

Private Debt in the Lower Middle Market: Trends and Opportunities

November 2024

Catalin Clougherty¹, Josh Lerner², and Cody Wilson³

Abstract

Private debt fundraising has expanded considerably over the past decade, in part due to regulations that constrain bank lending and interest rate trends. This growth has paralleled and supported that of the U.S. middle market, with many firms in this segment serving as borrowers of private debt. However, as banks and ever-larger private debt funds focus on lending to larger firms, the lower middle market has become a comparatively underserved segment. This whitepaper explores these trends, evaluating the historical returns to private debt and considering how private debt funds may achieve strong risk-adjusted returns in the lower middle market. The findings throughout this whitepaper highlight that a fund manager's skill can considerably impact their ability to take advantage of this market opportunity, highlighting the crucial role of manager selection.

Josh Lerner and Bella Private Markets ("Bella") have received compensation for advising institutional investors in private capital funds, private capital groups, and governments designing policies relevant to private capital. Bella was commissioned by Heard Capital to perform macroeconomic and industry analyses focusing on the private credit market. This report and the analyses contained herein were conducted independently and reflect the views of Bella only. This report is not meant to serve as an endorsement of Heard Capital or its services, nor of any other investment group or their services. This report is not meant to provide investment advice and should be viewed as educational in nature only. All errors and omissions are our own.

¹ Catalin Clougherty is an analyst at Bella Private Markets in Boston, MA (cclougherty@bella-pm.com).

² Josh Lerner is the Jacob H. Schiff Professor of Investment Banking at Harvard Business School in Cambridge, MA and managing partner of Bella Private Markets in Boston, MA (jlerner@hbs.edu).

³ Cody Wilson is an associate at Bella Private Markets in Boston, MA (cwilson@bella-pm.com).

I. Introduction

Since its emergence in the 1990s, private debt (“PD”) has witnessed remarkable growth as an investment strategy. At the end of 2023, PD represented over \$1.6 trillion in assets under management (“AUM”), making it the third largest private capital strategy in AUM behind only venture capital (“VC”) and buyouts.⁴ PD firms, which provide loans to private and public companies, have witnessed strong fundraising: PD funds attracted \$216 billion in 2023, a 74% increase from a decade earlier.⁵

The growth in PD is indicative of strong demand from investors. In early 2024, over 90% of surveyed limited partners indicated that they plan to maintain or increase their allocations to PD.⁶ This reflects another survey’s finding that nearly 60% of limited partners (“LPs”) are underallocated to the asset class, suggesting they plan to commit more capital to PD.⁷ Generally, LPs seem to be taking cues from leading institutional investors such as the California Public Employees’ Retirement System (CalPERS), the largest U.S. public pension fund. In November 2021, CalPERS announced a 5% AUM allocation to PD and increased this allocation to 8% in March 2024, when the value of its PD assets had reached \$12.3 billion.⁸

Given growth and strong demand, the market for PD has become highly competitive, leading LPs and fund managers alike to search for opportunities in this space. From 2014 to 2023, the average size of newly raised PD funds nearly doubled from \$487 million to \$910 million.⁹ Likewise, the share of PD capital raised by funds with at least \$1 billion in commitments grew from 57% to 81% over that same period.¹⁰ This suggests that larger funds have increasingly dominated fundraising.

⁴ “Global Private Debt 2024 H1,” PitchBook, September 24, 2024.

⁵ *Ibid.*

⁶ “Preqin Investor Outlook: Alternative Assets, H1 2024,” Preqin, March 26, 2024.

⁷ This survey defines “at target” as the limited partner’s current allocation being within 0.5% of their target allocation. Source: John Bakie and Wassyl Abdessemed, “Investor Report Full Year 2023,” Private Debt Investor, March 1, 2024, <https://media.privatedebtinvestor.com/uploads/2024/04/2023-full-year-investor-report-pdi-1.pdf>.

⁸ “CalPERS bets on Private Equity and Debt as it grows past \$500b,” SWF, November 18, 2021, <https://globalswf.com/news/calpers-bets-on-private-equity-and-debt-as-it-grows-past-500b>; Annie Massa, Ye Xie, and John Gittelsohn, “Calpers Proposes Adding \$25 Billion to Private-Equity Stake,” *Bloomberg*, November 12, 2021, <https://www.bloomberg.com/news/articles/2021-11-12/calpers-proposes-adding-25-billion-to-private-equity-stake>; “CalPERS Will Increase Private Markets Investments,” CalPERS News, March 19, 2024, <https://www.calpers.ca.gov/page/newsroom/calpers-news/2024/calpers-will-increase-private-markets-investments>.

⁹ “Global Private Debt 2024 H1,” PitchBook, September 24, 2024.

¹⁰ *Ibid.*

While growing fundraising and swelling fund sizes has raised competition in PD, these trends also point to a market opportunity in this space. The amount of capital that larger funds must deploy typically requires them to focus on only the largest lending opportunities. As a result, in the words of one practitioner, “Over the last four or five years, a white space has appeared in the market as numerous private credit managers, who would have historically been active in the lower mid-market, are no longer serving this market segment as their fund sizes have increased over time. ... This has created an interesting opportunity.”¹¹ That is, smaller deals in the lower middle market (“LMM”) represent an underserved segment with the potential for strong risk-adjusted returns.

Inspired by these trends and industry discourse, this whitepaper investigates the merits of, and opportunities presented by, investing in LMM-focused PD funds. Drawing insights from academic research and industry reports, we briefly introduce PD and describe factors behind its recent growth. We then discuss the qualities that make the LMM segment of this asset class particularly attractive. This whitepaper highlights aspects that draw both borrowers and lenders to this market sector, indicating the potential for growth and strong risk-adjusted returns. We close with a discussion of features that an LP might prioritize while looking for a fund manager capable of capitalizing on LMM opportunities.

2. Characteristics of private debt

PD represents an investment strategy of private capital, an umbrella term that includes a variety of assets unavailable for investment through public markets. Like other private capital strategies, PD generally operates under a closed-end fund structure that includes three parties: general partners (“GPs”) who raise and invest capital into companies; limited partners (“LPs”) who invest money into “funds” formed by GPs; and the companies that receive funding from the GPs (also referred to as “portfolio companies”). These funds are typically structured as blind pools, meaning an LP commits capital without specifically knowing where the GP will invest this capital. LPs can typically expect a PD fund to fully realize returns within eight to ten years, although some funds have durations as short as five years.¹²

Despite similarities in fund structure, PD exhibits unique qualities that set it apart from private capital more broadly. It is useful to compare PD to the two most common private capital strategies: VC and buyouts (two strategies that we collectively label as “private equity” or “PE”). VC funds typically take minority equity positions in high-growth, early-stage firms. Buyout funds

¹¹ “Mid-Market Lending,” Private Debt Investor, June 2024, <https://www.privatedebtinvestor.com/download-pdis-2024-mid-market-lending-report/>.

¹² Victor Leverett, “Private Debt – The Outlook for 2021: Is the Old New Again?” Campden FB, May 13, 2021, <https://www.campdenfb.com/article/private-debt-outlook-2021-old-new-again>.

tend to target later-stage firms, acquiring majority control positions (sometimes through the use of debt, leading to the term “leveraged buyouts”) and overseeing operational improvements. VC and buyout funds must often wait for liquidity events such as an initial public offering or acquisition to realize returns on their equity stake, which takes five years on average for a given portfolio company.¹³ Lengthy holding periods reflect the fact that a fund usually only “cashes in” on an investment after the business has experienced considerable growth.

By comparison, PD funds generally forgo equity, instead providing debt financing to companies and holding these loans to maturity. These funds do not need to wait for a liquidity event to realize profits on an investment. Rather, PD funds have many sources of returns that allow them to distribute capital to LPs at a faster pace than VC or buyout funds. These include interest payments on loans, transaction and origination fees, and termination fees if a company repays its loans early.¹⁴ LPs must still wait a few years for cash inflows to exceed outflows for PD funds, making this investment more illiquid than public credit (e.g., publicly traded bonds). However, PD represents a relatively liquid option among private capital asset classes. **Table 1** highlights the fact that, on average, PD funds have returned capital to LPs in less time (6.6 years) than buyout (7.0 years) or VC funds (8.2 years).

*Table 1: Time to return LP capital by strategy*¹⁵

Strategy	Average time (years)	Median time (years)
PD	6.6	6.5
Buyout	7.0	7.0
VC	8.2	8.1

Another difference between PD and other private capital asset classes is the activities of GPs. In buyout and VC funds, GPs often play a role in active management with value-additive services including strategic guidance, talent recruitment, identification of new opportunities and key partnerships, and more. The role of the PD fund manager is different but similarly important.

¹³ Gregory Brown, Robert Harris, Wendy Hu, Steven Kaplan, and David Robinson, “Private Equity Portfolio Companies: A First Look at Burgiss Holdings Data,” SSRN, January 2020, https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3532444.

¹⁴ Douglas Cumming, Grant Fleming, and Zhangxin (Frank) Liu, “The Returns to Private Debt: Primary Issuances vs. Secondary Acquisitions,” *Financial Analysts Journal* 75, no. 1 (Jan 2019): 48-62, <https://doi.org/10.1080/0015198X.2018.1547049>.

¹⁵ These calculations use Preqin data, last accessed July 25, 2024, and include funds with vintage years between 1980 and 2016. Fund vintages after 2016 are excluded so that only funds with at least eight full years of historical cash flows are included.

