

Navigating Private Credit: An Institutional Approach

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Dellarche

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Abstract

This paper provides an overview of the private credit market, focusing on borrower types across the lower, middle, and upper middle market, as well as the structural differences between sponsor backed and non-sponsor backed transactions. It also outlines common private credit structures, including senior secured, unitranche, second lien, and mezzanine debt, and discusses how risk, return, and leverage (both at the deal and fund level) vary across strategies and managers.

Private Credit is an asset class that has gained a lot of attention over the years, but what many don't know is the asset class has been around since the 1980's. It was created as a niche industry where non-bank lenders provided direct loans to businesses during the leverage buyout boom of that time. Post the Great Financial Crisis, traditional banks faced stricter regulations within their lending platforms, which reduced their lending activity to businesses. Due to this reduction, private credit funds rapidly expanded to fill the void left by the banking institutions. Today, private credit is a major asset class and its growth continues due to factors like investor demand and ongoing shifts within the banking landscape.

What is Private Credit Direct Lending?

Private credit direct lending is when a private non-banking entity provides a loan directly to a business. These businesses can either be private or public and can range from small to very large companies. Due to the private nature of these loans, which bypass more traditional financial lenders, their terms and covenants are often more flexible and can be customized to suit the borrower's needs. For those unfamiliar with how covenants function in lending, they act as a "safety net" for the lender, setting rules and safeguards that help ensure the borrower stays on track financially and can pay back the loan. These private loans generally come with three types of covenants: **affirmative, negative, and financial.**

Affirmative covenants require borrowers to take certain actions such as providing monthly financial statements or maintaining adequate insurance coverage.

Negative covenants restrict borrower specific activities, such as incurring additional debt beyond an agreed threshold, placing new liens on real assets (like property holdings), or making excessive dividend payments without prior approval from the lender.

Financial covenants are quantitative in nature and require borrowers to maintain specified financial ratios, such as minimum debt yield or debt service coverage ratios (DSCR), minimum liquidity levels, etc. These covenants may be lighter or heavier depending on the borrower's credit quality, size, and overall risk profile and will be implemented throughout the life of the loan.

Who are the typical borrowers within private credit and why might they seek private financing instead of traditional bank loans?

Borrowers in the private credit market generally fall into three size categories: lower middle market, middle market, and upper middle market. Lower middle market companies typically generate between \$5 million and \$25 million in annual EBITDA (Earnings Before Interest, Taxes, Depreciation, and Amortization). These businesses are often family or founder owned and have more limited access to traditional capital markets. Lower middle market companies tend to face tighter loan terms compared to borrowers within the middle and upper middle categories. Loan terms tend to be stricter for lower middle market borrowers because they typically have smaller scale, less diversified cash flows, and more limited credit history when compared to companies of larger size. Due to the smaller scale and financial limitations of these businesses, private lenders often demand stricter covenants and higher interest rates than would be typical in loans offered to larger businesses with greater earnings.

Middle market borrowers are those producing between \$25 million to \$100 million of EBITDA annually. These firms are generally more established, remain privately held, and tend to have greater operational scale and more formal financial reporting practices than those in the lower middle market. Due to the borrower's larger scale and more diversified operations, loan terms tend to be more favorable when compared to lower middle market borrowers.

Upper middle market borrowers, while representing a smaller portion of the total deal count, account for a larger share of overall loan volume. These companies typically generate \$100 million or more in EBITDA. They tend to be well-established businesses that often have access to the broadly syndicated loan market (BSL), often referred to as a bank loans, but may turn to private credit for greater speed, confidentiality, and execution certainty; particularly in competitive or time-sensitive transactions. These borrowers also tend to have the most favorable terms within the three borrower types. Their large scale and more diversified cash flows give them stronger negotiating power with private lenders. These attributes also allow them access to multiple sources of capital, which allows them to "shop around" for the best terms and covenants possible. Private lenders tend to win these deals due to their speed and term/covenant flexibility rather than purely on pricing.

Although the private credit market now approaches \$2 trillion in size, lower middle and middle market borrowers drive the majority of deal activity within the industry. Upper middle market transactions occur less frequently, but due to their larger loan sizes, account for the greatest share of total dollar volume.

