TELLARO CAPITAL PARTNERS

CIO Perspective

Third Quarter 2026

Institutional Private Credit | Lower Middle-Market



A market split in two. Leveraged loan issuance of $195 billion was the quietest quarter of 2026, and year-to-date volume is down a quarter, yet new money held firm and loans returned 2%, their best quarter in over a year. Capital is abundant but divided: a syndicated bid and record dry powder chase prime, non-cyclical credits, while weaker, cyclical and software-exposed borrowers pay wider spreads and accept real structure. The Federal Reserve raised rates for the first time since 2023. Capital is no longer the scarce input; discernment is.

$195Bn
Q3 2026 LEVERAGED LOAN ISSUANCE
Quietest quarter of 2026; YTD down 24%

S+522
UNITRANCHE SPREAD, JULY
Widest in more than a year

7%
PRIVATE LOANS BELOW 90% OF PAR
Up from 6%; stress is rising

TELLARO MARKET ASSESSMENT

Bifurcated Capital

Capital is abundant but it has split in two. A syndicated bid and record dry powder compete aggressively for a thin pipeline of prime, non-cyclical credits, which clear at tight spreads and, at the larger end, looser documentation. Weaker, cyclical, consumer-exposed and software-adjacent borrowers face wider spreads, lower leverage and real covenants. Higher base rates sit on top of both.

Allocation consequence: the premium is in the second tier, where structure and attachment are enforceable. Underwrite the divide, not the average, and decline the prime paper that competes only on price.

CIO PERSPECTIVE

- Leveraged loan primary volume was $195 billion, the quietest quarter of 2026, but the slowdown was all in repricing and extension amendments: net new-money issuance of $113 billion was a four-quarter high. Year-to-date gross activity of $659 billion runs 24% behind last year, with repricings down 42% and refinancings down 20%.
- An M&A revival arrived in September: $30.6 billion of buyout and acquisition loan volume, the busiest month since January 2022, carried by a dozen jumbo term loans. But the supply skewed sharply to quality. Of 2026 M&A volume, 48% went to borrowers rated BB-minus or higher, the highest share since the financial crisis, while only 14% went to B-minus credits, a fourteen-year low.
- Private credit new money stayed thin. Direct lending backing buyouts was $10.7 billion across 47 deals, down from $13.5 billion in the second quarter and $27.0 billion a year earlier. Unitranche spreads widened to S+522 in July, the widest in more than a year, while total leverage on new issuance fell to 4.5x, a trailing-year low. The lower middle-market was the pocket of activity, as lenders sought industrials and non-software businesses.
- The syndicated market pressed its advantage, refinancing a record $16.4 billion of private credit loans in the quarter and financing several large buyouts that might once have gone to direct lenders. Broadly syndicated spreads on the best credits tightened, while B-minus borrowers refinancing ahead of the 2028 wall paid up, on average 32 basis points over their original paper.
- High-yield issuance roared back in September to $50.2 billion, the strongest month in a year, led by AI and acquisition financing, including record cross-border packages for SoftBank's investment in OpenAI and Paramount Skydance. Volume is now roughly flat year to date after running 25% ahead through June, and new deals skew firmly to double-B.
- Stress is rising unevenly. The leveraged loan payment-default rate remains low near 1.4%, but it captures little of the private market, where small-borrower defaults are climbing and 7% of loans are now marked below 90% of par, up from 6%.

- The Federal Reserve raised the target range 25 basis points to 3.75% to 4.00% in September, its first increase since 2023, and signaled more. Futures price a further rise by December, with Term SOFR near 3.9% and the ten-year Treasury above 5% for the first time since 2007. Higher base rates lift the all-in cost of every floating-rate facility without a single renegotiation.
- The market now pays for discernment rather than for deployment. Wider spreads, lower leverage and firmer documentation reward lenders who can tell the two tiers apart, while the 2028 maturity wall, weighted heavily toward B-minus and lower credits, concentrates the risk in exactly the borrowers the market is pricing against.

INVESTMENT CONCLUSION

The quarter confirmed a bifurcated market. Capital is plentiful, but it has divided sharply between prime credits, which clear at tight spreads and looser terms, and everything else, which pays wider spreads and accepts real structure. Higher base rates sit on top of both tiers. In that setting returns accrue to lenders who can distinguish the two, not to those who deploy into the average.

