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LOUAY MIKDASHI
Head of Multi-Sector Private Credit

JONATHAN SHAHRABANI
Chief Operating Officer, Global Research Strategies
Senior Research Analyst, Financials

Navigating Private Credit's Next Act

Private credit has been one of the most dynamic and fastest growing asset classes over the last 15 years. While we expect growth will continue in the core direct-lending sector, we also anticipate that private credit will broaden to other non-corporate lending arenas, including asset-based lending and a variety of specialized sectors.

We believe this next act will require a more flexible and specialized allocation approach to capitalize on attractive opportunities across the rapidly evolving lending landscape. In this paper, we explore key structural trends supporting private credit, the rich opportunity set within this asset class and its deepening role within the broader financial system.

Structural Trends Supporting Private Credit

The private credit market continues to grow at a rapid rate: Total capital (invested and available for deployment) across corporate direct-lending sectors grew at a roughly 17.5% CAGR over the six years through the start of 2024.[1] We believe further expansion will be driven by three key structural trends shaping the opportunity for both corporate and non-corporate credit: the retrenchment of banks, governments and capital markets.

Retrenchment of Banks

The banking scare of 2023 may be in the rear view, but bank deposit growth still remains slow, as shown in figure 1. In the absence of robust deposit growth, banks inherently face greater challenges in extending credit, thereby creating expanded opportunities for private credit providers to step in.

FIGURE 1: BANK DEPOSIT GROWTH REMAINS SLUGGISH

Source: Federal Reserve; data as of December 25, 2024, for Large Domestic Banks NSA.

While we acknowledge that a watering down or elimination of Basel 3 Endgame (see Basel III Endgame and the "Reg Cap" Opportunity) or a potential softening of the regulatory regime by the Trump administration are tailwinds for banks, we believe neither are likely to alter private credit's positive long-term growth trajectory.

Retrenchment of Governments

Faced with escalating debt and budget deficits, global governments are under increasing pressure to exercise fiscal discipline, even as capital demands continue to rise. Achieving ambitious goals such as net-zero emissions, digitization and re-shoring involves multitrillion-dollar capital requirements. We believe these initiatives will necessitate substantial private capital participation to meet the immense financial demands.

Retrenchment of Capital Markets

In the U.S., the number of publicly listed stocks has been declining for more than two decades. We believe this trend indicates a shift in how businesses secure funding, as private markets are increasingly viewed as another option to consider, providing the potential for bespoke solutions and alignment with specific growth objectives.[2]

[1] Preqin, Goldman Sachs Global Investment Research, as of December 31, 2023.
[2] JPMorgan and World Bank.

A Rich, Sizable and Evolving Opportunity Set

Modern private credit markets have many incarnations, including both traditional corporate lending and, increasingly, non-corporate and asset-based transactions, where estimates of the total addressable market suggest it could be upward of $20 trillion (depending on whether investment grade, residential and commercial debt are included in the definition).[3]

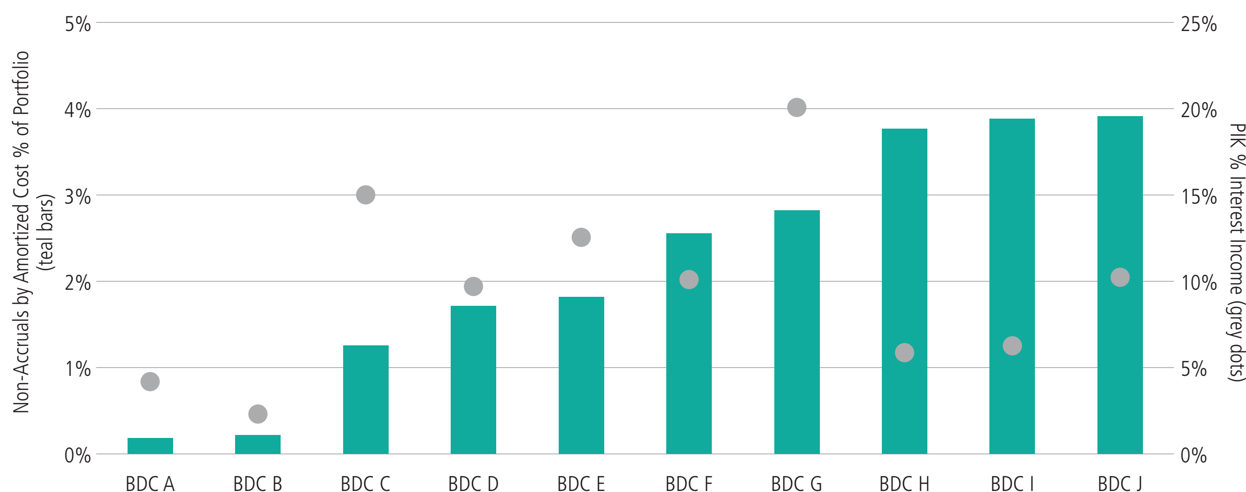
Here is a snapshot of the current, rapidly evolving opportunity set:

