

Recent Developments in Private Funds

-- Increasing Presence of PE and PD Funds and Their Recent Traits

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Private equity (PE) funds and private debt (PD) funds have expanded their assets under management since the global financial crisis, especially in the United States. Recent developments have indicated subdued performance of PE funds, reflecting factors such as a decline in valuations of portfolio companies following the rise in foreign interest rates. Exit timelines for portfolio companies have also been extended. PD funds have demonstrated robust performance, supported by wide lending spreads; however, spreads are showing a tightening trend amid intensifying competition. Furthermore, while the portfolio companies of both PE and PD funds have maintained robust business performance, they are facing increasing interest payment burdens, warranting close attention to their creditworthiness. It is important to closely monitor future developments in this area, as Japanese banks and domestic institutional investors have increased their interconnectedness with PE and PD funds through investments and lending, which may have an impact on Japan's financial system.

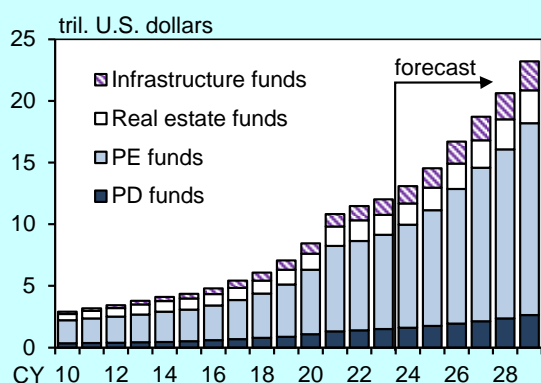
Introduction

Private funds are investment vehicles that raise capital from investors through private placements. They include hedge funds, as well as funds engaged in equity investments in unlisted companies (private equity,¹ PE) and lending to such companies (private debt,² PD). PE and PD funds, which invest in illiquid assets, have been expanding their assets under management (AUM). This growth is largely driven by increasing demand from long-term investors seeking alternative assets to improve returns and diversify risks. Looking ahead, further growth in AUM is expected (Chart 1).

Among private funds, PE funds have grown in scale by offering attractive returns to investors in a low-interest-rate environment following the global financial crisis. Additionally, PD funds, which provide direct lending mainly to medium-sized and small companies, have also expanded in scale. This growth has been driven by their role in complementing financial intermediation for companies, amid the strengthening of financial regulations on banks after the global financial crisis, coupled with their ability to attract investors by offering high yields supported by wide lending spreads. In recent years, there has also been an increase in cases where PD funds carry out large-scale transactions such as leveraged buyout (LBO) financing, replacing the bank-originated leveraged loans.

Japanese institutional investors, such as life insurance companies and pension funds, as well as Japanese financial institutions, are strengthening their interconnections with PE and PD funds through investments and loans. Consequently, understanding recent developments in these funds has become critical for assessing the interlinkages between PE and PD funds and Japan's financial system, and identifying potential risks to the system.³ In this context, foreign regulatory authorities and international organizations have recently expressed growing concerns regarding the increasing interconnectedness surrounding PE and

[Chart 1] AUM of Private Funds



Note: AUM figures, including forecasts, were compiled by asset type, based on data from Preqin's annual report. "PE funds" excludes renminbi-denominated funds. Figures exclude hedge funds.

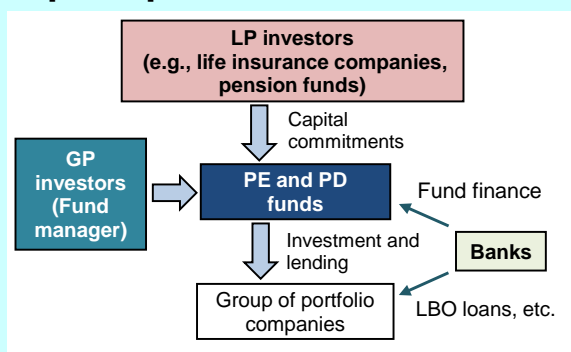
Source: Preqin.

PD funds within the financial system.⁴ This paper examines recent developments in this area, primarily in the United States, including the performance and capital flows of PE and PD funds, as well as the financial soundness of their portfolio companies, and assesses the potential risks these funds may pose to Japan's financial system.

