

PERSPECTIVES

Understanding Middle Market Direct Lending: Opportunities, Advantages and Misperceptions

June 2025

The growing direct lending market may offer investors a compelling opportunity to achieve strong yields and stable returns. However, as the market expands and becomes increasingly segmented, concerns about risk remain a consistent theme among investors evaluating their options. Examining the dynamics of core middle market direct lending may provide investors with a clearer understanding of why this segment can offer an attractive risk-return proposition within the broader credit landscape.

Why Middle Market Direct Lending May Offer a Compelling Risk-Return Profile

1 Relationship-Driven Lending Models

The middle market, often defined by businesses with annual revenues ranging from \$10 million to \$1 billion,¹ represents a dynamic and relationship-driven segment of the economy. These businesses are predominantly privately held, often individual- or family-owned, with only a small percentage (approximately 10%²) supported by private equity. This ownership structure fosters a distinctive lending environment, where personal connections and localized expertise play a pivotal role. Borrowers value lenders that demonstrate an in-depth understanding of their specific industries, regional nuances and operational complexities.

This relationship-centric model provides lenders with direct access to company management, enabling them to gain deeper insight into financial health and operational performance. Such access supports active portfolio management and allows lenders to identify early signs of financial stress, implementing mitigation strategies as needed. For instance, in addition to standard quarterly financial reporting, middle market lenders also may receive detailed reports such as management discussion and analysis (MD&A) documents and key performance indicator (KPI) updates. This detail enhances proactive decision-making and provides a level of visibility not commonly available in larger syndicated or up-market transactions, where lenders often have limited direct engagement with management.

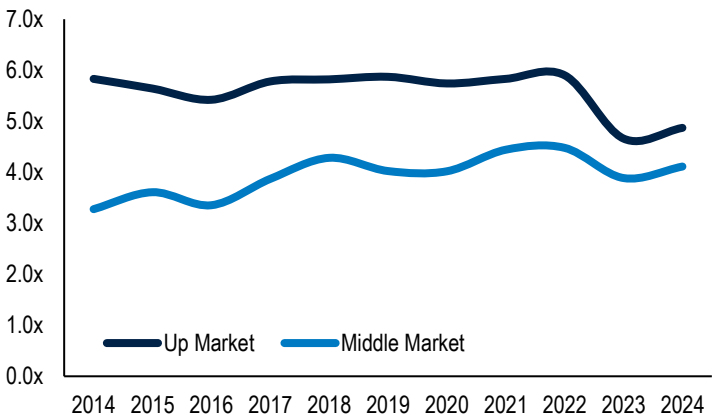
Additionally, middle market loans are generally characterized by smaller lender groups, typically composed of no more than four to five entities, or sometimes even a single lender. This

simplified lender structure streamlines decision-making, enhances control over covenants and loan terms and facilitates more effective risk management. Conversely, up-market loans often involve larger syndicates, leading to more complex decision-making and diluted lender oversight.

2 Conservative Leverage Profiles

Middle market loans have historically exhibited conservative leverage compared to up-market deals. While up-market transactions often feature leverage levels of 5-6x EBITDA, middle market deals typically average 3-4.5x EBITDA.³ This lower leverage profile provides borrowers with greater flexibility in the event of financial distress or downturns, thereby reducing the likelihood of default and enhancing lenders' ability to protect their investments.

Exhibit 1: Senior Leverage Comparison³



Sources: Lincoln International, Pitchbook LCD, PGIM Private Capital. As of 12/31/2024.

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The more restrained use of debt in middle market companies can be attributed to their ownership structures, which tend to favor conservative financial management. Privately owned and family-run businesses often avoid over-leveraging, recognizing the long-term risks associated with excessive debt and more limited access to capital markets.

3 Covenants and Structural Protections

Another consideration supporting the attractive risk profile of middle market lending is the presence of robust financial covenants and structural protections.

