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PRIVATE CREDIT

Collectors vs. Selectors: How (& Why) Direct Lending Business Models are Diverging

INSIGHTS

Direct lending deals are getting bigger—but arguably, the most compelling relative value (still) lies in the traditional or "true" middle market.

Stuart Mathieson
Head of Europe & APAC Private Credit & Capital Solutions

Tyler Gately
Head of North America Private Credit

Where does the direct lending market end and the broadly syndicated market begin?

With the growing prevalence of mega direct lending deals, the answer is less straightforward than it was even a few years ago, when privately negotiated and structured loans upward of $500 million, let alone $1 billion+, were a rare occurrence. It also centers largely on the dynamics playing out across the lending landscape—particularly the growing dichotomy between asset collectors and asset selectors.

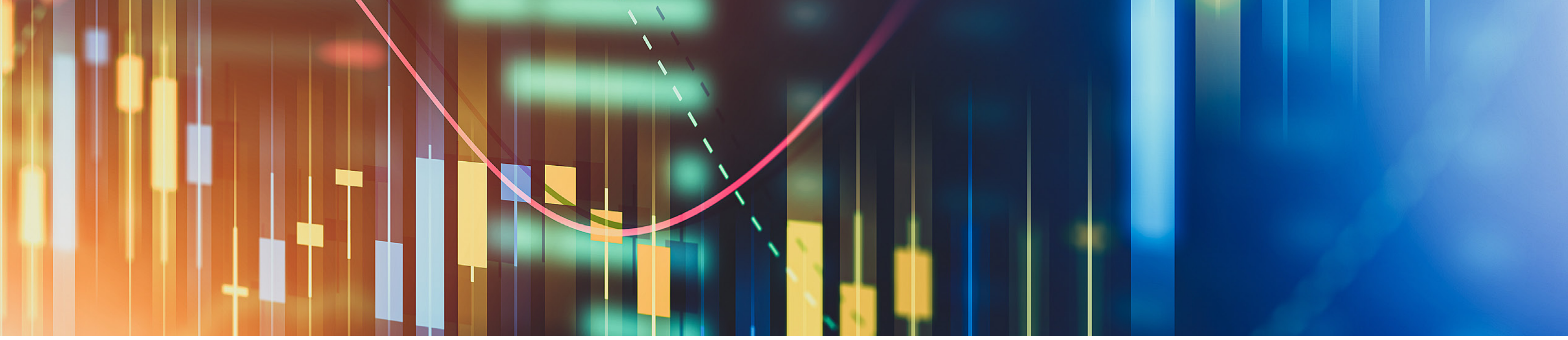
Asset Collectors & The Upper (Upper) Middle Market

There are a few notable drivers behind direct lending's disintermediation of the lower end of the broadly syndicated market. For one, deal flow has continued to come down in recent years after peaking in 2021 around $1.2 trillion.[1] At the same time, M&A volume has also decreased, from $4.7 trillion in 2021, to $3.5 trillion in 2022, to $3.1 trillion in 2023.[2] With less supply of deals in the market, and still-strong demand to invest, **some market participants have had to reconsider their approach to deploying capital**.

> *"As deal flow has slowed and M&A activity has decreased, some market participants have had to reconsider their approach to deploying capital."*

One trend that has come about as a result is the rise of so-called "**asset collection**," which can take a few different forms. On the one hand, asset collectors can include smaller lenders, namely new entrants to the market. These managers tend to be less experienced, particularly in originating assets, and therefore can face greater limitations when it comes to building portfolios. Often, the most efficient and cost-effective way to do so is by purchasing small pieces of other managers' deals—and while this can result in diversified portfolios, it gives managers **less influence over deal terms** and can make it difficult to achieve the consistency that comes from a more selective approach.

1. Global LBO deployment, excluding add-ons. Source: Pitchbook, Global Private Debt Report (2023).
2. Source: Pitchbook, Global M&A Report (Q1 2024).