Although typically less involved in the day-to-day operations of their borrowers, GPs of PD funds regularly monitor their companies and step into an active role if the companies face distress.¹⁶ They also expend considerable time on vetting prospective borrowers, with the average U.S. PD investor spending 100 hours on due diligence per deal.¹⁷ The predominant strategy of this asset class is direct lending, in which a borrower and lender bilaterally negotiate loans without mediation by a third-party such as an investment bank or broker.¹⁸ A GP's ability to perform these activities – from due diligence to negotiation of loan terms – can significantly impact returns, leading to dispersion between high-performing and low-performing PD fund managers.¹⁹ Sections 5 and 6 further discuss how PD fund managers differentiate themselves through due diligence and monitoring, particularly in the context of the LMM.

To compensate GPs for these activities, LPs typically pay around 1.5% of invested capital in management fees and 15% of fund profits in performance fees (referred to as carried interest, or “carry”) to PD funds.²⁰ While generally higher than those of public market products, these fees are lower than the typical “two and twenty” fee structure of buyout and VC funds (2% management fees and 20% carry).²¹

Given this background on the asset class, we next discuss the growth in PD and the way in which this growth has paralleled and supported that of the middle market.

3. Regulation, rates, and impacts on fundraising

PD has experienced long-term fundraising growth, particularly over the past decade. As illustrated by **Figure 1**, capital raised by PD funds reached an all-time fundraising high of \$292.8 billion in 2021. Following this peak, fundraising has declined somewhat, reflecting macroeconomic factors that have broadly reduced fundraising across private capital. Nevertheless, PD fundraising has remained relatively stable around 15% of total fundraising among private capital asset classes

¹⁶ Joern Block, Young Soo Jang, Steven N. Kaplan, and Anna Schulze, “A Survey of Private Debt Funds,” *The Review of Corporate Finance Studies*, 13, no. 2 (May 2024): 335-383, <https://academic.oup.com/rcfs/article-abstract/13/2/335/7609046>.

¹⁷ *Ibid.*

¹⁸ *Ibid.*

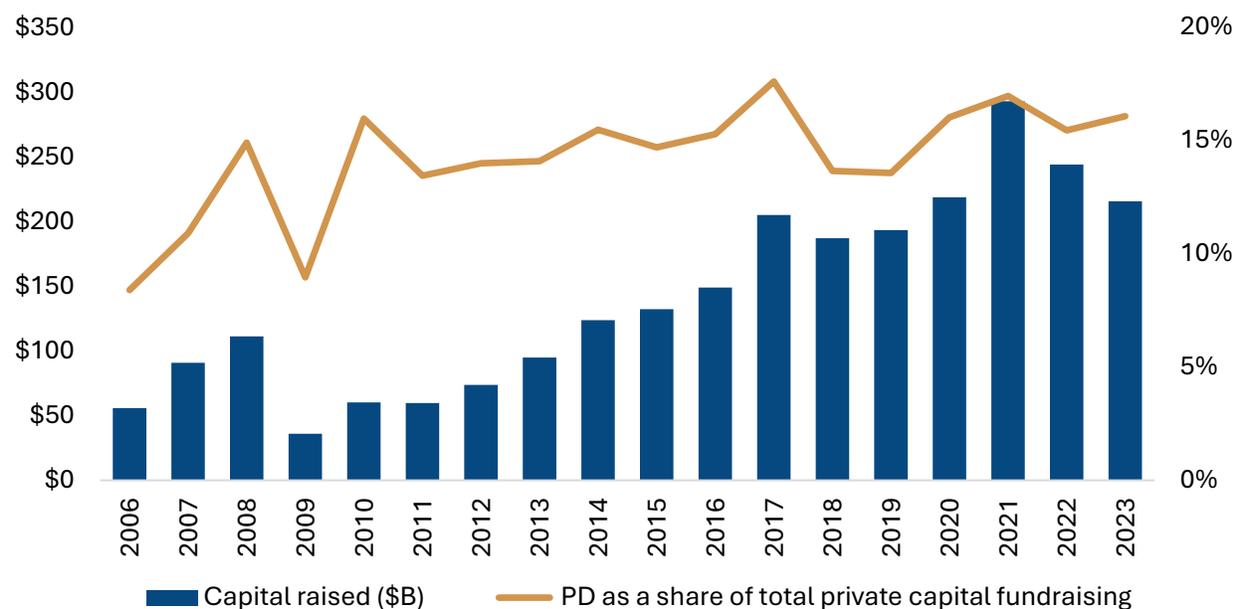
¹⁹ Pascal Böni and Sophie Manigart, “Private Debt Fund Returns, Persistence, and Market Conditions,” *Financial Analysts Journal* 78, no. 4 (2022): 121-144, <https://doi.org/10.1080/0015198X.2022.2092384>; Shawn Munday, Wendy Hu, Tobias True, and Jian Zhang, “Performance of Private Credit Funds: A First Look,” *The Journal of Alternative Investments* 21, no. 2 (Fall 2018): 31-51, <https://doi.org/10.3905/jai.2018.21.2.031>.

²⁰ Block et al., “A Survey of Private Debt Funds.”

²¹ Andrew Metrick and Ayako Yasuda, “The Economics of Private Equity Funds,” *The Review of Financial Studies* 23, no. 6 (April 2010): 2303–2341, <https://doi.org/10.1093/rfs/hhq020>.

over the past decade.²² In particular, two macroeconomic factors that have driven the historical growth of PD suggest this long-term trend is likely to persist: contractions in bank lending and the role of interest rates among fixed income investments.

Figure 1: Global PD fundraising activity by year, 2006 – 2023²³



First, following the Global Financial Crisis (GFC), increased regulatory pressure has limited the ability of traditional lenders – particularly banks – to lend to riskier firms with fewer assets. Loumioti (2022) finds that as banks have faced greater regulatory constraints, nonbank lenders (including PD funds) have become more active as direct lenders to smaller companies with limited credit history.²⁴ **Figure 2** illustrates this finding: the volume of nonbank relative to bank direct loans more than doubled from less than 40% in 2012 to over 80% in 2016. This reflects another paper’s insight that policy changes in 2013 prompted banks to reduce their leveraged loan activity, with nonbank lenders filling in the gap.²⁵ Additional studies have observed a direct link between bank

²² PitchBook includes the following asset classes in private capital: buyouts, VC, real estate, real assets, PD, fund-of-funds, and secondaries. Source: “PitchBook Private Market Fundraising Q2 2024,” PitchBook, September 10, 2024.

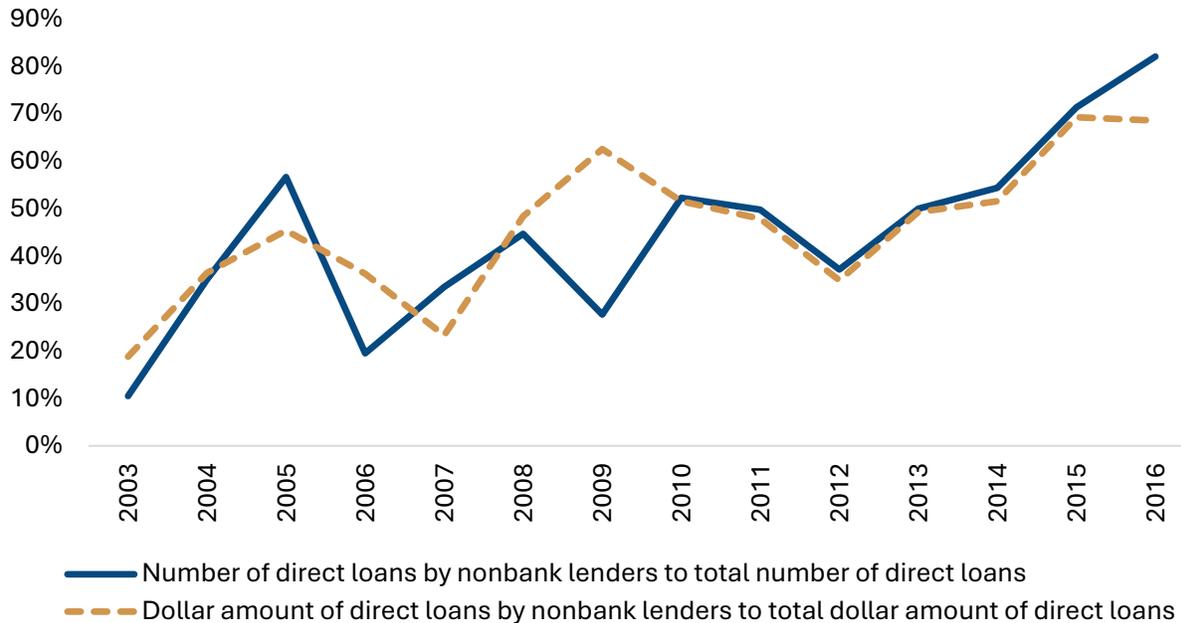
²³ “Global Private Debt 2024 H1,” PitchBook, September 24, 2024; “PitchBook Private Market Fundraising Q2 2024,” PitchBook, September 10, 2024.

²⁴ Maria Loumioti, “Direct Lending: The Determinants, Characteristics and Performance of Direct Loans,” SSRN, May 30, 2022, https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3450841.

²⁵ Specifically, this paper studies the 2013 Interagency Leveraged Loan Guidance (and later clarifications) as a driver for the migration of leveraged loans to nonbank lenders. Source: Sooji Kim, Matthew C. Plosser, and João A.C. Santos, “Macprudential policy and the revolving door of risk: Lessons from leveraged lending guidance,” *Journal of Financial Intermediation* 34 (April 2018): 17-31, <https://www.sciencedirect.com/science/article/pii/S1042957318300172>.

regulation and the growing importance of non-bank lenders such as PD funds.²⁶ Section 4 further describes the impact of banks’ lending constraints in the context of the LMM.

