CARLYLE

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2025 Credit Outlook: Back to Basics

Private credit's extraordinary growth has attracted a lot of attention in recent years, some of it hyperbolic and misplaced. But it is curious that so much of that growth has been concentrated in strategies inordinately dependent on sponsored M&A activity for deal flow. Competitive dynamics of the past year suggest that future growth may be focused on less penetrated spaces, like investment grade and asset-backed finance, where we believe private credit's historic return premium can be more reliably accessed.

STRONGER BORROWERS DEMAND BETTER TERMS

The interest rate shock did not dent economic activity to the extent anticipated by economic forecasters. That's partly because inflation did what inflation does: reduce real debt burdens. Though floating rate coupon payments rose substantially since 2021 for many corporate borrowers, debt-to-income ratios fell nearly 10% below pre-pandemic levels, as corporate revenue and EBITDA surged relative to outstanding principal balances (Figure 1). When excluding liability management exercises (LMEs) on credits that had entered the year trading at steep discounts to par, default rates on speculative grade loans finished 2024 at around 1%.[1]

Borrowers' stronger-than-expected financial standing led them to come back to market to demand more favorable terms. Refinancings and dividends consumed over 70% of syndicated loan proceeds in 2024, and this does not account for repricings, which covered another 50% of all loans outstanding. By the end of the year, spreads on single-B corporate credit had tightened to levels last seen in 2007.[2]

Figure 1.
Inflation, Real Growth Facilitate Corporate Deleveraging

NONFINANCIAL CORPORATE DEBT OUTSTANDING/CORPORATE VALUE-ADDED

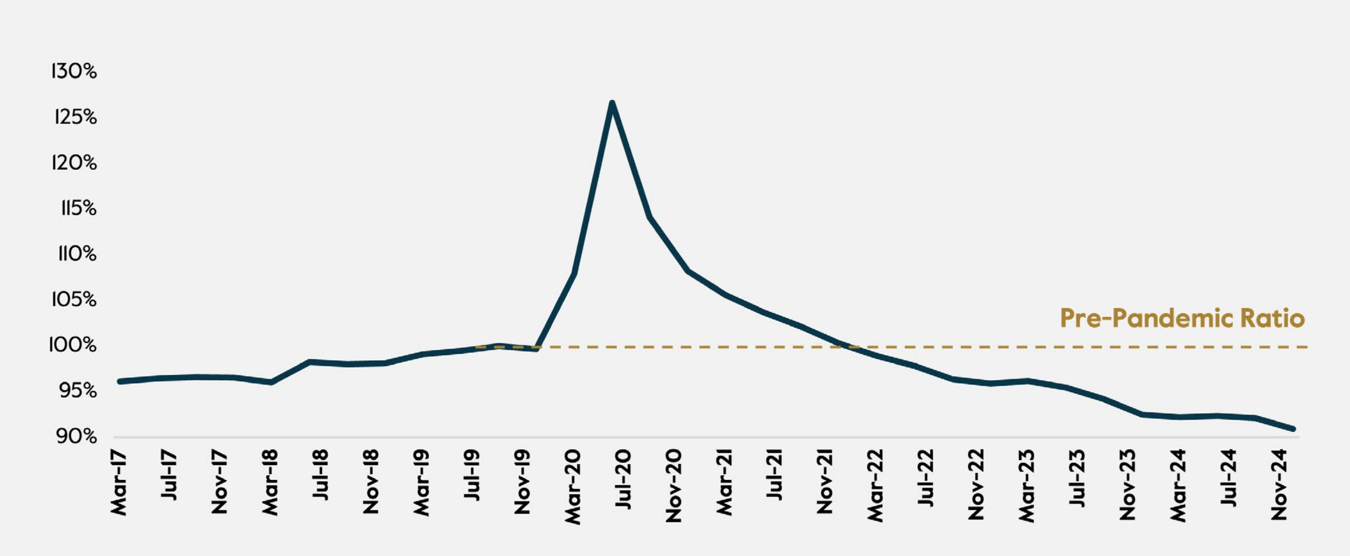


Figure 1. Source: Carlyle Analysis; Federal Reserve, March 2025. Income refers to "value added". There is no guarantee any trends will continue.

