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INVESTMENT MANAGEMENT

Weighing in on Direct Lending: Analyzing Durability & The Supply-Demand Balance

NORTH AMERICA PRIVATE CREDIT | October 2025

AUTHOR

NORTH AMERICA PRIVATE CREDIT

Summary

Direct lending remains an attractive private market strategy in a higher-for-longer interest rate environment, even as asset yields have declined. The asset class combines attractive return potential with strong downside protection and diversification benefits. Today, several converging dynamics support this argument:

- **REBALANCING DEMAND-SUPPLY EQUATION:** As the M&A recovery begins to take hold, we take stock of how that impacts the balance between capital providers and seekers in a direct lending context. We believe that PE middle-market demand can exceed middle-market direct lending supply by a factor of 2.2x, even after accounting for new evergreen fundraising *(Display 4)*.
- **RESILIENT PERFORMANCE ACROSS CYCLES:** Direct lending has delivered superior risk-adjusted returns over the last decade, besting that of comparable public credit and fixed income sectors as well as private-market alternatives *(Display 9)*. That outperformance remained intact during periods of shallow rate cuts by the Federal Reserve, similar to the present environment *(Display 8)*.
- **RESILIENT CREDIT QUALITY:** Industry credit quality has remained solid in data releases that track borrower stress. Fully loaded default rates, inclusive of restructurings, have trended lower in recent quarters; meanwhile, EBITDA-to-interest coverage ratios have moved modestly higher.[1] Credit quality would be aided by an EBITDA recovery. The mean consensus forecast calls for accelerating EBITDA growth among leveraged loan borrowers over the next four quarters.[2]

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[1] Source: Lincoln International, Fitch, S&P Global, Morgan Stanley Research. As of June 30, 2025.

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

For investors seeking yield, stability and long-term value creation, the rationale for investing in direct lending remains both structural and timely.

Introduction

The past fifteen years have seen private credit evolve from a niche alternative into a cornerstone of investor portfolios. Private credit has grown globally from $2 trillion in 2020 to roughly $3 trillion in early 2025, with projections to exceed $5 trillion by 2029.[3] Within that expansion, direct lending has emerged as a core investment allocation for institutional and individual investors alike.

Today, the case for investing in direct lending is not only strong on a structural basis but especially timely, reinforced by interest rate dynamics, recovering deal activity, M&A demand, and the potential risk of a pick-up in public market volatility. Taken together, we believe these forces present a potentially compelling moment for capital allocation to direct lending.

This market update re-examines the secular forces that propelled direct lending's impressive historic growth, as well as new drivers of future growth.

Revisiting direct lending supply

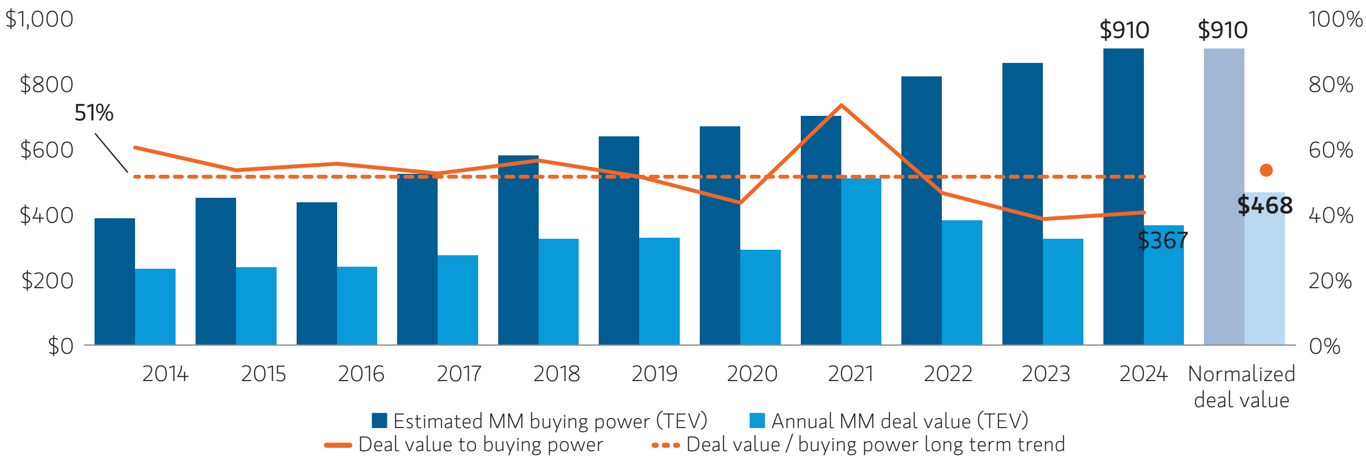
Direct lending is by far private credit's largest strategy, accounting for approximately half of all gross value invested.[4] The strategy has experienced explosive growth in recent years, especially in BDC vehicles that are unique to the U.S. Across all vehicle types, including traded and non-traded BDCs, interval funds and traditional drawdown funds, U.S. direct lending now stands at ~$1 trillion in size, up from ~$400 billion in 2019.[5] This has led some to speculate on whether lending supply has outrun borrower demand. With a more deal-friendly environment now developing, we assess whether the reverse may be true.

This can be accomplished by comparing deal flow and dry powder in that of its primary target market, the PE sponsored middle-market. A higher level of deal velocity among PE middle-market sponsors relative to direct lending deployment would indicate a market that is supply constrained. Conversely, a higher level of direct lending dry powder relative to PE middle-market deal flow would indicate the potential for oversupply.

