Morgan Stanley
INVESTMENT MANAGEMENT

Evolution of Direct Lending

Private Credit Primer

MORGAN STANLEY PRIVATE CREDIT | 2025

Overview of Private Credit

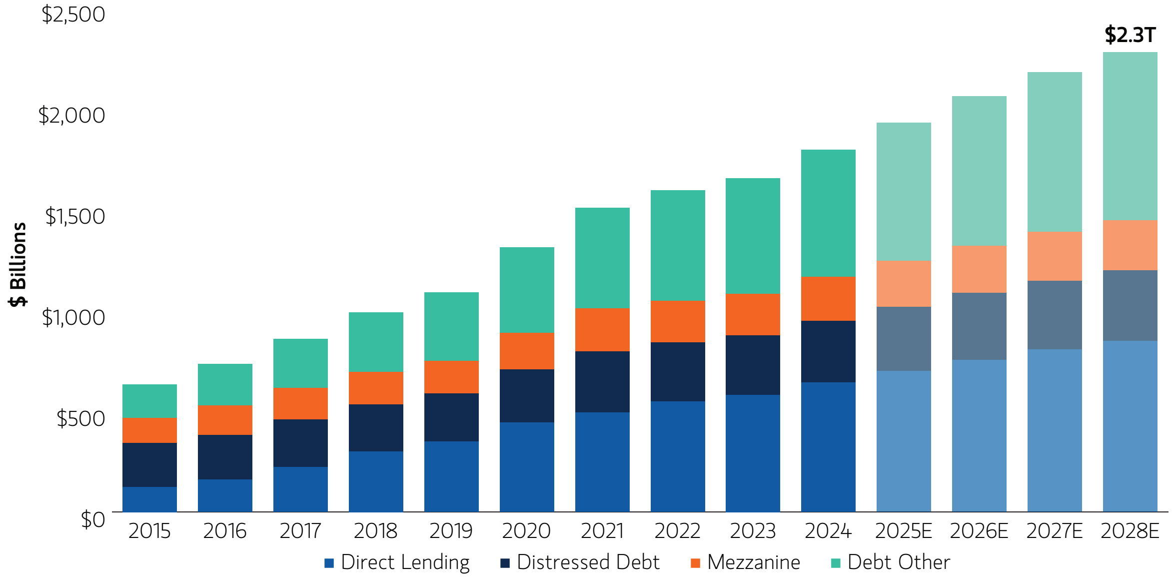
Private Credit investing is a form of lending capital outside of the traditional banking system, whereby lenders work with borrowers to originate and negotiate privately held loans not traded in public markets. Investor allocation to Private Credit has grown significantly in recent years, with a total market size of approximately $1.8 trillion as of the end of 2024 and forecasted to grow to $2.3 trillion by 2028.[1]

Historically, corporate borrowers have looked to banks for their lending needs. However, the number of US banks declined by 53% between 2000 and 2023. Most of that consolidation occurred in the years following the Global Financial Crisis ("GFC") in 2008, as regulations and increasingly conservative lending policies among banks reduced their willingness to lend. As a result of these changes, the market opportunity for Private Credit has evolved over the last several decades as private lenders have stepped in to fill the need for capital.

As lenders have sought to address the capital deployment needs of investors with different risk and return profiles, a number of Private Credit investing strategies have emerged. Direct Lending, which is discussed in detail in the following pages, now accounts for the largest share of Private Credit assets under management, making up over one-third of all Private Credit as of March 31, 2024.

DISPLAY 1

Projected and Historic Growth in Private Credit Assets



Source: PitchBook. Historical AUM and forecasts generated on April 19, 2024.

[1] PitchBook, Private Capital's Path to $20 Trillion report.

Types of Private Credit

Private Credit is generally made up of six sub-strategies. These sub-strategies are categorized either by the types of borrowers they lend to (e.g., Distressed or Venture strategies), the types of loans they make (e.g., Direct Lending or Mezzanine), or the collateral type (e.g., Asset-Based). Each strategy offers a tradeoff of risk/reward characteristics.

Direct Lending strategies provide credit primarily to middle market, non-investment grade private companies and generally focus on generating current income like other fixed income investments. Direct lenders typically concentrate their investment activity in first lien and unitranche debt, both of which are discussed in greater detail in the following pages.

Asset-Based Finance describes a wide range of strategies that target assets as opposed to operating companies. They include loans on real assets, such as real estate and infrastructure, or pools of assets such as equipment and fleet financing, or balance sheet assets of financial intermediaries such as student loans, credit card receivables, or account receivables in general held by non-financial companies.

Distressed Debt investing is lending to companies that are "distressed" because of issues such as bankruptcy or other complications with meeting debt obligations, with the intention of generating profit post-company turnaround. Distressed debt has a risk-return profile similar to equity securities because factors specific to the issuer have a greater effect on the debt's performance.

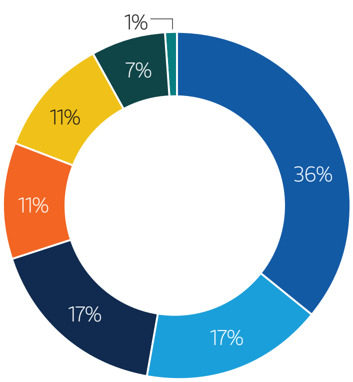
Mezzanine Lending provides borrowers with a hybrid of debt and equity financing. These debt issuances often have equity conversion rights or other types of embedded equity options. Mezzanine debt is subordinated to first lien debt.

Special Situations strategies focus on flexible solutions for planned events, such as corporate expansion, or unplanned events during periods of stress, such as restructurings. Also referred to as opportunistic or structured debt, their borrowers start out as performing although some may transition to distressed.

Venture Debt, like venture capital, focuses on startup or early-stage companies looking for funding. Debt financing for these firms has expanded as early-stage companies look to increase their working capital or capital investment without issuing new and dilutive equity.

DISPLAY 2

Share of Global Private Credit AUM by Sub-Strategy

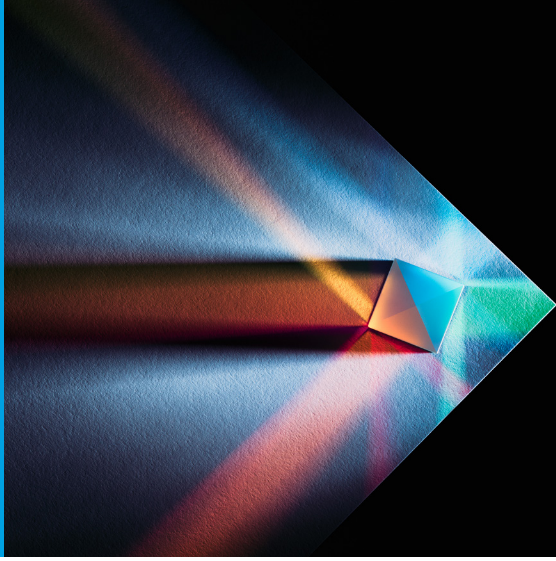


- Direct Lending
- Asset-Based
- Distressed Debt
- Mezzanine Lending
- Special Situations
- Multi-Strategy
- Venture Debt

Source: PitchBook, March 31, 2024.

