EXPERT Q&A

An uptick in M&A may not yet have materialised, but the direct lending market remains well positioned for growth, says Michael Occi, a managing director in Morgan Stanley's private credit team

How direct lending is navigating volatility

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Q The direct lending market appears to have grown at a rapid pace. In your assessment, has it run too far?

The direct lending market has grown, but we firmly believe that growth is defensible. At the macro level, direct lending has effectively stepped in to fill the void left by the banks that have generally retreated from mid-market lending post-crisis. At the same time, the public leveraged-finance market has skewed a bit more upmarket, and access to that has become inherently window-driven.

The growth of private credit is further supported by the scaling of the private equity industry, which has more than $4 trillion in assets under management and significant dry powder to invest. The size of US bank balance sheets is now north of $20 trillion, compared with $7 trillion a decade ago, and the growth of US direct lending seems to be in step with that pace of expansion.

Further, we see the growth of direct lending occurring at a similar rate to the growth of private equity and the growth of the S&P 500. It is therefore in step with other asset classes. So, fundamentally, we think the growth we see right now is here to stay. Many factors have driven mid-market borrowers to the private direct lending market, and there are many structural benefits to the direct lending product too, heightened by the way in which refinancing volumes continue to fuel growth.

This is a relatively young asset class, with fundraising levels that keep driving the expansion of dry powder. In our view, the growth has not been outsized, but instead we see plenty more room to run.

Q Why does direct lending remain an attractive area to invest?

The attraction of direct lending is, and always has been, about solid risk-adjusted returns. We are getting good absolute asset yields, historically low loss rates across the industry, and relatively low volatility.

There are a number of factors that drive those outputs, but loan structuring is really at the core. Mid-market loans often avoid the characteristics of larger debt structures and instead maintain financial covenants that allow managers to diagnose and respond to borrower underperformance before a lot of value erodes. In addition, private equity owners typically have a significant amount of equity cushion below us in the capital structure, which provides meaningful protection for direct lenders in the event of underperformance.

What we have found over time is that private equity sponsors will often be a source of incremental support for a business experiencing stress, and that is another reason that sponsor-backed direct lending is so attractive.

Q How has the recent tariff-driven volatility affected dealflow in private credit?

From a dealflow perspective, the volatility has led to a delay in M&A's recovery. We had previously expected that rebound to unfold at the beginning of this year. It is tough for sponsors to underwrite new transactions amid the uncertainty in trade policy, particularly in certain sectors.

We still believe that leveraged buyout activity will pick up, given the pent-up demand to harvest assets that still exists among private equity sponsors, but it now looks like that will happen in the second half of this year rather than in the second quarter.

Nothing has changed with respect to the quantum of dry powder out there and the ageing of some of those sponsor funds, which will be key drivers of activity.

The direct lending market is undoubtedly open for business, while access in the public sub-investment-grade credit market has been more window-driven. We welcome an environment where all financing markets are alive and well because that typically coincides with a healthy deal environment. But during covid-19 and the inflation-led volatility of 2022, while the banks were risk-off, we saw private credit step in to fill the void in the broadly syndicated loan markets.

Q How have terms evolved in the direct lending space?

Competition continues to be fierce in this space, but that has always been the case. Crucially, we are still seeing documentation with the proper protections. Intensive creditor protections have always been a hallmark of buy-and-hold investing in our market, and the sector has performed incredibly well, perhaps in part because of the resilience of the US mid-market economy.

We have seen spreads compress over the past few years, largely in response to an improvement in risk sentiment prior to the tariff discussions recently. Nevertheless, base rates remain elevated, so that continues to offer us an attractive nominal rate of return. We are still generating 150-200 basis points of spread premium relative to the syndicated market, according to 2024 statistics, and we should find that same range once public markets settle.

Q What impact might trade policy have on underlying borrower performance?

The credit impact of trade policies is a little tough to gauge right now, as it is a bit of a moving target. We have to acknowledge that the potential impact, if tariffs prove to be durable and meaningful, could be both secondary and tertiary for the private credit market.

We think the industry will be relatively well insulated, given the geographical and industry orientation of the US mid-market that is the ultimate borrower base. We started 2025 with good momentum and profit growth in the mid-market, and we expect the impact of tariffs to be less acute here than it will be for larger companies that do more trade overseas.

From a sector point of view, we have a bias in our portfolio towards professional services businesses and away from more trade-sensitive verticals such as manufacturing and consumer goods. We think consumer and capital goods are the sectors most likely to be hit, given their reliance on offshore assembly, and we think that a skew away from those segments is characteristic of mid-market direct lending portfolios overall.

From an investing perspective, the plan is to continue to be highly selective. The pricing of risk has certainly changed in the sense that we are going to be a lot more selective around certain sectors that are more obviously in the crosshairs of tariffs and other government reforms.

Generally, though, this is an environment where we see real opportunities. Mid-market borrowers still have financing needs, although those are perhaps not as abundant as they would be if the M&A market were thriving. So, we expect to have another active year.

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Q Focusing again on asset quality, how do you explain the increase in payment-in-kind (PIK) utilisation?

The emergence of payment-in-kind facilities is an industry trend that we have certainly been watching closely. As rates have declined only moderately and we have seen interest rate hedges roll off, there has been a focus on the ability of borrowers to manage their cash interest burden. That focus remains high given how elevated the combination of base rates and spreads continues to be.

In general, borrowers have an increasing appetite for structures that can offer PIK flexibility. From a manager perspective, in the right situation PIK can be an attractive and rate-enhancing solution. However, for us, that will depend on the rationale, the business fundamentals, the quality of earnings and the underlying capital structure. We are happy to embrace PIK but only where the conditions make sense to do that.

Q There has been some scrutiny lately around valuations for private direct lending loans. What's your view on that?

It is important to remember that we are in the business of providing first-lien loans backed by good sponsors and supported by meaningful equity cushions beneath that. The primary goal is the return of principal and, historically, the industry has done a pretty good job of delivering that.

Despite recent press coverage on this topic, regarding a lack of transparency and opaque valuation policies in the direct lending space, we do believe there are a host of policies in place that address these issues. Regulatory, legal and accounting regimes, among others, dictate that managers abide by stringent valuation policies, and these policies are multi-layered. They leverage both internal valuation models and third-party valuation firms to value individual loans.

Our view is that these valuations typically take into account both fundamental company performance and market factors. Their frequency will depend on the structure of the fund in which the loans are held. For instance, some perpetually offered business development companies could be valued as frequently as monthly.

Given that this is a club market, you do see exposure to some deals across managers, and it is not uncommon to see pricing differ from manager to manager. That does not cause alarm for us because managers are making their own assessments and have differentiated information, so we see that as a proxy for fair value.

Q What is the outlook for mid-market direct lending through the rest of 2025?

We acknowledge the uncertainty out there, but we believe the direct lending market is well equipped to respond to the financing needs of the mid-market in this kind of situation. All indications right now are that mid-market fundamentals look good.

And what's more, it is in periods of volatility that managers like us are typically well positioned for by providing opportunities to capitalise on and generate good returns for our investors. ■

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