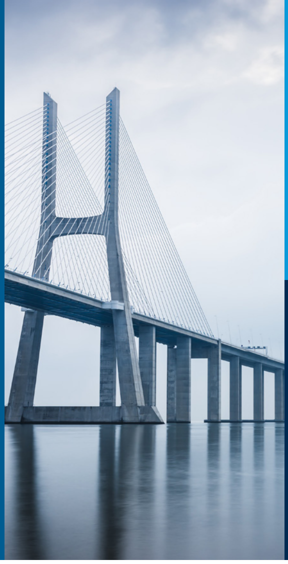
Morgan Stanley
INVESTMENT MANAGEMENT

The Outlook for Direct Lending



INSIGHT | PRIVATE CREDIT | 2025

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KEY TAKEAWAYS

In our opinion:

- The scale of private credit—lending to companies by institutions other than banks—is not outsized when considered in the context of several factors.
- While spreads generally tightened in 2024, the credit attributes of new deal activity have not changed dramatically.
- We expect deal flow will continue to increase amid generally conducive private and public financing markets, and as private equity (PE) remains poised to return investor capital.
- Direct lending—private credit extended primarily to middle market companies—remains an attractive market that has historically generated strong risk-adjusted returns.

The Growth of Private Credit—and Direct Lending—in Context

As banks have gradually retreated from middle-market lending, and public capital markets have skewed larger and exhibited volatility, private credit has stepped in to fill the void. Private credit expanded to approximately $1.8 trillion at the start of 2024, up from $1.3 trillion in 2020, and is estimated to reach $2.3 trillion by 2028.[1]

This growth has been supported by PE, which controls nearly $8 trillion in assets globally, including $4.1 trillion in the U.S.[2] We believe these firms have significant dry powder to invest. All of this is relative to $20T in U.S. bank balance sheets, which have grown by around $7T in the last decade.[3]

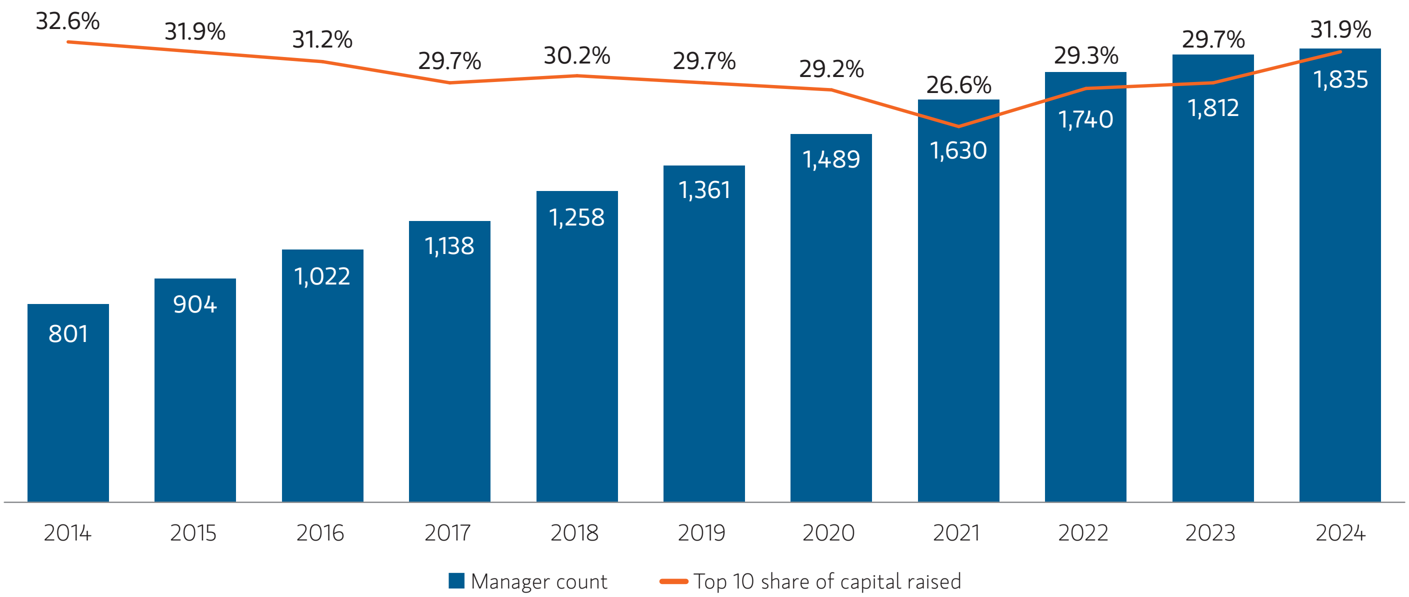
[1] PitchBook, Private Capital's Path to $20 Trillion report. As of May 1, 2024.

[2] Preqin, data as of December 2023.

[3] Bank of International Settlements data, as of 2023 year end, and 2013 year end.

DISPLAY 1

Private debt manager count and share of cumulative capital raised by the top 10



Source: Pitchbook LCD as of November 27, 2024.