Direct Lending now makes up 36% of the total Private Credit market, up from 9% in 2010.

Overview of Direct Lending



Direct Lending is a type of Private Credit strategy that makes direct, illiquid loans to middle market companies. While Direct Lending usually refers to first lien (including unitranche) loans, second lien and mezzanine lending similarly lend to middle market companies and have developed as a result of the same dynamics as senior first lien Direct Lending investing.

Defining the Middle Market

Companies within the "middle market" generally fall within a range of approximately $10 million to $200 million in EBITDA, roughly comparable to medium- and small-cap stocks included in indexes such as the Russell 2000. This middle market segment represents a major piece of the US economy, approximately one third of private sector GDP, and continues to grow, experiencing 8% earnings growth in Q3 2024.[2]

Middle market borrowers are typically either not within the lending profile of the broadly syndicated loan market or not interested in undergoing the often lengthier and less flexible process of broadly syndicated loan origination. As such, a large portion of the middle market is turning to Direct Lending to meet their capital needs. In exchange for providing capital to these borrowers, direct lenders can expect to earn higher interest rates to compensate for the added risk of lending to smaller companies, as well as an illiquidity premium for providing non-publicly tradeable issuances. These direct loans are often highly negotiated with protective covenants that provide downside protection for lenders.

Size and Scope of the Middle Market

$20M-$1B
REVENUE

$10-$200M
EBITDA

50M
MIDDLE MARKET JOBS[2]

$100M-$1B
ENTERPRISE VALUE

33%
MIDDLE MARKET BUSINESSES AS A PERCENTAGE OF PRIVATE SECTOR GDP[3]

$13T
MIDDLE MARKET BUSINESSES TOTAL ANNUAL REVENUE[4]

This middle market segment represents a major component of the U.S. economy, approximately one-third of private sector GDP, and continues to grow, experiencing 8% earnings growth in Q3 2024.[2]

[2] Golub Capital Altman Index, Q3 2024 US Middle Market Report.

[3] National Center for the Middle Market, "Year End 2023 Middle Market Indicator."

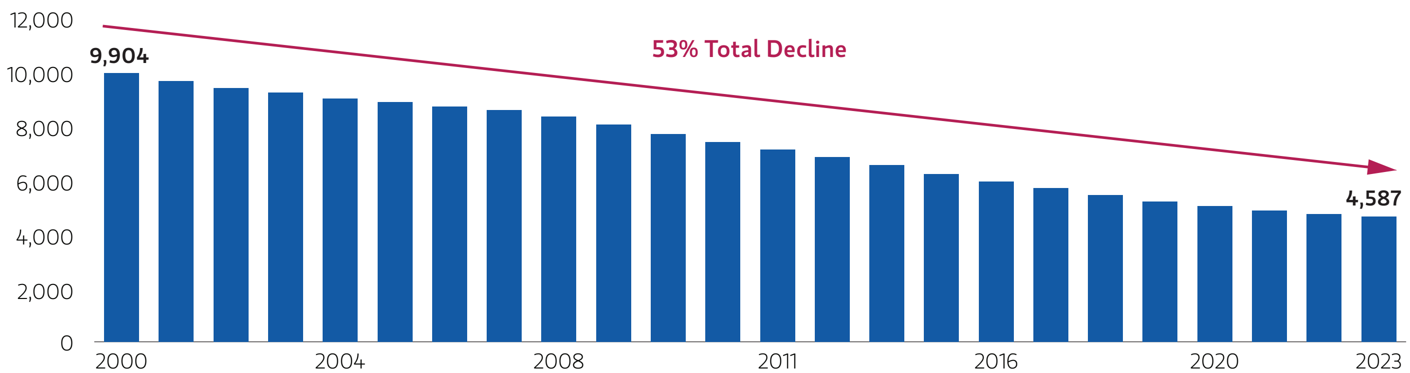
[4] J.P. Morgan, Next Street, "The Middle Matters: Exploring the Diverse Middle Market Business Landscape."

Direct Lending – Changing Sources of Capital

The increase in demand for Direct Lending to meet the needs of middle market companies has been driven by a decades-long trend of bank consolidation and further accelerated by regulations following the GFC, as described on page 5 in *Direct Lending – Regulatory Impacts.* As shown in *Display 3*, between 1999 and up to the start of the GFC in 2007, a period that included a number of high-profile mergers such as Chase Manhattan Bank with J.P. Morgan & Co., the number of US banks declined by around 15%, while their total assets more than doubled. From 2000 to 2023, the number of FDIC-insured banks fell by 53%.[5] This consolidation trend has generally resulted in a smaller number of banks that are more focused on lending to larger borrowers.

DISPLAY 3

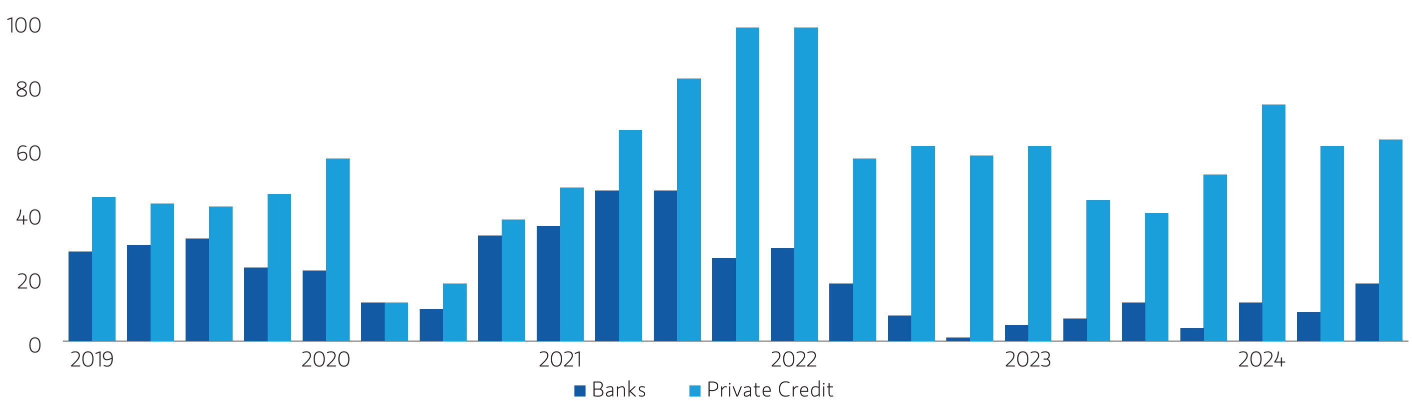
Number of FDIC-Insured Banks



Source: FDIC, as of December 31, 2023.

