EXPERT COMMENTARY

Investors wishing to benefit from positive tailwinds across US, Europe and Asia-Pacific would do well to consider a global direct lending strategy that looks across all three markets, say Tyler Gately, Justin Hooley and Orla Walsh at Barings

Investors take a global approach to direct lending

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The dynamic growth of direct lending over the last decade has captivated investors and captured its fair share of headlines. North America, the largest and most mature private credit market, is estimated to be worth around $1.5 trillion today and is expected to reach nearly $2 trillion by the end of the decade. The European direct lending market is about half that size, but it is growing quickly. Developed Asia-Pacific is the smallest market by AUM, standing at around $30 billion today, according to data from Preqin, but arguably has the longest runway for growth.

While there are compelling reasons to make standalone investments in each of these regions, there are also benefits to considering a global strategy that looks across all three markets, particularly as investors' appetite for the asset class continues to grow.

North America: The largest and most developed market

In addition to being the largest direct lending market, North America is highly competitive, having seen an estimated 500 new entrants over the past five years. That being said, dealflow continues to consolidate around fewer, larger and more stable managers. Five years ago, for instance, the top 20 managers raised 35 percent of the capital in the market; in 2023, the top 20 private credit managers raised 70 percent of total capital, according to Preqin data. In other words, competition is high, but points of access – particularly in the traditional mid-market – have narrowed.

Deal terms and pricing structures in North America depend largely on the part of the market where a manager is transacting. Broadly speaking, dealflow remains somewhat limited. For new platform deals, in particular, there is a meaningful supply/demand imbalance.

While that has driven pricing tighter overall, margin compression is more pronounced in the upper part of the market. Muted dealflow has been less of an issue for established platforms with the ability to deploy capital via off-market origination or add-on transactions.

Terms have remained more favourable for traditional, first lien senior debt in the core mid-market. Despite recent spread compression, our data shows that all-in, first lien yields continue to look attractive, sitting at roughly 10.5 percent for the last 12 months through March. The spread premium that the mid-market has historically offered over broadly syndicated loans has also remained compelling. The premium has historically ranged from 200-400 basis points, averaging 250 bps over the last five years, according to data collected by Barings and Credit Suisse.

Europe: Offering growth and diversification

The European direct lending market has evolved significantly over the past decade, and while it draws several parallels with North America, it has its own unique dynamics. While the market is typically considered to be five to 10 years behind the US in terms of development, that gap has arguably narrowed in recent times. Over the past five years, in particular, the market has seen an influx of new entrants. However, like in North America, there has been a flight to top-tier managers that have both scale and incumbency.

From a pricing and all-in yield perspective, spreads have compressed in Europe, but our data shows that origination yields have remained robust due to still-elevated base rates, at roughly 9.5 percent for the last 12 months through March. Meanwhile, data from Barings and Credit Suisse shows that the market also continues to offer a premium over the broadly syndicated market, to the tune of 250-300 bps.

One key difference between Europe and North America stems from Europe's regional diversity. Geographically, the UK was the first to adopt direct lending on a significant scale, followed by France, Germany and the Benelux countries. Southern European countries like Spain and Italy were next. Each of these markets and jurisdictions has its own legal systems and tax regimes, underscoring the need for large and highly specialised teams with local expertise and linguistic skills.

Developed APAC: Measuring its long runway for growth

The APAC direct lending market has experienced notable growth and transformation over the past decade but remains relatively nascent compared with North America and Europe. This evolution is partly due to the growth of the APAC mid-market, which has accelerated the funding needs of APAC-based businesses. At the same time, banks, the traditional source of mid-market funding, have begun to scale back. While the increase in non-bank lenders has resulted in more competition, the overall effect of that has been positive for the market, contributing to increased supply and a more efficient market with a much deeper opportunity set.

APAC is perhaps best known for its geographic diversity, with significant variations in the attractiveness and legal frameworks of different countries. We see the most value in developed APAC, particularly in Australia and New Zealand, as well as in Singapore and Hong Kong. These economies exhibit similar risk and return profiles as core direct lending strategies in the US and Europe. Notably, the regulations and bankruptcy laws in these countries are comparable with those in other developed markets, and the sovereign credit ratings are similar to those in the US and Europe.

Across these regions, mid-market companies tend to be first or second in their fields and often have dominant market share. EBITDA profiles, typically in the range of $15 million to $100-plus million, are similar to the US and Europe. Leverage levels tend to be consistent with transactions in those markets as well, and in some cases are slightly lower. Pricing has also historically been less volatile – while non-bank lenders are a growing presence in APAC, there are still fewer participants chasing deals relative to the US and European markets.

Pivoting for new opportunities

Each of these markets offers its own unique set of characteristics, but there are also benefits to considering a global strategy. In increasing the opportunity set of potential investments, a global strategy allows managers to invest more selectively and to opportunistically pivot from region to region as competitive dynamics and relative value ebb and flow. In this sense, global strategies can also provide a kind of natural hedge against regional-specific risks, allowing managers to efficiently ramp a well-diversified portfolio without the pressure to invest in a given region at a point in time when relative value is less attractive.

There are also tangible benefits for borrowers. Increasingly, sponsors are expressing an interest in transacting with fewer managers and looking for strategic ways to add value. In some cases, this means working with a global manager that can provide financing solutions in multiple currencies and across different jurisdictions.

Overall, there are similarities and regional nuances across direct lending markets in North America, Europe and developed Asia-Pacific. For investors looking to generate income, preserve capital, and achieve diversification – particularly at a time when macroeconomic and geopolitical uncertainties are high – taking a global approach to direct lending markets can be a part of the solution. ■

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