

Direct Lending shows vigorous growth

An attractive alternative to investments in the public capital market?

IN A NUTSHELL



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- Private Credit market has shown strong growth in recent years, with Direct Lending being the main driver of this development.
- In the U.S., Direct Lending is already much more diversified and established, but Europe is following closely.
- For investors, this segment can offer the opportunity for solid performance and sometimes even outperformance compared to other investment forms.

Direct Lending as an important component of the private credit market

Direct Lending has become an increasingly important component of global credit markets, especially in Europe, in recent years. In our view, the current market environment suggests that this trend is likely to continue in the coming months and years, particularly if economic recovery takes place, as expected. Attractive relative and absolute value continues to generate high demand and should support the success of private credit against the public capital market and help it secure an increasingly significant market share.

1 / The success story gains momentum

1.1 What is it all about?

Direct Lending, by our definition, refers to privately negotiated loans or credits provided by lenders outside the banking sector to privately owned companies. In most cases these lenders focus on medium-sized businesses seeking customized financing solutions. These lenders may not have sufficient size to access public credit markets or require levered structures or customization that are not available from bank lenders in today's regulatory environment. This type of lending differs significantly from traditional sources of debt capital for corporate borrowers, such as bank loans and widely syndicated loans. Similar to syndicated leveraged loans (but unlike most high-yield bonds), they are floating rate, reducing interest rate risk for investors and providing protection in an inflationary environment. The returns offered by these loans are typically markedly higher than those available in the public markets. This additional return is principally attributed to "illiquidity premium," that is the lack of a liquid secondary market for investors to access should they wish to exit early. The additional return may also be, in part, attributable to "customization or complexity premium" reflecting the bespoke nature of these financings. Valuation and thereby pricing assessments occurs at intervals and there is no daily market available.

Companies and financial sponsors are increasingly seeking financing from private credit managers due to their ability to offer high execution speed, flexibility, and transaction security — qualities that traditional banks often cannot match, especially during

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challenging market phases. They also like the privacy and homogeneity of a single private lending arrangement which removes the burden and cost of public issuance.

As traditional banks have withdrawn from lending and simultaneously tightened their lending standards, private credit managers have filled the demand gap. Large-volume loans are also playing an increasing role, shifting from banks and the public market to the “private” domain. We believe that the market environment will remain attractive for Direct Lending. For investors, the segment continues to offer high cash income-based yield, risk protection from a senior secured position in the capital structure, diversification benefits, and access to private companies that is not readily available to the same extent in public credit markets.

With ELTIF private investors in the EU can invest “like the big players”

For many years investments in private debt were open only to institutional investors, primarily due to the substantial investment minimums required for such engagements. To make this asset class accessible to retail investors, the European Union introduced European Long-Term Investment Funds (ELTIFs) in 2015. Through this vehicle, investors with smaller volumes now have the opportunity to invest in corporate debt, infrastructure and other long-term assets that are offered outside public markets. An important step in this direction was the revised ELTIF regulation that came into effect earlier this year. According to Germany’s Federal Financial Supervisory Authority (BaFin), this regulation aims to “facilitate capital management companies in offering long-term investment opportunities to investors.” It introduced enhancements for both private investors and distribution channels.¹

However, Scope, a European credit ratings agency, suggests that the wait for revised ELTIF regulation (also referred to as ELTIF 2.0) may have contributed to less favorable investment performance in 2023. Scope characterizes the development as “solid but not overwhelming.”² In its overview of the ELTIF market for 2023/2024, the rating agency notes that market growth was lower than in the previous year. The aggregated volume of these funds stood at €13.6 billion by the end of 2023, a 24% increase compared to the end of 2022. But in 2022 the volume had grown by 50%.²

The introduction of ELTIF 2.0 now allows virtually all retail investors to acquire shares in ELTIFs without the previous legal access restrictions. Under the old regulations, retail investors with a total investment portfolio of less than €500,000 could invest a maximum of 10% of their portfolio volume in ELTIFs, with a minimum investment of €10,000. The new legal framework removes these limitations.

