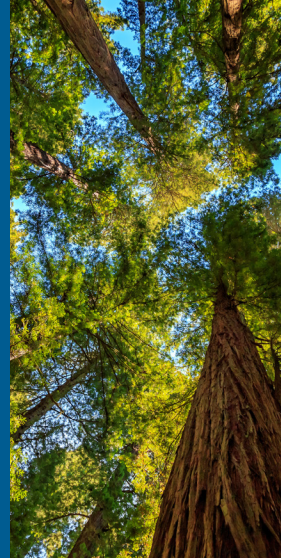


Uncovering Growth Credit: An Emerging Opportunity in Private Credit



INSIGHTS | November 2025

Executive Summary

- Growth credit is a distinct and fast-evolving segment of private credit, markedly smaller than direct lending but offering differentiated opportunities.
- Growth credit targets smaller, faster-growing companies—often venture-backed—where capital scarcity increases lender negotiating power and enhances return potential.
- Asset-level returns in growth credit are enhanced by additional upside from warrants that may benefit from favorable tax treatment.
- Structural features such as prime-rate indexing with rate floors can insulate growth credit returns from declining interest rates, in contrast to most SOFR-indexed loan products.

Introduction

Private credit has enjoyed widespread adoption by institutional and individual investors in recent years, with direct lending franchises leading the charge. Yet, within the broader private credit space lies an underexplored but increasingly relevant strategy: growth credit.

Growth credit represents debt financing provided to high-growth private companies, often backed by minority venture capital or growth equity sponsors. Growth credit is sometimes viewed as an extension of direct lending. However, it is distinct not only in scale but also in structure, borrower profile and return potential. Whereas direct lending is dominated by large, well-capitalized platforms focused on private equity-owned companies, growth credit deals tend to be smaller, with positions in the publicly traded venture debt BDCs averaging around \$14 million,¹ and often include equity kickers in the form of warrants.

This paper breaks down the strategic rationale for growth credit, its market dynamics, and its role within a well-diversified portfolio that includes a robust allocation to private credit. It also highlights key differentiators to direct lending given the latter's status as a well-understood and bellwether strategy within private credit.

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Morgan Stanley Expansion Capital

is a private investment team targeting late-stage growth equity and credit investments in technology, healthcare, consumer, digital media and other high-growth sectors.

¹ Source: LSEG, as of June 30, 2025.

DISPLAY 1
Direct Lending vs. Growth Credit

	DIRECT LENDING	GROWTH CREDIT
Sponsor/Strategy	Private Equity Buyout	Late-Stage Venture, PE Growth Equity
Lien Position	Senior/Junior/Unitranche	Senior
Outstanding Credit (Gross Assets)	\$1 trillion	\$29 billion
Target Market (Equity Value)	\$2.2 trillion	\$720 billion
Size of Avg. Investment	\$167.2 million	\$13.7 million
Origination Process	Sponsor	Sponsor/Direct
Target Asset Level Returns	9-12%	15%-20%
Warrants	Rarely	Usually
Tax Treatment	100% Current Income	Up to 25% Capital Gains

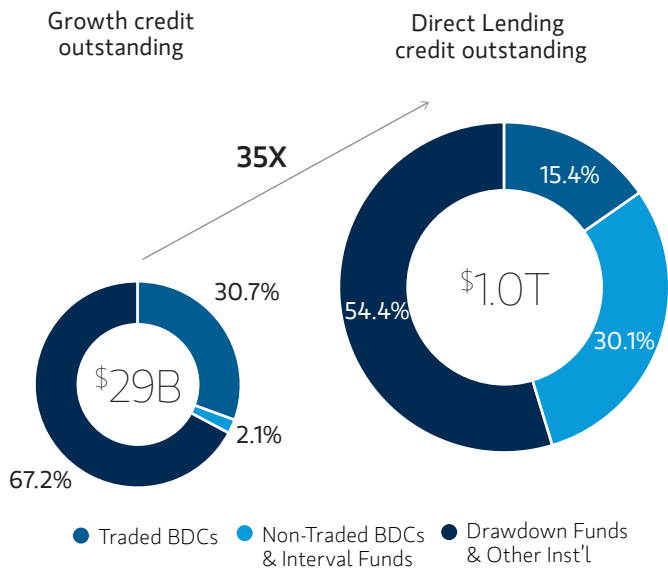
Source: Morgan Stanley Investment Management. Provided for illustrative purposes only.