Figure 2: Direct lenders over time, 2003 – 2016 ²⁷



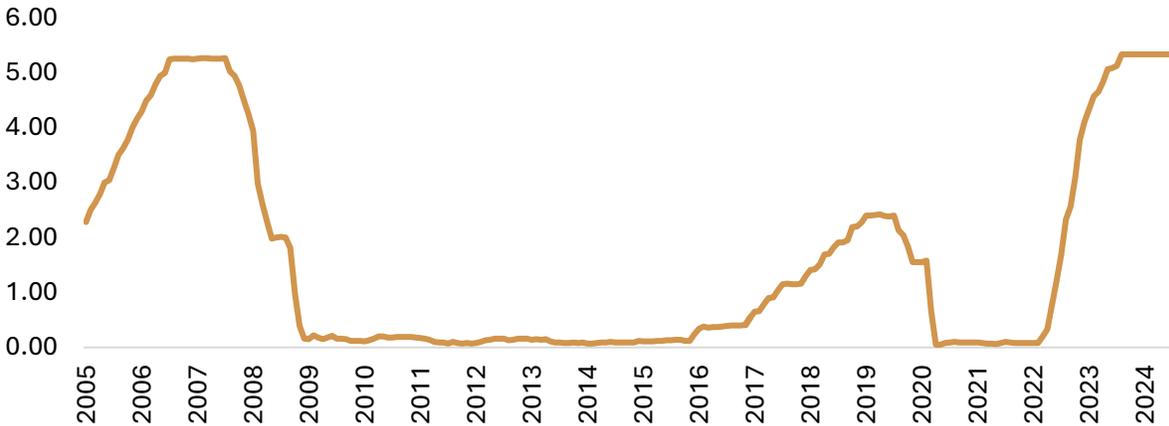
The second factor behind the growth in PD fundraising is the fact that interest rates hovered about zero for years following the GFC (**Figure 3**). Low historical rates corresponded with low yields on fixed income investments such as bonds. This posed challenges for institutional investors – such as pension funds and university endowments – that often depend on the reliable income streams of debt investments to cover their regular operating expenses and liabilities. In response, LPs turned to PD not only for the asset class’s fixed-income characteristics – such as relatively predictable cash flows and generally lower risk than equity investments – but also for its ability to provide sufficient returns to cover their liabilities. Due to the greater risk of the companies to which they lend, PD funds generally achieve higher yields by charging a premium above a benchmark

²⁶ Tetiana Davydiuk, Tatyana Marchuk, and Samuel Rosen, “Direct Lenders in the U.S. Middle Market.” *Journal of Financial Economics* 162 (September 2024), <https://doi.org/10.1016/j.jfineco.2024.103946>; Sergey Chernenko, Isil Erel, and Robert Prilmeier, “Why Do Firms Borrow Directly from Nonbanks?” *The Review of Financial Studies* 35 (2022): 4902-4947, <https://doi.org/10.1093/rfs/hhac016>; Isil Erel and Eduard Inozemtsev, “Evolution of Debt Financing toward Less-Regulated Financial Intermediaries in the United States,” SSRN, February 2024, https://papers.ssrn.com/sol3/papers.cfm?abstract_id=4151880; Rustom M. Irani, Rajkamal Iyer, Ralf R. Meisenzahl, and José-Luis Peydró, “The Rise of Shadow Banking: Evidence from Capital Regulation,” *The Review of Financial Studies* 34, no. 5 (May 2021): 2181-2235, <https://doi.org/10.1093/rfs/hhaa106>.

²⁷ Loumiotis, “Direct Lending.”

interest rate.²⁸ More broadly, this reflects the phenomenon of “reaching for yield” in which investors take on greater risk to achieve higher returns, especially in a low-rate environment.²⁹

Figure 3: Federal funds effective rate, January 2005 – August 2024³⁰



Outside of the context of near-zero interest rates, LPs have observed benefits of PD amid recent macroeconomic turbulence. Most PD loans operate on a floating-rate basis, so the interest charged to borrowers rises or falls corresponding to changes in a benchmark rate (such as the Secured Overnight Financing Rate).³¹ Industry observers have remarked that floating rate loans effectively insulate PD investors from interest rate volatility.³² After rates increase, bonds previously issued at a lower fixed rate become less attractive compared to newly available bonds offering higher interest. Similarly, as rates decrease, newly issued bonds are less appealing than

²⁸ Munday et al., “Performance of Private Credit Fund”; Chernenko, Erel, and Prilmeier, “Why Do Firms Borrow Directly from Nonbanks?”; Young Soo Jang, “Are Direct Lenders More Like Banks or Arm’s Length Investors?” SSRN, 2024, https://papers.ssrn.com/sol3/papers.cfm?abstract_id=4529656.

²⁹ Bo Becker and Victoria Ivashina, “Reaching for Yield in the Bond Market,” *Journal of Finance* 70, no. 5 (October 2015): 1863–1902, <https://doi.org/10.1111/jofi.12199>; Marco Di Maggio and Marcin Kacperczyk, “The unintended consequences of the zero lower bound policy,” *Journal of Financial Economics* 123, no. 1 (January 2017), 59–80, <https://doi.org/10.1016/j.jfineco.2016.09.006>.

³⁰ Board of Governors of the Federal Reserve System (US), Federal Funds Effective Rate [FEDFUNDS], retrieved from FRED, Federal Reserve Bank of St. Louis, <https://fred.stlouisfed.org/series/FEDFUNDS>, October 1, 2024.

³¹ Laura Fritsch, Wayne Lim, Alexander Montag, and Martin C. Schmalz, “Direct Lending: Evidence from European and US Markets,” *The Journal of Alternative Investments* 25, no. 1 (Summer 2022): 80–98, <https://doi.org/10.3905/jai.2021.1.150>; “Understanding Private Credit,” Goldman Sachs Asset Management Insights, October 20, 2022, <https://www.gsam.com/content/gsam/us/en/advisors/market-insights/gsam-insights/2022/understanding-private-credit.html>.

³² Joe Zidle, and Dwight Scott, “Private Credit Investing in Rising Rate Environments,” Blackstone, May 5, 2022, <https://pws.blackstone.com/education-insights/article/private-credit-investing-in-rising-rate-environments/>.

those previously available. By comparison, interest rate fluctuations have much less of an effect on the value of floating rate loans because the interest they receive adjusts commensurately.

One risk that a high-rate environment poses to floating-rate loans is that borrowers may not have anticipated having to make higher interest payments, leading to defaults on their loans. Section 5 discusses measures that PD funds adopt to avoid loan defaults. Given that fund managers can structure loans to successfully mitigate the possibility of defaults, floating rates represent an appealing feature of PD funds as investors face uncertain market conditions.

Given banks' limited ability to finance smaller firms and the currently elevated rate environment, PD will likely continue to attract capital from institutional investors. Another important consideration is the steady growth and opportunities presented by middle-market – especially LMM – firms, many of which have served as PD borrowers. The next section considers these borrowers in detail.

4. Middle market growth trends

The rise of PD has paralleled growth in the middle market. The National Center for the Middle Market (NCMM), a research center affiliated with the Ohio State University, defines the middle market as companies with revenues between \$10 million and \$1 billion.³³ As reported by the NCMM, these firms represent about one-third of private sector GDP and employment in the U.S. Generating more than \$10 trillion in revenue annually, the U.S. middle market could be considered equivalent to the fifth largest global economy.³⁴

The substantial size of the U.S. middle market reflects its consistent growth. **Figure 4** shows that the revenue growth rate of middle market firms – proxied by an index constructed by the NCMM – has remained relatively steady over the past three years, peaking at 12.9% in the second quarter of 2024. This compares favorably to the market as a whole; the S&P 500 has witnessed a declining growth rate, which dropped from 15.1% in Q2 2021 to 0.2% in Q2 2024.³⁵ Similarly, the NCMM finds that 82% of surveyed middle market companies reported year-over-

³³ “Mid-Year 2024 Middle Market Indicator: Growth and Investment Accelerate Despite Uncertainty,” National Center for the Middle Market, 2024, https://www.middlemarketcenter.org/Media/Documents/MiddleMarketIndicators/2024-Q2/FullReport/NCMM_MMI_MID-YEAR_2024_web.pdf.

³⁴ *Ibid.*; Douglas Farren, “Mid-Year 2024 MMI On-Demand Webinar,” August 6, 2024, posted August 8, 2024, by National Center for the Middle Market, YouTube, 40:42, https://www.youtube.com/watch?v=bg_e924r8k8.

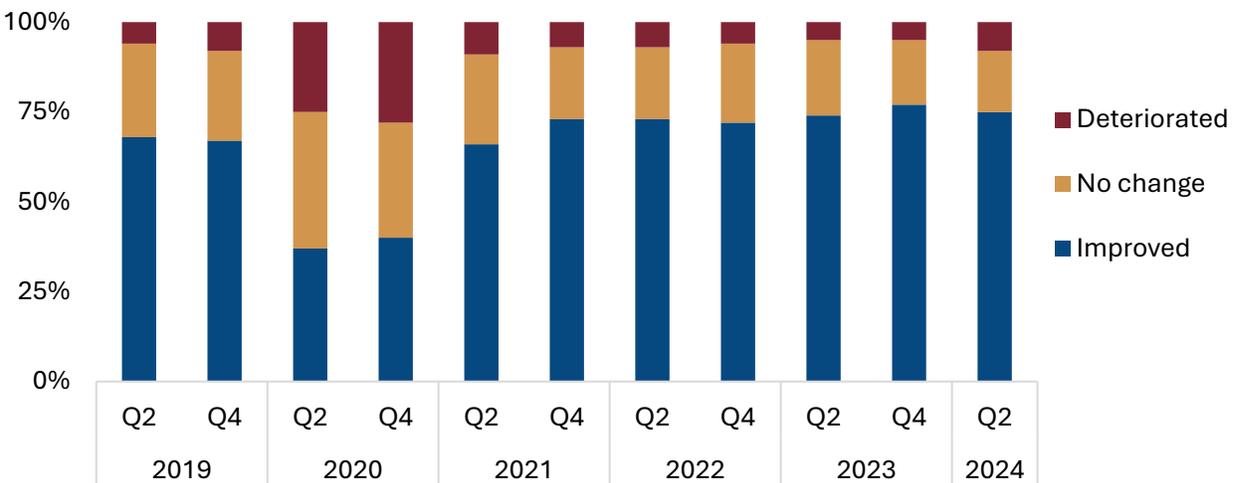
³⁵ The NCMM’s Middle Market Indicator (MMI) is derived from a survey of 1,000 CEOs, CFOs, and other C-suite executives of middle market firms related to “key indicators of past and future performance in revenue, employment, and allocation of cash.” Source: “Mid-Year 2024 Middle Market Indicator,” National Center for the Middle Market.

year revenue growth in the second quarter of 2024, the highest share of the past five years.³⁶ Indeed, **Figure 5** indicates that in the second quarter of 2024, 75% of surveyed middle market firms stated their business is performing better than a year ago, which is 11% higher than the historical average.³⁷ Taken together, these facts suggest the middle market remains robust and growing, despite broader macroeconomic headwinds.