As a starting point, PE buying power is a helpful demand-side barometer as it indicates the total enterprise value

DISPLAY 1

Pent-up demand is building as deal value persists below long-term average of 51% of buying power ($Bn)



Source: PitchBook LCD, Morgan Stanley Investment Management. 2024 PE MM buying power as of September 30, 2024. U.S. only. PE middle-market buyout funds only. Excludes growth equity funds that do not employ leverage. PE dry powder is assumed to be equity only, and is grossed up by an assumed equity contribution percentage of 60%, with the balance assumed to be debt funded (40% LTV). For example, for the year 2024, $546 billion / 60% = $910 billion.

[3] Source: PitchBook. 2029 Private Market Horizons. May 1, 2025.

[4] Source: PitchBook, Morgan Stanley Investment Management. As of December 31, 2024.

[5] Source: PitchBook. As of March 31, 2024. Data throughout is based on all BDCs and middle market drawdown funds using LSEG and PitchBook as sources. No exclusions made.

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that sponsors can buy. Dry powder in PE middle-market funds is estimated at $546 billion, but that will only fund the equity portion of any deal.[6] Applying a conservative equity contribution ratio of 60% (a loan-to-value ratio of 40%) produces $910 billion in an implied financing need, both equity and debt, for future middle market deals *(Display 1)*.[7] PE middle-market borrowers rely almost exclusively on direct lending for debt financing. In 2024, less than 1% of broadly syndicated loan (BSL) new-issue volume was to middle-market borrowers, and bank-led club loans were largely made to private companies without PE backing.[8]

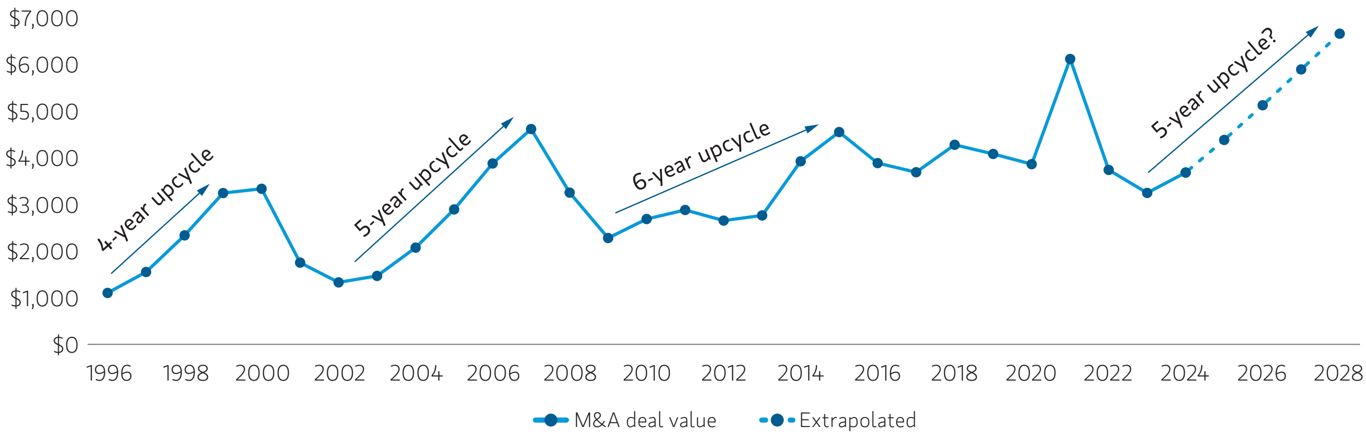
In a normal deployment environment, PE middle-market managers take approximately two years to fully exhaust buying power. This is supported by the fact that over the last 15 years, the annual value of PE middle-market buyouts has averaged 51% of buying power, implying just short of two-years to deploy 100% *(Display 1)*. The last few years have been anything but normal, however. PE managers slowed deployment due to higher interest rates and an inability to make returns work for their investors. Additionally, PE drawdown funds have been sensitive to the needs of their investors, slowing deployment and capital calls to align more with distributions and exits, which have been lean.

As a result of these factors, pent-up demand owing to delayed deployment has been building for more than four years. PE deployment relative to buying power in the middle-market fell to ~30% below historical levels in 2023 before improving slightly in 2024 and 2025. A full recovery to trend implies $468 billion in annual middle-market buyout value, a significant uplift to the $367 billion recorded in 2024 *(Display 1)*.

Strong M&A in general is a clear catalyst for deployment to fully unlock. Private equity and direct lending are both highly geared to the M&A cycle. PE buyouts account for ~40% of all M&A volume and M&A loans account for ~75% of all loans made by direct lenders in any given year.[9] Like PE, global M&A has fallen 35% to 40% below historical levels according to some estimates, creating pent-up demand that persists today.[10] With dealmaking now entering a period of renewed Fed Funds rate cuts and improved clarity around tariffs, a more robust M&A recovery is now coming back into view. Prior sharp setbacks in M&A that lasted for two years were often followed by four- to six-year upcycles. Trendline growth of 16% would result in M&A re-gaining the 2021 all-time high by 2027 and a five-year recovery may push it well beyond that point *(Display 2)*.

DISPLAY 2

A strong M&A recovery coming back into view in Q4 2025 and beyond ($Bn)



Source: Dealogic, Morgan Stanley Investment Management. As of June 3, 2025. Global.

[6] Source: PitchBook.

[7] Source: PitchBook LCD, Morgan Stanley Investment Management. 2024 PE MM buying power as of September 30, 2024. U.S. only.

