BARINGS

2025 OUTLOOK

NAVIGATING A SHIFTING LANDSCAPE

DIRECT LENDING

CONVERSATIONS

Our experts across the global direct lending markets discuss how they're navigating today's shifting landscape—and where they expect to see risks and opportunities in the year ahead.

TYLER GATELY
Head of North America Private Credit

STUART MATHIESON
Head of Europe & APAC Private Credit & Capital Solutions

JUSTIN HOOLEY
Managing Director, Asia Pacific Private Credit

JULIANNE RUSIE, CFA
Moderator
Managing Director, Client Portfolio Management

JULIANNE RUSIE (MODERATOR): As former President Donald Trump takes office in early 2025, the policies under his administration will be closely watched by investors and managers alike. What are the key issues that could shape direct lending markets going forward?

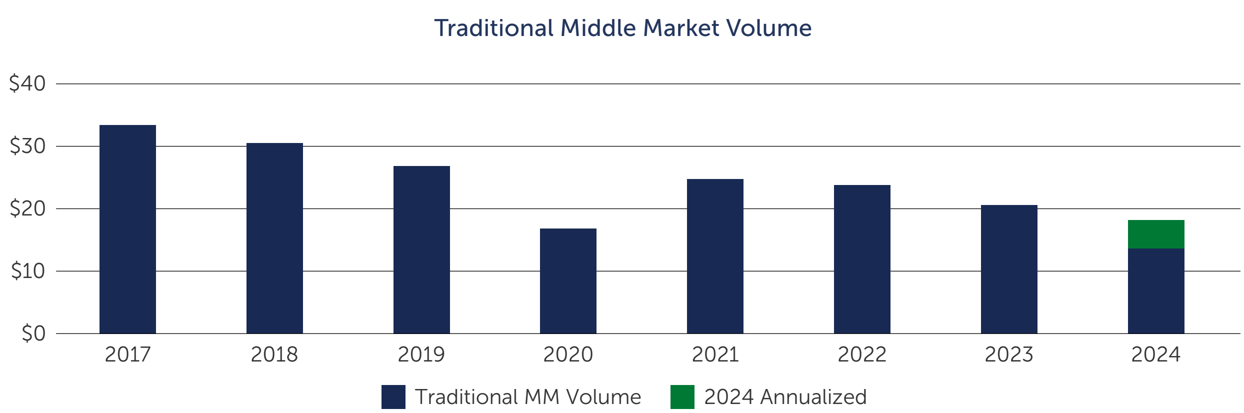
TYLER GATELY: This particular presidential election was unique in that there was an incumbency dynamic on both sides, meaning many market participants had a fairly good sense of what they would be getting. There is a general expectation that the incoming administration will be pro-business with a focus on deregulation, which would be positive for many middle market businesses. Tariffs stand out as a key issue, but many of the middle market companies in North America are domestically focused. In that sense, tariffs likely won't have a direct impact on these companies, although they could meaningfully impact supply chains and the broader economic picture.

STUART MATHIESON: Tariffs are the key issue to watch in Europe. Although their extent and reach remain to be seen, trade flows will likely be affected. Inflation could rise as well, which could keep rates higher for longer. While this scenario isn't particularly positive for European corporates—and could have a negative effect on cash flows—the middle market as a whole is relatively healthy, and most transactions have strong documentation and structural protections in place that can help managers navigate any challenges that arise in their portfolio.

JULIANNE RUSIE: With the uncertainty of the U.S. election behind us, and private equity sponsors sitting on $2 trillion of dry powder, have we reached a point where M&A could meaningfully unlock?

TYLER GATELY: Clarity certainly is improving as some of the key drivers of uncertainty subside and sponsors become less concerned about leaving money on the table. We're now starting to see green shoots, especially in terms of some of the leading indicators of deal volume. Buy-side diligence firms and accounting firms are doing quality-of-earnings reports, for instance, and investment banks appear to be sold out for the next three or six months. These factors point to a turnaround in M&A being a question of when, not if. While that's always true to an extent, we're getting to a point where bid-ask spreads, in terms of valuations, are beginning to compress as some of the causes for uncertainty subside **(Figure 1)**.

Figure 1: Core Middle Market Transaction Volume Improving but Remain Suppressed Due to Valuation Gaps Between Buyers and Sellers



Source: LSEG LPG. As of September 30, 2024.

