An Income Alternative
Exploring Middle Market Direct Lending

GOLUB CAPITAL

Contents

Sophisticated investors and their advisors have flocked to private credit in recent years as a complement to traditional allocations to public fixed income. Does this phenomenon reflect a fleeting "golden moment" for the asset class, as some have speculated, or is there an enduring case for private credit as a core component of investor portfolios? This essay seeks to cut through the jargon surrounding the term "private credit" by focusing on its largest and fastest-growing component: middle market direct lending. We will make the case for a core allocation to middle market direct lending as a compelling alternative to traditional investment strategies.

Our exploration encompasses three topics. First, we will situate middle market direct lending in the broader landscape of public and private credit strategies. In doing so, we will define the key characteristics of middle market companies and the direct lending ecosystem that surrounds them. Then, we turn to the investment characteristics of direct lending—how managers craft each individual investment, and in turn a portfolio of investments, in pursuit of consistent, premium income and compelling total returns over time. Finally, we offer several perspectives on how an investor might frame a strategic allocation to direct lending managers to gain long-term exposure to the asset class.

Starting from the Middle

The Emergence of Middle Market Direct Lending

Private credit is not a single strategy but many. To ensure we're working from the same asset map, let's first distinguish public corporate credit from private and unpack both (Exhibit 1). Investment-grade credit is the largest and most well-known category (with over $6 trillion in debt issued by the largest companies). Sub-investment-grade corporate credit is broken into high yield (with about $1.4 trillion outstanding) and broadly syndicated or leveraged loans (also with about $1.4 trillion in debt). Issuers of public credit tend to be larger companies with the scale that allows them to access liquid markets.

Private credit includes many sub-categories, from direct lending to venture debt, and is typically issued by small and mid-sized companies that lack the scale to be well served by the public markets. Each sub-category represents a distinct approach with different risk and return profiles. For example, distressed strategies thrive on market dislocation, engaging in the restructuring of firms going into or coming out of bankruptcy, and generate a return profile more closely resembling that of equity. Mezzanine investors target junior, unsecured debt or preferred equity investments.

Exhibit 1

The Private—Public Divide

Public Credit

Traditional, Liquid Markets

- **Investment-Grade Credit**
- **High-Yield Debt**
- **Leveraged (or Syndicated) Loans**

- **Traditional public credit** includes investment-grade and sub-investment-grade debt in the form of high-yield and broadly syndicated/leveraged loans.
- Public credit is available only to larger established companies; the debt is tradable in liquid markets, and investors can invest via traditional passive or active mutual funds or exchange traded funds.

Private Credit

Alternative, Less Liquid Markets

- **Direct Lending**
- **Distressed Debt**
- **Mezzanine Finance**
- **Special Situations**
- **Venture Debt**

- **Alternative, private credit** is issued by smaller companies that have been orphaned by public debt markets. It's less liquid and often held to maturity by the lender.
- Private credit strategies take several distinct forms (direct lending is the largest). Investors can access these strategies through private funds, business development companies (BDCs) and other vehicles.

Source: Golub Capital internal analysis. Note: For illustrative purposes only.

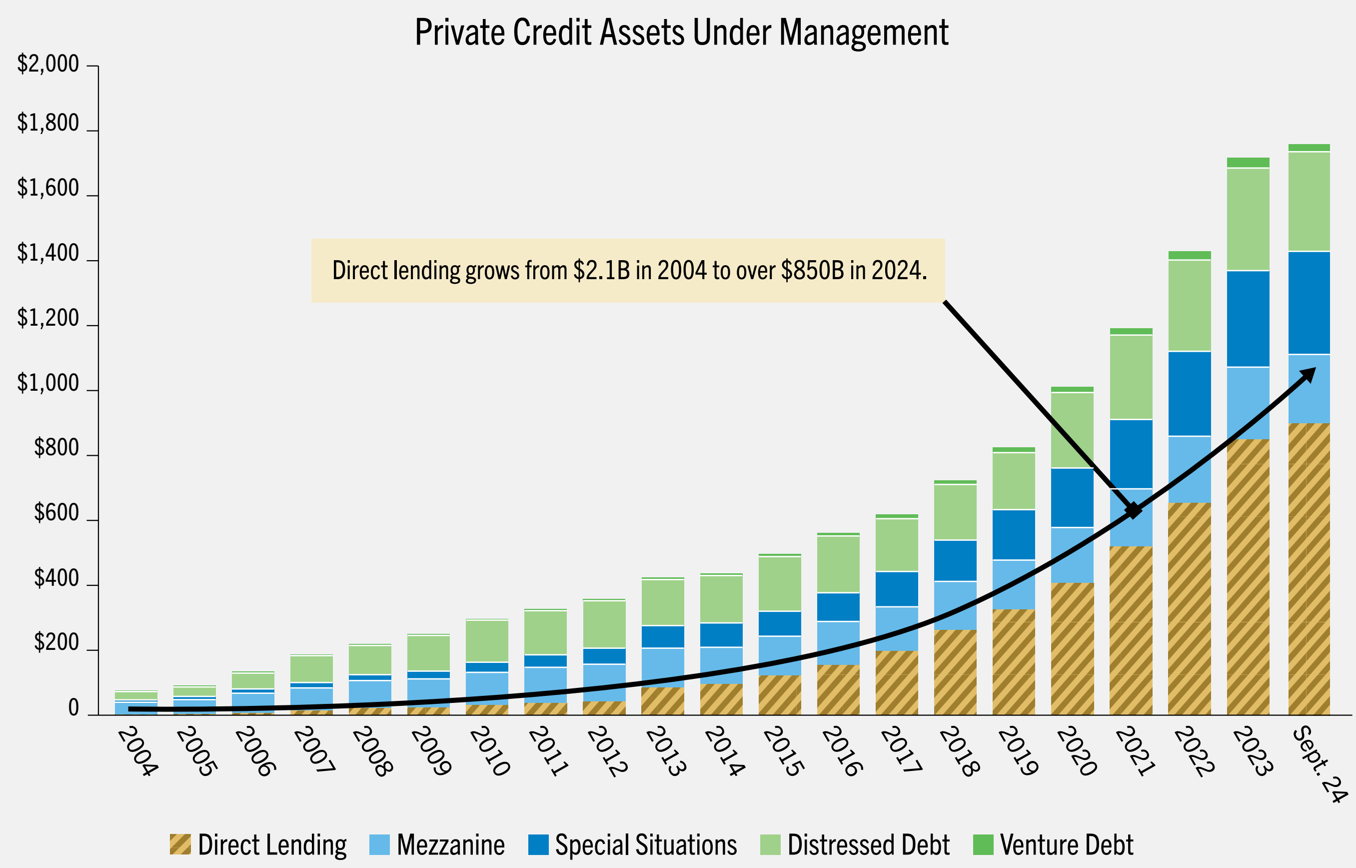
Direct lending was a small part of the whole twenty years ago but has seen remarkable growth over the last decade, directly paralleling the rise of private equity (Exhibit 2).

Today, at approximately $850.5 billion in assets spread across private drawdown funds and BDCs, direct lending represents the largest component of private credit and has become nearly synonymous with the category itself.

Having put direct lending on the map, we now turn to defining the middle market. The middle market fits snugly between two of the most well-known private equity categories: venture capital and large-cap buyout.

Exhibit 2

What's in a Name: Unpacking Private (Corporate) Credit



Source: Preqin. As of September 30, 2024.

