

Commentary

Private Credit Default Momentum Increasingly Tied to Distressed Debt Exchanges

Morningstar DBRS

March 19, 2026

Key Highlights

- Distressed exchange transactions now dominate default activity, primarily driven by increased use of interest deferrals as a late-stage tactic among borrowers after less severe capital support measures were attempted and were unsuccessful.
- We attribute the rise in distressed exchange situations to borrowers still struggling with declining revenue, weak operating margins, and a significant debt burden.
- We expect the recent accelerated pace of default to continue into 2026, following a 78% year-over-year increase of default events in 2025. We expect a high proportion of borrowers currently rated in the CCC through C categories to weaken further, particularly those that have relied on waivers or amendments that loosened covenant thresholds or required external capital support.

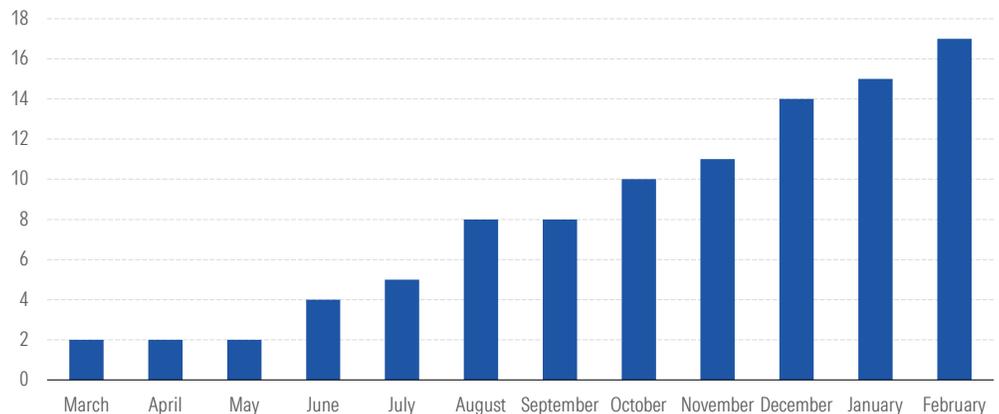
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Executive Summary

Default activity among private credit, middle market borrowers has accelerated meaningfully over the past year, led by distressed exchanges resulting from material impairment of debtholders' interest. Over the last 12 months, 16 of 17 private credit rating downgrades to D (default) or SD (selective default) met our criteria for a distressed debt exchange, which we view as a default event. For comparison, we recorded nine downgrades to D/SD in 2024, including four distressed debt exchanges. We attribute the rise in distressed exchange situations to borrowers still struggling with declining revenue, weak operating margins, and a significant debt burden. In most cases, distressed exchanges, whether involving payment deferrals or principal forgiveness, occur after lenders or sponsors have made unsuccessful attempts to provide borrower support.

Exhibit 1 Trailing 12-Month Cumulative Private Credit Rating Downgrades to D or SD



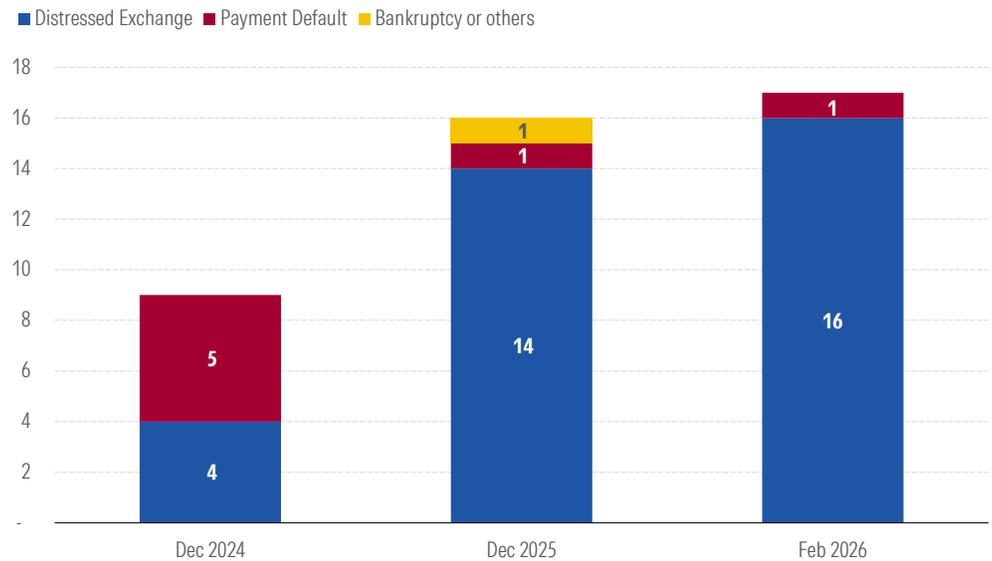
Data through February 28, 2026. Source: Morningstar DBRS.