Financial Covenants

More than 75% of middle market loans include financial covenants, compared to less than 10% of loans in the broadly syndicated loan market, which are typically “covenant lite.” Financial covenants provide lenders with regular tests of key metrics to monitor a borrower’s financial health. These can include:

- Debt / EBITDA – Assesses whether debt is becoming too high relative to earnings.
- Fixed charge coverage – Evaluates whether the borrower’s cash flow is sufficient to cover debt payments, interest and capital expenditures.
- Others such as maximum capex or minimum EBITDA – Helps monitor spending discipline and liquidity.

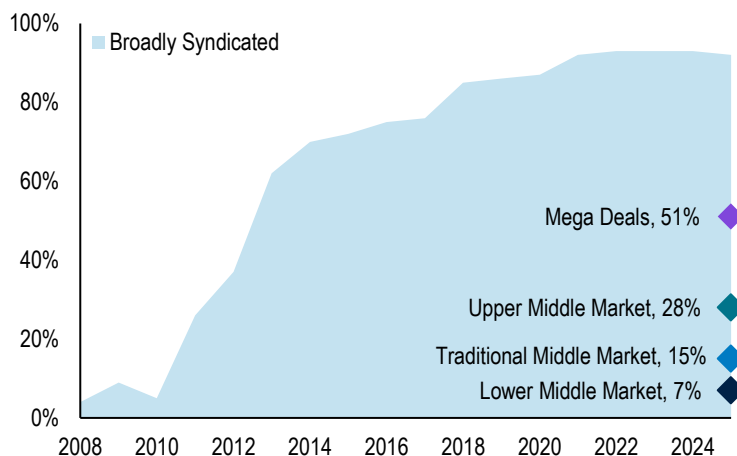
In contrast, covenant lite loans lack these ongoing maintenance tests and instead rely on incurrence covenants (event-driven restrictions triggered by specific borrower actions, such as issuing new debt or pursuing M&A).

Financial covenants are immensely helpful in acting as early warning systems, allowing lenders to intervene proactively if a borrower’s performance deviates from expectations. For example, if covenant headroom becomes tight, lenders may adjust payment schedules, increase pricing or require additional equity injections to strengthen borrower stability.

Document Protections

Beyond financial covenants, middle market loans also benefit from stronger documentation. This includes tighter negative covenants that restrict borrowers from actions such as incurring additional debt, paying dividends or making restricted investments – activities that could otherwise erode liquidity and compromise collateral. This stands in contrast to

Exhibit 2: Percent of Covenant Lite Loans⁴

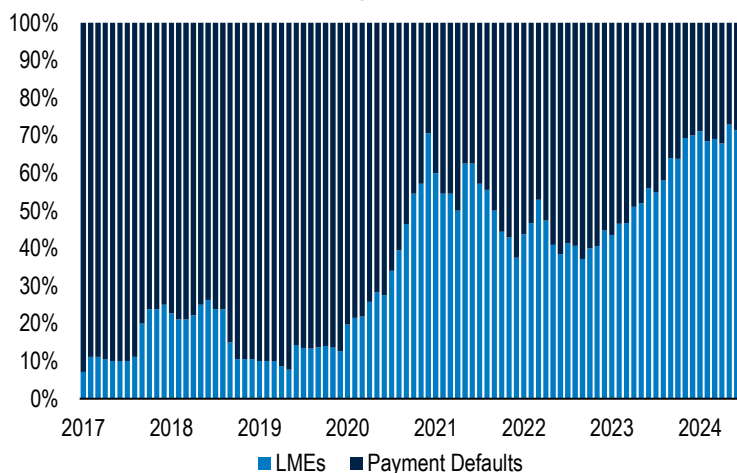


Sources: Pitchbook LCD, Covenant Review, PGIM Private Capital. As of 3/31/2025.

up-market dynamics, where supply-demand imbalances and precedent legal norms have shifted negotiating power toward sponsors, resulting in more borrower-friendly terms and weaker protections for lenders.

Document erosion is also a growing concern in the syndicated and up-market space, where competitive pressures and aggressive legal precedent have led to looser agreements. This environment increases the risk of liability management exercises (LME), where borrowers may restructure debt in ways that disadvantage certain lenders. In contrast, the middle market is more insulated from such risks. In the middle market, credit agreements tend to be more robust, with tighter definitions and documentation that closes off loopholes. Additionally, smaller lender groups in the middle market foster stronger communication and alignment, reducing the likelihood of lender-on-lender conflict.