These two strategies represent the outer ends of the private market continuum. Middle market companies are neither early-stage start-ups funded by angel investors and venture funds nor are they nationally known, large-cap companies that tend to be either already publicly traded or supported by larger bulge bracket buyout shops.

A typical "core" middle market firm is fairly mature (on average 31 years old), of reasonable size (typically between 50–500 employees) and has somewhere between \$10 and \$100 million in annual earnings before interest, taxes, depreciation and amortization (EBITDA) (Exhibit 3). Across the United States, the category includes approximately 200,000 companies, employing up to 1/3 of the U.S. workforce, but individually they remain geographically constrained (limited to one or two regional markets).[1] This universe of middle market companies includes many firms with strong and predictable revenues, making them highly attractive to non-bank lenders.

Exhibit 3

Starting from the Middle: Not Too Big, Not Too Small

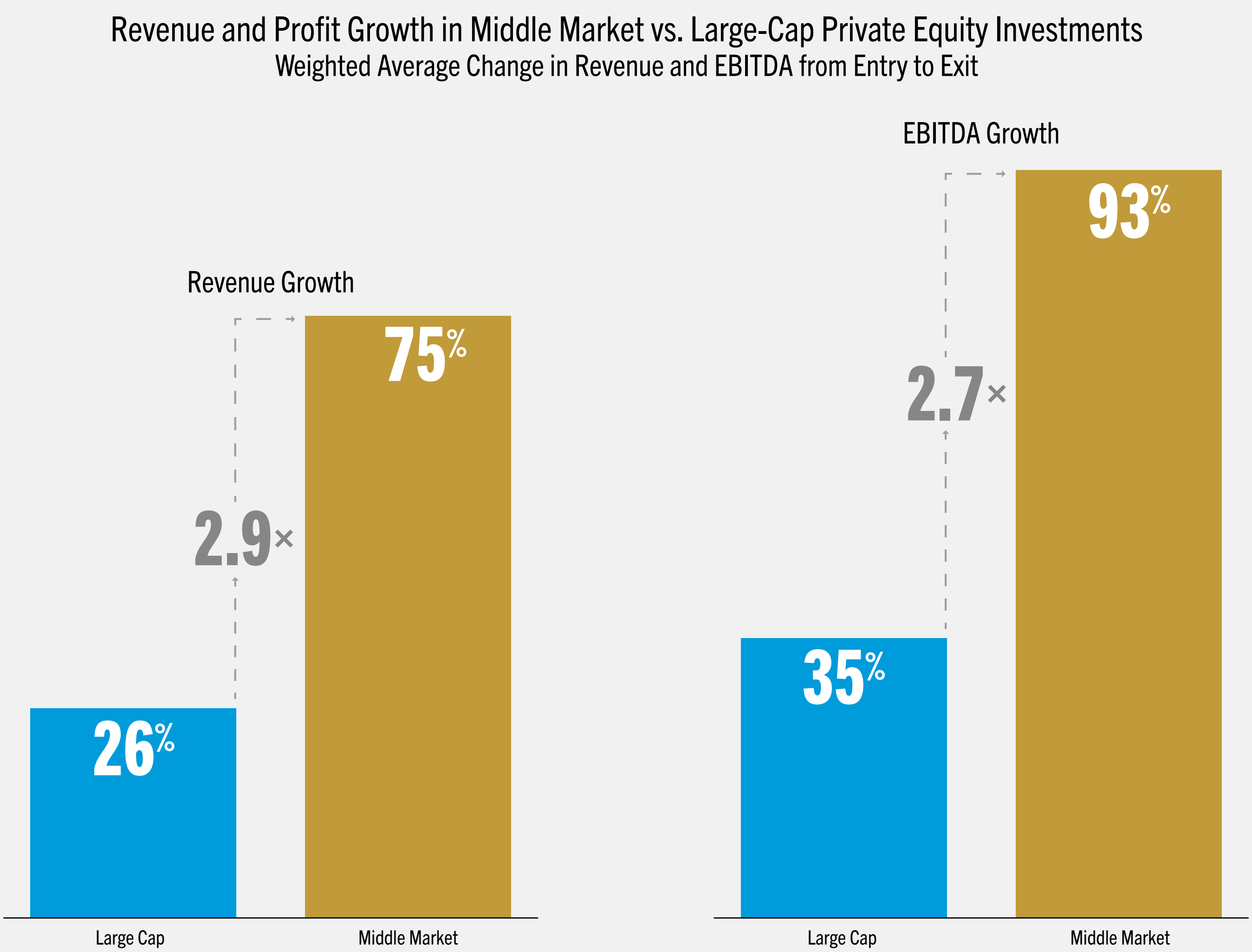
Source: Golub Capital internal analysis. The National Center for the Middle Market "Middle Market Update." As of 2024.

1. The National Center for the Middle Market, 2024 Middle Market Indicator.

At the same time, middle market companies often have untapped potential that makes them appealing acquisition targets for private equity "sponsor" firms. Specialists in middle market private equity provide capital and operational expertise to unlock companies' potential to grow rapidly (organically and/or by acquisition) and increase profitability. The potential value creation is staggering. A recent study analyzed the average weighted change in revenue and earnings, from entry to exit, comparing large-cap and middle market buyouts (Exhibit 4). The results show that sponsors of middle market deals achieved revenue and EBITDA growth almost three times that of traditional large-cap buyouts.

Exhibit 4

It's Better in the Middle: More Room to Grow



Source: MSIM database of transaction level information, including only U.S. deals and excluding Morgan Stanley transactions. Represents a sample of portfolio companies that report on EV, revenue, EBITDA, net debt and company status (public/private), with data as of 2023. MSIM analysis as of 2023. Given the sample universe and size, there is potential for selection bias. Middle market is defined as a transaction value of $500 million or less. Sample includes 166 total transactions—37 large-cap and 129 middle market. Analysis excludes outliers.

The Rise of Non-Bank Lending

Defining the Sponsor—Lender relationship

The outsize appeal of these private middle market companies to private equity sponsors is clear. That leaves the question of sourcing debt capital to enable the deal. A radical shift occurred in the sourcing of debt finance for middle market investments in the early stages of the asset class (Exhibit 5). The historic supply of debt financing moved from banks to "non-bank" financial institutions. There are several explanations for this.

A wave of consolidation in the banking industry came in the 1990s; regional banks, the traditional lenders to smaller, local businesses, were gradually acquired by larger rivals. These bigger banks generally focused on larger, more lucrative business customers. Then, after the financial crisis in 2009, Dodd-Frank legislation and Basel III regulations made it more costly for banks to hold corporate loans on their balance sheets—particularly leveraged loans favored by private equity sponsors. This encouraged the banks to step away from direct lending and focus instead on arranging loans to be sold (i.e., broadly syndicated) to institutional investors.

