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Capital Solutions Strategy

The Big Mispricing in Private Credit — And Why Emerging Markets May Actually Be Safer

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A Better Approach To Emerging Markets[®]

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The Big Mispricing in Private Credit — And Why Emerging Markets May Actually Be Safer

Institutional investors have long treated developed market (“DM”) private credit (specifically, senior direct lending) as a relatively safe, stable corner of their portfolios. That assumption once held true. DM deals were conservative: conventional leverage, protective covenants, and genuine lender controls. But the private credit landscape of 2026 bears little resemblance to that earlier era — and the old “DM = safe” heuristic is now dangerously out of date.

The irony is that emerging markets (“EM”) private credit, commonly dismissed as risky or exotic, currently exhibits the core characteristics that originally made private credit attractive: enforceable covenants, real collateral, and borrower stability shaped by decades of operating in volatile environments. In fact, EM private credit is similar to where DM private credit was 15 years ago, characterized by high natural yields, low LTVs, and stable coverage within senior secured collateralized USD loans. As a result, EM private credit today may offer stronger structural protections than many DM deals.

Although not within the scope of this paper, it is also important to distinguish senior secured, first lien EM private credit from public-market EM risk. While public bonds can be influenced by sovereign volatility and governance concerns, private credit structures emphasize asset-level collateral, enforceable covenants, and early intervention rights that materially mitigate risk outcomes. Importantly, this is not a geographic argument alone. Outcomes in private credit depend on manager discipline, underwriting standards, and structural controls.

When comparing private credit options in DM vs EM, today, investors should consider the following:

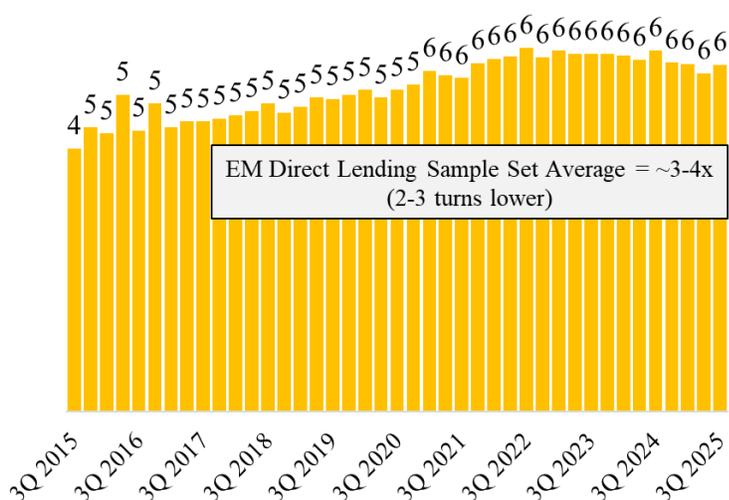
1) Less Competition in EM → Better Terms, Better Entry Points

DM private credit has become intensely competitive. Banks and direct lenders are now dueling for the same larger deals, compressing spreads and loosening terms. That competition has eroded lender protections as sponsors arbitrage public vs. private markets. In 2025, multiple sources documented tightening spreads and convergence of private credit and broadly syndicated loan (“BSL”) terms, reducing lender bargaining power. By contrast, EM private credit remains underpenetrated, with far fewer managers and far more bespoke situations. That scarcity of capital allows lenders to negotiate lender-friendly documentation, governance rights, and amortization structures—rather than accept borrower-friendly DM “market” terms.

2) Lower Borrower Leverage in EM → Lower Credit Risk

DM leverage metrics have drifted higher in recent years, with first-lien direct lending routinely underwriting 5.0x+ EBITDA and unitranche maturities stretching to 6–7 years—increasing duration and refinancing risk. EM corporate borrowers in sponsor-less transactions are frequently less levered (2-3 turns lower) and structured with “old-style” covenants that sustain interest coverage, do not rely upon payment-in-kind (“PIK”) and enable early intervention. Practitioners consistently note lower leverage and better coverage ratios in EM private credit relative to DM peers.

