

# CALLODINE | CREDIT

## Asset Based Lending

Quarterly Market Commentary: Q2 2025

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# Market Commentary

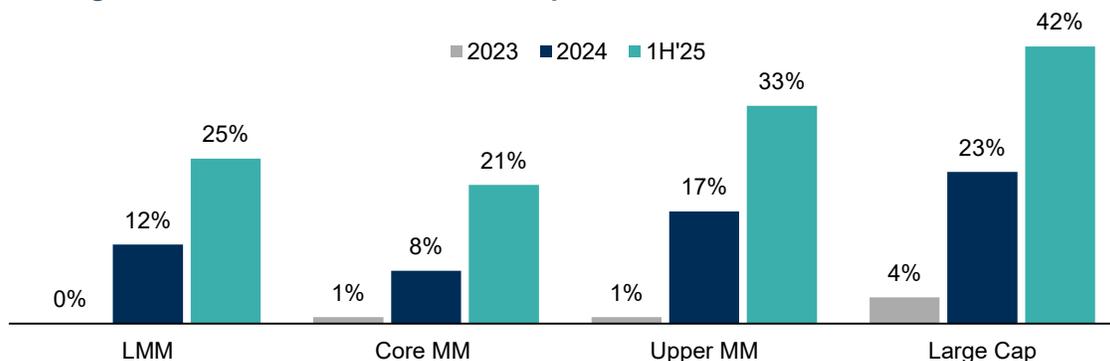
The second quarter of 2025 was a tale of two markets, or perhaps more aptly “two tariffs”. The tariff-related announcements of Liberation Day on April 2nd sent shockwaves through both equity and credit markets, which had a cascading effect on primary capital issuance early in the quarter. However, as the quarter progressed markets recovered, and animal spirits returned, driving equity markets to new highs, and credit spreads to multi-decade lows.

For credit investors eager to deploy capital, this uncertain economic backdrop and dearth of new issue supply created a challenging environment in Q2 2025.<sup>1</sup> The Trump administration’s April 2nd tariff announcement triggered a global financial sell-off and ushered in heightened uncertainty reminiscent of the early days of the COVID-19 pandemic.<sup>1</sup> A series of erratic U.S. policy shifts further fueled volatility, significantly slowing deal activity. Nowhere was this disruption more pronounced than in the syndicated loan market, which experienced its worst instability since 2020 – including a 15-day stretch without a single broadly syndicated loan launched in the U.S., the longest such pause since the pandemic.<sup>1</sup>

As the syndicated market faltered, private credit stepped into the void.<sup>1</sup> By May, rebounding secondary market prices helped stabilize conditions, allowing direct lenders to re-engage, much as they did during similar dislocations in 2022 and 2023.<sup>1</sup> According to market participants, many deals that had stalled during the volatility ultimately moved forward, but with private credit replacing syndicated loans as the financing solution.<sup>1</sup> In effect, the turbulence not only disrupted traditional lending, but also reinforced the ongoing shift toward private credit.

However, despite ongoing macroeconomic uncertainty, current market conditions remain favorable for borrowers. As shown in the exhibit below, pricing continues to compress, with an increasing share of private credit transactions now pricing inside SOFR + 500 basis points across EBITDA buckets in the first half of 2025.

## Growing Share of Deals With Sub S+500 Spreads



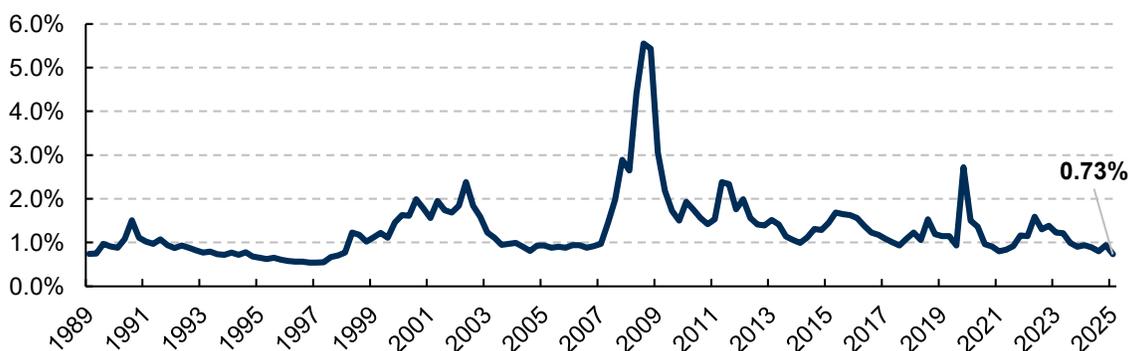
Source: KBRA DLD. Note: Middle-market EBITDA definitions are defined as: Lower Middle Market (LMM) = <\$20M, Core Middle Market (MM) = \$20M to < \$50M, Upper Middle Market (MM) = \$50M to < \$100M, and Private Large Cap. = \$100M+.