Corporate Ownership

Understanding the size and profile of the borrowers within the private credit industry sets the stage for how these companies access private credit. Although loans are generally categorized by the borrowing entity, they are also categorized based on their origin. These categorizations are called sponsor backed and non-sponsor backed deals.

A sponsor backed deal is a transaction in which a private equity firm (PE) sponsors, or supports, a company in obtaining financing. Typically, a private equity firm will sponsor this transaction to fund a leveraged buyout (LBO), add-on acquisition, a recapitalization, or a growth investment. In this structure, the private equity firm will act as both the equity owner and key decision maker on behalf of the company, often taking on operational responsibilities as well. Acting as company's equity owner, they often seek to enhance operational efficiency by providing strategic oversight over the company and installing experienced management teams when necessary. When a lender underwrites a sponsor backed deal, they evaluate not only the portfolio company's financials, but also the track record, capital strength and operational expertise of the PE sponsor themselves. These deals also tend to have more standardized documentation and deal sizes due to the banking relationships and negotiating leverage already established by the sponsor. Although the presence of a sponsor often provides additional confidence to the lender, that confidence typically comes at a price, as the lender tends to have less influence over loan terms when negotiating (typically around covenants and debt

flexibility). This extra layer of due diligence, hands-on operational involvement, and fresh equity commonly supplied by the sponsor, often leads these deals to be perceived as “less risky” when compared to their non-sponsor backed counterpart.

A non-sponsor backed deal is a type of transaction that occurs when a company obtains financing directly, without the involvement of a private equity firm or financial sponsor. These transactions are typically undertaken by independent, privately held companies seeking capital for growth, acquisitions, and recapitalizations or for refinancing existing debt. Compared to sponsor backed deals, non-sponsor backed loans are often smaller in size, which reflects the limited scale and access to capital markets these companies tend to have. Deal sizes generally range from \$5-100 million, depending on the company’s EBITDA, industry and credit profile. In this structure, the company itself drives the financing process, from preparing financials for evaluation to negotiating covenants and other loan terms. As a result, lenders focus almost entirely on the company’s credit quality, cash flows, and operational performance. Due to these factors, non-sponsor backed loans often have more restrictive terms and tighter covenants compared to sponsor backed deals. These transactions typically carry higher yields to reward the lender for taking on increased risk and underwriting effort. Unlike sponsor backed deals, where the sponsors often negotiate more borrower friendly terms, non-sponsor backed loans allow the lender to have more control over covenants, debt capacities, and operational oversight.

Private credit tends to encompass a broad range of financing instruments for borrowers, but what are some of the most common types of issuance within direct lending?

The most common type of debt issued through direct lending is a first lien loan, also called senior secured debt. These loans are typically secured by a borrower’s assets, future cash flows, or a combination of both, and have first priority in repayment in the event of default or bankruptcy. Some first lien loans specifically combine asset and cash flow security within the structure of the loan, which is often seen in leveraged buyouts or growth financing transactions. Generally, the more a loan is secured by future cash flows rather than tangible assets, the higher its risk profile. First lien loans typically carry the lowest risk in the direct lending spectrum and, correspondingly, offer lower yields.

Second lien loans are also a common type of debt instrument used within direct lending. These loans are structured similarly to first lien loans, but hold a junior position to first lien lenders in the collateral priority. In the event of a default or bankruptcy, second lien loans face greater risk of principal losses than their first lien counterparts. Due to this elevated risk, these loans tend to carry higher yields as compensation. Second lien loans are often used by borrowers who already have first lien debt outstanding but need to bridge funding gaps, fund expansions, or require additional funding to complete a project.

Subordinated (mezzanine) loans tend to be less common than second and first lien loans, but remain an important part of the private credit market. These loans sit below both first lien and second lien positions within the capital structure. They operate similarly to second lien loans but often include warrants or equity kickers to enhance returns. Borrowers typically use these loans to fund expansions, pursue growth initiatives, or bridge financing gaps, trading lighter covenant controls for equity like features that may not be available through a second lien loan. Due to their subordinated position, these loans generally carry higher interest rates than second lien loans.

