Special Report

Private Credit (Direct Lending): A Bubble or an Opportunity?

July 2026

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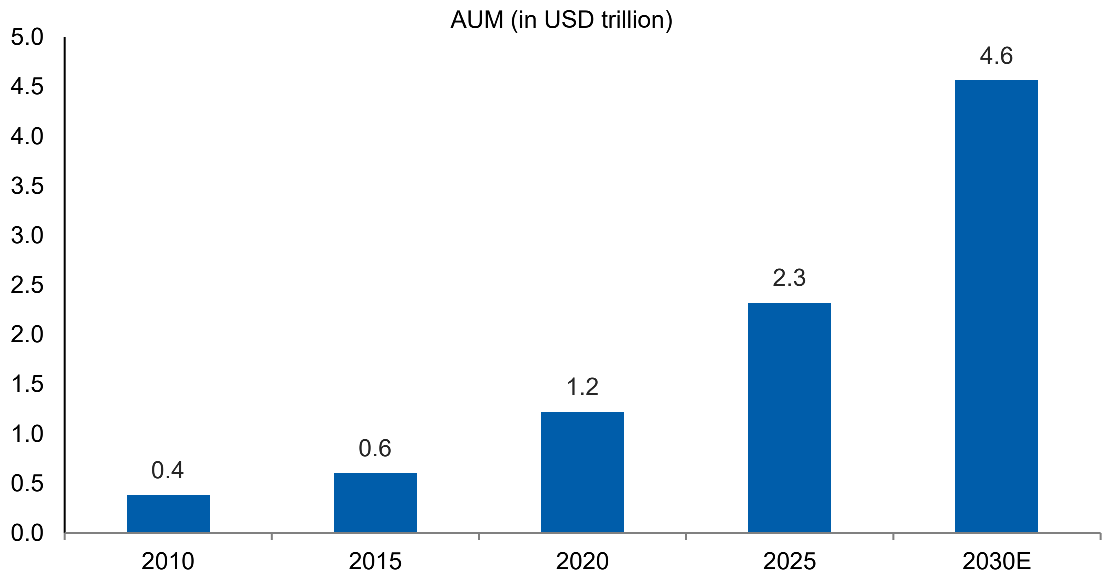
What's Happening in the Private Credit Space?

A Maturing Cycle, Not a Bubble; Scale, Performance and Emerging Stress Briefly

Private credit AUM (USD tn)

~6x growth in a decade, estimated to double by 2030

- Private credit AUM reached ~USD 2.3tn in 2025 and is projected at ~USD 4.6tn by 2030E; direct lending is ~60% of the market, compounding at 22.1% since 2010.



Key messages

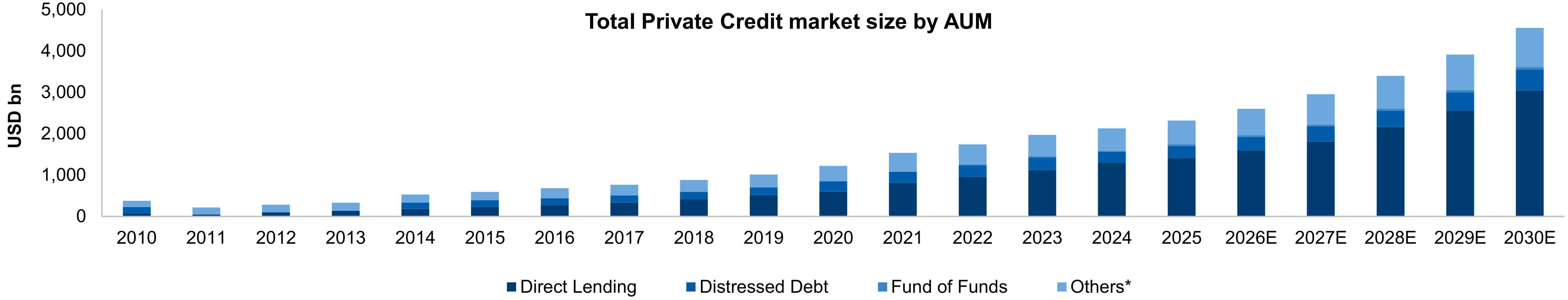
- **Structural, not cyclical, growth**
  - Bank retrenchment (Dodd-Frank, Basel III/IV), floating-rate income, insurer and retail capital, and PE demand **have re-routed mid-market lending to funds.**
- **Proven through-cycle performance**
  - Direct lending (CDLI) has delivered ~9–10% annualized returns with ~1.0% realized losses and only one negative year in twenty (2008),
  - At ~1.7% volatility over the last 15 years, Private credit has stood as the least volatile asset class amongst its peers.
- **Signs of rising stress - but lagged and concentrated**
  - Defaults hit a record 6.0% TTM (May-26) and PIK reached 8.1% of investment income.
  - Stress concentrated in sub-USD 25m EBITDA borrowers and 2021–22 software vintages, while realized losses remain low (0.64% in 2025).
- **The liquidity structure, not the loans, was tested**
  - Q1 2026 brought the first net outflow for non-traded BDCs (~USD 14bn requested, ~USD 8bn unmet). Redemption dispersion of 1.6%–40.7% shows investors differentiating managers, not exiting the asset class.

Aranca View - a maturing cycle, not a bubble: Expect selective stress, not systemic failure. Prioritize senior-secured income, European credit and data-centre opportunities, while preserving dry powder for the emerging distressed cycle.