Scope remains cautiously optimistic about the future of ELTIFs. The agency states that “strong demand will emerge when it becomes evident that ELTIFs can achieve high returns broadly or have a very favorable risk-return profile.” However, this will take years to develop; widespread investor participation will likely follow. Initially, we expect ELTIFs to gain traction in private banking and semi-institutional sectors before making an impact among high-net-worth individuals and even in the retail segment.

1.2 Current status of Direct Lending

Direct Lending stands out as the private credit segment with the most significant growth. Examining the years from 2016 to 2022, data from Preqin reveals that managed assets (Assets Under Management, AUM) in this area experienced average annual growth of approximately 28% globally. By contrast, private credit as a whole saw a more modest increase of 17.5%. The contrasts in the rate of growth are similar for the United States (28% versus 17%) and Europe (25% versus just under 16%). Direct

¹ New rules for ELTIF, Federal Financial Supervisory Authority as of 5/13/24

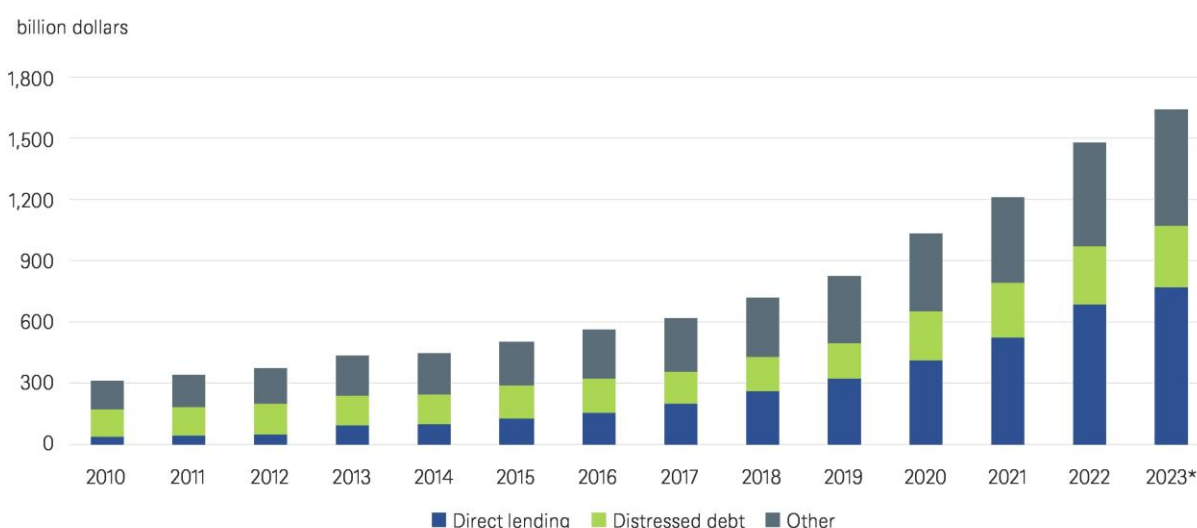
² A new era, Scope as of 5/7/24

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Lending has solidified its relevance within the private credit universe and is also emerging as increasing competition for public market segments.³

A survey conducted by Prequin, which provides data on the alternative assets market, at the end of last year also found that investors clearly favor Direct Lending within private debt strategies. A significant 67% view Direct Lending as offering the best opportunities in the private credit segment. Year after year Direct Lending is gaining in popularity, and the survey results reflect the high expectations for this segment. The second most popular strategy, distressed debt, has also seen noticeable growth in popularity since 2021, even though the observed growth in assets under management does not fully reflect this positive trend.⁴ In this sub-segment our assessment suggests that renewed investor optimism, driven by the economic outlook, is a key factor behind the positive sentiment.

Direct Lending accounts for a steadily increasing share in the global private credit universe (Assets Under Management)



Sources: Prequin, DWS Investment GmbH as of 7/25/24

*forecast // Forecasts are based on assumptions, estimates, opinions and hypothetical models that may prove to be incorrect.

