

BARINGS

# 2026 DIRECT LENDING: EVOLUTION, OPPORTUNITY & DISCIPLINE DIVIDE

CONVERSATIONS

Direct lending isn't fading—it's evolving. In this Q&A, Orla Walsh shares her insights on growth, competition, and what disciplined managers need to know as the market matures.



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## Is direct lending losing its luster amid rapid growth and heightened competition?

In our view, no—but the dynamics are shifting. The global direct lending market has grown at an extraordinary pace, attracting record capital and a broader borrower base across North America, Europe, and Asia Pacific. This surge has created new avenues for deployment and unlocked opportunities, but it has also introduced complexity and fueled concerns about whether vulnerabilities are emerging. Heightened competition has led some lenders to stretch on leverage, accept tighter pricing, or relax documentation standards in pursuit of deals—and as the lines between public and private markets blur, headlines have begun to question whether the “golden era” of direct lending is coming to an end.

Yet, sustainable performance in private credit isn’t about chasing momentum; it is about maintaining discipline. The most resilient managers are those who remain anchored to their core strengths and underwriting standards, even as transaction sizes and market pressures increase. To that end, not all direct lending is created equal. The traditional middle market continues to offer compelling risk-adjusted returns, especially in the more conservative parts of the capital structure—namely, first lien senior debt supported by robust documentation and structuring. Despite tighter spreads overall, origination yields have held steady, at roughly 9% for the last 12 months through June.<sup>1</sup> The market also continues to offer a premium over the broadly syndicated market, to the tune of 100–150 bps in North America and 200–250 bps in Europe.<sup>2</sup> This suggests private equity sponsors remain willing to pay a premium in exchange for resilience, reliability and certainty of execution.

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It’s also worth noting that while muted M&A activity has slowed deal flow for some, established lenders with scale, incumbency, and permanent capital bases remain well-positioned to source differentiated opportunities through off-market origination and add-on transactions. In short, direct lending isn’t losing its luster—it’s maturing. The opportunity remains compelling for managers who stay disciplined, focus on the right segments, and leverage scale and relationships to navigate a more competitive landscape.

1. Source: Barings. As of June 2025.

2. Sources: Barings; Credit Suisse. As of June 2025.

## Headlines around defaults and fraud have raised questions about credit quality. Should investors be concerned?

Concerns are understandable, but context matters. Recent headlines have cast a spotlight on vulnerabilities across credit markets broadly, and private credit specifically. While the major defaults making news have been more about fraud than credit stress—and are outside the scope of core middle market direct lending—they have nonetheless prompted questions about risk. This also comes against a backdrop of macroeconomic divergence: AI-driven investment is supporting certain sectors, while labor markets and consumer sentiment show signs of strain. Policy volatility, particularly around central bank rates, adds another layer of complexity.

In this environment, a modest increase in defaults may be plausible, especially in more cyclical segments or where underwriting standards have slipped. To the positive, managers are responding by prioritizing proactive monitoring and swift remediation when early signs of stress emerge—also using contractual levers designed to protect capital and engage with borrowers. In this context, the “red pen” is not a sign of weakness, but of prudent stewardship.

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Importantly, we’re starting to see a healthy re-examination of diligence and documentation standards across the industry. There is a renewed focus on tighter covenants, stricter limits on incremental debt, and enhanced reporting requirements. Investors are asking tougher questions, and managers are responding by codifying risk controls in legal terms, not just intentions. While this shift is partly a reaction to recent events, it is more broadly a recognition that robust documentation and transparency are essential to navigating a more complex and competitive environment. In practice, this means that even in competitive deal environments, the ability and willingness to walk away from transactions that do not meet certain standards is essential.

## Related to risks, what role does PIK play in today’s market?

Headlines around payment-in-kind (PIK) features have drawn attention, but structurally, this is not something we see a significant amount of in our portfolios. From a strategy perspective, our focus remains on performing senior secured, cash-pay loans. In Europe, most underlying borrowers have the contractual ability to opt for PIK if needed, with certain pre-baked mechanisms in place, but actual uptake has been limited—largely because minimum cash-pay requirements, typically around 4%, are standard.

While PIK could continue to be a feature in the broader market over the next several years, it is not a core component of our approach or of the core middle market, nor do we expect it to become one.

## How are regional dynamics shaping the market, and how do you think about the opportunities across North America, Europe and Asia Pacific?

Regional differences are certainly shaping the opportunity set, making a global approach increasingly relevant. Beneath the headlines, differences in market maturity, competitive pressures, and macroeconomic influences across geographies are influencing performance as well as portfolio construction strategies. North America remains the largest and most mature market, anchored by scale and depth of opportunity. Yet, macro shocks—such as tariff impacts—have introduced new complexities for borrowers, while downward pressure on fees and margins has intensified, making vigilant underwriting and selective deal execution critical.

Europe, meanwhile, is in the midst of a structural transition. Non-bank lending continues to gain share, and risk-adjusted returns remain attractive. Pricing dynamics have been more moderate, allowing for a measured approach to portfolio construction. The region's trajectory is also notable: while it lags North America in maturity, it has made significant progress, with more markets coming online and providing diversification potential. Developed Asia Pacific presents a different profile. While not a high-volume market, it offers select opportunities that can enhance portfolio diversification for those able to navigate local nuances and maintain underwriting discipline. However, success in APAC requires a thorough understanding of local market dynamics, legal systems, and competitive structures, underscoring the importance of specialized teams and local expertise.

Given these differences, the ability to tilt exposures toward regions where risk-adjusted returns are most compelling has become a hallmark of sophisticated portfolio construction.

## What is one key takeaway for investors as we head into 2026?

Direct lending is not standing still—it's adapting to new realities. Headlines will continue to amplify noise, but the real story is one of evolution: a market that rewards discipline, thoughtful risk management, and a willingness to recalibrate as conditions shift. For investors, success will hinge on partnering with managers who are able to focus on fundamentals while staying alert to structural changes and regional nuances. In a maturing asset class, clarity and conviction will matter more than ever.

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