1. Bank of America, High Yield Strategy, March 2025.
2. Pitchbook LCD, January 2025.

THE DOUBLE-EDGED SWORD OF HIGHER BASE RATES

Spread tightening of this magnitude does not arise solely because of improved borrower fundamentals. Eager to revive syndicated lending markets, U.S. banks accounted for as much as 30% of the demand for CLO AAA liabilities in 2024, up from near-zero participation in 2022 and much of 2023.[3] AAA spreads tightened to levels that facilitated record CLO issuance during the year, providing corporate borrowers with a lower-cost alternative to private credit (Figure 2).

But the biggest technical driver of spread tightening has been the higher-for-longer rate environment. Higher base rates simultaneously increased demand from investors for loans and depressed their supply, resulting in a market imbalance that squeezed lenders' margins.

Historically, the case for private credit – and private intermediation, more generally – has been predicated on a *relative* return premium to compensate for the assets' illiquidity. But higher base rates increased direct lending's appeal as an *absolute* return product. With all-in yields close to 10%, on average, unitranche loans offered returns above the 7% to 9% most institutional investors target for their *stock* portfolios.[4] And since these loans sit atop the capital structure, they're less risky, all else equal, than the equity they subordinate in the cash flow waterfall. Investor allocations to direct lending funds increased 40% in 2024 (Figure 3, Page 4) even as spread tightening would suggest the risk-return tradeoff in the product had deteriorated.

Unfortunately, higher base rates simultaneously depressed the sponsored M&A activity on which the direct lending market depends. Since the Fed first hiked rates in 2022, the annual growth in net credit outstanding halved, as prospective acquirers waited on the sidelines for lower financing costs, and would-be sellers postponed sales rather than accept the decline in valuations consistent with the new interest rate regime.[5] Weaker-than-expected deal flow has intensified pressure on direct lenders to offer greater concessions to win new deals, especially at the top of the market (>$400 million in annual EBITDA).[6] In 2023, nearly 60% of unitranche loans carried spreads in excess of 600bps; by the end of Q3-2024, that figure had fallen to roughly one-third (Figure 4, Page 4).

Figure 2.
Syndicated Lending Strikes Back in 2024

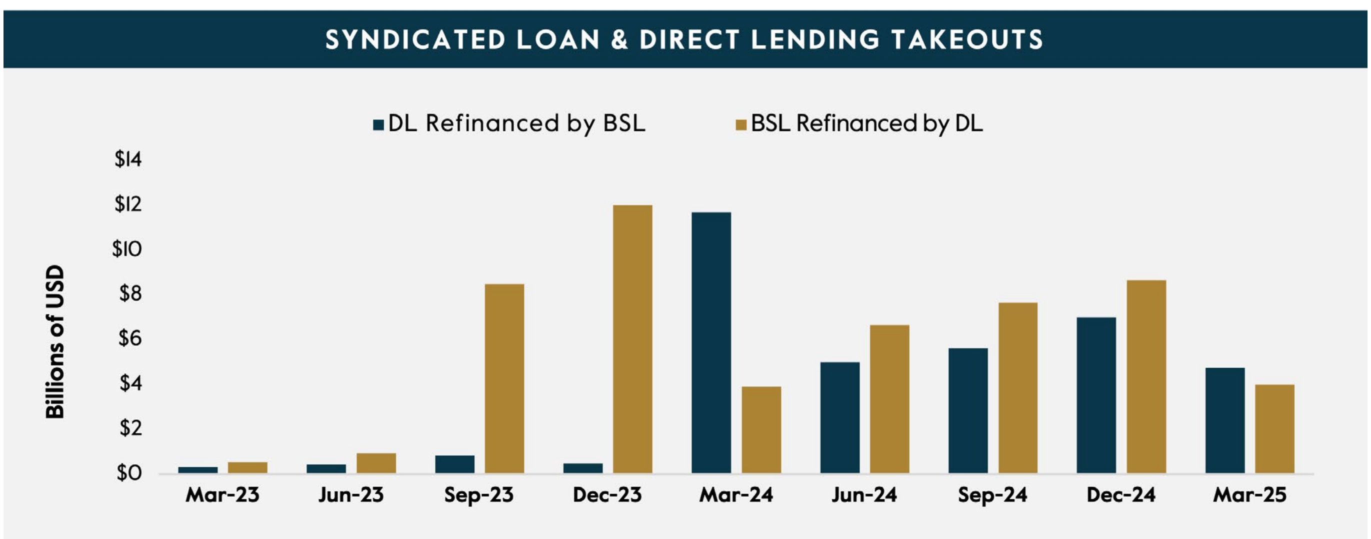


Figure 2. Source: Carlyle Analysis; Pitchbook, March 2025. There is no guarantee any trends will continue.

