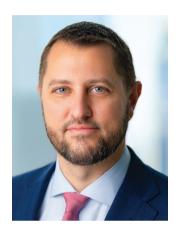
EXPERT Q & A

Bryan High, head of Barings' Global Private Finance Group, reveals where he sees direct lending heading in the rest of 2024



All to play for in 2024

Direct lending has continued to grow in prominence as an asset class. Attractive returns and durability have helped it gain allocations over other alternatives, but what does the rest of 2024 hold? We spoke with Bryan High, head of global private finance at Barings, which has been investing in the direct lending market for over 30 years and supports more than \$300 billion of credit investments globally.

How is the direct lending asset class positioned headed into the second half of the year?

Direct lending continues to offer the potential for compelling risk-adjusted returns versus other asset classes. Deconstructing the basic return components, base rates have remained elevated longer than many were anticipating, and even as central bankers look to begin easing cycles in developed markets,

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we expect the higher-for-longer rate environment to persist through 2024 and into 2025. When combined with consistent underwriting spreads that seasoned platforms can achieve for senior secured debt, we believe the all-in-yield profile for direct lending remains attractive. More generally, we expect this year's strong performance to continue and note that direct lending returns have proven durable historically, exhibiting consistency and low volatility over long periods of time.

Continuing the trends we've seen in recent years, direct lending has taken share from the public markets in a number of ways. From an investor standpoint, we attribute the movement into private markets to the yield premium on offer, largely a result of the illiquidity of the asset class. Historically, private mid-market loans have offered a premium of roughly 200-400 basis points over broadly syndicated loans – and importantly, lower default rates and higher recoveries.

And from a sponsor perspective, while the broadly syndicated market has reopened this year for some companies and certain transactions, we see direct lending continuing to provide value as a tailored financing solution insulated from the potential noise and volatility in public markets.

Today, direct lending has become somewhat mainstream within private credit, representing roughly half of the \$1.7 trillion market. But while the stable, income-producing nature of the asset class has led to increased adoption across a well-diversified global investor base, our observations suggest there is opportunity to grow allocations further.

For example, a majority of investors still report being underallocated to the asset class, especially relative to the largest allocators. Overall, we believe there is more capital that will move into the space – and while there's been a lot of focus on the growth in the market over the last few years, it's important to point out that aggregate direct lending dry powder today is a fraction of the anticipated financing needs for private equity activity in the vears to come.

What are some of the dynamics shaping the direct lending market today?

Sponsor-financed M&A activity has traditionally been a significant driver of dealflow in the direct lending market. However, over the last 18-24 months - coinciding with some of the most aggressive global central bank policy tightening in decades - leveraged buyout (LBO) activity has slowed substantially.

What this means is that at the same time we've seen a proliferation of allocations to the asset class, there has been a slowdown in terms of dealflow for new platforms - and this supply/ demand imbalance has created an interesting dynamic in the marketplace. Specifically, as dealflow and M&A activity have slowed, certain market participants have had to re-think their approach to deploying capital.

For some managers, this has meant style drift - moving up-market from the traditional or "true" mid-market lending strategy, opting to ramp larger portfolios quickly by making bigger investments in larger companies with \$100-plus million of EBITDA. As a result, we've seen several multi-billion dollar transactions in the direct lending space, a rare occurrence just a few years ago. But bigger isn't always better, and transacting in the upper end of the mid-market has implications, particularly from a return and protection standpoint.

For example, spreads on some of

these larger transactions have narrowed more materially than has been the case in the traditional mid-market. In some cases, they have come closer to those in the liquid broadly syndicated markets - suggesting an erosion of the premium that has historically stemmed from the illiquid nature of direct lending. Likewise, it should be noted that underwriting standards can differ at the upper end of the market, with fewer covenants, potentially weaker documentation and higher leverage, all of which can have negative return implications for investors in the event of a default.

Going forward, a slight tightening of spreads could catalyse some activity by private equity firms as their cost of debt financing comes down. Anecdotally, we've seen more platform opportunities arise in our pipeline whether they come to fruition remains to be seen - but we're encouraged by increasing activity levels. To some extent, this is also a function of the fact that distributions from private equity portfolios are at their lowest level in roughly 15 years, and managers are increasingly facing pressure from their LPs to realise assets and return capital.

Another contributing factor is the upcoming US presidential election. Election cycles often lead to uncertainty, driving market participants to transact ahead of any policy changes and seek to avoid execution risk and potential volatility that can exist in public markets.

What are the benefits of the mid-market?

As previously mentioned, there are a number of benefits to remaining disciplined and focusing on executing deals in the traditional mid-market, where company EBITDA tends to range from \$15 million-\$75 million. The more conservative parts of the capital structure, namely first-lien senior debt, continue to offer the potential for strong risk-adjusted returns. These deals tend to have lower leverage profiles, better documentation and more stringent financial covenants relative to the larger end of the market. For us, these are critical components of the direct lending market and key tenets of our investment philosophy - we've applied disciplined underwriting and portfolio construction to build diverse portfolios of mid-market companies designed to weather different environments.

How do direct lending managers differentiate themselves?

In direct lending, capital preservation and seeking to avoid losses are critical. If you think about the nature of a loan, you have a contractual rate of return and a bit of appreciation from a discount or fee on the front end. And that's it - there's not a lot of upside to that. It's really about protecting yourself from the downside and making sure you limit losses to the best of your ability. This comes down to a few key areas: credit selection, experience, scale and a long-standing presence are key differentiators. A deeply resourced team is also critical.

Importantly, these characteristics can allow managers to stay active and continue deploying capital to attractively priced opportunities, even as deal volume fluctuates. In environments like we're in today, where dealflow is somewhat muted relative to recent years, the most attractive opportunities from a risk/return perspective often are add-on transactions with existing portfolio companies.

Lenders like Barings, with a large book of portfolio companies, are particularly well-positioned in this respect. We've continued investing in new originations through portfolio M&A activity, as evidenced by a significant portion of our activity over the last 18 months coming from existing issuers. Ultimately, we believe it is critical to retain mid-market terms in businesses with longevity and established track records to build consistency of return for our investors.