MEKETA

Direct Lending Primer

CONTRIBUTORS
John McCarthy
Alison Adams, PhD
Frank Benham, CFA, CAIA

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Direct lending refers to debt financing provided by a non-bank lender directly to a corporate borrower, without the involvement of an investment bank or loan syndicator.[1] Transactions are bilaterally negotiated, leading to customized loan terms and structures. As a result, they are not freely traded in secondary markets. The borrower is typically a middle market company, defined here as a business with EBITDA between $25 million and $150 million a year.

Direct lending is the largest sub-strategy within the broader private credit universe, which also encompasses asset-based lending, special situations, and opportunistic credit strategies. This paper focuses on how institutional investors access direct lending.

Key Takeaways

- **Direct lending is the largest sub-strategy within private credit**, growing from approximately $115 billion to nearly $2 trillion in AUM between 2010 and 2025. The structural catalyst was post-Global Financial Crisis bank regulation that meaningfully reduced the supply of bank debt to middle market companies. Direct lending has consistently accounted for roughly 60-65% of annual private credit fundraising since 2015, reflecting durable institutional demand across market cycles.
- **Direct lending has historically offered higher yields than bank loans and high yield bonds.** Beyond yield, direct lending loans carry floating interest rates, maintenance covenants that give lenders early intervention rights, and call protection that contributes meaningfully to total realized returns. Bilateral loan structures also give lenders access to more timely borrower information and greater flexibility to negotiate amendments than is possible in broadly syndicated loan markets.
- **Direct lending has delivered favorable returns** relative to public credit alternatives, with lower observed volatility and default rates that have generally remained below those of bank loans and high yield bonds. That said, the asset class has not experienced an extended downturn comparable to the Global Financial Crisis, leaving long-cycle credit performance untested. Investors should also be aware that appraisal-based valuations smooth reported returns and dampen observed volatility.
- **The principal risks of direct lending are credit risk, structural illiquidity, and (in some cases) fund-level leverage.** These risks tend to be most acute in periods of economic stress, when borrower fundamentals weaken, liquidity is most valuable, and leverage can amplify portfolio losses.
- **Direct lending is best evaluated alongside other credit allocations**, with exposure built across multiple managers and vintage years. The floating-rate, income-generating nature of the asset class can complement fixed-rate holdings and help mitigate the J-curve effect common in other private markets strategies. Fund selection and vintage year diversification warrant careful attention.

Why Does Direct Lending Exist?

The borrowing costs for direct lending tend to be higher relative to taking out a bank loan or public market loan. This leads to a natural question of why borrowers choose direct lending over these (cheaper) alternatives.

Speed and certainty of execution are probably the most compelling reasons. A bilateral negotiation with one or two lenders can close in four to six weeks. In contrast, a broadly syndicated bank deal requires roadshows, rating agency processes, and market syndication risk. For a private equity-backed company closing an acquisition, execution certainty is often worth the additional borrowing cost.

Covenant and structural flexibility is the second reason. For a borrower who anticipates that they may need amendments or waivers to various covenants, dealing with one or two lenders is far preferable to seeking consent from a syndicate of 50 holders with divergent interests.

Size and market access matter for the lower middle market specifically. A company with $30 million of EBITDA simply cannot access the bank loan market, which requires scale to execute efficiently. For such borrowers, direct lending is the only institutional debt product available to them.

Confidentiality is a real but underappreciated factor. Public market debt requires SEC disclosure of financials, credit ratings, and business information. Many private companies, particularly founder-owned or private equity-backed businesses, have strong preferences against that disclosure.

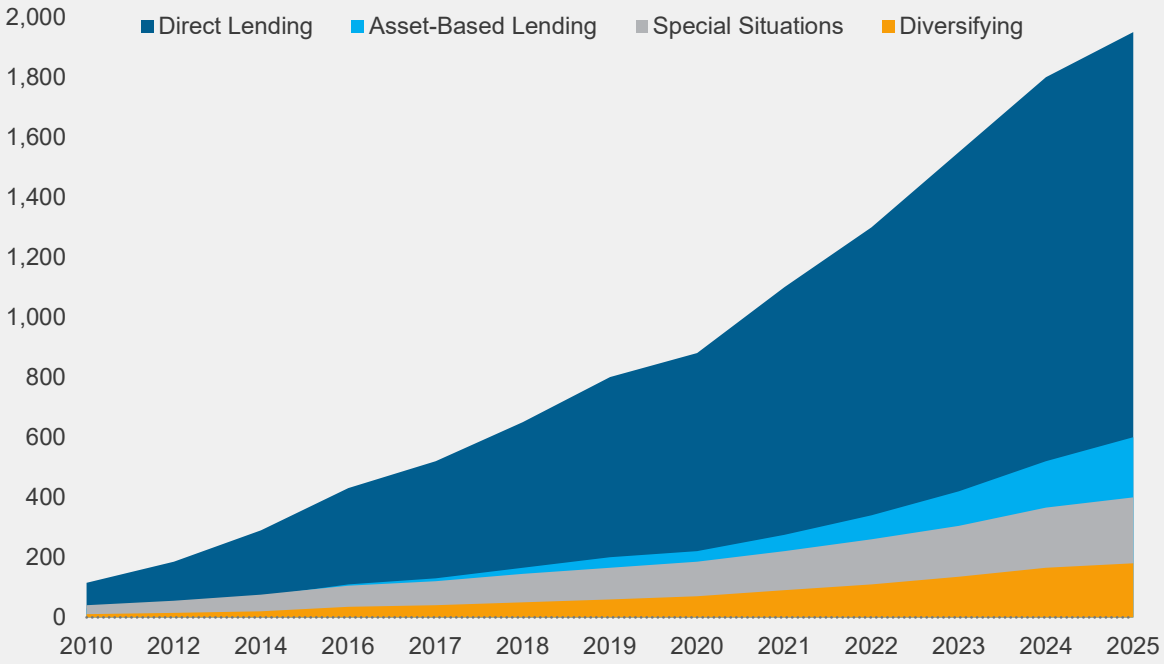
Direct lending is most commonly used to finance buyouts, add-on acquisitions, and growth initiatives for private equity-backed companies, as well as to refinance existing credit facilities as loans mature. Dividend recapitalizations and rescue or bridge financing represent additional use cases, though the latter category has increasingly overlapped with liability management activity as the market has matured.

