LORD ABBETT®

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Investment Perspectives

Private Credit: Bridging Public and Private Markets

The expansion of private credit has promoted synergy and innovation, driving the evolution of the credit market landscape.

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Key Takeaways:

- The growth of direct lending, or private credit, has created what we believe is a beneficial ecosystem for borrowers, asset managers, and investors. It has expanded financing options for corporate borrowers and provided asset managers with opportunities to find value.
- While private credit has characteristics of an alternative asset class, it shares many similarities with traditional credit strategies. Recent convergence among issuers and investors suggests that direct lending may eventually be viewed as a more mainstream credit option rather than an alternative asset class.

At Lord Abbett, we've been in the business of capturing credit risk premiums through diligent research and flexible allocations for decades. Today we see the growth of direct lending creating an attractive and healthy ecosystem for borrowers, asset managers, and end investors. For corporate borrowers, private credit has expanded and enhanced financing options. For asset managers, this space has grown to become an opportunity for flexible and well-resourced credit managers to find value across markets. And for end investors, the performance profile of direct lending offers the appeal of attractive income with a risk-reward profile that can potentially be both a great diversifier to traditional assets and a volatility dampener in asset allocations.

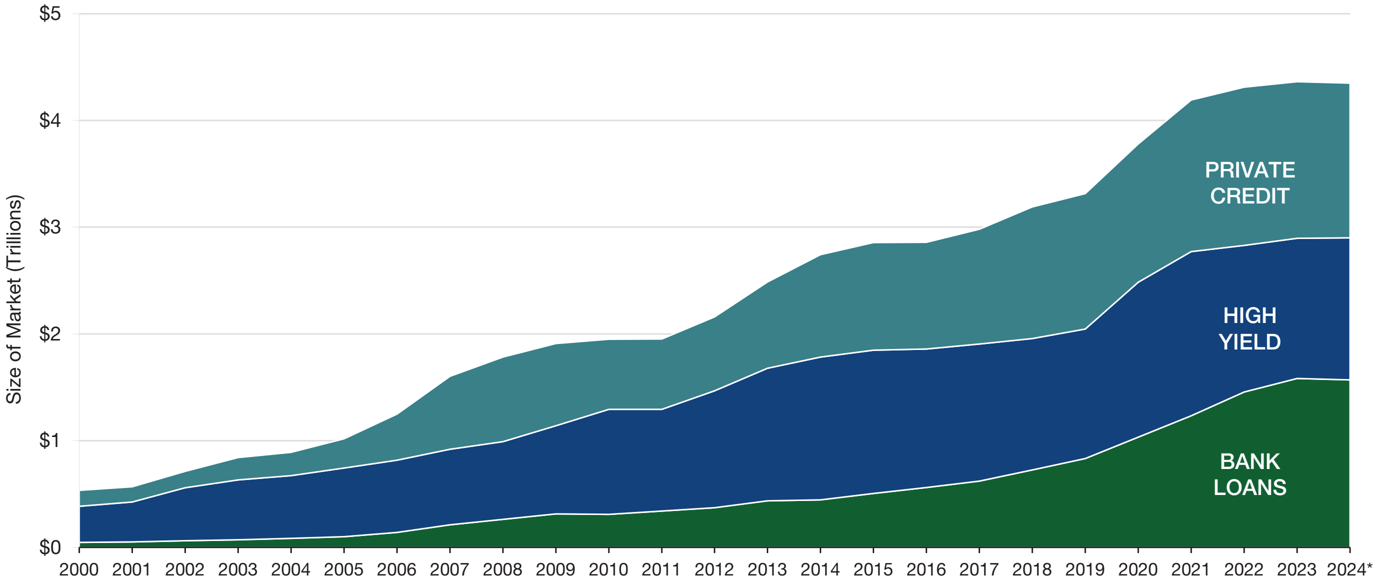
What is perhaps equally as interesting to those looking at this relatively newer investment option is that while private credit overall has some of the hallmarks of an alternative asset class—liquidity profile, product structures, private sourcing—it could be argued that there is more that ties it to traditional credit strategies than not. At its core, it's about lenders and borrowers, and we can imagine at some point, direct lending may not even be considered an alternative asset class. In the following pages, we discuss the growth of the direct lending market, its effect on, and convergence with, publicly traded credit, and our expectations for the credit environment going forward.