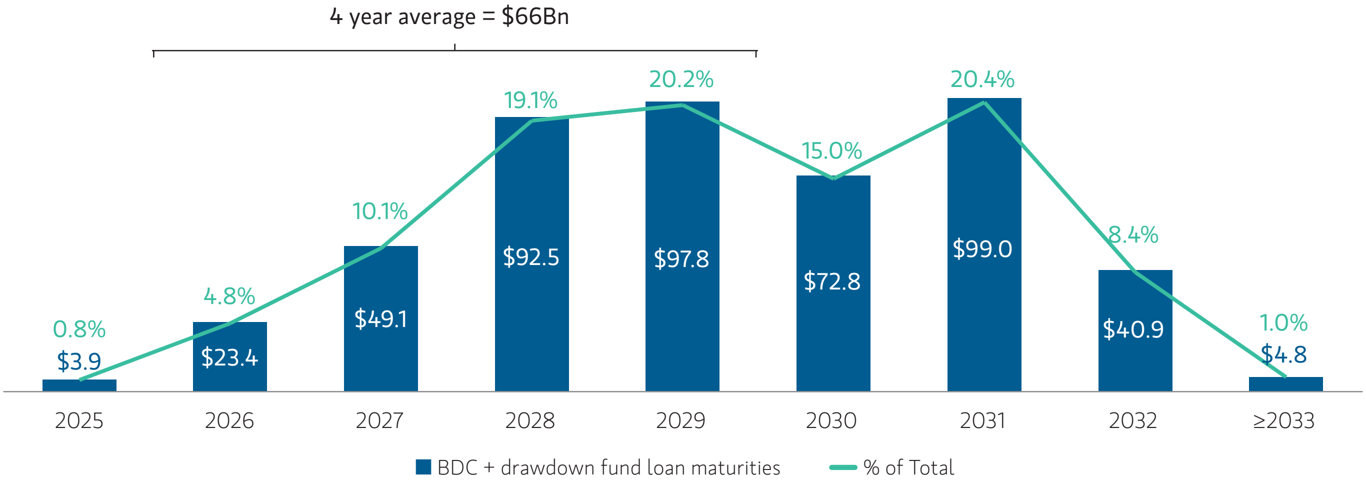
[8] Source: PitchBook LCD, LSEG. Middle-market loans are defined as facilities of less than $350 million.

[9] PitchBook LCD. As of June 30, 2025.

[10] Morgan Stanley Research, June 2025. The Pause is Over: Upgrade Mid-Cap Advisors

DISPLAY 3

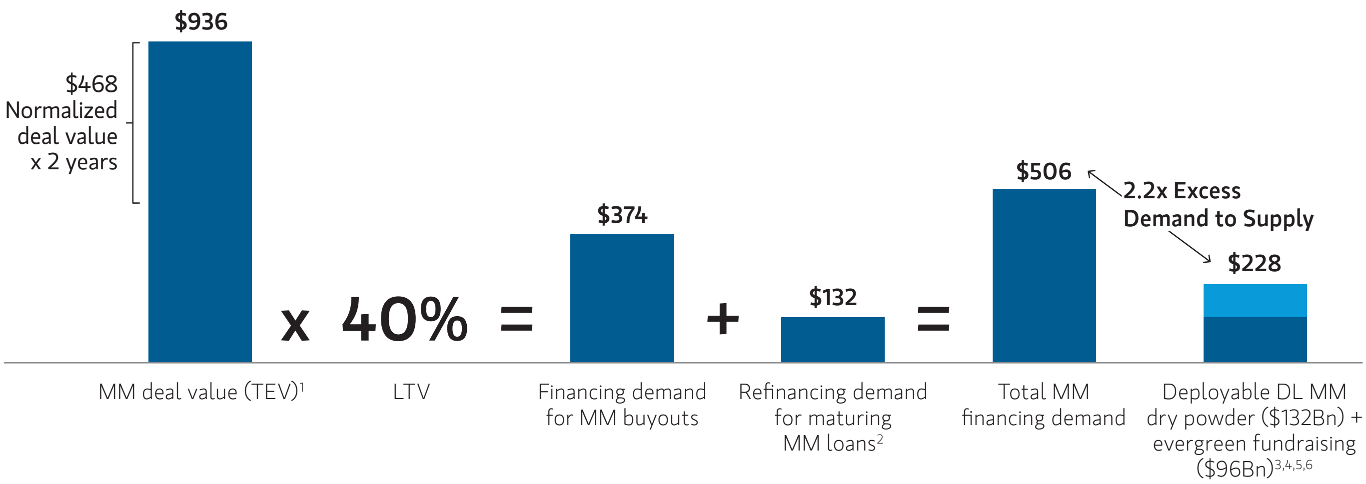
Sizable middle-market loan maturity wall supports refinancing demand for direct lenders longer term ($Bn)



Source: LSEG, PitchBook LCD, Morgan Stanley Investment Management. As of June 30, 2025. U.S. only. Represents the combined total of maturing loans in direct lending drawdown funds and BDCs adjusted to reflect the percentage of loans made to middle market borrowers and latest BDC filings (85% of all loans, 50% of all deployed capital).

DISPLAY 4

Potential demand from all sources significantly exceeds direct lending supply ($Bn)



Source: PitchBook, LSEG, Robert A Stanger & Co., Morgan Stanley Investment Management. All values are for the middle-market segment only and represent two-year totals to replicate a full deployment cycle, except for middle-market dry powder which is a cumulative total.

