

Perspective from



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Public insights on private credit

The evolving landscape of upper-middle-market direct lending:
A convergence with syndicated loan market dynamics

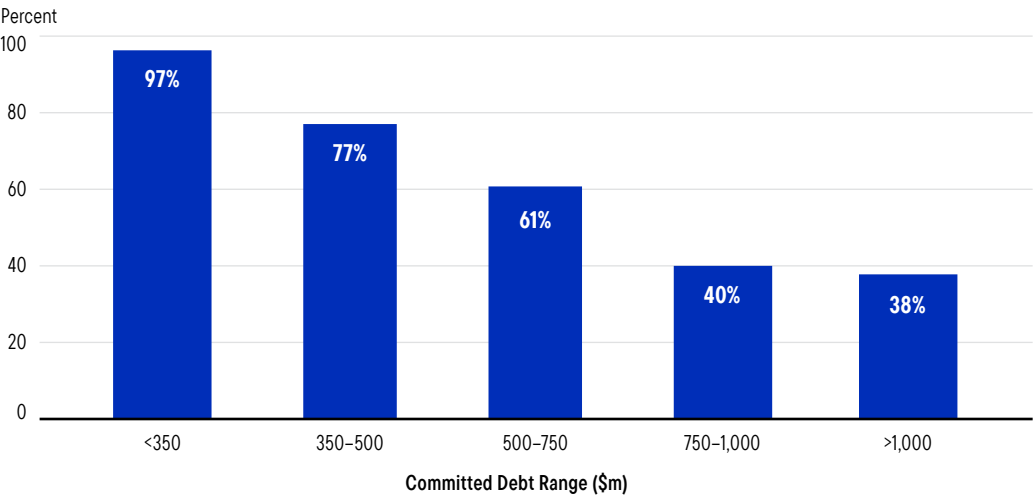


The upper-middle-market direct lending landscape is undergoing significant changes, characterized by the increasing prevalence of higher payment-in-kind (PIK) features and more lenient covenants in loan agreements. This shift is emblematic of a broader trend where these lenders are being compelled to acquiesce to more borrower-friendly terms, effectively blurring the distinctions between the upper middle market and the syndicated loan market.

Borrower-friendly terms: An upper-middle-market trend

In the upper middle market, the traditional lender advantage is being gradually eroded as borrowers gain increased negotiating leverage. The data presented in the chart on the next page illustrates this trend with striking clarity. As the committed debt range increases, the percentage of issuers with maintenance covenants decreases. For instance, deals under \$350 million exhibit a 97% prevalence of maintenance covenants, whereas deals exceeding \$1 billion witness a significant decline to 38%. This downward trend suggests that larger deals are more likely to feature more relaxed covenants. The reduction in maintenance covenants gives borrowers more room to maneuver, potentially increasing their ability to kick the can down the road when it comes to making tough decisions to right the ship. This implies that lenders are taking on more risk, as they have fewer triggers to intervene if the borrower's financial health begins to deteriorate.

Exhibit 1: Issuers with Maintenance Covenants

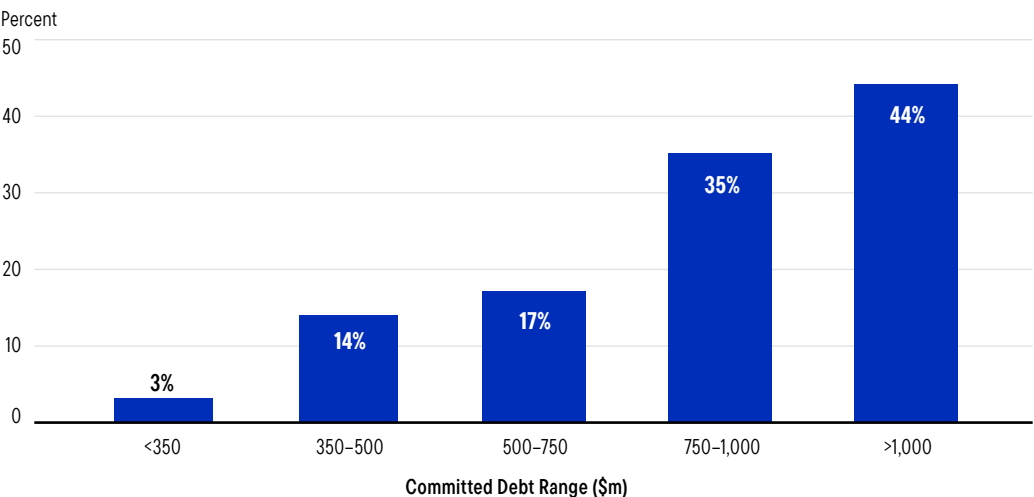


Sources: S&P, Morgan Stanley Research.

PIK features: A growing predilection in larger deals

The chart below highlights another critical facet of this trend: the escalating inclusion of PIK toggles in credit agreements for larger deals. PIK features enable borrowers to pay interest in kind rather than in cash, thereby providing them with enhanced flexibility in managing their cash flows. PIK features also mean that lenders are deferring cash receipts, which can impact their liquidity and ability to respond to other investment opportunities. The data indicates that over a third of direct lending deals with committed sizes surpassing \$750 million incorporate PIK features. Specifically, 44% of deals in the >\$1 billion range feature PIK toggles, compared to a mere 3% in deals under \$350 million. This pronounced disparity underscores the growing propensity of lenders to accommodate borrower needs in larger transactions.

Exhibit 2: Issuers with PIK Toggle Included in Credit Agreement



Sources: S&P, Morgan Stanley Research.

Convergence with the syndicated loan market: implications and insights

The recent evolution of upper-middle-market direct lending reveals a clear convergence with the syndicated loan market. As borrower-friendly features such as looser covenants and PIK toggles become more common, the traditional structural distinctions between these two are becoming increasingly nebulous. Lenders, in their quest for yield in a competitive environment, are being forced to relax their standards and offer more favorable terms to borrowers. This shift is not without risk, as it potentially exposes lenders to greater credit risk and reduced recovery prospects in the event of default.

Conclusion

In conclusion, the upper-middle-market direct lending landscape is evolving in response to changing market dynamics. The increasing prevalence of higher PIKs and looser covenants in larger deals reflects a trend towards borrower-friendly terms. The transformation represents more than a cyclical adjustment—it marks a structural shift in how risk and competition are distributed across the private credit spectrum. As upper-middle-market deals adopt more borrower-friendly terms, lenders may find greater differentiation and value in the core and lower-middle markets, where covenant strength, tighter documentation and relationship-driven origination remain prevalent. Ultimately, this evolution challenges lenders and investors not just to adapt, but to think about where genuine opportunity—and resilience—still resides within the broader private credit ecosystem.

Terms:

Payment-in-kind (PIK) toggle: A PIK toggle is a loan feature that allows the borrower to choose between paying interest in cash or by issuing additional debt, effectively deferring cash interest payments to preserve liquidity.

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