BARINGS

2024 OUTLOOK

COMING INTO FOCUS

DIRECT LENDING

CONVERSATIONS

Our direct lending experts bring into focus the biggest challenges and opportunities shaping private credit markets in the U.S., Europe and Asia Pacific.

ADAM WHEELER
Co-Head of Global Private Finance

TYLER GATELY
Head of Client Portfolio Management, Global Private Finance

JUSTIN HOOLEY
Managing Director, Global Private Finance

NATASHA SAHI
Managing Director, Client Portfolio Manager

NATASHA SAHI (MODERATOR): Given the widespread risks across markets today, many investors have concerns about the challenges posed by high interest rates, inflation, and growing geopolitical risk. How is the direct lending asset class positioned against this backdrop?

TYLER GATELY: The direct lending market certainly faces a number of headwinds, but there are also reasons to be optimistic. For one, this is an asset class made of directly originated and negotiated loans. This means that managers have access to, and often ongoing engagement with, management teams, which gives them access to information. Another factor contributing to the resilience of the asset class is that it is less exposed to heavily cyclical industries, like commodities, that tend to underperform in down cycles. This helps insulate the market from some of the volatility you see elsewhere.

It's also important to note that if or when things do go wrong, most direct lending transactions have strong covenants, which are a critical part of managing losses given that investors don't have the ability to sell out of deals. In addition to enabling managers to track the performance of a company, covenants give lenders a seat at the negotiating table if a company runs into trouble, allowing lenders to exercise their rights and remedies, which helps protect principal before it's too late.

ADAM WHEELER: I would also point out that direct lending, as an asset class, has performed very well over the last decade. While partly a result of the benign economic backdrop, this also stemmed from, and will continue to be impacted by, asset selection. As Tyler said, this is an asset class where managers are sourcing and originating their own assets and, as a result, they tend to be very selective about the assets and industries to which they want exposure. In public markets, by contrast, allocations are often made around an index, which tend to offer exposure across all industries—including those that may not perform as well in down cycles.

NATASHA SAHI: For direct lending, higher rates have resulted in more attractive returns for investors—but have they imposed too great a burden on borrowers in your regions? How healthy are middle market companies today?

ADAM WHEELER: Companies across the U.S., Europe, and Asia Pacific have faced a number of challenges over the last 18 to 24 months, from supply chain issues to higher energy costs. The biggest impact, however, has come from inflation, and particularly wage inflation, which has been especially pronounced in Europe. On the positive side, and somewhat surprisingly, demand has remained quite robust, which has enabled businesses to raise prices. **As a result, company performance across our portfolio has fared quite well, despite higher base rates and an increasingly uncertain economic backdrop.**

That said, having to pay an extra 500 basis points (bps) of interest expense on top of what these companies were paying before has also resulted in cash flows getting tighter, even among those businesses that are performing well today—and that's because as rates have moved higher, capital structures, broadly speaking, have become less able to support the level of debt that once went into transactions. To that end, performance will ultimately come down to company selection and portfolio management. Over the next year, as cash flows continue to tighten, it wouldn't surprise me to see certain companies, particularly those with more aggressive capital structures, begin to run out of cash. This will inevitably pose problems for some managers and could negatively impact portfolio performance. On the

other hand, managers who have favored more conservative companies with less aggressive capital structures look better positioned to withstand tighter cash flows and maintain performance.

JUSTIN HOOLEY: In terms of performance to date, it's a similar story in Asia Pacific, where companies have remained largely healthy. Across our portfolio, corporate profits, in the form of EBITDA, have been relatively constant, while interest coverage remains strong. This is largely due to our portfolio's tilt toward more defensive sectors like health care and education, where demand tends to be less discretionary or price sensitive, and therefore less impacted by changing economic conditions. Companies in these sectors also tend to have high cash flows and low capital expenditures. Typically, they are also number one or two in their field and have a dominant market share—a key difference versus the businesses we typically lend to in the U.S. and European markets. As we have seen over the past two years, that market dominance has value during periods of high inflation, as these companies have largely been able to pass through price increases due to their market position. While conditions may become more challenging in the months ahead, we believe this positioning will help bolster resilience as we move through the more challenging parts of the economic cycle.