Corporate / Direct Lending

We believe private direct lending could provide a meaningful spread over public market equivalents over a multiyear period, and from a risk-return standpoint, we believe direct lending (senior and junior) should remain a core allocation in any investor's portfolio. At the same time, we anticipate a significant widening in investment manager return dispersion as corporate balance sheets absorb the lingering effects of elevated purchase multiples from the COVID-19 era and adapt to the evolving landscape of interest rates, which, despite recent declines, have posed challenges due to their upward trajectory over the past two years.

As shown in figure 2, dispersion in non-accruals[4] has increased, along with the use of Payment-in-Kind (PIK) arrangements, where interest or dividends are paid in additional principal rather than in cash—a mechanism that can be indicative of a borrower's financial strain.

FIGURE 2: HIGH DISPERSION IN CREDIT QUALITY AMONG BUSINESS DEVELOPMENT COMPANIES



Source: KBW & Raymond James Research; data as of September 30, 2024 for top 10 BDCs by market cap as of December 31, 2024.

Given increased dispersion, we believe that manager selection will play an even more critical role in coming years, and allocators should diligently select managers with proven underwriting expertise and a sustainable edge in origination, increasingly crucial in a competitive and dynamic market.

Commercial Real Estate

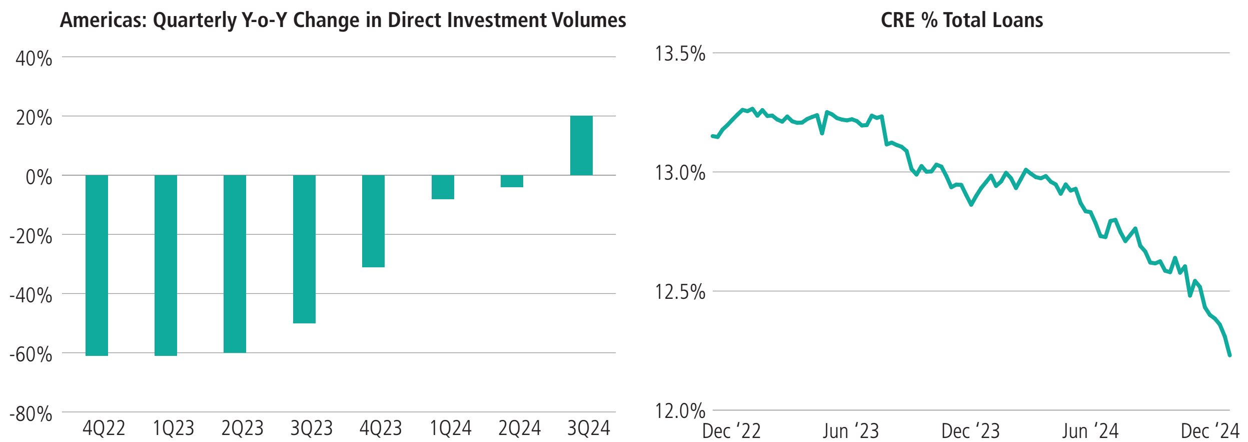
Historically, commercial real estate (CRE) has been one of the most significant areas of lending for banks. However, a series of challenges, including the impact of the Covid-19 pandemic, increasing interest rates and other pressures, have prompted many traditional lenders to reassess their strategies over the past few years.

Even though real estate fundamentals appear to have bottomed out and direct investment has picked up in recent quarters, banks have continued to reduce their direct exposure to CRE (see both sides of figure 3).

[3] S&P Global, "The Opportunity of Asset-Based Draws in Private Credit," November 20, 2024.

[4] A loan is classified as "non-accrual" when interest income is not recognized because repayment efforts have ceased. This can occur if the loan is past due by 90 days or more, or when there is reasonable doubt about the collection of principal or interest.