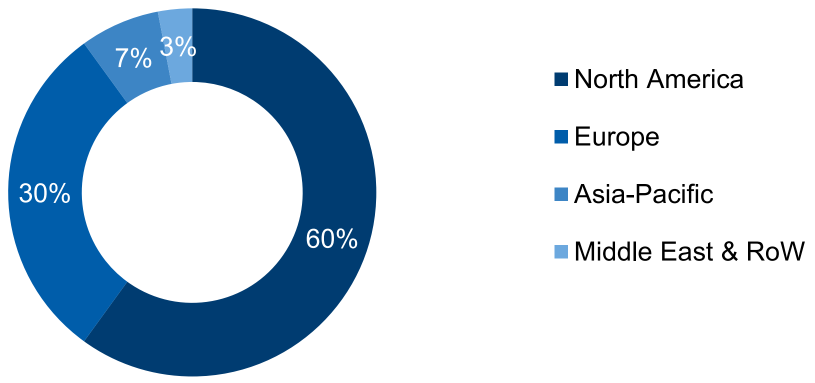
***Source**: Aranca Research*

Private Credit Has Evolved into a Multi-Trillion-Dollar Financing Market; US leads with ~2/3rd market

Direct lending has been the primary engine behind the rapid expansion of the global Private credit market, growing at a 22.1% CAGR between 2010 and 2025



Global Private Credit AUM by Region (2025)



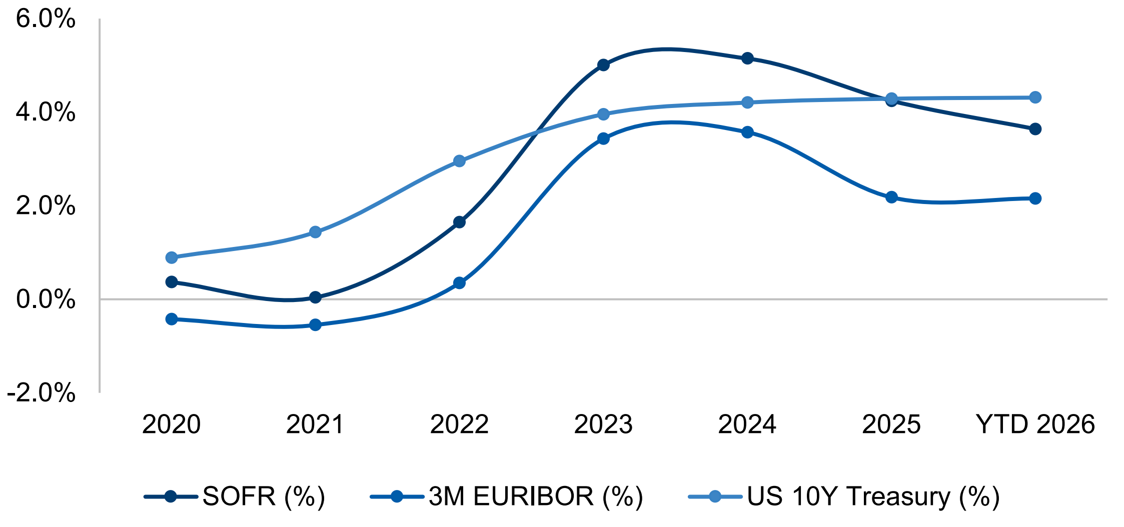
Strategy	Description	Approx. size	Yield (mid-2026)
Direct lending	Senior, 1L loans made directly to mid-sized, PE-backed companies	~$1.4tn	**9–11%**
Real estate credit	Loans against property, including bridge loans, construction finance, preferred equity, etc.	~$0.5tn	**9–14%**
Asset-based finance	Loans backed by hard, separable assets such as receivables, equipment, royalties, data centers, etc.	~$0.45tn	**8–12%**
Infrastructure debt	Long-term project loans provided for power, transport, and digital infrastructure.	~$0.35tn	**7–10%**
Distressed / special situations	Purchasing troubled loans at a discount, also called rescue financing, provisions loan-to-own	~$0.30tn	**15–20%+**

***Source**: Aranca Research, Fitch, AIMA/ACC | * Includes mezzanine financing, special solutions, multi-asset special solutions, and venture debt*

Direct Lending Market Growth Drivers (1/3)

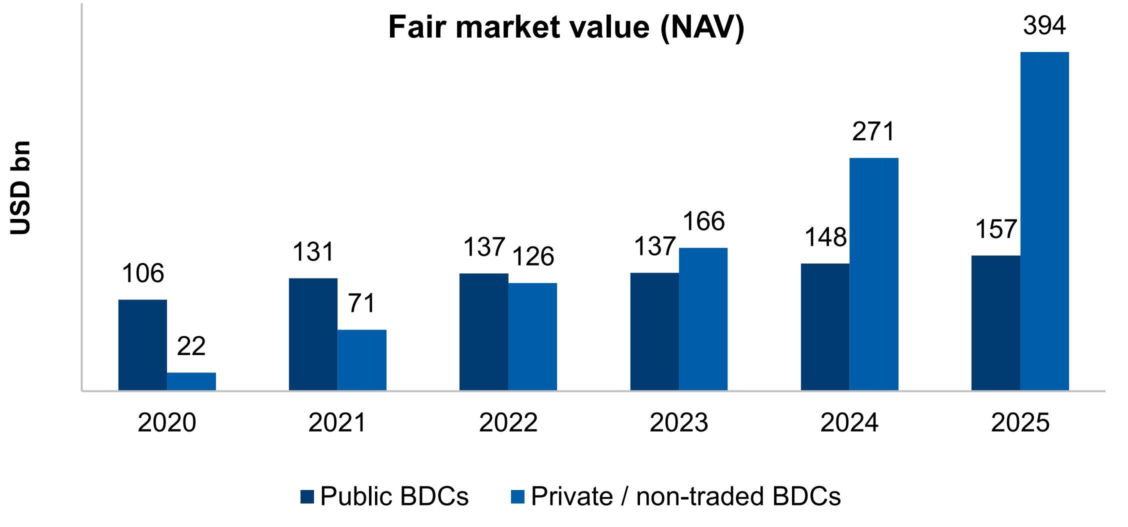
Floating-Rate Income and Retail Capital Have Fueled Private Credit Growth

Upward trajectory of benchmark rates bode well for floaters



- **Rising rates flow straight to lenders as income:** Direct lending loans pay a floating coupon i.e., SOFR/EURIBOR + Spread (~500bps). As SOFR surged from near zero in 2021 to ~5.4% by 2023, coupons reset higher almost point-for-point - investors earned more with every hike, driving record income and fundraising for Private credit.
- **Fixed-rate bonds took the opposite path:** With no coupon reset, fixed-rate benchmarks absorbed 13–16% price losses in 2022 alone, while floating-rate direct lending stayed positive - it has outperformed high yield in every rising-rate period since 2008.
- **The carry advantage persists after cuts:** At SOFR ~3.6%, a SOFR+500 loan still pays ~8.6%, which is ~2x the ~4.4% 10Y Treasury, keeping income the core return driver.

