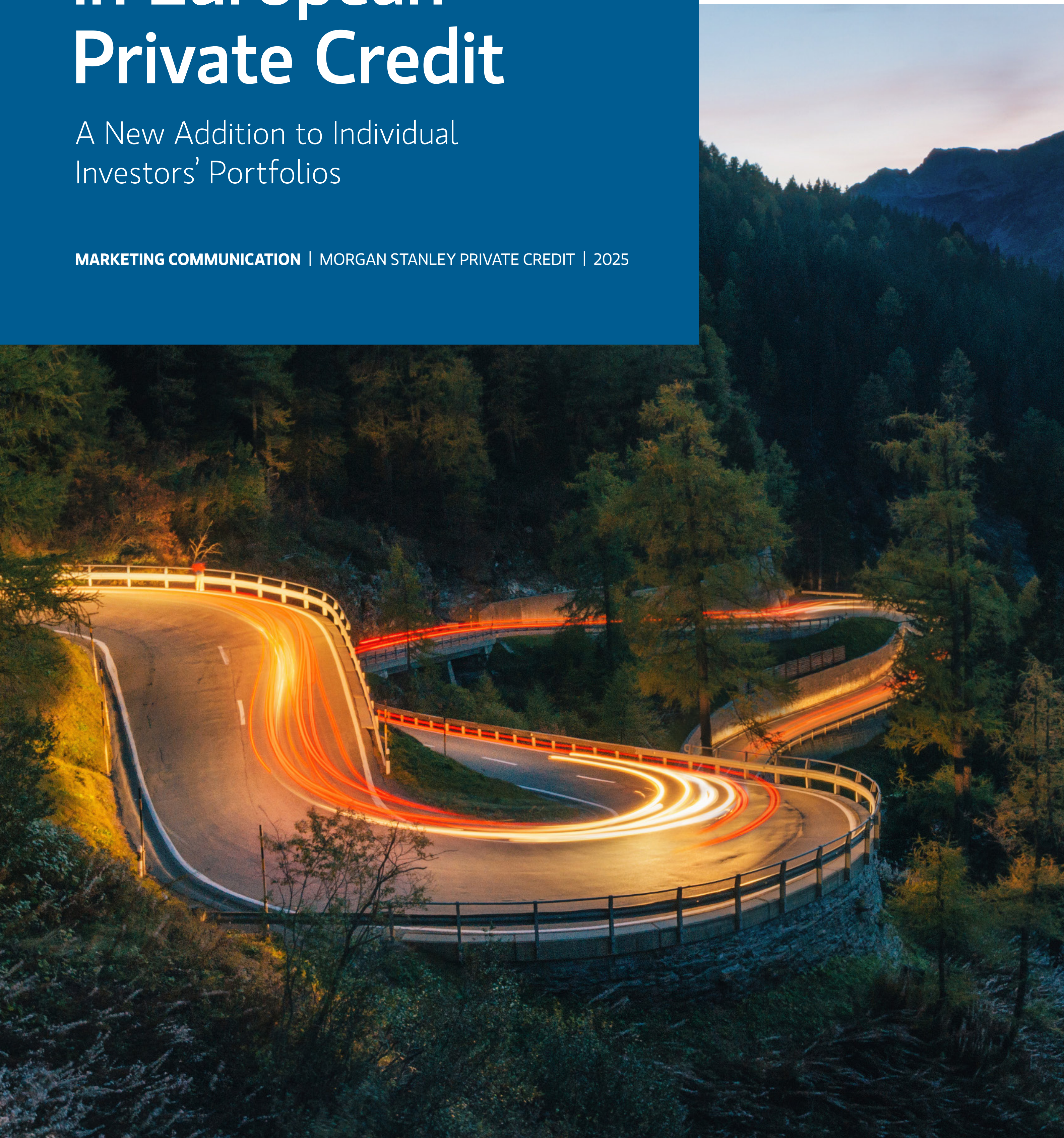
Morgan Stanley
INVESTMENT MANAGEMENT

Investing in European Private Credit

A New Addition to Individual Investors' Portfolios

MARKETING COMMUNICATION | MORGAN STANLEY PRIVATE CREDIT | 2025



Credit, or the practice of borrowing, has long been an essential part of both personal and corporate finance and plays a vital role in the global economy.

