

PRIVATE CREDIT SERIES | PART 2

BEYOND CAPITAL: THE NEXT PHASE OF DIRECT LENDING

Access Is Defining The Next Era



- The drivers of success in direct lending's next phase may differ from those that defined its first
- As capital becomes more abundant, access to opportunities becomes increasingly important
- The investable universe is broad beyond traditional sponsor-backed lending

Direct lending's growth story to date is well understood. But will the drivers that underpinned success during the asset class's first phase be the same ones that matter in the next?

As the market has matured, abundant capital and rising competition have expanded the opportunity set beyond its traditional boundaries. What was once viewed largely through the lens of sponsor-backed lending has evolved into a far more diverse market. That evolution is visible both in the types of borrowers accessing private capital and the growing geographic reach of the asset class. So, what might this mean for investors?

The answer lies partly in the changing composition of the direct lending market. In the U.S., sponsor-backed lending has become a mature and highly competitive segment, particularly where direct lenders finance leveraged buyouts for private equity sponsors. That competitive intensity is visible across the market spectrum, placing a greater premium on selectivity, origination access and disciplined underwriting.

Non-sponsored lending, meanwhile, remains underpenetrated globally, although that is changing. Tighter bank regulations, including Basel III reforms in Europe, are reshaping traditional financing options, while fragmented markets are creating localised opportunities for lenders with strong regional teams.¹

The overall shift is becoming global. Whilst direct lending first developed at scale in the U.S., meaningful opportunities now exist across a growing number of developed markets. Europe, Australia and other regions have all seen an increasing role for non-bank lenders.

What remains consistent is the presence of strong private companies seeking event-driven financing, whether for growth, acquisitions or strategic initiatives.² For lenders, beyond the growing borrower set, the bigger questions are whether jurisdictions offer creditor-friendly lending standards, supportive regulatory frameworks and sufficient legal certainty to underwrite risk with discipline.

¹ IPE, March 2026, "When I look at Europe, all I see is opportunity."

² PGIM, Enhancing Diversification Through Non-Sponsored Direct Lending

Anatomy of the Direct Lending Market

All Private Credit (\$B)		Corporate Direct Lending Segment (\$B)			Sponsored v Non-Sponsored (\$B)		
Direct Lending	1650	First Lien	800	39%	Sponsored	1200	73%
Mezzanine	250	Unitranche	600	29%	Non-Sponsored	450	27%
Capital Solutions	150	Second Lien	250	12%		1650	100%
Asset-Based Finance	1500	Mezzanine	250	12%			
Infrastructure	300	Capital Solutions	150	7%			
	3850		2050	100%			

Source: KBRA, Cliffwater, AIMA, S&P Global, Moodys, Macquarie, BIS, as of December 2025

GOING LOCAL TO GO GLOBAL

A market may look attractive in aggregate, but without local origination capabilities, a lender is often limited to buying what the market produces rather than constructing the portfolio it wants to own. That distinction becomes more important as managers move down the credit spectrum, where individual loan-level risk is higher and disciplined diversification depends on local relationships and informed credit selection.

For lenders, that argues for a measured approach to geographic expansion. Establishing an investment-grade credit presence first can help lenders understand the jurisdiction, test origination channels and build local underwriting expertise before selectively extending into sub-investment-grade opportunities.

The importance of local origination becomes even clearer as the composition of the market evolves. As overall deal momentum has slowed, non-sponsored direct lending has continued to grow its wallet share of new transactions. In the first quarter of 2026, PE-backed companies accounted for approximately six in 10 U.S. direct-lending deals, according to Pitchbook LCD data, down from more than eight in 10 during the post-pandemic deal boom.³

Increasing access to this non-sponsored segment extends the direct lending penetration curve in the U.S., Europe, Australia and other developed markets. In the U.S., 90% of middle market companies are non-sponsored, creating a significant pool of opportunities that institutional investors have only begun to access. But beyond the middle-market segment, there is a growing opportunity set across the direct lending spectrum.⁴

For managers, this translates into a powerful selection advantage. The ability to originate across both sponsored and non-sponsored channels broadens the deal funnel, improves relative value comparisons and reduces dependence on crowded private equity deal flow. Broader access introduces exposure to companies that are less widely represented within institutional portfolios, often because they are not intermediated through broadly syndicated processes.

