

01 · THE QUESTION

The Return of Gravity.

PRIVATE CREDIT STRESS IS WELL DOCUMENTED. THE QUESTION IS WHAT HOLDS UP.

In "The Naked Truth" we argued that dispersion is the signal and discipline is the answer. In "The Race We Didn't Run" we showed what that discipline looked like over seventeen years. This piece asks the next question: what does discipline actually protect you from?

It starts with the question investors are asking us more than any other: what do higher interest rates mean for the companies we lend to?

The question assumes rates are high. They are not. On September 16 the Federal Reserve raised its target range to 3.75% to 4.00%, its first increase since July 2023, and that is still below the average of the past half century. Yet coverage is thin, more borrowers have stopped paying interest in cash, and investors are asking for their money back.

None of that is news. The more useful question is which companies and lenders hold up under it, and why.

Our answer: higher rates are the stress test, not the whole story. Capital structures built for lower rates decide the result: high leverage, heavily adjusted EBITDA and few or no covenants leave little margin for error and little recourse. For well more than a decade, borrowers and lenders operated in a world where capital was extraordinarily cheap. The structures they built reflected it. Everyone thought they were flying. Gravity simply hadn't mattered. Now it does.

THE CURRENT SETUP

6.1×	4.0%	1.6×	21%
A heavy load	**Gravity is back**	**Little room**	**Fewer guardrails**
Median leverage · KBRA	*Fed target, upper bound*	*Median coverage · KBRA*	*Cov-lite deals, up from 15%*

"Interest rates are to asset prices ... sort of like gravity is to the apple."

WARREN BUFFETT · BERKSHIRE HATHAWAY, MAY 2013

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Higher rates aren't indiscriminately breaking businesses. They're exposing the capital structures with the least room for error. **Gravity reveals where the margin was thin.**

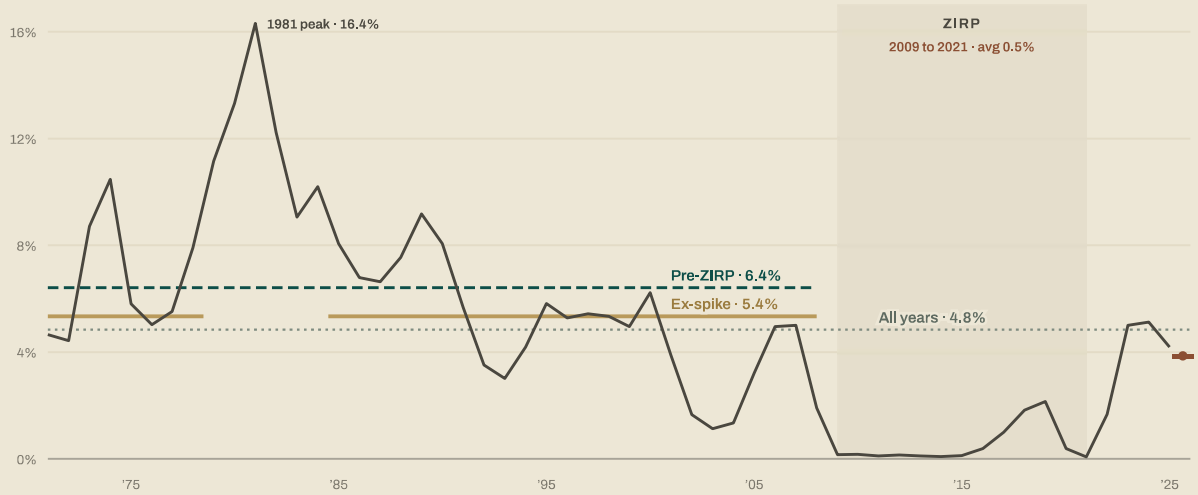
Rates aren't high. They're normal.

THE ANOMALY WAS ZIRP.

Since 1971 the federal funds rate has averaged 4.8%. During the zero interest rate policy years (ZIRP), 2009 through 2021, it averaged 0.5%. Before ZIRP it averaged 6.4%, or 5.4% leaving out the 1979 to 1984 spike. Today's target range of 3.75% to 4.00% is not historically extraordinary. Thirteen years near zero were.