Overview of PE and PD Funds

PE and PD funds are generally structured with general partner (GP) investors (fund managers) and multiple limited partner (LP) investors (such as institutional investors) (Chart 2). GP investors establish funds and secure capital commitments from multiple LP investors (fundraising). Investment decisions are made at the discretion of GP investors, while LP investors supply funding as needed through capital calls. In addition, financial institutions, such as banks, also provide loans to PE and PD funds and to the funds' portfolio companies.

[Chart 2] Structure of PE and PD Funds



Source: BOJ.

The majority of PE and PD funds are closed-end funds, in which investor redemptions are restricted. Their operations typically follow a cycle that consists of fundraising, executing investments and loans (deals), and harvesting returns through the sale of companies through M&A or IPOs, or, in the case of PD funds, through principal and interest repayments (exits). During this process, profits generated from sources such as interest income, dividends, and proceeds from exits are distributed to LP and GP investors after deducting various fees and expenses.

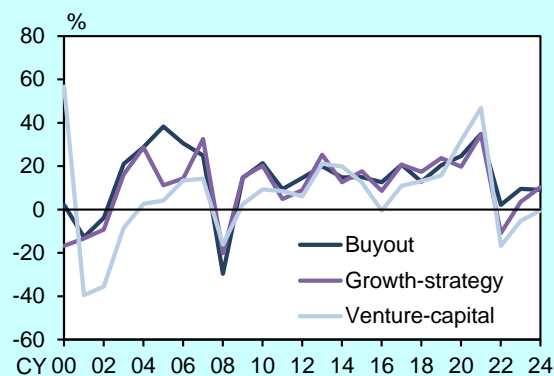
Trends in the Performance of PE and PD Funds

To evaluate the performance of funds, metrics such as the internal rate of return (IRR) are used, as they account for differences in investment periods and the

timing of cash flows across individual investments.

Looking at the performance of PE funds, although they maintained high returns throughout the 2010s, their performance has weakened since around 2022. This can be attributed to factors such as a decline in the valuations of portfolio companies and an increase in borrowing costs, driven by higher foreign interest rates (Chart 3). By investment strategy, growth-strategy funds and venture-capital funds,⁵ which primarily invest in start-ups that are more vulnerable to the effects of rising interest rates, have been particularly subdued. Meanwhile, when categorized by vintage (the year of fund creation), funds with 2020-2021 vintages, which aggressively used leverage in an environment of elevated stock market valuations, have shown notably weak performance (Chart 4).

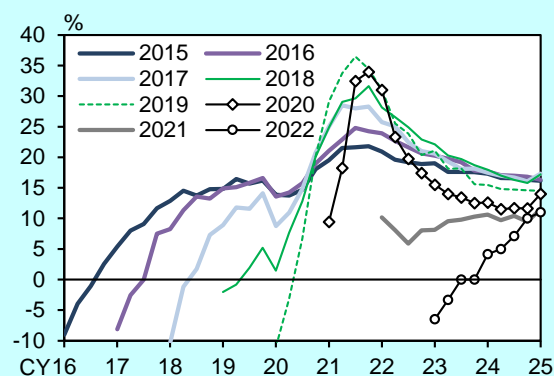
[Chart 3] IRR by PE Fund Strategy



Note: Latest data as of January-September 2024.

Source: Preqin.

[Chart 4] IRR by Vintage Year of PE Funds



Note: Latest data as of January-March 2025.

Source: Preqin.