³ Pitchbook, May 2026, PE-backed companies are losing their direct lending dominance

⁴ PGIM, The Evolution of Direct Lending

Case Studies: Local sourcing, long-term lending discipline

	United States	Europe
Borrower Profile	Founder-led provider of prefabricated building solutions seeking capital to support a large acquisition.	Family-owned consumer and leisure business seeking to simplify a fragmented financing structure.
Ownership	Initially non-sponsored; later transitioned to sponsor ownership through an LBO.	Non-sponsored borrower.
Financing Problem	Historically used bank financing.	Complex capital structure, reliant on more than 100 small credit lines across multiple entities.
Origination Advantage	Long-standing local relationship provided access before the borrower entered the sponsor-backed market.	Local relationships and direct management engagement provided access to a proprietary opportunity.
Financing Role	Co-lead lender initially; later joint lead arranger.	Sole lender.
Value Creation	Early access strengthened incumbency and supported better positioning in a later sponsor-backed transaction.	Proprietary sourcing supported selectivity and exposure outside competitive auction processes.
Outcome	Incumbency helped secure a lead role in the subsequent buyout financing.	Continued engagement led to a follow-on financing opportunity.

The transactions described above are for illustrative purposes only and are not representative of all PGIM investments. Past performance is not a guarantee of future results.

WINNING BY NOT LOSING

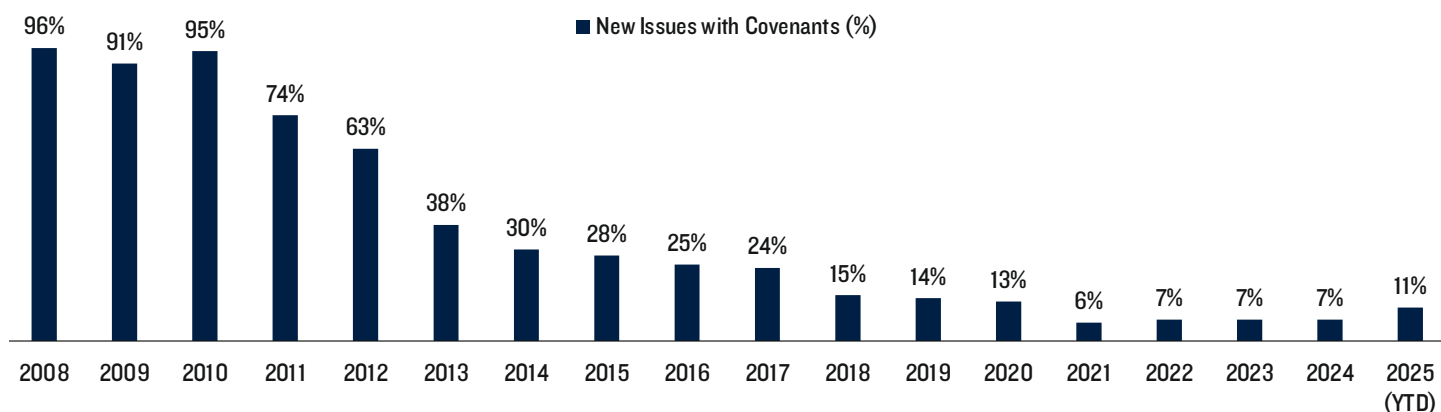
Direct lending starts with a simple premise: downside protection matters more when liquidity is limited. Unlike public credit, lenders cannot easily trade away from a deteriorating issuer once the loan is on the books. That places greater weight on the primary underwriting decision, including assessing factors like cash flow coverage, documentation standards and covenant protection.

This is particularly important in below investment-grade lending, where companies typically operate with higher leverage and heavier debt-service burdens.

As the chart below shows, maintenance covenants in the BSL market have become less prevalent in the last decade or so. The large cap DL market has generally followed this trend which could be deemed appropriate, given the robustness of the businesses that are financed in this market. In the Lower Middle Market and the Middle Market spaces, maintenance covenants are much more important because these businesses have less access to capital and are potentially more volatile. Maintenance covenants give lenders a seat at the table to protect their senior secured claims, potentially prior to more severe liquidity constraints.

The Vanishing Safeguard

Covenant Erosion In The BSL Market



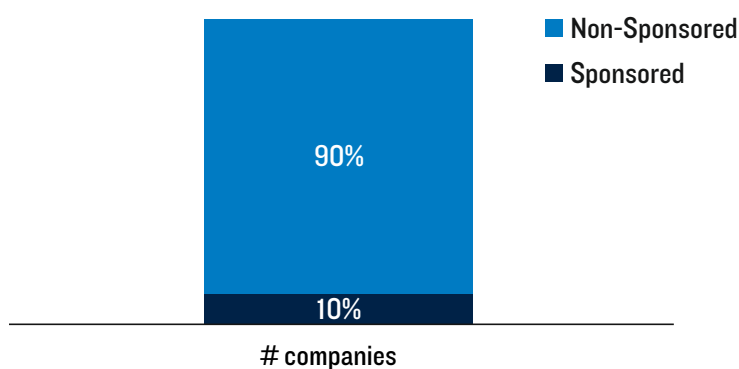
Source: Pitchbook LCD U.S. Leveraged Loans Quarterly Trendlines, as of September 2025.