Our [Framework for Assigning Default and Selective Default Credit Ratings](#) requires assigning an instrument rating of D when an issuer declares bankruptcy, commits an uncured payment default, or undertakes a distressed debt restructuring. A restructuring is considered "distressed" when a borrower negotiates a loan amendment, typically involving a partial or full suspension of cash payments or forgiveness of principal, which we determine was initiated to avoid an unavoidable and imminent default. We consider these transactions as distressed when they disadvantage creditors without adequate compensation.

Distressed Exchanges Now Dominate Default Activity

As we noted above, distressed exchange transactions accounted for 94% of downgrades to D or SD for the trailing 12 months ending February 2026, compared with 44% of defaults for the full-year 2024. Exhibit 2 illustrates the shift in the mix of default activity in recent years. We believe the rising prevalence of distressed exchanges primarily reflects increased use of interest deferrals as a late-stage tactic among borrowers to avoid hard payment defaults and conserve liquidity after less severe capital support measures were attempted and were unsuccessful. In our March 10, 2026, commentary, *The Post-Default Playbook: Lessons and Recovery Patterns in Private Lending to Middle Market Companies*, we presented such an example: a middle market borrower in financial stress negotiated a distressed debt exchange, which deferred all cash interest until maturity without tangible compensation to lenders (e.g., through a higher interest margin or a paydown in principal).

Exhibit 2 Composition of Default Activity



Data through February 28, 2026. Source: Morningstar DBRS.

Increased Reliance on PIK Elections for Late-Stage Capital Relief

Over the past year, we've observed a material increase in the inclusion and exercise of payment-in-kind (PIK) and deferred interest schemes among distressed middle market borrowers. We note that the use of payment deferrals generally occurs in the later stage of financial stress as sponsors look to avoid imminent payment default or foreclosure and preserve liquidity.

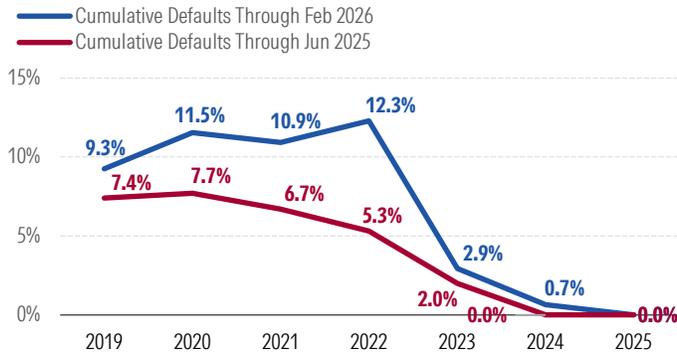
While the election of PIK interest can address near-term liquidity needs by deferring cash interest payments, it also capitalizes interest, which increases debt balances and weakens forward-looking credit metrics and expected recovery rates. Although PIK elections can be an effective, short-term tool to preserve liquidity under stress, prolonged reliance often fails to fully compensate lenders for the additional risk.

For lenders, a distressed exchange may be economically preferable to triggering a foreclosure immediately upon a payment default, which may result in lower recoveries. We find that lenders often attempt to support stressed borrowers through covenant relief, waivers, PIK interest elections, and amendments to reset the covenant thresholds or extend debt maturities. Contrary to the intentions behind arranging external capital support, in practice we find these measures to be rarely effective at staving off eventual default when an issuer's operating performance fails to materially improve. If these deferral options lead to a material economic loss to debtholders, we generally consider those actions as distressed exchanges.