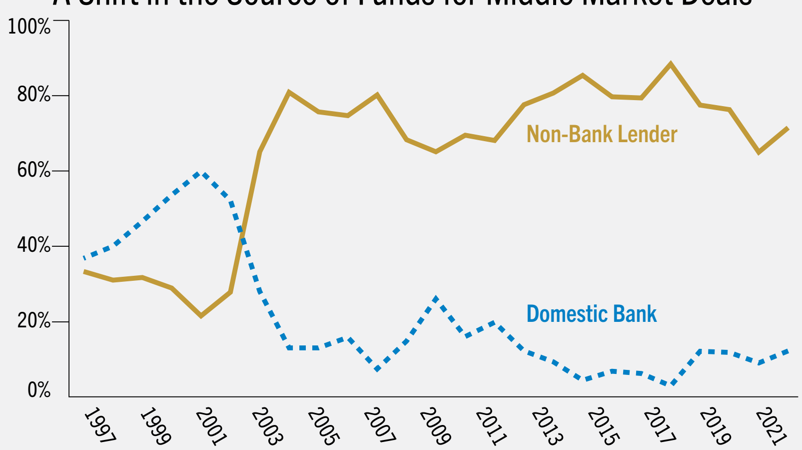
But there's another factor at work—the relationship at the heart of middle market direct lending, between the private equity sponsor and their lenders. Non-bank direct lenders stepped into the void left by banks, offering financing options tailored for the needs of private equity sponsors. Direct lenders offered bespoke solutions with less complexity, fewer stakeholders, greater speed and certainty of execution and the ability to grow the financing relationship over time. In a 2024 survey of sponsor preferences, these were the most highly valued characteristics of their financing partners.[2]

This enabling relationship between sponsor and lender became the heart of middle market direct lending. It's only natural then that middle market direct lending, in its truest form, may be more realistically denoted as *sponsor finance.*

Exhibit 5

Non-Bank Lenders and the Rise of Sponsor Finance

A Shift in the Source of Funds for Middle Market Deals



The Benefits of Direct Lending to PE Sponsors
Speed of Decision Making
Relationship Orientation
Certainty of Execution
Bilateral Negotiations/Confidentiality
Capacity to Lend in Scale
Ability to Structure Bespoke Solutions
Ease of Add-On Financings
No/Limited Syndication

Pitchbook, LCD, "High-End Middle Market Lending Review 4Q 2023." Excludes data for 2020, 2022 and 2023 because PitchBook LCD did not have enough observations. Data series begins in 1997.

2. The Proskauer Private Credit Survey 2024; Trends in Private Credit; The Industry Speaks.

One-Stop Shop

Innovation, Not Regulation, Drives Direct Lending

When direct lending is seen as emerging more from the critical symbiosis of sponsor and lender, a different creation story begins to gain conviction, one more dependent on innovation than regulation. Similar to the way that high-yield debt enabled the rise of private equity in the 1980s, the growth of direct lending may be premised on another innovation in debt structuring: the unitranche or *one-stop* loan.

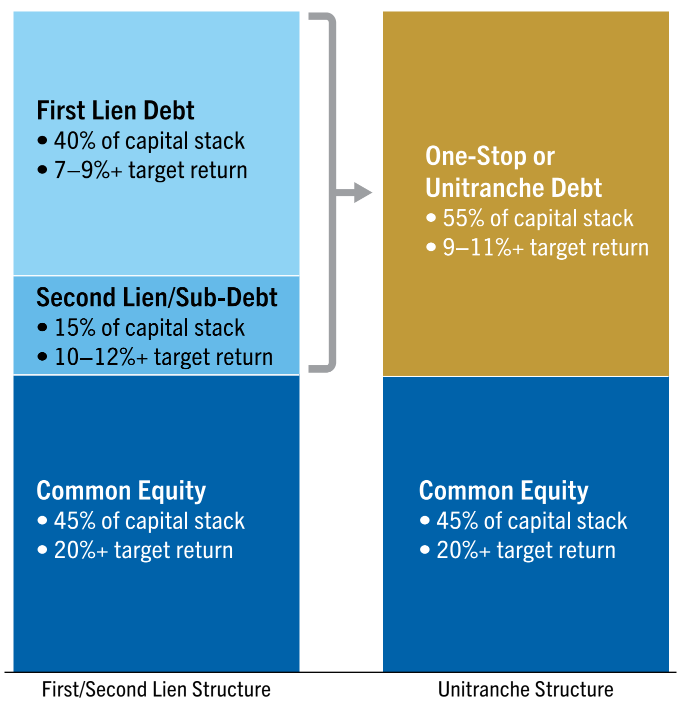
In the early 2000s, a typical private equity firm would finance a deal by going to a bank to get a senior loan. The bank would be restricted by a variety of different regulatory and internal bureaucratic issues. The loan would therefore need to be crafted very carefully with a certain amortization rate, limitations on leverage and specific documentation terms that fit within the square peg of what the bank was permitted to do. The sponsor typically would also need to borrow from a second source, a junior debt provider, usually an insurance company or a mezzanine fund. The insurance company or the mezzanine fund had their own needs and concerns. At the end, the sponsor has to invest time and money in negotiating an inter-creditor agreement among parties that look at the world differently.

The private equity sponsor soon realizes he has two lenders with different interests and incentives. The sponsor just wants to grow the company and increase its value over time, but the mezzanine investor really just wants to get paid back and keep their warrants. Meanwhile, the senior lender wants to avoid going back to their investment committee. Every time there's a need for new capital, the sponsor must navigate this very complicated labyrinth at two different sets of organizations.

The unitranche loan, invented in 2004, helped solve this dilemma. Merging multiple lenders that historically delivered different tranches of the capital stack into one, it radically simplified the entire process of deal financing, as well as the complicated, multi-layered capital structure. The presence of a single lender, well known from prior deals, with the scale and flexibility to work with a sponsor to address future bespoke lending needs (including, for example, potential "add-on" investments or "re-capitalizations") transformed the relationship to a long-term partnership in which lenders were incentivized after the transaction to lend more money. The sponsor's comfort in a reliable partner, and the efficiency of the one-stop solution, was a critical spark in the growth of middle market direct lending, or sponsor finance.

And this alignment of interests doesn't end with sponsor and lender. For the middle market investor, the benefits of the one-stop unitranche loan include a higher blended return (9–11%) between junior (10–12%) and senior debt (7–9%). In addition, the loan's total return consists almost exclusively of contractually derived and quarterly paid income. This stable income stream also came with little or no interest rate risk (given its floating-rate nature), and its senior secured status in the capital stack delivered strong collateral protection against the possibility of loss.

Traditional vs. Unitranche (or One-Stop) Structures



Source: Golub Capital and KBW research, as of December 31, 2023.

Building a Consistent Return Premium

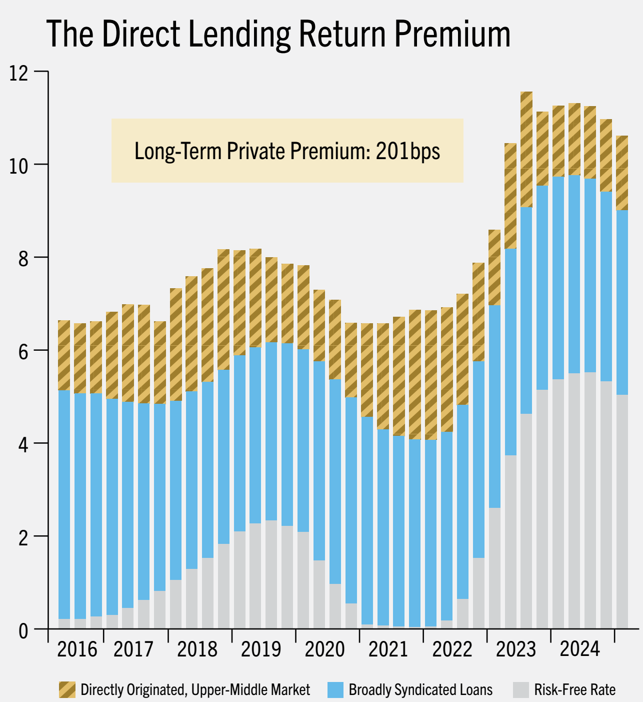
Creating Greater Certainty of Outcome

To understand the risk and return characteristics of private direct lending, we must first acknowledge some differences between public and private (or "alternative") investments. Investors may gain exposure to traditional asset categories passively through an index. Alternatively, they can allocate to an active manager who may over- or under-weight an index's constituent holdings in an effort to outperform that benchmark.