Market Overview

Both the broader private credit category and direct lending have grown considerably since 2010, with direct lending being the dominant category (see Figure 1). Direct lending grew from approximately $115 billion to nearly $2 trillion in AUM between 2010 and 2025 and remains the most widely allocated private credit strategy among institutional investors.[2]

Figure 1
Private Credit Growth ($ B AUM)

Source: Preqin data as of December 2025.



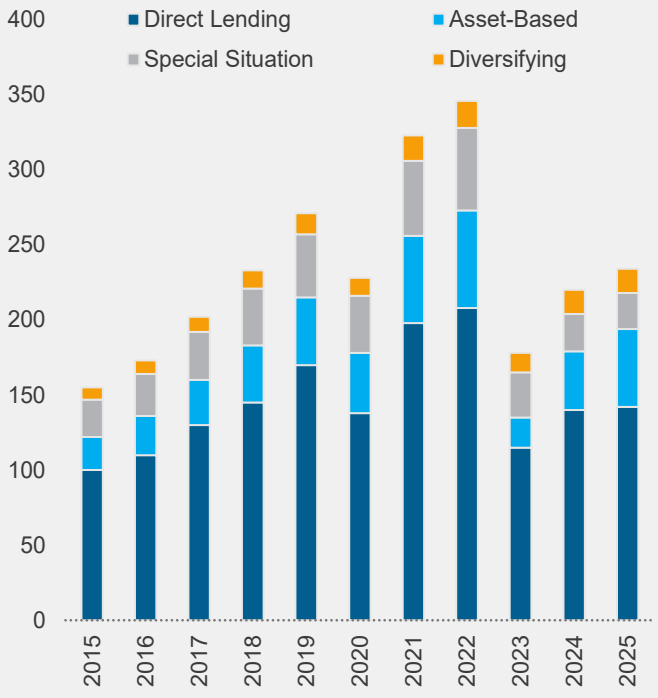
The structural catalyst for direct lending's growth was increased bank regulation following the Global Financial Crisis (GFC) that meaningfully reduced the supply of bank debt available to middle market companies. Empirical research has attributed approximately two-thirds of non-bank lending growth to bank regulations that constrain lending to unprofitable and highly levered borrowers.[3]

Gradually, banks have sought to become more active participants in middle market lending. For example, the bank-private credit partnership models that began to emerge more than a decade after the GFC represent a fundamental structural dynamic that warrants careful attention because it has the potential to significantly reshape the private credit landscape over time.[4] Likewise, regulatory developments continue to drive structural changes across private credit and bank lending.

Despite an evolving landscape, direct lending has consistently accounted for roughly 60-65% of annual private credit fundraising since 2015, underscoring durable institutional demand across market cycles (see Figure 2).

Figure 2

Annual Private Credit Fundraising by Strategy ($B)



Source: Preqin 2024 Global Private Debt Report; With Intelligence H1 2025 Report; Meketa estimates. Annual fundraising by vintage year. 2025 figures estimated based on H1 2025 data.

Direct Lending vs. Traditional Public Markets Lending

Larger companies (e.g., those with EBITDA above $150 million) are often able to borrow in the syndicated bank loan and high yield markets. Smaller companies are typically not able to borrow from such sources and therefore may seek to access the direct lending market when they want to raise meaningful capital.

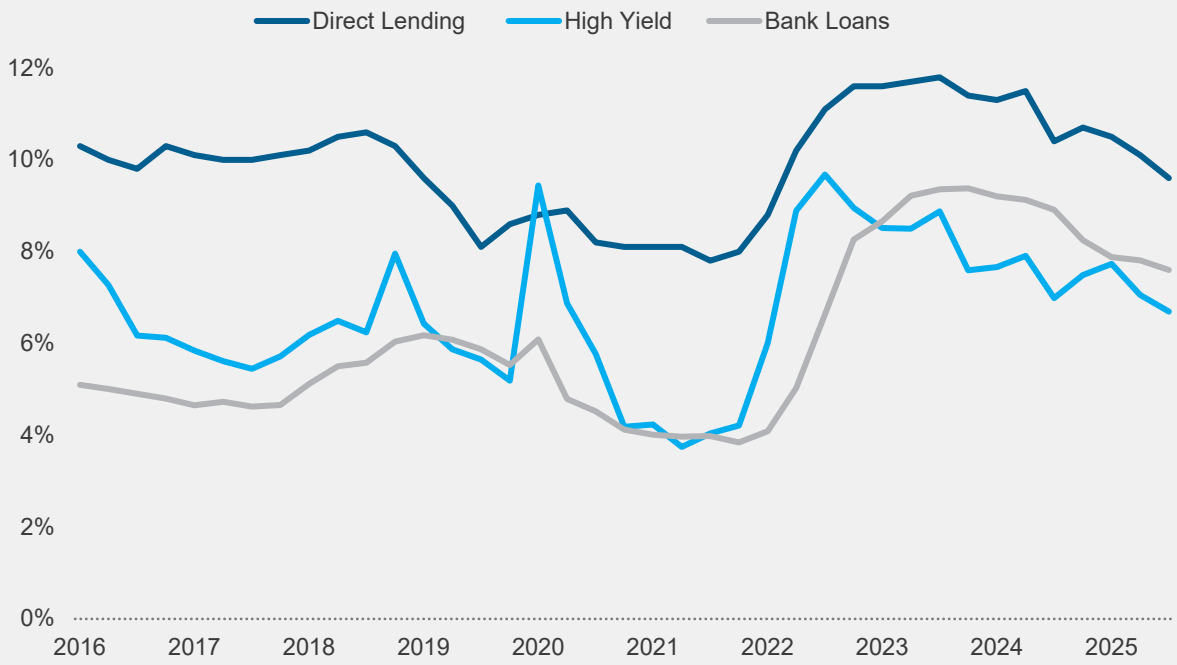
Direct lenders often seek to reduce the credit risk in loans by requiring senior capital structure positioning and more restrictive covenants. Hence, private loans (i.e., direct lending) are predominantly senior secured instruments, sitting at the top of a borrower's capital structure. This positioning provides primary downside protection: in a default or restructuring, senior secured lenders have priority claims on both cash flows and collateral, and the debt is typically secured by a lien on the company's assets.