Direct Lending: Scale, Stability and Maturity

Direct lending has become the anchor of private credit. Large investment vehicles, often evergreen in structure, deploy capital into private equity-sponsored companies. These deals are marked by consistent leverage—typically four to six times Earnings Before Interest, Taxes, Depreciation and Amortization (EBITDA)—with loan-to-values in the 40% to 50% range. Their risk-return profile is similarly consistent, with asset-level returns historically in the 9–12% range, which have attracted strong inflows to the strategy. Over the last five years, U.S. direct lending platforms have grown from \$400 billion to more than \$1 trillion in gross invested assets, over 35 times the \$29 billion in dedicated growth credit funds (*Display 2*).²

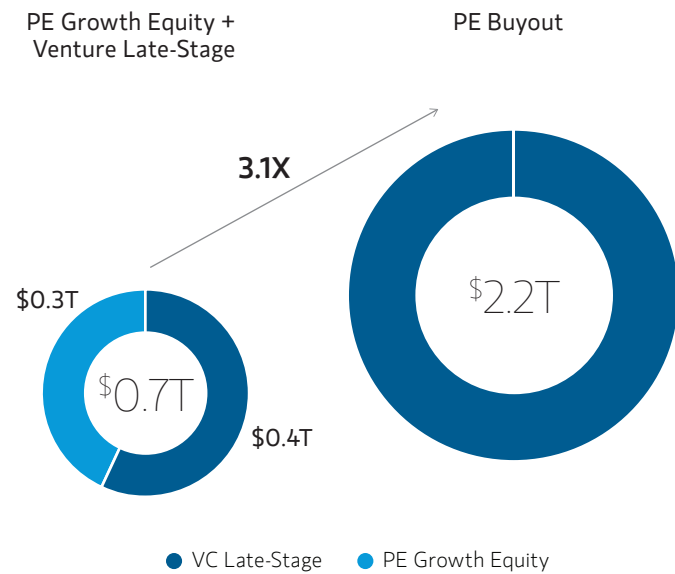
Despite the disparity in the size of the direct lending market compared to growth credit, the total addressable markets are much closer in size. Direct lending primarily targets PE-backed companies owned by buyout funds and those holdings had an equity value of \$2.2 trillion at the end of 2024. That compares to the \$720 billion in equity value for companies targeted by growth credit, representing the combined total of PE growth equity investments and VC late-stage investments (*Display 3* - see following page).

DISPLAY 2
Direct lending is the dominant strategy within private credit with gross assets more than 35-fold those of growth credit

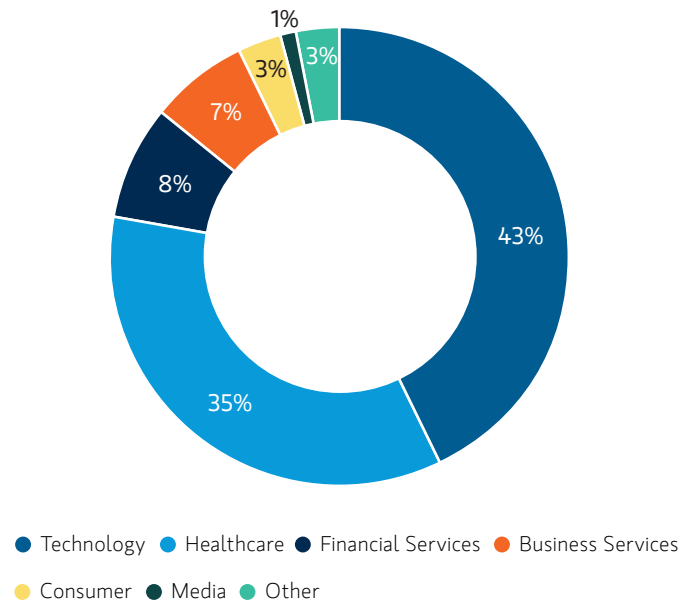


Source: PitchBook, LSEG, Morgan Stanley Investment Management. U.S. only. Gross asset value as of June 30, 2025.

² Source: PitchBook, BDC company filings, Morgan Stanley Investment Management.

