NON-SPONSORED DIRECT LENDING FUELS Main Street America's Comeback

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Since the end of the Great Financial Crisis in 2008, private credit has grown approximately 10-fold into a household investment strategy (from $230 billion to more than $2 trillion), which is now comparable to the leverage loan ($1.4 trillion) and high yield bond ($1.3 trillion) markets, according to the Federal Reserve. Institutional investors, governments, and sophisticated individuals have piled into the asset class, generating low double-digit net returns while investing in senior secured debt. Investors often believe private credit to be synonymous with private equity-backed LBO financings, but private credit as an asset class has many strategies which are frequently overlooked.

Sponsor finance dominates the headlines with 80-90% of total assets in the space. There are managers, however, offering a private credit strategy focused on millions of main street businesses—the non-sponsored direct lenders. The savviest of investors have caught this wave and are increasing allocations to this much less competitive (and much larger) segment of the market. The non-sponsored channel is different than sponsor finance, which focuses on supplying debt to private equity-owned companies. The direct lending focus provides investors access to the small business economy in the U.S., without middleman, distractions, banks, or private equity funds—just direct access to companies, and their management teams.

Most money raised by private credit has gone to supporting buyouts of companies by private equity funds. According to McKinsey's Global Private Markets Report 2025, 84% of leveraged buyouts were financed with private credit. When a private equity fund buys a business, it does not pay for all of it with equity. Instead, it typically sources approximately 60% of the purchase price with third-party debt (provided by banks or private credit funds) and fills in the remaining 40% with equity provided by its own fund. Private credit funds providing leverage for sponsor LBOs is commonly known as sponsor finance.

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Nearly 80-90% of the money raised in private credit ends up in sponsor finance, but research suggests that only 10-15% of companies in America's lower middle market are owned by private equity funds. This environment has led to a classic market supply-versus-demand imbalance, with so many private credit funds chasing relatively few opportunities. The field has quickly become crowded—and competition grows thick where the most dollars flow.

So, what happens to the other 85-90% of privately held companies looking for capital? Local bank lenders used to step into that space without hesitation, but after the financial crisis, stricter rules limited how much risk banks could take on. Political pressures and concerns about the systemic risk within the U.S. banking industry have pushed bank and regulators (e.g., OCC, the Federal Reserve, FDIC, and CFPB) to indirectly tighten lending standards. Over time, small business owners found fewer doors open when they needed capital.

Non-sponsored direct lending private credit as an asset class has existed for over 20 years—largely hidden from view and missed by most—but the world has started taking notice. Instead of chasing deals tied to private equity buyouts, direct lenders turn to everyday businesses that need cash but whose leaders do not want to give up control of family companies. These firms support American businesses run by families, founders, employees, and leaders who need funding primarily to hire more workers, expand operating capacity, buy a competitor, and/or simply invest in new ideas.

These direct lending fund managers help keep the heartbeat of America's economy steady. Unconstrained by bank approvals, or when businesses are not ready to sell control to a competitor or private equity fund, the direct lenders step in. Direct lenders' primary purpose is to support essential funding exactly where it is required most: to expand, upgrade, improve efficiency, and drive growth, ultimately creating jobs and creating wealth for Middle America.

The Nature of Non-Sponsored Direct Lending

Non-sponsored private debt transactions typically involve companies that are founder-owned, family-owned, employee-owned, or management-owned. These businesses tend to operate in the lower middle market, which is generally defined as having $10 million to $200 million of revenue and $2 million and $20 million of EBITDA. Often, they are raising institutional capital for the first time, having previously been capitalized by internal cash, friends and family, and/or bank loans requiring personal guarantees and hard collateral. These companies are established, with a history in business and profitability Importantly, they are no longer "venture" and subject to start-up risks.

Many lower middle-market businesses typically do not have a relationship with an investment banker and have a difficult time finding a qualified intermediary to bring them to the market. As a result, these opportunities are difficult to identify and can easily be overlooked by lenders accustomed to clean, well-presented data found in a highly intermediated transaction (typically found in private equity-driven processes).