For senior secured private credit the opportunity set is constructive but demands discernment. With the funds rate at 3.75% to 4.00%, Term SOFR near 3.9% and unitranche spreads near S+522, all-in yields on new originations sit near 9.5% to 10%. On middle-market leverage of 4.5x, nearer 3.7x in the lower middle-market, implied interest coverage is roughly 2.1x to 2.3x, thinner than a year ago.

The principal risks are structural and concentrated. Liability management remains the dominant restructuring tool, so recoveries turn on documentation rather than on payment capacity, and stress is building among smaller and cyclical borrowers even as the headline default rate stays low. Refinancing risk sits on the 2028 maturity wall, weighted heavily toward the weakest tier. Collateral quality, anti-layering language and intercreditor terms are first-order determinants of loss.

Tellaro's response is unchanged in philosophy and well suited to a bifurcated market. We originate senior secured loans to lower-middle-market companies where conservative leverage, meaningful equity support, durable cash generation and creditor-protective documentation establish downside protection before capital is deployed. The second tier is where our discipline is compensated, and the first tier, priced for perfection, is where we decline.

TELLARO MIDDLE MARKET CREDIT CONDITIONS INDEX™

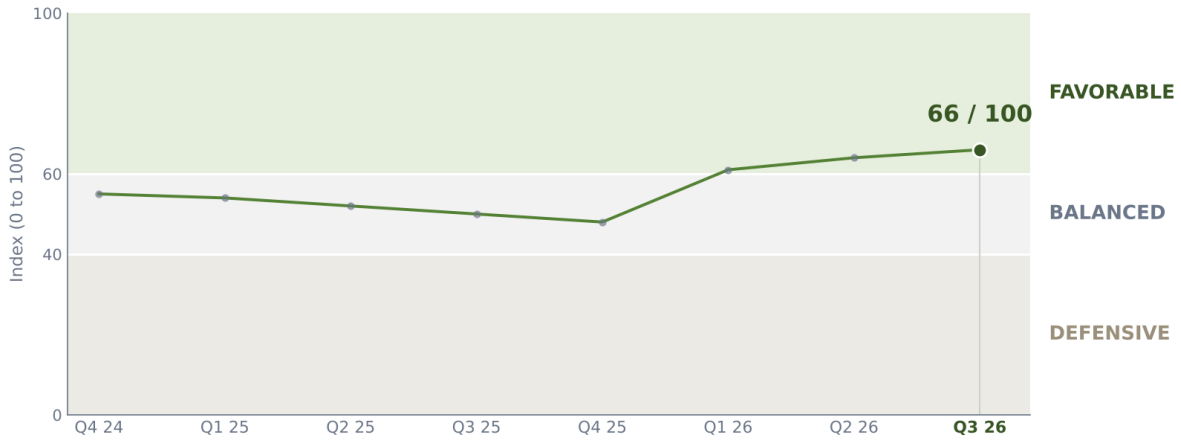
66 / 100

TMMCCI Q3 2026

Favorable

Firming. Up 2 points from 64 in the second quarter of 2026.

A single measure of how attractive today's conditions are for originating senior secured loans to lower middle-market companies. Higher readings indicate more lender-favorable underwriting conditions.



Q3 2026 INDEX DRIVERS *quarter-over-quarter direction*

Spread and yield	Leverage discipline	Equity cushion	Competitive intensity	Loss environment
↑	↑	↑	↑	↓

Component	Weight	Metric and public source	Normalization	Score
Spread and yield compensation	20%	Unitranche and first-lien all-in yields; SOFR floor (Houlihan Lokey; KPMG; FRED)	Percentile, trailing 5-yr	**78**
Leverage discipline	15%	Middle-market senior debt to EBITDA (Houlihan Lokey; KPMG; Lincoln International)	Inverted percentile, 5-yr	**76**
Equity cushion	15%	Sponsor equity share of purchase price; LBO multiple (Houlihan Lokey; Lincoln; Bain)	Percentile, trailing 5-yr	**68**
Documentation and creditor protection	15%	Tighter-documentation share; PIK-decline share (Houlihan Lokey survey; Morningstar LSTA)	Percentile, survey history	**66**
Competitive intensity	15%	Dry powder to trailing new-money issuance (Preqin; KPMG; Houlihan Lokey; Bain)	Inverted percentile, 5-yr	**54**
Base rate and coverage	10%	Term SOFR level; SLOOS net tightening (FRED; Federal Reserve)	Range-normalized, 5-yr	**62**
Loss and recovery environment	10%	LME-inclusive default rate; distressed-loan share (KPMG; Morningstar LSTA; Moody's)	Inverted percentile, 5-yr	**42**
Composite Index	**100%**	**Weighted sum of the seven sub-scores**	**Favorable 60-100 / Balanced 40-59 / Defensive 0-39**	**66**