The Growth of Private Credit

Although direct corporate lending has been a longstanding practice, a window of opportunity opened over the last 15 years as the financial constraints imposed on banks after the great financial crisis (GFC) led to a significant shortage of capital for middle-market companies. This regulatory shift led to a massive expansion in the role of direct lending to these businesses. Large private investment houses responded to the increased demand by raising this needed capital through vehicles such as public and private business development companies (BDCs) to allow investors to integrate direct lending into broader diversified portfolios. At the same time, the industry built out human capital to increase the sourcing, assessment, and management of direct lending portfolios to allow for greater loan diversity and transparency, while further increasing investor comfort with the asset class.

Figure 1. Public and Private Credit Growth Following the GFC and COVID-19 Crises

High yield, bank loan, and private credit market size, 2000-March 31, 2024

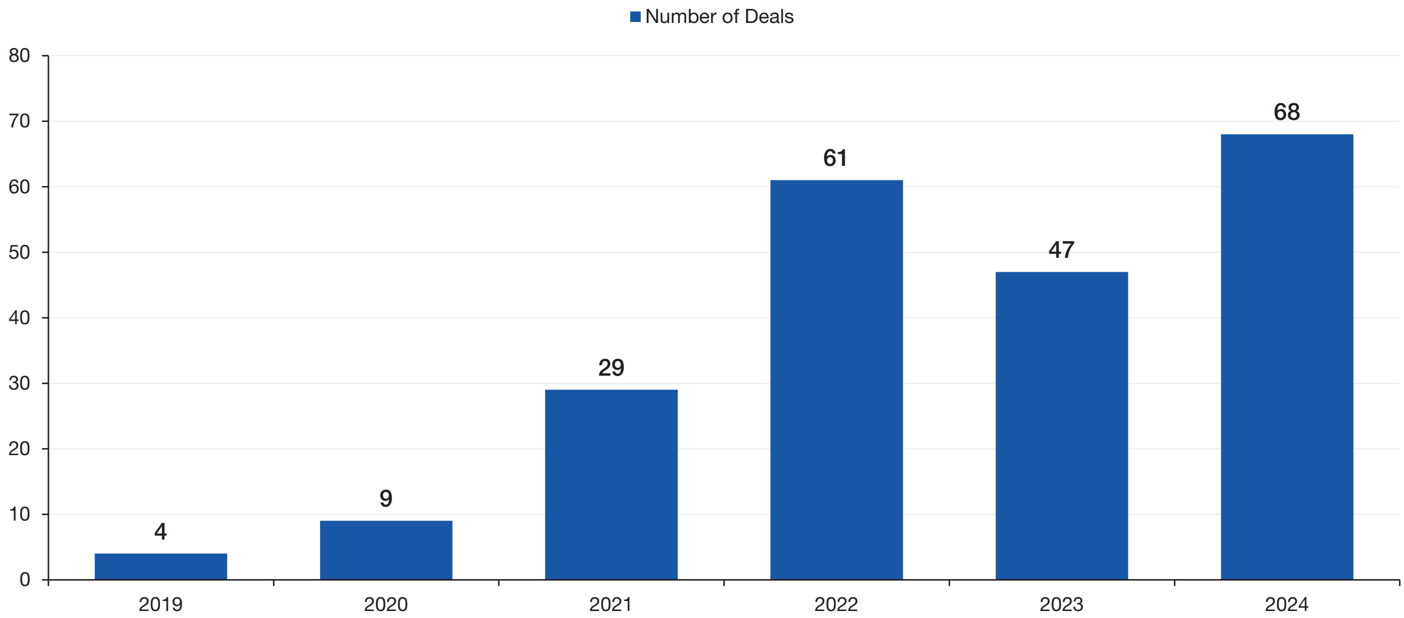


Source: Credit Suisse, ICE Data Indices LLC, and Prequin. Data as of March 31, 2024. Most recent data available. * 2024 to March 31, 2024. Market size growth as represented by the ICE BofA U.S. High Yield Index, the Credit Suisse Leveraged Loan Index, and the Prequin Private Credit Index. For illustrative purposes only and does not represent any specific portfolio managed by Lord Abbett or any particular investment. Indexes are unmanaged, do not reflect the deduction of fees or expenses, and are not available for direct investment. **Past performance is no indication or guarantee of future performance.**

