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INVESTMENT MANAGEMENT

Private Credit Strategies: Who Uses Them, Who Benefits, and Why

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Overview of Private Credit

Private Credit has grown in recent years to become one of the primary ways companies raise capital. While the private credit market, which amounts to roughly \$2.7 trillion,¹ has been around for decades, its popularity began to grow in earnest in the wake of the 2008 financial crisis, particularly for direct lending, when non-bank lenders stepped in to provide capital to companies after traditional banks pulled back from many types of lending.

In private credit, investors and funds lend capital directly to companies, and both lenders and borrowers negotiate customized terms over interest rates, fees, repayment schedules, collateral and financial covenants.

There are six main strategies that evolved within private credit: **direct lending** (senior secured loans to established companies), **asset-based finance** (loans backed by specific assets), **distressed debt** (investing in companies close to default), **mezzanine lending** (higher-risk loans that sit below senior debt), **special situations** (financing tied to corporate events) and **venture debt** (lending to venture-backed, early-stage firms).

Typically, investors in private credit are seeking steady income and an illiquidity premium for tying money up for long periods of time. Investors often consider private credit to be a core complement to private equity and real assets within a balanced alternative portfolio.

To better understand the nuances of private credit, we outline the six primary strategies below. This includes discussions about how each strategy works, the key benefits and risks, and how each strategy often fits within a private asset portfolio.

¹ PitchBook, 2029 Private Horizons report, May 1, 2025.



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.



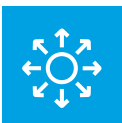
ASSET-BASED FINANCE describes a wide range of strategies that target assets as opposed to operating companies. They include loans on real assets, such as real estate and infrastructure, or pools of assets such as equipment and fleet financing, or balance sheet assets of financial intermediaries such 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.

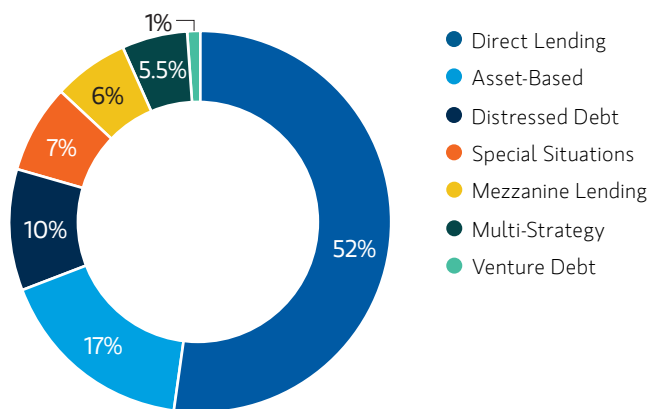


SPECIAL SITUATIONS strategies focus on flexible solutions for planned events, such as corporate expansion, or unplanned events during periods of stress, such as restructurings. Also referred to as opportunistic or structured debt, their borrowers start out as performing although some may transition to 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 1
Share of Global Private Credit AUM by Sub-Strategy



Private Credit strategies are differentiated by such factors as:

- Seniority within the capital structure
- Type of collateral
- Risk/return profile

Source: PitchBook, LSEG, Morgan Stanley Investment Management. Gross invested assets inclusive of leverage applied. Excludes uncalled capital in drawdown funds. As of September 30, 2025.



Direct Lending

The largest category of private credit, direct lending is a strategy where non-bank lenders provide loans directly to middle market companies. These companies, which are usually not large enough to easily access public debt markets, are often owned by private equity firms. Because the loans are privately negotiated, they are not traded on exchanges and are usually held until they mature.

Why Direct Lending Has Grown

Over the past two decades, direct lending has grown rapidly as traditional banks have reduced their lending to mid sized companies. Banks' increased regulation, consolidation, and a focus on large corporate borrowers have left a financing gap. Meanwhile, private equity ownership of mid sized companies has expanded significantly, increasing the demand for reliable sources of loans. Direct lenders have filled this gap by offering customized loans that can be arranged more quickly than traditional bank loans. They are now able to underwrite larger transactions, sometimes amounting to several billion dollars, making private credit an alternative to the broadly syndicated loan market.