Asset collection also extends to the lenders in the market that have continued to raise larger and larger funds, in some cases upward of $10 billion. In the direct lending market, capital needs to be deployed over a set time period, typically within 18 to 36 months, before it begins to weigh on returns. For lenders financing traditional middle-market deals, this can pose a challenge. **Deploying tens of billions of dollars into deals in increments of ~$100–$200 million is not only inefficient, but also difficult to execute in a timely manner**. As a result, many managers have chosen to move up-market, ramping large funds by making bigger investments in upper (upper) middle market companies ($100+ million in EBITDA), rather than patiently deploying capital into more traditional middle market opportunities. Executing these large transactions can certainly have advantages from a profit standpoint, given that a manager's overhead and deal team would likely be the same whether a deal is $100 million or $5 billion. But more often than not, there are implications for LPs, particularly from a return, documentation, and structuring standpoint. Once in a portfolio, large transactions can also create pressure if they represent a disproportionate portion of the assets.

One of the main implications of pursuing ever-larger deals is that direct lending managers are no longer competing only against other managers—they are also competing against market optionality. With deals of this size, borrowers often are in a position to choose between tapping public markets via broad syndication or raising funds through private markets in sole lender or club-style transactions. In some cases, this has resulted in **lenders consenting to less favorable terms in order to secure a deal**, leading to what is essentially public-market style documentation in a market that lacks public-market liquidity. **In certain transactions, spreads have narrowed as well**, inching closer to those in liquid markets—meaning the premium that has traditionally stemmed from the illiquid nature of the direct lending market has in some cases begun to fade. Even without the yield premium that would typically offset the illiquidity risk associated with these assets, investors in some instances are still paying the premium fees characteristic of private markets. Ultimately, this misalignment can lead to **scenarios in which investors are exposed to the risks associated with illiquid assets but positioned for lower total returns**.

Leverage in these transactions also tends to be elevated and in some cases resembles what is more typical of the broadly syndicated market than the traditional middle market. For context, middle market leverage today, on average, is close to 4.2x, versus roughly 6.0x for large broadly syndicated corporates.[3] In private markets, excessive leverage can prove to be onerous for borrowers and translate into cashflow issues, ultimately impacting their ability to service their debt.

WEAKER DOCUMENTATION: NOT ALL COVENANTS ARE CREATED EQUAL

Compounding this, financial maintenance covenants and other structural protections have become more diluted, particularly in the upper part of the middle market. Technically speaking, covenants in some form exist in almost all debt transactions. From 2023 through the first quarter of 2024, only ~2% of transactions in the traditional middle market (loans smaller than $500 million) were covenant-lite, compared with ~5% in the upper middle market (loans larger than $500 million).[4]

3. Source: LSEG LPC's Middle Market Connect. Leverage figures represent previous four-quarter averages to Q1 2024.
4. LTM basis. Source: LSEG LPC's Middle Market Connect—The Middle Market Opportunity. As of April 23, 2024.

However, there is an important distinction between covenants that "check the box" so to speak, and financial maintenance covenants that can help ensure a company's performance or liquidity issues are well-telegraphed. More specifically, financial maintenance covenants give managers a way to not only track a company's performance, but also test its financial health to ensure it is complying with specified performance metrics. In the event that challenges arise and performance falters, **financial maintenance covenants also ensure that lenders have a seat at the negotiating table and the ability to exercise their rights and remedies to proactively protect principal**. Given the critical role that maintenance covenants play when it comes to avoiding losses in the illiquid direct lending markets, this is an important distinction for LPs to make.