Loans may be structured as first lien, second lien, or unitranche instruments. Unitranche loans represent a hybrid combining first and second lien features into a single facility at a blended interest rate. The borrower deals with a single loan agreement and a single agent, simplifying the capital structure. Because a unitranche effectively incorporates junior debt layers that a traditional first lien facility would not include, it typically supports higher total leverage than a standalone first lien loan. In practice, many unitranche facilities are governed by an agreement among lenders (AAL) that economically divides the facility into first-out and last-out portions held by different lenders, preserving a risk hierarchy internally even though the borrower sees a single obligation.

To compensate investors for the lack of liquidity and company size, direct lending loans typically pay higher yields than bank loans or high yield bonds (see Figure 3). The spread between direct lending and bank loans has ranged between 150 basis points and 550 basis points since 2016, averaging 380 basis points.

Unlike high yield bonds, which are predominantly fixed rate and subordinated, direct lending loans carry floating interest rates expressed as a spread over the Secured Overnight Financing Rate (SOFR).[5] Floating rate structures in direct lending loans provide investors with natural protection when interest rates rise. Additional return components include an original issue discount (OID),[6] commitment fees, and, in some transactions, equity participation rights and prepayment fees (see Figure 4).

Figure 3
Historical Yields for Direct Lending, Bank Loans, and High Yield Bonds



Source: Lincoln Senior Debt Index (LSDI) for the period March 2016 through September 2025. Bloomberg High Yield Index as of September 2025. Morningstar Leveraged Loan Index as of September 2025. High Yield and Bank Loan yields reflect yield-to-worst and effective yields, respectively.

Figure 4
Comparative Terms: Direct Lending, Bank Loans, and High Yield Bonds

Feature	Direct Lending	Bank Loans (BSL)*	High Yield Bonds
Rate structure	Floating (SOFR)	Floating (SOFR)	Fixed
Spread / coupon	SOFR + 425–575 basis points	SOFR + 300–375 basis points	Treasuries + 275–500 basis points
Original Issue Discount / fees to lender	Yes (typically 0.5–2%)	Occasionally	Occasionally
Maturity	4–7 years	5–8 years	5–10 years
Covenants	Maintenance (LMM); declining (UMM)	Mostly covenant-lite	Minimal
Seniority	1st lien, unitranche, 2nd lien	1st lien, 2nd lien	Subordinated
Secured	Yes	Yes	Occasionally
Liquidity	Illiquid / bilateral	Secondary market	Secondary market

*Source: Meketa observations as of April 2026. Spreads vary by segment: upper middle market (EBITDA >$75M) at the lower end; lower middle market (EBITDA <$50M) at the higher end. **LMM** = lower middle market; **UMM** = upper middle market. **BSL** = broadly syndicated loans. Data as of March 2026; subject to market fluctuation.

Historical Performance and Credit Quality

Benchmarking private direct lending is challenging since each manager's portfolio is unique and both pricing and performance are typically delayed by a quarter or more, like most private market asset classes. From October 2012 through September 2025, the time-weighted return for direct lending was 8.4% per annum, compared to 5.1% for bank loans and 5.6% for high yield bonds.[7]

Since 2012, direct lending has been less volatile than bank loans and high yield bonds. While public market high yield and bank loan indices experienced multiple negative rolling one-year returns over this period, private direct lending funds largely avoided these downturns (see Figure 5). Direct lending may offer lower volatility to investors for several structural reasons that include underwriting, stronger covenants, borrower oversight and influence, and longer investment pool structures.[8] And, as with other private market structures that do not mark to market daily, observed returns tend to be smoothed.[9]

While direct lending has historically offered stronger performance and lower observed volatility, it remains relatively untested across a full credit cycle. The post-GFC era has been dominated by fairly accommodative monetary policy and no extended periods of significant market stress.

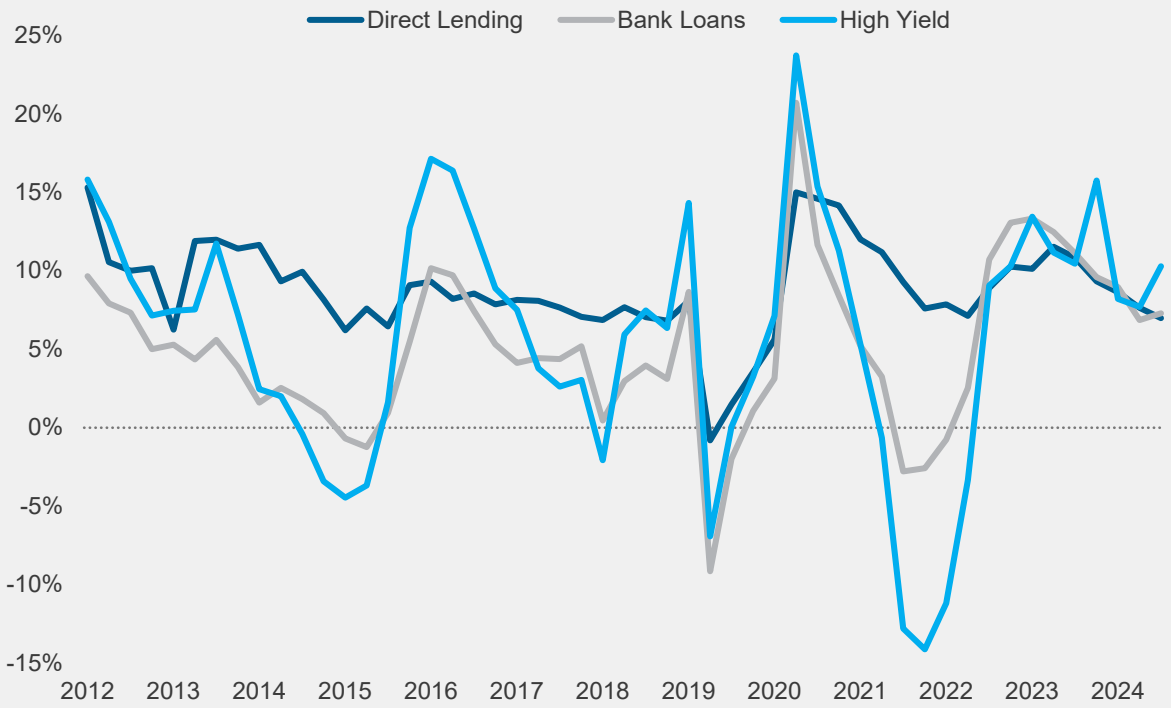
Why Investors Allocate to Direct Lending