In this publication, we explain a rapidly growing and increasingly mainstream part of the global credit ecosystem – 'private credit'. Private credit typically refers to a situation where a corporate borrower requires a loan from a specialist lending firm usually labelled a 'private credit fund'. These loans are directly negotiated between the company and private credit funds.

In the last decade, private credit has rapidly expanded as its potential benefits (to both investors and borrowers) have become progressively well evidenced. Consequently, private credit assets under management ("AUM") have risen by over four times in the last decade, from $425 billion in 2013 to $1.7 trillion in 2023.[1]

Institutional investors have historically been the main contributor into private credit. However, with the advent of suitable investment vehicles, retail investors are progressively becoming a mainstay of the overall private credit funding base.

UNDERSTANDING PRIVATE CREDIT

A GROWING ASSET CLASS

WHY INVEST IN PRIVATE CREDIT?

[1] Preqin data as of December 2023.

What is Private Credit?

‘Private credit’ refers to the provision of privately negotiated loans to borrowers that are issued by non-bank lenders called ‘private credit funds’, which deploy capital (i.e., funds) that they have raised from investors. Companies borrow for a number of reasons, for example, to make acquisitions, expand into new geographies, or buy new equipment and facilities that will enhance their productivity. When seeking to borrow, private credit can offer companies a more direct and efficient way to access capital, while ensuring confidentiality, speed and certainty of execution, as well as flexibility on loan structuring and repayment terms.

Since the Global Financial Crisis, private credit has become an increasingly attractive and mainstream asset class for investors (in Europe, private credit AUM totaled $505 billion in December 2023[2]). As described later, investors are attracted to private credit by potential strong risk-adjusted returns, exposure to high-quality and defensive companies, and diversification.

A wide range of investors allocate their funds to private credit, including pension schemes, insurance companies, sovereign wealth funds, family offices, and, increasingly, retail investors. For investors interested in diversifying their portfolio away from traditional equities and fixed income, private credit can be an attractive alternative holding.

KEY TERM

Private Credit and Direct Lending

Private credit loans are privately negotiated between a company and private credit fund. The funds used for the loan are raised from investors, including pension funds, insurance companies, and high-net-worth / retail investors.

Direct lending is often synonymous with private credit, however, technically ‘direct lending’ typically refers to the provision of senior secured loans to private equity-owned businesses. Direct lending makes up the largest portion (approximately 58%)[2] of overall private credit AUM. Other types of private credit include mezzanine lending, distressed debt, special situations, and venture debt.

DISPLAY 1

Private credit fundraising and investing model

INVESTORS
A range of investors provide funds for private credit vehicles to invest. In return, they potentially receive regular interest payments and repayments of principal at the end of the loan, minus fees

INVESTOR RETURNS
Investors receive interest, fees, and principal repayments, net of investment management fees

PRIVATE CREDIT FUNDS
Teams of investment professionals select high-quality companies to invest in and negotiate the terms of private loans

INTEREST PAYMENTS AND FEES
In return for their loan, borrowers pay interest on their debt and typically are charged ‘up-front fees’ to compensate the lender for originating the loan

COMPANIES
Companies seek out financing for a number of reasons including to acquire other companies, provide liquidity, and invest in facilities and equipment