Figure 4: Revenue growth rates for the U.S. middle market and S&P 500, Q2 2020 – Q2 2024 ³⁸



Figure 5: Surveyed middle market firms’ self-assessment of performance compared to the previous year, Q2 2019 – Q2 2024 ³⁹



³⁶ “Mid-Year 2024 Middle Market Indicator,” National Center for the Middle Market.

³⁷ Farren, “Mid-Year 2024 MMI On-Demand Webinar.”

³⁸ “Mid-Year 2024 Middle Market Indicator,” National Center for the Middle Market.

³⁹ Farren, “Mid-Year 2024 MMI On-Demand Webinar.”

Moreover, the middle market has witnessed consistent PE investment, which often complements PD deal activity as discussed later. **Figure 6** indicates that middle market firms have consistently represented a considerable share of U.S. deal activity from Q1 2019 to Q2 2024. Averaged across quarters, the middle market has represented 46% of U.S. PE deal activity over this period. Notably, over the past two years, the value of non-middle market deals has reduced significantly, while middle market deal activity has remained steady. This suggests demand for the market subsector has demonstrated resilience throughout various macroeconomic environments.

Figure 6: US PE deal activity, Q1 2019 – Q2 2024 (\$ billion) ⁴⁰

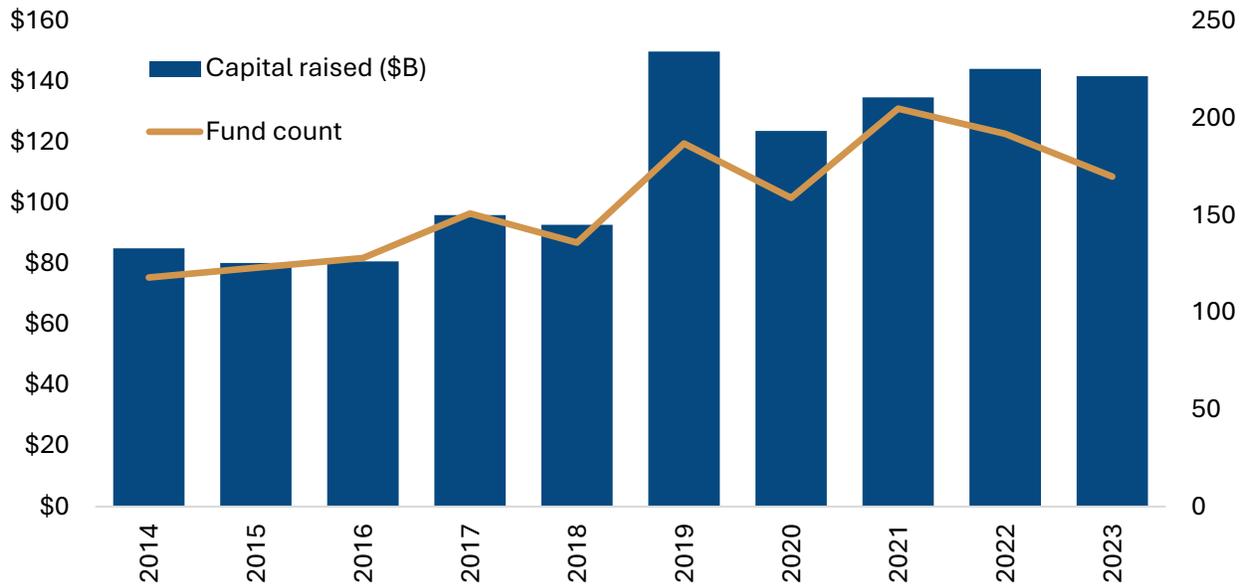


Similarly, U.S. PE middle market fundraising has steadily increased over the past decade and remained relatively stable despite the market turbulence of the past few years (**Figure 7**). This further suggests that the middle market has shown resilience and offers potential for sponsored deals – in which PD funds lend to PE-backed companies – in the LMM.⁴¹ Section 5.C delves into the advantages that PD funds realize from sponsored deals.

⁴⁰ “US PE Breakdown: Q2 2024,” PitchBook, July 9, 2024, <https://pitchbook.com/news/reports/q2-2024-us-pe-breakdown>; “US PE Middle Market Report: Q2 2024,” PitchBook, September 13, 2024, <https://pitchbook.com/news/reports/q2-2024-us-pe-middle-market-report>.

⁴¹ “US PE Middle Market Report: Q2 2024,” PitchBook.

Figure 7: U.S. PE middle market fundraising, 2014 – 2023 ⁴²



Recognizing this consistently strong growth, PD funds have become important lenders to middle market firms. As mentioned earlier, PD funds are a key type of nonbank lender that has stepped up to finance companies that traditional lenders otherwise would not, and this especially applies to middle market firms. Banks often limit smaller, riskier firms to asset-based loans (i.e., loans with physical assets as collateral), which effectively blocks firms with few or no assets from obtaining financing.⁴³ To this end, among 187 surveyed PD lenders, only 45% believed that at least 60% of their portfolio companies would be able to obtain bank financing without PD (the leading reason cited for these companies’ inability to secure bank funding is that their size is too small to qualify for bank syndication).⁴⁴

By comparison, PD funds are more willing to provide loans to smaller firms with stable cash flows despite low tangible collateral value. Chernenko et al. (2022) finds that among 1,269 debt contracts entered into by 579 mid-sized companies, around one-third are with nonbank lenders, including PD funds.⁴⁵ Among 400 loans to PE-backed firms, Jang (2024) finds firms that received loans from direct lenders (the majority of which are associated with PD funds) were half the size on average as those that received bank-sponsored loans.⁴⁶ Thus, the author observes borrowers of direct loans are “less likely to be in the ‘upper middle-market’ sector (i.e. revenues greater than

⁴² *Ibid.*

⁴³ Block et al., “A Survey of Private Debt Funds.”

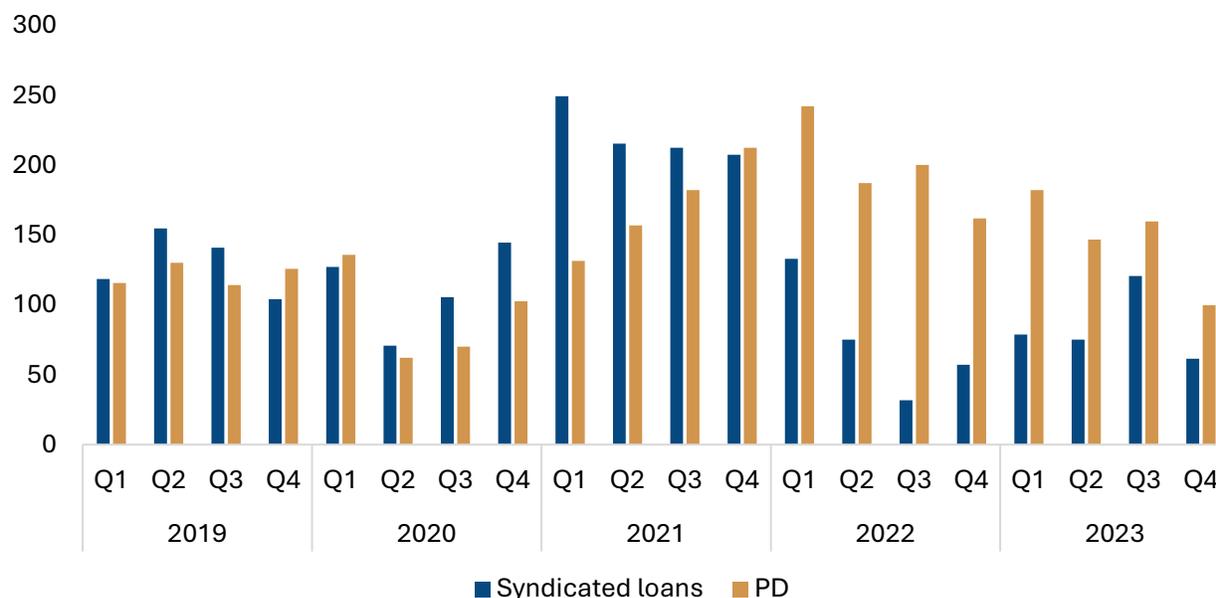
⁴⁴ *Ibid.*

⁴⁵ Chernenko, Erel, and Prilmeier, “Why Do Firms Borrow Directly from Nonbanks?”

⁴⁶ Jang, “Are Direct Lenders More Like Banks or Arm’s Length Investors?”

\$500 million) that tends to have greater access to bank-syndicated loans.”⁴⁷ Likewise, analysis of PitchBook data by investment management firm BlackRock finds that PD funds have become common in the middle market, as compared to bank-syndicated loans (**Figure 8**). This indicates that banks’ reduced appetite for risk has created a considerable opportunity for PD funds in the middle market.