Institutional investors allocate to direct lending to access a set of structural features that are not available, or not reliably available, in publicly traded credit markets. The case rests on the instrument's design rather than on a claim that private markets are systematically mispriced relative to public alternatives.

Direct lending loans carry floating interest rates set as a spread over SOFR, and all-in yields on senior secured direct lending have historically exceeded those available on bank loans and corporate bonds with comparable seniority. That yield differential reflects several factors, including origination costs, bilateral negotiation, and the absence of secondary market liquidity (i.e., an illiquidity premium). Investors with return objectives requiring meaningful current income, or with spending and distribution requirements, have found the income component of direct lending attractive on an absolute basis without needing to resolve the question of whether a specific illiquidity premium is being earned.

Figure 5
Rolling One-Year Returns for Direct Lending, Bank Loans, and High Yield (%)

Sources: Cambridge Associates Senior Debt Index (net of fees), Morningstar Leveraged Loan Index, and Bloomberg High Yield Index as of September 30, 2025. The analysis begins in 2012 as that is the first period for which at least ten funds are included in the Senior Debt Index.



Beyond yield, the structural features of direct lending loans distinguish them from public credit in ways that matter for long-term institutional holders.

Covenant protection and customization represent perhaps the most substantive advantage. Direct lending, particularly in the lower middle market, typically includes maintenance covenants that require borrowers to meet ongoing financial tests (e.g., coverage ratios, leverage limits) rather than rely only upon a triggering event as in incurrence-based structures. These covenants are negotiated bilaterally and can be tailored to the specific borrower's business model, industry, and capital structure in ways that standardized public instruments cannot accommodate.

Call protection and fee structures provide additional return components that public markets do not consistently offer. Direct lending typically includes prepayment premiums as well as origination fees and original issue discounts paid at closing. These features compensate lenders for the cost of underwriting a bespoke instrument and for the risk that a well-performing borrower refinances at the first available opportunity. In aggregate, these fee components contribute meaningfully to total realized returns and are less subject to competitive compression than headline spreads.

Access to borrower information can be more extensive and timelier in direct lending than in public credit markets. As a bilateral or club lender, a direct lender typically negotiates ongoing reporting requirements as part of the loan documentation, such as monthly or quarterly financial statements, budget-to-actual reporting, management calls, and in some cases board observation rights. This information flow allows lenders to monitor credit quality in near real time and to identify deteriorating trends before they appear in public disclosures or rating agency actions.

Lender concentration and the absence of secondary market liquidity, counterintuitively, create alignment of interests that benefits lenders over the life of a transaction. In a broadly syndicated facility, loan interests may be held by dozens of institutions with divergent investment mandates, time horizons, and risk tolerances, making coordinated lender action in a stress scenario slow and contentious. A direct lending facility held by one or two lenders allows for quicker, confidential negotiation of amendments, waivers, or restructuring terms when a borrower's circumstances change. The borrower's dependence on a small group of lenders also creates ongoing alignment, as borrowers who anticipate needing future flexibility or capital have an incentive to maintain the relationship, which typically means more transparent communication and more cooperative behavior than is common in broadly syndicated markets.

A final attribute worth noting for portfolio construction purposes is that direct lending returns are not marked to market on a daily or even monthly basis. Because loans are bilateral instruments with no active secondary market, valuations are determined by periodic appraisal rather than observable market prices, which produces a reported return stream that is smoother and less volatile than public credit returns. Investors should be aware that this smoothing understates true economic volatility. With that caveat noted, the absence of mark-to-market volatility has practical governance advantages for institutions.

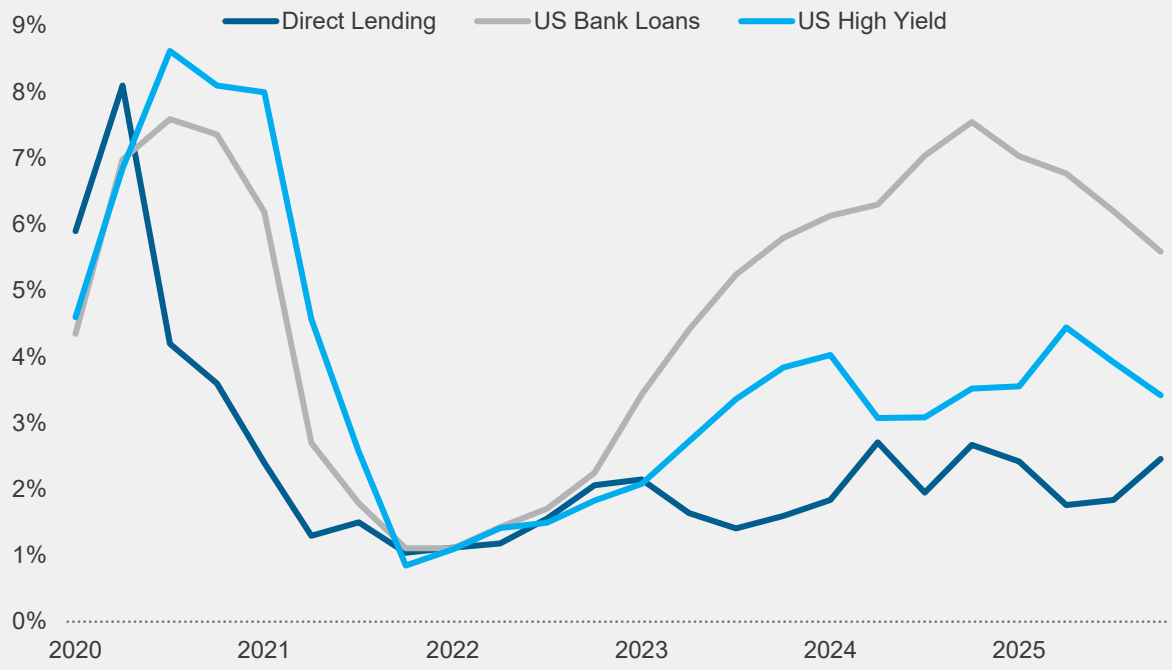
Taken together, these features make direct lending a structurally distinct credit instrument rather than simply a higher-yielding version of a publicly-traded loan.