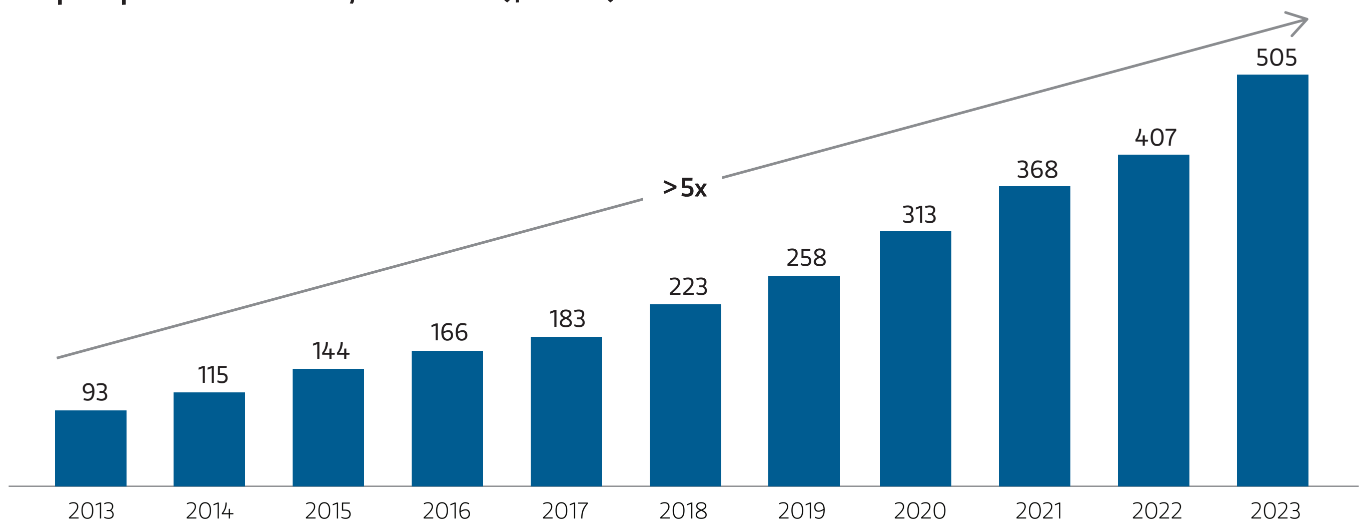
[2] Preqin data as of December 2023.

A Growing Asset Class

Private credit has been one of the fastest growing asset classes in Europe over the last decade, with AUM growing by over five times to $505 billion from 2013 to 2023.[3]

DISPLAY 2

European private credit AUM, 2013-2023 ($ billion)[3]



[3] Preqin data. European private credit AUM was $93 billion in December 2013 and $505 billion in December 2023.

Private Credit Growth Drivers

1
REGULATORY DRIVERS

- Since the Global Financial Crisis, traditional bank lending has been constrained by strict capital requirements imposed by governments and regulators
- This has created whitespace for private credit funds to grow into *(see Display 3)*

2
ADVANTAGES FOR BORROWERS

- Borrowers increasingly perceive private credit funds as long-term and trusted financial partners
- Private credit funds typically offer borrowers faster execution and greater flexibility than bank financing solutions

3
ENDURING PRIVATE EQUITY DEMAND

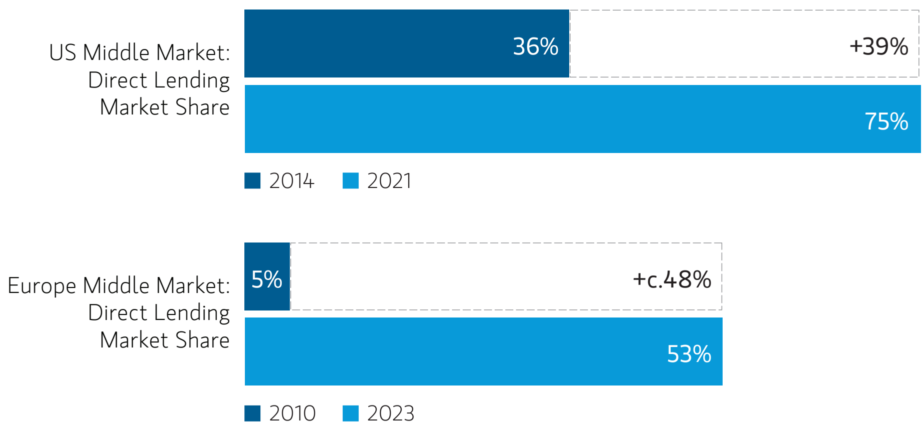
- Private equity funds have progressively increased their appetite for private credit financing across Europe
- This demand is expected to persist, with private equity dry powder of $289 billion currently over three times higher than private credit dry powder[4]

4
STRONG PIPELINE OF EXISTING REFINANCEABLE LOANS

- There is currently a pipeline of c.€290 billion of outstanding syndicated loans in Europe that mature by 2030, which could be refinanced with private credit solutions[5]

DISPLAY 3

Private credit market share has significantly expanded since the Global Financial Crisis[6]



KEY TERM

Dry Powder and AUM

Dry powder is the funds that investors have committed to an asset manager that have not yet been invested, making it one measure of a fund's ability to deploy in coming years.

