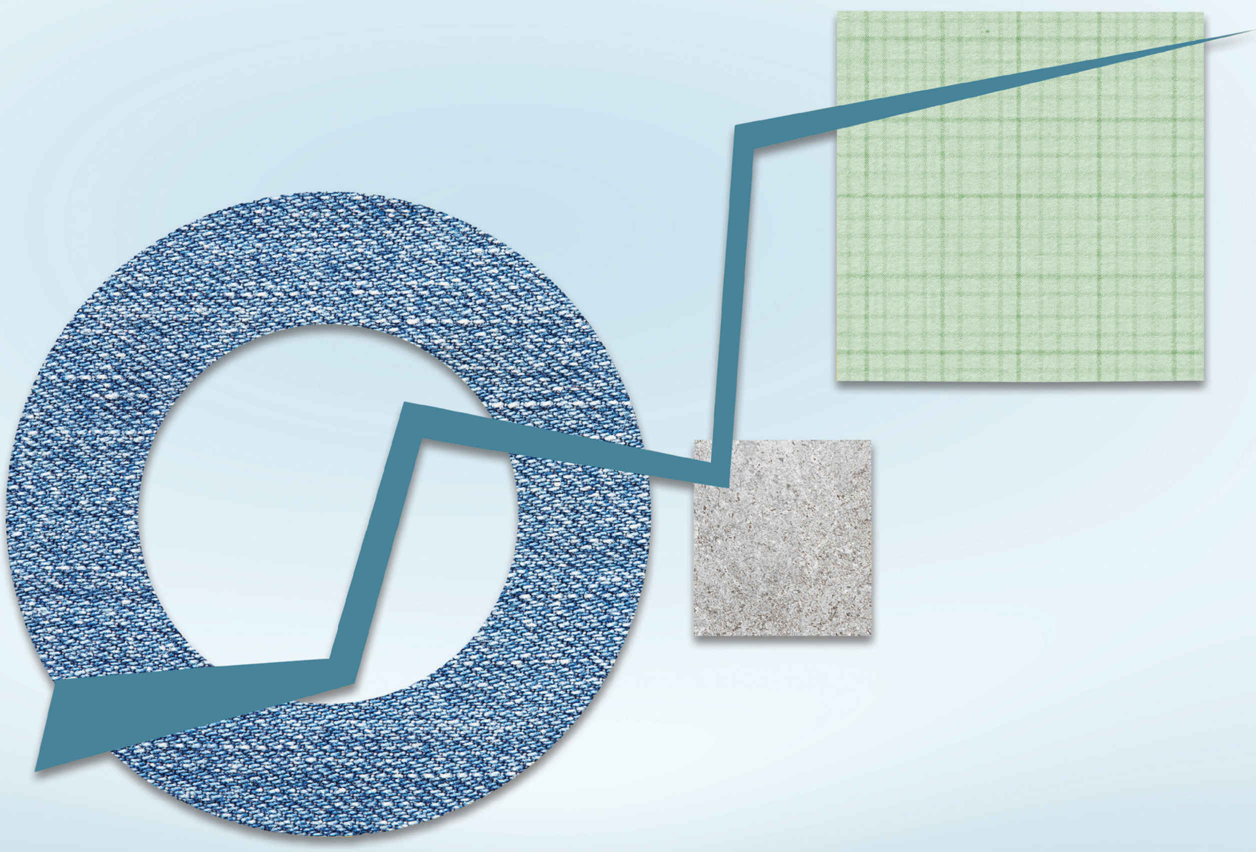

DIRECT LENDING: SELECTIVE EXPOSURE

A HEALTHY RESET

Credit selection and underwriting discipline are top of mind in a market that's seeing increased dispersion.

After years of rapid growth and consistent returns in direct lending, the asset class is entering a new phase. Credit stress is rising from historically low levels in some segments, underwriting differences are becoming more apparent and, as a result, performance is expected to diverge more meaningfully across the market. Yet this environment could be more attractive for institutional allocators because manager differentiation and underwriting discipline are once again being rewarded in direct lending.