Subsequent to the expansion in private credit following the GFC, the aftermath of the COVID-19 crisis served as another major catalyst for both supply and demand in middle market direct lending as well as the larger private credit universe. Figure 1 shows the sharp increase in direct lending's presence relative to U.S. high yield and bank loans, also known as leveraged loans, around this time and then the strong growth since. Banks pulled back from lending with the uncertainty surrounding COVID-19 and then again after Silicon Valley Bank's failure highlighted more balance-sheet concerns. Public market volatility also created a good deal of uncertainty around syndicated credit transaction levels and timelines. Having put the pieces in place around fund structures, talent, and adoption, the direct lending community was able to respond quickly to this demand boost. Multi-billion-dollar direct lending funds had the ability to underwrite large deals with certain and immediate terms, leading to increasing regularity of $1 billion+ transactions in the direct lending market, as shown in Figure 2. More supply is expected as the rate shock in 2022 and 2023 has investors shifting toward diversifiers outside of traditional fixed income, and direct lending increasingly fits the bill with its floating-rate loans and low volatility.

Figure 2. Growth in the Number of Billion Dollar-Plus Direct Lending Deals

Total amount of direct lending deals $1 billion or greater by year.



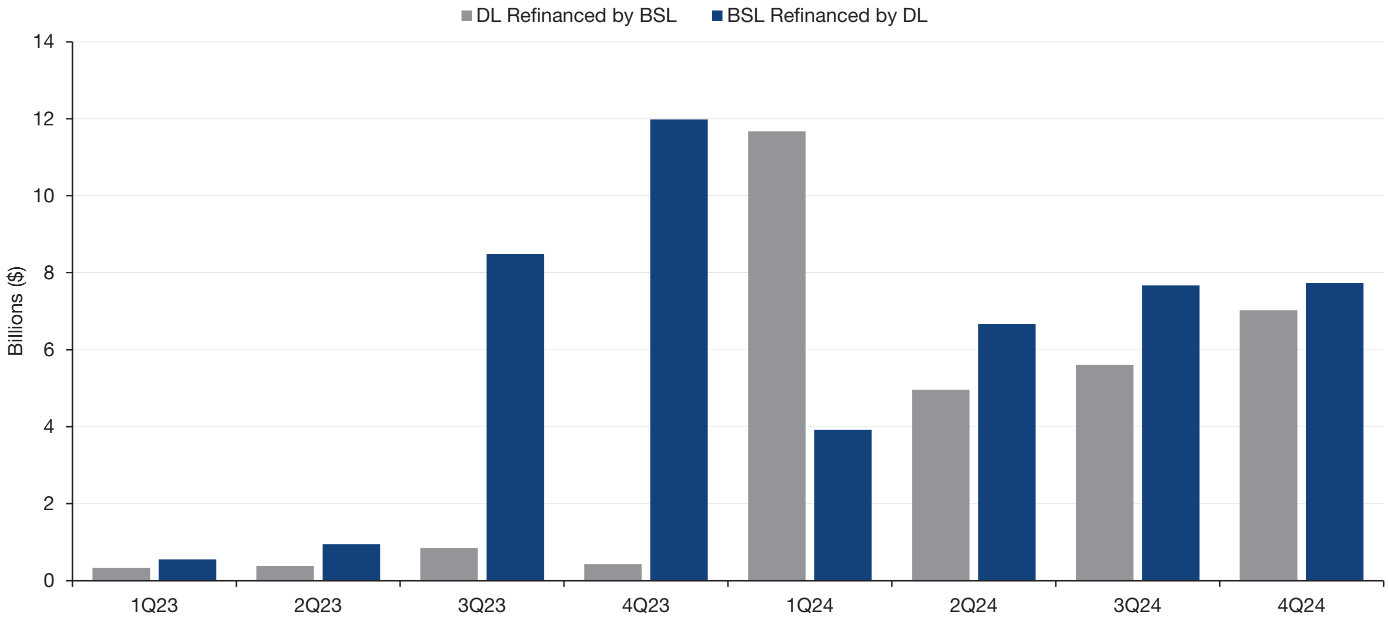
Source: JP Morgan and KBRA Direct Lending Deals. Data as of December 31, 2024. Most recent data available. For illustrative purposes only and does not represent any specific portfolio managed by Lord Abbett or any particular investment. Indexes are unmanaged, do not reflect the deduction of fees or expenses, and are not available for direct investment.

Convergence of Private and Public Credit

The demand pull for direct lending continues to develop even in more normal markets. While smaller private borrowers have usually transitioned to public credit markets once their borrowing needs became large enough to warrant public issuance, after they arrived in public markets, they typically stayed there, absent some negative development in the business. While the numbers are modest today, a growing number of borrowers are toggling between public and private markets and in some cases tapping both markets at the same time or even as part of the same issuance.

