

Direct Lending: Opportunities Beyond the Noise

Jim has a conversation with Jeff Day, Co-President of the Morgan Stanley Private Credit business, with 27 of experience in direct lending. In the audio they discuss:

- The definition of direct lending in the context of private credit.
- How a direct lending manager can differentiate itself in today's market.
- Managing risk in the direct lending space.
- Why now might be a good time to invest in direct lending opportunities.

Jim Caron: Hello, this is Jim Caron, CIO of the Portfolio Solutions Group. Welcome to another edition of Caron's Corner powered by The BEAT, our asset allocation framework across Bonds, Equities, Alternatives, Taxes and short-term Transitional (cash) investing.

There is a lot going on in markets today, a lot of volatility. It also creates opportunities, but a lot of this volatility is really surrounding the direct lending and private credit markets. So rather than me try to go through this, I thought it would be a great idea to bring in one of our professionals at Morgan Stanley. He's the co-president of the private credit business, and he's been investing in U.S. direct lending for the past 27 years. He's been one of the key architects for the firm's U.S. direct lending strategy and his name is Jeff Day. Jeff, welcome.

Jeff Day: Great thank you so much for this opportunity, Jim. I really appreciate it.

Jim: The pleasure is all mine. So I want to ask you a couple of questions, where I hope you can shed some light on a few things related to direct lending. Whenever I see volatility in markets, I always think that there's a reason for it, but then there's also some opportunities around that. So I know that you're one of the co-leaders of the direct lending business. Could you tell me why this might be a good opportunity and why now?

Jeff: Absolutely. Let me start by defining the market, as private credit is sometimes used interchangeably with direct lending. I thought it would be helpful to kind of just give a little bit of a background from that perspective. You know, while direct lending is a form of private credit, it's important to note that there are a lot of different forms of private credit out there. If you're a fan of ice cream you know that Baskin Robbins has 31 flavors. So I like to say there are "31 flavors" of private credit: you could be talking about sponsored direct lending or non-sponsored direct lending, opportunistic credit, distress lending, real estate lending, consumer finance, aircraft lending, asset-based lending, etc. All these different "flavors" of private credit offer different risk and return profiles for investors.

Our strategy for U.S. direct lending is focused on making directly originated, first lien, senior secured loans to private equity sponsored businesses, where we avoid the more deeply cyclical sectors. I'd probably describe our strategy as a bit more vanilla, but it's that vanilla ice cream that we provide that is designed to offer investors an attractive risk-adjusted return with hopefully low volatility and steady income generation. In terms of why investing in direct lending now makes sense, we entered 2026 with a constructive backdrop even if recent volatility in public markets has drawn some attention. You know, through the end of 2025, equities and credit markets were signaling stability, tight spreads, resilient earnings and strong private credit issuance. More importantly, the underlying macro forces have remained quite supportive. Monetary easing has stabilized, which has reinforced borrower credit metrics, while sustaining attractive floating rate income for lenders. It's also the stability in interest rates which we believe will result in a multi-year runway for private equity capital deployment, as private equity buyers can now afford to pay up and meet sellers' expectations while still generating attractive returns for their LPs. Private equity firms are going to need financing from direct lending managers like us to acquire those businesses. Against that backdrop, we believe that direct lending continues to offer compelling advantages for investors compared with public markets: Higher spread premiums, significant lower market-to-market volatility and limited exposure to duration and curve risk are especially attractive in today's market.

Jim: I am a big fan of vanilla ice cream, but also a big fan of managing risks. I'm curious about how you manage risks because today investors are talking about software, they're talking about AI, they're talking about disruption, and the private credit, direct lending markets come up in this conversation quite a bit. People talk about leverage and refinancing and all these various things. How do you understand and manage these risks so that investors can feel comfortable?

Jeff: That is certainly a topical question. We believe that volatility in software has been driven far more by sentiment than by fundamentals. Headlines about AI have prompted investors to reprice perceived risks quickly, but we haven't really seen widespread deterioration in cash flows or liquidity across enterprise software businesses, which is where we focus on our lending strategy. AI risk assessment is embedded as part of our investment process, and has been for many, many years. During our underwriting process we evaluate many attributes, including data ownership, pricing models, resilience, margin sustainability and customer attention dynamics. We also assess how management teams adapt their products and strategies to AI developments.

We focus on lending to mission critical system of record platforms such as enterprise resource planning (ERP) systems, workflow engines, infrastructure software and deeply embedded vertical fast businesses. These businesses have long cycles and sit at the core of their customers' operations. They often house proprietary data, operate in complex or regulated environments and carry extremely high switching costs. Replacing these systems is highly disruptive and thus it's rarely undertaken lightly. As a result, revenues tend to be sticky, renewal rates high and cash flows durable. These are often the last pieces of software a company would consider replacing. We also think it's important to distinguish between equity narratives and credit realities. Equity markets react to shifts in growth expectations and valuation multiples, while credit outcomes are driven by cash flow durability, liquidity and potential minimization

of downside risk, all of which remain intact across most of the software landscape that we're exposed to.

Jim: Based on what you have said, we can't paint a narrative with just one brush that all these strategies, whether private credit or direct lending, are created equal. If so, then what makes the way you invest different and how do you create value for your clients?

Jeff: I'm really glad you asked that Jim. Yes, all direct lending strategies are certainly not created equal. Some managers look to take on more risk in their book, whether that be more junior capital exposure or lending to more cyclical industries in an effort to earn higher yield on their portfolios. There can certainly be a place for those types of managers and clients' portfolios, but investors need to understand the different risk and return profiles when they make those investments. Getting back to my earlier comments about the different flavors of ice cream, you know some of those managers are more like Rocky Road or Mint Chip flavors, versus the more plain vanilla varieties referenced earlier. This is where we look to invest.

In addition, check size used to be a real differentiating factor in the U.S. direct lending industry. With many managers now continuing to raise private credit capital and LPs who are looking for co-investment opportunities alongside their managers, being able to write a large check is less differentiating. We certainly know that private equity partners want to generate maximum returns for their LPs, so their LPs will invest in the next fund that that private equity manager raises. The question then becomes what more can private credit managers do to add value to that private equity partner to distinguish themselves to get access to the really high quality deal flow. For us, being affiliated with the best-in-class global investment bank, we're able to offer banking services for our private equity clients such as M&A idea generation, capital markets expertise and LP fund investing. Many of our bankers are also already talking to the same private equity firms about selling their companies or taking their companies public. This is tangible value that we're able to provide to that private equity partner that most of our competitors who are just alternative asset managers simply cannot. This gets us proprietary access to deal flow, first and last looks on transactions and preferred allocations on some of the most highly sought after deals. It essentially creates a wider deal funnel of opportunities for us to choose from and enables us to be more highly selective. We're also able to leverage the firm for conducting due diligence, so we're regularly talking to the industry bankers that cover these sectors that we're looking to lend to. We thus get firsthand insights into key risks we need to be able to get comfortable with in our due diligence process we're talking to equity research analysts that cover the public companies to better understand enterprise value or potential corporate finance outs. It's these key insights on diligence that are designed to allow us to have an exceptionally high quality portfolio with low non-accruals and pick income as a percentage of total income relative to others in the market, and hopefully generate better risk-adjusted returns for our investors.

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