DISPLAY 4

Banks' Declining Share of LBO Loans to PE Borrowers



Source: Pitchbook LCD Data, as of September 30, 2024.

[5] FDIC, as of December 31, 2023.

The declining number of bank lenders, coupled with the declining willingness of these institutions to lend, has led to a major shift in the source of funding for certain borrower types. Private lenders have subsequently moved to fill this gap, driving a large part of lending outside the banking system.

Direct lenders have emerged as a provider of loans to the middle market. As shown in *Display 4* on page 4, global banks' share of the leveraged buyout loan market hasn't risen above 50% since 2019 and dropped to as low as 7% in 2023.[6]

Direct Lending – Regulatory Impacts

The post-GFC regulations, which are discussed in detail below, contributed to a shift in banks' ability and willingness to issue or hold certain assets, driving increased demand for Direct Lending.

- **Bank of International Settlements Framework III ("Basel III"):** Basel III regulations were formed as a direct response to market-wide contagion of bank collapses during the GFC. The Basel III framework is based on three target risk measures, requiring banks to maintain minimum levels of capital, liquidity, and stable funding. Higher and broader minimums were proposed as recently as 2023 after the Silicon Valley Bank failure and the mini-bank crisis that ensued.
- **Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank"):** Dodd-Frank is legislation that initially aimed to curb risk concentration of banks. In particular, the Volcker Rule, implemented under Dodd-Frank, restricted banks' ability to lend to riskier borrowers, creating a gap in funding for private equity transactions. While the Dodd-Frank Act was rolled back in 2018, its impacts have largely been unchanged, with banks' overall risk tolerance significantly lower than pre-GFC, and there are few indications of a potential reverse of this trend.
- **FDIC Leveraged Lending Guidance:** In 2013, the Federal Deposit Insurance Corporation (FDIC) updated its guidance on leveraged financed activities, decreasing risk appetite for banks and increasing the need for stress-testing exposures and portfolios.

[6] Pitchbook LCD Data. Based on deal count.

Private Equity Demand – An Additional Driver of Direct Lending Growth

Coinciding with ongoing bank consolidation and retrenchment, markets have also seen a shift from public equity to private equity. The number of publicly listed companies in the U.S. has been declining for over two decades, with the total number of listed US companies decreasing by 43% from 1996 to 2022.[7] This reduction is related to several factors, including regulations such as the 2002 Sarbanes-Oxley Act, which heightened requirements for public company filings and governance. Small and medium companies have also increasingly found value in working with private equity investors who generally have a longer-term focus on growth versus public investors who focus heavily on quarterly results.

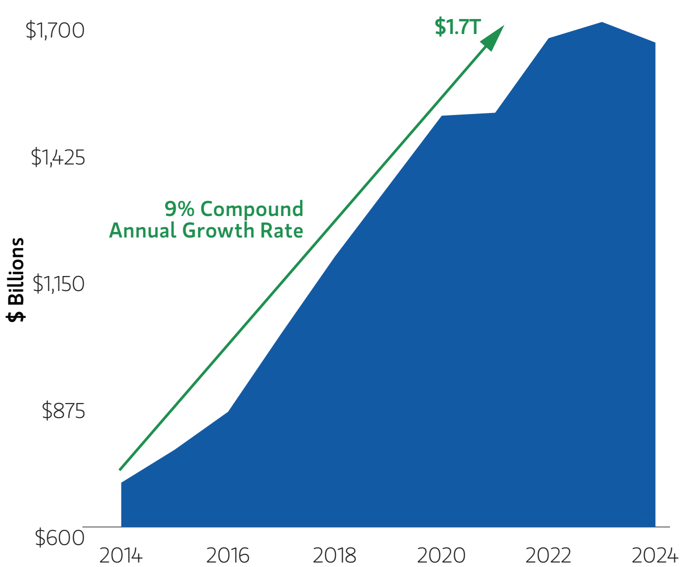
To address the growing debt capital need from private equity, Direct Lending has become a source of funding for private equity sponsors. The approximately 9% compound annual growth rate (CAGR) in private equity dry powder since 2014 (*Display 5*) suggests the demand for Direct Lending capital will likely continue.

While Direct Lending had previously been limited in its ability to underwrite at the size required to be a viable alternative to the syndicated loan market, this limitation has eroded significantly over the past few years. Direct Lending institutions continue to raise additional funds and expand the scope of their lending capabilities. The scale at which direct lenders are now able to underwrite debt and partner together makes Direct Lending a much more competitive option for private equity backed borrowers. A form of financing once only tapped by smaller, sponsor-backed companies evolved into a market that can meet the financing needs of much larger companies. Private equity firms are now able to execute debt financings of more than $5 billion for their portfolio companies in the private market.

Another potential factor that may contribute to continued need for Private Credit is the "maturity wall" for middle market companies with debt that is coming due. As shown in *Display 6* below, the combined value of maturing BDC and syndicated loans to middle market companies averages $155 billion per year through 2030, and peaks at $210 billion in 2028. The growing amount of maturing debt suggests that the middle market will remain in need of financing, and private lenders will likely benefit from this dynamic.

DISPLAY 5

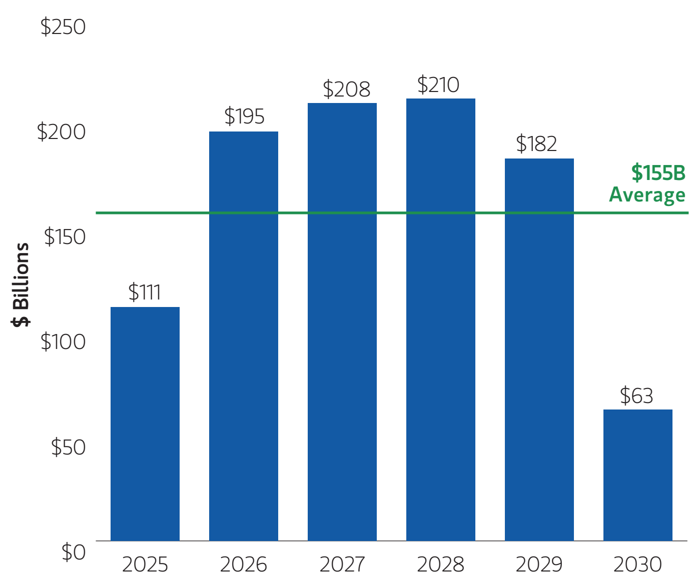
Global Private Equity Dry Powder



Source: PitchBook, as of June 30, 2024.

DISPLAY 6

Middle Market Debt Maturities Through 2030



Source: LESG LPC and Morgan Stanley Investment Management. Represents combined total of BDC and syndicated middle market loan maturities, as of September 30, 2024.

[7] World Federation of Exchanges, data as of December 31, 2022.