Default and Loss History

Measuring credit losses in direct lending is inherently complex due to data limitations, methodology differences across lenders, and the bilateral nature of transactions. The limited available evidence shows default rates that are usually no higher than for public credit comparables (see Figure 6). Importantly, this data, like the performance data, does not include the last major downturn in the credit cycle (i.e., the GFC). Of note, the underlying borrower populations are different for direct lending. For example, the high yield universe is composed of unsecured, subordinated debt on companies of varying size and credit quality, whereas direct lending is composed predominantly of senior secured, first lien loans. Whether these borrower differences and direct lending's structural advantages would produce materially better outcomes than public credit under severe stress is an open question, not a settled one. The limited stress-period data that does exist, including performance during the COVID shock, is not inconsistent with the structural case, but it is insufficient to quantify the advantage with confidence.

Figure 6
Rolling Annual Default Rates for Direct Lending, Bank Loans, and High Yield

Sources: Proskauer Private Credit Default Rate Index, Moody's Speculative Grade US Loan and US Bond default rates as of December 2025.

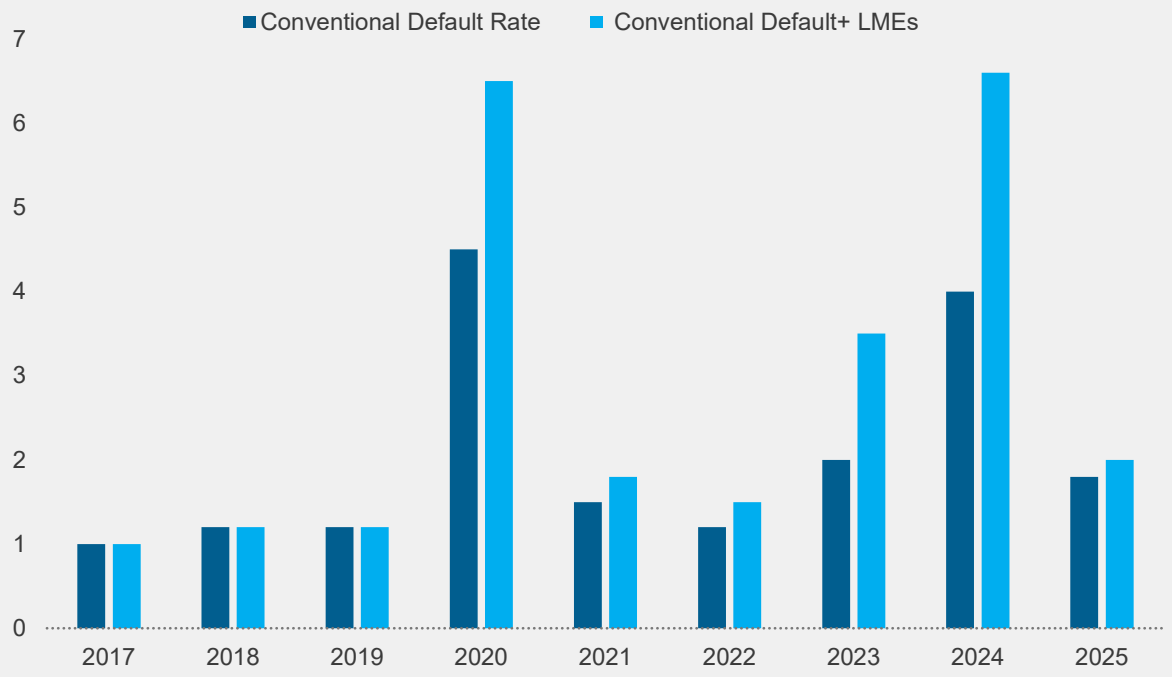


The lower default rates for direct lending reflect both genuine structural advantages and measurement differences that make cross-market comparisons imprecise. Direct loans are predominantly senior secured instruments with priority claims on borrower cash flows and collateral, providing a structural buffer that unsecured or subordinated high yield bonds lack. Maintenance covenants, particularly in the lower middle market, give lenders early intervention rights before a borrower reaches genuine financial distress. Concentrated loan ownership by one or a small number of lenders enables active monitoring and flexibility in renegotiating terms that the broadly syndicated market, with its diffuse creditor base, cannot replicate.

Note that the covenant advantage is most consequential at the point of recovery, not just default. Early lender intervention, triggered by a covenant breach months or years before a borrower would reach formal default, may preserve enterprise value and produce materially higher recovery rates than are typically achievable in a public restructuring where lender coordination is slow and enterprise value has already deteriorated.

For multiple reasons, direct lending default rates are not fully comparable to public credit default rates. The bilateral, illiquid nature of the market means there is no equivalent of a publicly traded price to force recognition of impairment. Lenders have some discretion in how and when they classify a loan as in default, and a liability management exercise (LME) may defer what would otherwise show up as a default. An LME is a negotiated restructuring action, such as a debt-for-equity exchange, covenant waiver, maturity extension, or payment-in-kind (PIK) conversion, that allows a borrower to address financial stress outside of a formal default or bankruptcy process. Such LMEs, when used well, give a lender genuine flexibility to prevent a full default. In other cases, LMEs may just be delaying the inevitable, allowing the lender to avoid reporting defaults while borrower fundamentals continue to deteriorate. Direct lending default rate estimates that include LME workouts paint a somewhat different picture, especially during periods of stress (see Figure 7).