1. Assumes acceleration of deployment pacing to 15-year average (51% of buying power of US middle-market drawdown funds versus 40% in 2024). Two-year sum.
2. Based on the average of middle-market loans maturing in 2026 through 2029. Two-year sum.
3. Dry powder represents the cumulative total of all uncalled capital for direct lending drawdown funds as of December 31, 2024, adjusted for typical deployment into the middle-market and fund leverage.
4. Evergreen fundraising based on the annualized average between January 1, 2024 and July 31, 2025 for non-traded BDCs and private credit interval funds, adjusted for typical deployment into the middle-market and fund leverage. Two-year sum.
5. Fund leverage based on average of all traded and non-traded BDCs as of June 30, 2025 and assumes 75%/25% levered/unlevered fund mix.
6. Direct lending dry powder and evergreen fundraising are both adjusted to reflect the percentage of loans made to middle market borrowers, and are based on latest BDC filings (85% of all loans, 50% of all deployed capital).

At the same time buyout activity is set to re-accelerate, a refinancing wave consisting of older middle-market loans is fast approaching. Looking out seven years, $475 billion in middle-market loans are coming due, with more than half maturing in the next four years. This translates to $66 billion in average annual demand that is refinancing-related *(Display 3)*.

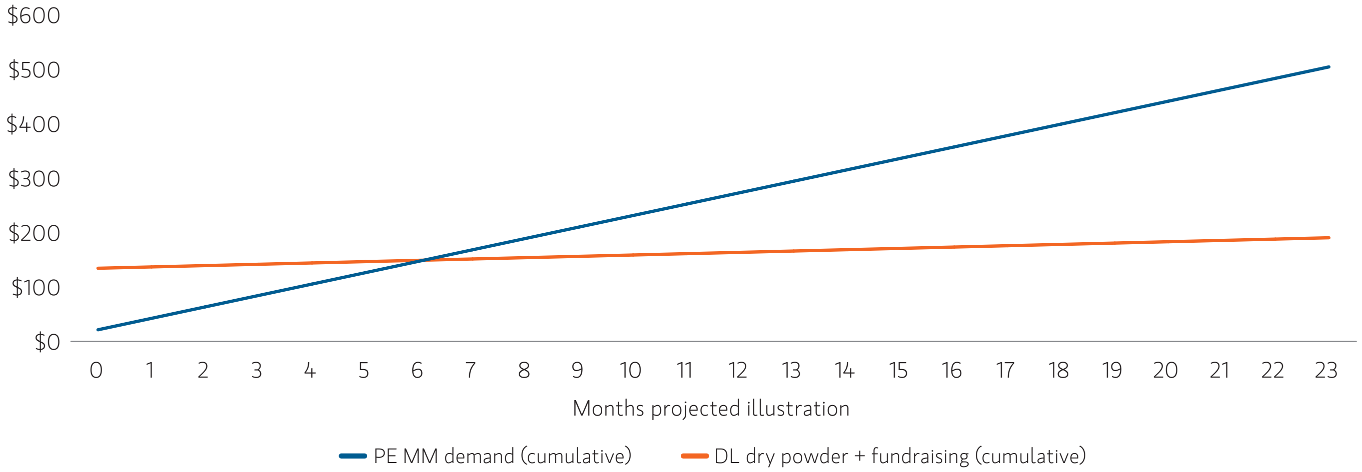
Taken together, refinancing and buyout-related financing translate to $253 billion in total PE middle-market demand, or $506 billion over a two-year deployment cycle *(Display 4)*. Only 1% of BSL new issuance is in the middle-market range (facilities less than $350M). As a result, this analysis assumes that all new deal demand and new refinancing demand related to middle-market (as defined) is going to direct lending. This compares to $132 billion in corresponding supply, as represented by the cumulative total of dry powder in direct lending drawdown funds earmarked for middle-market deployment and inclusive of fund leverage.

A final adjustment is made to direct lending supply to account for evergreen fundraising. Dry powder is limited to drawdown funds only. It captures uncalled committed capital that has yet to be deployed. Adjusting for what is effectively "hidden" dry powder in the form of expected evergreen fundraising over a two-year time frame results in $228 billion in total direct lending supply. Even with that adjustment, aggregate potential demand for PE middle-market financing significantly exceeds direct lending middle-market supply by 2.2x *(Display 4)*.

Not all pent-up deal-related demand will appear overnight, and refinancing demand will also take some time to ramp. However, even assuming a gradual release of these new demand factors over the next 24 months, supply-demand dynamics can eventually shift in favor of direct lenders, potentially setting the stage for improved pricing power and potential for excess returns for lenders and investors *(Display 5)*.

DISPLAY 5

A slow release of new demand factors can still shift deal dynamics in favor of direct lenders over time ($Bn)



Source: PitchBook, LSEG, Robert A Stanger & Co., Morgan Stanley Investment Management. For illustrative purposes only.

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While interest rate spreads have trended lower for most of 2025, direct lending has maintained an excess spread above BSL consistent with historical average ranges of 160bps in 2025 *(Display 6)*.

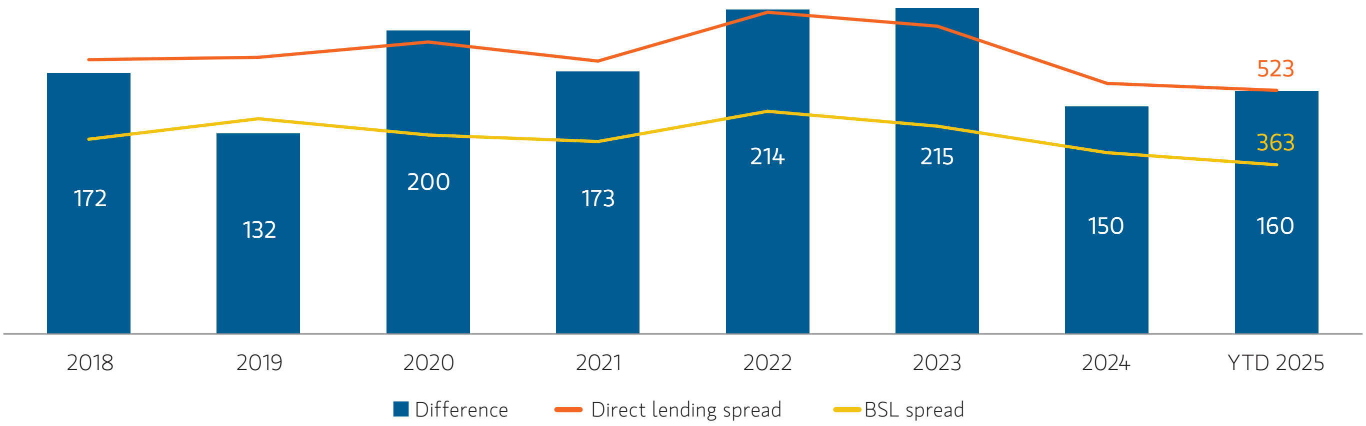
Direct lending's resilience across all cycles of a "higher for longer" environment