Direct Lending – Attractive Attributes for Borrowers

Beyond the supply-side market dynamics discussed herein, Direct Lending has a number of advantages that make it attractive to middle market borrowers and private equity owners of middle market companies, helping drive demand for the asset class. Features of Direct Lending can also increase alignment between the borrower and lender, which also can lead to better outcomes for both borrowers and lenders.

- **Speed and certainty of transactions:** Direct lenders can offer borrowers and private equity sponsors a more nimble underwriting process, leading to a quicker turnaround and lower fees than what banks had previously offered. A smaller number of lenders and a more bespoke process means transactions can close more quickly than a syndicated loan process.
- **No syndication risk:** The process of syndication can also introduce risks for borrowers, most notably that a loan's yield is not guaranteed during the syndication process of a transaction; borrowers may end up with a higher rate on their loan than the underwriters marketed. Likewise, the syndication process allows for possible changes in deal terms between arranging and close.
  - The scale at which direct lenders are now able to underwrite debt and partner together makes Direct Lending a viable competitive alternative to the syndicated loan market for private equity-backed borrowers. As mentioned above, private equity firms are now able to execute $5 billion or more debt financings for their portfolio companies in the private market.[8]
- **More flexibility:** Private Credit lenders typically have more flexibility than public debt lenders to meet a borrower's unique needs. Relative to their public counterparts, private lenders are more likely to be willing to negotiate the terms of a loan, such as the interest rate structure, the repayment schedule and the covenants. Additionally, optionality provided by Private Credit lenders such as committed Delayed Draw Term Loans (DDTL) allows borrowers to request funds after the loan's initial close for specific purposes such as acquisitions or major capital projects. DDTLs are typically available for up to two years post-close and allow borrowers to reserve their revolving loan capacity to manage working capital and fund ongoing operations. Further, unlike traditional term loans, payment of interest on DDTLs is not required until the DDTL is utilized.
- **No ratings requirement:** Ratings require additional hurdles and costs for borrowers. Rated transactions also result in borrowers' financial results being widely distributed.
- **Cost efficiencies:** Although Private Credit offers lenders an illiquidity premium, the costs to borrowers are often not significantly higher than public issuances fees. Instead, underwriting costs are captured by investors in a private deal through original issue discounts and call premiums.
- **Direct relationship:** In private debt transactions, the lender typically has a direct relationship with the borrower. This dynamic means that the lender can work with the borrower to develop a financing plan that meets their needs, while also monitoring its performance closely.
- **Longer-term focus:** Private debt lenders typically have a longer-term focus than public debt lenders. A patient approach to lending means that direct lenders are more likely to be partnership-oriented with borrowers who are experiencing temporary financial challenges.

[8] Bloomberg, "Private Credit Loans Are Growing Bigger and Breaking Records," Lisa Lee, John Sage. April 17 2023.

Characteristics of Direct Lending Investments

Structural Elements

To understand Direct Lending in greater detail, it is important to understand the structural elements that define a Direct Lending investment. The below elements are key components in determining the return and risk profile of a Direct Lending investment.

LOAN SENIORITY

Direct Lending loans range in their seniority from senior to junior, may be secured or unsecured by collateral, and may include equity components. Loan types are discussed in greater detail on page 9.

COUPON

Direct Lending investments provide a periodic coupon payment based on the terms of the loan. Direct Lending investments generally receive a floating rate coupon comprised of a benchmark return such as the Secured Overnight Funds Rate (SOFR) and a certain "spread" over that benchmark. The total coupon is the benchmark rate plus the spread over the benchmark rate. For example, if SOFR is 4.00% and the spread is 5.00%, the coupon is 9.00%.

TERM/TIME TO MATURITY

The term is the length of time over which the loan will be repaid. Direct Lending investments generally have terms of two to six years, which is shorter than typical fixed income investments, such as broadly syndicated loans.

ORIGINAL ISSUE DISCOUNT

Original issue discount (OID) is the difference between the face value of a debt instrument and its issue price. OIDs can be a way for direct lenders to enhance their return.

COLLATERAL

Depending on the loan type, direct lenders may issue collateral-based loans, backed by current assets, real estate or other non-liquid assets such as intellectual property. Direct loans usually also provide for a security interest in the borrower's common equity.

COVENANTS

Covenants are contractual provisions designated by lenders that reduce lenders' risk. They can include minimum financial performance and other operational requirements, and security interest maintenance mandates.

Senior, Junior and Unitranche Loan Comparison

When making direct investments, lenders usually make loans either as senior or junior debt, or a unitranche loan, which is a combination of the two, depending on the specific risk-return profile they are seeking and a borrower's capital need.

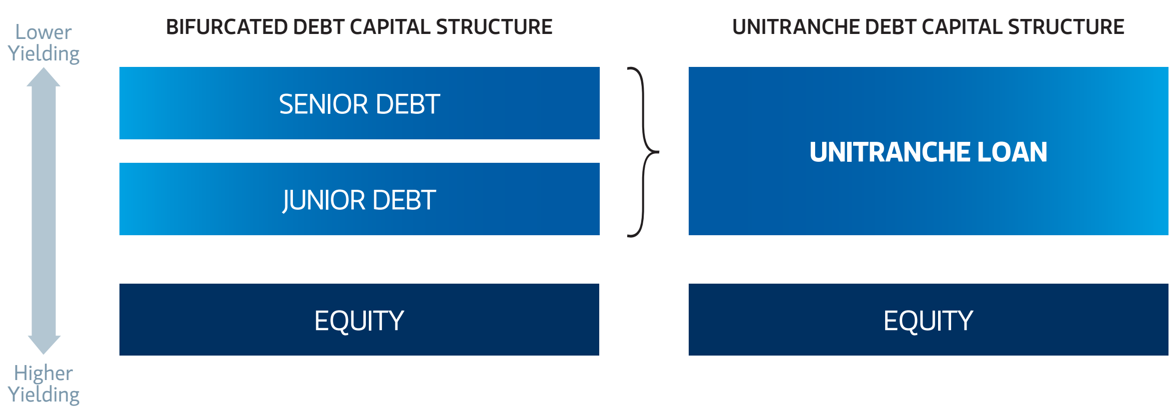
1. **Senior Debt:** Senior debt is the highest-ranking type of debt in a loan structure. Senior debt holders have first claim on the borrower's assets in the event of a default. Senior debt is typically issued by banks or direct lenders.

2. **Junior Debt:** Junior debt is the second-ranking type of debt in a loan structure. This means that junior debt holders have a claim on the borrower's assets after senior debt holders have been paid in full. Junior debt is typically provided by funds raised specifically to invest in junior debt, or other institutional investors who are willing to take on more risk in exchange for a higher return.