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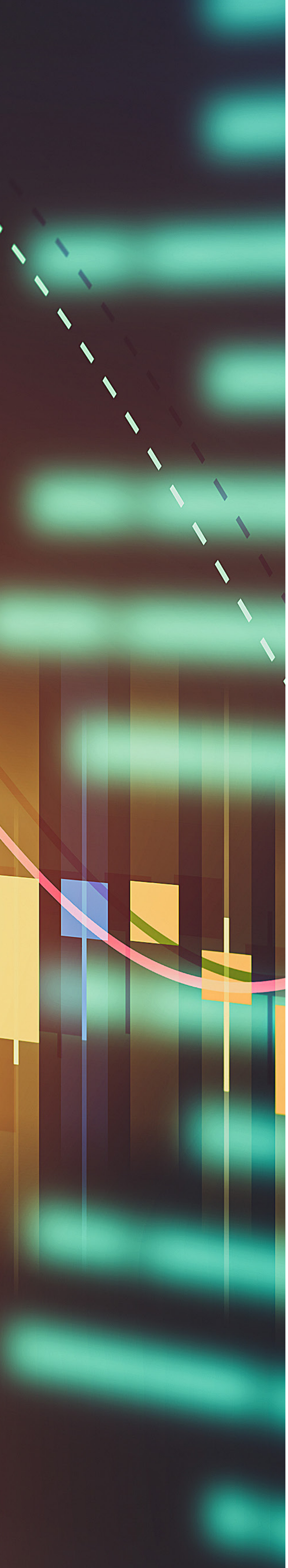
(VERY) LARGE CLUBS

Beyond the risks associated with terms and documentation, another consideration with regard to asset collection is that the holder base within large middle market deals can start to look very different from traditional direct lending deals. Europe, for instance, has historically been a sole-lender or bilateral market, meaning there is one lender and one sponsor in a direct lending transaction. North America has traditionally been more of a club market, with deals typically involving a sponsor and small group of lenders, usually anywhere from one to five.

In both regions, increased upper (upper) middle market activity has given way to the emergence of very large clubs, sometimes upward of 25+ managers. **As transactions begin to look more like the syndicated market, they tend to become susceptible to adverse scenarios like lender-on-lender violence**, losing some of the traditional benefits of direct lending like the ability to privately negotiate and restructure transaction terms as conditions change (as was prevalent through Covid).

Asset Selectors & The "True" Middle Market

Amid the growing prevalence of asset collection and upper (upper) middle market deals, there is a strong case to be made for "**asset selection**" and remaining disciplined in the traditional or true middle market. While this segment of the market has stayed largely out of the limelight, it continues to offer strong potential for attractive risk-adjusted returns over time, particularly in the more conservative parts of the capital structure, namely first lien senior debt.



Traditional, mid-market, first lien senior debt has been relatively insulated from some of the risks associated with the growth of large private market deals. As noted, leverage in this area of the market has remained modest, while documentation and covenant protections tend to be more robust. Historically, private middle market loans have also offered a **premium of roughly 200–400 bps over broadly syndicated loans—stemming from the illiquid nature of the market as well as the value that the asset class provides to sponsors via flexible and tailored financing solutions**.[5] Today, while that potential premium is closer to 150–200 bps, it remains favorable relative to the 0–100 bps premium typical of the upper (upper) middle market.[6] These characteristics look particularly compelling for long-term investors, offering them an opportunity to earn potentially higher risk-adjusted returns in exchange for giving up short-term liquidity that they do not necessarily require.

The opportunity in middle market direct lending is also unlikely to disappear anytime soon. The middle market represents a core component of the economy in the U.S., as well as in many parts of Europe and developed Asia Pacific. In the U.S. for instance, it consists of more than 200,000 companies that collectively employ millions of people and represent roughly one-third of private sector GDP.[7] Most of these companies are limited in their ability to directly access liquid capital markets, and thus rely solely on private lending as a means of raising capital for investments.