Exhibit 3: LME Share of Leveraged Loan Defaults⁵



Source: Pitchbook LCD, PGIM Private Capital. As of April 2025.

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Risk Management Starts at Origination

The ability of a direct lending manager to structure deals and negotiate terms effectively at origination is fundamental to helping minimize risk. Underwriting deals with lower leverage and implementing comprehensive covenant packages provide lenders with the tools to identify and mitigate issues before they escalate.

For instance, consider a scenario where a company experiences a 15% EBITDA decline due to early-stage disruption, compounded by a 30% drop from broader cyclical pressures. A borrower with 3.5x leverage and tight financial covenants is better positioned to absorb these shocks than one with 5.5x leverage and covenant lite terms. Despite the earnings decline,

the lower-leverage borrower maintains a fixed charge coverage ratio above 1.0x – indicating earnings still cover fixed obligations. Additionally, while covenants have not been breached, they serve as early indicators of financial strain. In contrast, the higher-leverage borrower sees its ratio fall below 1.0x, signaling that earnings no longer cover fixed expenses. Additionally, without maintenance covenants, lenders lack early warning mechanisms and may be forced into reactive interventions once liquidity issues surface.

These structural differences highlight the importance of disciplined lending practices.

Exhibit 4: Comparison of Different Loan Structures

3.5x Entry Leverage; Covenants				5.5x Entry Leverage; No Covenants			
\$M	Today	Initial Distress	Cycle	\$M	Today	Initial Distress	Cycle
Issuer EBITDA	\$30	\$26	\$21	Issuer EBITDA	\$30	\$26	\$21
3.5x Entry Leverage	\$105	\$105	\$105	5.5x Entry Leverage	\$165	\$165	\$165
S+575 Cost of Leverage	9.25%	9.25%	9.25%	S+575 Cost of Leverage	9.25%	9.25%	9.25%
Interest Expense	\$10	\$10	\$10	Interest Expense	\$15	\$15	\$15
1.0% Amortization	\$1	\$1	\$1	1.0% Amortization	\$2	\$2	\$2
Capital Expenditures	\$3	\$3	\$3	Capital Expenditures	\$3	\$3	\$3
Management Fees	\$1	\$1	\$1	Management Fees	\$1	\$1	\$1
Taxes (C-Corp)	\$4	\$3	\$2	Taxes (C-Corp)	\$3	\$2	\$1
Total Fixed Charges	\$19	\$18	\$17	Total Fixed Charges	\$24	\$23	\$22
Fixed Charge Coverage Ratio	1.58x	1.42x	1.24x	Fixed Charge Coverage Ratio	1.26x	1.11x	0.96x
Fixed Charge Coverage Covenant	1.15x	1.15x	1.15x	Fixed Charge Coverage Covenant	----- None -----		

The above examples are presented for illustrative purposes only, and do not reflect actual PGIM Private Capital investments. No investment strategy or risk management technique can guarantee returns or eliminate risk in any market environment.

Conclusion

The core middle market can provide a compelling opportunity for investors seeking attractive yields with potentially manageable risk. Its characteristics – conservative leverage profiles, robust structural protections and relationship-driven dynamics – may create a favorable environment for capital preservation and consistent returns.

Ultimately, the success of a direct lending allocation depends on the selection of the right fund manager. Investors can benefit from partnering with experienced managers who understand the nuances of the middle market and have a disciplined approach to deal structuring and risk management.

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ENDNOTES

1. Source: National Center for the Middle Market. As of June 2025.
2. Number of middle market companies sourced from National Center for the Middle Market; number of private equity backed companies sourced from Pitchbook.com; PGIM estimates.
3. Middle market leverage data sourced from Lincoln International. Up-market data sourced from Pitchbook LCD, LBO Quarterly Trend Lines report. As of 12/31/2024.
4. Percent of broadly syndicated covenant lite sourced from Pitchbook LCD, Leveraged Loan Quarterly Trend Lines report. Middle market covenant lite sourced from Covenant Review. As of 3/31/2025.
5. Source: Pitchbook LCD, Defaults Monthly. As of April 2025.

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