Figure 7
Illustration of Conventional vs. Combined Default Rate (with LMEs) for US Direct Lending (% of Loan Portfolio)



Sources: KBRA Direct Lending Deals (DLD) database, PitchBook LCD Distressed Weekly, Cliffwater LLC, Car & Hague, Fed FEDS Notes (2024). Conventional = missed scheduled payments. Combined includes distressed LMEs. Data through Q1 2025.

Other Credit Quality Indicators

Understanding certain loan features and practices is crucial for evaluating the credit quality of a portfolio. One such feature is the payment-in-kind provision. PIK loans allow borrowers to postpone their cash interest payments by instead accumulating the owed interest as additional principal. Rather than paying interest in cash at regular intervals, the borrower adds the interest to the loan balance, effectively increasing the debt owed over time. This arrangement can be attractive for companies facing cash flow pressures, as it provides short-term relief from cash payments. However, a high proportion of PIK loans in a lending portfolio deserves careful scrutiny. Since the borrower's debt grows and cash outflows are deferred, PIKs can signal financial strain and increase the risk that the borrower may ultimately struggle to repay the loan.

Liability management exercises (LMEs) are another indicator of credit quality. LMEs refer to a range of strategies that borrowers and lenders use to restructure debt and improve a company's financial position. These exercises may include debt-for-equity swaps, waivers of loan covenants, extensions of loan maturity dates, amendments to loan agreements, infusions of new equity, or conversions of conventional loans to PIK structures. LMEs are often initiated when a company faces financial distress or risks breaching its loan agreements. While LMEs can help avoid outright defaults and provide flexibility for both borrowers and lenders, they also indicate underlying credit stress.

Equally important to credit quality are loan covenants, which are the contractual terms and conditions set within loan agreements. Covenants typically outline financial benchmarks and operational restrictions that borrowers must adhere to throughout the life of the loan. These may include requirements to maintain certain debt-to-equity ratios, limits on additional borrowing, or restrictions on asset sales. Strong covenants serve as early warning systems, allowing lenders to intervene if a borrower's financial situation deteriorates. Conversely, weak or waived covenants reduce the lender's ability to monitor and respond to financial trouble, making the loan riskier. Therefore, the quality and enforcement of loan covenants are critical indicators of a portfolio's risk profile.

Risks of Direct Lending

Investors in direct lending must understand the risks in order to evaluate whether an allocation fits their objectives and to compare direct lending appropriately with other private fixed income alternatives.

Credit risk is the principal risk of direct lending, as the asset class involves lending to highly leveraged companies.[10] Further, middle market companies could have higher credit risk because they generally have fewer business lines and greater customer concentration relative to larger companies. A key mitigant can be the strength of financial covenants. Academic research has established that maintenance covenant violations that trigger lender intervention produce better recovery outcomes than in broadly syndicated markets.[11]

Illiquidity is a risk that direct lending shares with other private market assets. Direct lending portfolios tend to be managed in either open-end funds that offer limited liquidity or closed-end funds that have terms of five to eight years, and investors cannot easily sell their interests in these funds. Because the underlying loans are bilateral or club transactions with a limited number of lenders, the loans do not trade openly. If an investor chose to sell their interest in a loan, they would likely need to accept a price materially below the current fair value of the loan, especially in a stressed environment.

Relatedly, direct lending loans do not have broker quotes or observable market prices. The use of independent third-party valuers has become standard among institutional-quality managers and has improved valuation discipline considerably since 2017. Nevertheless, residual subjectivity remains, and regulatory bodies have flagged valuation opacity as a key vulnerability.[12]

Many direct lending funds employ fund-level leverage to augment returns. Leverage of 0.5 to 1.5 times debt-to-equity at the fund level is common, with some strategies using up to two times. However, adding fund-level leverage introduces counterparty and structural risk. Using leverage at the fund level exposes the fund to the financial health and actions of its lending counterparties, which can affect the fund's stability if those parties experience distress or change terms unexpectedly. Additionally, the structure of the leverage facility plays a critical role in mitigating these risks; poorly structured facilities (e.g., using mark-to-market leverage) can amplify losses or create liquidity challenges for investors. Ideally, the leverage facility should have structural protections including: 1) a limit on the overall leverage level, 2) a term facility structure matching the maturity of the loans, 3) only non-mark-to-market tests to assess the collateral, and 4) the ability to swap non-performing assets out of the leverage facility.

A longer-term risk is the potential for direct lending to become a victim of its own success. One of the most significant changes over the past decade is the volume of capital that has flowed into the direct lending market. US direct lending dry powder reached a record $385.3 billion at year-end 2025,[13] and the concentration of that capital among a relatively small number of large managers can create deployment pressure.[14]

The most observable consequence is spread compression, which reduces prospective returns for new commitments (i.e., it makes direct lending less appealing). The more consequential risk, however, may be at the level of underwriting standards rather than pricing. Managers under pressure to deploy capital may make incremental concessions on individual transactions, none of which appears decisive in isolation but which in aggregate can leave a portfolio with materially weaker structural protections than the manager's stated strategy would imply. This drift is difficult to detect from the outside and typically becomes apparent only when credit stress arrives.

A related dynamic is vintage concentration risk. Dry powder that accumulates and then deploys rapidly into a narrow market window concentrates credit exposure in a single point in the cycle. If that deployment coincides with peak valuations and loosening underwriting standards, the portfolio is exposed to a common set of cyclical risks with limited internal diversification across credit environments. This is a primary reason why building direct lending exposure across multiple managers and multiple vintage years reduces risk in ways that single-fund commitments do not.

Investor Implications

Since credit risk is the most prevalent risk in direct lending, it is best evaluated and considered alongside other (public) credit assets such as bank loans and high yield bonds. Direct lending allocations are often part of a broader private credit program rather than treated as an isolated asset class.

Direct lending contributes several distinct attributes to a portfolio. First, it provides meaningful current income, typically higher than most other asset classes. Second, the income contribution can reduce or substantially mitigate the J-curve effect that many other private markets strategies face, as investors may begin receiving distributions within the first year of investment. Further, like other private market assets, the observed volatility (and correlations) of the asset class will tend to be lower than that for similar public market assets (e.g., bank loans and high yield bonds). Finally, the floating-rate nature of direct lending means it can complement other fixed income assets in a portfolio that are negatively impacted by rising interest rates.