3. JPMorgan CLO Weekly, January 2024.
4. Andonov, A. and J. Rauh. (2018). "The Return Expectations of Institutional Investors," Hoover Institution Working Paper. Pitchbook, Q1-2025.
5. Bank of America, High Yield Strategy, March 2025.
6. Private Credit Firms Are Pushing Boundaries to Win Large Deals, Bloomberg, March 20, 2025.

Figure 3.
Direct Lending Allocations Surge 40% on Absolute Return Story

ANNUAL PRIVATE CREDIT FUNDRAISING

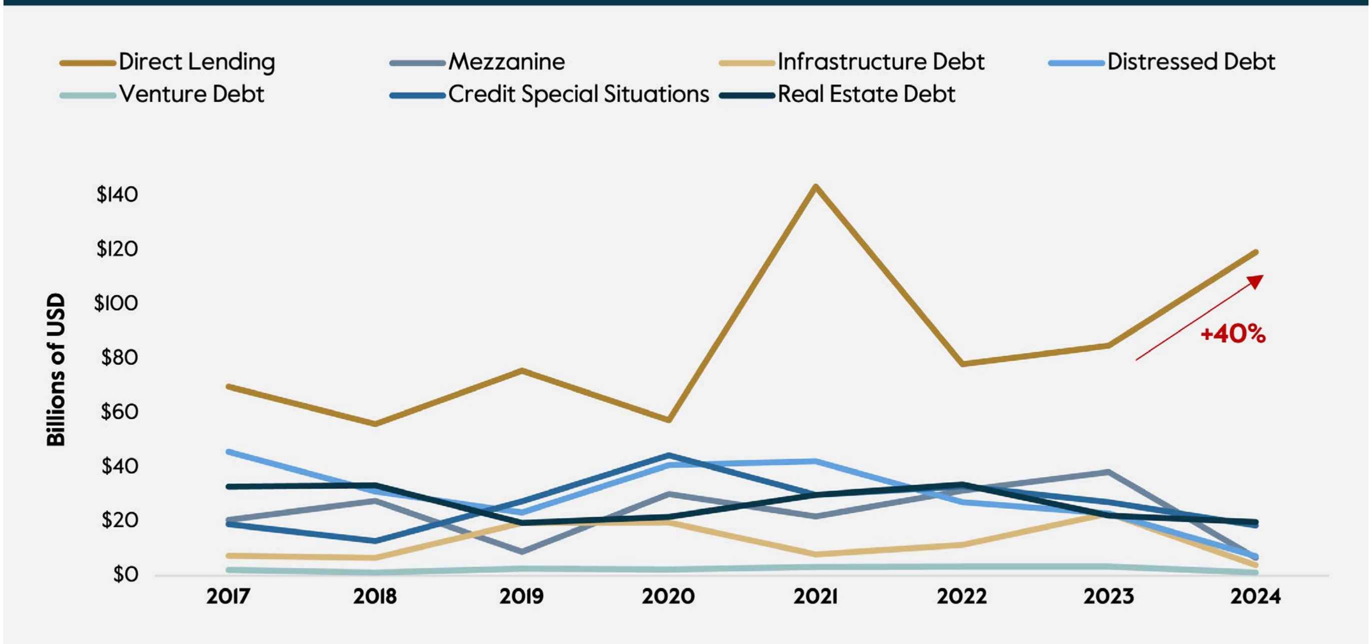


Figure 4.
Competitive Pressures Tighten Spreads

SPREAD RANGE (BPS) FOR UNITRANCHE LOANS HELD BY BDCS

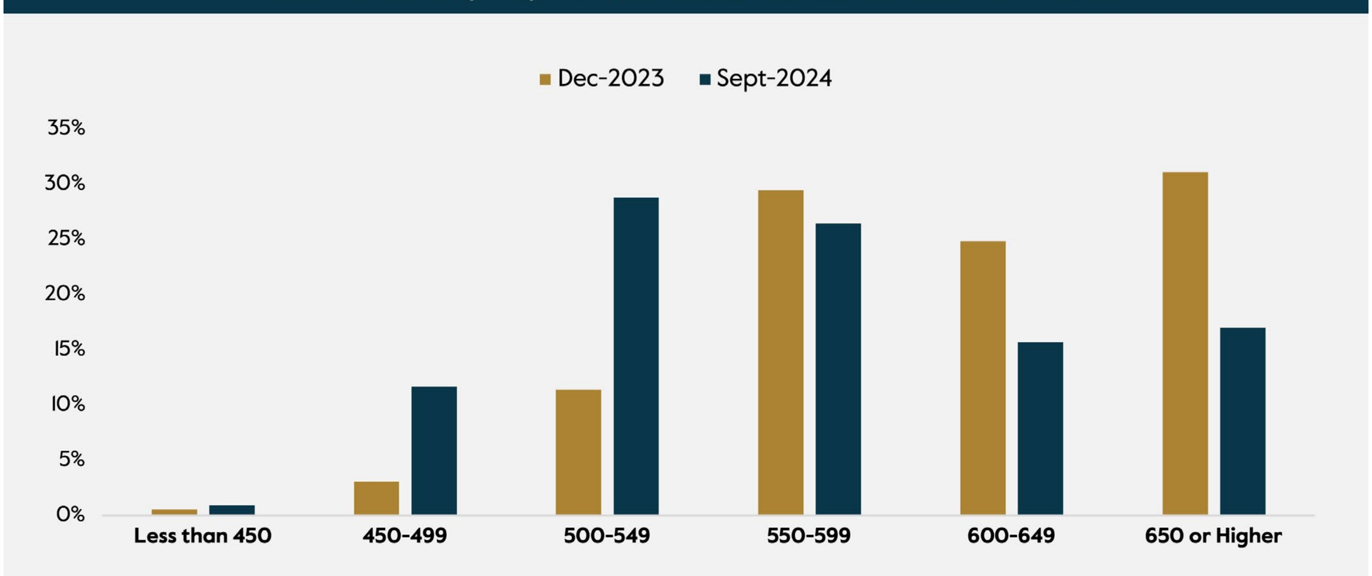


Figure 3. Source: Carlyle Analysis; Pitchbook, March 2025. There is no guarantee any trends will continue.
Figure 4. Source: Carlyle Analysis; Pitchbook, March 2025. There is no guarantee any trends will continue.

A CROWDED MARKET REVEALS MORE ATTRACTIVE AVENUES FOR GROWTH

To succeed, private intermediation must meet the needs of both its investors and investees. For investors, that means delivering an annual return premium of roughly 200bps relative to liquid alternatives facing the same default risk. For investees, that means providing financing solutions on terms (speed, certainty, flexibility, etc.) that merit the higher cost of capital. While understandable given current market realities, conceiving of private credit strategies as absolute return vehicles risks a departure from this basic value proposition.

