BARINGS

PORTFOLIO FINANCE

Portfolio Finance: Missing a $100+ Billion Annual Opportunity?

INSIGHTS

The rapid expansion of private markets has created an opportunity for investors to earn attractive returns in private IG credit, underpinned by the financing needs of asset managers and funds. Yet this segment of the market remains little known and less understood.

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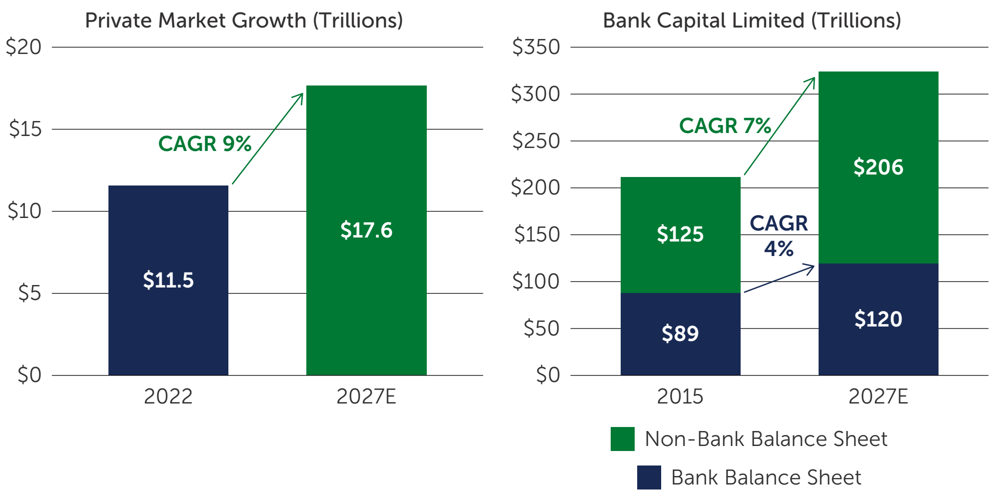
A Rapidly Growing Funding Gap

Private markets have experienced rapid growth over the last decade and show little sign of slowing, with the market segment forecast to expand by 9% each year to reach $17.6 trillion by 2027 **(Figure 1)**. At the same time, traditional banking capital sources—which asset managers and asset owners have historically relied on to finance the needs associated with their private market portfolios—are becoming increasingly limited, with bank balance sheets expected to grow by only 4% a year. As a result, the funding gap for asset managers has emerged and is getting bigger and bigger.

Figure 1: A Significant Funding Gap is Emerging



Source: Preqin, Future of Alternatives 2028 report; Source McKinsey & Company, The Global Banking Annual Review 2023. As of December 2023. Note: Excludes hedge funds and ventures asset classes as not targeted by Barings Portfolio Finance. Figures in $ trillion, excludes China.

This is where the opportunity for institutional investors comes in. As private markets continue their rapid growth and the financing needs of asset managers operating within them have become more sophisticated, specialized lenders have stepped in to address this funding shortfall in **portfolio finance**. But while investors, including insurance companies, have increasingly been recognizing this attractive opportunity in portfolio finance, the breadth and scale of it are often underestimated—and it is likely much larger than many realize.

What is Core Portfolio Finance?

Most investors likely associate portfolio finance with Private Equity (PE) Buyout NAV lending, where asset managers raise debt against their private equity portfolios to either fund further investment into their portfolio or pay out cash distributions to limited partners (LPs) as they await portfolio company realizations. Such a strategy can be attractive, particularly given the relative risk/return potential for investors. However, while NAV lending is projected to become a $75 billion annual opportunity, it is just one part of the broader portfolio financing landscape.

ESTABLISHED STRATEGIES

Beyond PE Buyout NAV lending, there is a range of lending strategies that have been in existence for over a decade paralleling private market growth. These established portfolio financing strategies—which we refer to as **"Core Portfolio Finance"**—provide alternative routes to finance private market portfolios in a way that can create high quality, investment grade (IG), private fixed income investments.