Accessing the Opportunity

When it comes to accessing the opportunity in the traditional middle market, **experience, scale and a longstanding presence** are key differentiators. A **stable and permanent capital base**, particularly one aligned with a large and diversified portfolio of invested assets, can also provide an advantage, enabling managers to remain active and continue deploying capital at attractively priced opportunities, even if (or as) deal volume fluctuates. Often, the most attractive deals from a risk/return perspective are add-on transactions, where managers have an existing relationship with a company and sponsor who need additional capital to fund the next leg of their growth journey. In this respect, **lenders with a large book of portfolio companies look particularly well-positioned given their ability to continue investing in new originations through portfolio M&A activity**. Whereas asset collection is inherently subject to market pricing risk, what is essentially a "buy-and-build" investment thesis enables managers to keep middle-market terms in businesses with longevity and established track records. It also provides an opportunity to augment and strengthen their existing portfolio by investing in companies they are already familiar with in an effort to make them larger, more attractive, and more diversified credits.

5. Source: Based on historical market observations.
6. Source: Based on Barings' current market observations.
7. Source: National Center for the Middle Market. As of December 31, 2023.

The benefits of a "buy-and-build" investment thesis extend to PE sponsors as well, offering them a strategic way to add value and reduce their cost basis with add-ons at lower purchase price multiples. Increasingly, this means partnering with managers that take an **institutional approach to sponsor relationships, with the ability to provide tailored solutions to support companies' long-term growth trajectories even (and especially) as financing needs evolve and change**. Often, financing needs extend beyond senior direct leveraged buyout lending to areas like capital solutions, portfolio financing, asset-backed finance, and equity co-investments—all the way to public credit market financing support. Ultimately, lenders with the capabilities and breadth to support these requirements are in a good position to serve as strategic, institutional partners to sponsors.

Key Takeaway

For borrowers and investors alike, it is important to understand how the direct lending landscape is evolving in response to the ever-growing presence of upper (upper) middle market deals. To be sure, asset collection has become increasingly prominent, with certain segments of the market nipping at the heels of broadly syndicated credit. However, for managers with strong sponsor relationships, asset selection in the traditional or true middle market remains compelling, offering both robust structural protection and the potential for attractive, long-term risk-adjusted returns.

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1992	80+	0.02%	$48+ B
Inception of Barings' Direct Lending Platform	Dedicated Investment Professionals	Senior Loan Annual Loss Rate Since Inception	Commitments

NORTH AMERICA	EUROPE	DEVELOPED APAC
776	293	95
Platform Investments	Platform Investments	Platform Investments
$31.0 B	€20.7 B	€3.7 B
Invested	Invested	Invested

As of March 31, 2024. Barings North American Senior Loan Strategy Inception: 2012, Barings European Senior Loan Strategy Inception: 2013, Barings Asia Pacific Senior Loan Strategy Inception: 2011.

Stuart Mathieson

Head of Europe & APAC Private Credit & Capital Solutions

Stuart is the Head of Europe and APAC Private Credit and Capital Solutions. He currently chairs the Capital Solutions investment committee and is a member of several firm investment committees including Europe Private Credit, North America Private Credit, APAC Private Credit, European High Yield and MassMutual Ventures Europe & Asia fund. Stuart joined Barings in 2002 and has extensive investment experience encompassing the sub-investment grade public and private credit markets, restructuring and special situations investments. Prior to joining Barings, he worked in the Business Recovery Services team in London at PricewaterhouseCoopers. He is currently a board member of Trafalgar Entertainment and has extensive experience of working closely with a number of businesses whilst at Barings. Stuart holds a B.Sc. in Chemistry from Keble College, Oxford and is a member of the Institute of Chartered Accountants in England & Wales.

Tyler Gately

Head of North America Private Credit

Tyler Gately is the Head of North America Private Credit for Barings' Global Private Finance Group. He is responsible for leading a team that originates, underwrites and manages North America private finance investments. Tyler has worked in the industry since 2008, focusing on investments across the capital structure. Prior to joining Barings in 2018, Tyler worked on the High Yield Bond Desk at Wells Fargo Securities, where he was a Lead Analyst covering the metals, mining, chemicals, and energy sectors. He has also held positions at Plexus Capital, a middle market-focused junior capital fund, and BofA Merrill Lynch, where he worked in the investment bank's capital markets division. Tyler holds a B.S. in Finance from Wake Forest University.

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