Over the past year, a competitive equilibrium seems to have been established in deal finance markets that suggests further market share gains may be difficult to achieve without potentially sacrificing the return premium that turned so many investors onto private credit in the first place. We think the next stage of the industry's growth is likely to come through expansion to less penetrated parts of the market, such as investment grade and asset-backed finance, where we believe the illiquidity premium remains healthier and more reliably attained.

When public instruments are used to meet financing needs in these markets, they require a high degree of standardization so as to appeal to a broad investor base. This sharply limits flexibility on loan terms, typically requires significant public disclosure that may compromise the borrowers' competitive position, and often involves a lengthy public issuance process that delays closing.

As an alternative, private credit can offer fast execution on bilaterally negotiated agreements with terms tailored to the needs of the borrower. Private securitizations also offer a solution for loan collateral that does not fit neatly into public asset-backed security categories, or involves novel features, like claims on future home price appreciation or delayed drawdowns. Private credit funds could also serve as a home for loans originated by standalone or affiliated FinTech platforms or other nonbank consumer lenders.

In total, outstanding loan balances in markets accessible to private credit currently stand at over $20 trillion.[7] While lower cost public markets and securities will likely remain the more suitable home for the bulk of this lending, it's not inconceivable to think nearly $2 trillion of it could gravitate to private markets over the next decade, especially when accounting for the continued growth in outstanding balances across these categories (Figure 5, Page 6).