Direct lending's appeal begins with its ability to consistently generate attractive absolute and risk-adjusted returns. Unlike fixed-rate bonds, most of private credit is structured with floating rates, giving investors real-time protection against interest rate movements and inflation. This feature has been critical in recent years. During the Federal Reserve's tightening cycle of 2022-2023, direct lending consistently delivered double-digit returns. The same has been true in other rising-rate environments. Since 2008, across seven distinct rising-rate periods, direct lending has produced average annual returns of 11.6%,[11] two full percentage points above its long-term average.

Even in a moderately declining rate environment, returns have held up, indicating that private credit is not dependent on a single monetary backdrop. Recent evidence suggests that private credit can continue to outperform in a "higher-for-longer" rate environment characterized by higher cycle lows and sticky inflation.

DISPLAY 6

Direct lending spreads continue to trend lower from the '22 peak but the differential to liquid loans is now slightly expanding (bps)



Source: PitchBook | LCD. Data through June 30, 2025. U.S. only. Spreads reflect newly issued LBO loans to all PE-backed borrowers.

[11] Source: Cliffwater Direct Lending Index (CDLI). Rising rate environments are defined as periods of uninterrupted monthly increases in the 10-year US Treasury yield of 75 basis points or more.

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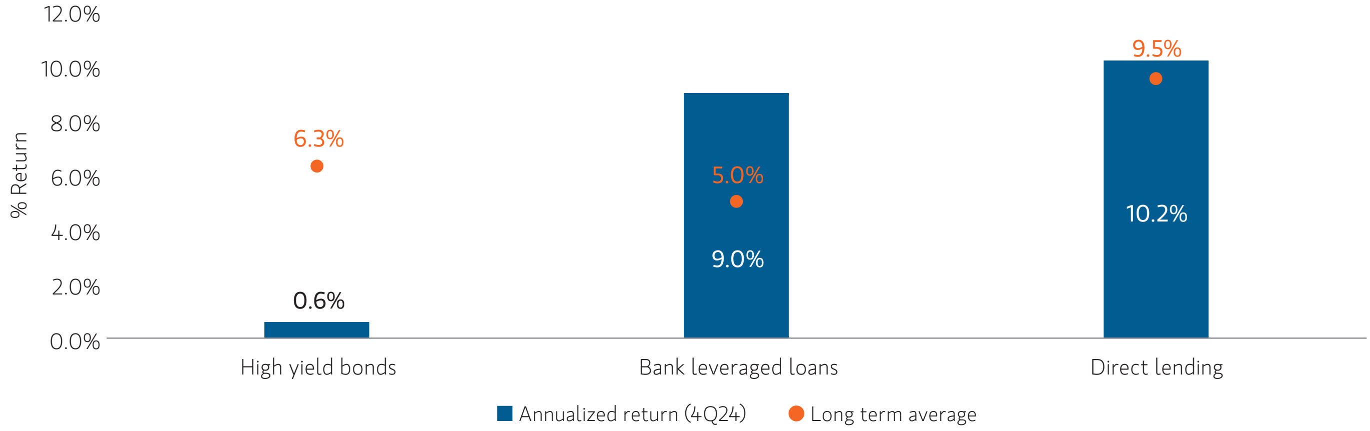
DISPLAY 7

The Q4 2024 episode suggests that private credit can outperform in a shallow rate cut cycle



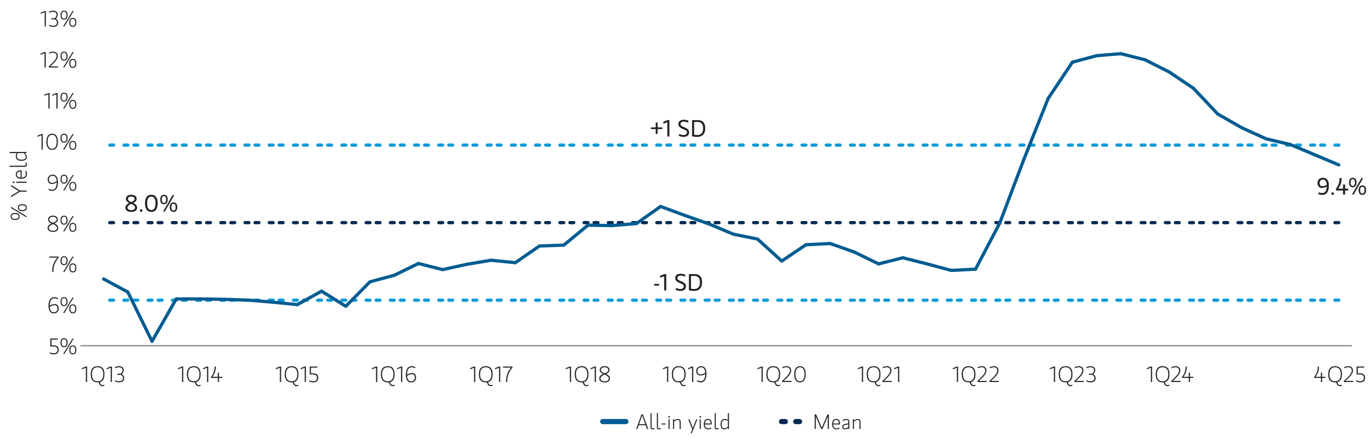
Source: Cliffwater, Morningstar. Q4 2024 returns are annualized. Long-term returns represent the annualized average for the 20 years ending June 30, 2025. U.S. only.