3. **Unitranche:** Unitranche is a type of debt financing that combines senior and junior debt into a single loan. This debt structure means that unitranche lenders have a senior claim on the borrower's assets, but they also need to accept some of the risks associated with junior debt. Unitranche loans can reduce the borrower's burden of holding two loans, coordinating with multiple lenders, and reduce the cross-default risk from issuing two loans. In return, direct lenders can expect higher rates on unitranche loans relative to senior debt, as well as a premium for their illiquidity. In recent years, unitranche loans have grown as a popular stand-alone option for Direct Lending, with global market for unitranche loans expected to reach $1 trillion by 2025.[9] Unitranche loans are the preferred alternative for private equity owners to a syndicated loan execution with senior and junior debt.

DISPLAY 7

Direct Lending Capital Structure Option Comparison



[9] Preqin, Preqin Global Report 2023: Private Debt.

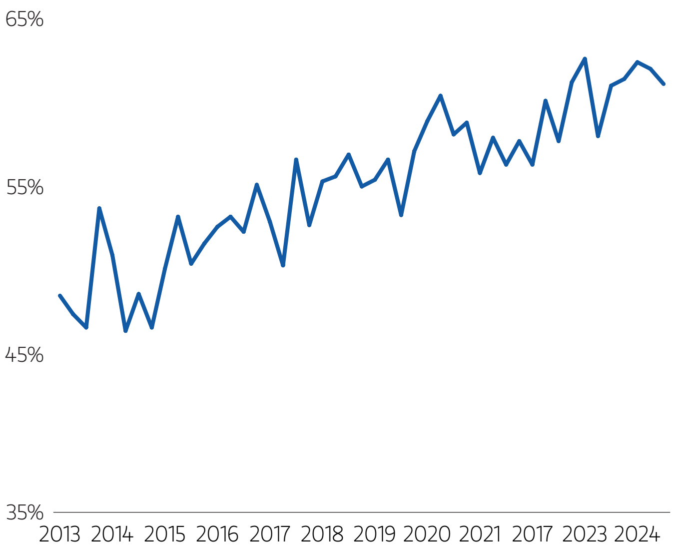
Increasing Equity Contributions

As Direct Lending has grown, there has also been a trend toward greater equity contribution in deals and lower loan-to-enterprise value (LTV). There is an inverse relationship between equity contribution and LTV. This shift means that private equity sponsors are contributing greater equity to new buyouts and are relying less on debt financing. As shown in *Display 8,* average equity contribution was 49% in 2013 and 61% for the last 12 months, ending September 30, 2024. Correspondingly, as shown in *Display 9,* loan-to-enterprise value in middle market LBO deals has moved downward consistently since 2015. For the last 12 months ended September 30, 2024, average LTV was the lowest level on record. The primary reasons for lower LTVs and higher equity contributions are rising interest rates, increased regulatory scrutiny and a more cautious approach to risk by private equity sponsors.

The trends discussed above can generally be taken as a positive sign for lenders that private equity sponsors believe they can still generate attractive returns on their investments, even with less debt. Further, on average, private equity firms that buy companies with a greater percentage of equity are more aligned with lenders in the performance of their portfolio companies. As such, they are more likely to support their portfolio companies with additional equity capital in times of need, which can improve lender recovery rates versus non-private equity-sponsored transactions.

DISPLAY 8

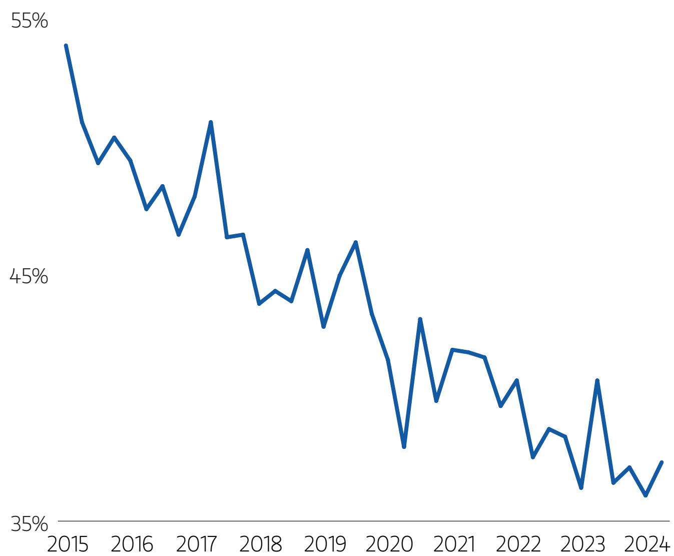
LBO Total Equity Contribution for Middle Market Loans (%)



Source: LSEG LPC US Sponsored Middle Market Private Deals Analysis. Data as of September 30, 2024. Annual #s based on average across each quarter.

DISPLAY 9

LBO Loan to Value for Middle Market Loans (%)



Source: LSEG LPC U.S. Sponsored Middle Market Private Deals Analysis. Data as of September 30, 2024.

Why invest in Direct Lending?

Rationale for Private Credit Portfolio Allocation

Investors should consider an allocation to Private Credit for a number of reasons. In general, both the attractive return and downside protection elements define the profile of the asset class. Several characteristics are driving investors to allocate to Direct Lending. While not comprehensive, investors generally allocate to Direct Lending for the following reasons:

Returns Enhancing

Current Income: Direct Lending offers investors current income in the form of periodic distributions.

Illiquidity Premium: Unlike traditional assets such as stocks and bonds, Direct Lending investments are less liquid and therefore command a premium associated with liquidity risk. *Display 10* illustrates the historic spread above the risk-free rate, and broadly syndicated loans that direct lending has provided. This premium can enhance returns for investors whose investment horizon allows them to bear this illiquidity.

Enhanced Risk/Return: As discussed in detail in the following section, portfolios including Private Credit offer enhanced alpha and higher returns with lower volatility.

Downside Protection

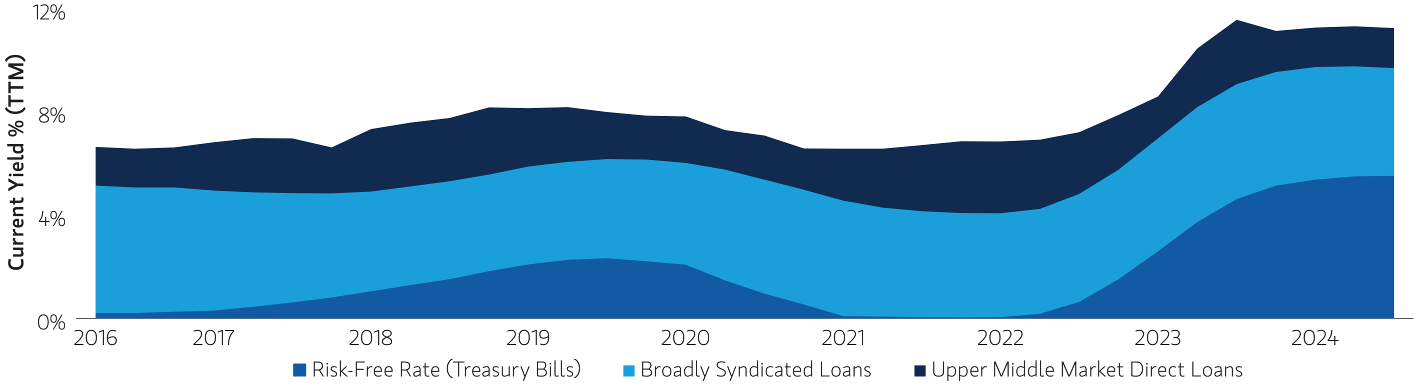
Inflation Protection: Private Credit may provide investors with inflation protection by way of the floating rate coupons associated with the underlying loan.

