

Bridge or Band-Aid? Whether Private Markets Solved Their Liquidity Crisis.

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Abstract

Higher for longer interest rates have frozen the exit market private equity depends on, leaving \$3.8 trillion of unsold companies. In response, the industry has leaned on continuation funds, NAV loans, and private credit to manufacture liquidity without genuine sales. This paper argues whether these tools are a bridge or a band-aid is not a function of the tools themselves, but of who is using them and why. Evidence of the divide is already visible in lenders' own filing, with reports of rising default rates and payment in kind income across the sector. In the end, these tools will not sink the market as a whole but rather separate the disciplined firms that use them to cross a gap from the over-levered ones that used them to hide a fall.

Thesis

Private Markets have engineered around the liquidity drought with tools (NAV loans, Continuation Funds, Private Credit) that are safe in disciplined hands, but dangerous in weak ones. Their result is a bifurcation between well capitalized, disciplined firms who use these tools as genuine bridges, while over-levered, poorly underwritten players use them to defer losses. The reckoning is real and will separate the well-oiled organizations from the rest.

The Liquidity Drought

As an industry, private equity is sitting on around 33,000 unsold portfolio companies worth roughly \$3.8 trillion. At the current pace of exits, this would take about 9 years to be realized. After several years of advantageous valuations and cheap debt, current economic conditions of higher rates are causing difficulties in exit markets that private funds depend on to return capital to their investors, which have driven distribution to a record low. As a result, the industry has created a set of band-aids to cover the current wounds. Continuation funds, NAV loans, and the troubling reliance on private credit has allowed for the manufacturing of liquidity without any sales. This paper investigates these channels and determines whether they are sustainable or just deferring losses that ultimately arrive.

Private equity operates under capital raised by investors, typically pension funds, endowments, or insurers known as limited partners (LPs). The fund uses these funds and combines it with large amounts of borrowed money to buy companies, implement a strategic plan, and sell them to recoup their investment. In the past decade, returns came from three main levers; cheap debt, expanding valuations, and operational improvement. This opportunity for growth and improvement was aided by the near zero interest rates and rising market valuations, regardless of management. This environment shaped how much debt a deal could carry. In the past, the industry standard for percentage of the deal as debt would be around 60-70%. Today as debt has become more expensive, the standard is around 50%. The current conditions of higher for longer interest rates have effectively eliminated the first two levers, leaving only operational improvements as the main condition for success. And operational improvement, however well executed, is worthless to investors until it is sold and turned into cash.

Despite the harsher conditions in today's landscape, the scale of private equity is growing. The industry's global buyout deal value reached \$1.8 trillion, up 20% from 2024, the second highest year on record (McKinsey). To corroborate this, total alternative asset AUM grew 10-15% to roughly \$8.5 trillion in 2025 (McKinsey). To a skeptic, this looks like a market healing on its own, but that growth is not broad based. It is carried almost entirely by the larger deals. Transactions over \$500 million jumped 44% to \$1.1 trillion, the highest on record, even as the overall number of deals collapsed, with the first half of 2026 seeing 67% fewer transactions than a year earlier. Yet the aggregate deal value continues to rise (McKinsey, PwC). These larger deals are inflating the headlines and the scale at the top is staggering. In 2026, Apollo and Blackstone assembled a record \$35 billion investment in the AI company Anthropic for chip backed computing capacity, a single deal larger than many entire funds (Apollo). With the large deals doing the heavy lifting in the industry Bain labeled the result a "K shaped recovery" (*See Exhibit 1*) in which the mega funds transact freely while mid-market funds struggle for success. If you take away the

mega deals, the headline recovery largely disappears, and it is precisely those mid-market funds that are relying on financial engineering to work around their liquidity problems.