From 17% to 71%: Perpetual BDCs made retail the dominant capital source



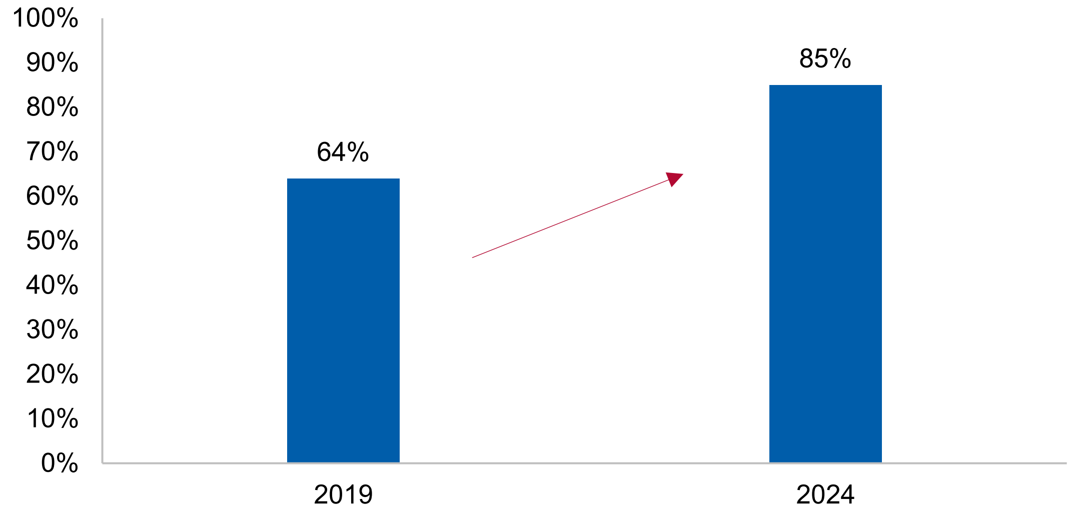
- Perpetual Private credit funds have opened the asset class to individual investors through low minimum investments, continuous subscriptions at NAV and periodic redemption windows, eliminating the need for traditional capital calls.
- Retail participation has accelerated rapidly, with USD 306bn flowing into non-traded BDCs since 2020, increasing portfolio value 18x (USD 22bn to USD 394bn) and lifting their share of total BDC assets from 17% to 71%.
- Continuous fundraising through perpetual structures has made retail investors the fastest-growing source of capital, providing managers with a stable, always-deployable funding base for private credit.

Source: *Aranca Research, Bloomberg, Houlihan Lokey*

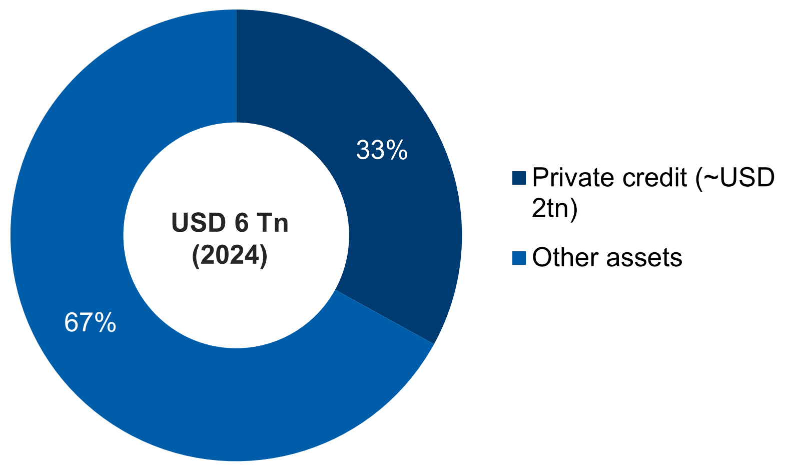
Direct Lending Market Growth Drivers (2/3)

Bank Retrenchment and the Insurer Pivot Provide Structural, Long-Duration Capital

Private credit share of US buyout financing has surged



US life insurers have chased direct lending for higher yields



- **Regulation drove a structural retreat:** Consolidation and post-2008 capital rules (Dodd-Frank, Basel III/IV) made below-investment-grade, middle-market lending punitive for banks, pushing them out of leveraged lending.
- **Private credit absorbed the vacated share:** The Private credit share of US buyout financing rose from 64% in 2019 to ~85% in 2024, cementing funds as the primary lender to sponsor-backed mid-market companies.

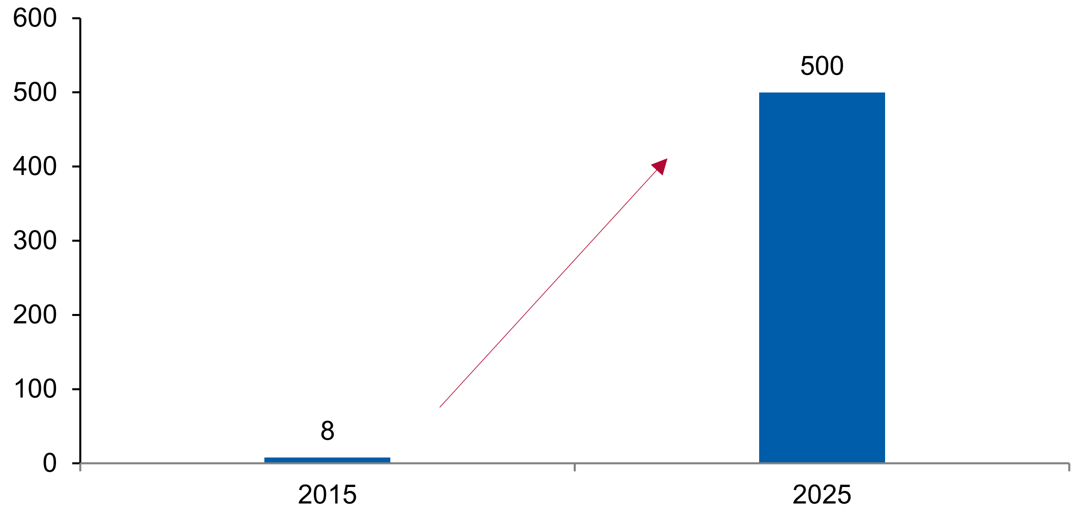
- **Insurers became a permanent capital base:** Seeking higher yields after a decade of near-zero rates, US life insurers moved ~1/3rd of their USD 6tn general account assets into private credit by end-2024.
- **And the allocation is still growing.** 58% of insurers surveyed by Goldman Sachs plan to increase Private credit allocations, reinforcing insurers as one of the most stable long-term sources of capital for the asset class.