The past three years have demonstrated that the Direct Lending segment continues to grow solidly, even though growth has been significantly stronger on the American side of the Atlantic. In 2023 persistently high interest rates did not deter private credit. In fact, these elevated rates led to attractive yields for investors, compensating for the slight increase in loan defaults. In the United States the growth in AUM in Direct Lending followed seamlessly from the strong years of 2021 and 2022. Meanwhile, Europe experienced even more substantial growth compared to those two years. Notably, the market demonstrated resilience in the face of significant challenges, including rising financing costs and tighter monetary policies. Direct Lending saw robust demand and high activity levels.⁵

The current fundamental environment supports continued growth in Direct Lending. This growth is driven by an improving economic outlook combined with sustained investor interest in high-yield alternatives within the private credit space. As central banks worldwide are expected to ease their monetary policies, business activity in this sector should further expand, creating new investment opportunities. Historically, Direct Lending has shown resilience at times of high inflation and geopolitical tension. Providers of Direct Lending have adapted, offering flexible financing solutions and robust risk management practices.

³ Prequin Global Report Private Debt 2024, Prequin as of 7/25/24

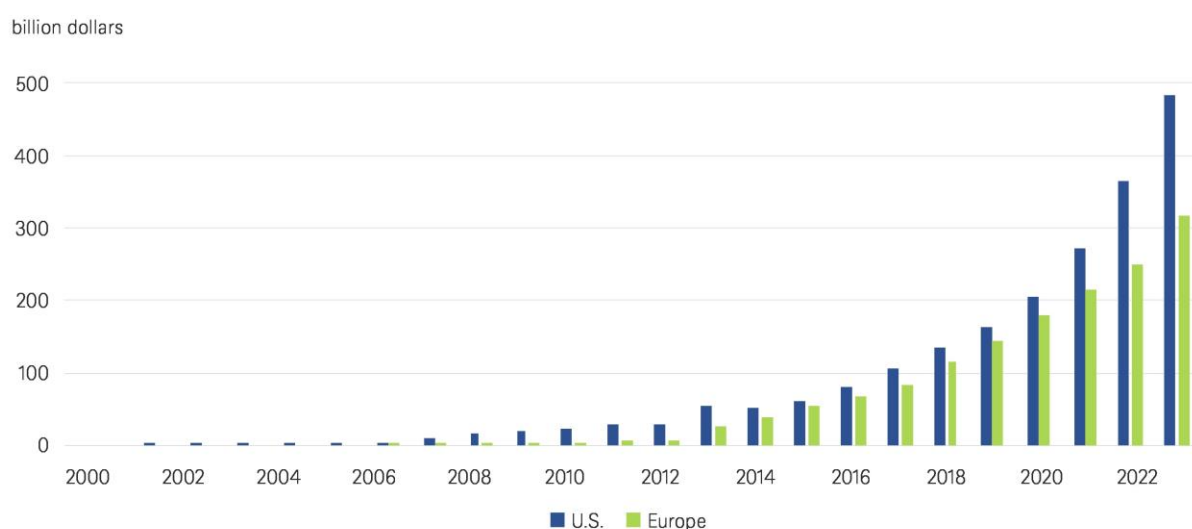
⁴ Prequin Global Report Private Debt 2024, Prequin as of 7/25/24

⁵ Prequin Global Report Private Debt 2024, Prequin as of 7/25/24

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However, a closer look at the raw numbers reveals that the start of 2024 was not without challenges—particularly in completed transactions. According to Debtwire data, the volume of Direct Lending transactions in Europe during the first quarter of 2024 amounted to €13.7 billion, spread across 208 deals. This represents a decline from €15.2 billion compared to 164 transactions in the same period the previous year. Despite a 16% increase in transaction volume, the annual decline of approximately 10% underscores the subdued interest in large leveraged acquisitions within the mergers and acquisitions (M&A) market.⁶

Assets Under Management: In Direct Lending, the U.S. still maintains a significant lead



Sources: Preqin, DWS Investment GmbH as of 7/25/24

1.3 Distinguishing Direct Lending from broader public markets

It's not only the potential for attractive returns that make the Direct Lending market increasingly interesting for investors. In an environment of rising interest rates, the variable interest rates of these credit products may help investors to mitigate inflation risk, with safeguards that are not present in the market for broadly syndicated loans. Additionally, there are several other structural features that set it apart positively from its more liquid alternatives.