Unitranche loans are loans that combine elements of the three previous loan types—senior secured, second lien, and subordinated/mezzanine—into a single facility. Unitranche loans can be issued by a single lender or multiple lenders through a syndication process. When syndicated, the lenders allocate risk via a first-out and last-out structure. The first-out lenders receive a lower interest rate due to their repayment priority, similar to a first lien position, while last-out lenders earn higher yields to compensate for their lower position within the internal waterfall, similar to a second lien or subordinated position. For lenders, a unitranche loan allows participation in a single, simplified borrower facility while structuring the economics internally so each lender assumes the level of risk they are comfortable with. For borrowers, this structure simplifies negotiation and documentation,

as they only deal with one loan, one rate, and one set of covenants. Due to the origination costs, these loans tend to be more common amongst middle and upper middle market borrowers but can find their way within the lower middle market as well.

Fund Leverage

Up to this point, the focus has been on the capital structures used by portfolio companies when obtaining debt financing. However, leverage doesn't just exist at the borrower level, fund managers themselves often use leverage within their fund vehicles. One of the main reasons fund managers use leverage is to enhance the return profile of the fund. By using borrowed capital on top of investor equity (the amount that has been invested in the fund), managers can amplify the returns of invested capital. For example, if a fund earns an 11% yield on the loans it has originated and the cost of borrowing (leverage) is 6%, that 5% spread benefits the fund and its investors. Another reason a fund manager might take on fund level leverage is to help bridge the timing gaps created by uneven cash flow timing. Because new investments can take time to close and repayments come in lumpy intervals, funds may have idle capital sitting uninvested while waiting for new commitments or capital calls. Leverage helps bridge these gaps and keeps capital working efficiently. Fund level leverage can also allow managers to make investments or distributions without immediately calling capital from limited partners (LP's). Doing this helps smooth cash flows and improves internal rate of return (IRR) metrics.

There are several forms of fund level leverage but the two most common types are NAV facilities and Lines of Credit. Lines of Credit are typically low cost short term loans, typically 30-180 days, backed by investors uncalled capital commitments. This form of leverage is commonly used to make new investments quickly before drawing limited partner (LP) capital and are often used within all fund sizes. These loans are typically repaid when capital is called from LP's. NAV facilities are a type of credit facility that, rather than subscription loans that are secured by uncalled capital commitments, provide loans secured by the portfolio assets held within the fund. These type of loans are typically used to make follow on investments or provide liquidity later in the fund life. They are more common for mature funds and typically hold a higher cost than subscription lines since the collateral is deemed riskier than LP commitments.

For funds that employ leverage, it will typically range anywhere from 0.25x to 2x (for every \$1 of investor capital, \$0.25 to \$2.00 of borrowed capital). The funds that invest in riskier loans tend to employ less leverage (or none) at the fund level. Upper middle market funds typically leverage their funds more than lower middle market funds due to the holdings within the fund. Upper middle market funds generally target larger, more seasoned companies with stable operations and predictable cash flows. Banks and other credit providers tend to be more willing to lend against these larger companies. However, since these businesses are usually more mature and their growth trajectories have stabilized, fund managers often rely more heavily on leverage to drive returns and achieve their target IRRs.

While leverage is great tool to boost returns and provide liquidity within the fund, it does come with a couple of noted risks. Liquidity risk is one of such risks. If a portfolio's cash flow slows or defaults rise, the fund might have trouble servicing its own debt. This can also lead to refinance risks. If markets tighten, due to deteriorating market conditions brought on by defaults, renewing credit lines or NAV facilities can get expensive or even sometimes become unavailable, potentially magnifying losses for fund investors.

Putting it All Together

Now that we've established a basic groundwork for understanding some of the terms and attributes of private credit, let's put that knowledge to work. In the table below we have provided an illustration depicting three different private credit funds. The table is a consolidated version of the information DeMarche provides to clients when conducting a private credit search and serves as an executive summary that may be reviewed during a search meeting.

Upon initial review, given the similarity of performance targets, one might assume that the three private credit funds have similar approaches and risks. However, each fund takes a very different path to reaching their net return target of around 12%.