AUM, or 'assets under management', is the sum of dry powder and deployed capital.

[4] Preqin data. European private credit dry powder as at December 2023 stood at $92 billion; European private equity (buyout) dry powder stood at $289 billion.

[5] Pitchbook LCD European Leveraged Lending Review – Q3 2024 Report, accessed October 2024.

[6] U.S. data sourced from Bain Global Private Equity Report 2023. Data reflects the proportion of financing for middle-market buyouts provided by direct lenders, where 'middle-market' is defined as issuers with revenue less than $500 million and total loan packages less than $500 million. European market share for 2023 was derived from the Houlihan Lokey MidCapMonitor for Q3 2023. The market share for 2010 is based on the European Investment Team's experience and knowledge of the private credit market but has not been independently validated.

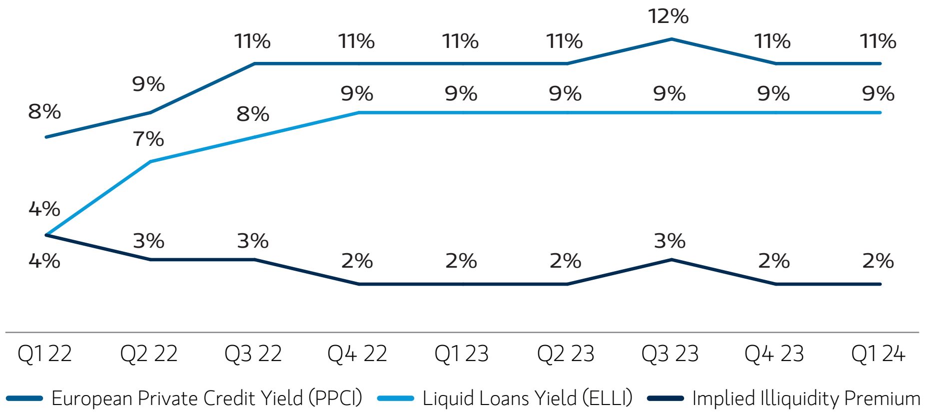
Why Invest in Private Credit?

1 Illiquidity premium and potentially strong risk-adjusted returns

Private credit loans have historically provided a yield premium of c.200 basis points (bps) relative to syndicated loans *(Display 4)*.[7] According to the Cliffwater Direct Lending Index ("CDLI"), direct lending has averaged an annualised 9.46% gross return since index inception in 2004 *(Display 5)*.[8]

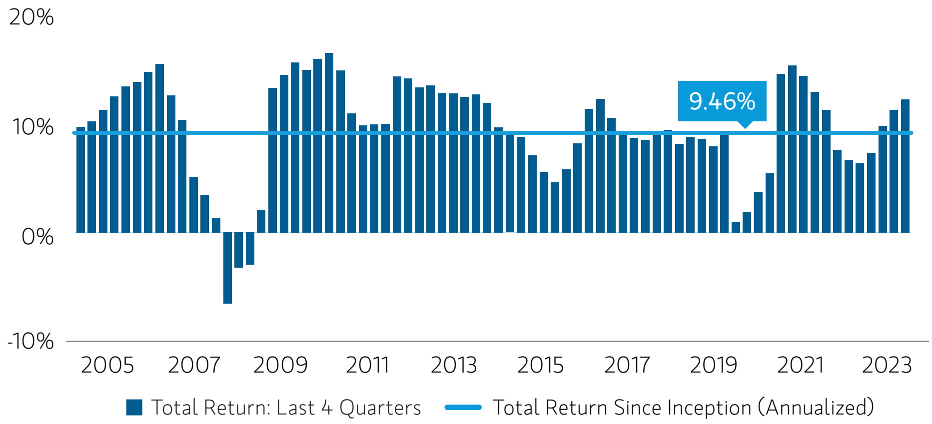
DISPLAY 4

Implied illiquidity premium on European private credit loans versus liquid loans[7]



DISPLAY 5

U.S. direct lending annual total returns[8]



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

[7] The European Private Performing Credit Index ('E-PPCI') is a composite of private loans with base rates other than SOFR. Data from the E-PPCI below indicates that private credit yields have maintained a persistent and significant illiquidity premium relative to the European broadly syndicated loan ('BSL') market, with all-in yields for private credit +183bps higher than the European Leveraged Loan Index ('ELLI') in Q1-24.