Direct lending posted an annualized return of 10.2% in the fourth quarter of 2024, beating high-yield bonds and leveraged loans in the process, even while the Federal Reserve was cutting rates *(Display 7)*. Market expectations call for the current round of rate cuts to be equally as shallow, or 100 to 150 basis points in total.[12] That is an environment in which private credit can continue to deliver potentially compelling returns.

An additional 100 basis points cut in base rates by the end of 2026 on top of the 150 so far in 2024-2025, would unwind less than half of the historic Fed Fund hikes of 2022-2023, clearly a higher low and even above where rates topped out in July 2019. Immediately following the most recent of the Fed Fund rate cuts on October 29, direct lending yields adjusted to ~9.4%. That is still elevated by historic standards and leaves direct lending yields in the upper half of their 12-year range *(Display 8)*.

DISPLAY 8

Direct lending yields remain elevated, even after Fed rate cuts



Source: LSEG, Morgan Stanley Investment Management. Yield data as of October 30, 2025.

[12] Source: Market probability tracker, Federal Reserve Bank of Atlanta, as of October 7, 2025.

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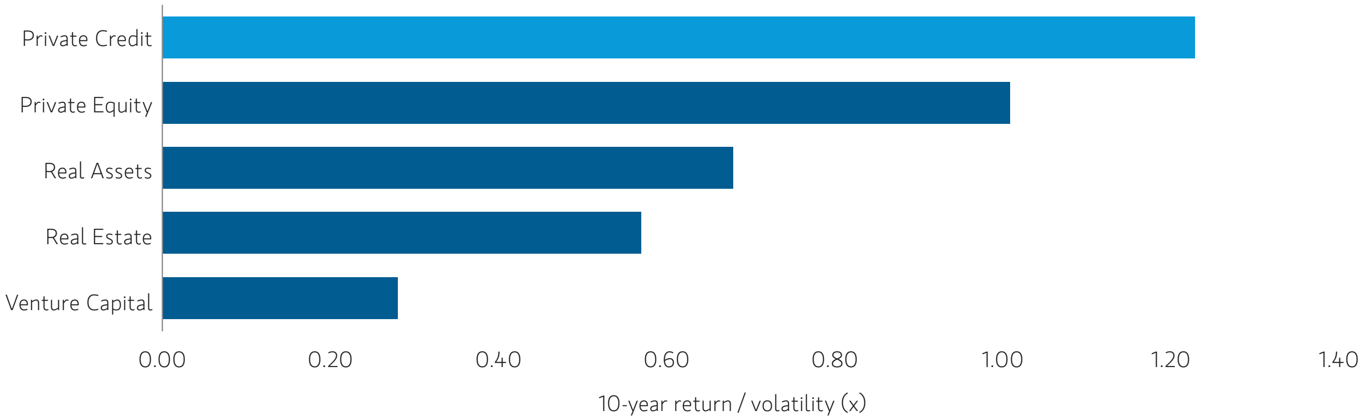
DISPLAY 9

Among other private assets, private credit leads the pack in returns per unit of volatility



Source: PitchBook, Morgan Stanley Investment Management. For the ten years ending March 31, 2025. All private assets represent fund performance net of fees with returns unsmoothed to remove artificial effects of delayed reporting of fluctuations in asset fair value.

Longer term, private credit's ability to deliver attractive returns, when adjusted for risk, is perhaps most prized by investors, leading to increased allocations and asset class growth over the years. Private credit has delivered the highest net returns per unit of volatility among private asset classes, outpacing real estate, infrastructure, venture capital and private equity *(Display 9)*.

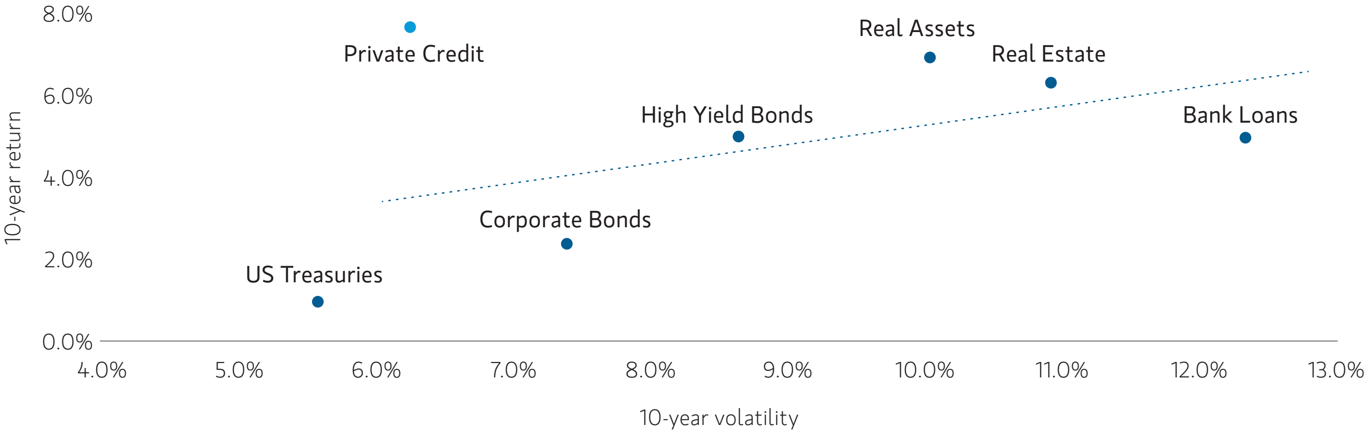
Looking at income-oriented asset classes only, both public and private, the same pattern can be seen. Over the last ten years, private credit funds have outperformed corporate bonds, high-yield bonds and leveraged loans in addition to real estate and infrastructure, even after deducting fees and unsmoothing returns *(Display 10)*.