Figure 3. Direct Lending and Syndicated Loan Takeouts

Amount of direct lending refinanced by broadly syndicated loans and amount of broadly syndicated loans refinanced by direct lending.

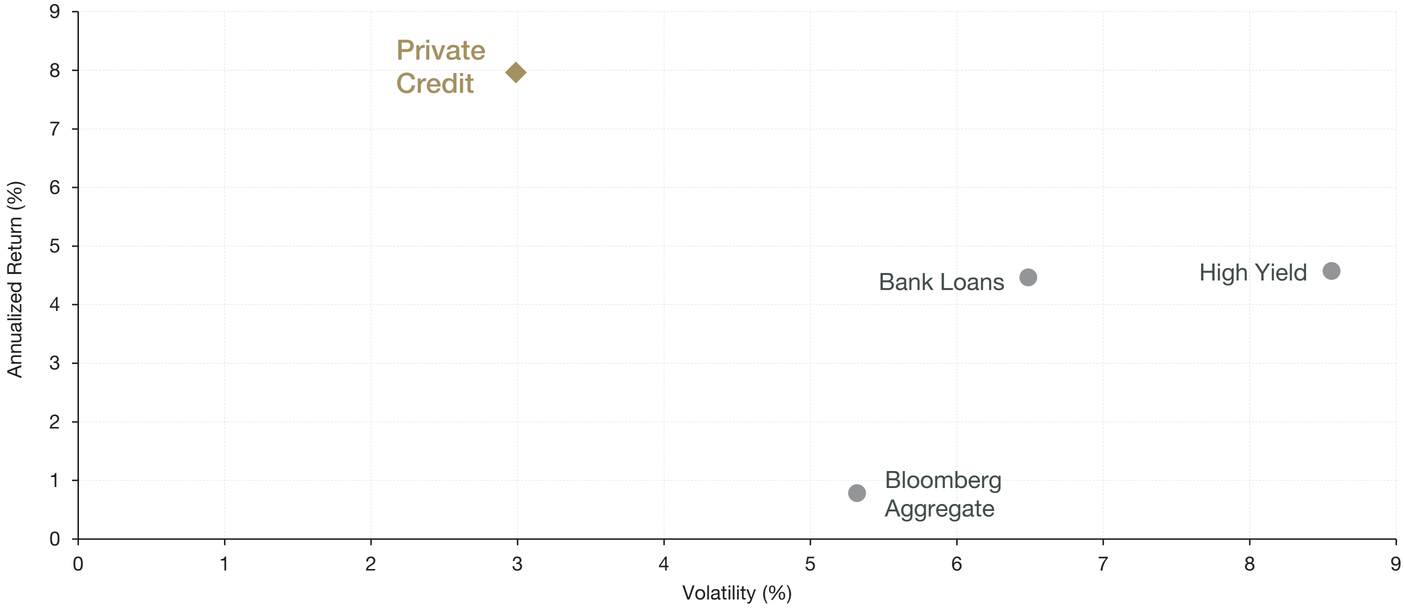


Source: Pitchbook | LCD. Data as of 12/31/2024. BSL=broadly syndicated loans. DL=direct loan. For illustrative purposes only and does not represent any specific portfolio managed by Lord Abbett or any particular investment. Indexes are unmanaged, do not reflect the deduction of fees or expenses, and are not available for direct investment.

We expect this trend to continue, as borrowers will always look for the best combination of terms and cost in their capital structure, and private markets have developed into a competitive value proposition for those borrowers. We believe it is critical for investors to do the same kind of value shopping. In that regard, private credit has historically provided an attractive risk and return profile that can potentially enhance an overall credit allocation (see Figure 4).