How Direct Lending Works

In direct lending transactions, private investment firms work closely with company owners and management teams to structure a loan. These loans are often secured by a company's assets and may include contractual protections. Interest rates are typically floating, meaning they adjust as interest rates change. Because the loans are private and illiquid, investors generally commit capital for several years.

Key Advantages

Direct lending offers investors several potential benefits. First, it has historically generated higher interest income

than traditional fixed income investments, partly because investors are compensated for illiquidity and for lending to smaller companies. Second, the floating rate nature of many loans helps protect loan values when interest rates or inflation rise. Third, direct lenders often have greater control and visibility into their loans, including regular access to company financials and direct communication with management.

Key Risks and Considerations

Direct lending is not without risk. Because loans are illiquid, investors generally cannot sell them quickly if market conditions change. Borrowers are smaller, which may increase the risk of financial distress in downturns. Valuations are also less transparent since there is no daily market pricing. Outcomes therefore depend heavily on the skill and discipline of the investment manager in selecting borrowers and structuring loans.

How Direct Lending May Fit in a Portfolio

For many long term investors, direct lending complements traditional bonds, potentially offering higher income and diversification in exchange for reduced liquidity. It is often used to enhance portfolio returns and stability, particularly for investors with longer time horizons and can tolerate illiquidity.



Asset-Based Finance

This is a broad category of private credit that focuses on the value of specific assets that generate income or can be pledged as collateral. These assets may be physical—such as real estate, infrastructure or vehicle fleets—or financial, such as student loans, credit card receivables, or other receivables on corporate balance sheets. The defining feature is that the asset itself is central to how the investment is underwritten and repaid.

Many businesses hold large pools of assets that generate predictable cash flows, assets that do not fit neatly into traditional lending frameworks. For investors seeking income with risk drivers other than stocks or bonds, asset-based finance may be able to meet their need for long term capital with assets that can be financed outside of public markets.

How Asset-Based Finance Works

In an asset-based financing, a lender or investor provides capital that is secured by a defined pool of assets. Cash flows from these assets are used to pay interest and principal over time. Because these assets are identifiable and often separate from the broader business, investors can analyze their quality, durability, and cash flow in detail. Structures are generally designed to isolate assets from other business risks and align repayments with the performance of the underlying assets.

Key Advantages

A key advantage of asset-based finance is the clarity of risk. Investors can focus on specific assets and cash flows rather than relying solely on a company's financial health. Many assets produce steady, contractual payments, which

can support predictable income. Asset-based finance may also help limit losses due to the value of the pledged collateral, particularly when the assets remain useful in stressed economic conditions.

Key Risks and Considerations

Asset-based finance carries important risks. Performance may fall below expectations because of economic cycles, changes in technology, and consumer behavior. Some assets can lose value faster than anticipated or become obsolete. Liquidity is limited and investors may not be able to exit positions quickly. Evaluating asset quality and creating protections requires specialized expertise, and outcomes can vary significantly depending on underwriting standards.

How Asset-Based Finance May Fit in a Portfolio

In a diversified portfolio, asset-based finance can complement traditional stocks and bonds. For long term investors, asset-based finance can provide steady income, diversification, and exposure to underrepresented parts of the economy. While it is not a liquid investment, it may enhance a portfolio's resilience and return potential.



Distressed Debt

Focusing on companies facing significant financial pressures, distressed debt investors typically step in when uncertainty is high and prices are depressed, with the goal of earning attractive returns as a company improves its situation through asset sales, refinancing, restructuring or a turnaround. Performance depends on how much a business is worth, how debts are structured, and what happens in creditor negotiations. Because outcomes vary significantly, distressed debt has a risk-return profile that often behaves more like equity than debt—particularly when investors are effectively underwriting a turnaround.

Opportunities often arise when borrowing conditions worsen. High interest costs strain cash flows, and lenders are less willing to refinance weaker businesses, especially when large amounts of debt are coming due. Economic slowdowns and unexpected costs can also push companies into distress even if markets appear stable.