<sup>1</sup> Source: Pitchbook LCD Q2 2025 US Private Credit and Middle Market Quarterly Wrap.

Within the private credit landscape, the upper middle market has seen the most notable spread compression, with the largest number of deals pricing at or below SOFR + 500 basis points. This is likely due to increasing competition for deals from both private lenders and the syndicated market .<sup>1</sup>

Furthermore, this trend has persisted into Q3 2025, as the extra yield investors receive for owning investment-grade corporate bonds over Treasuries has narrowed to just 73 basis points, the lowest level since 1998, according to Bloomberg index data shown in the exhibit below:

### The Spread Between U.S. Investment-Grade Corporate Bonds and Treasury Yields Hit 27-Year Low



Source: Bloomberg as of 8/15/25

This compression reflects broader investor behavior. The drop suggests bonds have become unusually expensive, as investors rush to lock in current interest rates despite risks from a slowing economy and the U.S. trade war.<sup>2</sup> Bond traders are betting the Fed will cut rates as soon as next month, following economic data showing inflation in line with expectations and a weakening labor market.<sup>2</sup>

In parallel, we are seeing increasing signs of liquidity stress within the private credit market. In our Q1 2025 ABL Market Commentary, we highlighted the rising pressure on cash flow generation and the growing use of payment-in-kind (PIK) structures by borrowers to manage short-term liquidity constraints. That trend accelerated in Q2 2025, with the share of private credit borrowers deferring at least part of their cash interest payments reaching the highest level in nearly four years, according to data from Lincoln International. This uptick signals mounting stress within the \$1.7 trillion private credit market.<sup>3</sup>

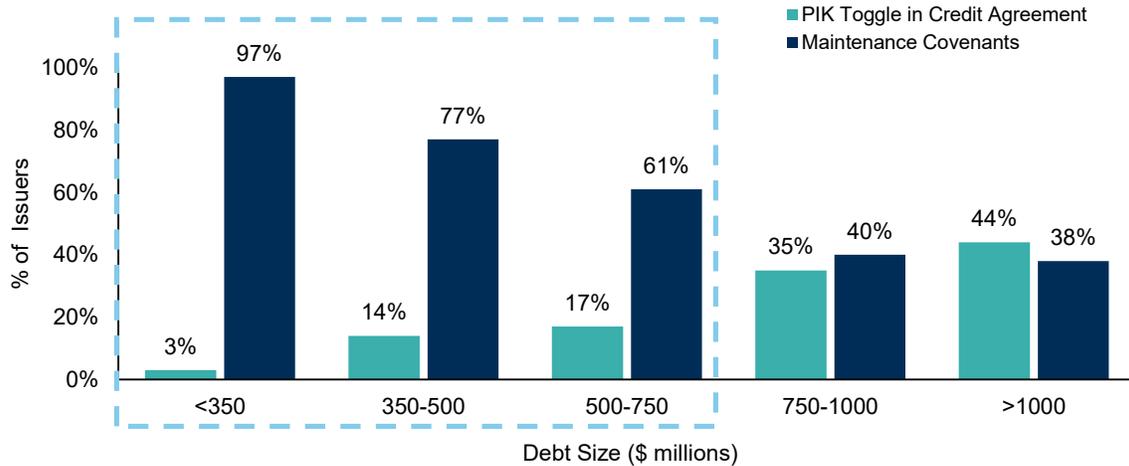
<sup>1</sup> Source: Pitchbook LCD Q2 2025 US Private Credit and Middle Market Quarterly Wrap.

<sup>2</sup> Source: Bloomberg: [US Corporate Bond Spreads Sink to 27-Year Low as 'FOMO' Sets In \(August 15, 2025\)](#)

<sup>3</sup> Source: Bloomberg: [Private Credit PIK Usage Nears Four-Year High: Lincoln \(August 12, 2025\)](#)

Concurrently, covenant packages have continued to shift in favor of borrowers, eroding lender protections. As shown in the chart below, you can see the inverse relationship between the debt size and presence of a PIK toggle or financial maintenance covenant. We continue to see value in the lower middle market where there's fewer PIK loans and stronger covenant protections.