***Source**: Aranca Research, Lord Abbett, Goldman Sachs, Morgan Stanley*

Direct Lending Market Growth Drivers (3/3)

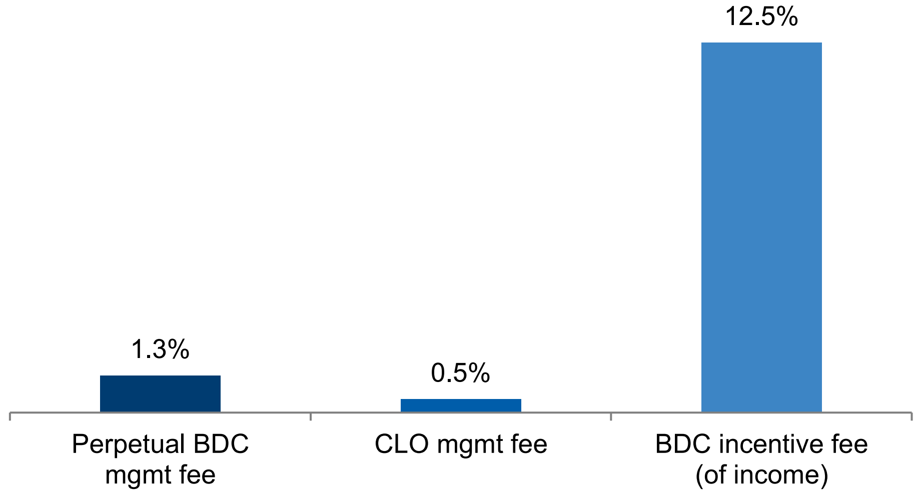
Private Equity Demand and Manager Fee Economics Reinforce the Supply of Credit

Software direct lending outstanding (USD bn)



- **Sponsors concentrated demand in technology:** PE firms completed 1,900+ software acquisitions worth USD 440bn+ between 2015 and 2025, financed predominantly through private credit for the speed and certainty of a single lender.
- **A ~60x expansion in a decade:** Software direct lending grew from ~USD 8bn in 2015 to over USD 500bn by 2025, making software the largest single sector exposure across major BDC portfolios.

Manager economics: perpetual BDC vs traditional CLO



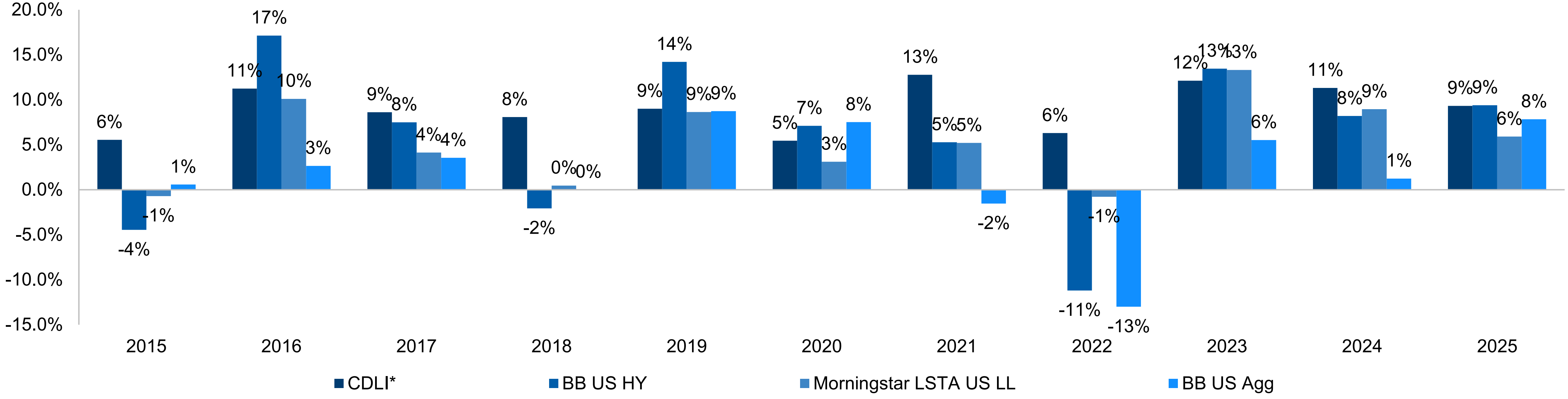
- **Fee structures reward scale:** Perpetual BDCs combine ~1.25% recurring management fees with ~12.5% performance-based incentive fees on income, materially richer economics than the ~0.4–0.5% earned on traditional CLO vehicles.
- **Continuous fundraising compounds the incentive:** Together with always-open subscriptions, these economics have pushed asset managers to scale Private credit platforms and expand distribution through wealth management channels.

***Source**: Aranca Research, With Intelligence, Brookfield, Morgan Stanley*

Direct Lending Performance (1/2)

Direct Lending Have Generated Higher Returns Consistently Indicating Proven Performer

Resilient returns outperforming most fixed income benchmarks over the past decade