DISPLAY 3**Growth credit is more comparable in size to direct lending by target market**

Source: PitchBook. U.S. only. Net asset value as of December 31, 2024.

DISPLAY 4**Growth credit companies are concentrated in the innovation-driven tech and health care sectors as well as high-growth segments of other industries**

Source: LSEG, Venture Debt BDC filings. As of August 31, 2025.

As direct lending has matured, it has taken on more characteristics of the publicly traded loan market. Both markets have seen spreads tighten to decade lows, although all-in yields remain in the upper half of the range in the case of direct lending. At the same time, their SOFR-based loan structures expose coupons to more downside in a Federal Reserve rate cut cycle. Minimum rate floors averaging 100 basis points are unlikely to brake those declines, given the current consensus forecast from economists that suggests that the Fed Funds rate will only bottom out once it reaches 3%.³

Growth Credit: Smaller, Scarcer and Potentially Higher-Yielding

Growth credit occupies a different part of the private credit landscape. With just \$14 billion raised over the last five years and \$29 billion in total invested assets including venture debt BDCs, it is a small fraction of the size of the direct lending market. Yet scarcity creates opportunity. For every dollar of equity invested in growth companies, only about eleven cents of credit has been issued. This dramatic imbalance between the amount of equity and credit invested in growth companies can translate to more white space and less competition among growth credit lenders, and potentially better leverage in borrower negotiations.

The deals themselves are smaller—averaging under \$14 million for traditional publicly traded venture debt lenders—but they often generate higher returns. Warrants provide further upside, and because a portion of returns can qualify for long-term capital gains tax treatment, lenders may benefit from incremental tax efficiency. Borrowers are distinct as well. Growth credit companies tend to be younger, growing 20–30% annually, and are highly concentrated in the technology and health care sectors as well as other growth niches within financial services, business services, consumer and media (*Display 4*). In many cases, particularly in the technology and related sectors, company gross margins can exceed 70–80%. High margins provide flexibility to either scale aggressively in favorable conditions or quickly cut discretionary spending (like go-to-market or research and development expense) to preserve cash flow should market conditions tighten.

³ Source: The Federal Reserve Summary of Economic Projections as of September 17, 2025.

Filling the Gap in an Underserved Market

Growth credit exists in a relatively underserved corner of the market. The companies that borrow through growth credit are typically not large enough to attract the attention of direct lending platforms, nor are they mature enough to secure financing through traditional capital markets.

These businesses often find themselves in a funding gap: too established for venture equity but too early-stage or unconventional for traditional bank loans. Growth credit fills this void by providing capital in a structured, senior-secured form that is less dilutive than equity yet more flexible than bank financing. Lenders in growth credit are effectively compensated for solving this problem, earning higher cash yields, and participating in upside potential through warrants.

The bespoke nature of these deals means each investment is carefully negotiated, allowing managers to tailor covenants, collateral and structures to specific borrower needs. This complexity is one reason the space has not scaled rapidly, but it is also the source of its attractive return profile.

Market Dynamics and the Equity Backdrop

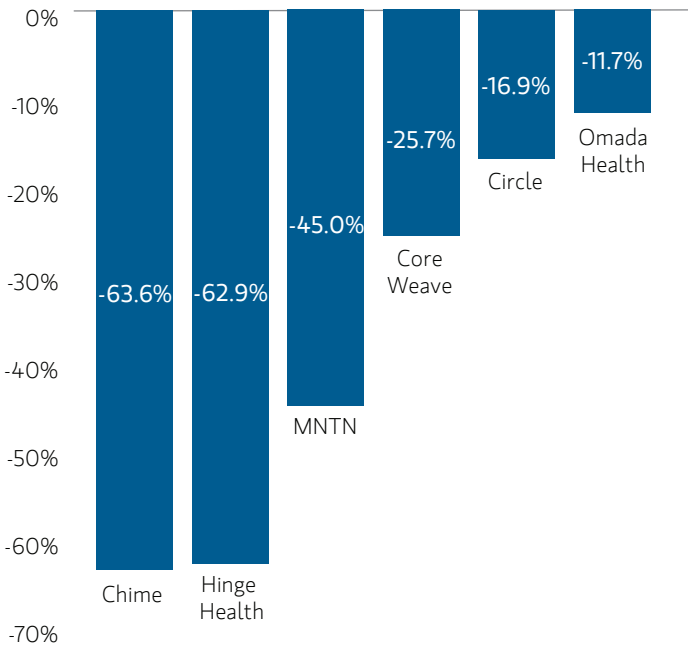
We believe the current market environment is particularly interesting. The surge in valuations and deal activity in