"The last five years were billed as the golden age of credit, and the next phase will be defined as the golden age of selection," said Christopher Remington, managing director and head of portfolio and client strategy, private credit, at Morgan Stanley Investment Management. "Returns going forward are likely to be driven less by beta and more by manager skill. That's healthy for the asset class, because underwriting discipline, portfolio construction and workout capability will matter more looking ahead."

The direct lending market is entering a period of greater dispersion, particularly as the 2021 vintage of deals completed during an aggressive M&A environment continue to unwind and expose differences in manager performance, according to David Gaito, CFA, head of direct lending at Fidelity Investments. "You can learn which firms were truly investing, which firms truly understood the risk return that they were taking on, and which firms were deploying," he said. "Direct lending is not a market that you just allocate to. This is a market where you have to handcraft a portfolio."

"In the years ahead, I think we'll see meaningful dispersion not only in underlying credit performance but also by manager style," Remington said, adding that direct lending will continue to offer attractive forward return prospects fueled by a strong U.S. economy and resilient corporate earnings.

Beyond the headlines

What of the ongoing headlines about defaults, evergreen fund redemptions and payment-in-kind transactions? Are these warning signs for institutional investors — or evidence of a maturing asset class?

"The catchphrase for 2026 is 'signal over noise,'" Remington said. "The headlines have been much worse than what we're seeing on the ground in terms of borrower performance, credit stress and portfolio outcomes." He noted that the gap between headlines and reality has driven significant uncertainty among intermediary clients and even their advisers.

The underlying operating performance of borrowers has been broadly healthy, Remington said, with continued resilience across Morgan Stanley's direct lending portfolios. He sees the market undergoing a normalizing reset after years of pronounced growth rather than experiencing a period of systemic stress. "This will prove out as a pause on our path forward, which we think is a bright one."

The secular tailwinds supporting private credit are firmly intact, he added. "The total addressable market in this asset class is substantial and continues to expand as institutions further deploy and build out their alternatives allocation."

A redrawn map

One of the most significant shifts in the last five years has been the way the direct lending market has segmented as it has scaled, said Fidelity's Gaito.

"What was once two asset classes — call it traditional direct lending and the broadly syndicated loan market — rarely saw the two sides collide," he said. Today's market has three distinct segments: the BSL market, the upper middle market (borrowers with loan facility size of roughly $500 million or more) that was established by the larger asset managers, and the traditional middle market (borrowers with loan facility size generally less than $500 million). It's the latter segment where Fidelity sees the most attractive risk-adjusted return opportunities.

The expansion of private direct lending has significantly increased the addressable market. The first $1 billion direct loan was completed in 2019, and more than $400 billion in loans of that size or larger have been originated since then, pointed out Audie Apple, managing director and head of equity capital formation at Fidelity Investments.

Another outcome of the rapid market expansion is that some of the smaller, stand-alone managers have faced growing challenges to raise both equity and debt capital consistently across market cycles, Gaito said, leading some to join larger-scale platforms. These types of developments give institutional limited partners a good reason to reassess long-standing manager relationships and determine whether firms are still executing the investment strategy they originally committed to, he said. "There are some institutional investors that have been investing in this space for 10, 15, 20 years and should be asking themselves: Is the portfolio delivered by my manager today reflective of the same structural character and lender protections as it was historically?"

KEEN FOCUS ON SELECTION

LPs are looking for managers with consistent origination and execution in specific market segments that can target long-term alpha.

As institutional LPs consider the performance dispersion in direct lending, they are becoming more diligent in assessing how a manager executes across a loan's lifecycle, from sourcing deals via established partners, building pipelines and underwriting risk to preserving — and growing — capital over time.

Consistent approach

"In terms of what's important in evaluating investment opportunities, it's underwriting, documentation and return potential," Remington said. In Morgan Stanley Investment Management's middle market direct lending strategies, the median borrower has EBITDA of around $90 million, which is a "sweet spot" between lower middle market opportunities and large-cap direct lending abutting the BSL market, he said. These companies have established scale with staying power, durable cash flows and clear reasons to exist in their space, while offering lenders attractive risk/reward profiles.