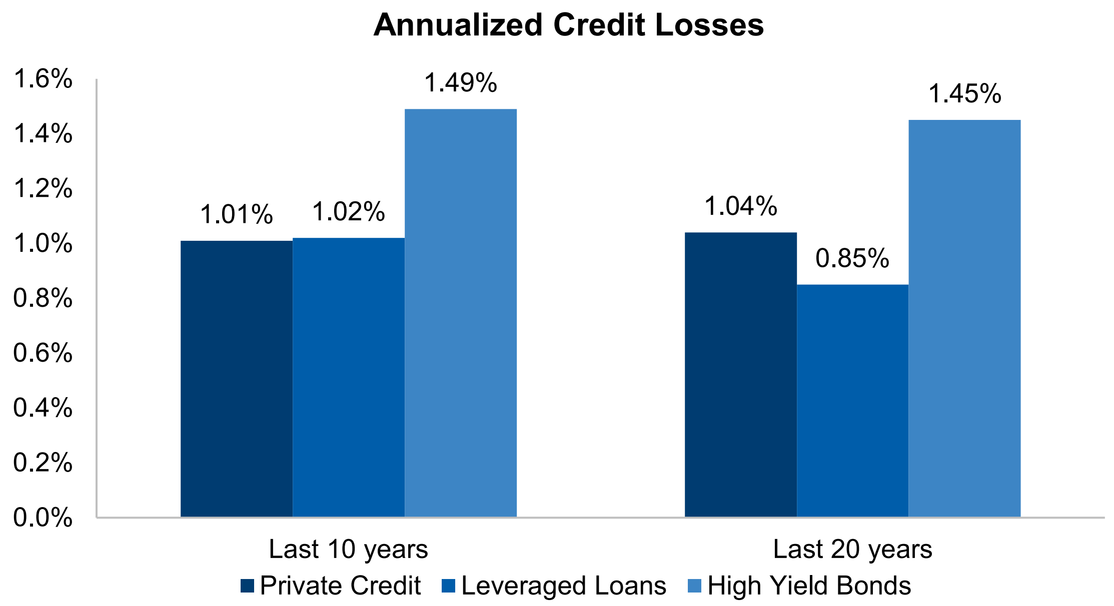
- Direct lending generated **positive returns (6.29%) every year** from 2015–2025, including 2022, when both HY and IG bonds posted double-digit or negative returns. This reflects the floating-rate nature of private credit and the limited mark-to-market volatility of privately held loans.
- Over the past decade, CDLI* delivered approximately 9–10% annualized returns, outperforming both the US HY Index (~6%) and the Morningstar LSTA LL Index (~5%) on a risk-adjusted basis.
- Private credit returns are less volatile because portfolios are valued quarterly using fair-value models based on borrower fundamentals, whereas public bonds and leveraged loans are marked to market daily.

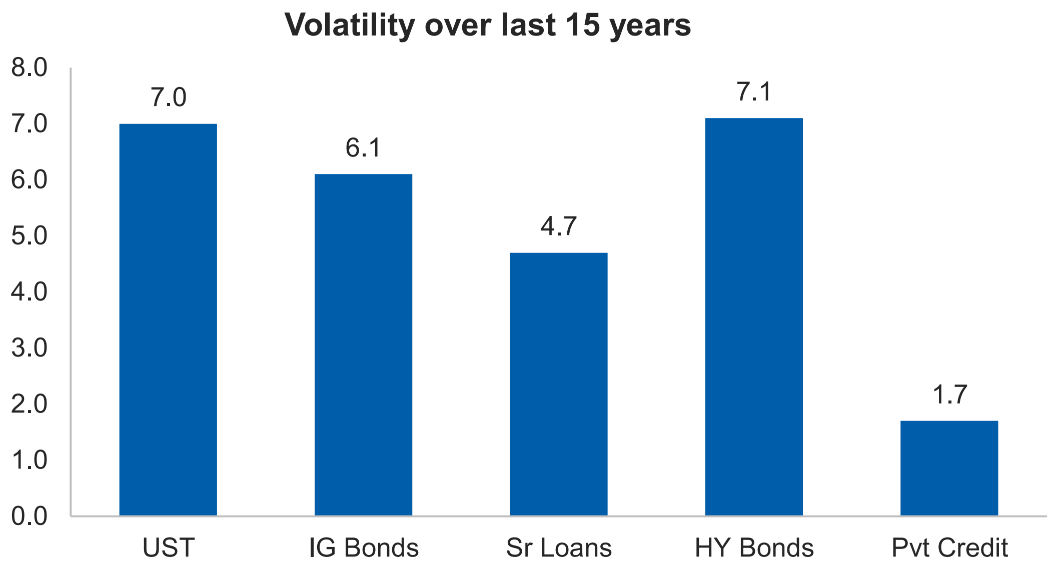
Source: *Aranca Research, Bloomberg, Brookfield, Houlihan Lokey | *Cliff Water Direct Lending Index*

Direct Lending Performance (2/2)

Direct Lending Combines Higher Returns with Resilient Credit Performance

Lower realized losses highlight the defensive characteristics of direct lending





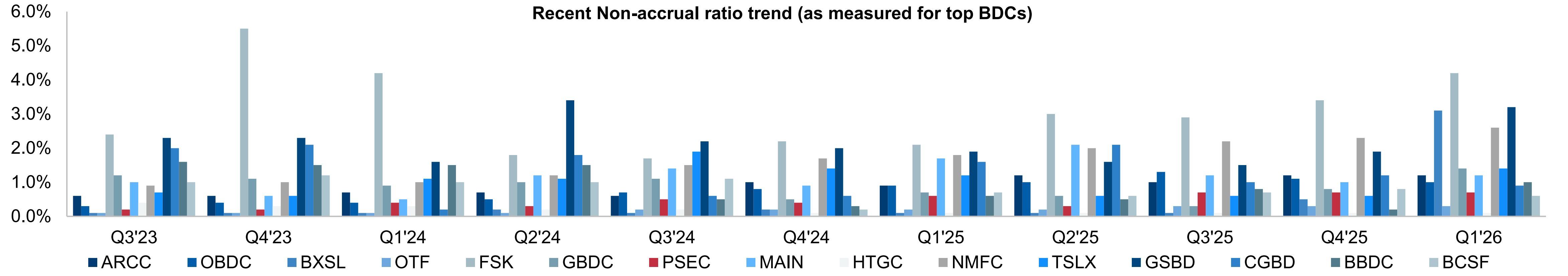
- Annualized realized credit losses **have remained low at ~1.0%** over the past decade, below US high-yield bonds (~1.5%) and broadly in line with leveraged loans (~1.0%) **despite lending to predominantly below-investment-grade borrowers**.
- Private credit has been the **least volatile major credit asset class, with ~1.7% annualized return volatility over the past 15 years**, supported by floating-rate loans, senior-secured structures and limited mark-to-market pricing**.**
- Strong collateral protection, tighter covenants and direct lender-borrower relationships have helped preserve capital and deliver more stable risk-adjusted returns across market cycles**.**

