

E X P E R T Q & A

Grier Eliasek of Prospect Capital says a bifurcation in direct lending approaches has led to a proliferation in mid-market opportunities in the US, benefiting firms with the right resources



Finding untapped opportunities in the lower mid-market

Q Now that we're more than halfway through 2026, what have been some of your biggest reflections on how the private credit market has fared this year?

It's clear to us that the story on the ground does not match many of the more negative headlines we've been seeing about the private credit market in the past year. It's been almost 20 years since the last significant recession, and conditions today are nowhere near those in 2007 at the onset of the global financial crisis.

The key question today is what is real stress in direct lending versus what is clickbait. Managers like Prospect,

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which have lent through multiple prior cycles, understand that difference better than newer allocators.

One issue that has rapidly risen up the agenda this year is the impact of artificial intelligence on software loans. When a large sponsor hands over a huge software company to its private credit lenders, that gets people's attention. Many of our peers have between 25-50 percent of software exposure across their portfolio, compared with only 3 percent of the Prospect portfolio. Software will remain a key sector to

watch regarding which companies can refinance and which cannot.

Outside of software, borrowers are still facing headwinds from operating cost and interest cost inflation, but that dynamic is simply the continuation of a multi-year trend. Companies have dealt with elevated short-term rates for more than three years and remaining issues are largely related to legacy credits that were underwritten in a very different rate environment. We monitor our borrowers closely, and on average, they have over 200 percent interest coverage, which we consider to be robust.

Redemptions at perpetual, non-traded BDCs are considerably reducing lending capacity across the BDC

market because less equity means there is less capital available to lend. Our flagship fund is a listed BDC, so redemptions aren't relevant to us, but it's still interesting to look at what else is happening in the market.

We believe that 'avoid direct lending' is the wrong message to be sending to investors – while large-cap returns have been declining, mid-market returns remain stable and, in our view, quite attractive on a risk-adjusted basis.

Q With that in mind, to what extent is this the right time to be building in downside protection when the economic cycle turns?

In credit, you're always supposed to be building downside protection into your investments. A credit strategy should never be a reaction to the current market environment and that's been our philosophy across four decades and multiple cycles. In the mid-market, where we focus, we can still be disciplined about credit documents, providing the downside protections our large-cap peers are rarely able to obtain today.

Credit is a glass-half-empty type of business. If everything goes well, the most you get back from an investment is your contractual interest rate and

your initial capital. That asymmetry is why initial credit metrics and documentation matter just as much as pricing.

At Prospect, we underwrite a near-term recession as the base case for all financial projections, not just as a downside case, and we benchmark those assumptions against what happened to the company and/or industry in the global financial crisis or a previous market decline. We look at the peak-to-trough revenue decline for every business because 'trouble' for a company generally relates to revenue rather than costs.

We then compare that projection with our calculations around the level at which revenue decline would break through the 100 percent fixed-charge coverage amount. We require conservative leverage ratios and strong fixed-charge coverage ratios on all of our investments, measured on what we call our 'true north profitability' matrix, by which I mean that we limit the allowance for add-backs, which we feel have got out of hand in the market. We also insist on high SOFR floors and quarterly tested maintenance covenants, so that we can get back to the negotiating table early if a borrower runs into trouble.

Q With that in mind, how do you instill discipline into your investment process, especially on a day-to-day basis?

One factor that significantly helps our approach to discipline is that we are significant investors ourselves. We have almost \$1 billion of capital invested alongside our investor capital, which tends to keep one focused. Culture is also critical, and we've been honing ours for nearly 40 years, with an emphasis on excellence, continuous improvement and discipline.

The initial investment decision is critical in direct lending, where loans are illiquid. Our goal is to originate as many opportunities as possible, so we

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can be highly selective: Prospect often originates more than 3,000 direct lending opportunities per annum and our book-to-look ratio is typically under 0.5 percent.

The deals that advance go through a two-tier approval process: a sub-committee review runs alongside the first two or more months of diligence, and only once the sub-committee approves does a loan reach the full investment committee. Most of the debate happens through written questions and answers, which we find far more detailed and accurate than a conference room discussion.

The same individuals who champion a loan remain responsible for it throughout the investment life cycle until repayment. If you have to clean up your own mess, you are less likely to make one in the first place. Many credit firms separate origination from underwriting and portfolio management, and maybe that works in more cookie-cutter asset-based lending-type transactions, but it doesn't work in

"The best opportunities exist around direct lending to mid-market companies with \$50 million or less of EBITDA"



Q To what extent is capital crowding starting to impact the opportunities you see?

The headline number is that more than \$2 trillion has been raised across this credit cycle. But the bulk of that capital is concentrated on large-cap direct lending, where it is faster and easier to deploy in a more commoditised fashion.

At Prospect, by comparison, we see far more opportunities in the lower and core segments of the US mid-market. Only an estimated 10,000 of the 230,000 private companies in the US mid-market have more than \$50 million of EBITDA, which is the segment that larger lenders are chasing. This leaves the remaining 220,000 companies to us as a much more fertile hunting ground.

It's like kids' soccer, where everyone is crowding around the ball at the larger end of the market, where private equity owns so many companies and sponsors snap their fingers to produce term sheets from multiple competing lenders. Things are less efficient at the smaller end of the market, but that is where one can obtain the risk protections and enhanced returns I've talked about. The erosion of lender protections in club and syndicated large-cap lending is another reason why Prospect focuses on deals where we are the sole or majority lender.

cashflow lending, where critical judgment is required.

Q To what extent are we seeing a bifurcation of direct lending? And what is driving this?

We've been seeing a bifurcation in this market for 10 years, so this is not a new trend. Direct lending and mid-market lending were previously largely one and the same, with larger companies going to the broadly syndicated loan market.

Over the past decade, the big asset aggregators have raised billions of

dollars to extend direct lending to large-cap companies. Those large-cap direct lenders did very well during the pandemic, when their main competition – namely the broadly syndicated loans marketed by Wall Street banks – was dormant, but the situation has since evolved, with the BSL market winning the greatest proportion of LBO financing volume in the first half of 2026.

Heightened competition for deals has tightened spreads, increased leverage and weakened documentation at the large-cap end of the market, and returns are declining in that segment as

a result. Prospect, on the other hand, loans to borrowers with less than \$50 million of EBITDA in processes that contain lower leverage, higher spreads, higher floors and stronger documentation and downside protection, including financial maintenance covenants.

Q Looking ahead, where are you seeing the biggest investment opportunities and challenges?

We think the best opportunities exist around direct lending to mid-market companies with \$50 million or less of EBITDA, where there is less lender capital available. That means lower leverage, higher coverage and better documentation on the risk side, coupled with higher credit spreads and higher SOFR floors on the reward side.

We are also focusing more on smaller funded sponsors – those with fund sizes of \$500 million or less – as well as independent sponsors and direct company financings. Independent sponsors often need some equity too, which suits us – we like to co-invest to enhance returns and align interests.

In terms of potential threats, artificial intelligence is the biggest one. For any new borrower – or indeed for our existing portfolio companies – we now have to consider how AI might disrupt that company or its industry over the next five or more years because we are making multi-year senior secured loans.

AI does, however, also offer opportunities for our borrowers to be more efficient. One of the financial services-focused companies in our book has used AI to optimise its digital marketing expenditure to greater effect. We have multiple AI engineers and operating consultants on staff, who work with our internal teams and our portfolio companies, both protecting them from AI threats and helping them to capitalise on AI opportunities. ■

Grier Eliasek is the president of Prospect Capital