Private markets function differently. In private markets, there is no defined or investable index. Nor is there a public market with rules for "fair disclosure" that allows for democratic and equal-footed engagement with the underlying investments.

Exhibit 6

A Business, Not an Index: Hand-Crafting a Premium Return



Sources: Golub Capital internal analysis; Cliffwater 2024 Q1 Report on U.S. Direct Lending. Risk premiums are estimates only.

Instead, private market investing involves asymmetric knowledge across investors, often achieved via non-disclosure agreements, (NDAs). In short, the investment returns in any private market alternative category are highly dependent on the idiosyncratic interaction between the manager and the assets they buy and sell. Investment managers in the private markets are akin to artisans working in different media, essentially creating and calibrating the risk and return characteristics of each individual asset. In their case, the goal is not to pursue aesthetic outcomes but to achieve a return premium and greater control over the investment's outcome.

As an example, consider the structural advantages of a private middle market loan, framed in relation to its closest public market equivalent, broadly syndicated or leveraged loans. The return premium sometimes offered by the *alternative* asset is driven by specific factors unique to this private market context and is the result of direct engagement between sponsor and lender (Exhibit 6).

Some distinctions between the two include:

- **Information Asymmetry:** Syndicated loans have publicly available credit ratings and analyst research, and information sharing is governed by regulation; middle market lenders must undertake extensive and confidential business diligence directly with the sponsor and company management, selectively enabled by NDAs.
- **The Illiquidity Premium:** Where a syndicated loan is offered widely to investors based on a term sheet from a bank's trading desk, direct lenders demand precise borrower requirements and typically do not trade paper, instead holding loans to maturity.
- **The Scarcity Premium:** Scarce middle market deal flow is off-market and relationship-driven, with very few lenders of size allowed to or even able to compete for any single deal.

- **The Complexity Premium:** The terms of a directly originated middle market loan are heavily negotiated, with settled definitions of leverage, debt and EBITDA and limits on other items that might distort actual earnings.
- **Controlling the Outcome:** Direct loan documentation will have strong creditor protections to close loopholes for value leakage and typically include financial maintenance covenants that enable lenders to get to the table early and proactively address problems to maximize recovery.

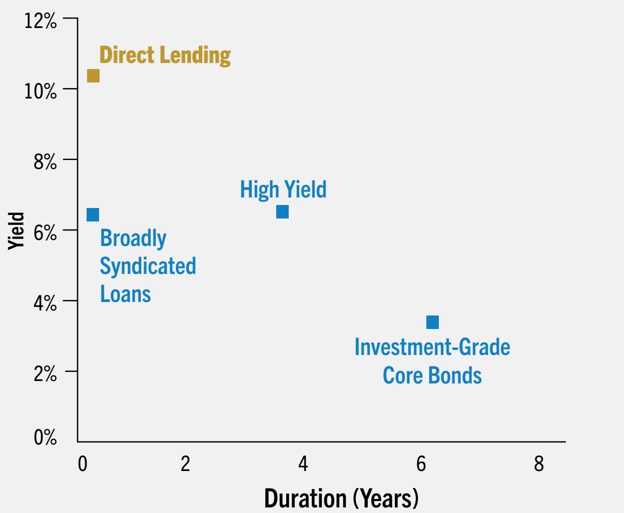
All of these together have historically enabled a highly consistent return advantage over its closest public market credit peer of about 200 basis points annually.

A more traditional visual that shows total returns and risk or volatility over the last 20 years including several familiar public fixed income categories, helps put the "premium" associated with this private market asset into clearer context. Able to preserve capital thanks to its senior-secured status in the capital stack and its lack of exposure to interest rate risk, direct lending appears to have far lower volatility than other fixed income staples. Meanwhile, the total returns of direct lending are derived mostly from contractual income from borrowers, minus an annual average credit loss rate of about 1%, giving it a long-term net return of over 9%.

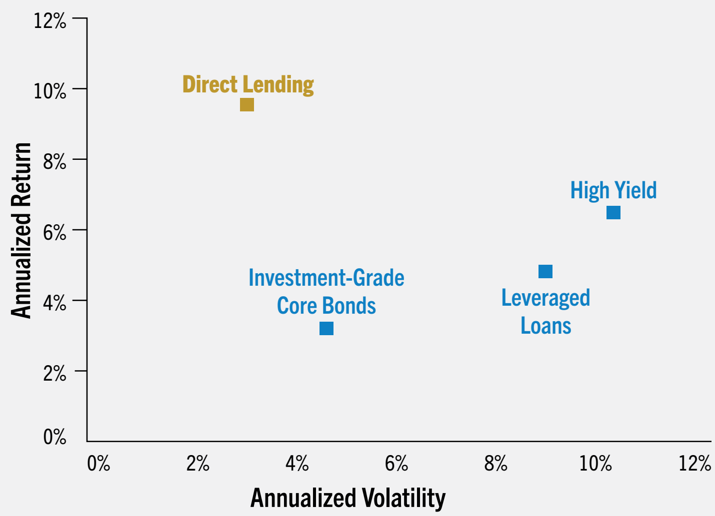
Exhibit 7

An Outlier: Measured by Return or Yield, Volatility or Duration

Yield vs. Duration: Direct Lending vs. Traditional Fixed Income[1]



Return vs. Volatility: Direct Lending vs. Traditional Fixed Income[2]



1. Source: Morningstar. Cliffwater Direct Lending Index ("CDLI") Q2 2015–Q1 2025. Data as of April 30, 2025. Duration for direct lending and broadly syndicated loans are floating rate and are for illustrative purposes only.
2. Returns are measured by annualized returns, which are calculated based on quarterly returns. Annualized volatility is measured by standard deviation of quarterly returns. Data from September 30, 2004, through December 31, 2024. The indices used in this analysis are as follows. Direct lending is represented by the CDLI, and high yield is represented by the ICE BofA US High Yield Index. The ICE BofA US High Yield Index tracks the performance of dollar-denominated, below-investment-grade corporate debt publicly issued in the U.S. domestic market. Leveraged loans are represented by the Morningstar LSTA US Leveraged Loan Index. The Morningstar LSTA US Leveraged Loan Index is a market value-weighted index designed to measure the performance of the U.S. broadly syndicated leveraged loan market. The Morningstar LSTA US Leveraged Loan Index typically encompasses 90–95% of the entire broadly syndicated leveraged loan market. Investment-grade bonds are represented by the Bloomberg US Aggregate Bond Index. The Bloomberg US Aggregate Bond Index represents securities that are SEC-registered, taxable and dollar-denominated. The index covers the U.S. investment-grade fixed-rate bond market, with index components for government and corporate securities, mortgage pass-through securities and asset-backed securities. These major sectors are subdivided into more specific indices that are calculated and reported on a regular basis.

Note: Past performance does not guarantee future results. You cannot invest directly in an index, and index returns do not take into account trading commissions and costs. The volatility of indices may be materially different from the performance of Golub Capital Funds. Index returns reflect all items of income, gain and loss and the reinvestment of dividends and other income.