Unlike private equity-backed deals, non-sponsored transactions frequently lack data rooms, audited financial statements, standardized internal reporting systems, or institutional-grade processes. The lender must have the skills to identify the critical path diligence items and work with the company to obtain the necessary data for the underwrite. While the data may not come to the lender in a neat, well-structured package, direct lenders have a skill set unique to the lending industry that allows them to extract the required data. These abilities increase the barriers to be a true direct lending credit manager.

What these transactions lack in structure is often made up for in alignment between the owners and the direct lender. They are resilient businesses with long customer relationships, conservative balance sheets, and deeply committed management teams and owners. The challenge (and the opportunity) lies in finding them, underwriting them, and, most importantly, developing a meaningful trusting relationship.

Why Diligence Matters

Just because lenders perform commonly named functions like origination, diligence, and investment monitoring, it does not mean sponsor finance and direct lending are comparable or interchangeable. In sponsor finance, the core of underwriting/diligence is effectively performed by the private equity fund, which conducts extensive pre-investment analysis, engages third-party advisors, and identifies the core investment thesis and risks. Sponsor finance lenders rely on this work and believe the equity cushion

provided by the sponsor will act as a safety net for them (i.e., if the sponsor is investing equity below the lender, it must be a good investment for the lender). This logic fails to account for the fundamental difference in the absolute level of risk and return each party is willing to accept. As a result, lenders focus more on underwriting the sponsor and the sponsor's capabilities, rather than the company, its market position, and resulting risk profile. A lender needs to get its money back 100% of the time (lower risk; hitting singles and doubles), while the equity investor is optimizing for two-to-four-times cash-on-cash return (higher risk; hitting triples and home runs). Both strategies are valid, but when the diligence tells a story that's good for one party, it might not be for the other.

In non-sponsored direct lending, sponsor equity does not support the debt, with no assumption that a deep-pocketed owner will step in to support the business if conditions deteriorate. This reality fundamentally changes the lender's role.

If the direct lender runs a private equity-style diligence process, much of that gap can be filled. Rather than relying on surface-level credit metrics, lenders must develop a deep, bottom-up understanding of how the business truly operates. This includes analyzing customer concentration, revenue durability, revenue models, billing and collection capabilities, margin structure, vendor and customer relationships, fixed versus variable costs, capital expenditure requirements, and working capital dynamics, among many other critical work streams. In addition, substantial and meaningful third-party work must be completed that might include a quality of earnings, market studies, engagement of qualified industry executives as operating partners, background checks, and industry specific diligence items as required (e.g., environmental studies and coding and billing audits). Candidly, this cannot be check-the-box diligence—real care must be taken, the right experts must be found for each deal, and relationship intelligence is a requirement. This level of insight allows lenders to size leverage, design covenants that reflect real operating risks, and ensure that adequate equity remains beneath the debt.

It also means fully understanding the people in the business. This is the "soft" side of the underwrite that requires a lender to have substantial emotional intelligence. This means spending time with the executives and second-level managers to understand who the lenders' "partner" will be and how they might behave should the road get bumpy. Companies are only as good as the people who run them—period. The lender's ability to evaluate people is paramount to making solid foundational investments.

This level of diligence is not typical in traditional private credit, sponsor finance, or when the borrower is a larger company (i.e., more than $50 million of EBITDA), but it is essential in lower middle-market non-sponsored direct lending. By doing the work traditionally associated with equity investing, debt investors can more accurately assess downside risk and structure loans accordingly.

Building Stronger Alignment with Management

Direct lending often involves backing founders or management teams who have spent decades building their businesses. These owners are deeply invested, emotionally and financially, in the long-term success of the company. An in-depth diligence process fosters closer collaboration between lender and management, as both sides work together to surface data, analyze trends, and evaluate strategic options. This is an opportunity for both parties to establish credibility and trust before any money moves.