Equally important is a conservative approach to structuring investments. Morgan Stanley's underwriting centers on stable, recurring cash flows, targeting approximately 40% loan-to-value through a diversified portfolio of senior and secured first-lien loans that provide significant downside protection. "At its core, direct lending is all about capital preservation," Remington said. "Clip an attractive coupon, protect your downside and remain positioned to capitalize on future opportunities."

Besides that, the key to performance for institutional LPs comes down to manager selection. "Assessing managers is ultimately about the investment process, the consistency and continuity of that process over time, and the results," he said.

The focus on consistency has become even more important for investors as the rapid growth of retail-oriented evergreen fund structures has, in some cases, pushed managers to put capital to work regardless of whether the underlying risk/reward was compelling, said Leanne Heeg, executive director and direct lending specialist at Morgan Stanley Investment Management. She noted that Morgan Stanley prioritizes downside protection over origination volume. "We see a tremendous amount of investment opportunities, though we've remained highly selective about which loans we ultimately originate."

For instance, the firm's strategy on software and the potential for AI disruption has been to focus on mission-critical systems that have high switching costs in industries that require 100% accuracy, like finance and other regulated industries, Heeg said. "Our best borrowers tend to provide products or services that customers can't easily turn off, especially during periods of economic uncertainty. Our overarching view on AI is that there will be winners and losers, but many of our portfolio companies are positioned to benefit from greater efficiency, stronger productivity and improved margins in an AI-enabled economy."

Refining the lens

Most direct lending managers today describe the borrower characteristics that they look for in very similar terms: "a business with a durable moat," strong recurring cash flow and a capable management team, said Gaito, making it challenging for institutional LPs to differentiate between managers. A rigorous and thorough underwriting process sets managers apart.

The comparative spreads of the market segments are also instructive, where traditional middle market spreads are down but "not down nearly as much because the upper middle market has converged with the broadly syndicated loan market," Apple explained. The BSL market is priced around 70 to 75 basis points per turn of leverage compared to 75 to 80 basis points in the upper middle market and 115 to 120 basis points in the traditional middle market, he said. "The upper middle market had decoupled from the traditional middle market and is converging on terms and risk-adjusted pricing with the BSL market."

Apple said a more meaningful measure isn't focusing on loan-to-value alone but spread earned per turn of leverage — a gauge, he said, of compensation relative to risk. "The more statistically significant risk-adjusted measure is to look at leverage as a multiple of earnings," he said.

Robust framework

Fidelity Investments' underwriting framework involves a four-part process built around the private equity sponsor, the company, the industry and utilizing the

