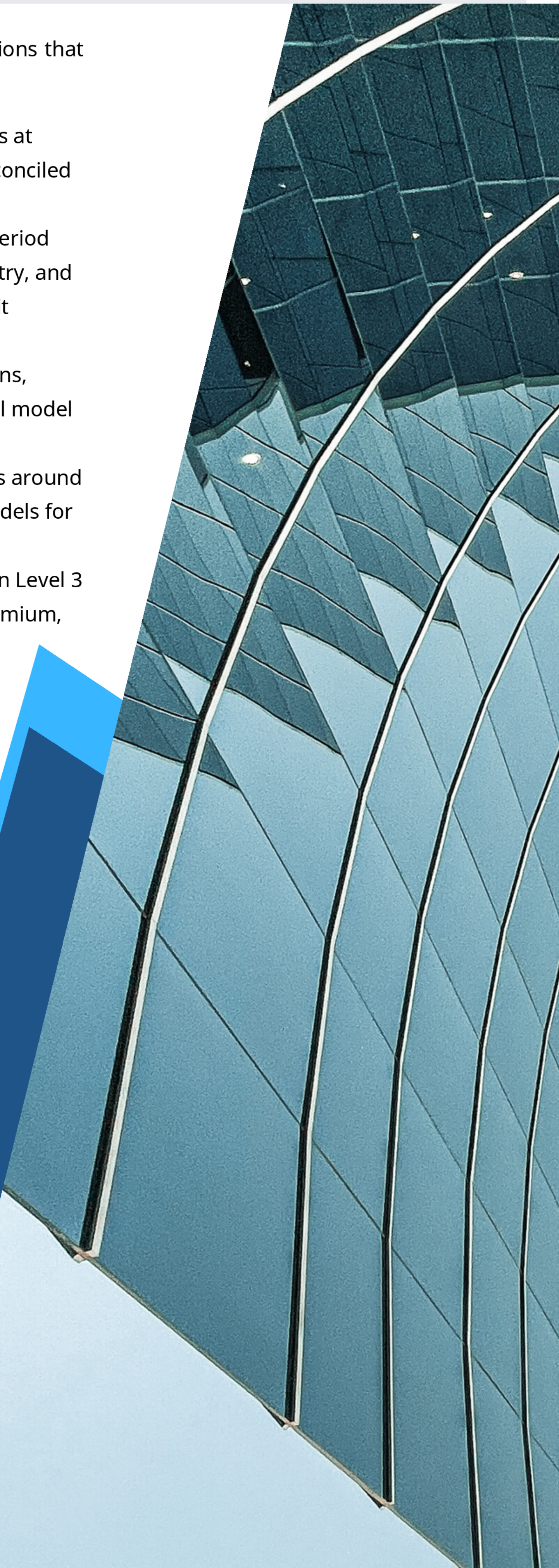
4. Best Practices for Valuation Governance

Across our advisory work, five practical steps distinguish valuations that withstand auditor and LP scrutiny:

1. **Anchor to Inception:** Establish clear yield and spread metrics at underwriting. Every subsequent mark should be explicitly reconciled back to this origin point.
2. **Decompose Rate vs. Credit Drivers:** Separate period-over-period yield adjustments into distinct risk-free, market spread, country, and credit risk components. Unattributed mark shifts will fail audit reviews.
3. **Treat Amendments as Revaluation Triggers:** PIK conversions, covenant resets, and maturity extensions must trigger formal model reassessments rather than rolling forward historical inputs.
4. **Stress-Test Downside Scenarios:** Include sensitivity analyses around the discount rate and prepare recovery-based liquidation models for watchlist assets.
5. **Document the Rationale, Not Just the Math:** Defensibility in Level 3 assets relies on the qualitative evidence trail behind each premium, not just formulaic calculations.



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5. Conclusion

The methodologies applied when measuring the fair value of private credit instruments must remain consistent over time and anchored to parameters established at deal inception. Given the inherently unobservable nature of private markets, engaging independent valuation specialists with deep direct lending experience is essential to maintaining credible estimates.

Independent valuation plays a vital role in fund governance across three key pillars:

- **Enhances Investor Confidence:** Independent valuations increase transparency and credibility, giving investors greater confidence that reported NAVs fairly reflect the underlying loan portfolio.
- **Strengthens Risk Management:** Independent specialists provide an objective challenge to internal assumptions regarding credit quality, default probabilities, and recovery rates—creating an additional control layer that helps identify emerging risks earlier.
- **Ensures Audit & Regulatory Compliance:** Delivers a documented, defensible audit trail that satisfies the rigorous review standards of auditors, regulators, and Limited Partners (LPs).

As private credit matures into a $2+ trillion pillar of global capital markets, independent valuation will transition from a periodic compliance exercise to a standard requirement of institutional-quality fund management.

Contact Us

Vincent Pang
CFA, FCPA, FCPA (Aust.), MRICS, RICS Registered Valuer

Managing Partner
+852 3702 7338
+86 138 1023 8603
vincent.pang@avaval.com

ABOUT AVISTA GROUP

AVISTA Group ("AVISTA") is a leading professional advisory firm. We are experienced in performing a full range of Valuation Advisory, Risk Management Advisory, ESG Advisory, Corporate Advisory and Property Consultancy services for various purposes.
AVISTA is a corporate member of The International Valuation Standards Council (IVSC). With a strong presence in the Asia-Pacific region, we have offices in Hong Kong, Shanghai, Beijing and Shenzhen. Through effective utilization of our local and international networks and the synergies among our service lines, we aim at providing high-quality services to clients and assisting clients in formulating strategies to maximize their value under complex business circumstances.

Sources: Preqin (2025); Financial Times; Fitch Ratings U.S. Private Credit Default Rate (May 2026); Moody's Ratings; Proskauer Private Credit Default Index (Q1 2026); Lincoln International; With Intelligence Private Credit Outlook 2026; Morgan Stanley; IPEV Valuation Guidelines. Market data as at July 2026.

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