As some direct lenders are discovering, healthy valuations are not a substitute for resilient cash flows. That distinction has become more visible in the software sector lending, where recurring revenue and high enterprise-value multiples once gave lenders comfort that leverage could be supported despite uneven cash flows. As sector sentiment shifted, those valuation assumptions became less reliable.

According to the Bank for International Settlements, outstanding loans to software-as-a-service (SaaS) firms rose from almost \$8 billion in 2015 to more than \$500 billion by the end of 2025⁵, or nearly a fifth of total direct loans, underlining the lesson that asset prices can move faster than loan structures allow lenders to react.

Concentration risk compounds that challenge. Sponsor-backed lending often gravitates towards industries favoured by private equity and over time that can leave portfolios with similar sector exposures. For institutional investors, the risk is not simply owning too much of one sector but owning the same crowded thesis through multiple managers. Diversifying lending exposures across sponsored and non-sponsored borrowers can help reduce that overlap, but only if underwriting discipline remains consistent across channels.

Non-Sponsored Market is Large and Underserved by Most Direct Lenders



Source: National Center for the Middle Market, as of December 2025

That is where local presence becomes a valuable risk-control tool. Covenant packages, documentation standards including “perfected security” and the simple safeguard of size vary materially across France, the UK, Germany, Australia and other developed markets. The fundamentals of credit analysis may be consistent across jurisdictions, but the way those protections are structured and negotiated is highly local.⁶

Even within the well-established U.S. legal framework, middle-market direct lending documentation remains highly negotiated and can vary materially across transactions. Loose definitions, generous covenant cushions, expansive restricted payment and investment baskets, and lingering liability management exercise vulnerabilities can all weaken lender protections and create paths for value leakage. As a result, relationships are often as important as capital and in a competitive market, these relationship-driven advantages can be a meaningful differentiator in preserving downside protection and improving risk-adjusted returns.

THE ALLOCATION TEST

The decision to allocate to direct lending should go beyond headline yield. Investors are not simply buying additional spread; they are exchanging liquidity for access to borrowers that may be difficult to reach in public markets. That distinction is increasingly important as direct lending is used as both a substitute for and a complement to traditional fixed income.

The structure through which investors access the asset class also matters. Some investors may want whole-loan exposure, accepting the full risk and return profile of the underlying loans. Others may prefer a targeted participation through senior risk tranches or middle-market CLO structures that segment the risk spectrum.

⁵ BIS Quarterly Review, March 2026, Private credit’s software lending meets AI disruption

⁶ PGIM, 2026, Headlines vs Health in Private Credit

While these innovations can broaden access and improve capital efficiency, the broader question for investors is whether the chosen structure aligns with the institution's risk tolerance and liquidity budgets.

Indeed, direct lending remains an illiquid, cyclical asset class, even when accessed through vehicles designed for wider distribution. But democratisation can be positive if it expands access to institutional-quality private assets, provided investors understand what they own, why they own it and how it is likely to perform when market conditions become less forgiving.

THE ROAD AHEAD

Direct lending still has a long adoption curve ahead. In mature markets such as the U.S., the opportunity set continues to broaden beyond sponsor-backed lending into founder, family and management-owned businesses while in Europe and Australia, the runway is longer still, as more companies become familiar with non-bank capital.

The second structural trend is the widening of investor access. Private credit is moving beyond the domain of large institutions into private wealth, defined contribution schemes and other channels. Those growth prospects need to be matched by continued discipline. Daily valuations, transparency, portfolio construction and liquidity design will matter as much as a deep origination network.

Finally, the opportunity set is substantial in the asset-based finance market. But the industry's licence to grow will depend on getting the alignment right: suitable structures for the assets and clear education for investors.

In the next article in our private credit series, we will turn to the global ABF markets—a \$40 trillion opportunity set—to examine how the market is evolving, where private capital may fill gaps left by banks, and what its growth could mean for institutional portfolios.⁷

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⁷ S&P Global, Nov 2024, The Opportunity of Asset-Based Finance Draws in Private Credit.

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