Figure 4. Historically Attractive Risk and Return Profile

Annualized return and volatility, September 30, 2016-June 30, 2024

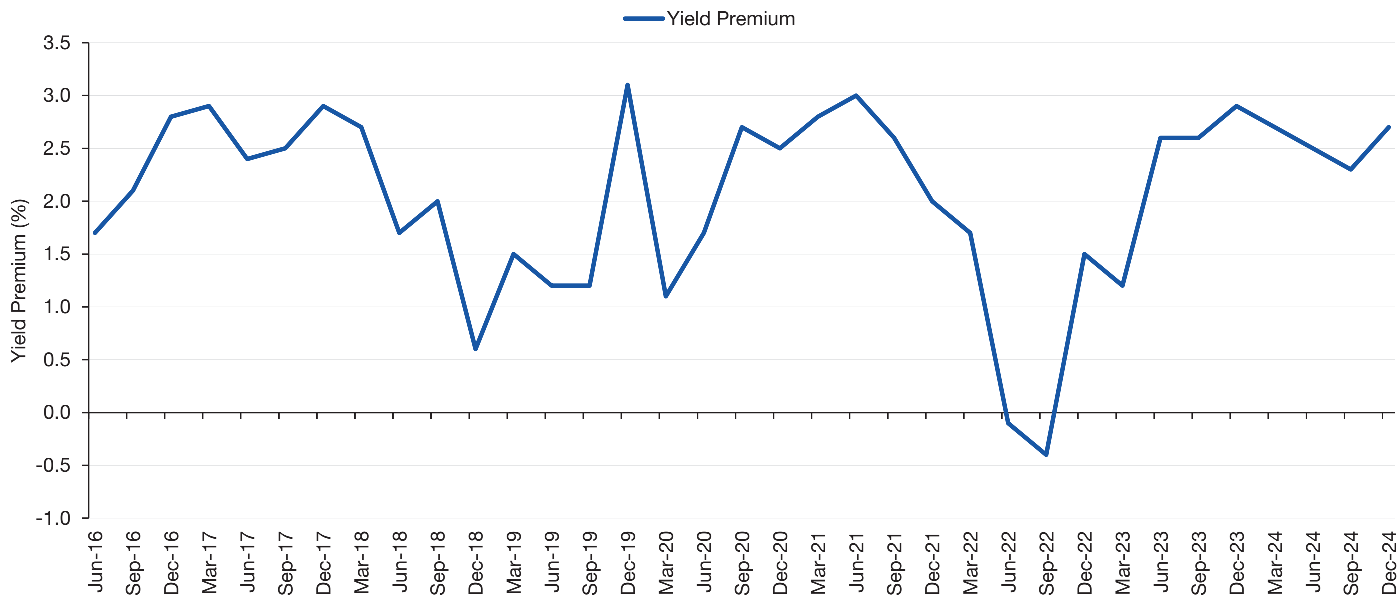


Source: Morningstar Direct and Cliffwater. Data as of June 30, 2024. Most recent data available. Private Credit as represented by the Cliffwater Direct Lending Index, bank loans as represented by the Credit Suisse Leveraged Loan Index, high yield as represented by the ICE BofA U.S. High Yield Index, and Bloomberg Aggregate as represented by the Bloomberg U.S. Aggregate Bond Index. Volatility as measured by standard deviation of returns. For illustrative purposes only and does not represent any specific portfolio managed by Lord Abbett or any particular investment. Indexes are unmanaged, do not reflect the deduction of fees or expenses, and are not available for direct investment. **Past performance is not a reliable indicator or a guarantee of future results.**

Private credit spreads have also historically provided an attractive yield relative to BSLs, shown in Figure 5, while volatility has been low primarily because of the absence of mark-to-market accounting. But it is important to remember that much of the public market volatility is driven by liquidity provisioning because the vehicles that hold public credits are often daily liquid vehicles. So, rather than thinking about private credit volatility as understated, it is just as valid to think about public credit volatility as overstated relative to variation in estimated losses from default. Simply put, private structures are purpose-built for spread capture, allowing a manager to focus on the merits of a credit rather than liquidity provisioning.

Figure 5. Historically Attractive Yield Premium Over BSLs

Middle market direct lending yield premium over broadly syndicated loans, June 30, 2016-Deceber 31, 2024



Source: BofA Global Research. Data as of December 31, 2024. For illustrative purposes only and does not represent any specific portfolio managed by Lord Abbett or any particular investment. Indexes are unmanaged, do not reflect the deduction of fees or expenses, and are not available for direct investment. **Past performance is not a reliable indicator or a guarantee of future results.**

We believe the time is fast approaching when direct lending will be viewed not as an "alternative," but rather a critical piece of market and company risk. Even stand-alone public debt strategies will be made better by the integration of private debt skilled professionals into their teams, and private debt teams will benefit from the insight and reach of their public debt focused colleagues, in our view. At Lord Abbett, we've used multi-sector capabilities for decades in our efforts to achieve attractive risk-adjusted outcomes, while managing risk and liquidity, and we believe the best opportunities going forward will be available to creditors and investors who are able to navigate between private and public markets.

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Glossary & Index Definitions

A broadly syndicated loan (BSL) is a type of leveraged bank loan that is provided by a group of lenders and is commonly used to finance mergers, acquisitions, and recapitalizations. These loans are syndicated by originating banks to a wide range of institutional investors, such as collateralized loan obligations (CLOs), mutual funds, and insurance companies.

