

E X P E R T Q & A

*There is a growing cohort of companies that don't fit neatly within the direct lending or asset-based finance markets. Capital solutions can offer an alternative path, says Barings' Michael Searles*



## How capital solutions looks beyond traditional lending parameters

### **Q** How have private markets evolved to create a need for capital solutions?

Over time, the direct lending market has become more closely aligned with the syndicated loan and high-yield bond markets, with borrowers increasingly expected to meet a defined set of financial characteristics. Many asset managers operating in the space are focused on scale, which naturally guides them toward opportunities that fit within these established metrics and underwriting frameworks – an approach that is relatively straightforward for LPs to evaluate.

At the same time, a large universe of companies and situations sit just outside

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these parameters. Capital solutions can be well suited for these businesses. In such situations, lenders can spend more time understanding the counterparty and developing a customised solution that aligns with the company's needs – be it cashflow flexibility or incremental capital to support growth initiatives. These scenarios often require a more bespoke approach than is typically feasible in the traditional direct lending or high-yield markets.

Increasingly, companies are recognising that the lowest cost of capital is

not always the optimal choice. Many are willing to pay a modest premium for a bespoke structure that better supports long-term value creation.

### **Q** Do you view this as different from opportunistic lending?

Opportunistic lending often carries an association with stressed financing. By contrast, our focus is on fundamentally sound companies that simply fall outside traditional definitions.

The level of due diligence required in capital solutions – both quantitative and qualitative – is more akin to the private equity underwriting process than what is common in the broadly

syndicated loan or traditional direct lending markets.

### **Q How do the sourcing channels differ from the traditional direct lending ecosystem?**

Direct lending has long benefited from a highly efficient sponsor channel. The model is designed to deploy capital prudently, preserve downside protection and meet target returns within a repeatable underwriting framework.

Capital solutions, however, opens the door to a wider set of counterparties beyond private equity, including traditional banks, specialised investment bankers, lawyers and investment managers other than traditional sponsor channels.

Take, for example, family offices. These groups tend to have more flexibility, with longer-term investment horizons and fewer LP-driven constraints, resulting in more unique deal opportunities. Their distinct objectives make them a natural fit for more tailored, structured financing approaches.

### **Q How does structuring provide a competitive advantage in capital solutions?**

Structuring should ultimately reinforce the credit work, not compensate for gaps in it. The goal is to design terms that address the specific needs identified during diligence, rather than rely on structure as a substitute for thoughtful underwriting.

Covenants and strong protections remain essential, as always. We negotiate protections in the credit agreement to mitigate credit risks we identify in diligence. In certain situations, features like payment-in-kind (PIK) can be valuable if a company needs to divert cashflow to drive growth. Ultimately, the process begins with an open conversation between the manager and the business to determine what the company needs and what the manager requires to protect their risk. Every situation is different.

### **Q How significant a role is asset-based finance (ABF) playing in capital solutions today?**

Borrower demand is certainly strong. Speciality ABF represents a substantial share of our current pipeline, and it's a space that we believe offers attractive risk-adjusted return potential relative to corporate credit. Part of this is due to the broader market environment, where many traditional direct lending managers are having to move up the risk spectrum in search of excess spread.

At the same time, the traditional ABS market is evolving into a more conforming market, similar to the evolution seen in direct lending. Issuers are often expected to meet rating agency standards and achieve certain thresholds of size and scale to participate. But many companies have attractive asset profiles outside those parameters.

As a result, they often turn to other forms of financing – whether that's direct lending or the broadly syndicated loan market – leading to a higher blended cost of capital simply because their profiles don't align neatly within existing frameworks.

In many cases, this is less about company quality and more about operating in sectors that are too small or niche for ratings agencies to fully cover. Agencies are, ultimately, businesses, and some industries lack the scale to justify the dedicated resources and monitoring methodologies.

Against this backdrop, we see a meaningful opportunity to generate attractive returns by providing multi-tranche financing solutions tailored to these companies – taking senior and junior positions at different pricing points within the asset value. It's a segment of the market that is developing quickly, and one that we believe offers a compelling opportunity today.

### **Q How can you avoid the ABF pitfalls that have been laid bare in some of the**

### **recent headline-grabbing failures?**

We believe many of the high-profile issues have stemmed from situations where lenders prioritised deploying capital over conducting the depth of diligence required. In certain cases, these lenders became repeat buyers of assets without undertaking the level of due diligence that helps manage downside risk.

To that end, it's critical to ensure that the numbers align and that information from management teams is accurate and appropriate. We experienced one situation where, after reaching the exclusivity stage and reviewing the quality of earnings reports, the numbers did not consistently match the audited results. When follow-up questions did not yield sufficient answers, we chose to step away from the transaction.

Ultimately, it all comes down to the breadth of a lender's sourcing funnel, and whether the lender has the discipline to maintain strong underwriting standards – regardless of market pressure to put capital to work. In the instances when processes have failed, it is often clear that key diligence steps – as well as the legal work needed to ensure collateral is fully secured – were not executed to the level required.

When the right questions are asked, and when a lender is comfortable declining opportunities that don't meet its criteria, the ABF space can offer a well-understood and attractive area in which to operate. Capital solutions strategies are designed to meet companies where they are, particularly those that fall just outside traditional lending frameworks but remain fundamentally strong. By pairing rigorous diligence with flexible structuring, the strategy can support growth while managing risk in a thoughtful, customised way.

As private markets continue to evolve, we believe capital solutions will play an increasingly important role in filling the gaps left by more traditional forms of financing. ■