On the other hand, PD funds have demonstrated robust performance, supported by wide lending spreads (Chart 5). The recent rises in foreign interest rates have also contributed to their robust performance, as the majority of loans provided by PD funds are structured as floating-rates loans. That said, while the lending spreads of PD funds remain at a high level,⁶ these

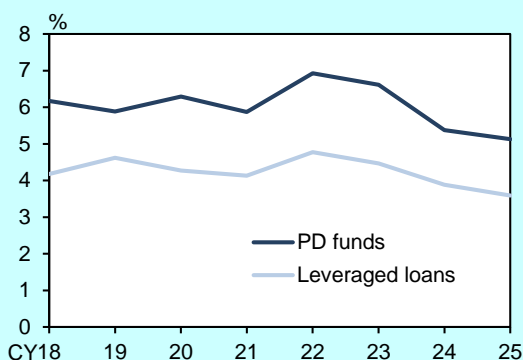
spreads have narrowed amid increasing competition both among PD funds and with leveraged loans offered by banks (Chart 6).⁷ Regarding the latter, in large-scale transactions such as LBO finance -- where PD funds have recently entered as lenders -- banks' lending stance has moderately recovered since around 2024,⁸ with some borrowers preferring leveraged loans because of their lower spreads compared to PD fund loans.

[Chart 5] IRR of PD Funds



Note: Latest data as of January-September 2024.
Source: Preqin.

[Chart 6] Spreads of PD Funds



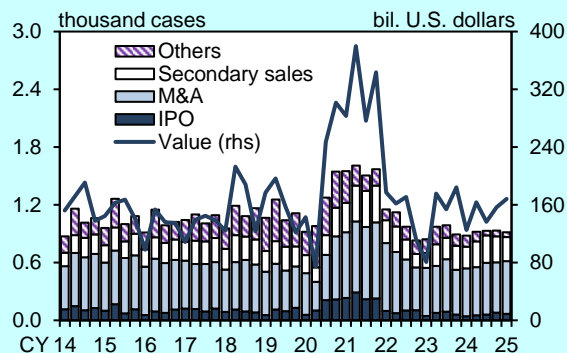
Notes: 1. The spreads of both loans are those in U.S. LBO financing. PD refers to direct lending.
2. Latest data as of January-June 2025.
Source: PitchBook.

Trends in the Capital Flows of PE and PD Funds

Next, this paper examines trends in the capital flows of PE and PD funds. For PE funds, the sale of portfolio companies (exits) serves as a primary source of distributions to LP investors. If exits are delayed, payments of distributions to LP investors may also be delayed, which may in turn slow new investments by LP investors, hindering fundraising activities for PE funds. The timeliness of exits is a key indicator of capital flow trends in PE funds.

Looking at the trends in PE fund exits, factors such as rising foreign interest rates since 2022 and heightened uncertainty in financial markets have made it difficult to value unlisted companies, resulting in a slowdown in exit activities (Chart 7).⁹ Amid interest rate cuts by foreign central banks, there have been views that exits are showing a moderate recovery trend. However, more recently, as uncertainty surrounding U.S. policy conduct has come into focus, some have pointed to a slowdown in the pace of this recovery.

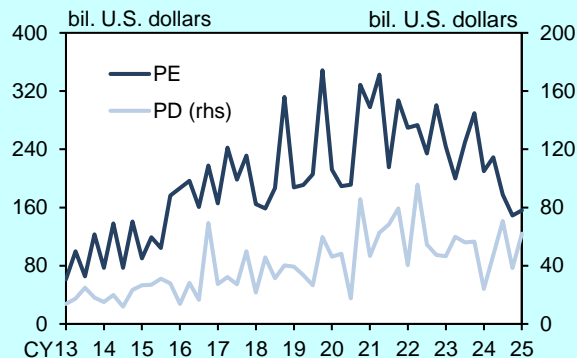
[Chart 7] PE Fund Exits



Note: Latest data as of January-March 2025.
Source: Preqin.

Moreover, for PE funds, fundraising has stagnated due to delays in exits. As for PD funds, although there remains demand from institutional investors who appreciate their robust performance, their growth has also been sluggish. This is because many PD fund borrowers are companies invested in by PE funds,¹⁰ making PD funds more exposed to the negative impact of the sluggish PE deal activity (Chart 8).

[Chart 8] Fundraising of PE and PD Funds



Note: Latest data as of January-March 2025.
Source: Preqin.