Source: *Aranca Research, Bloomberg, Brookfield, Houlihan Lokey*

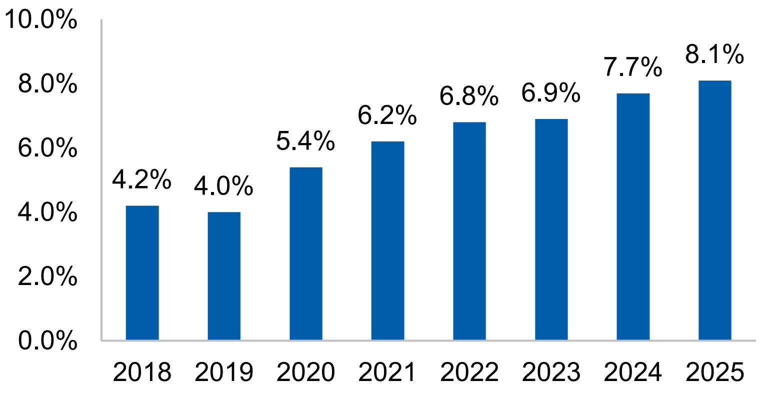
Current Market Risk (1/3)

Early Warning Indicators Point to Gradually Rising Credit Risk

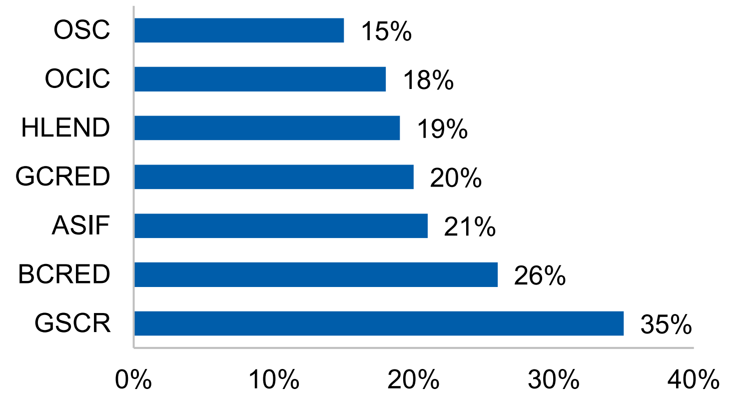
Credit stress is gradually emerging as BDC non-accruals trend higher



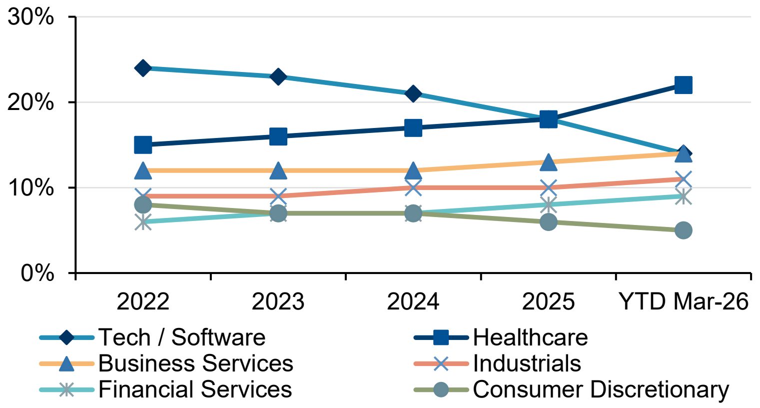
Growing reliance on PIK income signals rising borrower stress



High software concentration increases exposure to technology sector cycles (YTD 2026)



Sector allocation is shifting toward defensive industries amid rising borrower stress

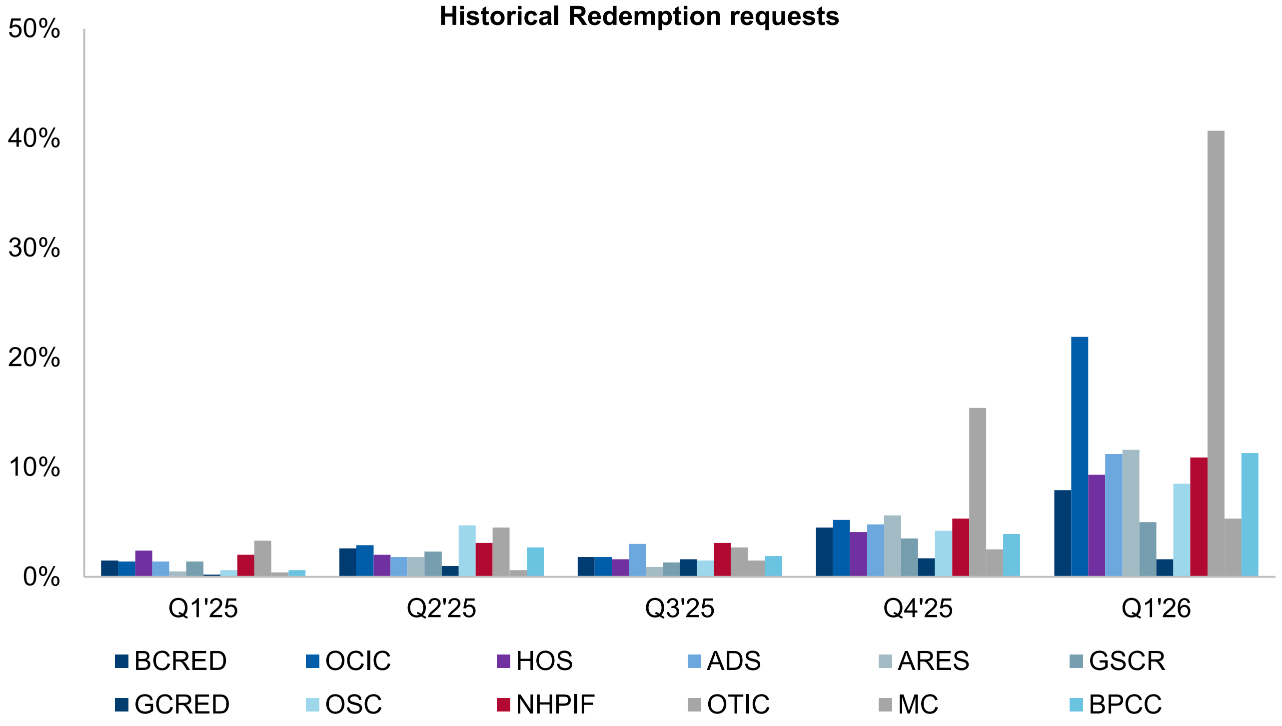


Source: *Aranca Research, Fitch, Houlihan Lokey*

Current Market Risk (2/3)