Likewise, while direct lending capital raising has remained strong, and is an important factor that impacts lending terms, recent data from Pitchbook suggests that the flow of new entrants has slowed sharply, and if anything the industry has entered a consolidation phase. The concentration of capital raised by the top ten largest private credit managers has increased steadily from 26.6% in 2021 to 31.9% at the end of 2024.[4]

We believe that direct lending is positioned for continued growth for three fundamental reasons: (1) the U.S. middle market is large; (2) private equity dry powder remains at near record highs and what has been reinvested is in dire need of refinancing; (3) there are enduring structural benefits for borrowers.

Cutting through the Noise

Despite recent press on purported lack of transparency and opaque valuation policies in the direct lending space, we believe a host of regulatory, legal, accounting and other regimes dictate that managers abide by stringent valuation policies. These policies are typically multi-layered, and they leverage both internal valuation models and third-party valuation firms to value individual loans. These valuations typically take into account fundamental company performance and market factors. Their frequency will depend on the structure of the fund in which the loans are held. For instance, some perpetually offered business development companies ("BDCs") could be valued as frequently as monthly.

It is important to remember that in the business of making first lien loans backed by a deep base of sponsor equity, the goal is return of principal.

What We've Been Seeing in the Direct Lending Market

- **DOCUMENTATION:** While competition for deals remains fierce, we generally have witnessed documentation that remains prudent, with proper protections. Intensive credit underwriting and documentation have typically been a trademark of buy-and-hold investing in the direct lending market.
- **SPREADS:** Spreads on new loans have compressed over the last two years, largely in response to improving risk sentiment and a resurgence in the public capital markets; however, despite the compression in direct lending spreads the average liquidity premium in 2024 still remains at ~175 basis points (bps), in line with the average from 2018 to date, and resulting in total coupons of approximately 10%.[5]

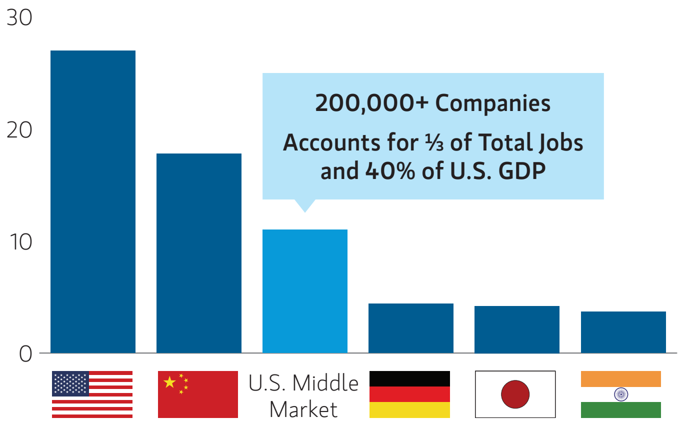
[4] Pitchbook Leveraged Commentary & Data (LCD). As of November 27, 2024.

[5] PitchBook LCD. Direct lending spread data reflects senior secured first-lien loans and unitranche facilities. BSL data reflects loans issued to borrowers rated B-minus. Data from 2018 - 2024 year end.

DISPLAY 2

1 **The U.S. Middle Market is Large**[6]

Top 5 Economies by GDP ($Tn)



2 **Other Factors Driving Potential Future Market Growth**

~$1.4Tn
Private Equity Dry Powder[7]

~$0.9Tn
Middle Market Debt Maturities Through 2029[8]

[6] Sourced from the National Center for the Middle Market's Middle Market Indicator (MMI) Overview as of December 31, 2023, and the International Monetary Fund as of December 31, 2023.

[7] Pitchbook LCD. Data as of March 31, 2024.

[8] S&P Global Ratings Private Markets Analytics as of March 31, 2024. Based on traded BDC maturities.

3 **Reasons Why Private Equity May Prefer Direct Lending.**

- **PRIVACY:** ability to partner with a small group of lenders, rather than a group of banks that need to underwrite the credit and then syndicate it to investors.
- **STRUCTURING:** ability to customize financings, including the ability to have some unfunded capital at the outset.
- **CERTAINTY OF FINANCING:** ability to line up private lenders relatively quickly.
- **ADD-ON FINANCING:** ability to obtain additional capital to finance an acquisition.

- **CREDIT QUALITY:** Credit quality has not changed dramatically in the past year. While the industry has seen an uptick in the use of payment-in-kind (PIK), not all of PIK utilization is an indicator of borrower distress. We believe that the sector has performed extremely well throughout this inflationary environment, perhaps in large part due to the resilience of the underlying U.S. economy and the emerging signs that the Federal Reserve's efforts to combat inflation has begun to work.
- **DEFAULTS:** Non-accruals and defaults for direct lending remain below historical averages—in the low-single digits. Should interest rates remain elevated, it is possible we would see expectations for defaults to increase gradually and trend to the historical averages. Conversely, repricing activity and lower rates would provide some relief to borrowers.
- **DEAL FLOW:** Sponsored middle market loan activity remained relatively resilient during the first half of 2024, partly supported by demand for incremental or add-on financings. We remain optimistic that new middle market leveraged buyout activity may accelerate with more visibility on the trajectory for interest rates. We expect deal flow to continue to accelerate into 2025, as PE remains poised to return investor capital.

Conclusion

We believe direct lending continues to offer compelling relative value compared with other assets classes and offers an attractive diversification alternative to public fixed income. And, importantly, when considered in the context of other markets, private credit has significant room to grow.[9]

[9] Preqin, Future of Alternatives 2029 Report. As of September 2024.

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