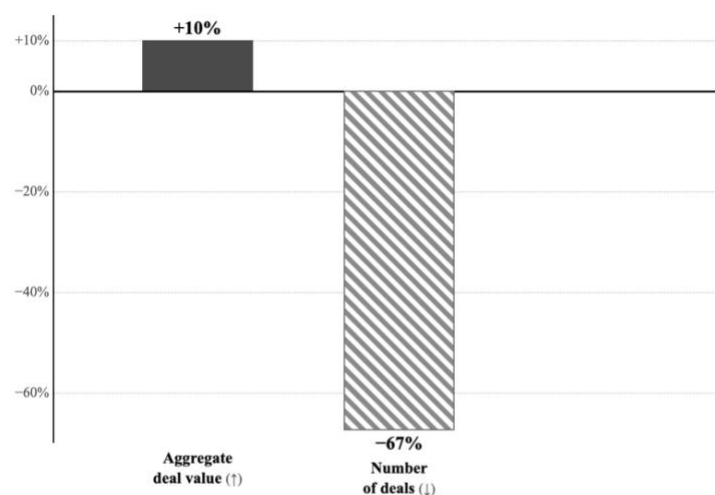
Manufacturing Liquidity

When Private Equity sells a company, a process called the distribution waterfall then occurs. First, capital equaling 100% of the investment must be returned to the LPs, then a preferred return is paid to the LPs of typically 7-8%, then the manager can collect its shares, known as carried interest. To keep investors satisfied, a manager must produce returns. DPI has emerged as the defining metric as unrealized gains and paper valuations have come under significant pressure. Investors are prioritizing actual cash rather than theoretical returns. The problem is that there are not many deals. In the first half of 2026, there were 67% fewer PE transactions than in the H1 of 2025, yet aggregate deal value rose around 10% (PwC). The average holding period at sale is up from 3-5 years to roughly 6-7 years (Bain). It is this pressure to produce cash for investors which has caused some firms to rely on artificial manufacturing of liquidity through financial engineering rather than real exits.

Exhibit 1

A K-Shaped Market: Fewer Deals, Bigger Dollars

Change in U.S. private-equity deal count vs. aggregate deal value, H1 2026 vs. H1 2025



The "K": the number of deals collapsed by two-thirds, yet total deal value still *rose* — because a shrinking set of very large transactions is doing the work of the whole market. Deals over \$500 million jumped 44% to a record \$1.1 trillion (McKinsey), even as mid-market activity froze. The headline "recovery" is concentrated at the very top.

Source: PwC, Global M&A trends in private capital: 2026 mid-year outlook (deal count and aggregate value, H1 2026 vs. H1 2025). Mega-deal figure per McKinsey, Global Private Markets Report 2026.

The first of these three tools is the continuation fund. When a fund is nearing the end of its lifespan and a manager does not want to sell in the current market, assets can be moved to a new vehicle that the manager also controls. Existing investors are given an option to cash out at an agreed price or roll their stakes into the new fund and stay invested. With traditional exit routes such as IPOs and strategic sales experiencing headwinds since 2022, continuation funds have dramatically increased. GP-led continuation vehicles grew 62% year over year, a 37% annual growth rate since 2022, and total secondary volume rose 41% (Bain). What began as a niche workaround has become a mainstream exit channel, as continuation vehicles are now estimated to account for roughly 20% of all private-market distributions in 2026 (Houlihan Capital). Alarming, these prices are not set by the open market but negotiated between the manager and a narrow constituency of secondary buyers.

Unsurprisingly, in valuing continuation funds managers' valuations are often optimistic. Roughly 59% of continuation fund deals close at a discount to the net asset value, with an average settlement

discount of around 8% (Houlihan Capital). The implication is that the price the market values the asset at is often below the mark the manager had been reporting to its own investors. Continuation vehicles are gaining traction not only in scale but in size. There was a record 147 continuation fund exits in 2025, a 18.5% increase from 2024 (Kroll). There was also a large jump in size of deals as the average continuation vehicle transaction rose 15% YoY to \$1 billion in 2025. The number of \$1 billion exits increased 57% from 2024 and 29% of deals exceed \$1 billion (Morgan Lewis). Deals are becoming ever larger and more concentrated in a system that is engineered by the manager. Independent fairness opinions and investor votes have become standard practice because of the structural conflict that cannot be resolved. Managers are obligated to sell an asset for the highest price while simultaneously running the vehicle that is buying and benefiting from paying less. This has caused the SEC to open an inquiry into the continuation vehicles centered on conflict of interest, valuation, and disclosure (Reuters).

A continuation fund might move the asset, while NAV loans move nothing at all. Instead of selling or transferring a company, managers borrow against the net asset value of the fund's entire portfolio. They facilitate this by pledging their equity stake in every holding as collateral. This has become increasingly popular and is expected to grow to \$350 billion by 2030, from the \$100 billion today (AllianceBernstein). When the cash arrives from these loans, they typically go toward three avenues. The cash is distributed to investors, invested into existing portfolio companies, or used to finance upcoming debt. In a frozen market the appeal is obvious. A fund can produce a distribution critically increasing their DPI without having to take a price they consider premature (AllianceBernstein). However, this distribution of cash does not reduce the debt inside the portfolio that it is borrowed against.