Figure 8: Broadly syndicated vs. private debt loans by count, Q1 2019 – Q4 2023 ⁴⁸



As banks have become less likely to lend to riskier companies, large PD funds have become increasingly prevalent in their place: **Figure 9** shows that PD fundraising over the past decade has favored funds that exceed \$1 billion in size (in 2023, 81% of PD capital raised went towards these bigger funds, compared to 57% in 2014). And yet, practitioners have noted that “the volume of private debt capital available is not sufficient to satisfy the level of demand.”⁴⁹ These findings suggest that to deploy a larger amount of capital, sizable funds must typically pursue larger deals. As a result, while PD has supported growth in some middle-market firms, ever-increasing PD fund

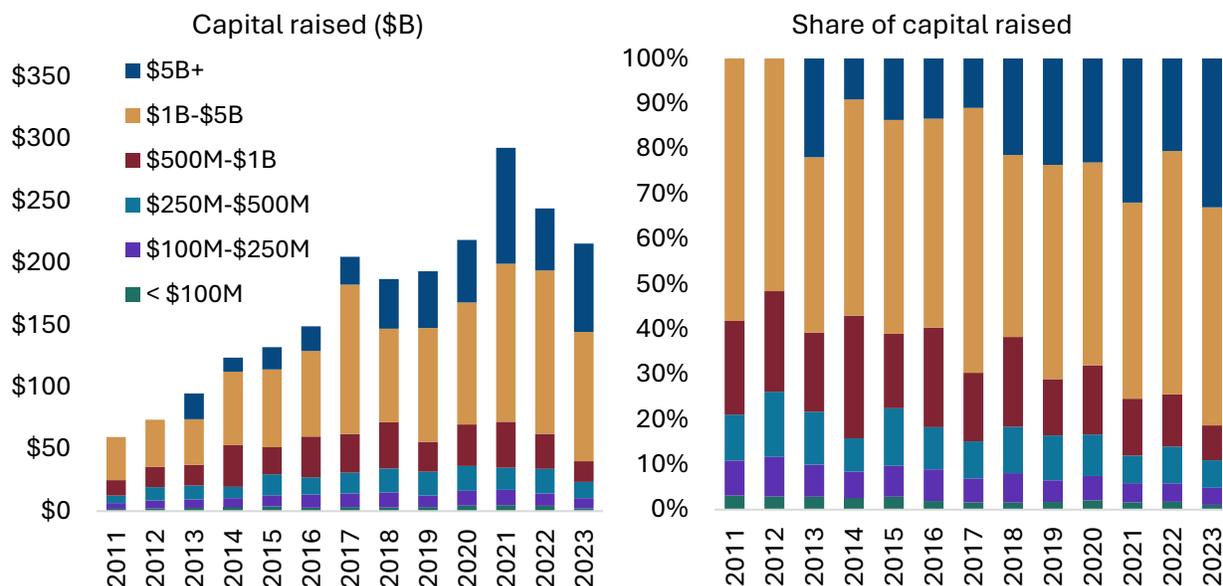
⁴⁷ *Ibid.*

⁴⁸ These numbers are based on BlackRock analysis of Pitchbook LCD data as of November 30, 2023. Source: James Keenan, Stephan Caron, Phil Tseng, and Raj Vig, “Private Debt: The Core Middle Market,” BlackRock, February 2024, <https://www.blackrock.com/institutions/en-us/literature/whitepaper/private-debt-the-core-middle-market-stamped.pdf>.

⁴⁹ “Mid-Market Lending,” Private Debt Investor.

sizes have likely caused some would-be borrowers on the lower end of the middle-market spectrum to be overlooked.⁵⁰

Figure 9: PD capital raised by fund size, 2011 – 2023⁵¹



These overlooked, would-be borrowers represent an untapped source of returns. For instance, academic research supports the assertion that access to financing can allow these otherwise overlooked LMM firms to expand. Davydiuk et al. (2024) finds that borrowers – particularly those in the middle market – experience a significant boost in employment and

⁵⁰ Some practitioners use earnings before interest, taxes, depreciation, and amortization (EBITDA, a measure of a firm’s financial performance) to delineate the LMM, often with an upper limit of \$25 million in EBITDA. However, EBITDA can be problematic in this setting. Chernenko et al. (2022) finds that nonbank borrowing – which includes loans from PD funds – is particularly common among firms with negative EBITDA. This poses difficulty in defining a lower bound for the LMM, which is necessary to separate the LMM from startups and other relatively small businesses. Alternatively, other PD lenders have defined the LMM based on a borrower’s revenue, in alignment with the NCMM. The NCMM specifies this market segment as containing firms with revenues between \$10 billion and \$50 billion. Sources: “Mid-Market Lending,” Private Debt Investor; Chernenko, Erel, and Prilmeier, “Why Do Firms Borrow Directly from Nonbanks?”; Stephen Nesbitt, Fran Beyers, Jeff Topor, and Kelly McKenna, “2023 Q3 Report on U.S. Direct Lending, Cliffwater, 2023, <https://8357303.fs1.hubspotusercontent-na1.net/hubfs/8357303/CDLI/Cliffwater>; Keenan et al., “Private Debt: The Core Middle Market”; James Fisher, Joseph Taylor, and Brian Senatore, “The Enduring Appeal of Lower Middle Market Direct Lending,” PineBridge Investments, August 26, 2024, <https://www.pinebridge.com/en/insights/the-enduring-appeal-of-lower-middle-market-direct-lending>; Michael Smith, “Lower Middle Market Private Credit – A Golden Vintage,” Muzinich & Co., June 26, 2023, <https://www.muzinich.com/opinions/2023-06-26-lower-middle-market-private-credit-a-golden-vintage>; “Mid-Year 2024 Middle Market Indicator,” National Center for the Middle Market.

⁵¹ “Global Private Debt 2024 H1,” PitchBook, September 24, 2024.

innovative activity after receiving a direct loan.⁵² By fueling this growth, lenders may be able to realize strong risk-adjusted returns through deals relatively overlooked by banks and larger PD funds.

5. PD returns, benefits for borrowers and lenders, and risk-mitigation mechanisms

In evaluating the ability of PD funds to take advantage of growth in the LMM, it is useful to consider the asset class’s historical performance and strategies that funds have employed to secure relatively high risk-adjusted returns. This section first considers the question of historical returns and then describes how GPs secure these returns while lending to smaller, higher-risk firms than those considered by banks. These approaches to risk mitigation underscore the importance of manager selection in PD.

A. PD returns compared to private and public markets

While regulatory constraints on banks and low yields on fixed income investments boosted PD fundraising following the GFC, relatively high returns have sustained its growth. As follows, we find that PD has realized high returns for the amount of assumed risk compared to VC and buyout funds. Moreover, PD has consistently outperformed bonds and other similarly risky debt.

We begin by considering the annualized returns and standard deviations – a common measure of risk in finance – of private capital asset classes.⁵³ These metrics are calculated using the State Street Private Equity Index (“SSPEI”) from Q3 2014 to Q2 2024 (the decade leading up to the most recently reported SSPEI data).⁵⁴ Reflecting common practices in academic research, we de-smooth the SSPEI to combat the issue of inconsistent and infrequent reporting of private capital returns.⁵⁵ As **Figure 10** illustrates, PD has achieved an annualized return of 8.1% over the past

⁵² As is common in academic literature, this paper uses the number of patents filed by a company as a proxy for innovation. Source: Davydiuk, Marchuk, and Rosen, “Direct Lenders in the U.S. Middle Market.”

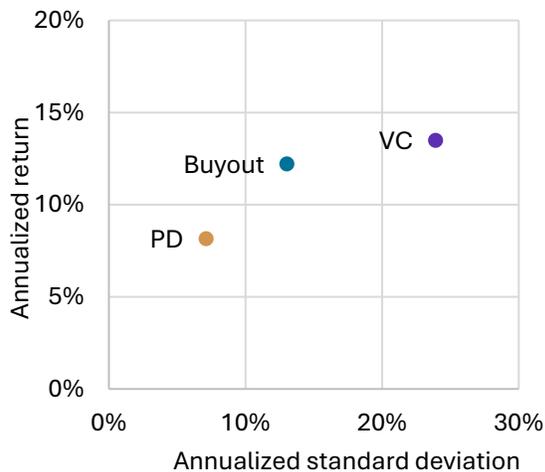
⁵³ A standard deviation represents variation around an average. In finance, a lower standard deviation suggests returns tend to be close to the average. A larger standard deviation represents greater risk.

⁵⁴ Global financial services company State Street calculates and updates the SSPEI on a quarterly basis. The index provides a well-respected benchmark and encompasses the returns of more than 3,800 unique PD, buyout, and VC partnerships reported by LPs. Source: “State Street Private Equity IndexSM – SSPEI,” State Street, 2023, https://globalmarkets.statestreet.com/research/dam/public/peindex/SSPEI_Product_Sheet.pdf?_=1679011200040.

⁵⁵ Private capital often faces the “stale pricing problem” in which outdated valuations persist despite undocumented changes in the asset’s real value. “Stale pricing” results from the fact that private asset valuation is a time-intensive, subjective process with no readily available market prices or real-time price information that may be available in public markets. In effect, this “smooths” out the volatility in private

decade with the lowest annualized standard deviation of the strategies considered at 7.1%.⁵⁶ By comparison, buyouts have realized higher returns (12.2%) with suitably greater risk (13.0%). VC achieves the highest returns of the strategies considered (13.5%) at the expense of the greatest risk (23.9%). These results support the assertion that PD features lower volatility than other private capital asset classes with correspondingly lower returns.