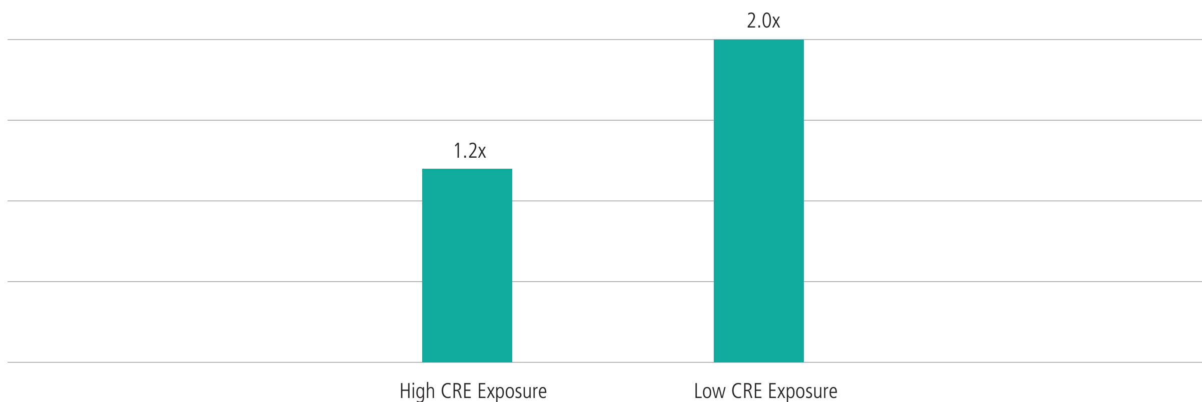
FIGURE 3: BANKS STAY ON THE SIDELINES AMID COMMERCIAL REAL ESTATE RECOVERY



Source: JLL, "Growth in Transactional Activity More Evident in Q3", November 2024, and Federal Reserve, data as of December 25, 2024, for Large Domestic Banks NSA.

We believe banks continue to take such protective measures in part to appeal to public-market investors who may still be concerned about the underlying health of the CRE market. Indeed, our analysis of the top 100 banks by market cap reveals that those with the highest CRE exposure are assigned lower price to tangible book value (P/TBV) multiples compared to their peers with lower exposure (see figure 4).

FIGURE 4: COMMERCIAL REAL ESTATE EXPOSURE WEIGHS ON BANK PRICE/TANGIBLE BV MULTIPLES

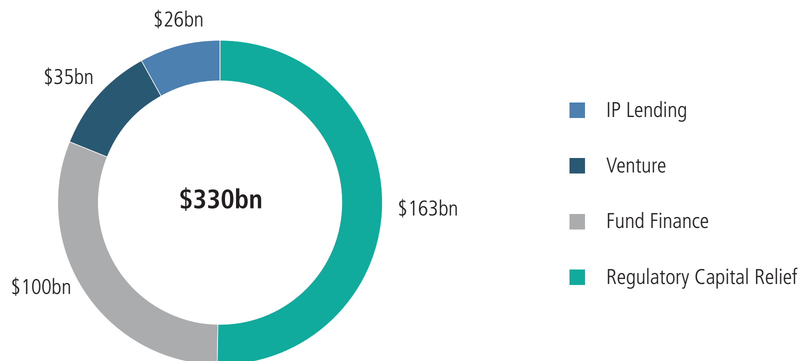


Source: FactSet and KBW Research for CRE/Total RBC %. Note: "High CRE Exposure" and "Low CRE Exposure" categorize banks into the highest and lowest quintiles by CRE/Total RBC % based on regulatory data as of September 30, 2024. Analysis includes the top 100 banks by market cap as of December 31, 2024, excluding GS, MS, STT, BK and NTRS.

In our view, this valuation disparity highlights a market preference for banks with reduced CRE risk, encouraging management teams to pivot away from heavy CRE involvement. We believe private credit suppliers, many of whom are already active in CRE, may find the evolving landscape offers additional lending opportunities and a potentially more favorable competitive environment.

Other Specialized Lending Sectors
In addition to corporate direct lending and real estate, private credit opportunities now span an array of specialized sectors that, while offering potentially attractive risk-return profiles at various points during an investment cycle, can often lie beyond the reach of banks. These sectors include Intellectual Property/royalty financing, NAV lending, venture lending and regulatory capital relief trades—a collective addressable market equal to roughly $330 billion (see figure 5).

FIGURE 5: AN ARRAY OF SPECIALIZED LENDING SECTORS NOW PRESENT A SIZABLE OPPORTUNITY



Source: Bloomberg, Fitch, NCVA, Verified Market Research. Total figures are based on Neuberger Berman estimates.

We believe navigating these sectors demands deep expertise and a nuanced understanding of the underlying assets and their unique risk profiles. Additionally, this type of lending often comes with a high capital charge for banks, making it particularly suited for private market players, in our view. Furthermore, as borrowers increasingly accept and turn to private markets for their financing needs, we believe these sectors will continue to grow and attract talent away from traditional banks.

Rethinking Credit Creation: How Banks and Private Credit Can Work Together

In response to evolving market dynamics, banks have been seeking new ways to adapt their origination models and optimize their balance sheets. One approach has been to establish partnerships with non-bank participants.