[8] Cliffwater Direct Lending Index as of December 31, 2023. "Cliffwater," "Cliffwater Direct Lending Index," and "CDLI" are trademarks of Cliffwater LLC. The Cliffwater Direct Lending Indexes (the "Indexes") and all information on the performance or characteristics thereof ("Index Data") are owned exclusively by Cliffwater LLC, and are referenced herein under license. Neither Cliffwater nor any of its affiliates sponsor or endorse, or are affiliated with or otherwise connected to, Morgan Stanley, or any of its products or services. All Index Data is provided for informational purposes only, on an "as available" basis, without any warranty of any kind, whether express or implied. Cliffwater and its affiliates do not accept any liability whatsoever for any errors or omissions in the Indexes or Index Data, or arising from any use of the Indexes or Index Data, and no third party may rely on any Indexes or Index Data referenced in this report. No further distribution of Index Data is permitted without the express written consent of Cliffwater. Any reference to or use of the Index or Index Data is subject to the further notices and disclaimers set forth from time to time on Cliffwater's website at https://www.cliffwaterdirectlendingindex.com/disclosures.

KEY TERM

High Yield Bonds and Leveraged Loans

High yield bonds refer to debt securities issued by corporate borrowers that are rated BBB- (S&P) or lower that are typically purchased by pension funds, mutual funds, banks, and insurance companies.

Leveraged loans or broadly syndicated loans are loans issued by corporate borrowers that are rated BBB- (S&P) or lower that are typically purchased by a range of market participants including collateralised loan vehicles (CLOs), mutual funds, pension funds, and banks.

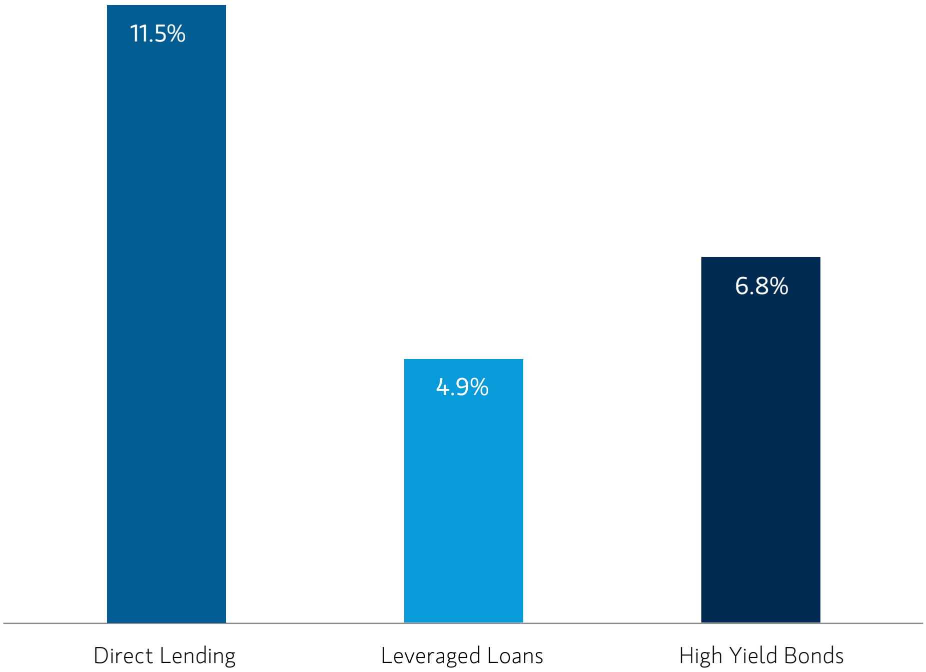
Both high yield bonds and leveraged loans are sometimes considered 'public' debt as each bond or loan is usually held by many investors with a bank intermediary to help structure the loan subject to market feedback.