Business development company (BDC) is a type of investment company in the U.S. that provides capital to small and mid-sized businesses, as well as distressed companies. BDCs are designed to help these firms grow during their early stages or regain financial stability.

A **basis point** is equal to one one-hundredth of a percentage point.

Base rate: Variable interest rates fluctuate in line with a base rate which, typically, shifts in reaction to market factors.

The **capital stack**, or **capital structure**, refers to the layers of debt and equity capital used by companies to finance operations. Within the capital structure, segments called tranches represent different risk classes that are available to investors.

A **direct loan** refers to a privately negotiated loan provided by non-bank lenders directly to a borrower, typically a middle-market company.

GFC refers to the global financial crisis of 2008–09.

Loan origination is the process lenders use to assess and approve borrower applications for various forms of debt. These include loans and mortgages.

Loss Given Default (LGD) is a measure used by financial institutions to estimate the potential loss they would incur if a borrower defaults on a loan. It is typically expressed as a percentage of the total exposure at the time of default. LGD is calculated by considering factors such as the amount of collateral, recovery rates, and any other mitigating circumstances. For example, if a bank lends $1 million and expects to recover $600,000 in the event of a default, the LGD would be 40%.

Middle market lending: The middle market segment is typically considered to be credit for firms larger than small businesses but too small for large-scale commercial lending or syndicated credit.

Private equity refers to capital investments made in companies that are not publicly traded.

Risk-adjusted return measures how much risk is associated with producing a certain investment return.

Securitized products broadly refer to pools of financial assets that are brought together to create a new security, which is then divided and sold to investors. The value and cash flows of the new asset are based on its underlying securities.

Spread is the percentage difference in current yields of various classes of fixed-income securities versus Treasury bonds or another benchmark bond measure. A bond spread is often expressed as a difference in percentage points or basis points (which equal one-one hundredth of a percentage point). The option-adjusted spread (OAS) is the measurement of the spread of a fixed-income security rate and the risk-free rate of return, which is adjusted to take into account an embedded option. Typically, an analyst uses the Treasury securities yield for the risk-free rate.

Standard deviation is a statistical measure of the amount of variation or dispersion in a set of data values. It indicates how much individual data points differ from the mean (average) of the data set.

Structured credit is a type of financial instrument, usually a secured-asset investment with a set coupon rate (interest payment), that has been packaged into various risk categories to meet specific investor needs or risk profiles.

Underwriting is the process by which the lender decides whether an applicant is creditworthy and should receive a loan.

Yield is the income returned on an investment, such as the interest received from holding a security. The yield is usually expressed as an annual percentage rate based on the investment's cost, current market value, or face value. The gross yield of an investment is its profit before taxes and expenses are deducted.

ICE BofA U.S. High Yield Index tracks the performance of U.S. dollar-denominated corporate debt that is rated below investment grade and publicly issued in the U.S. domestic market. This index includes bonds with a fixed-coupon schedule and a minimum outstanding amount of $100 million.

Credit Suisse Leveraged Loan Index tracks the performance of the investable universe of U.S. dollar-denominated leveraged loans. These loans are typically rated below investment grade and are used by companies to finance various operations.

Bloomberg U.S. Aggregate Bond Index is a broad-based benchmark that measures the performance of the U.S. investment-grade bond market. This index includes a diverse range of fixed-income securities, such as: Government Treasury securities, corporate bonds, mortgage-backed securities (MBS), asset-backed securities (ABS), and municipal bonds. To be included in the index, bonds must be of investment-grade quality, have a fixed-rate coupon, and meet specific criteria regarding their issuance size and maturity.

The Cliffwater Direct Lending Index (the "CDLI") seeks to measure the unlevered, gross of fees performance of U.S. middle market corporate loans, as represented by the underlying assets of Business Development Companies ("BDCs"), including both exchange-traded and unlisted BDCs, subject to certain eligibility requirements. The CDLI is an asset-weighted index that is calculated on a quarterly basis using financial statements and other information contained in the U.S. Securities and Exchange Commission ("SEC") filings of all eligible BDCs. Cliffwater believes that the CDLI is representative of the direct lending asset class. The CDLI is owned exclusively by Cliffwater, and is protected by law including, but not limited to, United States copyright, trade secret, and trademark law, as well as other state, national, and international laws and regulations. Cliffwater provides this information on an "as is" and "as available" basis, without any warranty of any kind, whether express or implied.

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