FEDERAL FUNDS RATE SINCE 1971

Annual average and current target. Dashed: 1971–2008 average · Gold: same, excluding the 1979–84 spike · Dotted: all years



Source: Federal Reserve Board via FRED, annual effective rate; FOMC, Sept. 16, 2026.

So the level of the rate is not the whole story. **The rate is the stress test. The capital structure determines the result.** A 4% policy rate was unremarkable for most of the last fifty years, and companies borrowed, grew and repaid their debts through it. What changed is what was built while rates were at zero: capital structures at six and seven times earnings that only worked because the interest bill barely registered.

Most private loans are floating rate, so a normal base rate reaches those structures within a quarter. It exposes them in three ways.

1. **Cash flow.** Interest takes a larger share of earnings, leaving less for growth and less cushion for a bad year.
2. **Refinancing.** Highly levered capital structures put in place in 2021 and 2022 are coming due at today's coupons. Extending the maturity, or letting interest accrue instead of being paid in cash (payment-in-kind, or PIK), buys time but does not reduce the debt.
3. **Valuation.** Higher rates lower what buyers will pay for a company. The equity beneath the loan shrinks, and the lender's cushion shrinks with it, even if the company has done nothing wrong.

Gravity has a vintage. The companies lenders are taking over were mostly bought in 2021 and 2022, when rates were near zero and leverage was abundant. Those two years account for about 70% of loans taken over in the first half of 2026. Takeovers are running at roughly twice last year's pace: six months nearly matched all of 2025 (Lincoln International). Rates alone did not cause every takeover, but stress isn't appearing randomly. It is clustering in capital structures built near the end of the free-money era.

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Historically ordinary rates can still be extraordinarily demanding for capital structures designed around near-zero borrowing costs. **A capital structure that only works at zero was never strong. Normal rates are exposing it.**

The market is separating. The headlines haven't caught up.

PRIVATE CREDIT SHOWS IT IN PIK AND MARKS. PUBLIC MARKETS SHOW IT IN DAILY PRICES.

To see where this is showing up, we once again look to business development companies (BDCs), the one part of private credit that publishes loan-level data every quarter. BDCs skew toward larger, sponsor-backed borrowers, so they show how the crowded part of the market is holding up. Start with the figures everyone watches. Loans on non-accrual are 1.9% of BDC portfolios (Octus), and 4.0% at the ten largest public BDCs (PitchBook LCD). Covenant defaults are 2.7% (Lincoln International, a broader private-market sample). Both look manageable on the surface.

But defaults are a lagging and incomplete measure. Before a borrower defaults, it often stops paying interest in cash and adds it to the balance instead, known as payment in kind, or PIK. PIK agreed at origination is a financing choice; PIK added after closing usually signals strain. Four signs the default rate misses:

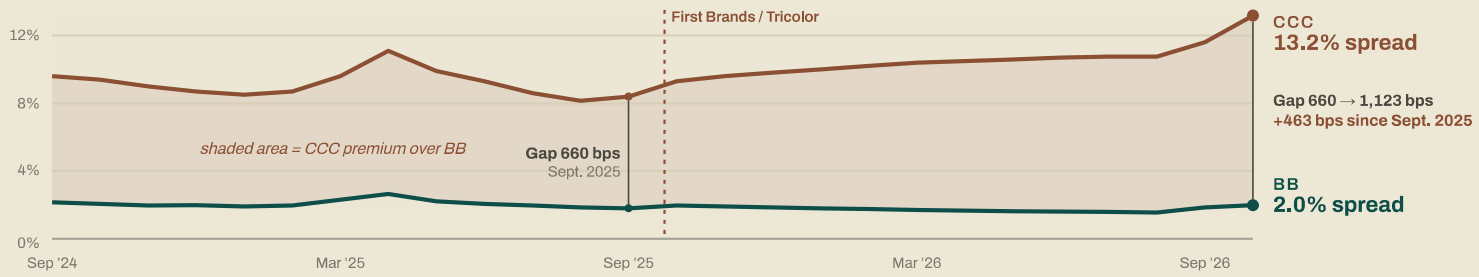
- **Rising use.** PIK is on about 10% of BDC loans, up from about 6% three years ago (Boston Fed).
- **Switching mid-loan.** 6.2% of loans were allowed to stop paying cash after closing (Lincoln).
- **Lower marks.** Lenders mark PIK loans about five points below cash-pay loans (PitchBook LCD).
- **A leading indicator.** LCD flags 583 of about 5,200 BDC borrowers as stressed at June 30, up 25% since year-end.