This is different to the more bespoke negotiation by a private credit fund and a borrower previously described.

In rising interest rate environments, the performance of direct lending is particularly strong relative to other credit asset classes such as high yield bonds and leveraged loans. As shown below in *Display 6*, when measured over six different periods of high interest rates between the first quarter of 2009 and the second quarter of 2022, direct lending yielded 11.5% on average compared with 4.9% for leveraged loans and 6.8% for high-yield bonds.[9]

DISPLAY 6

Average returns over high interest rate environments[9]



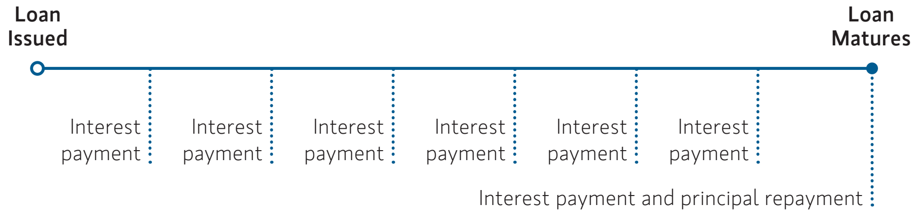
[9] Data represents the period from 1Q 2009 to 4Q 2022. The six time periods in scope (1Q 2009-2Q 2009, 4Q 2010-1Q 2011, 4Q 2012-4Q 2013, 3Q 2016-4Q 2016, 3Q 2020-1Q 2021 and 3Q 2021-4Q 2022) were identified as periods when rates increased by 75bps+. "Direct Lending" is represented by the Cliffwater Direct Lending Index (CDLI) and is calculated from quarterly data, which has been annualised. "Leveraged Loans" is represented by the Morningstar LSTA U.S. Leveraged Loan Index calculated from annualised monthly data. "High Yield Bonds" is represented by the ICE BofA High Yield Index calculated from annualised monthly data.

2 High cash yields

Private credit investors typically receive ongoing income from interest payments and fees on the loans. Borrowers pay upfront fees on private credit facilities and interest on their debt on a monthly, quarterly, or annual basis, which potentially generates high cash yields for investors.

DISPLAY 7

Regular loan interest payments facilitate ongoing cash yields for investors



3 Inflation hedge

As the diagram below shows, income on private credit loans is generated from three elements: The base interest rate set by the central bank (such as EURIBOR in the EU and SONIA in the UK); the spread (or additional interest rate) above the base rate; and arrangement fees traditionally paid at the start of the loan. Private credit loans are generally ‘floating rate’ loans (i.e., fluctuating with central bank base rates), providing an inherent hedge against inflation. This means that when central banks raise base rates to combat inflation, the relative yield of floating-rate debt rises whereas fixed rate debt remains anchored to a lower base rate.

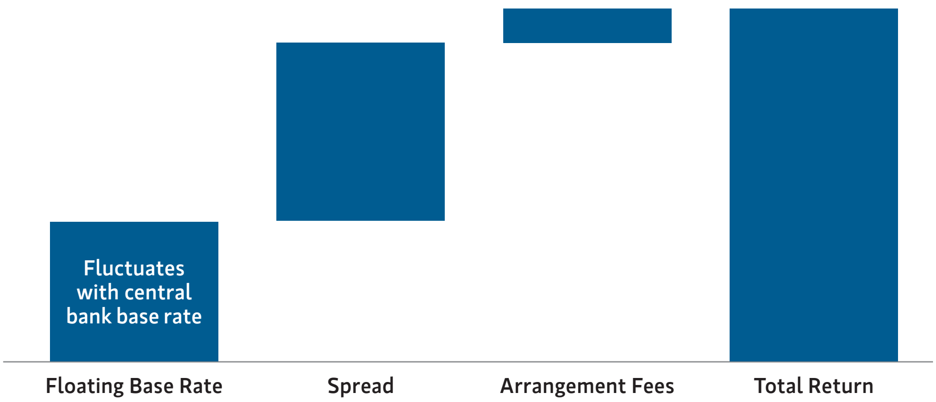
KEY TERM

Floating Rate Loan

The interest payable on **floating rate loans** is linked to a central bank base rate that fluctuates over time. By contrast, the interest rate on fixed rate loans is set on a fixed base rate.