In private transactions the degree of standardization is lower by nature. This applies to contractual arrangements as well as the examination and due diligence of individual loans. Regarding contracts, it can be said that in private markets we believe greater importance is placed on investor protection than in public markets. Similarly, credit assessments typically are more thorough.

Furthermore, the Direct Lending segment is typically valued quarterly using accounting methodologies (and not on a daily mark to market basis) leading to fewer market fluctuations. This can lessen the nervousness arising from massive daily fluctuations. However, one could also argue that these aspects significantly limit investors' ability to act, which could be considered a negative.

Direct Lending market loans have historically had a higher prevalence of lender protections and are also typically first ranking senior secured. They therefore have embedded features which allow lenders to act quicker and recover more in the event of individual borrowers suffering distress.

⁶ 1Q24 European Direct Lender Rankings, ION Analytics as of 5/2/24

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In general, it can be observed that since the Direct Lending market in Europe is building a successful track record as an attractive alternative to liquid public markets, we are seeing that there is a rising trend in the quality of borrowers who opt for financing solutions through the private market.

Large-volume transactions pose new challenges for direct lenders

Another trend that, in our opinion, reflects the success of this segment quite well is the significantly increased volumes of individual transactions. The average volume of a Direct Lending transaction in Europe has grown considerably in recent years. In the first quarter of 2020 the average size was 90 million euros, but by the second quarter of 2022, it had almost increased tenfold to 861 million euros.⁷ This growth reflects the breadth of the Direct Lending market and demonstrates that direct lenders are willing to provide substantial financing and compete directly with the syndicated leveraged finance sector.

In the United States the Direct Lending market has also experienced growth in transaction sizes. In 2023 the average transaction size for deals reached \$4.2 billion, compared to \$3.8 billion in 2022 and \$2.5 billion in 2021. This is twice the average deal size in the 10 years leading up to 2022, highlighting the growing importance of the Direct Lending market in the U.S. financial landscape.⁸

Consequently, direct lenders in this large transaction segment of the market are no longer just competing against other lenders; they are increasingly competing against the market's range of options. When it comes to deals of this size, borrowers often find themselves choosing between using public markets through broad syndication, raising funds via private markets from a single lender, or even opting for so-called club deals. In "club deals," multiple lenders collaborate to handle larger transactions. In some cases, this choice may lead lenders to accept less favorable terms to secure a deal. We see some evidence that pricing in the large transaction segment of the private market may converge with those in the public market reducing the illiquidity premium on offer. In addition, the maximum debt ratios or other strict financial metrics that must be adhered to as covenants in Direct Lending tend to be higher or rather more relaxed for larger transactions, evolving toward the typical ratios seen in the public syndicated market.

1.4 Performance

Investments in Direct Lending have yielded solid returns in recent years, outperforming comparable assets in the so-called public market.

But first, let's start with a brief definition of the nature of the returns in Direct Lending. They consist of several components. The foundation is a variable short-term market interest rate equivalent to a money market rate such as Euribor or the Secured Overnight Lending Rate (SOFR). The credit spread serves as compensation for the risk taken. Additionally, there is a commitment fee that covers the costs associated with structuring the loan. Furthermore, an illiquidity premium can also be considered, as exiting the loan agreement before maturity is not possible, unlike common bank loans or publicly traded syndicated loans (which have a daily market price). Notably, the variable interest rate has increased significantly in recent years due to substantial global interest rate hikes, enhancing the attractiveness of the Direct Lending segment. This type of interest rate also provides good protection against heightened inflation.

The substantial rise in global interest rates over the past two years has drawn attention to Fixed Income, particularly its credit segment. Within Private Credit, demand for Direct Lending has been strong, primarily due to the variable interest rate, relatively low volatility, and a solid track record of attractive risk-adjusted returns. By allocating less to traditional assets such as stocks and bonds, portfolio returns could potentially be increased without significantly compromising the portfolio's risk profile.