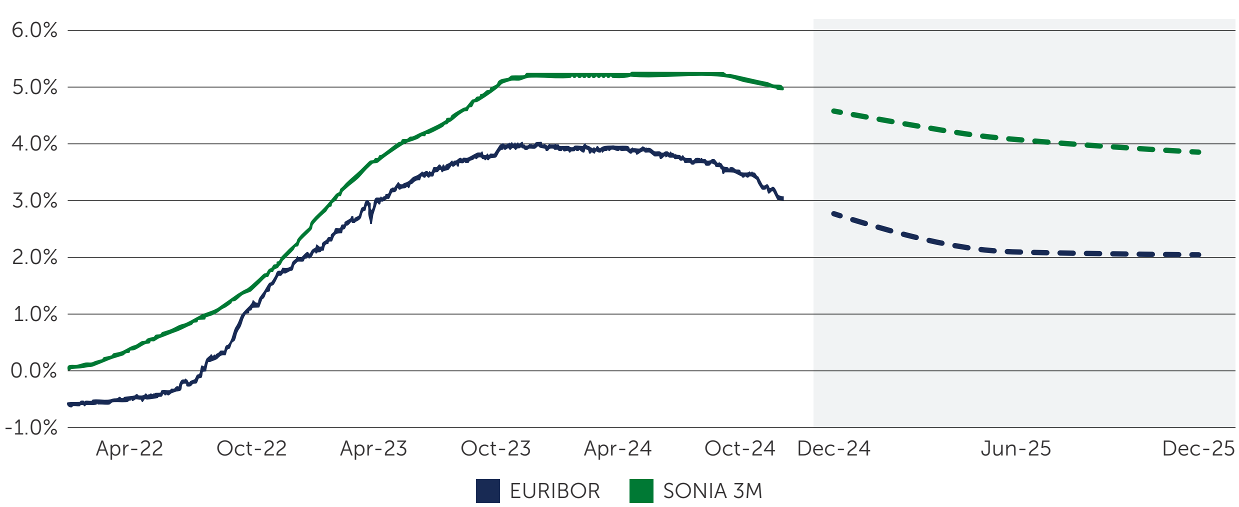
STUART MATHIESON: I agree with Tyler that conditions seem to be ripe for higher M&A, and anecdotally we are seeing signs of a pick-up in new platform activity. But perhaps a more relevant question is how reliant certain platforms are on M&A for origination and growth—and the answer is, it varies by manager. Looking at our global portfolio of 350+ companies over the last year, there is a notable mix of new platform deals and "off-market origination," or add-on transactions in which we have provided additional financing to sponsors or companies we've lent to previously. That is to say, while a stronger M&A environment would certainly be positive, incumbency matters and will continue to drive significant origination and opportunity as sponsors grow their investments.

JUSTIN HOOLEY: In Asia Pacific, we see many of the same recovery factors that we're seeing in other regions, but it's less certain that M&A will come back meaningfully in the short term. We've seen a number of M&A processes that have started but aren't getting across the finish line. Additionally, LPs are continuing to push private equity firms to try and exit some of their businesses, which should remain a key catalyst for M&A going forward. For now, however, many private equity sponsors seem to be holding assets at higher valuations closer to their entry point, and are reluctant to crystallize losses if they're pressed to sell too soon or before they've maximized value creation.

JULIANNE RUSIE: A higher-for-longer rate environment is somewhat of a double-edged sword—investors benefit from higher yields, but borrowers can come under greater pressure. How healthy are middle market companies today?

STUART MATHIESON: We rely on a number of regular data points, as well as ongoing discussions with company management and private equity sponsors, to gauge the health of our portfolio companies. What we've seen is that most companies have held up very well in the face of challenges—not only from higher interest rates, but also from higher inflation, high prices generally, labor shortages, and supply-side shortages. Of course, the combination of high prices and elevated interest rates will continue to put pressure on cash flows, perhaps to a greater extent in the U.K. than in Europe, as U.K. rates are expected to be higher for longer **(Figure 2)**. But companies that have been able to adjust and adapt thus far should continue to fare well.

Figure 2: Interest Rates, Europe vs. U.K.