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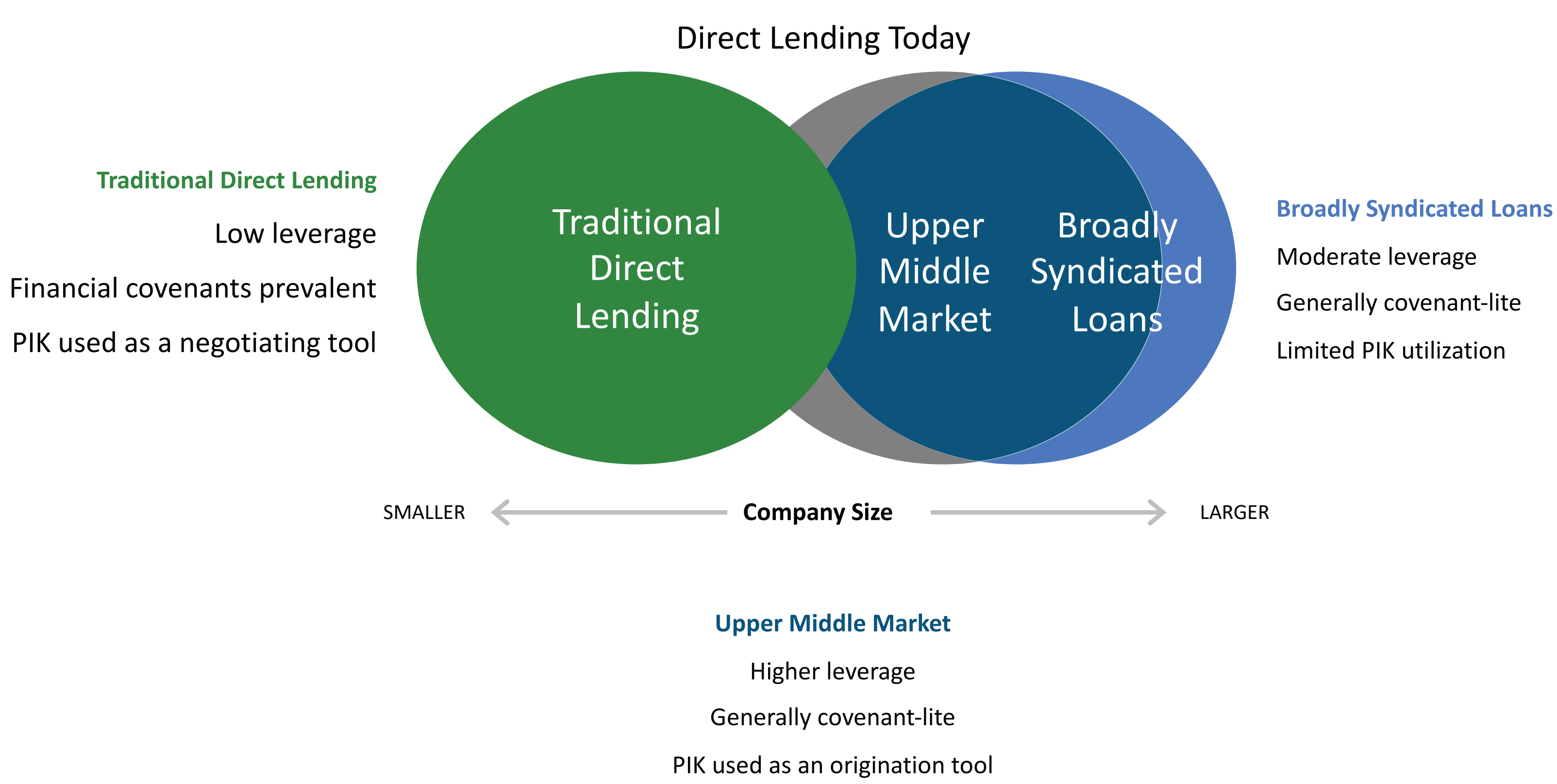
Evolution of Direct Lending

Convergence of the UMM & BSL market adds pressure to pricing and structure



Source: Fidelity Investments

firm’s own scale as a diversified asset manager. Gaito said 95% of its deals are via private equity sponsors that the firm has worked with before, giving it a “general feel for how they might behave when stress comes about” and support a potential workout situation. Developing a history with sponsors over time matters because roughly one in five buyout investments results in a loss for equity investors, a signal that the credit likely experienced some level of stress, Apple said.

Beyond the sponsor, underwriting must stand on the company’s merits and industry fundamentals. The direct lending team’s due diligence process typically takes 30 to 90 days, after which it focuses on the industry fundamentals. A key capability is the team’s ability to draw on roughly 500 sector-focused analysts across Fidelity’s asset management platform, spanning equity, high-yield and investment-grade research. In software, for example, the information mosaic is also supported by the firm’s direct operating insights as a vendor to, or customer of, over 1,000 software providers. The team can consult with the procurement team on software investments to obtain real-world visibility on whether a given system is mission-critical or easily replaced, Gaito said.

The process doesn’t end at closing. “The real work starts after we close the investment,” he said, via ongoing weekly, monthly, quarterly and annual monitoring of each deal.

BUILDING A RESILIENT PORTFOLIO

Understanding the fine print on recoveries and workouts is part of the process for this expanding asset class.

Long-term success in private credit depends not only on generating income, but on the structural protections built into a loan and understanding how managers are able to navigate — and overcome — periods of stress.

