CRESTLINE MANAGEMENT

Private Credit in 2026: Why the Lower Middle Market Makes Sense

Private credit has faced sustained scrutiny in 2026. Headlines around AI disruption, deteriorating credit quality, and concentrated exposure in technology-heavy portfolios have led some investors to pause new allocations. At the same time, a common perception persists that lending to smaller borrowers in the lower middle market carries inherently greater risk than lending at scale. We believe the data challenges both of these assumptions. What follows is a summary of the structural case for direct lending, and why the core and lower middle market is a particularly compelling segment of the opportunity set today.

The Return Premium

Direct lending has historically delivered consistent, income-driven returns that have outpaced public credit markets across multiple time horizons. Using the Cliffwater Direct Lending Index (CDLI), an asset-weighted index covering middle market loan holdings, here's how the asset class compares:

Historical Returns	Last 5 Yrs	Last 10 Yrs	Last 21 Yrs
Direct Lending (CDLI)	10.3%	9.4%	9.5%
Bloomberg High Yield	4.5%	6.5%	6.6%
Leveraged Loans	6.4%	5.8%	5.1%

Source: Cliffwater 2026 Q1 Report on U.S. Direct Lending, Exhibit 15. Returns through March 31, 2026. CDLI returns are unlevered and gross of fees. Actual investor returns in direct lending funds will be reduced by management fees, incentive fees, and fund expenses.

What explains this premium — and why it has persisted — is the role of contractual income. The CDLI has generated average annual income of 10.8% since inception (September 2004), creating a durable return floor that we believe public credit simply doesn't offer.[1] In our view, that income also makes outcomes far more predictable: in 48.0% of calendar years since 2005, total returns were within two percentage points of the long-term average.[2]

Credit losses, which tend to dominate headlines, have historically been modest and well-absorbed by that income. Realized losses have averaged -1.0% per year — in line with leveraged loans and below the -1.5% loss rate for high yield bonds.[1] Even in 2008, the CDLI's worst year, the drawdown was -6.5% versus -26.0% for high yield and -29.0% for leveraged loans.[1] The asset class has delivered positive calendar year returns in 20 of the past 21 years.[1]

Why the Lower Middle Market ("LMM") and Why Now

Within direct lending, a common assumption is that lending to smaller borrowers means taking more risk. We believe the opposite is true today — and that the lower and core middle market offers a compelling risk-adjusted opportunity driven by a structural imbalance between where capital is flowing and where the best terms are available.

The 20 largest private credit managers raised 68% of capital in 2025. That capital needs to be deployed, and as a result, roughly 76% of reported senior secured deals have targeted companies with $50-100mm in EBITDA — just 22% of the total opportunity set. The remaining 78% of addressable companies, those with $5-$50mm in EBITDA, remain significantly less competitive.[3]

That imbalance has loosened structures and documentation at the top of the market, contributing to lower recovery rates among larger borrowers. At the same time, unitranche spreads have compressed and converged across all EBITDA brackets, largely eliminating the pricing discount that larger borrowers historically enjoyed. Yet lower middle market borrowers are levered at roughly 4.0x compared to 6.5x for large-cap borrowers.[4] **In other words, lenders in the LMM are capturing comparable economics at meaningfully lower leverage, which translates directly into more equity cushion beneath the loan.**

Importantly, that pricing advantage does not appear to come at the cost of higher risk. Heading into 2H 2026, lower middle market borrowers are outperforming their larger peers across key credit metrics:[5]

	LMM	Non-LMM
Non-Accrual Rate	1.7%	2.4%
Default Forecast	2.3%	2.5%
Spread Change (Q1 to Q2)	Flat	+25bps

Source: KBRA DLD Direct Lending Index (default and non-accrual rates; LMM defined as EBITDA <$20mm). Spread data from Lincoln International Q2 2026 Valuation Preview Deck (LMM reflects companies with EBITDA <$40mm)

With larger restructurings expected to surface during 2Q BDC reporting season, this performance gap is likely to widen. Much of that pressure, and much of what is driving the negative headlines around private credit in 2026, traces to software and technology exposure, which is disproportionately concentrated in upper middle market portfolios. Software accounts for roughly 43.0% of historical jumbo (private loans totaling $1bn or more) private credit volume, and the 2028 software maturity wall has barely moved, shrinking only 5.0% this year versus 42.0% for the rest of the market.[4] For investors allocating to the upper middle market today, **these dynamics represent a concentrated and largely unresolved headwind, one that lower middle market portfolios, by virtue of their size and sector diversification, are naturally less exposed to**.

When defaults do occur, recovery rates reinforce the structural advantage. S&P CreditPro data from 1987–2025 shows lower middle market loans recovering 84 cents on the dollar versus 68 cents for large-cap loans – **a function of tighter documentation, financial maintenance covenants, and fewer lenders per transaction**.[6]

None of this is to say the lower middle market is without risk – borrowers are smaller, diligence is more intensive, and individual name selection matters more. But on a structural basis, **the data suggests that the risk-adjusted profile of the LMM is more favorable today than conventional wisdom assumes, and we believe the current environment reinforces the value of a disciplined, lower middle market approach**.

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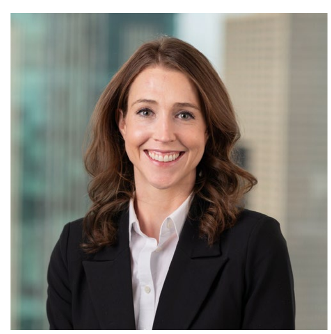

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Footnotes

[1] Cliffwater 2026 Q1 Report on U.S. Direct Lending. CDLI income return, realized credit loss rates (Exhibit 8), and calendar year return comparisons (Exhibit 15)

[2] Cliffwater Research, "The Arithmetic of Direct Lending," April 23, 2026. Return consistency analysis

[3] Preqin Global Report: Private Credit in 2026; PitchBook database as of 6/8/2026. Capital concentration and opportunity set data

[4] Kirkland & Ellis, Private Credit Market Update, July 2026 (Lincoln International Q2 2026 data). Unitranche spread convergence, software sector exposure, and maturity wall data

[5] Lincoln Q2 2026 Valuation Preview Deck; KBRA DLD Default Weekly 7/17/26. Non-accrual rates, default forecasts, and spread dynamics

[6] S&P CreditPro (1987–2025). Recovery rate data by loan size

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