Diversification: According to Preqin data, diversification is the most frequently cited reason to add Private Credit to a portfolio; more than 70% of surveyed investors indicated diversification as a driver.[10]

Loan Level Protections and Operational Enhancements: Unlike traditional fixed income, direct loans tend to be more highly negotiated, with the opportunity for covenants and contractual obligations within the loan terms. Direct lenders also may have a more direct relationship with borrowers, allowing for closer alignment and therefore positive outcomes for both borrowers and investors. These factors can potentially reduce default risk or increase recovery amounts for the underlying loans and improve performance for investors.

DISPLAY 10

Historical Yield Differences Between Direct Lending, Broadly Syndicated Loans and T-Bills (2016-Present)



Source: Cliffwater Data as of September 30, 2024. Chart provided with permission of Cliffwater. Please see disclosures for further details.

[10] Preqin, Global Report 2023, Private Debt.

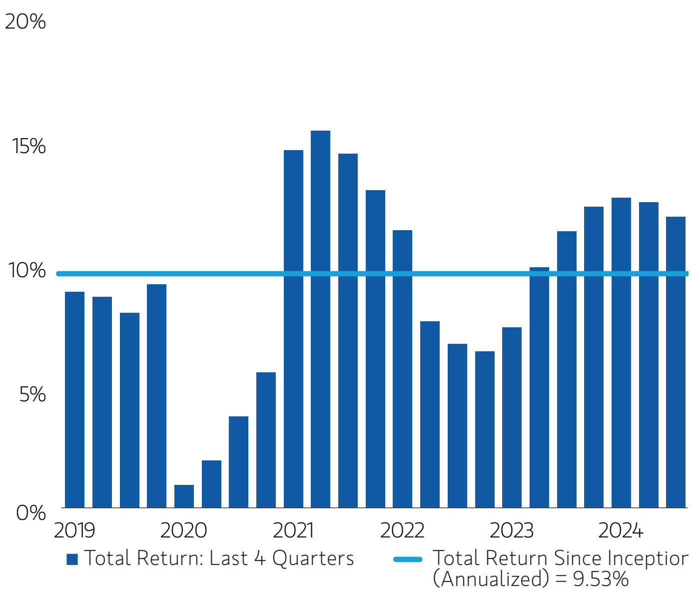
Historical Performance

Direct Lending has shown strong returns over time on both an absolute basis and relative basis when compared with fixed income and a number of other asset classes. One of the ways performance of Direct Lending can be measured over time is from the performance of a group of investment vehicles know as Business Development Companies, or BDCs, which are entities registered under the Investment Company Act of 1940, with the specialized focus of making investments in small to medium sized US companies. According to the Cliffwater Direct Lending Index (CDLI), which consists of approximately $393 billion of direct loans held by public and private BDCs, Direct Lending has averaged 9.53% annualized gross return since index inception in 2004 (*Display 11*).[11]

Spreads over the floating rate benchmark for Direct Lending have maintained a steady margin above syndicated deals. According to Pitchbook data (*Display 12*), direct lending spreads on LBO loans averaged 178 basis points above comparably rated syndicated loans for most of 2024. This incremental return is primarily the result of the "illiquidity premium" investors receive for providing direct loans to middle market companies.

DISPLAY 11

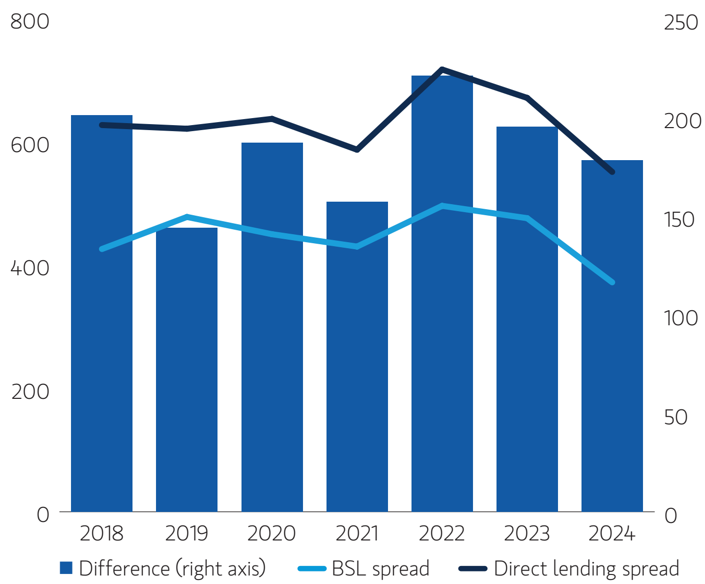
Direct Lending Annual Total Return (%)



Source: Cliffwater Direct Lending Index as of September 30, 2024. Chart provided with permission of Cliffwater. Please see disclosures for further details.

DISPLAY 12

LBO Loan Spreads: Direct Lending vs. BSL



Source: PitchBook LCD. Data through December 4, 2024. BSL data reflects loans issued to borrowers rated B-minus.

In rising rate environments, Direct Lending's performance is particularly strong relative to its fixed income counterparts, such as broadly syndicated loans, leveraged loans, and high-yield bonds. As shown in *Display 13* (left-hand side), when measured over seven different periods of high interest rates between the first quarter of 2009 and the second quarter of 2022, private credit generated average returns of 11.5%, compared with 4.9% for leveraged loans and 6.8% for high-yield bonds.[11] Likewise, the strategy has performed well during periods of volatility, such as the Global Financial Crisis, and more recently, the COVID-19 pandemic.

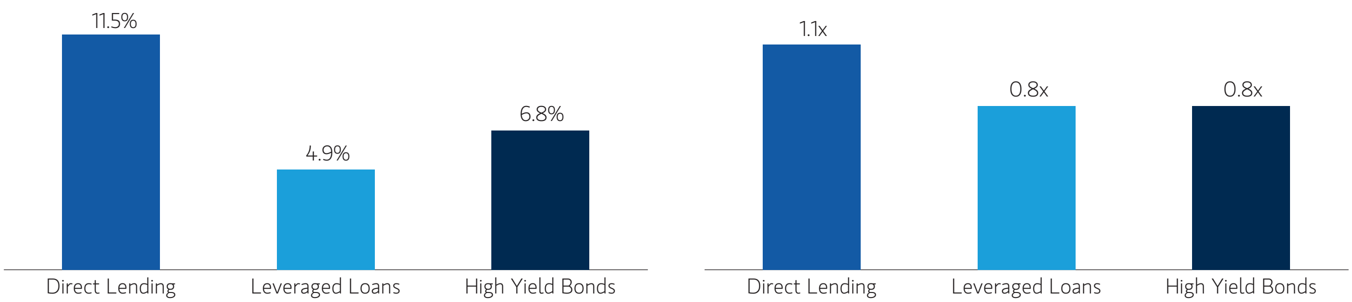
Middle market loans, the traditional target of Direct Lending, have exhibited a better ability to repay principal over time. As shown in *Display 14*, when compared with large corporate loans, middle-market loans have shown lower rates of default, higher recovery rates, and lower cumulative loss rates. Over the last 25 years, the average default rate for middle market loans was 1.0% compared to 2.1% for large corporate loans.