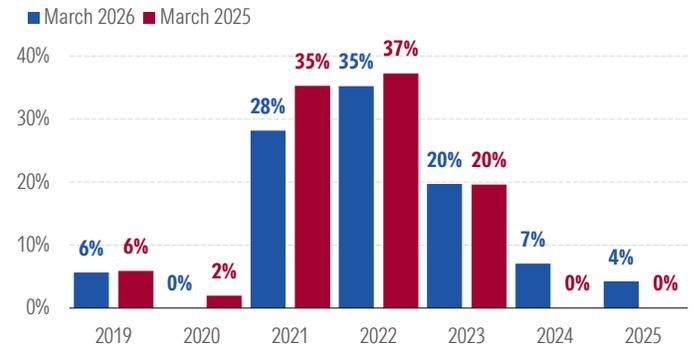
In our [2026 private credit outlook](#), we noted that the credit quality for many of our rated middle market borrowers remained challenged in 2025 by soft top-line growth, margin erosion, and restricted liquidity. Accordingly, we expect the recent accelerated pace of default to continue into 2026, following a 78% year-over-year increase of default events in 2025. We expect a high proportion of borrowers currently rated in the CCC through C categories (16% of current active credit ratings) to weaken further, particularly those that have relied on waivers or amendments that loosened covenant thresholds or required external capital support. Among defaulted issuers over the past two years, we found that defaults had been disproportionately concentrated among borrowers that previously received some external capital support. In our September [commentary](#) on borrower capital support, we observed that this category represented 10% of actively rated private borrowers. We also noted an additional 18% vulnerable to credit deterioration based on weak sales growth or margin trends. If their operating performance does not meaningfully improve and external capital support diminishes, a default, either a payment default or a distressed exchange, becomes more likely.

Default Frequency is Migrating Toward 2022 Vintage Borrowers

Most of the defaults we have observed among our rated private borrowers have been concentrated in the 2019 to 2021 vintages (based on the year that we assigned credit ratings to the borrowers), with an average time to default of 3.4 years. Exhibit 3 shows a comparison of cumulative default distributions by vintage year taken in June 2025 and in February 2026. The most recent snapshot shows that more defaults are now coming from the 2021 and 2022 vintages compared with the earlier period.

Exhibit 3 Cumulative Defaulted Borrowers by Vintage

Data as of March 4, 2026. Source: Morningstar DBRS.

Exhibit 4 Distribution of CCC (high)- to C-Rated Borrowers by Vintage

Data as of March 4, 2026. Source: Morningstar DBRS.

We have also begun to see some defaults among the 2023 vintage borrowers, which we believe may increase over the next year if business conditions remain challenging. Meanwhile, default frequency for the pre-2021 vintages appear to be moderating, as they have been fully seasoned or a significant number of borrowers have been otherwise discontinued.

Exhibit 4 shows the distribution of currently active borrowers rated CCC (high) through C, which represents the most vulnerable borrowers based on current operating performance. We expect a higher proportion of future defaults to come from this pool. Compared with our distressed borrowers a year ago, 63% of borrowers are clustered in the 2021 and 2022 vintages, indicating persistent financial stress for borrowers in those vintages. We also observe the same proportion of CCC (high) through C borrowers from the 2023 vintage (20%), but we are also seeing an increase in the number of borrowers from 2024 and 2025 vintages. We attribute a portion of the increase in 2025-vintage borrowers to a higher number of initial credit ratings in the CCC categories compared with prior vintages. The CCC categories may also contain borrowers that were previously downgraded to D or SD but have been upgraded based on revised capital structures.

Related Research

- [The Post-Default Playbook: Lessons and Recovery Patterns in Private Lending to Middle Market Companies](#), March 10, 2026
- [Private Software Companies Face Increased Competition in Shift Toward Artificial Intelligence](#), February 19, 2026
- [Private Credit Rating Actions: Weaker Credit Trends Persisting in the First Quarter of 2026](#), February 17, 2026
- [Leveraged Finance Spotlight: New Year, Same Credit Challenges](#), January 29, 2026
- [2026 Private Credit Outlook Negative: Margin Compression and Rising Leverage Are Key Challenges](#), December 16, 2025

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