2020–2021 left many companies overextended. Now, with valuations sharply lower, equity fundraising depressed, and mid-sized venture funds shrinking, many companies face the unattractive prospect of raising a “down round” of equity, if they can find available equity at all. (Display 5). Growth credit offers a solution. By providing capital that does not require a repricing of a company’s equity securities, growth credit lenders enable companies to avoid dilution while bridging to a more favorable market or strategic outcome. The collapse of Silicon Valley Bank in 2023 further contracted the lender base, heightening scarcity and opportunity in the growth credit markets.

At the same time, the backlog of venture-backed companies continues to grow. As private company exits remain muted, tens of thousands of companies now sit in portfolios awaiting liquidity events. This creates a pipeline of potential borrowers that continues to expand. These are companies often at the epicenter of the innovation and AI economy, given their venture and growth equity backing and pedigree (Display 6).

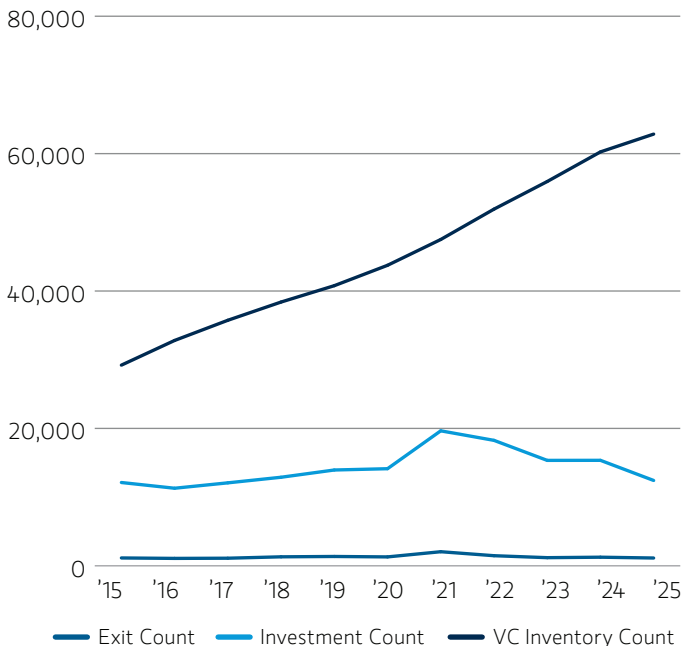
In many ways, the current environment is reminiscent of what ensued following the dot-com bust of the early 2000s. Growth credit emerged as a vital financing tool during that time, while equity markets recalibrated. The shake-out

DISPLAY 5
The major venture-backed IPOs in Q2 2025 were all done at down-rounds from their private valuation peaks



Source: PitchBook. As of June 30, 2025.

DISPLAY 6
Venture backlog and company investments vs. exits remains high



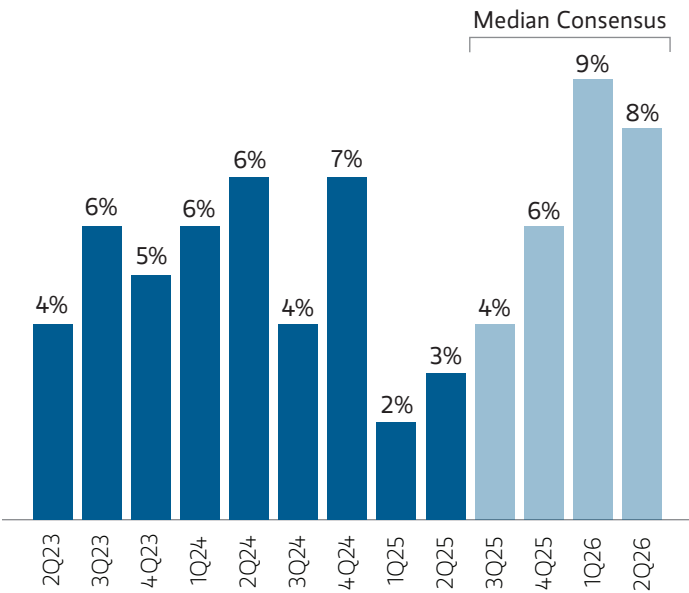
Source: PitchBook. U.S. only. As of March 31, 2025.

forced high growth companies and their equity owners to rapidly pivot from growth-at-all costs strategies to one that focused on profitability and capital efficiency. Investors who positioned themselves at the cusp of that recovery reaped the greatest rewards.