How Distressed Debt Works

Investors need to assess whether a business can survive long enough to stabilize. To do so, they look at liquidity, cash generation, and realistic paths to improvement. They also study the capital structure: who is owed what, in what order, and what collateral can support those claims. Some creditors come ahead of others, and others face greater uncertainty. Returns may come from buying debt at a discount and later selling it at a higher price. They may also hold the debt through a restructuring and get paid in new securities that come as part of a reorganization. In some cases, investors provide new capital to help fund operations through the restructuring process.

Key Advantages

The appeal of distressed debt is straightforward: if you can buy a claim cheaply and a company's recovery is stronger than the market expects, the upside can be substantial.

Key Risks and Considerations

Risks are also significant and require careful attention. Recoveries are uncertain and can be weaker than expected if a company deteriorates further or its assets are worth less than assumed. Restructurings can also be time-consuming, legally complex, and influenced by creditor negotiations. Investments may be illiquid, pricing can be volatile, and outcomes may hinge on details that are easy-to-overlook without a specialist's expertise.

How Distressed Debt May Fit in a Portfolio

Distressed debt is higher risk and more opportunistic than investing in healthy companies. It may add different sources of performance, especially in a market dislocation. Because the strategy involves complex underwriting, uncertain timelines and potential drawdowns, it is best suited to investors with a long time horizons with a healthy tolerance for risk.



Mezzanine Lending

Mezzanine lending is a type of private credit designed to fill the gap between traditional senior loans and equity. In a typical capital structure, senior secured lenders are paid first and have the strongest claim on collateral. Equity holders are last in line but benefit most if a business performs well. Mezzanine sits in the middle: It is a form of debt, but it often allows investors to share in a company's upside. Thus, mezzanine is commonly described as a hybrid of debt and equity.

To compensate investors for taking a junior position, mezzanine is typically priced to deliver higher overall returns than senior direct lending. Those returns can come from several sources, including "PIK" (payment in kind) interest that accrues to the loan balance instead of being paid in cash. It may include warrants that give investors the potential to benefit if a company's value increases. Borrowers like mezzanine because it can reduce equity dilution while still providing meaningful financing. This can be important when banks and traditional lenders pull back from riskier lending.

How Mezzanine Lending Works

In practice, mezzanine transactions are highly structured. Investors focus on a company's cash flow (to support interest payments), the durability of its business model, and the amount of "value cushion" beneath the mezzanine position. Because mezzanine sits below senior debt, the enterprise value needs to be sufficient to cover senior claims before mezzanine lenders are fully repaid. Covenants and reporting requirements also can affect outcomes, particularly in stressed scenarios. Lenders often negotiate protections to improve visibility if performance deteriorates.

Key Advantages

For investors, the main appeal of mezzanine is the potential to combine income with upside participation.

Mezzanine generally offers higher returns than direct lending, and an equity-linked component may add more returns if a borrower performs well and reaches a successful exit.

Key Risks and Considerations

The key risk considerations come from where mezzanine sits in the capital structure. Because it is subordinate to senior debt, mezzanine debt typically carries higher downside risks and can behave more like equity in stressed situations, lowering recoveries if a company underperforms. PIK features can increase refinancing risk by allowing debt balances to grow over time. Many mezzanine investments are also illiquid so investors may need to hold on through challenging market cycles.

How Mezzanine Lending May Fit in a Portfolio

Mezzanine commonly draws investors seeking higher yields than other private credit strategies, particularly in competitive environments when lending spreads compress. In a private credit portfolio, mezzanine is more aggressive with both risks and returns. For investors with long time horizons and a tolerance for illiquidity, mezzanine can broaden exposure across the private credit spectrum while adding a measured degree of equity participation.



Special Situations

Special Situations is a strategy that provides flexible financing to companies needing something more tailored than a bank loan. As the name indicates, “special situations” is usually event driven, meaning it is tied to a specific issues that can impact a company’s path. Sometimes these events are planned and sometimes they are unexpected. The goal is to provide flexible financing when timing, complexity, or uncertainty makes traditional funding difficult to obtain or slower to execute.