At 66, conditions are Favorable for disciplined senior secured origination and modestly firmer than the prior quarter. The reading rises on compensation and structure: wider spreads, lower leverage in the lower middle-market, and firmer documentation outside the largest credits. It is held back by a deteriorating loss environment, as liability management, smaller-borrower stress and a growing share of loans marked below par all point one way. The Index therefore describes a market that pays well, but only for discernment. It supports origination into first-lien, well-documented lower middle-market credits, and counsels against the prime, tightly priced paper where the compensation no longer covers the structure given up.

Methodology. *The Index is a fixed-weight composite of seven components, each constructed from public data published every quarter. For each component the underlying metric is converted to a percentile within its trailing five-year quarterly history and oriented so that lender-favorable readings score higher, producing a 0 to 100 sub-score; components built from more than one metric equal-weight their inputs before scoring. The composite is the weighted sum of the seven sub-scores at the weights shown, mapped to fixed bands of Favorable, Balanced and Defensive. Construction, weights, sources and bands are held constant; once constructed, the Index requires only a data refresh and applies the stated methodology without quarter-specific adjustments. The first quarter of 2026 is the back-cast baseline established at launch.*

MARKET OVERVIEW

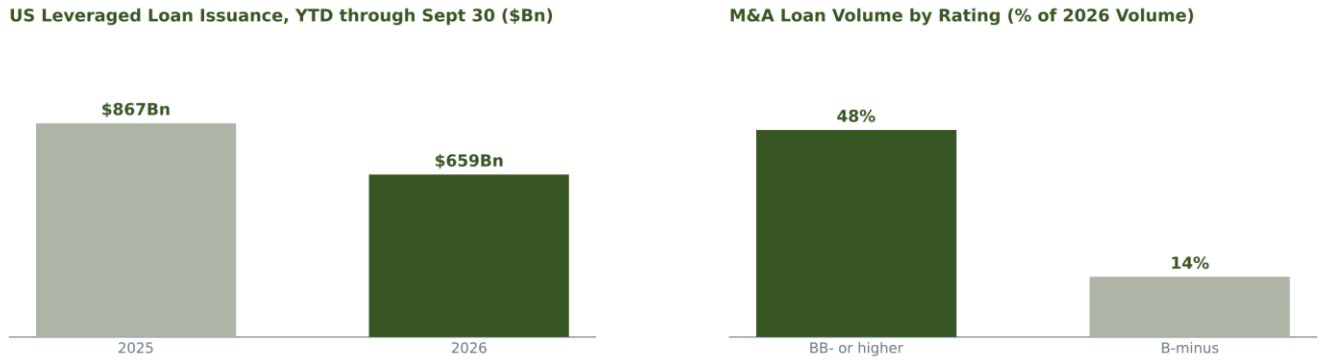
The third quarter was quiet on the surface and divided underneath. Leveraged loan primary volume of $195 billion was the lowest of the year, but the shortfall was entirely in repricing and extension amendments; new-money issuance held steady and, after Labor Day, accelerated into a genuine M&A revival. Loans returned 2%, their strongest quarter since the second quarter of 2025, as demand outran a thin and quality-skewed supply.

The rate backdrop turned against borrowers. The Federal Reserve raised the target range 25 basis points to 3.75% to 4.00% in September, its first increase since 2023, and signaled further tightening into year-end, removing the cuts penciled in as recently as June. Term SOFR reset near 3.9% and the ten-year Treasury pierced 5% for the first time since 2007. For the floating-rate lender the arithmetic improved; for the levered borrower it did not.