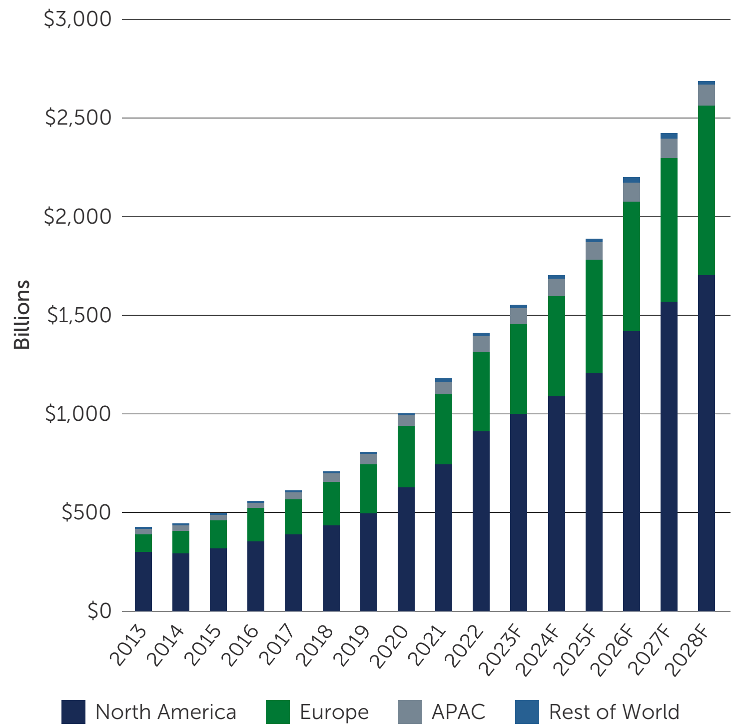
Private Credit Portfolio Finance

Private Credit Portfolio Finance is the financing of a cross collateralized portfolio of private credit assets. This type of financing is used to tailor a private credit strategy to suit an investor's unique needs, from specific investment goals to return targets. For instance, if an investor likes an asset manager's direct lending strategy but requires higher returns, this type of financing allows for a separately managed account (SMA) or levered sleeve, with the potential to achieve the desired returns without altering the underlying strategy's risk profile. Looking ahead, there is robust growth potential for Private Credit Portfolio Finance, especially given the rapidly rising popularity of the private credit market **(Figure 2)**.

Secondary Portfolio Finance

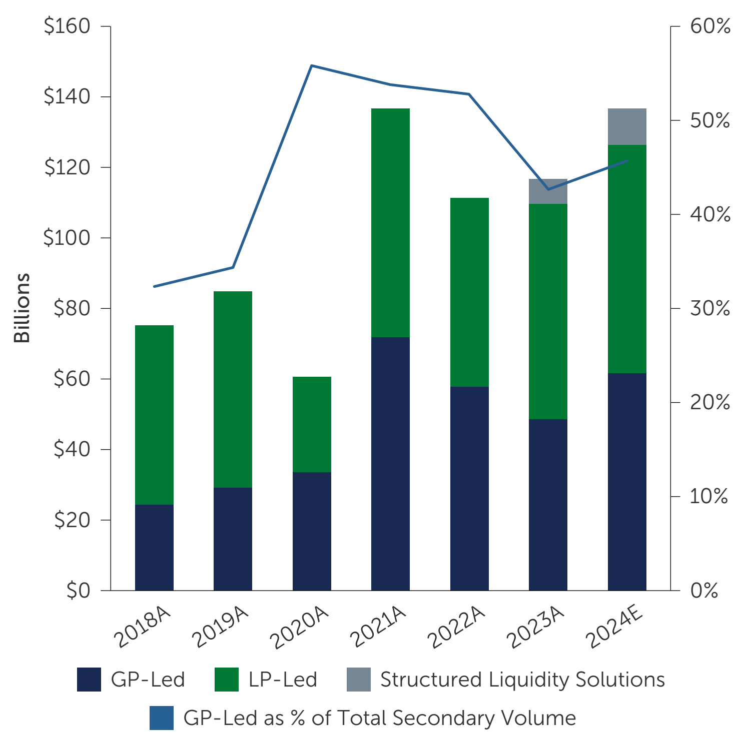
Financing on private market secondary portfolios has been around since the early 2000's. The shape of these transactions is typically lending against a cross collateralized portfolio of LP interests in funds. This results in a credit investment which benefits from significant diversity of the underlying assets, often in the hundreds or even thousands. Following its establishment, the market for secondary sales of LP stakes in private funds has expanded rapidly, evolving into what is today a $120+ billion market **(Figure 3)**. LPs' motivations for selling stakes can vary and often include portfolio management goals like managing exposures to different vintages, styles, and managers, or freeing up capital to invest in new vintage funds. Regardless of the motivation, utilizing Secondary Portfolio Finance can help close the "bid-ask" spread between buyer and seller to make such transactions possible. It is also increasingly used as a portfolio management tool by secondary PE asset managers to smooth distribution profiles, refinance deferred consideration, or help get the fund closer to 100% invested.

Figure 2: Private Credit Markets Have Grown Rapidly in Size



Source: Preqin. As of June 30, 2023.

Figure 3: Secondary Market Transaction Volume



Source: PJT Partners. As of April 2024.