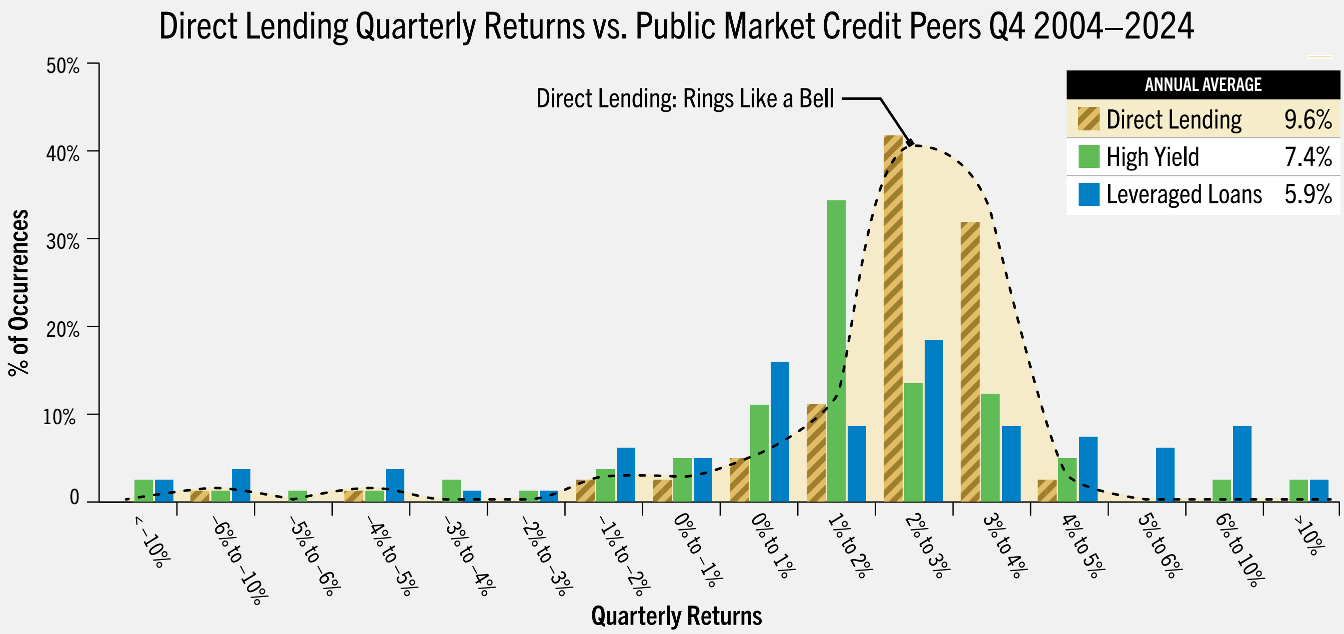
An Income Alternative

Direct Lending Historically Provides Strong and Consistent Returns

Comparing direct lending more specifically to its public credit peers, such as high yield and leveraged loans, may help illustrate some of the distinct characteristics of this alternative income source. While both direct lending and leveraged loans are *floating rate* and *secured,* high-yield debt is both unsecured and has inherent duration or interest rate risk, both of which lead inevitably to deeper losses and wider swings in return. One way to discern these differences in return behavior is to illustrate the returns of high yield, leveraged loans and direct lending chronologically in a histogram of quarterly total returns over the last 20 years (Exhibit 8). The returns from direct lending are "high and tight," meaning they are remarkably consistent and consistently higher, with over 70% of quarterly returns coming in between 2% and 4% (if we include 1–2% quarterly returns, the frequency rises to about 85%). The curve illustrated by the quarterly returns of high yield and leveraged loans is hardly bell-like at all, with lower returns, much wider dispersion and a distinct skew to both the right and left tails.

Exhibit 8

High and Tight: Seeking Consistent Returns



Returns are measured by annualized returns, which are calculated based on quarterly returns. Data from September 30, 2004, through December 31, 2024. The indices used in this analysis are as follows. Direct lending is represented by the CDLI, and high yield is represented by the ICE BofA US High Yield Index. The ICE BofA US High Yield Index tracks the performance of dollar-denominated, below-investment-grade corporate debt publicly issued in the U.S. domestic market. Leveraged loans are represented by the Morningstar LSTA US Leveraged Loan Index. The Morningstar LSTA US Leveraged Loan Index is a market value-weighted index designed to measure the performance of the U.S. broadly syndicated leveraged loan market. The Morningstar LSTA US Leveraged Loan Index typically encompasses 90–95% of the entire broadly syndicated leveraged loan market. These major sectors are subdivided into more specific indices that are calculated and reported on a regular basis.

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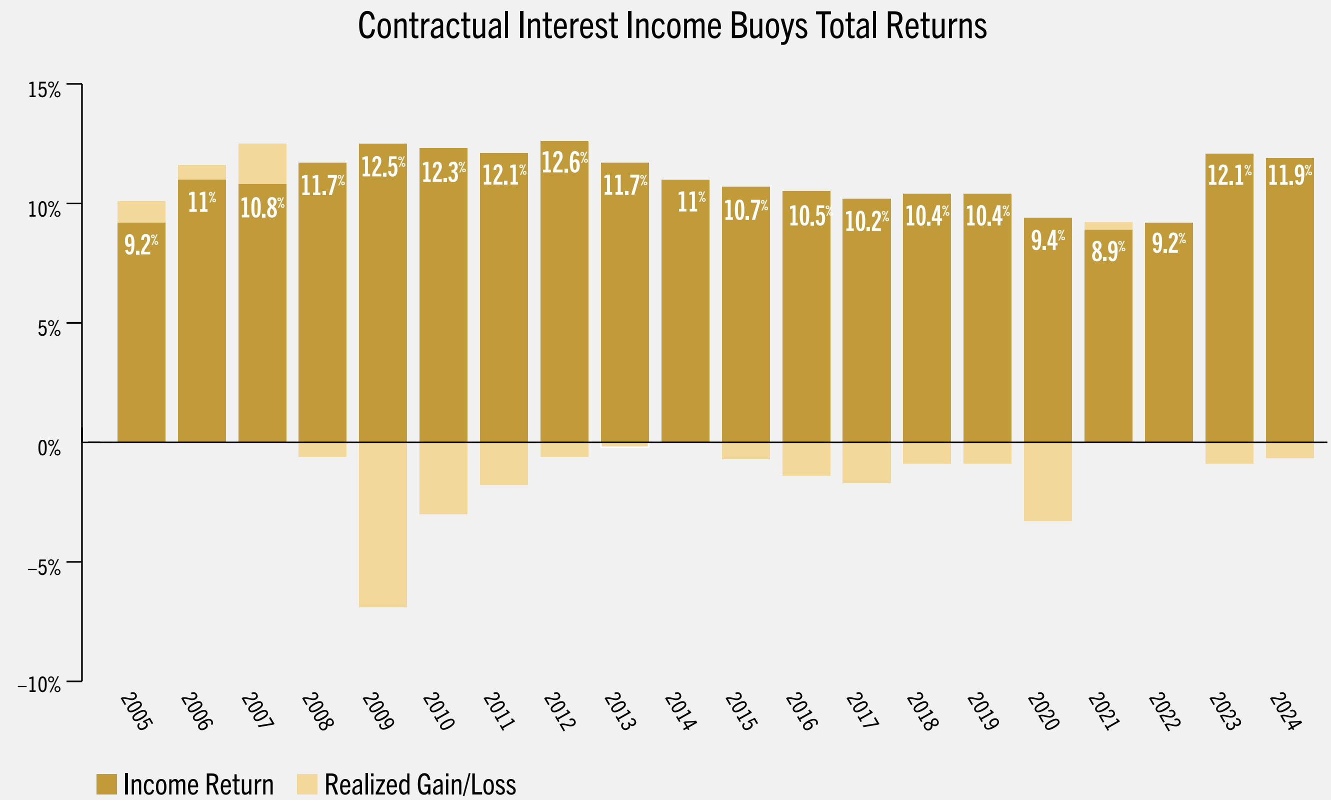
Because of its floating-rate nature, returns from direct lending suffer little impact from duration risk but are more exclusively yield- and credit-driven. Its total return derives almost entirely from contractually negotiated coupon income, which has measured mostly in the double digits over the last 20 years. The average annual investment *income* from direct lending, at just under 11%, is double that of its nearest public credit peer, leveraged loans. Consistency over time, not just the size of this recurring stream of income, is what stands out (Exhibit 9). This robust and stable yield cushion helps buoy total returns, mitigating the impact of periodic credit impairment, realized or not. This in turn provides a comforting margin of safety for investors and a smoother investment experience overall.