Risk appetite was selective, not absent. Investors added risk through the quarter and into the Federal Reserve's decision, but they concentrated it in higher-rated, lower-yielding credits, leaving a supply shortage in quality paper and rising premia for everything else. For a balance-sheet lender that holds to maturity, the value is not in chasing the prime bid but in underwriting the second tier where structure is still available.

LEVERAGED FINANCE

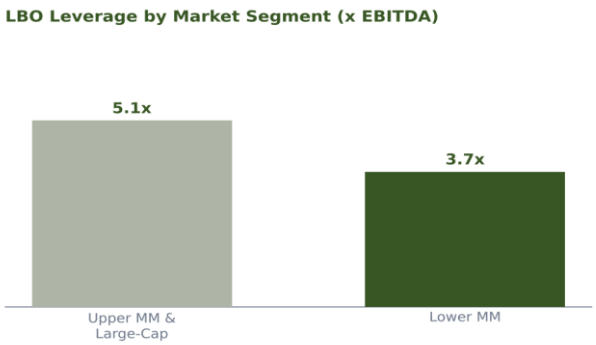
Composition, not headline volume, is the signal. Year-to-date gross institutional activity of $659 billion runs 24% behind last year, but the decline is in opportunistic refinancing, down 20%, and repricing amendments, down 42%; new-money issuance tied to buyouts, acquisitions and growth has kept pace with 2025 at $191.5 billion. September brought the busiest run of jumbo financings in five years, a dozen term loans above $1 billion, eight of them backing buyouts.



Left: US leveraged loan issuance, year to date through September 30. Right: M&A loan volume by borrower rating in 2026; new supply has skewed sharply to higher-quality credits.

The supply that cleared was concentrated in quality, with nearly half of 2026 M&A volume going to borrowers rated BB-minus or higher, the highest share since the financial crisis. Software's long dominance has faded to a 10% share of new issuance, its lowest since 2015, with media and healthcare taking the top spots. Entry multiples remain elevated at 12.6x, but sponsors are funding 63% of the structure with equity, up from 59%, a thicker cushion beneath senior debt.

Pricing and leverage divided along the same line. Broadly syndicated spreads on the strongest credits tightened, while B-minus borrowers refinancing ahead of the 2028 wall paid up, on average 32 basis points over their original paper. In private credit the gap runs by size: unitranche spreads near S+522 and leverage of 4.5x, with the lower middle-market at 3.7x against 5.1x for large-cap. For allocation, the lower middle-market is where compensation and structure still travel together.



LBO leverage by market segment. Upper middle-market and large-cap borrowers hold near 5.1x while the lower middle-market has fallen to 3.7x, the widest gap in the series.

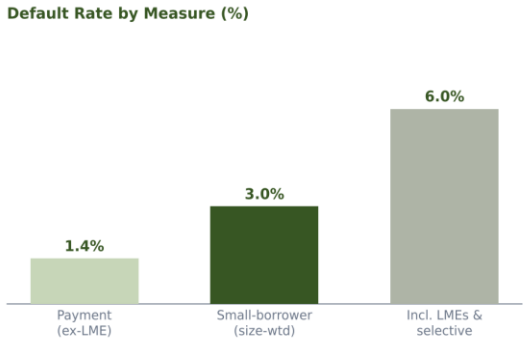
HIGH YIELD MARKET

High-yield primary markets came back with force in September. Issuance of $50.2 billion was the strongest month in a year and topped July and August combined, led by AI and acquisition financing, including a record cross-border package for SoftBank's investment in OpenAI and the debt backing Paramount Skydance. Volume is now roughly flat year to date after running 25% ahead through June, with new deals skewing firmly to double-B and little triple-C.

The AI-funding wave is the structural feature to watch, and it must be read through a credit lens. Many of the data-center bonds are already trading near or below issue, and their performance is tied to the fortunes of a small set of core tenants. For a senior secured lender the questions are unchanged: contracted cash flow, asset specificity and the seniority of any secured claim. Where a bond market merely defers a reckoning for a weak borrower, open access postpones the problem without underwriting it away.