Public markets offer another perspective. While private credit stress can emerge gradually through PIK elections, amendments and periodic marks, public credit markets reprice risk daily. Since September 2025, spreads on lower-rated high yield bonds have widened while stronger credits have remained comparatively stable. The widening gap between BB and CCC spreads suggests investors are becoming more discriminating about credit quality.

These are different markets, with different borrowers and structures. But the underlying message is consistent: investors are distinguishing more sharply between credits that can absorb today's cost of capital and those that cannot.

ONE MARKET, TWO PRICES

BB and CCC high yield spreads: the widening premium for weaker credit, September 2024 to October 27, 2026



Source: ICE BofA BB and CCC & Lower US High Yield option-adjusted spreads via FRED, month-end, with the latest reading on Oct. 27, 2026 (BB: Oct. 26). Gap is CCC minus BB.

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None of this is a crisis. Earnings still grow and realized losses remain low. But beneath manageable headline numbers, stress is becoming more visible and more concentrated. Public markets are drawing sharper lines between credits; private market indicators show deterioration defaults don't capture. The dispersion we described in "The Naked Truth" is harder to ignore. **The first sign of trouble is rarely a default. It is the disappearance of cash interest.**

Is smaller really riskier?

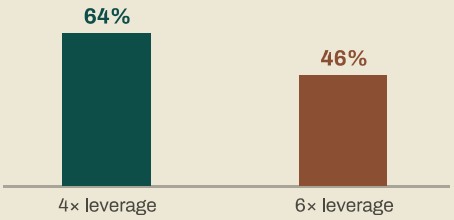
SMALL BORROWERS BREAK FIRST, OR SO IT GOES. SIZE IS ONLY PART OF THE STORY.

If normal rates are exposing fragile capital structures, the next question is where those structures sit. The conventional answer is with the smallest companies. The two carry different kinds of risk. Smaller companies are more exposed to business risk: fewer customers, less pricing power, thinner management teams. Larger borrowers carry more financial risk: more debt per dollar of earnings and lighter covenants. A rising base rate acts on financial risk.

The arithmetic is simple. Take two borrowers paying 9% interest. One owes four times its annual earnings, so interest eats 36% of those earnings. The other owes six times, so interest eats 54%. Each further rise in rates costs the second borrower 50% more than the first.

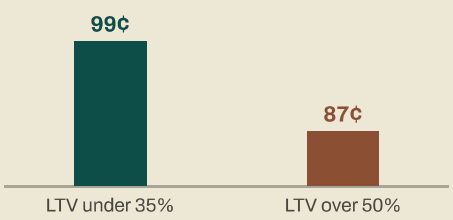
MARGIN FOR ERROR

Earnings decline before interest is uncovered, interest only, at a 9% coupon



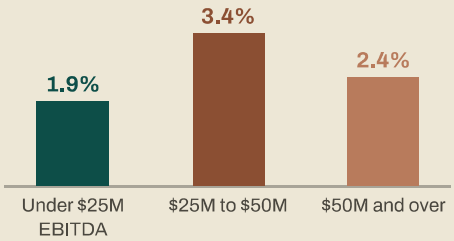
EVEN IN SOFTWARE, STRUCTURE DECIDES

Software loan prices by loan-to-value (LTV), cents on the dollar. Axis from 80¢.