Credit outlook

A lower interest rate environment could benefit a direct lending borrower's credit profile by reducing interest expense, all else equal. While macro uncertainty remains on the horizon, recent evidence suggests that direct lending default rates (including out-of-court restructurings in addition to court-supervised restructuring proceedings

DISPLAY 10

Net of fees, private credit's risk-adjusted return stands out versus other income-oriented assets, both private and public



Source: PitchBook, Morningstar. U.S. only. For the 10-years ending March 31, 2025. All private assets represent fund performance net of fees with returns unsmoothed to remove artificial effects of delayed reporting of fluctuations in asset fair value.

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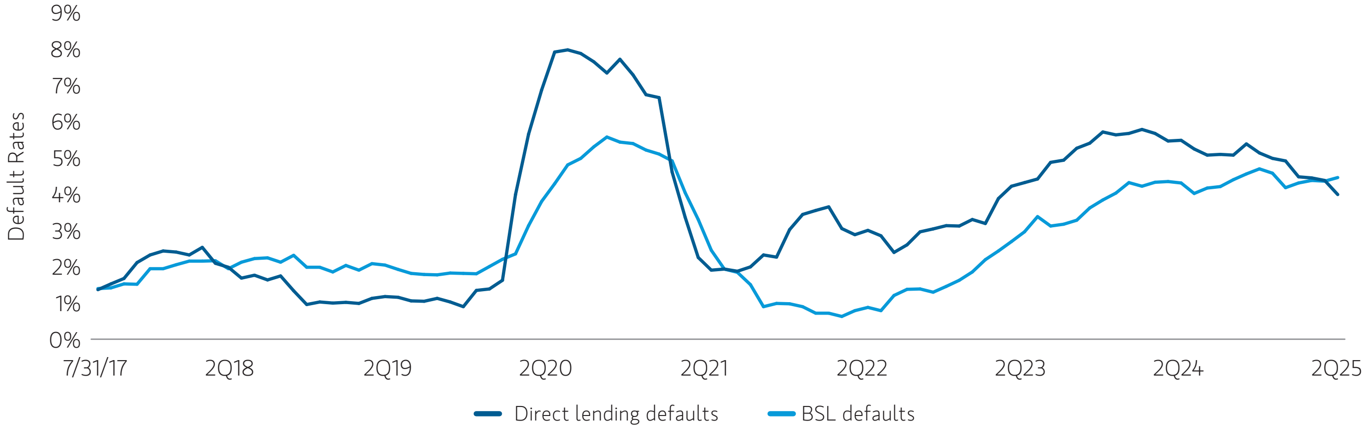
DISPLAY 11

Default rates inclusive of restructurings have improved recently, dipping below syndicated loans



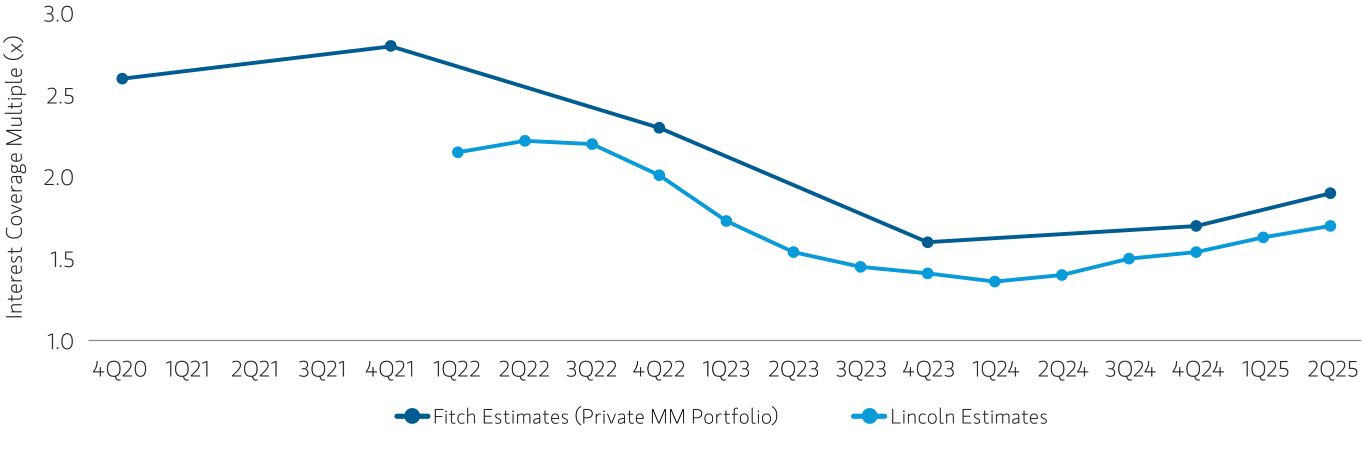
Source: PitchBook LCD, S&P Global. As of June 30, 2025. U.S. only. Direct lending default rate is based on S&P's universe of middle-market companies receiving "credit estimates" and includes distressed exchanges as a default event.

and bankruptcies) have declined modestly. Gradual relief began in April 2024, shortly after base rates topped out in 2023 and gained speed following the first round of Fed Fund rate cuts in 4Q 2024. Default rates including restructurings recently fell below 4% for the first time in two years and have crossed below like-kind default rates in the BSL market *(Display 11)*.