A similar transition is playing out today. There are many more capital seekers than providers for young, high-growth private companies. To justify lofty valuations, many are preserving capital and driving hard to create EBITDA growth even if at the expense of top-line growth. Those efforts appear to be paying off. After troughing in Q1 2025, the median of consensus estimates among analysts following large leveraged loan borrowers points to a sharp EBITDA recovery over the next year (*Display 7*). We believe that is indicative of a broader recovery in EBITDA growth.

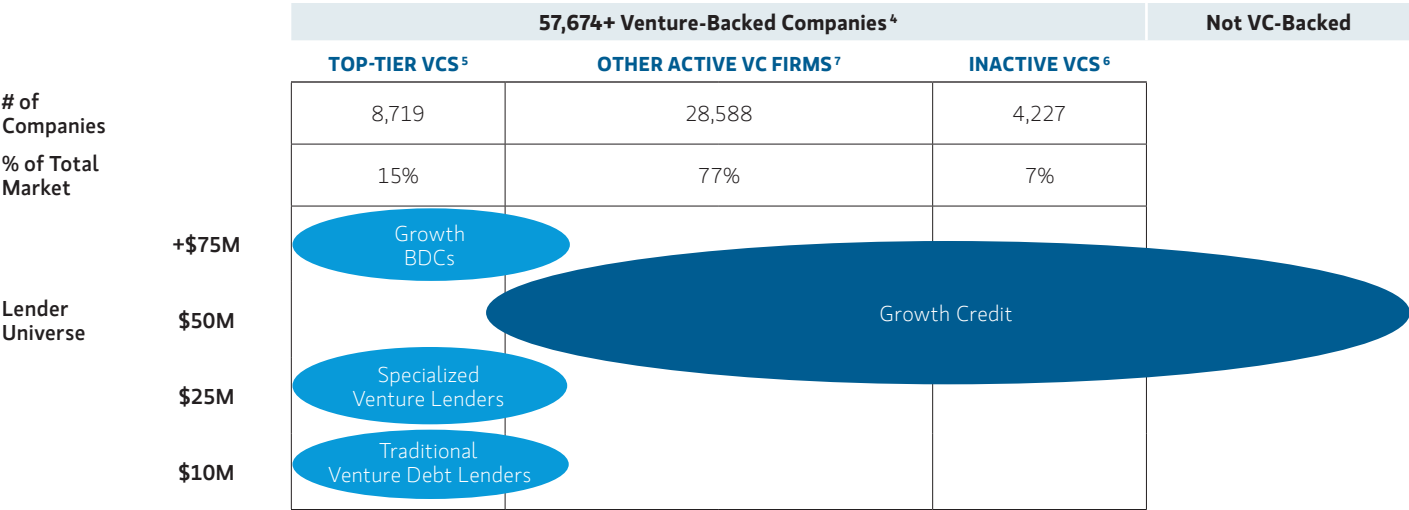
Growth credit provides a bridge during transitions in capital efficiency and technology paradigms. These repeating cycles demonstrate that the strategy is not merely opportunistic, but a recurring feature of the capital markets ecosystem whenever equity exuberance gives way to restraint.

DISPLAY 7
Median consensus estimates of forward EBITDA growth among large leveraged loan borrowers point to a strong rebound over the new year



Source: Bloomberg, PitchBook, S&P Capital IQ, Morgan Stanley Research. As of June 30, 2025.

DISPLAY 8
85% of VC-backed companies,⁸ plus those companies with no VC sponsors, fall outside of traditional venture lending criteria



Source: Morgan Stanley Investment Management. For illustrative purposes only.