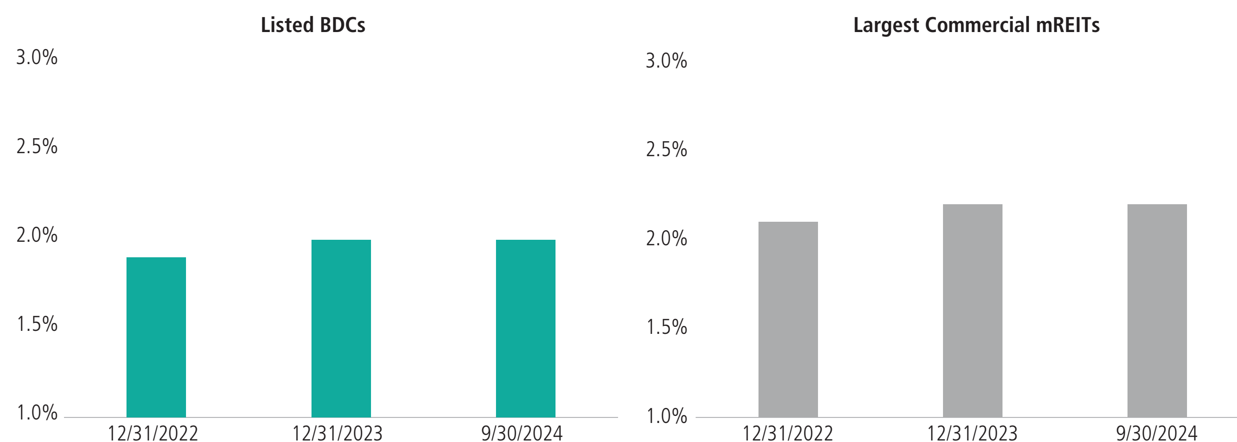
Joint Ventures (JVs)
JVs can create mutually beneficial arrangements for banks and private market players, although there is no guarantee of success. These partnerships allow banks to maintain borrower relationships and generate steady fee income, which is generally viewed favorably by equity investors due to its stability compared to net interest income or trading revenue, which can be more volatile. These arrangements can also prove advantageous for banks when loans deviate from traditional credit parameters or pose concentration risks. As for private credit managers, JVs can be a source of additional deal flow.

The long-term outcomes of these partnerships are still evolving. In the meantime, we believe that limited partners (LPs) and public shareholders should carefully examine their structures and seek to confirm that the incentives and institutional cultures of both sides are well aligned.

Lending to Private Lenders
Banks play an essential role in providing financing to private market players, who generally tend to be some of their largest clients. These financing arrangements are typically cross-collateralized by a broader pool of diversified assets, historically resulting in minimal losses.

From a bank's perspective, this type of lending can be seen as more efficient by offering better capital treatment compared to making direct loans. Evidence of this is demonstrated by the spreads on primary secured financing agreements that banks offer to private market counterparts, which have remained remarkably stable over the past three years, even amidst the banking challenges of 2023 (see Figure 6). It is our understanding that, in some cases, banks are offering even more competitive terms as 2025 gets underway.

FIGURE 6: STABLE SPREADS ON PRIMARY BANK-SECURED FINANCING TO PRIVATE MARKET COUNTERPARTS



Source: Company filings; average of the three largest externally managed BDCs and average of the largest three listed externally managed diversified commercial mREITs by market cap as of December 31, 2024, based on company filings as of September 30, 2024.

Expanding the Allocator Toolbox

Given the rapid evolution of private credit, we believe LPs will require a more flexible and specialized allocation approach to capitalize on the next stage of its expansion.

While some allocators may still favor a single-sector, single-asset approach, the sheer diversity of the non-corporate and asset-based lending universe is such that a more opportunistic, multi-sector model has the potential to yield attractive results, in our view. Indeed, many lending sectors exhibit very different risk-return characteristics depending on prevailing market conditions.

For example, we find NAV lending quite compelling today given limited liquidity options for some sponsors' underlying portfolio companies as well as for their LPs; on the other hand, when liquidity is ample (typically mid-cycle), we would expect the relative value for NAV lending to be less attractive.

Likewise, other sectors like significant risk transfers (SRTs, discussed in our previous paper), have seen significant spread compression over the last 12 months. While we believe there is still some selective value in this sector today, we do not expect the relative value to be constant throughout the market cycle.

As such, we believe a flexible approach that allows investors to pivot to the most compelling opportunities can allow improved efficiency and potentially deliver compelling risk-adjusted returns with reduced correlation to traditional corporate spread risk.

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New York, NY 10104-0001

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