	Fund A	Fund B	Fund C	
Private Credit Fund Characteristics	Anticipated Fund Size	\$4 billion	\$1.5 billion	\$750 million
	Anticipated Strategy	Junior Credit 80%+ 2 nd lien	90%+ 1 st Lien & Unitranche Loans	80%+ 1 st Lien Loans
	Focus Areas	Upper Middle Market (EBITDA \$75m - \$750m)	Middle Market (EBITDA \$20m - \$100m)	Lower Middle Market (EBITDA \$5m - \$30m)
	Additional Portfolio Attributes	90%+ PE Sponsor Backed 10-15% Preferred Equity	90%+ PE Sponsor Backed Leads and Arranges “club deals”	50% PE Sponsor Backed 50% of Deals Targeted to Offer Warrants (stock options)
	Anticipated Geographic Focus	Primarily North America, Non-U.S. exposure is capped at 20%	North America (Developed)	North America (Developed)
	Deal Size Range	\$50m-\$200m	\$25m-\$100m	\$10m-\$50m
	Leverage	None	1.5x	0.5x
	Net IRR Target (Life of Fund)	10-14%	9-12%	11-17%

Fund A: The key distinguishing factor of this fund’s approach relative to the others is its focus on second lien loans. As discussed earlier, second lien loans carry greater potential for credit risk as the underlying assets that are in place to secure the loan must be used to pay first lien holders first in the event of a default. Interestingly, part of this fund’s approach to offsetting some of the higher credit risk, is its focus on larger, more diversified businesses (upper middle market) that are backed by a private equity sponsor. Additionally, the fund does not employ leverage to achieve its results. This fund seeks to maximize the impact of its core competency in underwriting junior credit while generally minimizing other types of risk common in private credit funds.

Fund B: Differentiates itself from the other candidates with its focus on higher quality first lien loans with sponsor backed mid-sized businesses. This part of the private credit market tends to be more conservative in nature, with commensurate lower yields. Further, the fund’s utilization of club deals (deals where the lead investor brings in others to invest in the loan as well) as a key component of their approach lends itself to greater portfolio diversification across borrowers. Because the fund has employed

lower levels of risk at the loan level, the firm applies leverage of 1.5x to achieve a performance result competitive with strategies that focus on higher yielding loans that carry more credit risk.

Fund C: This fund seeks to maximize the use of its credit underwriting capabilities in areas of the market where there is less competition due to the smaller size of the loans and businesses. Smaller companies with less diversified revenue sources can carry more business specific risk than larger enterprises, and also typically have less robust financial reporting. Those two factors cause underwriting in this part of the market to be more labor/credit intensive than in the middle and upper middle markets. The trade-off the firm gains by operating in this space is that less competition leads to loans with higher interest rates, more strict and enforceable covenants, and greater access to warrants as part of the deal. Warrants act similar to stock options in the public markets, offering the investor the right to buy equity at a predetermined price, providing equity-like upside to the fund. In an interesting juxtaposition relative to the other funds, this strategy may invest in parts of the market with greater perceived risk, but also has the strictest, most enforceable covenants relative to peers. Due to the higher risk/return nature of the approach, this fund is comfortable employing leverage, but it is capped at 0.5x. This strategy offers the highest return potential, but also carries highest credit risk of the candidates.

Which Fund is Best?

In short, each fund is the best fit for a different investor. Fund A is a great fit for a client with a moderate risk profile that may already have exposure to a higher quality first lien focused strategy. Fund B is well positioned to benefit a client seeking exposure to the asset class, while minimizing some of the credit risk associated with the lower middle market and more junior credit. Fund C is uniquely positioned to maximize the alpha potential of the asset class given the deeper credit underwriting and less competitive nature of the space where they operate. The higher risk/return potential of Fund C aligns nicely for clients with a more conservative public markets credit portfolio (allowing for a greater credit risk budget in their private market portfolio), or as a satellite manager within a broader private credit portfolio. The beautiful thing about the private credit asset class is that investors truly have the opportunity emphasize which kinds of risk will be utilized in their private credit portfolio while accomplishing similar return outcomes.

While seemingly complex, we hope this paper helps shed light on some of the key attributes, risks and opportunities of direct lending within private credit. DeMarche works with clients every day to help them understand the unique risks and opportunities of asset classes across the private markets. We welcome the opportunity to discuss whether direct lending is an appropriate fit for your investment objectives.

Put Research To Work

with the DeMarche Team



Mark Andes

Senior Consultant

(913) 384-4994



Chad Gloudeman

Senior Analyst,

Investment Manager

Research

(913) 384-4994

Sources Utilized:

- *Guggenheim Investments*
- *Altss*