Investors may also evaluate their allocation against an "illiquidity budget." Many investors have an implicit or explicit limit to how much they can invest in illiquid assets while still being able to meet their obligations. They then may ration or "budget" that allocation to illiquid assets in the way that they deem most suitable for meeting their objectives and constraints.

These are general frameworks; the optimal allocation for any institution depends on its specific circumstances and should be developed through a strategic asset allocation process that reflects the investor's total portfolio objectives.

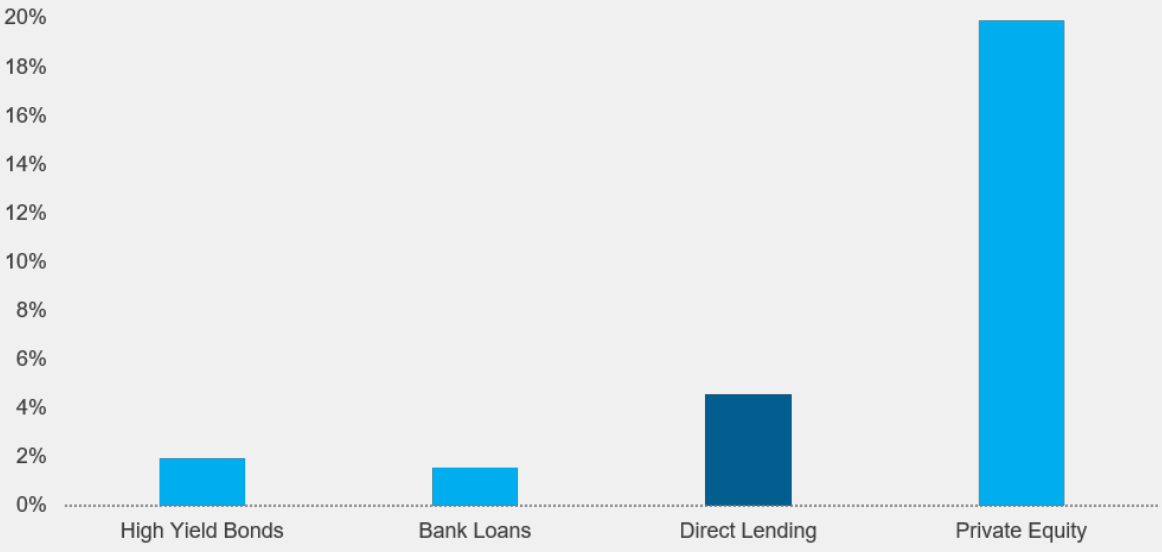
Manager Selection

Manager selection in direct lending is highly consequential. Unlike public credit, where performance dispersion across managers is constrained by observable market prices, direct lending returns depend heavily on origination sourcing, underwriting discipline, and workout capability, none of which is easily observable.

Interquartile spreads (i.e., the gap between the 25th and 75th percentiles in a manager universe) can be interpreted as how much potential value lies in selecting superior active managers within an asset class. The range of potential return outcomes within direct lending is illustrated by the interquartile spreads (see Figure 8). The level of return dispersion among direct lending managers is larger than that for bank loans and high yield bonds, though it is considerably less than private equity. This implies that funds in the direct lending universe have more potential to add value than their public credit counterparts, but less potential than some other private markets asset classes such as private equity. Just as importantly, a poorly selected direct lending manager can produce substantially worse outcomes than the asset class averages would suggest.

Figure 8
Interquartile Spreads (Trailing 10 Years)

Source: Cambridge Associates via IHS Markit, IRR quartiles by vintage year, and eVestment data pulled in June 2025. Private asset funds raised Vintage Year 2012 to 2021. High yield and bank loan data for the trailing 10 years as of June 2025. Indices: Cambridge Associates Senior Loan Index, Cambridge Private Equity Composite, eVestment High Yield Universe, eVestment Bank Loans Universe. Average fund count is 74 for direct lending, 2,487 for private equity, 86 for bank loans, 155 for high yield. For more information on the bank loans and high yield alpha calculation, see Meketa's Manager Alpha Whitepaper.



Building exposure across multiple managers and vintage years is beneficial to achieving diversification. It also provides greater certainty about the returns of a portfolio of direct lending funds given the dispersion of funds returns implied by interquartile spreads. Most institutional-grade direct lending funds hold 20-60 loans, with position sizes of 2-5% common and occasionally as large as 10%. A given fund's performance is heavily influenced by credit conditions at the time of origination. Missing out on a particularly good year, or overcommitting to a particularly bad one, will harm performance. Investors may address both forms of risk through multi-manager, multi-vintage approaches.

Vehicle Selection and Fees

The traditional closed-end or drawdown-style vehicle has historically been the most prevalent fund structure for direct lending investors. This is due to the illiquid nature of the direct lending market and the irregular pace at which managers originate new loans. These funds typically have an investment period of two to four years and a final term of five to eight years. The fee structures for these vehicles resemble those for many other closed-end private market funds. Management fees typically range between 1.0% and 1.5%, with carried interest of 15% to 20%. Hence, the net-of-fee return premium over public credit may be substantially narrower than the gross yield differential implies.

Evergreen and open-end fund structures represented a small niche of the market until they started to attract meaningful assets in 2022.[15] These structures offer more flexible capital deployment and periodic liquidity windows, making them more accessible to investors with ongoing liquidity needs. Because they recycle capital, they also partly mitigate the need to make regular vintage year commitments in order to construct a diversified portfolio. They also allow investors to buy into a diversified portfolio of assets, potentially mitigating the J-curve and blind pool risk often associated with private markets assets.