On the whole, these metrics suggest Direct Lending can provide an attractive current yield across multiple market environments, with potentially greater downside protection than traditional fixed income investments.

DISPLAY 13

Direct Lending, Leveraged Loans, High Yield Bond Return Comparisons

Average Returns Over High Interest Rate Environments | **Annualized Returns Divided by Volatility**

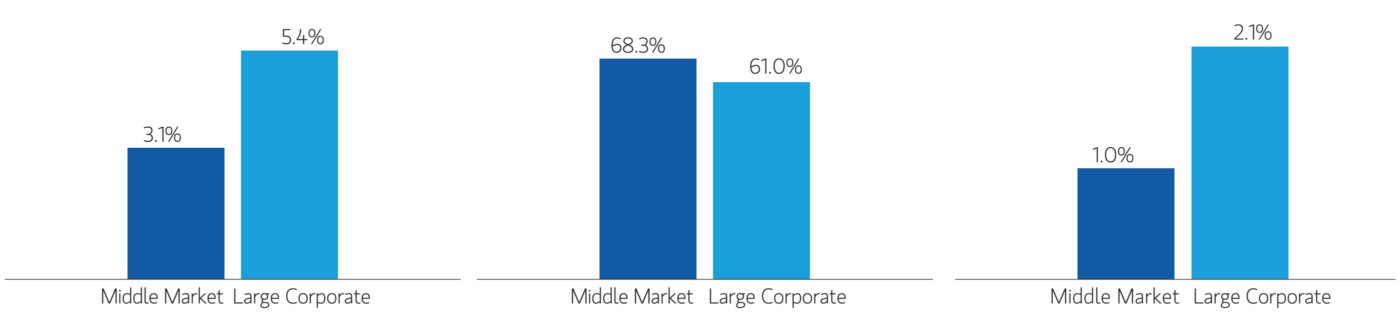


Source: "Direct Lending" is represented by the Cliffwater Direct Lending Index (CDLI) and is calculated from quarterly data, which has been annualized. "Leveraged Loans" is represented by the Morningstar LSTA U.S. Leveraged Loan Index calculated from annualized monthly data. "High Yield Bonds" is represented by the ICE BofA High Yield Index calculated from annualized monthly data. High-rate environments are defined as periods of uninterrupted monthly increases in the 10-year US Treasury yield of 75 basis points or more. Return comparisons are based on the average of annualized monthly returns during seven such periods between 4Q'08 and 1Q'23. Volatility is measured using the standard deviation of annualized monthly returns. Ratios are based on the average of all monthly data between Q1'08 and Q4'22.

DISPLAY 14

Cumulative Default, Loss, and Recovery Rates on Large Corporate vs. Middle Market Loan Sizes (1998-2023)

CUMULATIVE DEFAULT RATE[12] | **CUMULATIVE RECOVERY RATE[13]** | **CUMULATIVE LOSS RATE[14]**



Notes: Middle-market is defined as facility size of $250M or less. Large corporate loans defined as facility size greater than $250M.

[11] Please see notes to Display 13.

[12] PitchBook LCD data. Based on the cumulative total of defaults between 1998 and 2023 on broadly syndicated institutional loans (12,223 issuers).

[13] S&P Credit Pro data. Based on cumulative recovery on defaulted loans in the broadly syndicated institutional market between 1995 and 2023.

[14] Cumulative loss rate is calculated using the following formula: Loss Rate = Default Rate x (1 – Recovery Rate).

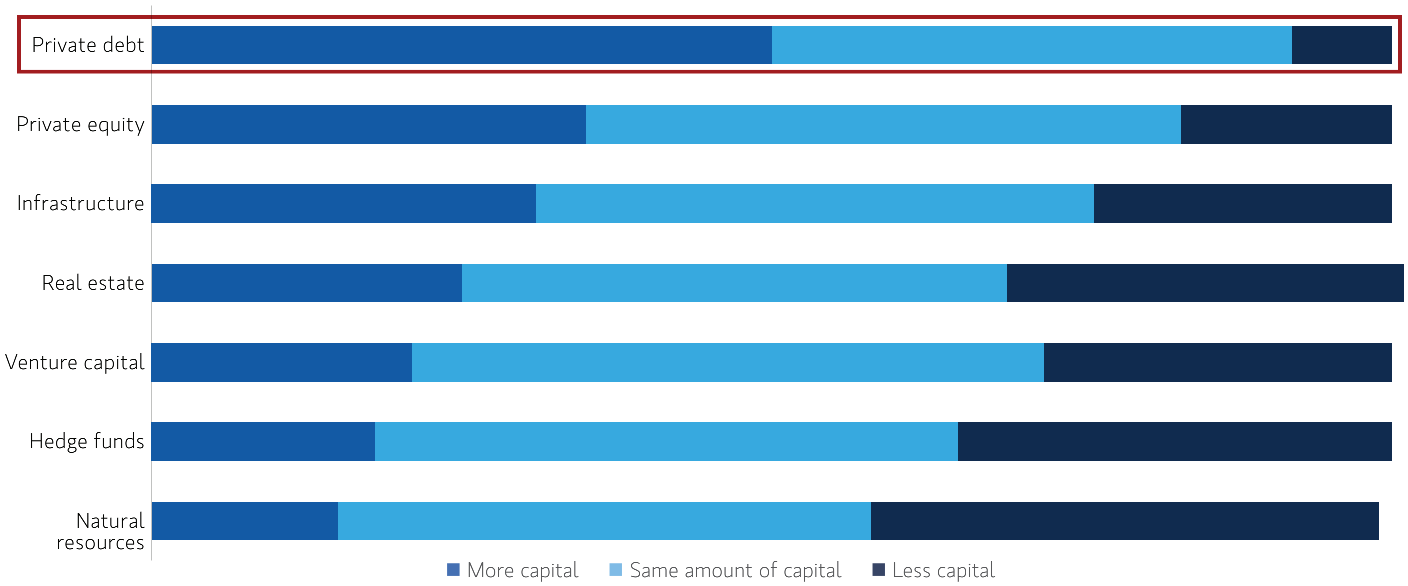
Where Does Direct Lending Fit Into a Portfolio?