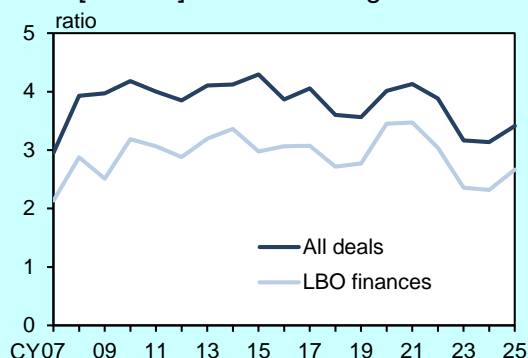
Trends in Creditworthiness of PE and PD Funds

This section examines the creditworthiness of PE and PD funds, focusing on the financial soundness of their portfolio companies and the leverage employed by the funds themselves (fund finance). It should be noted that there is limited disclosed information on PE and PD funds, as well as their respective portfolio companies, which presents certain challenges in obtaining a comprehensive understanding of their actual conditions.

Financial soundness of portfolio companies of PE and PD funds

Given the robust performance of the U.S. economy so far, the operating performance of portfolio companies held by PE and PD funds, such as revenue and EBITDA, appears to be broadly improving. However, while foreign interest rates, particularly in the United States, have remained at high levels, signs of a decline in the debt repayment capacity of portfolio companies have also been observed. For instance, the interest coverage ratio (ICR) of leveraged loan borrowers, which are believed to overlap to some extent with the portfolio companies of PE funds, has shown a declining trend (Chart 9).

[Chart 9] ICR of Leveraged Loans



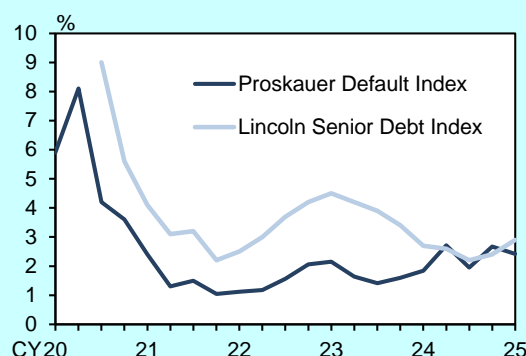
Notes: 1. Aggregates newly issued leveraged loans borrowed by companies with EBITDA over 50 million dollars.

2. Latest data as of the beginning of January 2025 to June 24, 2025.

Source: PitchBook.

On the other hand, there appears to have been no significant deterioration in the default rates of PD funds' portfolio companies (Chart 10). In this regard, PD funds are understood to maintain close relationships with their portfolio companies and engage with shareholders -- primarily PE funds -- at an early stage of credit deterioration, for instance, by taking initiatives to improve business performance. Such actions may be preventing further deterioration in the creditworthiness of portfolio companies.

[Chart 10] Default Rates of PD Funds' Portfolio Companies



Notes: 1. Note that due to data limitations in the PD market, figures vary considerably depending on the data source.

2. The Lincoln Senior Debt Index is the default rate of direct lending.

3. Latest data as of January-March 2025.

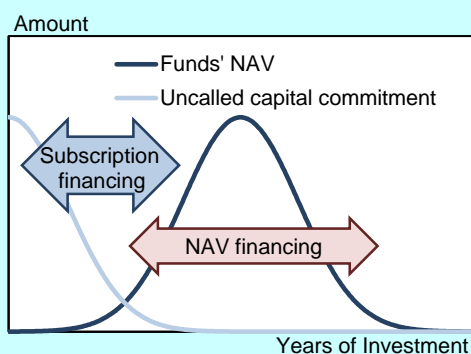
Sources: Proskauer Rose LLP; Lincoln International LLC.

However, it has been pointed out that the relaxation of lending conditions by PD funds may be contributing to a delay in the materialization of defaults. For example, there has been an increase in the use of payment-in-kind (PIK) loans, which allow the deferral of interest payments until maturity for lump-sum repayment. In this regard, PIK loans are also provided by PD funds as a form of flexible lending conditions for companies with limited cash flow generation capabilities at the time of lending but with high future growth potential. Therefore, an increase in PIK loans does not necessarily imply a deterioration in portfolio companies' creditworthiness. Nonetheless, concerns have been raised that PIK loans may be increasing as a means of differentiating lending terms amid intensifying competition, or of easing lending conditions for portfolio companies facing challenges in meeting interest payment obligations. In addition to PIK loans, an increase in relaxation of covenant terms in loans provided by PD funds has been pointed out. It is necessary to carefully monitor whether these developments might lead to a deterioration in the quality of PD funds' lending.