⁷ European Direct Lending Booms As Other Markets Dislocate, Arcmont as of 8/31/22

⁸ LBO report: Sponsor equity contributions top 50%, yields soar as deal financing costs remain high, Pitchbook as of 2/1/24

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The Cliffwater Direct Lending Index (CDLI) is generally considered one of the most important barometers for Direct Lending performance. Its development in past years gives a good impression of the segment's attractiveness for investors. In the first quarter of this year, the CDLI achieved a total return of 3.02%, and a trailing four-quarter return of 12.49%. Over a five-year period, the trailing total return was 9.14%, and looking at the past ten years, it stands at 8.85%. Since its inception on September 30, 2004, the CDLI has achieved an annualized return of 9.50%.⁹

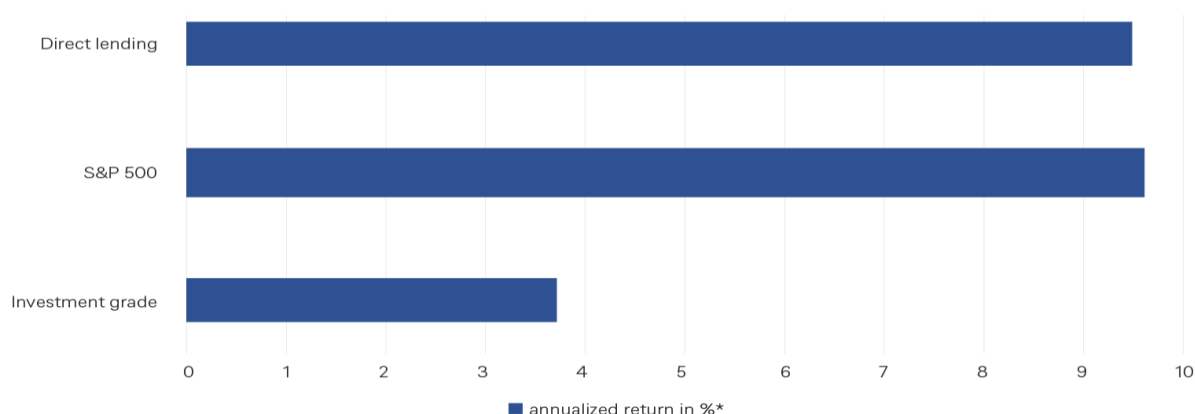
The three-year takeout yield (which is the expected annual return on investment until it is taken out or replaced with longer-term financing, typically in three years) on the index decreased slightly from 12.29% to 12.20% in the fourth quarter of 2023, primarily due to a minor narrowing of spreads. Since that time, it has remained at this level. For comparison, the yield-to-maturity on the Morningstar LSTA US Leveraged Loan 100 Index also decreased slightly from 9.68% to 9.63%, while the Bloomberg High Yield Bond Index saw a slight increase from 8.50% to 8.88%.

Robust historical performance

In historical analysis, Direct Lending (CDLI) has yielded average annual returns of approximately 9.4% from 2005 to 2023, comparable to those of stocks – investing in the S&P 500 Index would have yielded a marginally higher return of 9.6% over the same period.⁹ Compared with fixed-income securities however, the performance gap is far more pronounced: Their average annual return from 2005 to 2023 was just 3.7%. However, it should not be concluded that the increased return potential of Direct Lending is automatically associated with significantly increased risks, as the maxim 'higher risk equals higher return' might suggest. Stepstone, a global private markets firm, emphasizes that while liquidity and credit risks exist, Direct Lending experienced 'only' similar losses to investment-grade bonds during periods of financial market stress.¹⁰

Notably, in 2022, the low interest rate risk associated with Direct Lending helped shield the asset class from significant declines, which was not the case in the investment-grade universe.¹⁰ Looking ahead, we believe that Direct Lending's low interest rate risk will continue to keep the volatility of the asset class relatively low. Examining risk compensation is also interesting. As of the end of 2023, Direct Lending had a spread of approximately 450 basis points over ten-year U.S. Treasury yields. By comparison, according to Stepstone's calculations, the comparable premium for the S&P 500 was 55 basis points, and for the investment-grade sector it was around 150 basis points.¹¹