However, open-end structures may introduce liquidity risk at the fund level that closed-end vehicles do not carry. Periodic redemption windows create a structural mismatch between the liquidity offered to investors and the liquidity available in the underlying loan portfolio, which has no active secondary market. In stable conditions this mismatch is usually manageable; however, in periods of market stress redemption queues can form and become self-reinforcing.[16] Investors who observe a queue forming have an incentive to join it before it lengthens, accelerating outflows regardless of their own liquidity needs. Managers facing sustained redemption pressure may impose gates or extend redemption queues, and if redemptions are honored at valuations that do not fully reflect portfolio stress, investors who remain in the fund effectively subsidize those who exit. Liquidity in open-end direct lending structures is therefore best understood as contingent rather than contractual. That is, it will likely be available in normal markets, but subject to restriction precisely when investors are most likely to want it.

Conclusion

Direct lending has grown from a niche post-GFC phenomenon into a mature institutional asset class. Bank retrenchment from middle market lending, demand for customized debt solutions, and the financing needs of private equity-sponsored companies all gave rise to the asset class, and these structural features remain largely intact. The result is an asset class with a demonstrable if relatively short track record, a coherent investment rationale, and attractive return and yield characteristics.

The investment case for direct lending rests on a combination of yield premium, structural protections, and portfolio construction attributes that are not reliably available in public credit markets. Senior secured positioning, maintenance covenants, floating-rate income, and bilateral lender relationships each contribute to the risk profile in ways that distinguish direct lending from broadly syndicated loans and high yield bonds. For institutions with long investment horizons and the capacity to tolerate illiquidity, these features collectively support an allocation to the strategy as part of a broader credit program.

That said, direct lending is not without meaningful risks, and those risks deserve clear-eyed evaluation. The asset class carries concentrated credit exposure to highly leveraged borrowers and has not been tested through a full credit cycle, leaving the magnitude of its structural advantages under severe stress as yet unquantified. Liability management exercises and payment-in-kind provisions are double-edged: used well, they give a direct lender genuine flexibility to work with a stressed borrower and avoid an unnecessary default; used poorly,

they can defer recognition of impairment and obscure the true state of portfolio credit quality. The use of leverage at the fund level amplifies existing risks and introduces new ones. The different fund structures are contractually or contingently illiquid. Investors who understand these dynamics are better positioned to select managers, structure their exposure, and hold their allocation with conviction through periods of market stress.

For investors considering a direct lending allocation, the practical implementation questions include sizing, vehicle structure, manager selection, and pacing commitments across vintage years. The answers depend on each institution's return objectives, liquidity constraints, and illiquidity budget. Direct lending can be implemented as one component of a broader private credit program or as a standalone allocation, that is preferably constructed with exposure across multiple managers, vintage years, and market segments to mitigate vintage concentration and manager selection risk.

End Notes

[1] In this paper we use the term bank loans synonymously with large-company, broadly syndicated loans.

[2] Source: PitchBook, Private debt fundraising saw sharp contrasts in 2024, March 12, 2025.

[3] Source: Chernenko, Erel & Prilmeier, "Why Do Firms Borrow Directly from Nonbanks?" November 2022.

[4] Arrangements such as Wells Fargo-Centerbridge and Barclays-AGL (in 2023 and 2024) allow banks to retain borrower relationships and origination capabilities while shifting balance sheet exposure to private credit managers.

[5] SOFR replaced LIBOR as the key lending reference rate in 2023.

[6] The OID is an upfront fee paid to the lender at closing. For example, a 1% OID on a $100 million loan means the lender advances $99 million but the borrower repays $100 million at maturity.

[7] Sources: Cambridge Associates Senior Debt Index (net of fees at the limited partner level), Morningstar Leveraged Loan Index total return, and Bloomberg High Yield Index total return from October 2012 to September 2025. The analysis begins in the fourth quarter of 2012 as that is the first period for which at least ten funds are included in the CA Senior Debt Index. We note that time-weighted returns (TWR) are an imperfect measure for any private market asset class but can be useful when comparing performance to public market assets. Further, an unknown percentage of these funds employ leverage, which makes the comparison to public credit less than perfect. The net-of-fee return premium for direct lending over public credit may be substantially narrower than the performance numbers imply after adjusting for leverage.

[8] Source: Review of Financial Studies, N. Smith, "Creditor Control Rights, Corporate Governance and Firm Value," 2012. Lincoln International, Lincoln US Senior Debt Index, Q3 2025.

[9] Research has found that appraisal smoothing can cause reported volatility to understate true economic risk by 40-70%. Source: Block, J., Jang, Y.S., Kaplan, S.N., and Schulze, A. (2024). "A Survey of Private Debt Funds." Review of Corporate Finance Studies, 13(2), 335–383. Survey of 225 GP professionals at firms managing over $390 billion in AUM. https://doi.org/10.1093/rcfs/cfae001

[10] Source: Proskauer, "Private Credit Insights Report," February 2025. The typical range of debt to EBITDA for lenders is 4x-5x. Average closing leverage on U.S. direct lending deals was 4.6x in 2023 and 5.0x in 2022; Proskauer's dataset draws on more than 360 deals and 140 private equity sponsors.

[11] Source: Block, J., Jang, Y.S., Kaplan, S.N., and Schulze, A. (2024). "A Survey of Private Debt Funds." Review of Corporate Finance Studies, 13(2), 335–383. Survey of 225 GP professionals at firms managing over $390 billion in AUM. https://doi.org/10.1093/rcfs/cfae001.

[12] Source: Jang, Y.S., Kim, D., and Sufi, A. (2025). "The Lending Technology of Direct Lenders in Private Credit." NBER Working Paper 34500. https://www.nber.org/papers/w34500.

[13] Source: S&P Global Market Intelligence, citing Preqin data, January 2025.

[14] Source: With Intelligence, "Private Credit Outlook 2025," January 22, 2025. Five funds accounted for approximately 40% of 2024 private credit fundraising.

[15] Source: BIS Bulletin No. 106, "Retail Investors in Private Credit," 2024. And With Intelligence, "Evergreen Private Credit Funds Surpass $500 Billion," March 2025. Retail investors in private credit typically invest in liquid BDC and interval fund structures. This paper is focused on illiquid private investment vehicles. Retail semi-liquid vehicles are outside the scope of this paper.

[16] This dynamic is not just hypothetical. It produced persistent redemption queues in open-end core real estate funds during the 2022 to 2025 period, and the structural parallels to open-end direct lending vehicles are meaningful.

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