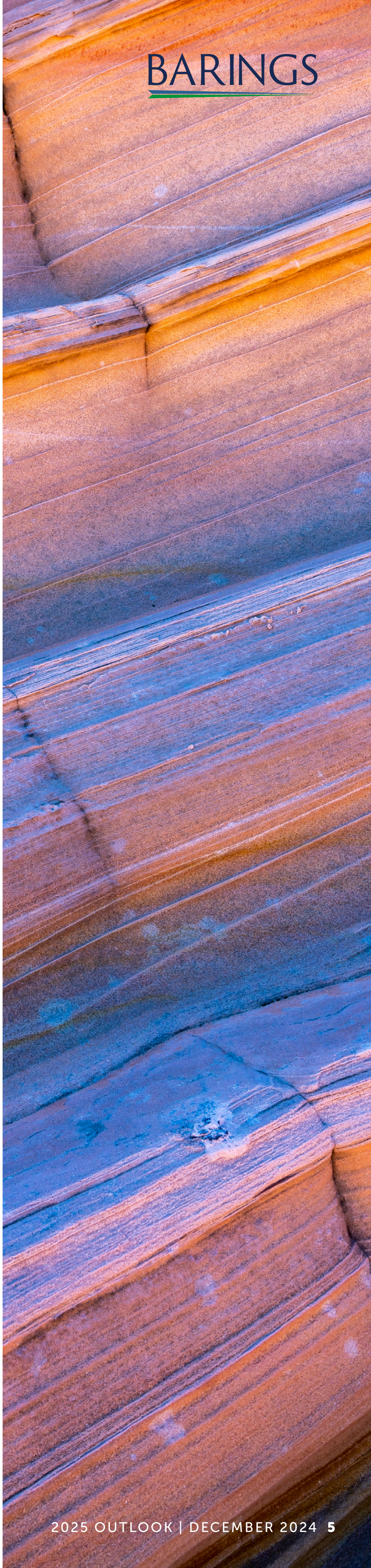
Source: Bloomberg. As of October 2024.

With regard to capital structure resilience, the vast majority of our lending is around a sponsor-led "buy-and-build" strategy, where capital structures are positioned for flexibility rather than simply to maximize leverage. In order to grow value, you have to be in a position where you can draw down a facility at a point in time when a company or sponsor wants to buy an asset, and that can be more challenging with a stretched balance sheet. That's a key benefit of the core middle market generally—capital structures tend to be more conservative, with value drivers coming from operational improvements and buy-and-builds, rather than leverage.

> "While a stronger M&A environment would certainly be positive, incumbency matters and will continue to drive significant origination and opportunity as sponsors grow their investments."

JUSTIN HOOLEY: I would add that the overall health of our portfolio companies is tied to our more conservative approach to lending. When we're looking at structures and deciding whether to lend to a company, one of the first and most important metrics we assess is the serviceability of the debt. Overall, we're fairly conservative in terms of what that looks like, with interest coverage of about 2.5x across our global portfolio—and that's under the assumption of a higher-for-longer rate environment.

In terms of APAC specifically, most companies have remained healthy, particularly in the sectors where we concentrate. Defensive sectors like education and health care have fared well, with companies exhibiting consistent corporate profits and strong interest coverage. Companies in these sectors also tend to have high cash flows and low capital expenditures, and demand tends to be less discretionary or price sensitive and therefore less impacted by changing economic conditions. Because the regions in APAC are smaller in size and less developed from a capital markets perspective, middle market companies also tend to be first or second in their fields and typically have dominant market share and the pricing power to pass along higher costs.



TYLER GATELY: Middle market companies in North America also appear to be on solid footing, overall, and there are a few key factors that we believe could influence portfolio performance going forward. One is the economic backdrop, and generally speaking, there are reasons for optimism on that front. While we do see pressure points, they tend to be idiosyncratic in nature. There isn't one significant trend or factor that we believe could result in massive degradation of the portfolio, and the middle market more broadly has proven to be quite resilient over time.