Exhibit 9

Consistent Yield Cushion Helps Smooth the Ride



10.9% Average Annual Income Return Since 2005

AVERAGE ANNUAL INCOME RETURN	
Direct Lending	10.9%
High Yield	7.4%
Leveraged Loans	5.9%

Returns are measured by annualized income returns, which are calculated based on quarterly income returns. Data from January 1, 2005, through December 31, 2024. The indices used in this analysis are as follows. Direct lending is represented by the CDLI, and high yield is represented by the ICE BofA US High Yield Index. The ICE BofA US High Yield Index tracks the performance of dollar-denominated, below-investment-grade corporate debt publicly issued in the U.S. domestic market. Leveraged loans are represented by the Morningstar LSTA US Leveraged Loan Index. The Morningstar LSTA US Leveraged Loan Index is a market value-weighted index designed to measure the performance of the U.S. broadly syndicated leveraged loan market. The Morningstar LSTA US Leveraged Loan Index typically encompasses 90–95% of the entire broadly syndicated leveraged loan market. These major sectors are subdivided into more specific indices that are calculated and reported on a regular basis.

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Downside Defense

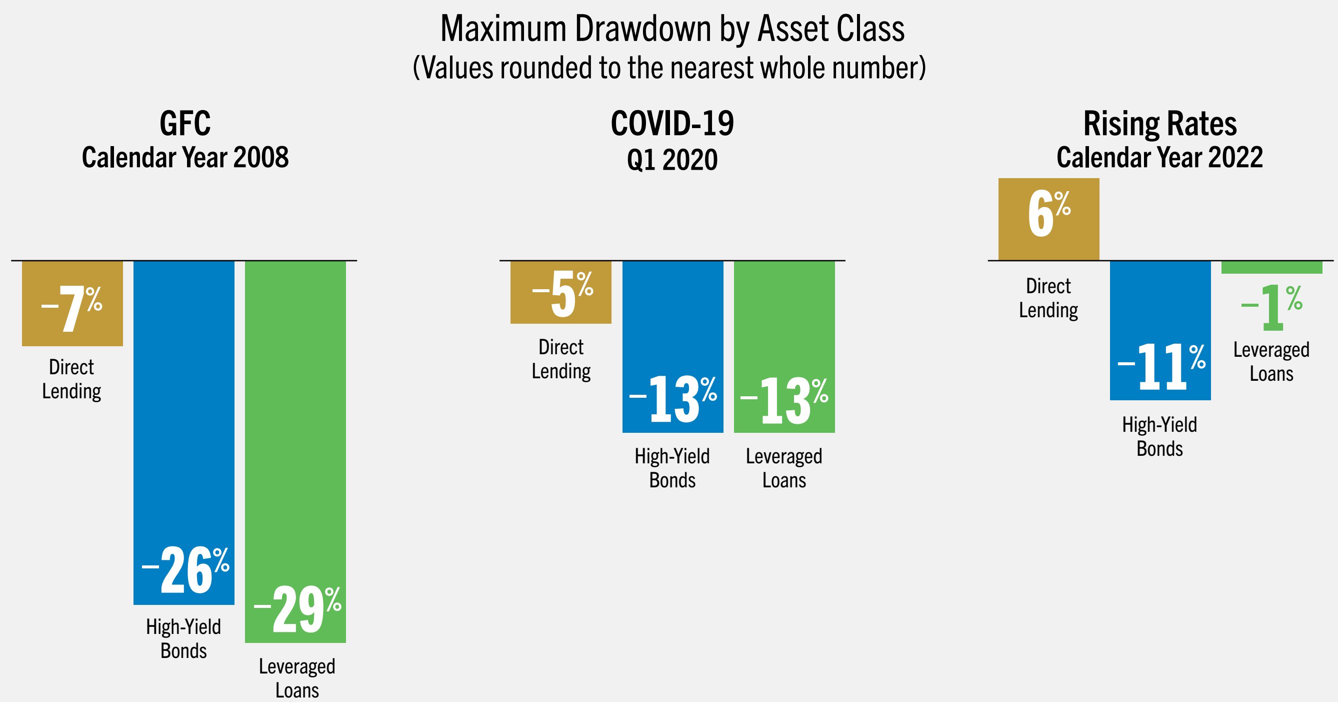
Seeking an All-Weather Asset for a Strategic Allocation

The asymmetric return profile of all debt investments (limited upside with substantial downside risk) requires an inveterate focus on defense by managers. And in the case of direct lending, credit risk is the primary vulnerability. Measures of credit risk, including default, recovery and loss rate, are familiar terms across most debt investments, but the methodologies for measuring them differ across public and private market strategies, which makes precise comparison of those metrics difficult.

For example, in public credit markets, the definition of "default" employed by credit ratings agencies is consistent and widely accepted (a failure to pay interest or principal and likely bankruptcy). This is not the case in direct lending, where a technical default could be triggered, for example, by the borrower's breach of a financial maintenance covenant (say, an interest coverage ratio) embedded in the loan's terms or documentation. This functions as an early warning system to all participants to address a pending issue

Exhibit 10

Resilient in Dislocation and Drawdown



Returns are measured by annualized returns, which are calculated based on quarterly returns. The indices used in this analysis are as follows. Direct lending is represented by the CDLI, and high yield is represented by the ICE BofA US High Yield Index. The ICE BofA US High Yield Index tracks the performance of dollar-denominated, below-investment-grade corporate debt publicly issued in the U.S. domestic market. Leveraged loans are represented by the Morningstar LSTA US Leveraged Loan Index. The Morningstar LSTA US Leveraged Loan Index is a market value-weighted index designed to measure the performance of the U.S. broadly syndicated leveraged loan market. The Morningstar LSTA US Leveraged Loan Index typically encompasses 90–95% of the entire broadly syndicated leveraged loan market. These major sectors are subdivided into more specific indices that are calculated and reported on a regular basis.

Note: Past performance does not guarantee future results. You cannot invest directly in an index, which also does not take into account trading commissions and costs. The volatility of indices may be materially different from the performance of Golub Capital Funds. Index returns reflect all items of income, gain and loss and the reinvestment of dividends and other income.

down the road. In other words, direct lending managers will embed various lender protections in the creditor agreement to reduce the very possibility of default. As a result, portfolios of middle market loans historically provide excellent downside protection for investors.