Figure 10: Risk/return by private capital asset class, Q3 2014 – Q2 2024⁵⁷



Strategy	Annualized return	Annualized std. dev. ⁵⁸	Return per unit of risk ⁵⁹
PD	8.1%	7.1%	1.14
Buyout	12.2%	13.0%	0.94
VC	13.5%	23.9%	0.56

assets' real prices. To calculate annualized standard deviations from the State Street quarterly return time series, we “de-smooth” returns by applying a simple first-order autoregressive model, similar to Kinlaw et al. (2013) and Kinlaw et al. (2014).

Sources: Ege Y. Ercan, Steven N. Kaplan, and Ilya A. Strebulaev, “Interim Valuations, Predictability, and Outcomes in Private Equity,” SSRN, May 13, 2024,

https://papers.ssrn.com/sol3/papers.cfm?abstract_id=4833819; Tim Jenkinson, Miguel Sousa, and Rüdiger Stucke, “How Fair are the Valuations of Private Equity Funds?” SSRN, March 7, 2013,

https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2229547; William B. Kinlaw, Mark Kritzman, and David Turkington, “Liquidity and Portfolio Choice: A Unified Approach,” *The Journal of Portfolio Management* 39, no. 2 (2013): 19–27, <https://www.pm-research.com/content/iijpormgmt/39/2/19>; William B. Kinlaw, Mark Kritzman, and Jason Mao, “The Components of Private Equity Performance: Implications for Portfolio Choice,” SSRN, MIT Sloan Research Paper No. 5084-14, February 2014,

<https://doi.org/10.3905/jai.2015.18.2.025>.

⁵⁶ This annualized return of 8.1% for PD is consistent with academic research. Across 476 private debt funds with vintage years (i.e., the year a fund is formed) ranging from 2004 to 2016, Munday et al. (2018) calculates a pooled internal rate of return (IRR) of 8.1%. Likewise, Erel, Flanagan, and Weisbach (2022) calculate an average IRR of 8.6% over a sample of 532 funds with vintages between 1992 and 2015. Sources: Munday et al., “Performance of Private Credit Fund”; Isil Erel, Thomas Flanagan, and Michael Weisbach, “Risk-Adjusting the Returns to Private Debt Funds,” SSRN, NBER Working Paper No. w32278, March 2024, https://papers.ssrn.com/sol3/papers.cfm?abstract_id=4779852.

⁵⁷ Annualized returns and annualized standard deviation calculated using the State Street Private Equity Index. Source: State Street Global Markets, as of Q2 2024.

⁵⁸ As described in footnote 55, these standard deviations are calculated using de-smoothed returns.

⁵⁹ Return per unit of risk is calculated by dividing each asset class’s annualized return by its respective annualized standard deviation.

To further illustrate the relationship between risk and return, we consider the dispersion of returns among private capital asset classes. Past research has highlighted that dispersion – in other words, the difference in returns between high- and low-performing funds – is relatively high for PE funds compared to managed funds focused on public assets.⁶⁰ This underscores the fact that an LP’s selection of fund managers can significantly impact their returns in PE. **Figure 11** explores whether PD exhibits similarly high dispersion. For vintage years 2006 to 2020, the difference in returns between a high-performing fund (75th percentile) and low-performing fund (25th percentile) is less for PD than for buyouts and VC.⁶¹ The average difference between high- and low-performing funds is 6.7 percentage points for PD, as compared to 12.0 for buyout funds and 15.5 for VC. This further supports the notion that PD exhibits less risk than other private capital asset classes and offers more predictable returns.

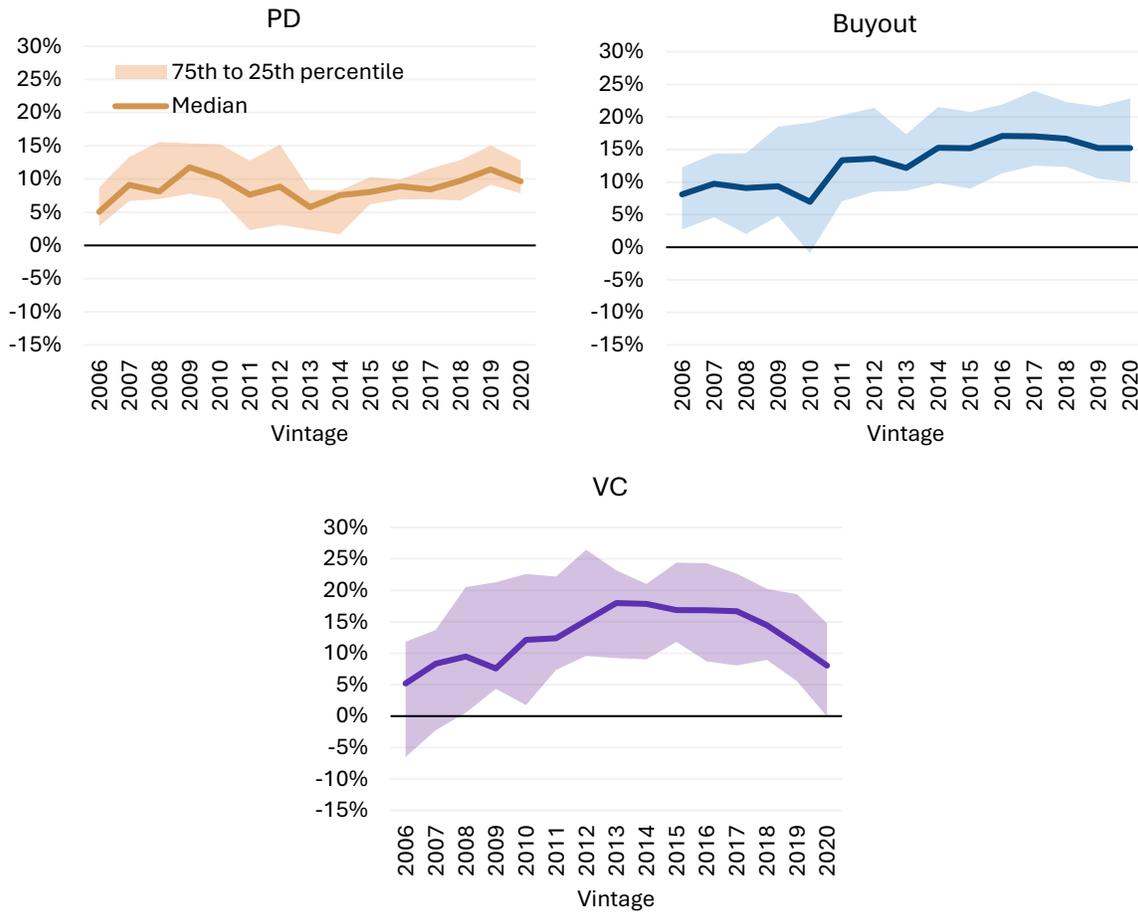
This wide dispersion among VC and buyout funds is especially problematic given the decline in performance persistence, or the ability of a GP to replicate past outperformance. Academic research has found that VC and especially buyout firms are increasingly less likely to consistently replicate past strong performance.⁶² In other words, LPs face high uncertainty as to whether a fund will ultimately finish near the top or bottom of the range of returns despite investing with fund managers that achieved high returns in the past. Given diminishing persistence, asset classes with relatively narrower dispersions in returns, such as PD, can be especially attractive among investors seeking to mitigate risk.

⁶⁰ Josh Lerner and Mark Baker, “An Empirical Analysis of Investment Return Dispersion in Emerging Market Private Equity,” *The Journal of Private Equity* 20, no. 4 (Fall 2017): 15–24, <https://www.jstor.org/stable/44397530>; “Private Investments: AMAC Private Investments Subcommittee,” Cambridge Associates, September 16, 2020.

⁶¹ Note that throughout this section, we generally exclude funds with vintage years more recent than 2020 because these funds are likely too young to meaningfully evaluate their performance.

⁶² The probability that the successor to a top quartile VC fund achieves top quartile performance itself declined significantly from 39% among funds formed before 2001 to 30% among those formed in 2001 and afterwards. This decline is even greater among buyout funds from 37% to 24%. Notably, the authors measure previous funds’ performance as of the time of their successors’ fundraising to reflect the information that an LP would have had when choosing whether to invest in the successor fund. Source: Robert S. Harris, Tim Jenkinson, Steven Kaplan, and Ruediger Stucke, “Has Persistence Persisted in Private Equity? Evidence from Buyout and Venture Capital Funds,” *Journal of Corporate Finance* 81 (August 2023), <https://doi.org/10.1016/j.jcorpfin.2023.102361>.