The returns achieved with Direct Lending are quite impressive (annualized total return from 2005 to 2023)



Sources: Stepstone, Bloomberg Finance L.P., DWS Investment GmbH as of 7/25/24

*from January 1, 2005 to December 31, 2023

Direct Lending: Cliffwater Direct Lending Index, IG: Bloomberg Global-Aggregate Total Return Index

⁹ Private Direct Lending Performance, Q1 2024 Update, wealthmanagement.com as of 6/25/24

¹⁰ Direct lending's attractive risk-adjusted returns, Stepstone as of 1/25/24

¹¹ Comparison of different asset classes with different risk profiles

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Given our assumption that interest rates and yields should remain higher than in the past decade, we believe that Direct Lending will continue to offer attractive risk-adjusted returns. In a scenario of sharply falling interest rates, the yield provided by traditional fixed-income securities would indeed decrease significantly. However, in Direct Lending a floor on interest rates is typically in place, helping to mitigate downside risk. Therefore, in our view, the attractiveness of Direct Lending is almost independent of the interest rate environment.

2 / European Direct Lending also on the rise

UK as a pioneer, significant differences between European countries

Over the past decade the Private Credit market in Europe has evolved from a niche financing form to a significant force in corporate finance. Direct Lending, in particular, has asserted itself and taken the lead, growing substantially. Meanwhile, the segment has also become an acknowledged asset class in Europe. The robust growth is primarily driven by traditional banks' retreat from certain credit activities, creating an expanding field of opportunity for Direct Lending. In consequence, lenders sometimes collaborate to finance large transactions, typically exceeding one billion euros. This approach has become increasingly common as borrowers seek alternatives to syndicated loans and bonds. In Europe, Direct Lending continues to offer attractive returns that often outperformed syndicated loans. Despite high interest rates, the yields remain resilient, enhancing the appeal from an investor's perspective.

However, the market segment is not only growing in size but also expanding geographically. For a long time, the UK held the top position in Direct Lending in Europe, supported by an established legal framework and the still earlier withdrawal of banks from the credit business compared to other European markets. In recent years other countries have rapidly caught up and developed their own ecosystems for Direct Lending. Countries like France and Germany have seen significant growth, while the Benelux and Nordic countries, as well as Southern Europe, have increased their share of the overall volume. Each European country has its own market dynamics, regulatory and political conditions, and business cultures.¹²

In France the growth trajectory of Direct Lending has followed a similar path to that of the United Kingdom, albeit with some delay. The Netherlands, once a market dominated by banks, has now become one of the fastest-growing Direct Lending markets in Europe. Private Credit is firmly established as a credible alternative in these countries, and we believe the groundwork has been laid for further gains in market share in coming years. In contrast, in Germany banks continue to defend their relatively high market share, partly due to the historical significance of numerous regional banks in corporate finance. However, credit allocation is gradually shifting toward Private Credit. Unlike the British market, where straightforward structures prevail, German borrowers often have specific needs that are met with tailor-made financing packages.

3 / Conclusion & Outlook

Direct Lending has found its role in the private credit sector and is likely to expand it further in coming years. The demand from companies that cannot or do not want to finance themselves in the public market and prefer not to rely on bank credit is growing steadily. The increasing level of individual Direct Lending transactions also speaks volumes. For investors, the segment has established itself as an attractive asset class, which has demonstrated risk adjusted outperformance, especially compared to fixed income.

¹² Five key success factors in the European direct lending market, Partners Group as of February 2022

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In our estimation the Direct Lending market will continue to grow and increasingly attract larger companies. Based on its own forecast models, Prequin expects rapid growth in Private Credit, which could increase global assets under management from 2022 to 2028 at an annual rate of 11%, reaching an all-time high of 2.8 trillion U.S. dollars – nearly double the volume of 1.5 trillion U.S. dollars in 2022.¹³ Direct Lending is likely to play a significant role in this.