CREDIT QUALITY

Reported defaults understate the stress. The leveraged loan payment-default rate remains low near 1.4%, but it excludes liability management, which has become the dominant restructuring route, and it says little about the private market. Houlihan Lokey's valuations show 7% of private loans now marked below 90% of par and 4% below 80%, a multi-year high, while small-borrower default rates ran at 3.0% on a size-weighted basis in the second quarter. Of roughly 5,000 companies held by business development companies a year ago, some 600 showed credit pressure by mid-year, up a quarter from year-end.



Default rate by measure. The headline payment-default rate understates the picture once liability management and smaller-borrower stress are included.

For senior secured lenders the implication is procedural as much as statistical. Uptiering, drop-down and priming transactions redistribute recoveries among creditors of the same issuer, so position and documentation increasingly determine outcomes independent of headline default frequency. The 2028 maturity wall concentrates the risk: of $152 billion of loans due that year, 62% are rated B-minus or lower, precisely the tier the market is now pricing against. Maintenance covenants, still standard in the lower middle-market and scarce above $50 million of EBITDA, are the difference between a seat at the table and a markdown. We allocate on the evidence of documents and collateral, not on the promise of a refinancing.

TELLARO PERSPECTIVE

The Tellaro Underwriting Hierarchy

Regimes change; our order of priority does not. We ask five questions of every credit, in the same order, before we discuss price.

1 Recovery. What do we collect if the business fails? Collateral quality and the attachment point set the floor on loss.

2 Documentation. Can our claim be primed, subordinated, or diluted before we can act? Anti-layering, anti-drop-down, and intercreditor terms are collateral in their own right.

3 Position. Are we senior with first-lien against the assets, not merely first in name?

4 Durability. Does the business service and repay its debt from its own cash generation, without depending on a favorable refinancing?

5 Price. Only now do we ask whether the spread compensates for the residual risk the first four tests cannot remove.

Price is the last question we ask, never the first.

The quarter confirmed the bifurcation we have tracked all year. Record dry powder and a reopened syndicated market bid the best credits tighter and looser, while weaker and cyclical borrowers pay up and accept real structure. The market no longer moves as a block; it moves credit by credit, and the dispersion is the opportunity.

We see the clearest opportunity in the lower middle-market, where the bifurcation runs most in a disciplined lender's favor. It is the one segment where leverage has fallen to 3.7x, where maintenance covenants remain standard, and where a scarcity of large buyouts has pushed capable sponsors and non-software businesses toward bespoke, well-structured financing. Recurring-revenue businesses with durable cash conversion, defensible positions and conservative leverage remain our priority, and the premium the market now pays for certainty of execution favors balance-sheet capital over the syndicated bid.

We remain cautious at the top of the market, where capital is chasing quality into terms that no longer compensate. Prime credits are clearing at tight spreads and loose documentation, and we will not buy perfection at those terms. We are equally cautious on consumer-exposed and cyclical borrowers, on software and AI-adjacent names where substitution risk is real, and on any credit whose 2028 maturity depends on a refinancing market that may not be open to it.

Our underwriting principles are unchanged and, in this market, decisive. We size leverage to downside cash flow rather than to sponsor projections, we require meaningful equity subordination, and we lend to businesses whose cash generation is demonstrated rather than promised. We treat extensions and amendments as signals to reunderwrite, not as neutral events. Certainty and speed of execution are part of the value we provide, and they are what disciplined borrowers select for.

Documentation is the decisive variable, and the market is proving it in real time. With cov-lite structures now 41% of upper middle-market and large-cap deals but under 4% below $50 million of EBITDA, the protections a lender keeps depend on where it lends. We insist on maintenance covenants, anti-layering and anti-drop-down provisions, robust collateral coverage, tightly drawn baskets and intercreditor terms that preserve senior priority through a restructuring. When liability management is the dominant restructuring tool, these terms are the difference between par and impairment.

We construct portfolios accordingly, favoring granularity, senior secured first-lien positions and diversification across end markets that do not share a single macro dependence. We accept lower gross yields in exchange for structural protection and position in the capital stack, because durable net returns through the cycle are earned by avoiding impairment rather than by reaching for spread. We would rather forgo a transaction than compromise on leverage, collateral or documentation.