Figure 11: Median IRR by vintage year with interquartile range, 2006 – 2020 ⁶³



While understanding the performance of PD against similarly structured but higher-risk private capital asset classes is useful, a natural next question is whether PD outperforms similar publicly traded fixed income securities. Thus, we turn to the public market equivalent (PME), a metric that compares a private market fund’s returns against those that an investor would have generated from investing the same amounts in a public index over the same period. ⁶⁴ The commonly used Kaplan-Schoar PME is a ratio that exceeds one if the private asset outperforms the public asset and falls below one if the private asset underperforms. ⁶⁵

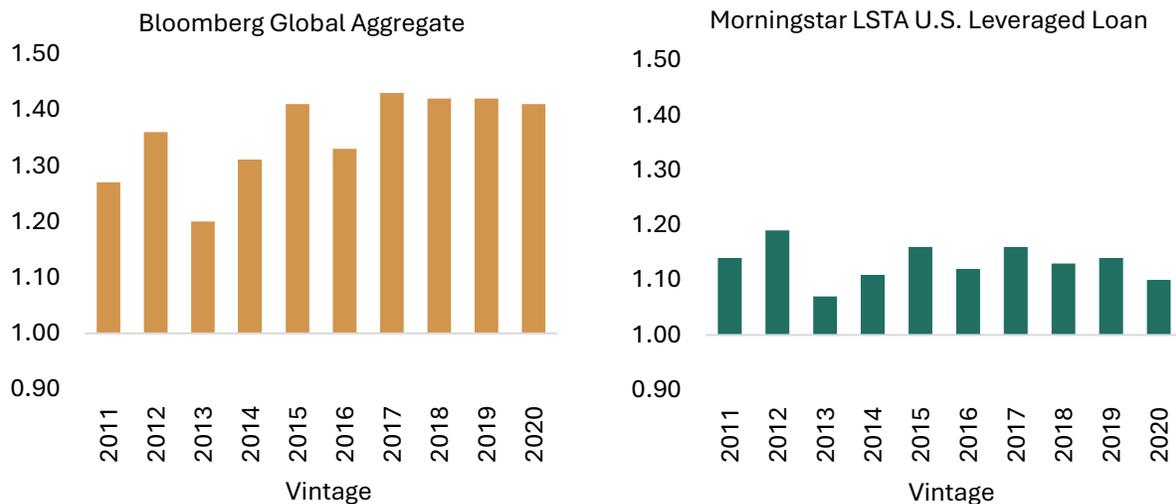
⁶³ State Street Global Markets, as of Q2 2024.

⁶⁴ Josh Lerner, Ann Leamon, and Felda Hardymon, *Venture Capital, Private Equity, and the Financing of Entrepreneurship* (John Wiley & Sons, Inc., 2012).

⁶⁵ More specifically, the Kaplan-Schoar PME is a multiple that takes the ratio of the present value of private funds’ distributions over the present value of contributions, using a public index return as the discounting rate. Source: Steven Kaplan and Antoinette Schoar, “Private Equity Performance: Returns, Persistence, and Capital,” *Journal of Finance* 60, no. 4 (2005): 1791- 1823, <https://doi.org/10.1111/j.1540-6261.2005.00780.x>.

Figure 12 illustrates the PME for PD funds across vintage years 2011 to 2020, compared to two public indexes. The first is the Bloomberg Global Aggregate index, a bond index. PMEs calculated against this index are greater than one for every vintage year considered, indicating PD consistently outperformed publicly traded bonds. Averaged across years, the PME against this bond index was 1.36, meaning on average, PD funds outperformed the index by 36% from inception through Q2 2024. The second public index against which to compare PD is the Morningstar LSTA U.S. Leveraged Loan Index (LLI), which measures the performance of the U.S. leveraged loan market.⁶⁶ Similar to the PMEs calculated against bonds, PD returns have exceeded those of investing in the LLI for every vintage considered. The average PME of 1.13 indicates that PD funds outperformed the LLI by 13% from inception through Q2 2024. This reflects a similar finding in Munday et al. (2018) that PD exhibits superior performance against the LLI.⁶⁷

Figure 12: Kaplan-Schoar PMEs for PD funds, 2011 – 2020⁶⁸



Altogether, the historical performance of PD compared to bonds and leveraged loans has been impressive. These results support the assertion that PD can act as a private capital alternative to fixed income investments by achieving strong risk-adjusted returns relative to other private capital asset classes. It is important to recognize the common adage that “past performance is no guarantee of future results.” This is especially relevant for a relatively young

⁶⁶ We use an LLI in accordance with Munday et. al. (2018), which evaluates various public indexes to calculate PMEs for PD and concludes that the LLI “does the best ... in terms of overall goodness of fit.” Similar to PD funds, leveraged loans generally charge borrowers a spread over the risk-free interest rate, making them a more suitable benchmark compared to bonds, which are often issued with minimal or no spread. Source: Munday et al., “Performance of Private Credit Fund.”

⁶⁷ *Ibid.*

⁶⁸ State Street Global Markets, as of Q2 2024; data on the Bloomberg Global Aggregate and Morningstar LSTA U.S. Leveraged Loan indexes from Bloomberg, accessed October 8, 2024.

asset class like PD, given past financial products that performed well until they did not.⁶⁹ Nevertheless, bank regulation has offered PD a critical role in the marketplace, and these funds have used strategies to mitigate risk among their portfolio companies. The next section looks more closely at these strategies and outlines how they make PD suitable for LMM borrowers in particular.

B. The benefits of PD relationships and how PD funds mitigate risks

Considering the inherent risk involved in PD lending, both borrowers and lenders seek assurances in the lending relationship. From the perspective of borrowers, a key advantage of PD loans is the greater flexibility they provide in comparison to those of banks. Block et al. (2024) finds that over half of surveyed PD lenders indicate that a more flexible covenant structure is a key factor attracting borrowers to PD.⁷⁰ Likewise, BlackRock asserts that borrowers in the middle market have recently turned towards private lenders for their funding needs due in part to the lending flexibility established through a long-term financing relationship.⁷¹

Academic research supports that PD lenders have demonstrated flexibility when borrowers face extenuating circumstances, thereby allowing these funds to maintain stable relationships. Jang (2024) compares how PD lenders and banks approached distressed borrowers during the COVID-19 pandemic. While borrowers of bank loans and direct loans experienced similar “levels of distress” – measured by revenue contraction between Q4 2019 and Q4 2020 – borrowers of direct loans (the majority of which were issued by PD funds) had a 25% probability of renegotiating for payment deferrals with a 3% probability of bankruptcy proceedings. By contrast, firms with bank loans experienced a lower probability of payment deferrals (9%) and a higher probability of bankruptcy proceeding (14%). The banks and direct lenders in this sample both held senior loans that would take priority and potentially allow them to recover their investment in bankruptcy proceedings. However, the fact that PD funds were more willing to renegotiate loan terms during the crisis indicates that these lenders place a high value on preserving relationships with lenders.⁷² This flexibility is mutually beneficial, allowing PD funds to later take advantage of

⁶⁹ For example, portfolio insurance, a product designed to hedge against a fall in stock prices, collapsed in 1987 and contributed to a selling frenzy that intensified a market downturn. Likewise, mezzanine debt, a sub-strategy of PD with equity-like characteristics, came to prominence in the 1980s but “nearly disappeared” in the late 1980s and again in the mid-1990s reflecting fluctuations in the high-yield market. Sources: Robert Shiller, “Portfolio Insurance and Other Investor Fashions as Factors in the 1987 Stock Market Crash” in *NBER Macroeconomics Annual* (Massachusetts: MIT Press, 1988), 287–297, <https://www.nber.org/books-and-chapters/nber-macroeconomics-annual-1988-volume-3/portfolio-insurance-and-other-investor-fashions-factors-1987-stock-market-crash>; Justin Schack, “Stuck in the middle,” *Institutional Investor*, September 30, 2000, <https://www.institutionalinvestor.com/article/2btfwte0lc2ld6ykiczcw/portfolio/stuck-in-the-middle>.

⁷⁰ Block et al., “A Survey of Private Debt Funds.”

⁷¹ Keenan et al., “Private Debt: The Core Middle Market.”

⁷² Jang, “Are Direct Lenders More Like Banks or Arm’s Length Investors?”

valuable, repeated interactions with borrowers and PE sponsors when applicable, as described in Section 5.C.

In addition to the benefits of flexibility, research suggests there are few downsides to this approach given that defaults have been similar between bank and PD borrowers. After controlling for firm and loan characteristics, Erel and Inozemtsev (2024) find that nonbank borrowers are no more likely to default or exhibit worse accounting performance in the five years after obtaining a loan.⁷³ Similarly, other studies report that nonbank borrowers are no more likely to go bankrupt or exhibit worse profitability; in some instances, they even have better post-issuance credit performance than borrowers of bank loans.⁷⁴ Thus, it appears that flexibility allows PD funds to maintain stable relationships with borrowers without realizing any higher default rate.

While lending flexibility may play a role in the avoidance of bankruptcy, PD lenders also commonly use covenants to mitigate risk and work closely with portfolio companies in the event of covenant violation, in contrast to the relatively less hands-on approach of banks. Covenants represent conditions that a borrower must meet in order to fulfill the terms of a loan. They can take a variety of forms, including financial covenants in which the lender checks (or monitors) the borrower’s financial performance on a periodic basis.⁷⁵ Financial covenants allow lenders to preempt risks before the firm defaults on a payment. If a firm violates a covenant – for example, their debt to EBITDA ratio exceeds a predefined threshold – this indicates the borrower may later default on their loan, and the lender can work with them to avoid this risk.⁷⁶

Numerous studies find that PD lenders do monitor firms in practice to ensure their ability to repay loans. An academic survey of PD lenders indicates that 87% of respondents hold periodic meetings with portfolio companies, 85% check updated financial statements, and 85% regularly perform covenant checks.⁷⁷ Likewise, Jang (2024) finds that nearly all loans by direct lenders

⁷³ Erel and Inozemtsev, “Evolution of Debt Financing toward Less-Regulated Financial Intermediaries in the United States.”

⁷⁴ Chernenko, Erel, and Prilmeier, “Why Do Firms Borrow Directly from Nonbanks?”; Loumiotis, “Direct Lending.”

⁷⁵ Financial covenants ensure that borrowers “maintain a satisfactory level of operating performance” through scrutiny of accounting records. Breach of these could result in loss of control to creditors. These differ in nature to negative covenants, which limit the actions of borrowers. Negative covenants are not regularly checked for compliance; rather, the borrower must verify certain actions with their lender for potential covenant violation, in which case the lender can prevent the action. Source: Block et al., “A Survey of Private Debt Funds.”