Redemption Pressure Emerges as the First Liquidity Test for Private Credit

Redemption requests increased significantly following the Q4 2025 market sell-off



- **Redemptions broke higher in Q1 2026**. Requests stayed at 0.2% - 4.7% through Q1 - Q3 2025, within ~5% caps, before surging to ~USD 14bn in Q1 2026. Around USD 8bn went unmet, marking the first net outflow for perpetual non-traded BDCs.
- **Tech exposure drove the divergence**. Software equities fell ~30% from October 2025 to February 2026, with the most tech-heavy funds facing the longest redemption queues.
- **Liquidity caps accelerated early exits**. With redemptions capped near 5% of NAV and listed BDCs trading ~25% below book, investors sought to exit at stated NAV before markdowns. More than half of Q1 2026 requests were deferred.
- This is a **liquidity-channel test, not a solvency event**. Redemption rates ranged from 1.6% to 40.7%, showing investors were differentiating by software exposure and mark credibility, not abandoning Private Credit.

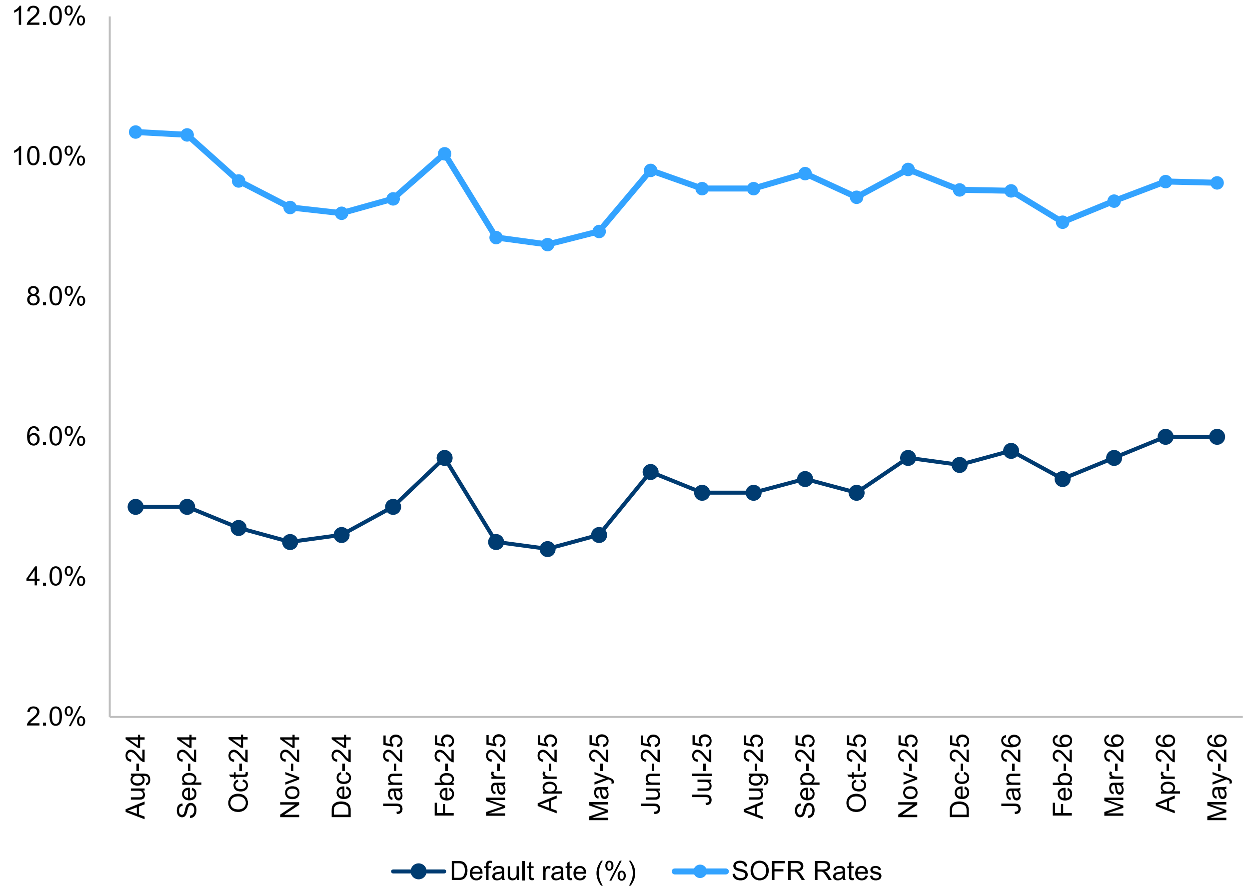
Aranca Take: The wide dispersion in redemption requests (1.6% to 40.7%) indicates investors differentiated between managers and portfolio exposures, suggesting a selective reallocation of capital rather than broad-based exits from Private credit.

***Source**: Aranca Research, Proprietary BDC Performance Tracker (32 BDCs, Q1 2026, built from SEC filings).*

Current Market Risk (3/3)

Private Credit Faces Rising Credit Stress as Higher Rates Continue to Weigh on Borrowers

Private credit default rates continue to rise despite declining base rates



- **Defaults are lagging, not defying rate cuts**. SOFR has fallen ~180bps since August 2024, yet defaults rose from 5.0% to a record 6.0%. With an 18–24-month lag, today's defaults reflect 2022–24 peak rates, not current easing.
- **Borrower repair trails rate relief.** Loans underwritten near zero rates absorbed a 50%+ increase in interest costs, driving fixed-charge coverage from 1.40x in Q1 2022 to ~1.04x at peak SOFR. Floating-rate, lightly hedged structures transmitted the full shock to cash flow.
- **PIK and restructurings delayed recognition**. PIK exposure rose from ~5% to ~11% during 2022–25, keeping stressed loans nominally current. Over half of the May 2026 6.0% TTM default rate reflected deferrals and PIK conversions, while ~65% of 2025 defaults were distressed restructurings. Realized losses remained low at 0.64%.
- **Defaults should plateau, not fall with SOFR**. With SOFR near 3.6% and further 2026 Fed cuts largely priced out, pressure remains on over-levered borrowers and 2028–29 refinancers. Stress is concentrated in sub-USD 25m EBITDA borrowers, which defaulted at 15.8% in 2025 versus 4.0% above USD 100m, and in 2021–22 software vintages.