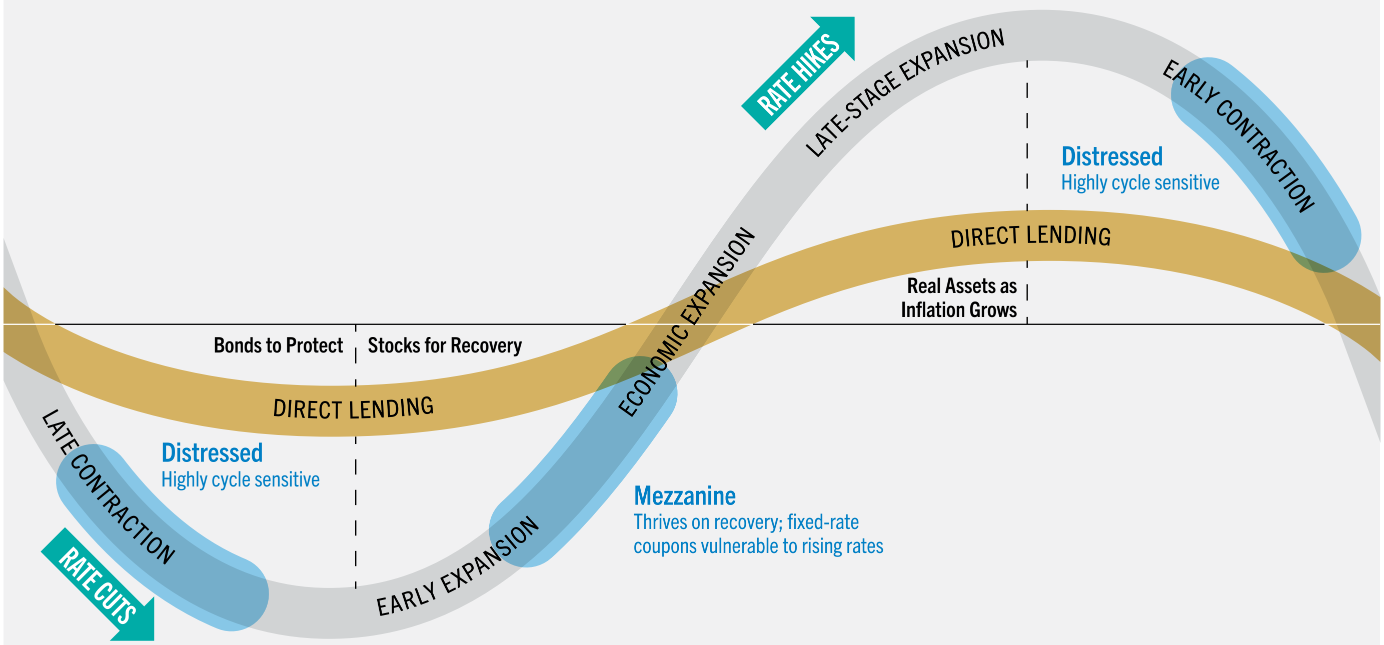
In point of fact, direct lending has proven to be fairly resilient in even the worst market dislocations. When leveraged loans and high yield dropped precipitously in the global financial crisis, down between 26 and 29 percentage points, direct lending fell just over 6%. The COVID-19 experience produced a similar result, with both public credit categories down 13–14% and direct lending down just 5%. As one would expect, the duration exposure in high yield generated a strong negative reaction in the 2022 period of rising rates, sending high yield total returns down almost 11%, while, conversely, direct lending rose over 6%, buoyed by the increase in base rates (Exhibit 10).

But for investors seeking long-term exposure, it's not just during moments of particularly severe downturns when direct lending shines. Economic and interest rate cycles can smile or frown on different assets at different times: stocks in recovery; bonds to protect in a contraction; commodities in late-stage expansions as inflation grows. Other segments of private credit can be highly rewarding but may be intensely tactical in their deployment. Distressed investing indicates by its very name its sensitivity to particular and often short-lived points in the cycle. But direct lending tends to manage through both rate and economic cycles with a high degree of resilience. Because of the insensitivity to rate risk embedded in the nature of the asset, as well as its resilience to credit risk achieved by manager skill and direct negotiation, middle market direct lending may be the closest thing in corporate credit to an "all-weather" allocation (Exhibit 11).

Exhibit 11

Direct Lending: An "All-Weather" Asset?

Asset Class Performance Across Business and Interest Rate Cycles



Direct lending is not immune to cycle risk, but its floating-rate nature and seniority in the capital stack may help preserve capital. **By mitigating these cyclical risks, direct lending may be the closest to an "all-weather" strategic allocation in corporate credit.**

Source: Cambridge Associates and Golub Capital.

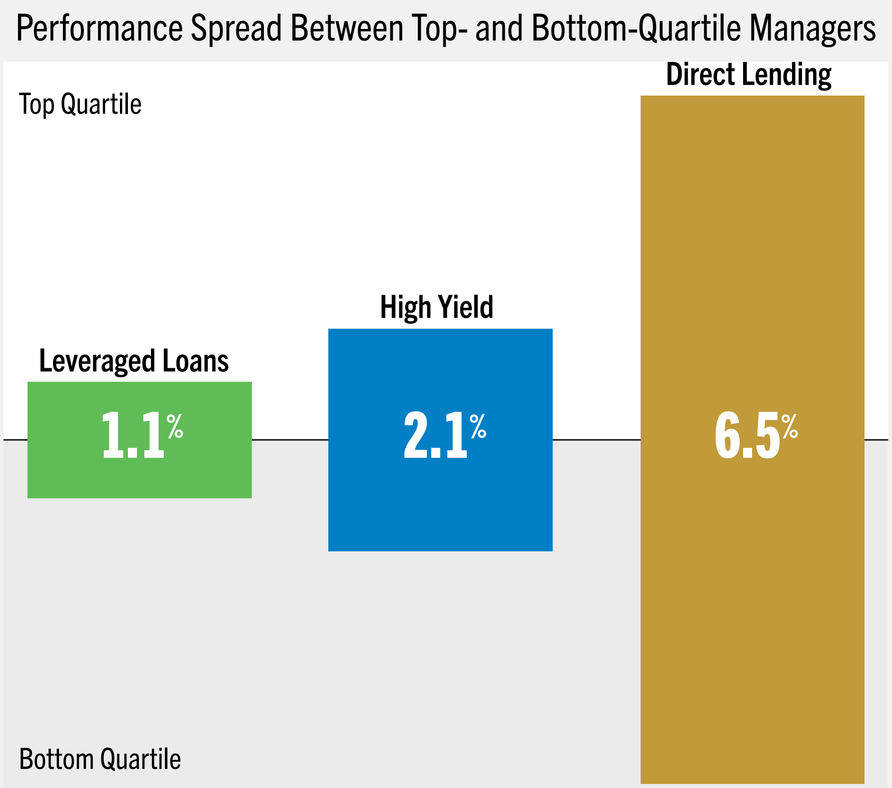
The Manager Matters

Manager Dispersion and Performance Persistence

Another important aspect of this private market asset class is the degree of control any individual manager is able to bring to the investment process and its outcome. Even the most active of active managers are often at the mercy of their "beta," with the vast majority of their returns rising and falling along with the generic tide of market conditions. In the absence of any inherent beta, as the illiquidity of any asset category rises, so does the variability or dispersion in performance across managers. While there may be a modest and tolerable spread of one to three percentage points between top and bottom quartile public credit managers, that difference widens in less liquid private debt markets. In direct lending, the percentage point gap between top and bottom quartile managers widens by a factor of three or more (Exhibit 12).