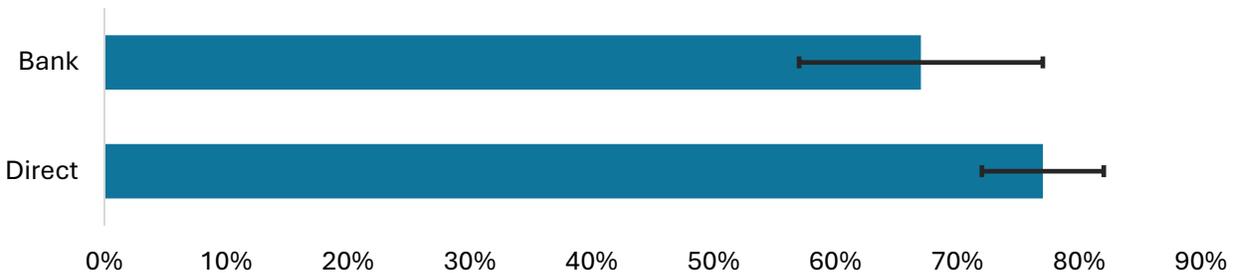
⁷⁶ Jang, “Are Direct Lenders More Like Banks or Arm’s Length Investors?”

⁷⁷ Block et al., “A Survey of Private Debt Funds.”

include financial covenants.⁷⁸ Direct loans are more likely to have covenants based on EBITDA and capital expenditures than bank loans, reflecting the active role of PD lenders in monitoring the financial health of their borrowers.⁷⁹

Jang (2024) also observes that PD lenders work closely with borrowers and often take a hands-on approach to help these companies if they violate a covenant. As shown in **Figure 13**, this author observes that upon a covenant violation, direct lenders are more likely to work with borrowers to find solutions (77% of direct loan violation) than banks do (67% of bank loan violations).⁸⁰ This intervention by PD funds often takes the form of a more active role in monitoring the company, such as through board observation rights or the appointment of a lender-approved financial advisor. Compared to banks, direct lenders are more likely to institute tighter financial covenants and schedule lender meetings in response to a covenant violation. Thus, covenants represent an important way that PD lenders add value to portfolio companies by leveraging their expertise and helping borrowers “course correct” if they risk defaulting on a loan, thereby preserving returns for fund investors.

Figure 13: Mean frequencies of renegotiated terms upon covenant violation (with 95% confidence intervals)⁸¹



In the case of the LMM, the potential for greater returns inherently comes with greater risks. However, the targeted use of covenants by sophisticated PD funds can help minimize risks while preserving the potential of strong returns for those funds’ LPs. This is shown in BlackRock analysis

⁷⁸ There is some contention regarding the ubiquity of covenants in the nonbank lending space as Chernenko (2022) and Loumiotis (2022) argue that covenants do not play a large role in direct loans. Chernenko (2022) finds that financial covenants are less common in nonbank loans and that these rather use other methods, such as warrants, to align repayment incentives. However, Jang (2024) – which finds widespread use of covenants among nonbank lenders – uses a more recent dataset with a higher concentration of PD lenders than the other two studies. Sources: Jang, “Are Direct Lenders More Like Banks or Arm’s Length Investors?”; Chernenko, Erel, and Prilmeier, “Why Do Firms Borrow Directly from Nonbanks?”; Loumiotis, “Direct Lending.”

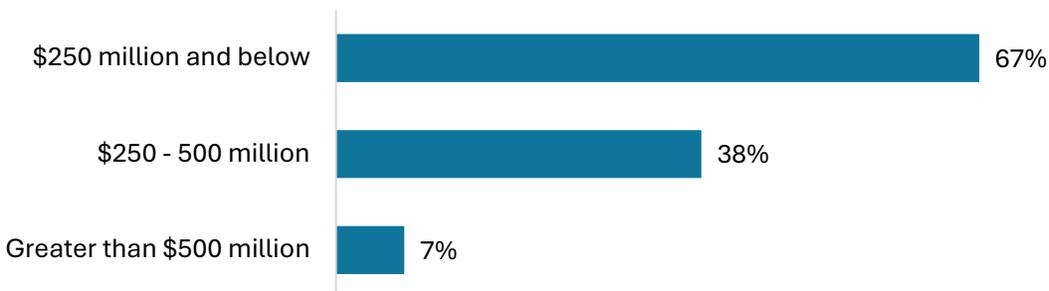
⁷⁹ Jang, “Are Direct Lenders More Like Banks or Arm’s Length Investors?”

⁸⁰ *Ibid.*

⁸¹ *Ibid.*

of Moody’s data as well, which illustrates covenants’ prevalence in the LMM.⁸² **Figure 14** indicates that 67% of LMM deals include covenants, while only 38% of core middle market and 7% of upper middle market deals include these. Practitioners have recognized that payment defaults are often the “first sign of distress” among upper parts of the middle market that involve fewer covenants and often greater access to bank financing.⁸³ By contrast, covenants in the LMM allow PD funds to detect changes in a borrower’s risk profile and act early.

*Figure 14: Share of middle market deals with maintenance covenants by deal size*⁸⁴



Overall, covenants serve as a tool for lenders to minimize risks in PD deals. PD deals hinge heavily on relationships between borrowers and lenders, and the LMM offers the opportunity for close collaboration in negotiating and customizing terms like financial covenants.

C. PD lenders, PE sponsors, and benefits to borrowers

Another aspect of PD lending in which relationships play a central role is sponsored deals. In a sponsored deal, a PD fund lends to a firm that is either wholly- or majority-owned by a PE firm. Lenders often prefer sponsored deals due to perceived advantages in deal quality. If a reputable PE firm has conducted thorough due diligence on a company and is actively engaged in its operations and management, this signals that the sponsored company may pose a lower risk in loan repayment. Moreover, Section 4 indicates that middle market PE deal activity and fundraising has remained strong over the past decade, reflecting the potential for sponsored deals in the LMM.

Block et al. (2024) highlights three advantages of sponsored deals. A majority of surveyed PD lenders indicate that these deals are higher quality, increase the quantity of deals available to PD funds, and provide a pipeline of deal flow through repeated transactions with the same PE

⁸² Keenan et al., “Private Debt: The Core Middle Market.”

⁸³ “Mid-Market Lending,” Private Debt Investor.

⁸⁴ Analysis by BlackRock of Moody’s Investors Services, September 30, 2023. Source: Keenan et al., “Private Debt: The Core Middle Market.”

sponsor.⁸⁵ Thus, PE fund managers generally view PE sponsorship as complementary; in fact, many (if not most) PD deals in the U.S. take the form of sponsored deals.⁸⁶

Further research indicates that PE sponsors work with PD lenders in helping portfolio companies weather challenging market conditions. Jang (2024) finds that PE sponsors are more likely to inject equity to support a distressed portfolio company for direct loans (40%) than for bank loans (23%).⁸⁷ In this way, PE funds undertake efforts to help PD funds avoid defaults, and lenders reward sponsors that inject equity by providing more loans to their portfolio companies in the future.⁸⁸ These findings indicate that beyond providing deal flow, relationships with PE sponsors allow PD funds to mitigate risk if a borrower faces challenges. One practitioner describes the importance of these sponsor relationships in practice: “We have consistently seen these experienced sponsors support their companies in strong environments and when they need help.”⁸⁹

Altogether, high risk-adjusted returns for PD reflect a variety of strategies that these lenders employ to mitigate risk, such as monitoring through covenants and maintaining relationships with PE sponsors. These strategies are especially relevant in the LMM due to strong middle market PE deal activity and PD funds’ ability to work closely with smaller companies to negotiate targeted loan terms.

6. Conclusions: The role of fund manager selection

While the LMM presents considerable opportunity for PD funds, some fund managers are better-equipped to capitalize on these opportunities than others. As noted in Section 5, PD in general exhibits an average dispersion of 6.7 percentage points between high-performing and low-performing PD funds.⁹⁰ In other words, while this dispersion is much lower than that observed for other alternative asset classes, manager selection still matters.

One central consideration in fund manager evaluation is a fund manager’s ability to build and sustain relationships with borrowers. Repeated interactions, whether with portfolio

⁸⁵ Block et al., “A Survey of Private Debt Funds.”

⁸⁶ *Ibid.*

⁸⁷ Jang, “Are Direct Lenders More Like Banks or Arm’s Length Investors?”

⁸⁸ *Ibid.*

⁸⁹ “Mid-Market Lending,” Private Debt Investor.

⁹⁰ These returns are calculated across fund with vintages ranging from 2006 to 2020. High-performing (75th percentile) funds achieved an average IRR of 12.4% while low-performing (25th percentile) realized an average IRR of 5.6%. Source: State Street Global Markets, as of Q2 2024.

companies or PE sponsors, allow PD funds to source deals and facilitate due diligence.⁹¹ Likewise, as described in Section 5, stable relationships play a key role in fund managers' ability to help borrowers navigate difficult market conditions, thereby preserving returns. Researchers have emphasized that PD funds act as "relationship lenders" and LPs might benefit from recognizing this fact in evaluating potential fund managers.⁹²

Another factor to consider is the fund manager's industry expertise. Research has found that borrowers exhibit better ex-post credit performance when they align with a direct lender's industry expertise, which translates into higher returns.⁹³ As described by Loumioti (2022), "direct lenders are successful in identifying high-quality borrowers when they focus on industries they are more familiar with."⁹⁴ Beyond allowing for the identification of promising opportunities, industry expertise can be useful when a fund manager adopts an active role to assist a lender, such as by advising on a company board. Thus, LPs could realize value by prioritizing fund managers with practical knowledge of a specialized set of industries.

Overall, the LMM has high potential for PD investment, and fund managers with strong relationships and industry expertise are particularly well-equipped to capitalize on this relatively overlooked market segment.

⁹¹ Block et al., "A Survey of Private Debt Funds"; Jang, "Are Direct Lenders More Like Banks or Arm's Length Investors?"

⁹² Jang, "Are Direct Lenders More Like Banks or Arm's Length Investors?"

⁹³ Loumioti, "Direct Lending."

⁹⁴ *Ibid.*