This process builds trust early in the relationship. Rather than being viewed as a passive capital provider, the lender becomes a thought partner, one who understands the business in detail, is invested because of its potential, and wants to be part of that coming success. Over time, this can lead to repeat transactions with the same families, incremental investments into existing portfolio companies, and long-standing partnerships with management teams.

From an investor's perspective, these relationships can be highly valuable. Familiarity with a management team and its operating philosophy reduces uncertainty and allows capital to be deployed efficiently.

Keeping Owners in Charge & Boosting Returns for Lenders

Small businesses don't sell very often—many families are defined in their communities by the business they own, the people they employ, and the products they produce. Because direct lenders are not bound by a playbook, they can tailor their debt to match the specific need of the business, something not typically available to them if dealing with a bank lender.

Some of the options may include minimally dilutive growth capital that allows founders to retain control, hybrid structures combining debt with minority equity participation, or covenant packages aligned with the way their business is run, rather than a standardized covenant template.

For many founders, this flexibility is highly attractive, and they are willing to pay for it. Instead of selling majority control to a private equity firm, they can partner with a direct lender who provides growth capital, strategic support, and operational resources, while allowing management to retain control and most of the upside.

For lenders, these structures can enhance returns without materially increasing risk, particularly when supported by rigorous diligence and conservative leverage.

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Skipping LBO Unlocks Pricing Power, Enhanced Structures & Returns

Direct lending is materially less competitive than sponsor finance. The work required to source, diligence, and execute these deals acts as a natural barrier to entry, and many lenders simply lack the resources or inclination to engage at this level.

As a result, investors willing to lean into this market can benefit from improved structuring, pricing power, stronger documentation, and more favorable risk-reward dynamics as compared to sponsor finance. Returns are often higher, not because the assets are riskier, but because fewer participants are able to find them and/or equipped to underwrite them. In fact, in direct lending deals, leverage levels are almost always lower when compared to their sponsor finance brethren. Direct lenders focus heavily on structure in their transactions—leverage rarely exceeds three to four times, loan to value infrequently reaches above 50%, EBITDA definitions minimize addbacks, and covenants are set off of a model that the lender builds, with cushions that allow the company to perform while giving the lender a voice if trouble presents itself.

This inefficiency is particularly visible in periods of market froth, when sponsor-backed transactions can become crowded, aggressively priced, and poorly structured. Non-sponsored deals, by contrast, tend to remain relationship driven and valuation disciplined, often generating 150-200 basis points more return than a sponsor finance transaction.

The Importance of Selectivity

The non-sponsored universe is not uniformly attractive—in fact, it requires extreme selectivity. A high percentage of opportunities fail to meet institutional standards once subjected to rigorous diligence. This is not a flaw in the approach; it is a feature. The typical number of investment opportunities that meet the standard and get funded is between 1-2% of all deals sourced. An in-depth diligence process naturally results in a low conversion rate from deals reviewed to deals executed. Lenders must be willing to examine hundreds of opportunities to identify a small subset that meets stringent criteria for business quality, management capability, and downside protection.

The funnel is tight and only the best opportunities are funded, the rest are discarded.

Over time, this selectivity translates into a more resilient portfolio, particularly during periods of economic stress. All fund managers say they are selective and carry out rigorous due diligence, but, in reality, this is something no fund manager or investor has seen tested over the past 14 years. The shakeout will happen, and everyone will eventually know that the emperor has no clothes.

A Differentiated Role in Capital Markets

For institutional and individual investors, non-sponsored direct lending underwritten with private equity rigor occupies a differentiated role within a broader portfolio. It offers exposure to established American businesses, attractive current income, and structural protections, while avoiding some of the herd behavior that can characterize more intermediated markets.

Importantly, this strategy is not about replacing sponsor finance or private equity. Rather, it complements them. Sponsor deals offer scale, efficiency, and predictability. Direct lending deals offer depth, alignment, structure, diversity, and opportunity for differentiated returns.