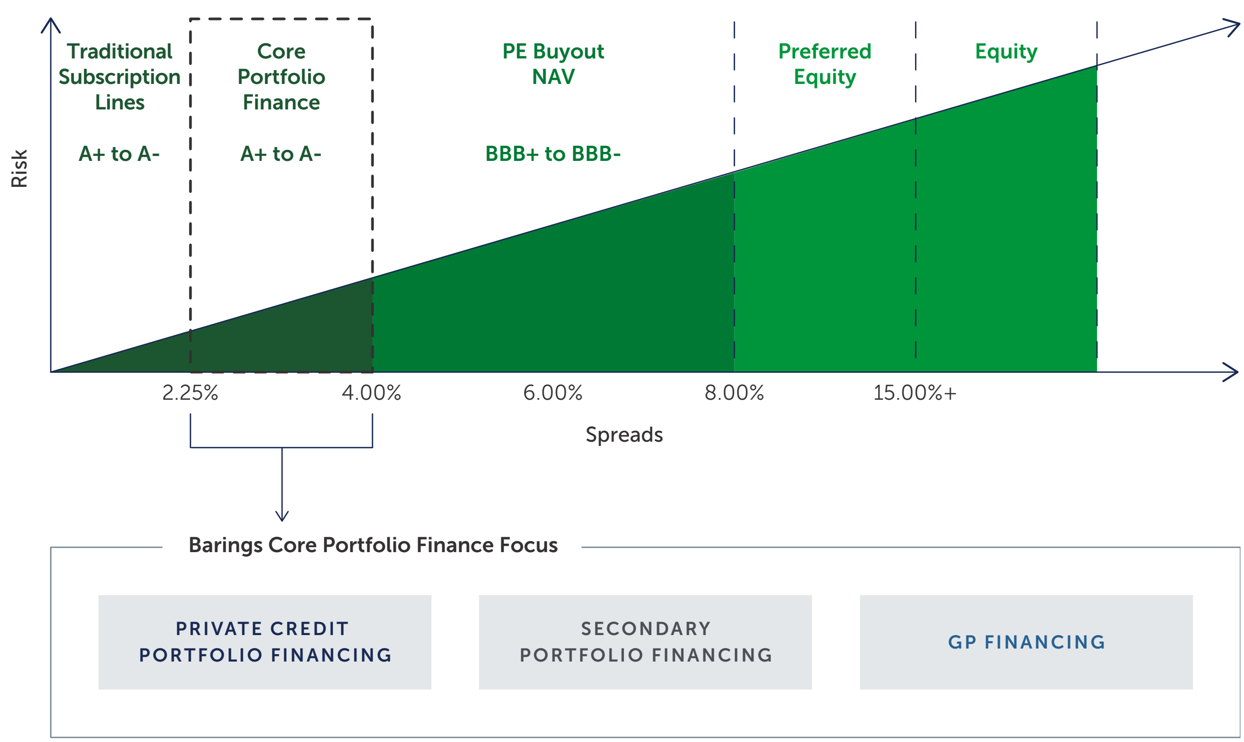
GP Financing

General partners (GPs) are typically required by LPs to invest their own capital in their funds such that they are aligned with LPs and have "skin in the game." But as asset managers grow and raise additional funds, they may not have capital freely available to invest in the next fund. When this is combined with longer hold periods, continuation vehicles, and strategic growth initiatives, there is a growing need for capital to help GPs further align themselves with LPs. GP Financing can be an effective solution, allowing them to continue investing alongside LPs in their own funds while not being forced to raise dilutive equity capital. Such financing can also help GPs invest in the growth and expansion of their own platforms, manage succession planning, and engage in other activities that require capital to run their businesses.

A Broader and Higher-Rated Opportunity Set

For investors, Core Portfolio Finance offers access to IG private credit across various private market segments. While PE Buyout NAV financing represents an attractive and growing investment opportunity, Core Portfolio Finance offers investors exposure to A rated credit profiles, and the potential to earn attractive spreads relative to similarly rated opportunities. In particular, Barings Portfolio Finance have historically generated a 200 basis points (bps) spread premium to public benchmarks in yielding, average A rated investments.[1] The strong relative value is driven from direct origination and specialized asset class expertise, delivering high value-add solutions to asset managers.

Figure 4: Core Portfolio Finance Offers Exposure to Varying Risk-Return Profiles & Market Segments



Source: Barings. As of May 31, 2024.

1. Source: Barings. As of May 31, 2024.

Sizing Up the Significant—and Possibly Overlooked—Opportunity

The rising demand for tailored investments, expanding secondary market, and growing need for GP capital should provide a tailwind for significant growth in the portfolio finance market in the coming years. But the potential scale of the market opportunity is difficult to quantify. While current forecasts, as mentioned, call for growth to roughly $75 billion per year by 2028, most focus almost exclusively on PE Buyout NAV Lending and largely disregard Core Portfolio Finance strategies.