⁴ Source: Pitchbook. NVCA Venture Monitor Q3 2024.
⁵ Top-Tier Venture Capital ("VC") Sponsors defined as the largest 50 Venture Capital Funds in the US; Source: VCJ50, Venture Capital Journal November/December 2024 and FundCom.com "The Largest Venture Capital Funds investing in North America".
⁶ Source: Pitchbook. Inactive investors as defined as no longer active making investments / closed or Investors with legacy commitments from Funds past their legal life. As of September 30, 2025.
⁷ Calculated as 100% minus the sum of % of Total Market due to Top-Tier VCs and % of Total market due to Inactive VCs.
⁸ Calculated as 100% minus the % of Total Market due to Top-Tier VCs.

Structural Distinctions: Origination, Underwriting and Resilience

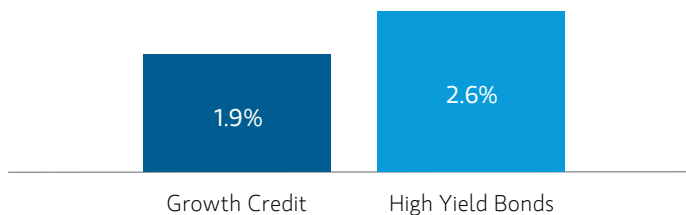
Unlike other areas of leveraged finance, where scale enables efficiency, growth credit is inherently bespoke. Two challenges dominate: origination and underwriting. Small deal sizes make origination expensive, and a greater diversity of business growth models complicates due diligence.

Many lenders rely on sponsor lending strategies, investing only in companies backed by a narrow set of top-tier VCs in order to drive their origination strategies and inform their underwriting conclusions. While this lowers origination costs and leverages sponsor diligence, it also limits potential opportunities to a much smaller part of the market. By contrast, sponsor-agnostic platforms that develop in-house origination and underwriting capabilities can tap into the 85% of the market that lies outside top-tier sponsorship (*Display 8*).

These structural differences also shape risk. Growth credit typically applies lower leverage, with loan-to-values (LTV) typically below 25%, to reduce the risk of default. Growth credit lenders that carefully value prospective investments based on a hard analysis of a company's private market value (even based on a stressed set of market assumptions) need to be 75% wrong in their assessment in order to approach an impairment. That compares to a typical range of LTVs between 40% to 50% in other funding markets that cater to more mature sub-investment-grade companies. Public data from venture debt BDCs suggest loss ratios of under 2%, below those experienced in the high-yield bond market featuring much larger companies (*Display 9*). Moreover,

DISPLAY 9

10-year historic loss ratios in growth credit have been lower than the much larger high-yield bond market



Source: Cliffwater, Moody's. For the 10 years ending June 30, 2025. High-yield loss rates are calculated from annualized monthly data and use the following formula: average LTM default rate * (1 minus average recovery rate). Growth credit loss rates are calculated from annualized quarterly data reported by the Cliffwater Direct Lending Index–Venture (CDLI-V) of net realized and unrealized losses.

growth credit returns are generally structurally more resilient to interest rate cuts. By indexing to the prime rate and locking in floors at the prevailing level at the time of investment, growth credit has less exposure to shrinking coupon pay rates than SOFR-based lending.

Conclusion

Growth credit is no longer a niche curiosity. It has matured into a distinct, high-returning strategy within private credit, differentiated by its borrower base, structural features and market dynamics. The scarcity of capital, the dislocation in venture equity markets, and the expanding backlog of high-growth companies all point to an unusually attractive environment for growth credit investors today.

DEFINITIONS

Earnings Before Interest, Taxes, Depreciation and Amortization (EBITDA) is essentially net income with interest, taxes, depreciation, and amortization added back to it, and can be used to analyze and compare profitability between companies and industries because it eliminates the effects of financing and accounting decisions.

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

Leverage is the degree to which a company uses fixed-income securities such as debt and preferred equity. The more debt financing a company uses, the higher its financial leverage. A high degree of financial leverage means high interest payments, which negatively affect the company's bottom-line earnings per share.

Leveraged Loan is a loan provided to issues that already have high levels of debt

Loan-to-value (LTV) ratio is a financial metric used by lenders to assess the risk of a secured loan by comparing the loan amount to the value of the asset, typically expressed as a percentage

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

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.

Unitranche is a hybrid loan structure that combines senior and subordinated debt

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

Risk Considerations

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