Increase in Fund Finance

In addition to borrowings by portfolio companies, PE and PD funds themselves may also take on borrowing. Such fund finance can be broadly classified into two types: subscription financing, which is primarily used at a fund's launch and is secured by capital call rights against LP investors; and NAV financing, which is secured by the fund's NAV (such as its portfolio assets) and is primarily used later in the fund's lifecycle (Chart 11).¹¹

[Chart 11] Use of Fund Finance over the Fund's Lifecycle



Source: BOJ.

In this regard, in addition to the use of subscription financing, in recent years, the use of NAV financing has increased, driven by growing capital needs during the later stages of PE funds' lifecycles amid stagnant exits. The increase in NAV financing appears to be partly attributable to its use to fund distributions to LP investors who have been awaiting returns, in a context where there are limited opportunities for cash inflows from exits. Such use has raised concerns among LP investors, as it may lead to higher leverage without necessarily increasing the fund's value. It also risks increasing the burden of interest payments for funds.¹² Recently, there have been some indications that such use of NAV financing has declined, but data limitations make it difficult to accurately assess the situation.

It is widely believed that NAV financing has not led to excessive leverage, as its loan-to-value (LTV) ratios have generally been kept relatively low. However, NAV financing is considered a relatively high-risk form of lending, as it is secured by the NAV of portfolio companies that themselves have received LBO financing and other forms of debt, resulting in a multi-layered collateral structure. Also, it inherently contains the credit risk of the fund itself, unlike subscription financing that relies on the creditworthiness of LP investors. Therefore, it is important to carefully monitor the future expansion of NAV financing.

Conclusion

This paper focuses on PE and PD funds, analyzing the trends in their performance, their capital flows, and their creditworthiness.

PE and PD funds have played a significant role in providing risk capital to medium-sized and small companies, which have faced challenges in obtaining credit ratings, securing bank loans, or accessing capital markets, as well as contributing to the diversification of

institutional investors' portfolios. As a result, their importance in financial intermediation has been increasing.

Recent developments in PE and PD funds suggest that defaults among portfolio companies remain relatively low. However, signs have emerged of deteriorating creditworthiness among portfolio companies as these companies face an increasing interest payment burden due to past rises in interest rates. Additionally, there are indications that defaults are being delayed through means such as the relaxation of repayment terms. Although the United States and Europe began cutting interest rates in 2024, if interest rates remain at a high level, the financial burden on portfolio companies is likely to persist.

In addition, it has been pointed out that due to limited disclosure, it is difficult to fully understand the investment situations of PE and PD funds, and the performance and creditworthiness of their portfolio companies. Furthermore, the valuation of portfolio companies by the funds often lacks sufficient transparency,¹³ and there are concerns regarding liquidity risks posed by semi-liquid funds.¹⁴

Meanwhile, PE and PD funds have become more deeply integrated into the global financial system. Institutional investors, such as life insurance companies and pension funds, have further enhanced their presence as providers of equity capitals to these funds. In addition, in recent years, primarily in the United States, there has been an increase in acquisitions of life insurance companies by fund managers. Furthermore, there are cases of insurance contracts being transferred (or reinsured) to PE-affiliated reinsurers, primarily based in Bermuda. These subsidiary life insurance or reinsurance companies have strengthened their relationships with fund managers by investing in funds established by those managers. Additionally, financial institutions in the U.S. and Europe have also deepened their ties with the PE and PD markets not only by providing fund finance but also through partnerships with and equity investments in fund managers, as well as through the establishment of PD funds.

Institutional investors in Japan are also expanding their exposure to PE and PD funds through investments in alternative assets. Additionally, domestic financial institutions, especially major banks, are focusing on providing fund finance. This aims to improve the profitability of foreign lending and secure associated business opportunities, such as supporting portfolio companies in issuing bonds and equity. These developments have strengthened the interconnectedness between Japanese financial

institutions and PE and PD funds. Under such circumstances, the potential impact of shocks in the PE and PD markets on Japan's financial system is expected to have increased.