Most companies in a private equity fund are pre-loaded with debt from the original acquisition of the company. A NAV loan then borrows on top of that already indebted business, this time at fund level. The same underlying business now must support two tiers of claims, the asset level and the fund level. Due to the NAV cross collateralization against the entire portfolio, all fates are linked together. Distress in one holding can trigger claims against all of them, converting an isolated problem into a fund-wide one. The Institutional Limited Partners Association (ILPA), which represents the investors in these funds, explicitly warned that NAV loans increase fund level debt and could amplify losses in periods of stress. Most prominently, this happens when the fund takes on leverage against leverage for the sole purpose of increasing its DPI. For funds with a strong portfolio, this is a bridge to a better exit. For those whose assets are impaired, this is a way to lever up their sinking position.

Continuation funds and NAV loans are often ways for a fund to return cash to investors. Private credit is something different, it is not a distribution tool, but rather the financial engine that sits beneath the entire system. Over the past decade, it has grown from a niche corner of finance into a market growing by 19% in 2025 to \$2 trillion and now underwrites private equity at nearly every level (McKinsey). It provides debt for companies to buy in the first place, lends to those companies once they are owned, and is increasingly the source of NAV and continuation fund financing. When the first two tools help a fund manufacture liquidity, private credit is what makes that manufacturing possible, the balance sheet behind the bridge.

Private credit is the linchpin in the entire structure, both its greatest asset and its greatest vulnerability. Because the same institutions sit on every side of the trade, the risk created by the workarounds is not dispersed out of the system but recycled within it. A private credit fund could lend to a buyout, finance a NAV loan taken against it, and hold the debt of the company itself, all at once. The market for private credit has grown beyond a specialized market. US banks have extended roughly \$300 billion to private credit funds (Moody's), tying the traditional banking system to the health of an opaque and lightly regulated market. The scale and reach of private credit are also very difficult to track. The Financial Stability Board identified that missing loan level data makes the true exposure genuinely difficult to size. And the instability is no longer hypothetical. US private credit default rates have reached a record 6% in April 2026, the highest that Fitch has tracked. Now, approximately 40% of private credit borrowers carry negative free cash flow which has coincided with a rise in PIK (Allianz). The balance sheet that allowed private equity to play fast and loose is itself beginning to strain.

Liquidity or Solvency?

These three factors are having a real impact on the industry, but there are questions on whether this is a crisis or just a difficult stretch in a maturing industry. That question comes down to a single distinction. Are private markets facing a liquidity problem or a solvency problem? A liquidity problem is one of timing. In theory, the assets are fundamentally valuable, but they cannot be sold at a fair price right now due to a frozen exit market. If this is true, then continuation funds, NAV loans, and private credit are exactly what they claim to be, bridges that carry valuable assets into the clearer waters where their gains can be capitalized. A solvency problem is a different kind. This is a problem of value; the assets are worth less than they claim to be and the debt against them is a comeuppance that no amount of delaying will prevent. If this is true, these financial tools are not bridges. They are simply time bought to prevent a sinking ship. Managers who have created real value and are truly waiting on a more favorable exit will be able to use a NAV loan strategically. Therefore, these instruments are either a lifeline or a trap depending entirely on which problem they are being used to solve. And from the outside, they can look nearly identical.

The Evidence

Most of private credit is invisible. Loans are privately negotiated and rarely traded which is why the rift below the industry is so hard to observe directly. However, one sector of the industry is visible due to their quarterly filings with the SEC. Business development companies (BDCs) are publicly traded lenders that must disclose the health of their holdings. Consider looking at two of the largest BDCs, Ares Capital (ARCC) and FS KKR (FSK). Ares Capital reported non-accruals, loans on which borrowers have stopped paying, at 2.1% of its portfolio. This is well below the average sector norm at 4%. Ares also reported a payment-in-kind income near 7%, showing that it is structurally sound and has lent to strong borrowers. On the other hand, FS KKR tells the complete opposite story. It reported non-accruals of 8.1%, nearly four times higher than Ares, and for successive quarters it has pushed new companies onto a non-accrual status. Its payment in kind income has also grown from 10.5% to 14.8% in two years. Over that same time frame, FS KKR's net asset value fell nearly 10% and its dividend was cut by 40%. Ares and FS KKR face the same asset class, the same frozen market, and the same interest-rate environment, yet show two completely different trajectories. (*See Exhibit 2*)