DM Private Credit (BDCs) Net Leverage Ratio (x)



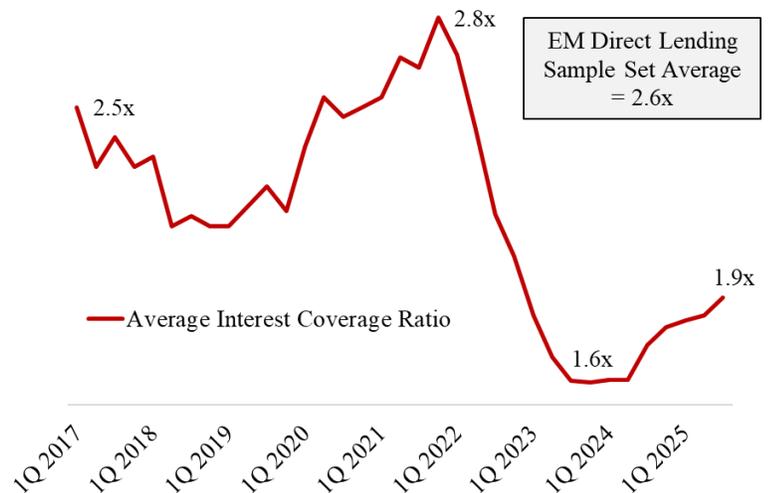
Source for BDC data: Bloomberg Intelligence. Includes data averaged from a selection of BDCs (Business Development Companies, a proxy vehicle for DM Private Credit) as available. EM Direct Lending Sample Set is comprised of deals screened by Gramercy’s Capital Solutions team.

3) EM is Resilient to High Rates (Because They've Lived with Them)

EM borrowers and local markets are accustomed to mid-teens borrowing costs—they build resilience into business models and balance sheets. In Brazil, for example, the policy rate re-tightened in late 2024 and corporate/local lending costs commonly ran in the mid- to high-teens (or higher in retail), yet credit growth and corporate issuance continued, reflecting structural adaptation to high-rate environments. In DM, “higher-for-longer” has pressured coverage ratios and raised refinancing risk—especially as spreads tightened and covenants loosened in 2024–2025. While returns have been buoyed by floating base rates, default pressure in BSLs rose to 5.3% in 2024, and survey data shows covenants loosening under competitive pressure. These operating realities directly influence how loans are structured and, critically, what lenders can rely on if performance deteriorates.

One measure of rate resiliency (or lack thereof in DM private credit) uses Interest Coverage Ratios to gauge how comfortably borrowers can meet their debt servicing costs over time. The situation became significantly less comfortable in DM as interest rates soared amid the 2022 inflation spike. The average Interest Coverage Ratio in DM private credit plunged from levels well above 2x to as low as 1.6x in 2023, recovering modestly to 1.9x in 2025. This sensitivity to interest rate levels clearly presents debt service coverage risks in a “higher-for-longer” interest rate environment. Contrary to DM, our EM Direct Lending clearly presents debt service coverage risks in a “higher-for-longer” interest rate environment. Contrary to DM, our EM Direct Lending sample set includes borrowers who are accustomed to paying higher rates and have fortified their balance sheets accordingly. The current average Interest Coverage ratio in our EM Direct Lending sample set is 2.6x.

DM Private Credit (BDCs): Interest Coverage Ratio



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4) Conservative LTVs & Uncorrelated Real-Asset Collateral in EM — Often Family-Owned

EM deal flow is predominantly sponsor-less and family-owned, where lenders secure real-asset collateral (real estate, receivables, inventory) and conservative LTV buffers providing true downside protection that is harder to obtain in DM sponsor-driven deals. Across private credit, the case for asset-based lending (ABL) is clear: collateral-driven structures, borrowing bases, and performance triggers materially reduce loss severity. Despite its scale, ABF/ABL remains under-represented in investor portfolios relative to corporate direct lending, representing room for diversification and credit remote income streams.

5) Asset-Backed Collateral as a Default in EM, Not a Niche

EM loans frequently tie repayment/collateral to assets—inventory, receivables, hard assets—rather than enterprise value alone. That collateral orientation aligns with conservative LTVs and faster amortization. Global analyses show rapid growth of private asset-based finance and lenders' use of tight borrowing bases and early triggers to protect capital—approaches that are standard practice in EM deal structuring.