Going forward, understanding the situations

¹ For an overview of PE funds, see Watanabe, K., Igarashi, K., and Inaba, H., "The recent growing momentum of private equity funds," Bank of Japan Review Series, no. 2018-E-1, 2018.

² For an overview of PD funds, see Kuroda, K., Hasebe, A., Ito, S., and Ikeda, D., "Private Debt Funds: What They Are and Trends under Interest Rate Hikes," Bank of Japan Review Series, no. 2024-E-1, 2024.

³ For developments in the exposure of Japanese banks and domestic institutional investors to foreign private funds, see Box 3 in the April 2025 issue of the *Financial System Report*.

⁴ The Bank of England (2024) and the IMF (2025) have pointed out the risks of shocks to portfolio companies of PE and PD funds being transmitted not only to banks and institutional investors but also to other markets and regions, against the backdrop of the global banking sector and institutional investors increasing their exposure to PE and PD funds through investments and loans. See the BOE, *Financial Stability Report*, June 2024 and the IMF, *Global Financial Stability Report*, April 2025.

⁵ Buyouts represent a strategy focused on enhancing corporate value through engagement in the management of mature companies. Venture-capital, on the other hand, involves equity investments in startups with the goal of financially supporting the expansion of new businesses. Growth-strategy is positioned between buyouts and venture-capital, targeting companies in their expansion stage.

⁶ Compared to conventional bank loans, direct lending is typically characterized by longer loan tenures and higher risks associated with the borrowers. As a result, wide lending spreads are often applied.

⁷ Direct lending primarily involves providing bilateral loans to medium-sized and small companies. Additionally, strategies such as distressed debt, which targets lending to distressed companies, and mezzanine debt, involving instruments such as subordinated loans, are also employed.

⁸ For recent developments in LBO finance by banks, see Kanaguchi, T., Inatsugu, H., and Miura, K., "Trends in LBO Financing and Risk Management," Bank of Japan Review Series, no. 24-J-8, 2024 (available in Japanese).

⁹ Amid the stagnation of exits, there has been an increase in transactions in the secondary market by LP investors seeking to liquidate their fund stakes and GP investors facing such needs. Coupled with the growth of secondary funds capturing these transaction opportunities, the secondary market has been expanding rapidly in recent years. According to Jefferies'

surrounding PE and PD funds will become increasingly important for identifying risks in foreign PE and PD markets and assessing their interconnections with Japan's financial system. It is essential to carefully monitor developments in these areas.

"Global Secondary Market Review," the market size more than doubled between 2018 and 2024.

¹⁰ PD funds are often utilized in LBO financing by PE funds. For details, see Naono, M., and Watanabe, S., "Lending Practices of Private Debt Funds: Traits of Direct Lending," Bank of Japan Review Series, no. 22-J-1, 2022 (available in Japanese).

¹¹ In addition to the methods discussed in this paper, there are other financing techniques, such as PD fund finance secured by the loan claims of PD funds and equity margin lending secured by listed stocks. For details on fund finance, see Kanaguchi, T., Kawakami, T., Hasebe, A., and Ogawa, Y., "The Overview and Risks of Fund Finance," Bank of Japan Review Series, no. 2023-E-5, 2023.

¹² According to Rede Partners' "NAVigating NAV Financing, LP perception survey and lender market report," the proportion of LP investors who have a negative view of the use of NAV financing for the purpose of making distributions to investors is higher compared to other uses, such as add-on M&A, new platform investments, or refinancing of existing debt.

¹³ The Financial Conduct Authority (FCA) in the United Kingdom conducted a survey targeting fund managers and asset management firms to assess their valuation methodologies and governance practices. While the findings published in March 2025 identified good practices in areas such as investor reporting and documentation of valuation processes, the survey also pointed out room for improvement in clarifying and addressing potential conflicts of interest within valuation processes, as well as ensuring the internal independence of valuation functions.

¹⁴ In an effort to broaden the investor base to include high-net-worth individual investors and others, there has been an increase in the establishment of relatively more liquid (semi-liquid) funds that offer certain redemption options.

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