Exhibit 2

A Bifurcation in Plain Sight: Two Large Private-Credit Lenders, One Environment

Portfolio-health metrics, Ares Capital (ARCC) vs. FS KKR (FSK), most recent filings (Q1 2026)

Metric	Ares Capital (ARCC)	FS KKR (FSK)	Sector avg.
Non-accruals (% of portfolio, at cost) loans on which borrowers have stopped paying	2.1%	8.1%	~4%
PIK income (% of income) interest paid on paper, not in cash	~7%	14.8% (up from 10.5%)	—
Net asset value (NAV) trend	Stable	-10%	—
Dividend	Maintained	Cut 40%	—
<i>Read</i>	<i>Disciplined / sound</i>	<i>Deteriorating</i>	

Sources: Ares Capital Corp. and FS KKR Capital Corp., Form 10-Q filings (period ending March 31, 2026), U.S. Securities and Exchange Commission. Sector non-accrual average per industry data.

Note: Both firms lend into the same asset class, interest-rate environment, and frozen exit market. The divergence therefore reflects underwriting discipline and portfolio quality, not external conditions — the firm-level evidence of the bifurcation this paper describes. PIK = payment-in-kind; NAV = net asset value.

These two firms are not outliers inside the industry; they just give us visibility into it. Across the sector, the stress is real and rising. According to Fitch, the US private credit default rate reached a record 6% in April 2026, the highest since it began tracking. This, combined with the fact that 40% of private credit borrowers are generating negative free cash flow, up 25% in 2021, raises large red flags from the outside. These two statistics are connected. A borrower who is not generating enough cash to cover its interest does not immediately default. Instead, lenders allow firms to pay in kind. This allows for more interest on the loan balance rather than a transfer of cash. This is why PIK is such a revealing statistic. It shows that private credit firms are allowing for a solvency problem by quietly deferring it. Eventually, the loan can no longer be extended, at which the cash problems resurface and turn the deferrals into defaults. This is already visible from the data in FS KKR's climbing PIK and the industry's record default rate, and for the weaker half of the market, it shows a clear solvency issue. In the end, the deferral is not a solution but a delay, and every PIK is a loss pushed forward rather than absorbed.

The Counterargument

The strongest case against this argument is that the system is designed to absorb these losses. The objection is serious and is built from three main strengths. First, the credit lenders sit senior in the capital structure, so that private equity companies' equity is lost before the lender loses a dollar. With equity contributions now around 50% of a deal, that cushion is thick. Secondly, the funds are mostly closed-end, with capital locked into deals for multiple years, so there cannot be a fire sale from depositors like seen in 2008. Lastly, not all this borrowing is defensive. Around 45% of NAV loans are funded towards acquisitions and growth (Moonfare), genuine value creation rather than disguised distributions. Each of these claims is valid and serves as a counter argument against a sudden collapse. Seniority only protects lenders until the cushion is exhausted, and the cushion is thinnest precisely among the weakest, most over-levered borrowers. Locked up capital prevents a fire sale but does nothing to save an impaired asset. It just converts a fast loss into a slow one. Therefore, what these defenses describe is not safety but a slower failure. The losses are absorbed quietly by the weaker half of the market rather than a crash felt by all at once.

Conclusion

The question that this paper began with, whether private markets have solved their liquidity crisis or merely deferred it, does not have a single answer. Continuation funds, NAV loans, and private credit are neither the innovations their proponents describe nor the time bomb their critics fear. They are instruments whose character depends entirely on what they are used to do. For a disciplined manager holding sound assets with a clean balance sheet, they are a bridge, a rational way to wait out a frozen market until the value can be realized. For an over levered manager sitting on impaired assets, they are a band-aid, a higher risk way to borrow against inflated marks, manufacture the appearance of liquidity, and postpone a loss that only grows while it waits. The result is not a uniform bubble bound to burst, but a bifurcation. Private markets are quietly splitting into those who used these tools to cross a gap and those who used them to avoid admitting they have fallen into one. The evidence is there to suggest this is already underway and visible within the industry. The reckoning, when it comes, will not arrive as a crash. It will arrive slowly, borrower by borrower, as deferrals run out of room. What to watch is not a single moment but a trend, rising PIK and rising defaults meeting the wall of debt coming due in 2027 and beyond. Those numbers will reveal, better than any argument, whether these tools were a bridge or a band-aid all along.

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