TYLER GATELY: We also put a strong emphasis on selecting companies that have a reason to exist through all parts of an economic cycle—which typically means less cyclical or consumer-related businesses. As a result, similar to what Adam and Justin have seen in their regions, most companies in the U.S. have held up well from a margin standpoint, as they have largely been able to pass price increases through to consumers. **Going forward, however, the question is what the contagion could look like if a recession starts to affect specific parts of the economy.** That, of course, is where a diligent approach to underwriting on the front end will come into play, as well as oversight from a portfolio management perspective.

NATASHA SAHI: Can you describe the competitive landscape in your region and how that is impacting the pricing, terms and structures of the deals you're currently seeing?

ADAM WHEELER: M&A has certainly slowed down, and there is less capital competing for transactions in Europe. As a result, pricing has widened out, and is actually more similar to the U.S. versus the last few years. Given the rate increases over the last 18 months, there is also significantly less leverage across the market today, and the return profile is the highest we have seen in a while. While there has been a slight reduction in enterprise values to date, there is still a significant equity cushion sitting behind most transactions, usually in the ballpark of 55–60% versus 20–25% a decade ago.[1] These dynamics bode well, from a return perspective, for managers able to raise capital—particularly as activity levels begin to normalize going forward.

1. Source: Barings' observations. As of December 2023.

JUSTIN HOOLEY: The dynamics underlying the APAC market are slightly different from the U.S. and Europe. Specifically, institutional lending in APAC is more limited, and accounts for less than 10% of all financing today.[2] That said, a number of global credit funds have recently come into the market, which has been somewhat of a double-edged sword. On one hand, with much more capital now chasing fewer deals, the lending environment has become more competitive and thus more challenging. On the other hand, managers are now able to present private equity sponsors with more viable solutions because the volume is there. In fact, we've seen a few deals this year in the unitranche space that have exceeded $1 billion, which is unusual for our market and suggests institutional lenders are beginning to more meaningfully fill that gap left by banks.

What's been interesting about the institutional lenders coming into the market so far is that most have been fairly disciplined and have held their pricing—despite the increased competition. Terms, for the most part, have remained favorable as well, particularly relative to other regions, with meaningful covenants still in place across most transactions.

TYLER GATELY: In North America, deal flow has been relatively subdued, so it's difficult to read into overall pricing trends. The question today is more around what's financeable in the market. Overall, the quality of assets remains high and, as a result, enterprise value multiples continue to be relatively insulated from the broader dislocation in markets. One trend that has materialized in the years since Covid—due to both increased competition and, more recently, limited supply—is that top-tier private equity firms are consolidating around fewer larger and more stable managers. In particular, they are focusing their deal flow and relationships on lenders they believe can support the strategies and growth initiatives for their businesses through all stages of the economic cycle. Ultimately, that has the potential to impact the types of assets that managers are able to add to their portfolios, and can be a big differentiator in terms of performance.

JUSTIN HOOLEY: That's an important point with respect to APAC as well. Today, most of the top private equity firms in the region prefer to work with fewer lenders—often only one or two—and look specifically for those with larger hold sizes who can provide speed, certainty, and reliability to close. As a result, some of the smaller managers that cannot provide as much of the capital structure that is being sought are missing out on deals, especially those that are higher-quality and involve tier-one assets and sponsors. As Tyler alluded to, this could have significant implications for portfolio performance going forward.

NATASHA SAHI: That's a good segue into manager performance—are you starting to see signs of increasing dispersion across direct lending managers, or is it too early to say?

TYLER GATELY: It is tough to analyze manager performance, as this is still a fairly opaque asset class. In North America, there is some degree of transparency vis-à-vis the business development company (BDC) market. More broadly, though, valuation methodologies—and the reporting of underperforming assets—is all manager specific. And there is a very wide range in terms of transparency from manager to manager.