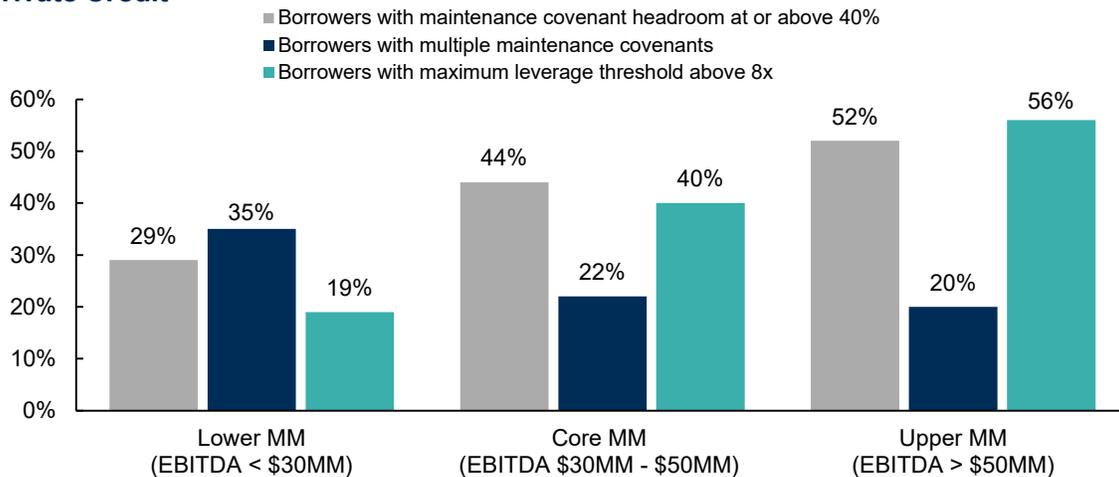
### PIK Down & Covenants Up In The Lower Middle Market



Source: S&P Global Ratings-adjusted debt. PIK = Payment in kind. S&P Global Ratings as of July 2025.

While maintenance covenants remain common across most private credit agreements, their effectiveness has deteriorated due to increasingly generous leverage limits (as shown in the chart below). These loose covenants make it harder for lenders to respond proactively to early signs of borrower underperformance.

### Guardrails Removed: Loose Maintenance Covenants Have Permeated Throughout Private Credit



Source: S&P Global Ratings "Loose Maintenance Covenants Permeate Private Credit" published 4/23/25

For example, more than a third of borrowers in S&P Global Ratings' Credit Estimate pool with actively tested leverage-based covenants had headroom exceeding 40%, with even higher levels observed in the core and upper middle market segments. According to S&P, these wide cushions reflect covenant thresholds set well above closing leverage levels, rather than meaningful deleveraging.<sup>4</sup> While ample covenant headroom provides borrowers with flexibility during periods of stress, we believe the widespread use of loose covenant terms could ultimately impair recovery values for lenders.

The combination of looser terms and rising financial pressure has contributed to a sharp rise in selective defaults<sup>5</sup>, according to the recent report *S&P Private Credit: The Rising 'Defaults'*. In 2024, selective defaults<sup>5</sup> outpaced conventional defaults by a 5:1 ratio, largely driven by flexible covenant structures and the increasing use of PIK conversions. Historically, the most common drivers of selective defaults<sup>5</sup> have been cash-pay interest tranches switching to PIK or maturity extensions that lack sufficient compensation for investors.<sup>4</sup> Both trends accelerated in Q2 2025, with a 50% increase in issuers extending maturities and a 20% rise in PIK activity compared to Q1 2025.<sup>4</sup> These developments reflect the fragile liquidity positions of weaker issuers, many of whom are prioritizing short-term relief over long-term balance sheet repair. This, in our experience, is a dangerous game.

The current investment landscape presents a host of challenges for credit investors including tighter spreads, an uncertain economic outlook, and unfavorable supply/demand dynamics that we would argue are overwhelming the underlying fundamentals. At the same time, limited capital availability within the true middle market has resulted in interesting opportunities for lenders that can provide thoughtful capital solutions.

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<sup>4</sup> Source: S&P Global Report: Private Credit: The Rising 'Defaults' (July 2025)

<sup>5</sup> **Definition: Selective Default:** S&P Global defines a selective default ('SD') rating as occurring when an obligor (an entity that owes a financial obligation) has defaulted on a specific issue or class of obligations, but is expected to continue meeting its payment obligations on other issues or classes of obligations in a timely manner. This differs from a general default ('D') where the obligor is expected to fail on most or all obligations. A selective default also includes completing a distressed exchange offer, where one or more financial obligations are repurchased or replaced with instruments of lower value. However, it does not include hybrid instruments classified as regulatory capital.

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