Among planned events, companies may be seeking to acquire a competitor, enter a new market, launch a new product or make a major capital investment. Moves like this may make sense, but they may require capital structures that don’t fit conventional categories. Unexpected special situations can include liquidity stress, market dislocation or restructurings. During such situations, companies may need a bridge to get them back on a path back to stability. The goal is a clearer outcome, and it may involve protections and pricing that reflect the added risks and complexity.

How Special Situations Work

Special Situations typically begins with an “event thesis,” where underwriting is anchored around a catalyst that can change a company’s credit profile. Investors evaluate how that catalyst may unfold under a variety of scenarios. They then structure financing in ways that align incentives and protect capital. Returns can come from a blend of yield, fees and structural features, and they may also include collateral, reporting requirements and covenants to manage downside risk. Events can change quickly, so monitoring is important, especially if a borrower’s outlook begins to deteriorate.

Key Advantages

A key appeal of Special Situations is the potential to earn attractive returns for complexity and customization.

These investments may offer stronger downside protection through negotiated structures—such as collateral, covenants or enhanced controls that are tailored to specific risks.

Key Risks and Considerations

Special Situations carries meaningful risks, starting with event risk: the event may be delayed, or it produces unanticipated effects that weaken performance. Complexity risk is also relevant as outcomes may depend heavily on documentation, collateral, and cash flow durability, all of which can be difficult to measure, especially in a downside scenario. If a borrower becomes distressed, the investment outcome may hinge on negotiations and restructurings that are time-consuming and uncertain.

How Special Situations May Fit in a Portfolio

Special Situations are a way to enhance returns by accepting more complexity than other forms of private credit. It may also offer diversification since performance may be driven by factors that are more idiosyncratic than interest rates alone. Ultimately, the decision to invest in special situations depends on their liquidity tolerance, and their preferences for an allocation that is actively managed and heavily structured.



Venture Debt

Venture debt is a private credit strategy designed for early-stage venture-backed companies that are growing fast but may not yet be generating consistent cash flow. The strategy emphasizes a company's growth trajectory, its access to future equity, and the value of a company's technology. Often, it functions as a runway-extension to support companies that are between equity rounds, and terms may include equity warrants, which are less common in conventional cash-flow lending. Founders and investors are increasingly looking for ways to support growth between equity rounds, and venture debt can help finance the need for working capital, customer acquisition, hiring and other investments while limiting near-term dilution.

How Venture Debt Works

Venture debt is typically a loan or revolving credit facility provided to venture-backed startups that are still scaling and may not yet be profitable. Repayment is generally expected from future equity fundraising or a liquidity event such as an acquisition or IPO. Because credit risk can be higher than in traditional lending, venture debt often comes with lender protections, such as covenants, and pricing that reflects the added risks. Lenders may also receive equity warrants, which allow lenders to participate in some of the upside if a company performs well. In practice, venture debt is often a "bridge" to extend a company's runway, to reduce the size of equity fundraising, or to help a business to reach milestones that support a stronger valuation in the next funding round.

Key Advantages

This strategy exists because founders and investors in early-stage companies may want additional capital without issuing new equity at unfavorable valuations. It may also be faster to execute than raising new equity. For investors and lenders, venture debt can offer an attractive yield compared to traditional credit, with the possibility of additional upside potential using warrants, while still sitting "above" equity in

the capital structure. It can also improve capital efficiency by enabling startups to fund growth without re-opening valuation negotiations every time capital is needed.

Key Risks and Considerations

Venture debt carries meaningful risks because many borrowers have limited operating history, negative cash flow, and business models that can change quickly. Repayment may depend on a company's ability to raise fresh capital, the willingness of existing investors to support the company, or the achievement of growth milestones, all of which can deteriorate rapidly in a downturn. From a lender's perspective, collateral can be limited and recoveries in default are uncertain. But even protections like covenants cannot eliminate the risk of a company failing.

How Venture Debt May Fit in a Portfolio

Venture debt is often viewed as a way to access high-growth areas of the economy with a return profile that blends loan income and the additional potential upside of warrants. Venture debt may fit within a broader private credit allocation depending on an investor's risk tolerance, liquidity needs and level of comfort with technology and growth-driven credit exposures.

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