2. Source: Barings' observations. As of December 2023.

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That being said, there is a sense that underperformance may start to shake out in the months ahead. As a result of higher rates and a potentially weakening economic backdrop, we are starting to see some of the pain materialize that may have been masked in 2020 and 2021. In that regard, one of the most telling trends that that I would look to is the conversion of cash interest to payment-in-kind (PIK). While that can stem some of the cash needs of businesses, it also aligns managers with an equity takeout if the agreement dilutes the existing shareholder equity position. **Ultimately, I think we will see a significant difference in performance between disciplined, top-tier managers and those that were less disciplined in the good times.**

ADAM WHEELER: It's also interesting to compare and contrast the European landscape with North America. As Tyler mentioned, the BDCs do give more transparency to manager performance in the U.S., with the market—generally speaking—more opaque in Europe. And to Tyler's point, it takes a long time for issues to materialize. In Europe, for instance, managers have a range of valuation policies that sometimes results in very little movement in NAV until a major problem emerges. To that end, I think a lot of managers are trying to hold the tide back. But, as cash flow becomes tighter and businesses start to underperform, I do think we will start to see quite a divergence in performance.

The fact that the European market is also more of a sole-lender market will further exacerbate the dispersion in manager performance. With fewer managers doing more transactions, those that are not one of the two or three direct lenders that a private equity firm wants to go to, will be unable to access higher-quality deals—which will likely lead to adverse selection. Whether managers are seeing high-quality deal flow and able to invest in quality businesses will be a key question for LPs to ask going forward. While admittedly not easy to diligence, a place to start is by looking at raw data like debt-to-EBITDA ratios and interest coverage, as well as portfolio diversification.

NATASHA SAHI: Adam, looking ahead, what are your bull and bear cases for the asset class over the next 12 months?

ADAM WHEELER: In the next few months, performance will likely come down to liquidity, which will depend largely on the direction and movement of interest rates. The more bullish case for the next year is that interest rates have peaked and will begin to move lower. In this scenario, we would expect to see more free cash flow, uncertainty would start to fade, M&A would begin to return, and the industry would begin to deploy more capital again.

I think it's more likely we see a bearish scenario play out, with rates looking likely to remain higher for longer. Under this scenario, I do think we will see liquidity, but also a peaking of employment and more businesses with broken balance sheets. While a more challenging environment overall, this could also lead to select opportunities for us on the credit side. **Along with a significant dispersion in private equity performance, I would also expect to see a transfer of return from equity to debt, which hasn't happened for over a decade.**

NATASHA SAHI: **What is your advice to investors on their direct lending allocations in 2024?**

TYLER GATELY: The direct lending asset class continues to grow for many good reasons. For one, the opportunity set is expanding as private credit effectively follows the playbook used by private equity since the 1980s and cannibalizes syndicated markets. Returns, too, continue to look very attractive on a risk-adjusted basis given today's base rate environment. But manager selection will continue to play a key role when it comes to navigating this growing market. **In addition to scale and liquidity, investors looking at a private credit allocation will want a manager with staying power, who will be there through all parts of the cycle and have access to high-quality deal flow and top-tier assets.**

JUSTIN HOOLEY: As far as their allocations are concerned, LPs have to decide where in the risk spectrum they want to be. Do they want to be conservative, defensive, and concerned about capital preservation while earning an attractive return, or do they want to go on the riskier side and get the alpha? Private credit continues to grow in popularity among institutional investors and LPs in APAC who increasingly see the potential benefits. But it is still a relatively new asset class. And for that reason, it's critical for investors to peel the onion back and work out where they actually want to be before they deploy capital.

ADAM WHEELER: To Justin's point, this is still a relatively new asset class for many institutional investors, having only recently gone from a niche allocation to a permanent allocation. That means there will be more capital flowing into the asset class looking for a home, which is a structural shift that is going to eat into public markets. The growth also is reshaping the business, with fewer managers deploying larger funds and being responsible for more of the deal flow. For these reasons, over the next cycle, manager selection will become even more important, with high-quality deal flow, scale and incumbency in great demand.

This piece has been adapted from our 2024 Direct Lending Outlook Roundtable. Watch the full webinar here.

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