6) Highly Covenanted (vs. DM's Cov-Lite Drift)

EM private loans often retain full financial maintenance tests, asset-movement restrictions, dividend blockers, and tight reporting. Practitioners highlight “old-style” documents in EM that preserve creditor rights. By contrast, in DM the majority of BSLs are covenant-lite (over 90% cov-lite) and surveys show ongoing erosion of protections in private credit under deal competition, weakening lenders’ ability to reprice risk or intervene early.

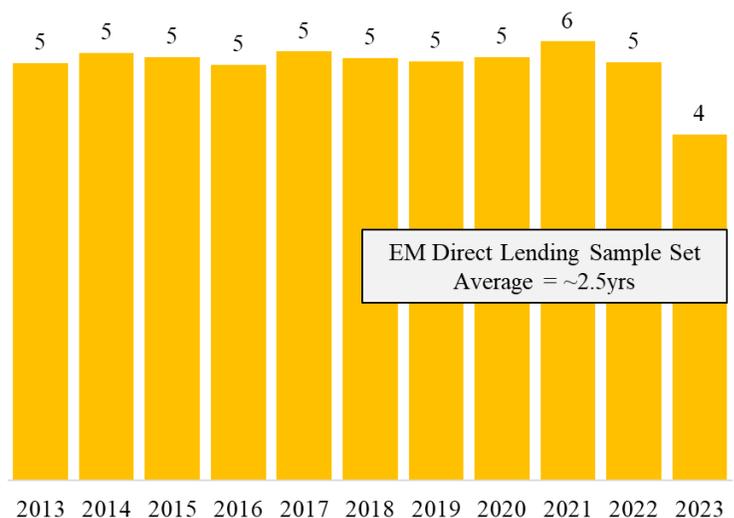
7) Fund-Level Leverage: Discipline Instead of Turbocharging

EM managers commonly target modest back-leverage (e.g., $\approx 1.0\text{--}1.5\times$ NAV) to deliver returns primarily from underwriting and structuring, not from leverage. Market research across 50 managers confirms leverage usage remains modest and targeted. In DM, widespread back-leverage facilities (SPV “warehouse,” ABL, note-on-note) have become commonplace—amplifying returns but adding structural fragility in downturns.

8) Shorter Duration & Amortization (vs. DM's 5–7-Year Bullets)

Duration risk is one of the most underappreciated differences between DM and EM private credit today. In DM, extended maturities, bullet structures, and refinancing optionality have become normalized, increasing exposure to capital market-cycles. EM private loans are frequently 2–4 years with sculpted amortization and prepayment incentives—reducing mark-to-market and refi risk. Practitioners point to principal repayment within five years as a common target, backed by cash coverage and covenant discipline. DM unitranche deals have extended maturities to 6–7 years. These longer durations introduce refinancing risk, which lenders attempt to manage not through discipline but through extensions, PIK toggles and other mid-loan amendments as credit quality deteriorates — a cycle that defers rather than reduces risk.

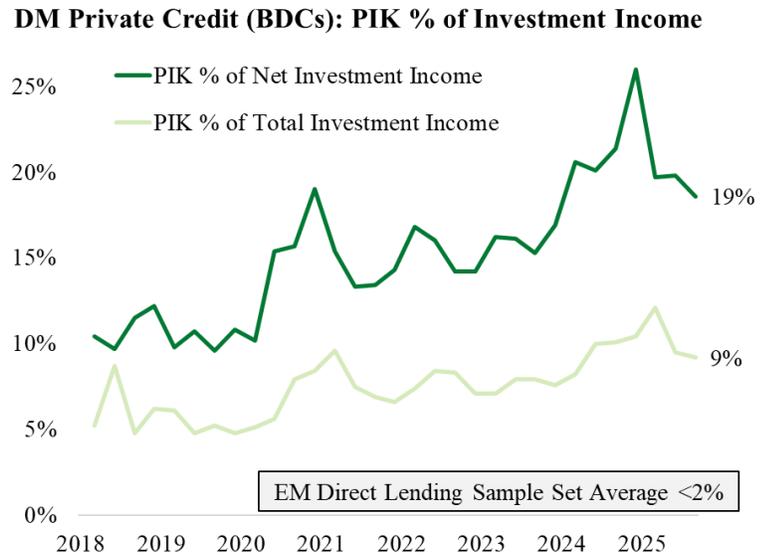
DM Private Credit: Weighted Average Life