As Private Credit markets have matured, Direct Lending has become a standard allocation across many institutional and individual investor portfolios through a variety of vehicle types. Managers have continued to build out their Direct Lending platforms, widening the range of options to access Direct Lending. As highlighted in *Displays 15* and *16*, institutional investors, such as pension funds, endowments, and insurance companies, have been allocating a greater portion of their portfolios to private credit strategies to capture higher yields and enhance their overall portfolio performance.

According to an analysis conducted by Preqin, Private Debt consistently enhanced the Sharpe ratio (return divided by volatility) across a broad range of scenarios when included in a portfolio of public assets (1.29 to 1.72) versus the same portfolio without Private Debt (1.03 to 1.23). Moreover, the analysis concluded that Private Debt can reduce portfolio tail risk during periods of exceptionally high volatility.[15]

DISPLAY 15

Investor 12-Month Allocation Expectations for Alternative Asset Classes



Source: Preqin Investor Survey, June 30, 2024.

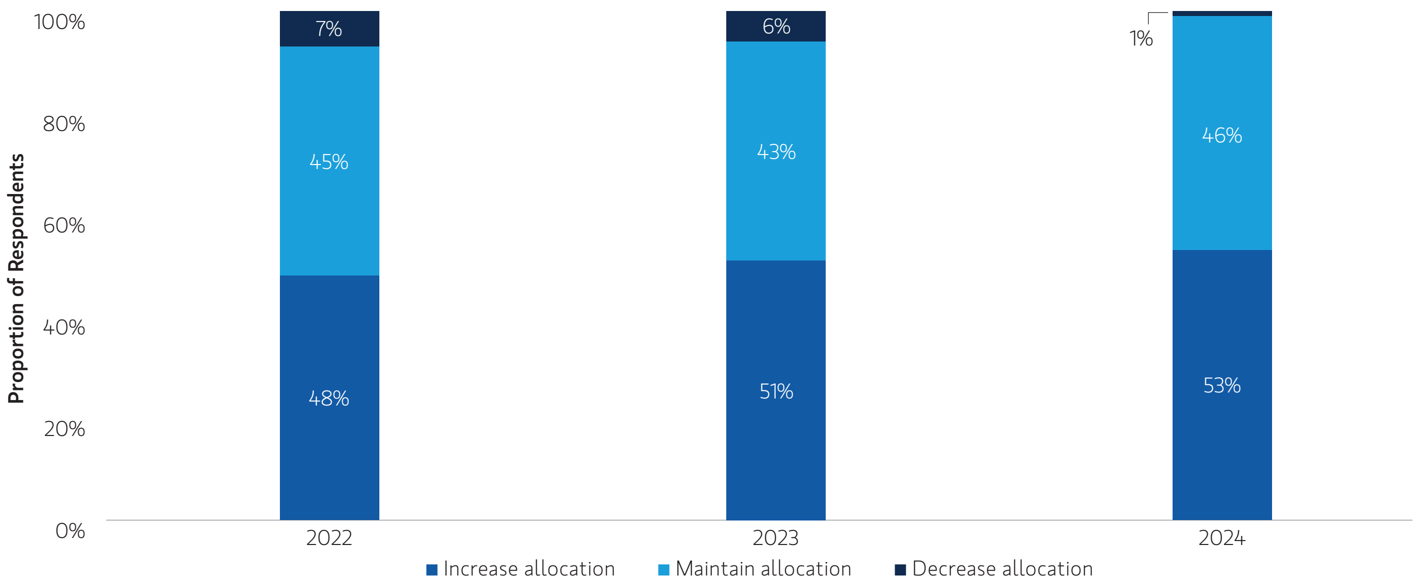
[15] Preqin Global 2023 Report: Private Debt, January 1, 2023.

Asset allocation data suggests optimized portfolios should include a 10-20% exposure to Direct Lending, which surveys indicate is the direction many investors are following. Specifically, Cliffwater found the optimal portfolio allocation to unlevered Direct Lending to be 11% and the optimal portfolio allocation for a 1:1 levered Direct Lending strategy to be 20%.[16,17]

As shown in *Display 16*, according to a 2024 poll by Preqin, 53% of investors planned on boosting their commitment to private credit, up from 48% in 2022. Private credit led all other alternatives as an area of increased allocation in the year ahead. Overall, we expect the appetite for Direct Lending to grow, as it becomes a more standard allocation tool for investors of all sizes.

DISPLAY 16

Institutional Investor Plans to Allocate to Private Credit (2022 – 2024)



Source: Preqin Investor Surveys, June 2022 – 2024

[16] Range of 8% to 14% based on risk tolerance.
[17] Assumes no more than 40% allocation to illiquid assets and no more than 20% to any individual asset class.

Appendix

GLOSSARY DEFINITIONS

Bloomberg Barclays US Aggregate Bond Index – represents securities that are SEC-registered, taxable, and dollar denominated. The index covers the U.S. investment grade fixed rate bond market, with index components for government and corporate securities, mortgage pass-through securities, and asset-backed securities. These major sectors are subdivided into more specific indices that are calculated and reported on a regular basis

Bloomberg Barclays US Corporate Bond Index – measures the investment grade, fixed-rate, taxable corporate bond market

Bloomberg Barclays US Corporate High Yield Index – measures the USD-denominated, high yield, fixed-rate corporate bond market. Securities are classified as high yield if the middle rating of Moody's, Fitch and S&P is Ba1/BB+/BB+ or below.

BSL – Broadly syndicated loans

Call protection – bond provision that prohibits the issuer from buying it back for a specified timeframe

EBITDA – Earnings before interest, taxes, depreciation and amortization

First Lien (also referred to as senior debt) – Secured debt with first priority lien on borrower assets

Leveraged Loan – Loan provided to issues that already have high levels of debt

Loan to Value – the relationship between the loan amount and the market value of the asset securing the loan

Mezzanine – debt between secured senior debt and equity

Middle-Market Companies – companies that, in general, generate annual EBITDA in the range of approximately $15 million to $100 million

OID – original issue discount

Morningstar/LSTA Leveraged Loan Index – is a market value-weighted index designed to measure the performance of the US leveraged loan market based upon market weightings, spreads and interest payments.

Second Lien (also referred to as junior debt) – Secured debt with second priority lien on borrower assets

Special Situations – investments in companies involved in a takeover or financial difficulty

Sponsor – Private equity firm acquiring the majority of target company's equity

The Cliffwater Direct Lending Index (CDLI) – seeks to measure the unlevered, gross of fee performance of U.S. middle-market corporate loans, as represented by the asset- weighted performance of the underlying assets of Business Development Companies (BDCs), including both exchange-traded and unlisted BDCs, subject to certain eligibility requirements.

UBTI – Unrelated business taxable income

Unitranche – hybrid loan structure that combines senior and subordinated debt

Venture Debt – loans extended to startups or fast-growing companies

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