This suggests that the size of the potential opportunity could be much greater—up to $100 billion or more per year. We break this down as follows:

Annual Financing Needs by Sector Through 2028

$75 B
IN PE BUYOUT NAV LENDING

PE fundraising was around $500 billion in 2023. By 2028, these funds will be in year five and will therefore provide a base of NAV for financing. Assuming that a 15% LTV is financed, this suggests annual market volume of $75 billion in PE Buyout NAV Portfolio Financing. This figure assumes all funds are fully deployed and all funds in that vintage take NAV financing. It also assumes no growth in the NAV of that vintage, and that other vintages have already been financed.

+

$114 B
IN PRIVATE CREDIT PORTFOLIO FINANCING

Adding to this is Private Credit Portfolio Financing, which is typically structured at the inception of the fund. A survey of private debt funds suggested the mean leverage in U.S. funds was 40% and in European funds was 11%.[2] In order to create a high-level global view, we blended these figures by the weighting of U.S. to EU private credit AUM (which is a roughly 66:34 split), which resulted in a weighted average private credit leverage of 30%. We applied this level of leverage to $263 billion of forecast 2028 North American and European fundraising in the resultant debt-to-equity split. This creates a requirement of $114 billion in Private Credit Portfolio Financing.

+

$24 B
IN SECONDARY PORTFOLIO FINANCING

In order to forecast the need for Secondary Portfolio Financing, we based our calculations on annual secondary deal volume. While there are several forecasts for the growth of the secondary market–with some research even suggesting a $1 trillion market by 2031—we have taken a more conservative view and based our forecast on a market size of $300 billion by 2028. Assuming 20% of the transactions use 40% of leverage, we forecast around $24 billion in Secondary Portfolio Financing. While this calculation excludes dividend recapitalizations of funds, it provides a rough idea of the volume that can be expected.

+

$5 B
IN GP FINANCING

Finally, we take a look at GP Financing—which is a smaller but growing segment of the market. Fundraising across the private market is expected to be around $1.49 trillion in 2028.[3] GP commitments are typically around 2%. If we assume a third of firms use financing for 50% of their commitments, it results in a need for $5 billion of GP Financing. This excludes financing for succession, acquisitions, or other strategic growth initiatives. When compared to the $11.5 billion of GP stake activity seen in 2022, this figure seems reasonable.[4]

= $218 B **IN ANNUAL COMBINED NEEDS FOR PORTFOLIO FINANCING**

2. Source: Becker Friedman Institute for Economics at University of Chicago. As of January 2023.
3. Source: Preqin. As of December 2023.
4. Source: Pitchbook; GP deal activity; Public PE and GP Deal Roundup. As of November 4, 2023.

Key Takeaway

Against a backdrop of expanding private markets, increasingly sophisticated financing needs of asset managers, funds, and asset owners, and a structural shift away from traditional bank capital, portfolio finance presents an increasingly interesting opportunity. While this is not a new market, much of the attention to-date has focused on PE Buyout NAV financing. However, we believe the market is missing an even more sizeable near-term growth opportunity when we broaden the lens to include Core Portfolio Finance. More specifically, and based on our estimates, the incremental opportunity to put capital to work in these strategies is likely to exceed $100 billion per year—representing a private IG fixed income credit asset class that the market is largely overlooking.

Barings Portfolio Finance

In order to access the broad spectrum of investment opportunities, investors can benefit from partnering with managers who have a scaled platform, established relationships with key market participants, influence over the legal documentation and terms, and the ability to tailor portfolios to meet investors' specific needs.

The Barings Portfolio Finance platform, established in 2017, acts as a conduit between investors looking for directly originated private IG debt and asset managers seeking customized portfolio financing solutions. Our dedicated team includes over 30 professionals in the U.S. and Europe that span investment origination, underwriting, structuring, servicing, and portfolio management. To source investment opportunities, we leverage our industry wide relationships and established partnerships with more than 50 asset managers globally. We are credit-focused, emphasizing capital preservation and downside protection through rigorous underwriting, the negotiation of strong structural protections, and active portfolio management.

Above all, we believe in taking a partnership-oriented approach with both our investors and asset manager partners. This approach has enabled us to drive consistent value over time in a complex, inefficient market as we aim to deliver attractive risk-adjusted returns for our investors and value enhancing solutions for asset managers.

Barings' Portfolio Finance Platform

$38 B+	2017	100+	$16 B+
Originations of Investment Grade Portfolio Finance Loans	Inception of Strategy	Facilities with Diversified Collateral	Repayments or Maturities—No Losses

Source: Barings. As of May 31, 2024.

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