Aranca View: Defaults may stop rising sharply, but they are unlikely to fall quickly. Stress is concentrated in weaker, smaller and heavily indebted borrowers, **not across the entire private-credit market**.

Source: *Aranca Research, Fitch Ratings, Moody's, Morgan Stanley*

Growth Outlook (1/2): Private Credit Sub-Asset Classes

Direct Lending Matures While Adjacent Strategies Drive the Next Leg of Growth

01	Direct lending	Moderate	• ~USD 1.4tn core engine is the most mature segment: competition is intense, spreads have tightened, focus has shifted from deployment to credit selection. • 2025 opening of the ~USD 13tn US 401(k) market is the next structural demand source, while Q1 2026 redemptions reset supply-demand in lenders' favor, but returns now come from selection, not beta.
02	Asset-based finance	Strong	• Basel IV capital rules are pushing banks to offload collateral-backed lending, creating structural loan supply. ABF fundraising reached ~USD 70bn in 2025, with specialty finance alone raising USD 37bn, more than the prior two years combined. • Markets estimate USD 5-6tn in lending to shift to non-banks within a decade, while the migratable US pool is sized at USD 9-10tn.
03	AI & data-centre credit	Strong	• AI infrastructure funding needs exceed traditional bank capacity. **Over USD 1.5tn of the projected USD 3tn AI infrastructure buildout** through 2028 is expected to rely on external capital, creating a significant opportunity for Private credit. • Meta's USD 29bn private financing and Apollo–Blackstone's USD 35bn AI platform illustrate this shift, while Amazon plans to raise USD 25bn of debt to fund AI expansion.
04	Infrastructure debt	Strong	• Digitalization, decarbonization and AI power demand require long-duration lenders that banks cannot match. • Global infrastructure AUM is expected to reach **USD 3tn by 2030, at a ~23% annual growth rate**.
05	Distressed / special situations	Cyclical	• Rising defaults (record 6.0% US TTM rate, April 2026) and redemption-driven forced selling are creating the best entry conditions since 2009. • **~USD 175bn of forced secondary supply is expected over 18-24 months**, and opportunistic funds have already raised USD 100bn+ to absorb it.

***Source**: Aranca Research, Morgan Stanley, Preqin, Fitch Ratings, McKinsey, PIMCO, With Intelligence*

Growth Outlook (2/2) - Regional Opportunity Set

Europe and Asia-Pacific Offer the Strongest Structural Runway; North America Turns Selective

01 North America — Moderate

- The largest and most mature direct lending market with intense competition, tightened spreads, and a transition from deployment to credit selection and portfolio management.
- Access to the ~USD 13tn 401(k) and insurance capital pool could unlock the next wave of demand, while Q1 2026 redemption pressure strengthens lender pricing power.

02 Europe — Strong

- Banks still provide **~88% of corporate financing** (vs ~25% in the US), implying substantial runway.
- Europe accounted for 35% of 2025 global fundraising (~EUR 65bn in nine months), funded by locked-up institutional capital with minimal retail exposure, avoiding the US redemption shock entirely and mid-market unitranche still prices at E+525–625.

03 Asia-Pacific — High growth

- APAC is becoming the **next growth engine for direct lending**. **Private Credit AUM** is projected to **grow from USD 59bn to USD 92bn by 2027 (~16% CAGR)**, driven by underpenetrated Private credit markets, infrastructure funding needs and bank retrenchment.
- Australia offers institutional maturity and legal certainty, while **India presents the strongest growth opportunity** for sponsor-backed and infrastructure direct lending.

04 Middle East — Emerging

- An emerging direct lending opportunity backed by Vision 2030, infrastructure financing needs and maturing capital markets.
- Saudi Arabia is the region's preferred private debt destination (97% of institutional investors), while DIFC, ADGM and Gulf sovereign wealth funds provide the legal and capital foundations for long-term market expansion.

Portfolio stance: Prioritize senior secured carry | Overweight Europe & ABF | Build APAC selectively, hedged | Reserve dry powder for distressed

Source: *Aranca Research, Morgan Stanley, Preqin, Fitch Ratings, Apollo, ECB, With Intelligence*

Investment Implications

Defensive Carry Remains Attractive, While Vehicle Liquidity and Manager Selection Become the Differentiators

PORTFOLIO OPPORTUNITIES - Where to Lean In?

01 Senior secured carry remains the anchor

At SOFR of ~3.6% + ~500bps spreads, 1L direct lending yields ~8.5-9%, roughly double the 10Y Treasury, with ~1% historical realized losses.

02 Dispersion creates selection alpha

Q1 2026 redemption requests ranged 1.6%-40.7% across managers, reflecting that the market is rewarding credible marks and diversified books; manager choice now drives outcomes.

03 Distressed vintage is forming

~USD 175bn of forced secondary supply over 18–24 months and record 6.0% defaults create the best opportunistic entry since 2009 for funds with dry powder.

04 Structural growth legs are underpriced

Europe (E+525–625), asset-based finance and AI/data-centre credit offer premium spreads, tighter documentation and stronger downside protection than crowded US sponsor finance.

KEY RISKS - What to Underwrite?

01 Liquidity mismatch in semi-liquid vehicles

Q1 2026 marked a liquidity inflection with ~USD 14bn of redemption requests, and over half deferred. Gates preserved stability, but perpetual vehicles now face slower fundraising and rising reflexive outflow risk.

02 Defaults plateau high; PIK masks stress

Rate cuts will not clear the credit cycle quickly with defaults lag by 18–24 months, while PIK at 8.1% of income delays recognition and keeping stress elevated through 2026–27.

03 Valuation credibility gap

Listed BDCs trade ~25% below book, exposing the risk of stale private marks. Funds with weaker valuation credibility face deeper redemption queues and forced-sale pressure, making non-accruals and PIK disclosure critical.

04 Sector and vintage concentration

2021–22 software vintages defaulted hardest (sub-USD 25m EBITDA at 15.8% vs 4.0% above USD 100m); AI disruption adds tail risk to tech-heavy books.

Portfolio stance: Prioritize quality carry | Diversify vehicle liquidity | Lean into Europe & ABF | Underwrite manager marks

Source: *Aranca Research, Fitch Ratings, Morgan Stanley, Cliff water*

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