E X P E R T Q & A

Capital solutions strategies continue to gain attention, driven by borrowers' need for flexible financing options and investors' desire for uncorrelated income streams and unique origination channels, says Michael Searles at Barings

Driving opportunities through bespoke capital solutions

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Q Can you start by defining capital solutions, and how the opportunity set differs from distressed debt?

We think of capital solutions as flexible, often credit-focused strategies that offer investors access to unique dealflow and give sponsors and borrowers access to customised or bespoke financing solutions. These strategies typically target a return profile between traditional, sponsor-backed direct lending and private equity. However, the way managers target that return profile can vary significantly.

While some capital solutions strategies focus primarily on junior capital investments, we tend not to venture into that risk spectrum. Rather, we focus on driving returns through investments in senior secured debt, which makes up roughly three-quarters of our portfolio. In our view, this not only positions us to potentially achieve the attractive returns characteristic of this asset class, but also provides investors with greater downside protection and resilience through economic cycles.

One of the ways that today's capital solutions strategies differ from traditional distressed strategies is that the primary focus is not on rescuing companies after they've got into trouble. Much more often, these are investments made into companies that are growing and going through some type of transition where traditional capital raising channels may not be the best fit. These tend to be more advantageous situations for investors from the start.

Q Given that the US economy is in a position of strength compared with the rest of the world, how do you expect near- to medium-term economic policy to impact your portfolio companies?

Today's environment is certainly complex. On one hand, the current

economic backdrop in the US is positive, and we continue to see robust capital flows into the economy. That's reflected in our underlying portfolio companies as well – between public and private leveraged loans and bonds, our teams are looking across thousands of issuers and seeing consistent strength in those US businesses. While inflationary pressures still exist, most companies continue to be able to pass price increases on to customers.

On the other hand, uncertainty remains high. There are many unknowns surrounding Trump 2.0, including what policies the new US administration will put forward, and how those may impact portfolio companies.

Tariffs, in particular, will be a key issue to watch, given that they are inherently inflationary. In this environment, portfolio positioning is key – even if challenges arise, portfolios of highly diversified, globally diverse assets, with less correlation to broader markets, should fare well.

Q Where are you seeing the best opportunities in the asset class today?

We have a broad remit in that we look across both public and private markets to uncover opportunities. One area that continues to stand out is insurance. We tend to look for transactions where we can gain exposure to the underlying risk with significant diversification, low correlation to the broader macroeconomic climate, and low historical loss rates.

A recent opportunity involved P&C sidecar reinsurance vehicles. In these types of transactions, we typically own both the upside and the downside, but ultimately have a degree of protection through excess of loss coverage, to the extent that loss rates exceed certain thresholds.

We also see attractive opportunities in asset-based lending, where we have focused on acquiring or partnering with other platforms that can serve as an extension of our origination efforts. This includes non-bank asset-based lending, aviation finance, litigation finance and pharmaceutical royalites, as examples. We partner with these platforms in a variety of ways – from providing capital support, to accessing dealflow, to delivering structured solutions.

More broadly, we think there is significant opportunity across this space that will persist. We consider capital solutions as part of the broader class of 'private credit 2.0' strategies that managers are offering to investors alongside asset classes like portfolio finance, asset-based finance, real estate debt and others.

Over the past decade, investors have become very comfortable with traditional, sponsor-backed direct lending strategies, and areas like capital solutions can offer diversification to that existing exposure. In some cases, the asset class can offer higher returns and the ability to customise portfolios to meet investors' unique risk-reward targets.

Q What does the looming maturity wall mean for the current portfolio and future deployment?

The looming maturity wall is a logical consequence of the growing asset class, with origination volumes increasing in both the syndicated leverage loan market and the direct lending market – meaning each year we face more maturities than the last.

That said, as long as the asset class continues to grow and there is supply in the market from an originator standpoint, there should be enough capacity to address looming maturities for performing businesses. For underperforming companies, challenges may arise.

However, it's important to make the distinction that an underperforming business is not necessarily a 'bad' business. And for good businesses that are underperforming or aren't hitting expectations because they need to work through a specific issue, capital solutions strategies should be able to find opportunities to provide capital support.

> *"Portfolios of highly diversified, globally diverse assets, with less correlation to broader markets, should fare well"*

Q What are your thoughts on the convergence between public and private markets?

The convergence between public and private markets has gained momentum over the past few years. There will always be a reason to have a syndicated loan market and a true private market, but borrowers increasingly choose markets based on pricing and specific needs.

Private markets often offer borrowers greater flexibility and customisation in terms of structuring loans, as well as less stringent regulatory requirements. They can also provide companies with capital when public markets are less accessible. On the other hand, private markets typically require higher interest rates and fees (borrowing costs) than broadly syndicated markets.

We will likely see continued convergence or crossover in bigger deals at the upper end of the market. In club deals, for instance, you may have five holders of a $1 billion facility, held in different structures at different times. If someone wants to offload a piece, how do they make that happen? How liquid is it, really? As a result, while we will likely see more of these crossover deals, especially in bigger transactions, it may not be as widespread in the near term as some have suggested. ■

Michael Searles is head of North America for Barings' Capital Solutions group