DISPLAY 8

Illustrative breakdown of private credit loan returns



4 Exposure to high-quality companies

Direct lending strategies typically focus on highly cash generative companies that operate in non-cyclical sectors such as software, technology, healthcare, education, and financial services.[10] Direct lenders typically also target businesses with the following characteristics:

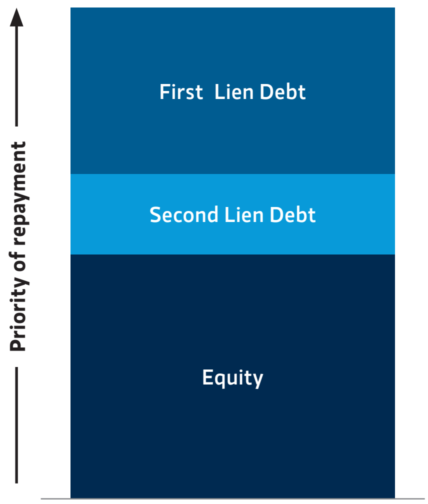
- Strong management teams
- Defensible, leading market positions
- Niche strategy or other barriers to entry
- Low technology or market risks
- Diversified products, customer and suppliers
- Stable cash flows
- Low capital expenditure requirements

5 Senior lending position enhances capital preservation

Direct lenders generally issue debt facilities that are 'senior' in the capital structure, meaning they are among the first to be repaid if a company defaults or becomes insolvent. This means that direct lenders are potentially more likely to recover their investment in the event of default.

In addition to investing in senior debt, direct lenders typically prioritise investments with strong equity cushions – i.e., those where the equity investors have heavily invested and are hence incentivised to expand the business and remedy any trading issues.

DISPLAY 9
Illustrative financing structure for a middle-market corporate



6 Legal protections

Direct loans usually have conditions (called 'covenants') that require the company to keep debt within certain limits and report performance and operational information regularly to the lender. These conditions are usually stricter than for leverage loans and high yield bonds.

[10] Proskauer 2022 Private Credit Insights Report. c.70% of European private credit exposure is linked to non-cyclical industries. Internal MSPC calculation.

7 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.[11]

Moreover, research indicates that incorporating private credit into a portfolio has historically meant both higher returns and lower standard deviation compared to a standard 60/40 equity/fixed income portfolio.[12]