Source for DM Private Credit data: Federal Reserve, Pitchbook. EM Direct Lending Sample Set is comprised of deals screened by Gramercy's Capital Solutions team. Given minimal amortization features in the data set, Average Maturity is utilized as a proxy for Weighted Average Life.

9) The Rise of (Bad) PIK in DM → A Stark Sign Credit Deterioration, Not Present in EM

The increasing prominence of PIK in DM private credit whereby borrowers defer cash interest payments in favor of accruing additional principal is frequently featured in recent financial headlines. As of September 2025, PIK accounted for 19% of Net Investment Income and 9% of Total Investment Income of Business Development Companies (“BDCs”), nearly double what it was five years ago. While PIK is a legitimate flexibility tool in the debt structuring toolkit, the magnitude and timing of its implementation are important factors to observe. Excessive PIK that enables cashflow challenged borrowers to “kick-the-can down the road” is an obvious cause for concern upon maturity/refinancing. However, a more sinister utilization of PIK for default suppression has risen in recent years. So-called “bad PIK” is amended into the loans not at origination, but amid the life of the loan when borrowers’ cash flow situations become distressed. This masks of credit deterioration and some have called it a “shadow default rate” accounting for as much as 6% of deals in recent periods, an interesting concept amidst the curiously low default rates on the surface of the opaque DM private credit market. Contradicting this trend, within our sample set of EM Private Credits, we see PIK used sparingly at <2% of income on average, implemented intentionally at the point of origination.



Source for BDC data: Bloomberg Intelligence. Includes data averaged from a selection of BDCs (Business Development Companies, a proxy vehicle for DM Private Credit) as available. EM Direct Lending Sample Set is comprised of deals screened by Gramercy's Capital Solutions team.

10) The “Elephant in the Room”: Rule of Law

The elephant in the room, when investors discuss emerging-market private credit, is rule of law. While the United States and the United Kingdom benefit from mature legal systems and standardized credit documentation, it is incorrect to assume that EM lending relies primarily on weak or unpredictable courts. In practice, most institutional EM private credit transactions are governed by New York or English law and structured through bankruptcy-remote offshore vehicles that hold direct claims on assets or cash flows, providing enforceability that is largely independent of local court systems.

Where local proceedings are required, outcomes vary by jurisdiction, but in many cases, they have proven workable and effective when supported by strong documentation, security packages and top-tier local counsel. The key point is that EM private credit is not a one-size-fits-all legal environment. It is a structurally engineered one built upon thorough due diligence, expertise, and collaboration with leading local law firms, culminating in robust and effective credit protections. Ironically, while developed-market lenders rely on predictable courts, they increasingly operate with weaker covenants and fewer protections, whereas EM lenders often compensate for legal complexity with much stronger contractual control, collateral and early-intervention rights.

The “DM = Safe” Fallacy

DM’s deep markets can breed complacency: longer duration, higher sponsor leverage, cov-lite, and fund back-leverage collectively raise systemic and cycle risk. Multiple 2024–2025 studies reveal competition that has steadily reduced lender protections. In EM, discipline is the feature—strong covenants, hard collateral, shorter tenors, lower leverage—and active governance that allows lenders to enhance structures quickly if cash flow deteriorates. Despite EM comprising ~90% of population and ~50% of global GDP, EM private credit is <10% of AUM—a scarcity that preserves terms and structural discipline for lenders.

For investors seeking true resilience and superior risk-adjusted returns, EM private credit isn’t a niche; it’s a structurally advantaged allocation.

-Robert Koenigsberer, Managing Partner and CIO, Gramercy Funds Management

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