Middle-market credit quality stability can be seen in EBITDA to interest coverage ratios as well. Coverage ratios for middle-market companies compressed significantly during the supply chain-induced inflation shock of 2022 to 2023 and have slowly recovered ever since *(Display 12)*.

DISPLAY 12

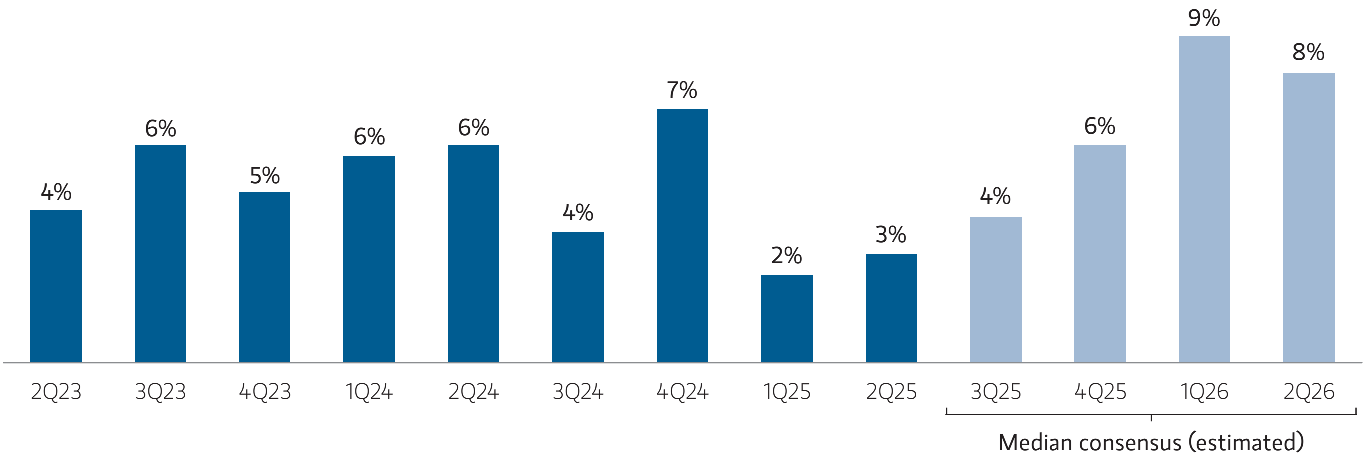
Interest coverage ratios are on the mend for middle-market borrowers



Source: Lincoln International, Fitch, S&P Global, Morgan Stanley Research. As of June 30, 2025.

DISPLAY 13

Consensus estimates point to accelerating YoY EBITDA growth among leveraged loan borrowers



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

A lower Fed Funds rate could pave the way for reduced interest expense among direct lending borrowers. Meanwhile, EBITDA growth is showing signs of accelerating despite tariff-related headwinds. It's estimated that the public subset of companies that tap the leveraged loan market achieved average EBITDA growth of 3.1% in 2Q 2025, up from a trough of 2% in the prior quarter. Based on the median of consensus estimates for those same borrowers, EBITDA growth is expected to climb to 8-9% in the first half of 2026 on a 4-5% recovery in sales *(Display 13)*.

Conclusion

Direct lending has firmly established itself as the financing market of choice for PE middle-market borrowers. For investors, it has become a core strategy in a fully diversified portfolio that combines private and public investments. Today, an investment in direct lending remains potentially compelling for many of the same reasons that have driven historic returns in addition to new drivers of future growth. The asset class combines proven resilience across rate cycles with potentially compelling risk-adjusted returns, consistently outperforming both public credit and other private markets. It is underpinned by powerful demand drivers: private equity's buying power, a large refinancing wall, and deployment levels that remain well below long-term averages, signaling pent-up activity still to come.

At the same time, the supply of direct lending capital is far more limited than generally perceived, especially when pent-up demand is fully released. This can create an imbalance that allows lenders to preserve discipline, strengthen terms, and capture the illiquidity premium to public markets. Industry consolidation further tilts the balance toward scaled platforms with the sponsor relationships, origination capacity and underwriting rigor to take the lead in the current environment.

Lastly, barring any unforeseen macro shock or recession event, the combination of declining interest expense and rising EBITDA levels could support solid fundamentals among direct lending borrowers as supported by comparative recent trends in defaults.

For investors seeking yield, diversification and downside protection, direct lending offers a potentially compelling opportunity in an uncertain backdrop. With structural tailwinds, cyclical catalysts, and potentially compelling fundamentals converging, the question is no longer whether direct lending deserves a place in portfolios, but how to allocate.

Risk Considerations

Diversification does not eliminate the risk of loss.

Alternative investments often are speculative and include a high degree of risk. Investors could lose all or a substantial amount of their investment. Alternative investments are appropriate only for eligible, long-term investors who are willing to forgo liquidity and put capital at risk for an indefinite period of time. They may be highly illiquid and can engage in leverage and other speculative practices that may increase the volatility and risk of loss. Alternative Investments typically have higher fees than traditional investments. Investors should carefully review and consider potential risks before investing.

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RO 4873186 Exp. 31/10/2027 25Q330963_KC_1025 A4