Exhibit 12

Caveat Emptor: The Manager Matters in Direct Lending

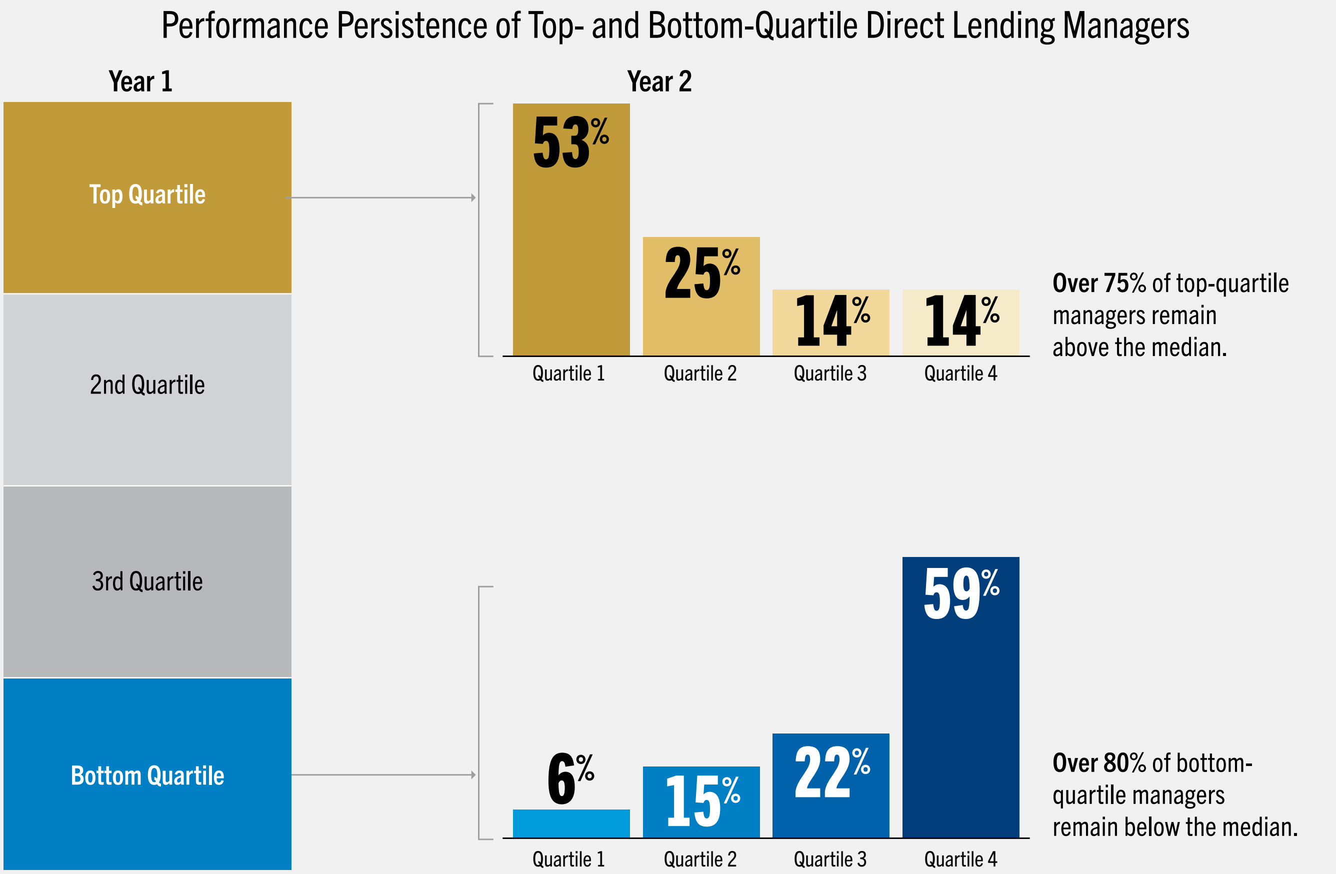


Source: Performance dispersion from Morningstar, Preqin and Golub Capital. Includes performance of actively managed mutual funds and ETFs for leveraged loans and high yield over the 10-year period through March 28, 2024, and Preqin Vintage Year IRRs for top- and bottom-quartile funds.

Another important characteristic of direct lending is performance persistence. Evidence of continued outperformance by individual managers is slight at best in public market allocations. But private market managers tend to show a much higher degree of repeat performance, which holds for both good and less good managers. Recent studies show that a top-quartile manager has over a 50% chance of repeating their performance in year one the following year and a 75% likelihood of remaining above median.[3] Similarly, bottom-quartile direct lending managers in year one have a 59% likelihood of remaining in the bottom quartile (and an 80% likelihood of being below the median) in the following year (Exhibit 13).

Exhibit 13

Performance Persistence in Private Markets



Performance persistence data from "Direct Lending Returns," Antti Suhonen, Financial Analysts Journal 80:1, 57–83, 2023. The underlying source data adds up to more than 100 due to rounding.

3. Performance persistence data from "Direct Lending Returns," Antti Suhonen, Financial Analysts Journal 80:1, 57–83, 2023.

Caveat Emptor

Incumbencies and Competitive Advantage

If manager selection is so important—if direct lending strategies aren't all about market beta—then how do you find managers who achieve and sustain that alpha? The long-term winners in this business have the same characteristics as the long-term winners in any other business—they have sustainable competitive advantages.

The power of competitive advantage is the ability to deliver consistent, premium returns to investors. That return history should be evident in a track record that is consistent across different vintages, time periods and market environments. Bad vintages should not appear, and that's not by chance. This level of performance, we believe, will only be sustained by a firm with extensive partnerships across the sponsor community, where preferred lender lists are getting shorter and the desire for repeat business is rising. Sponsors need the confidence that their lenders can work with speed and in scale to deliver bespoke financing solutions that, if necessary, will sustain any portfolio company through turbulent markets and potential extended add-on acquisitions (Exhibit 14).

In addition to deep partnership with the sponsor community, we would include relations with traditional bank lenders and the broader ecosystem of middle market companies, where reputation and long-standing incumbencies carry serious weight. Within the direct lending management team, prospective investors should find senior-level investors with longevity and expertise in debt structuring and documentation, as well as restructuring and workouts. Origination and underwriting teams should operate in active balance, guided by senior leadership on both sides and supported by comparable compensation structures. And the north star shining over all of this must be strong alignment of interest across lender and allocator. Finding all of these characteristics together is a rare thing, but we believe it's the right recipe to ensure a consistently positive outcome for investors seeking strategic exposure to private credit in the form of direct lending.

Exhibit 14

Seeking Competitive Advantage

What Matters in a Core Direct Lending Manager

1	Long-term, consistent and high-quality track record in core middle market lending
2	Extensive relationships across the private equity sponsor community
3	Large number of existing borrowers (incumbencies)
4	Ability to work with sponsors in scale and with speed across a variety of bespoke financing needs
5	Healthy tension between origination and underwriting teams
6	Deep expertise in structuring, restructuring and workouts
7	Alignment of interests with lender team

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Sophisticated investors and their advisors have flocked to private credit in recent years as a complement to traditional allocations to public fixed income. Does this phenomenon reflect a fleeting, “golden moment” for the asset class, as some have speculated, or is there an enduring case for private credit as a core component of investor portfolios? This essay seeks to cut through the jargon surrounding the term “private credit” by focusing on its largest and fastest growing component: middle market direct lending.

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