The environment favors lenders who can tell the two markets apart. Abundant capital is not the same as sound credit, and a tight spread on a prime borrower is not the same as a well-paid risk. Our focus is unchanged: originate senior secured loans to lower-middle-market companies where structure, business fundamentals and pricing together deliver durable risk-adjusted returns, and exercise the discipline to decline everything else. Where is the market offering better attachment points, and at what price to structure?

WHAT WE'RE WATCHING

Consistent with the Bifurcated Capital regime, we monitor a concise set of leading indicators rather than offer forecasts. Each is chosen for what it would imply for underwriting, not for what it predicts about market direction.

Indicator	Why It Matters	Potential Underwriting Implication
The 2028 maturity-wall clearing rate	The pace at which lower-rated borrowers refinance rather than extend signals whether deferred stress converts into realized loss.	Slower clearing argues for higher attachment quality, tighter covenants, and reunderwriting at every amendment.
LME share of total defaults	A rising liability-management share means recoveries turn on documentation rather than on payment capacity.	Reinforce anti-layering, anti-drop-down, and intercreditor terms; price for the risk of being the next restructuring counterparty.
Direct-lending spreads and OID	Whether the quality bifurcation persists or compresses as record dry powder competes for the same prime credits.	Lock structural gains while terms favor lenders; step back where spreads compress without a commensurate gain in protection.
BDC discounts and evergreen redemptions	Vehicle-level liquidity pressure, independent of credit performance, can force selling into a thin bid.	Maintain hold-size discipline and prepare to supply liquidity to motivated sellers on our terms.
Software and AI-infrastructure performance	Binary AI-disruption outcomes and unproven data-center demand concentrate tail risk in a small set of correlated credits.	Underwrite contracted cash flow, asset specificity, and creditor priority rather than secular-growth projections; decline where offtake visibility is absent.

WHAT COULD CHANGE OUR VIEW

We hold our conclusions with conviction but without certainty. The following developments would weaken the thesis and, if sustained, would change how we allocate. None is our base case today.

- A durable easing cycle that reopens inexpensive refinancing and compresses the premium the second tier now pays, pulling the two markets back together.
- A sustained decline in liability-management frequency, with recoveries reverting to historical norms, which would reduce the primacy of documentation over business performance.
- A broad re-rating of software and AI-adjacent credits that proved substitution fears overdone, which would reopen a large share of the market we are currently underweight.
- Evidence that the loose documentation seen at the top of the market has migrated into the core lower middle-market, which would raise our bar for every new credit.
- A deterioration concentrated in lower-middle-market fundamentals rather than in headline-sensitive large-cap and software credits, which would challenge our preference for that segment.

Each of these would change allocation, not philosophy. Our discipline is built to be right across regimes, not only in this one.

Q3 2026 CREDIT MARKET DASHBOARD

Metric	Q3 2026	Q3 2025	Private Credit Investor Read-Through
Leveraged loan new-issue volume	$195Bn	$216Bn	Quietest quarter of 2026; new-money steady
Refinancing loan volume (Q3)	$52.1Bn	n/a	Four-quarter high; 35% from B-minus
M&A and LBO loan volume (Q3)	$39.9Bn	n/a	September revival; skewed to quality
High-yield volume (September)	$50.2Bn	n/a	Strongest month in a year; AI-led
Unitranche spread (July)	S+522	n/a	Widest in more than a year
90-day term SOFR	3.9%	~3.7%	Reset higher after the September hike
Fed funds target range	3.75-4.00%	3.50-3.75%	First hike since 2023; more signaled
Private vs. public spread premium	178 bps	166 bps	Above the 2025 average
LBO leverage, lower middle-market	3.7x	n/a	All-time low; 5.1x at large-cap
Loan payment-default rate (ex-LME)	~1.4%	n/a	LMEs remain the dominant tool
Private loans below 90% of par	7%	n/a	4% below 80%, a multi-year high
LBO purchase-price multiple	12.6x	11.6x	Equity contribution up to 63%

Sources: PitchBook | LCD US Credit Markets Quarterly Wrap and Morningstar LSTA US Leveraged Loan Index (through September 30, 2026); Houlihan Lokey Capital Solutions and KBRA DLD (through July 31, 2026); Federal Reserve (FOMC); New York Fed (term SOFR). Figures are period measures, rounded, and reflect data available through quarter-end; certain comparatives are not disclosed on a like basis (n/a).

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