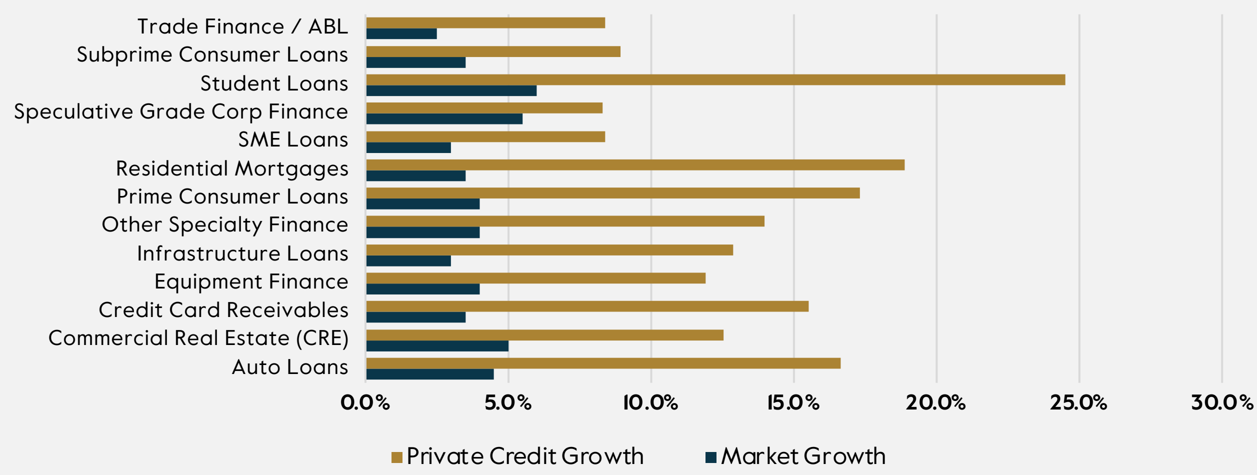
REFOCUS ON RELATIVE VALUE

Private credit's *raison d'être* is very simple: deliver an annual return premium of roughly 200bps relative to liquid markets without assuming incremental credit risk. And this basic value proposition applies as well to equipment finance and consumer receivables as it does to sponsored M&A. Rather than accept slower growth or a diminished illiquidity premium, look for the private credit industry to grow its footprint in less penetrated sectors eager to explore alternatives to one-size-fits-all public markets.

7. Carlyle Analysis. Federal Reserve Flow of Funds (Z.1) supplemented by data from the Equipment Leasing and Finance Foundation (2024), Preqin (2025), and MeasureOne (2024).
Note: This estimate excludes $10 trillion in mortgage and student lending backed by the federal government or government-sponsored enterprises.

Figure 5.
Private Credit's Growth Potential

POTENTIAL RELATIVE GROWTH RATES IN CREDIT OUTSTANDING BY CATEGORY, 2025-2035(F)



POTENTIAL GROWTH IN PRIVATE CREDIT SHARE ACROSS LOAN CATEGORIES

Category	Private Credit Market Share	
	2025	2035(F)
Auto Loans	5%	15%
Commercial Real Estate (CRE)	10%	20%
Credit Card Receivables	4%	12%
Equipment Finance	12%	25%
Infrastructure Loans	8%	20%
Other Specialty Finance	10%	25%
Prime Consumer Loans	3%	10%
Residential Mortgages	1%	2%
SME Loans	18%	30%
Student Loans	1%	5%
Subprime Consumer Loans	15%	25%
Trade Finance / ABL	20%	35%

Figure 5. Source: Carlyle Analysis; Federal Reserve Flow of Funds (Z.1) supplemented by data from the Equipment Leasing and Finance Foundation (2024), Preqin (2025), and MeasureOne (2024). There is no guarantee any trends will continue.

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Prior to joining Carlyle, Mr. Jenkins was a Senior Managing Director at CPPIB and responsible for leading CPPIB's Global Private Investment group. He was Chair of the Credit Investment Committee, Chair of the Private Investments Committee and also managed the portfolio value creation group. While at CPPIB, Mr. Jenkins founded CPPIB Credit Investments, which is a multi-strategy platform making direct principal credit investments. He also led CPPIB's acquisition and oversight of Antares Capital and the subsequent expansion in middle market lending. Prior to CPPIB, he was Managing Director, Co-Head of Leveraged Finance Origination and Execution for Barclays Capital in New York. Before Barclays, Mr. Jenkins worked for 11 years at Goldman Sachs & Co. in senior positions within the Fixed Income and Financing groups in New York.

Mr. Jenkins earned a B.Comm degree from Queen's University. He served on the boards of Wilton Re, Teine Energy, Antares Capital and Merchant Capital Solutions.

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Prior to joining Carlyle, Mr. Thomas served on the White House staff as Special Assistant to the President and Director for Policy Development at the National Economic Council. In this capacity, Mr. Thomas acted as the primary adviser to the President for public finance.

Mr. Thomas received a BA from Claremont McKenna College and an MS and PhD in finance from George Washington University, where he studied as a Bank of America Foundation, Leo and Lillian Goodwin Foundation, and School of Business Fellow.

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