In coming years, we see the European Direct Lending segment getting closer to its U.S. counterpart, although we believe this process will be rather slow. It will likely take years for the European market to reach the depth and breadth already available to investors in the U.S. On the other hand, yield premiums in the U.S. and Europe seem already to have become quite similar. The European market is continuously evolving in terms of its Direct Lending structures and is increasingly converging with the conditions in the U.S.

While the U.S. market seems to already have created a homogeneous regulatory environment, European Direct Lending still offers greater dynamism in, for example, pricing structures or frameworks, which can also provide advantages for investors. Much will depend on how strongly banks cling to their remaining role in the credit market and how aggressively Direct Lending providers fight to increase their share. A recovering economy should contribute to rising demand for loans as the willingness to invest grows.

¹³ Direct lending set to spur private debt AUM to \$2.8tn by 2028, Prequin as of 10/17/23

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Glossary

Assets under management (AUM), also called funds under management, is the total market value of the securities a financial institution (such as a bank, mutual fund, or hedge fund) owns or manages on behalf of its clients.

One **basis point** equals 1/100 of a percentage point.

Bloomberg High Yield Bond Index measures the high yield bond market. High yield bonds have a lower credit rating and thus pay a higher yield due to having more risk than higher rated bonds.

CDLI is an asset-weighted index of directly originated middle market loans that was created to help investors better understand direct lending characteristics and benchmark manager performance.

Credit spread is the difference between the yield (return) of two different debt instruments with the same maturity but different credit ratings.

Direct lending to corporates does not use an intermediary such as a broker or investment bank.

Distressed debt refers to the securities of a government or company that has either defaulted, is under bankruptcy protection, or is in financial distress and moving toward the aforementioned situations in the near future.

Diversification refers to the dispersal of investments across asset types, geographies and so on with the aim of reducing risk or boosting risk-adjusted returns.

The **Euro Interbank Offered Rate (Euribor)** is the average interest rate for unsecured euro term deposits and is the key reference rate for a large number of loans, such as variable-rate mortgage loans.

European Long Term Investment Fund is a type of regulated fund introduced in the European Union to encourage investment into companies and projects who need long-term capital, for example infrastructure projects.

The **European Union (EU)** is a political and economic union of 27 member states located primarily in Europe.

Federal Financial Supervisory Authority, better known as BaFin, is Germany's integrated financial regulatory authority.

Floating-rate securities are securities whose coupon rate is tied to a specified market rate and can change periodically.

High-yield bonds are issued by below-investment-grade-rated issuers and usually offer a relatively high yield.

Illiquidity premium is an incremental return that compensates an investor for owning an asset that is not highly liquid.

Inflation is the rate at which the general level of prices for goods and services is rising and, subsequently, purchasing power is falling.

Interest rate is the proportion of a loan that is charged as interest to the borrower, typically expressed as an annual percentage of the loan outstanding.

Investment grade (IG) refers to a credit rating from a rating agency that indicates that a bond has a relatively low risk of default.

Monetary policy focuses on controlling the supply of money with the ulterior motive of price stability, reducing unemployment, boosting growth, etc. (depending on the central bank's mandate).

Morningstar LSTA US Leveraged Loan 100 Index measures the performance of 100 large loan facilities meeting the criteria defined in Eligibility Criteria. The index is capped market-value weighted.

Overnight rate is generally the interest rate that large banks use to borrow and lend from one another in the overnight market. In some countries, the overnight rate may be the rate targeted by the central bank to influence monetary policy.

Private credit is an asset defined by non-bank lending where the debt is not issued or traded on the public markets.

The **S&P 500** is an index that includes 500 leading U.S. companies capturing approximately 80% coverage of available U.S. market capitalization.

On the **secondary market**, securities or assets are purchased from other investors, rather than from issuing companies themselves.

The **spread** is the difference between the quoted rates of return on two different investments, usually of different credit quality.

In the event of a company's bankruptcy or liquidation, a **senior security** is one that ranks highest in the order of repayment before other security holders receive a payout.

U.S. Treasury yield is the annual return investors can expect from holding a U.S. government security with a given maturity.

Volatility is the degree of variation of a trading-price series over time. It can be used as a measure of an asset's risk.

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