SIZE ALONE DOESN'T DECIDE IT

Default rate by borrower size, Q2 2026



Source: Avante illustration (interest only); Lincoln International, Q2 2026; Proskauer, Q2 2026 (716 loans).

The evidence on size is mixed. Proskauer's index, one law firm's deals over a single quarter, shows the smallest borrowers defaulting least. Houlihan Lokey finds the opposite in BDC portfolios: about 12% of borrowers with under $20 million of EBITDA are marked below 90 cents, up from 1% in 2023, against 3% of the largest (Houlihan Lokey, Q2 2026).

So we look at risk differently. Not big versus small, or software versus healthcare. Size and sector tell you about the business. Structure tells you about the loan, and how much of the risk reaches the lender. Covenants show the split: 91% of 2025's covenant-lite deals were at companies above $50 million of EBITDA (Proskauer). Below that line, lenders still have guardrails.

That gives "discipline" a concrete meaning: what is already in the capital structure when gravity returns, with no dependence on refinancing or PIK to get through a bad year. On a simplified, interest-only basis at a 9% coupon, earnings at our 3.6 times leverage can fall about two-thirds before interest goes uncovered; at the market's 6.1 times, less than half. The market is moving this way too: most lenders surveyed by PitchBook LCD expect sponsors to put in more equity over the next six months.

THE AVANTE SETUP

3.6×	2.3×	100%
A lighter load	**More room**	**Real guardrails**
Net leverage · market 6.1×	*Coverage · market 1.6×*	*Covenants · market 79%*

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Discipline isn't the absence of risk. It's building a capital structure with enough room for reality. **Size alone doesn't protect a lender. The business matters. The structure determines how much room it has to disappoint.**

Ask about the cushion, not the label.

FIVE QUESTIONS FOR ANY PRIVATE CREDIT MANAGER, INCLUDING US.

The question isn't whether a manager lends to small companies or large ones. It's whether those companies can absorb a bad year without asking the lender for more time, more leverage or more capital.

1 **Leverage.** What is leverage across the portfolio today, on reported earnings and after stripping out adjustments?

2 **Cushion.** How much can EBITDA decline before fixed-charge coverage falls below 1.0×, at today's base rate and 50 basis points higher?

3 **Deferred interest.** How much income is paid in kind, and how much of that was added after the loan was made?

4 **Marks.** Where you hold a loan that other lenders also hold, how does your mark compare with theirs?

5 **Overlap.** How much of your portfolio do I already own through my other private credit funds?

We began with a question about higher rates. What we found is the mechanism behind this series: dispersion is the signal, discipline created different exposures, and capital structure is why those differences now show up in outcomes. The era of free money hid that. It no longer does.

OUR READ

Gravity does not pick winners. **It reveals who was standing on something.**



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Sources.

Sources are named in the text and charts; full citations follow. Avante Capital Partners portfolio data · Berkshire Hathaway Annual Meeting (May 2013) · Federal Reserve Board (FOMC statement, Sept. 16, 2026; effective federal funds rate via FRED) · Federal Reserve Bank of Boston, "PIK in BDC Portfolios" working note (Aug. 2026) · Houlihan Lokey (Sept. 2026, via PitchBook LCD) · ICE BofA BB and CCC & Lower US High Yield indices (via FRED) · KBRA Middle Market Compendium (Q2 2026) · Lincoln International (Private Market Index and software loan-to-value analysis, Q2 2026; lender takeover data, H1 2026) · Octus (Q2 2026) · PitchBook LCD (BDC Quarterly, Q1 2026; BDC credit pressure, cash-to-PIK and non-accrual analyses, Aug. to Sept. 2026; US Credit Markets Quarterly Wrap, Q3 2026) · Proskauer Private Credit Default Index (Q2 2026, via PitchBook LCD) and Private Credit Insights covenant survey (2025 and 2024 editions). Avante figures are portfolio medians at entry for current investments (net leverage, fixed-charge coverage, share of loans with financial covenants); market comparisons are KBRA middle market medians (leverage, coverage) and Proskauer's 2025 deal sample (covenants), so populations and definitions differ.

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