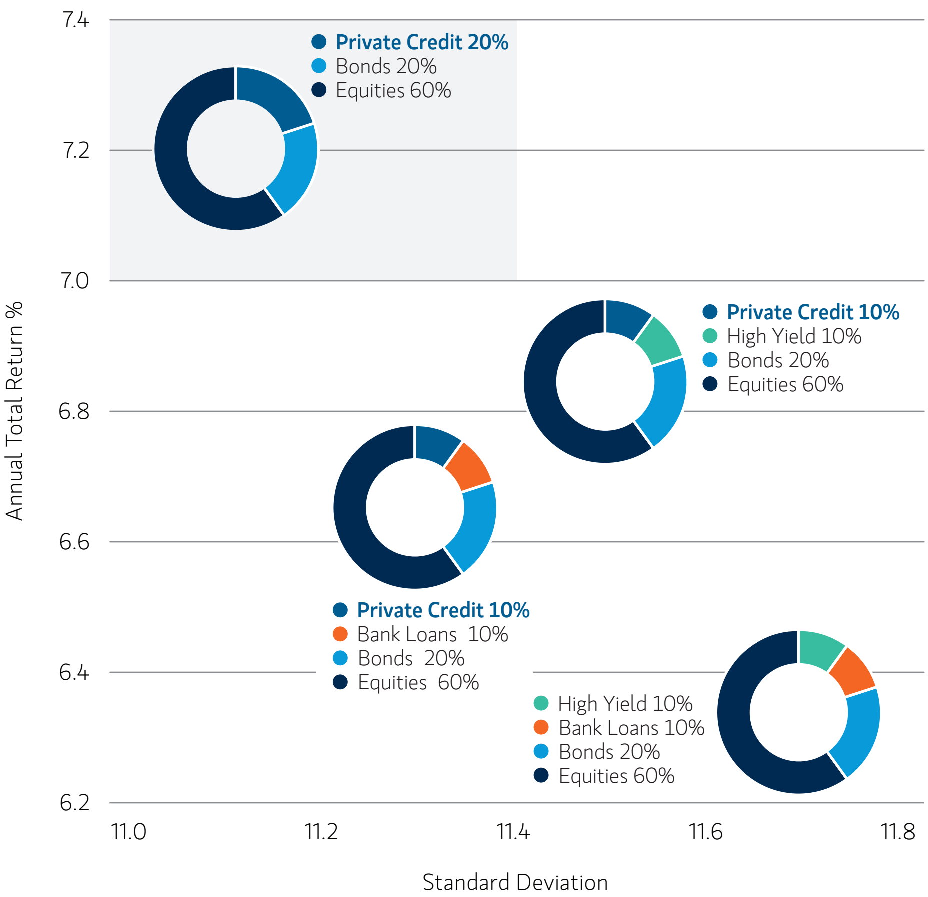
KEY TERM

Senior Debt and Covenant

Seniority is the order in which investors are repaid if a borrower becomes insolvent. **Senior debt** is the highest-ranking type of debt in a loan structure and senior lenders have first claim on the borrower's assets in the event of a default. Senior debt is typically issued by banks or direct lenders.

Covenants are conditions that borrowers must comply with, which serve as contractual protections for lenders. Covenants can include keeping debt below certain limits, abiding by laws and regulations, and reporting information to lenders.

Illustrative breakdown of private credit loan returns



Source: All returns data is for September 2005 to September 2024 inclusive. Annual returns figures are computed as the average of annual returns for the aforementioned period, measured on a quarterly basis in March, June, September, and December. Volatility is calculated as the standard deviation of the annual returns figures for the aforementioned time period. Annual returns and volatility for each portfolio is calculated as an asset weighted average of each respective metric. Past performance is no guarantee of future results. Portfolio compositions, returns, and volatility shown above are hypothetical only and do not represent the performance of any actual underlying portfolios managed by Morgan Stanley, which may not be able to replicate these returns. Private credit data: Cliffwater Direct Lending Index. Data provided with permission of Cliffwater. please see disclosures for further details. High yield data: Bloomberg High Yield Index. Bond data: Bloomberg Aggregate Bond Index. Bank loan data: Morningstar US Leverage Loan Index. Equities data: MSCI World Index.

[11] Preqin, Global Report 2023, Private Debt. Diversification does not eliminate the risk of loss.

[12] Source: Calamos Report, 'Pursuing an Expanded Efficient Frontier with Private Credit' (June 21, 2023). Underlying data: Aksia, Morningstar Direct and Preqin Ltd, 1/1/2004-9/30/22. Equities represented by the MSCI World Index. Bonds represented by the Bloomberg US Aggregate Bond Index. Bank loans represented by the Credit Suisse Leveraged Loan Index. High yield represented by the Bloomberg US High Yield 2% Issuer Cap Index. Private credit asset class return data is comprised of time weighted returns of deals within the Aksia research database. A minimum of six data points for each period and segment is required. The total number of accounts in the Aksia research database is greater than 650. Past performance is no guarantee of future results.

Advantages of Private Credit for Borrowers

Some borrowers increasingly see benefit in using private credit financing versus more traditional bank financing. In many cases, private credit provides a valuable alternative for companies seeking financing, particularly if they are contemplating large and/or complex transactions that require more bespoke and creative debt arrangements.

DISPLAY 10

Why Borrowers Choose Private Credit Solutions

1. Confidentiality around financing details and M&A activity
2. Greater certainty that funding deadlines will be met
3. Private debt lenders typically have a longer-term focus than public debt lenders, creating a better partnership dynamic
4. Generally larger debt capacity for middle-market companies than banks
5. Creative and/or flexible debt structuring required beyond banks' appetite
6. More nimble underwriting process and ability to work at speed in tandem with private equity processes

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