Institutional investors need to be realistic about the nature of private credit as defaults in lending are inevitable, said Gaito at Fidelity Investments. “Unlike in public markets, troubled positions can’t simply be sold. In the private markets, you have to work through a problem because you can’t trade out of it,” he said. Direct lending managers need to be able to demonstrate that they have the workout experience and toolkit to recover when faced with credit challenges.

According to Morgan Stanley’s Remington, the structural advantages of private credit can be particularly valuable when borrowers encounter challenges. When borrowers run into trouble, as some may inevitably do, the structure of private credit gives lenders an advantage compared to the broadly syndicated loan market. “Private credit is, by its very nature, structurally different,” he said. “We have smaller lender groups, which makes it easier to negotiate outcomes to preserve value. And we have more flexibility to restructure as compared with the BSL market, where you have many more hands in the pot when it comes to the overall debt holder pie.”

Avoiding pitfalls

As part of their manager assessment, it’s important for LPs to look at the managers’ loan documentation and workout capabilities when performance goes sideways.

One loan aspect that they should watch for is payment-in-kind structures, which have become more common in the upper middle market, Gaito said. More managers in this segment are applying PIK structures — which allow a borrower to pay some or all interest by issuing additional debt versus making the cash payment as “market,” he said.

Gaito views PIK as a workout tool, not an origination tool. “If you think about why a company would need PIK, there is usually one answer: It’s an over-levered business,” he said. While PIK is common in mezzanine and junior capital structures, it should be rare in first-lien, senior secured lending outside of a workout situation. “We think about PIK very carefully, and we have very limited usage of it,” he said. “Fundamentally, we believe that if you are doing a first-lien senior secured loan, you should receive cash interest on the whole structure.”

Covenant protections are another area where LPs should examine differences across the market. Gaito pointed out that covenant-lite loans have become more prevalent in the larger loans. “Sixty percent of loans above $750 million are covenant lite,” he said. Fidelity’s traditional middle market lending, however, typically includes financial covenants. “When you have a covenant, you bring the owner back to the table.”

Fidelity’s Apple said that the covenant default-versus-payment-default distinction is one of the most misunderstood metrics in the asset class. “When an investor hears default, they think the company is out of money,” Gaito added. “That’s just not the case in a covenant default.” Financial covenants “are designed to be triggered and bring that borrower back to the table when there is a lot of enterprise value left.”

Taking a long-term view

Recovery rates, not just default rates, should be central to how LPs assess private credit, Remington said. “Investors often focus on defaults because they’re easy to measure. Credit losses are what ultimately matter,” he said. “Recoveries are a very important part of the overall credit picture.”

The relationship-based nature of private credit and smaller lender groups can help optimize workout situations, and a significant majority of the outcomes can end up as soft restructurings, Remington said. Morgan Stanley’s research points to 70% to 80% recoveries for core direct lending on its look-ahead forecast, he noted.

While direct lending is entering a period where evergreen funds are being tested by redemptions, these vehicles are actually functioning as they were intended, Remington pointed out. The non-traded business development company structure in these funds was designed to provide periodic liquidity while maintaining exposure to longer-term private credit investments, he said, adding that the current redemption activity reflects a shift after years of inflows rather than a failure of the structure itself.

“Non-traded BDCs thread the needle,” Remington said. “They give the investor the option to have periodic access to liquidity, unlike traditional drawdown funds, but without the volatility periodically inherent in publicly traded BDCs.”

Looking ahead, Heeg at Morgan Stanley said investors are increasingly folding direct lending into their broader fixed income exposures. “Investors are really leaning more toward considering private credit and direct lending as part of their overall credit and income sleeve rather than a standalone alternative asset class,” she said.

“We think some of the best risk-adjusted return prospects available today can be found in core middle market direct lending. The asset class remains a foundational allocation for institutional alternatives portfolios,” Remington said, noting that investor interest extends outside of the core segment as well. “We think there are going to be attractive opportunities unfolding in the next year and beyond in more opportunistic credit strategies,” such as hybrid capital and more junior capital positions, he said. These can be found in “good companies with the wrong balance sheets that need more outcome-oriented and flexible solutions.”

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—Christopher Remington
Morgan Stanley Investment Management

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