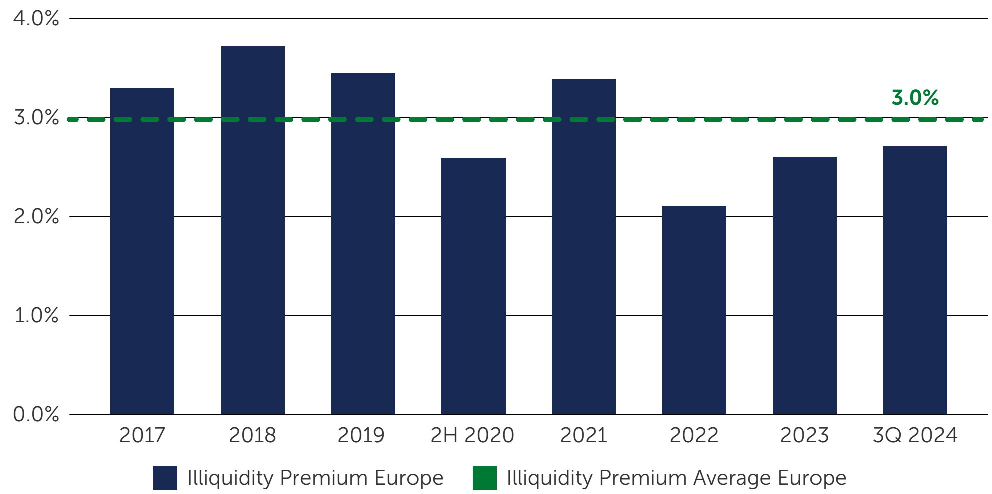
Another factor is how managers have structured their portfolios over the last several years. Recently, we have started to see a bifurcation in the market between managers who have positioned themselves conservatively and those that are experiencing more of a headwind from the effects that higher rates have had on their portfolio companies. Justin mentioned that the interest coverage for our global portfolio is around 2.0x to 2.5x—that compares to 1.2x to 1.6x for the middle market more broadly. To that end, our portfolio looks fairly conservative and should be well-positioned going forward.

JULIANNE RUSIE: In terms of the deals that are getting done today, what do terms and pricing structures look like, and how is that changing?

TYLER GATELY: Deal terms and structures depend largely on the part of the market where a manager is transacting. North America has the most developed direct lending market, and it's the most competitive landscape as well, with an influx of new managers having entered the market in recent years. These new entrants are contributing to a sense of heightened competition, although it may be better described as a convergence of what we refer to as "asset collectors" or "asset aggregators," which typically fall into one of two categories: smaller new entrants that lack the ability to scale or lead deals, or lenders that have continued to raise larger funds and face challenges when it comes to deploying at sufficient scale. Asset collection can lead to challenges when it comes to deploying capital, particularly in an environment where new M&A has been limited. As a result, many of these participants, which tend to focus on upper middle market assets, have consented to less favorable terms in order to secure a deal. Specifically, fees and spreads have come down in some of these transactions, with structures and documentation weakening as well. How can managers defend against that unnatural drift? To Stuart's earlier point, managers with large existing portfolios are arguably at an advantage, as they have the ability to continue sourcing differentiated opportunities and deploying capital in off-market transactions, even in a competitive environment. So, while competition has pushed structures and squeezed pricing, more established (and disciplined) managers have in many cases enjoyed a bit of shelter from broader market headwinds.

STUART MATHIESON: The situation is similar in Europe, in terms of the emergence of asset aggregators and the effect that has had on pricing and deal terms in certain parts of the market. In some larger private transactions that could be financed in the public markets, margins have compressed, with structures and documentation weakening as well. However, in the core or traditional middle market, terms have remained quite favorable. Middle market first lien senior debt tends to be more insulated from the risks associated with the growth of large private market deals. Documentation and covenant protections in this part of the market also tend to be more robust. The spread premium that the middle market has historically offered over broadly syndicated loans has remained compelling as well, despite spread compression. Historically, that premium has ranged from 200–400 bps, and while it is closer to 250–300 bps in Europe today, it's up from last year and overall yields remain attractive, in our view, considering where rates are currently **(Figure 3)**.

Figure 3: Illiquidity Premium vs. Broadly Syndicated Market



Source: Data represents 3 year discount margin (All-In Spread (DM-3) = [(fee/3) + spread + greater of floor or base rate) / (1 – fee)] - base rate) for both Barings and CS LL Index.

JULIANNE RUSIE: The increase in new entrants and heightened competition have gone hand-in-hand with the growth of the market overall, but is there a point when that becomes unhealthy or dilutive to returns?

TYLER GATELY: In North America, while it's true competition is increasing, deal flow is also consolidating around fewer, larger, and more stable managers. Five years ago, the top 20 private credit managers raised 35% of the capital. Last year, the top 20 private credit managers raised 70% of the capital.[1] In that context, new entrants are arguably less of a concern. Anecdotally, it's also been some time since we've seen a new firm in a deal. And that largely comes down to the fact that it's fairly easy for new entrants to compete in the upper part of the middle market, where they may take a $10 or $20 million allocation in a $2 billion deal. But under that type of scenario, you're rarely driving terms, which as mentioned, can ultimately have negative implications for LPs—not only from a return standpoint, but also in terms of documentation and structuring. So, with significant growth has also come greater consolidation, and there will be winners and losers on the back of that.

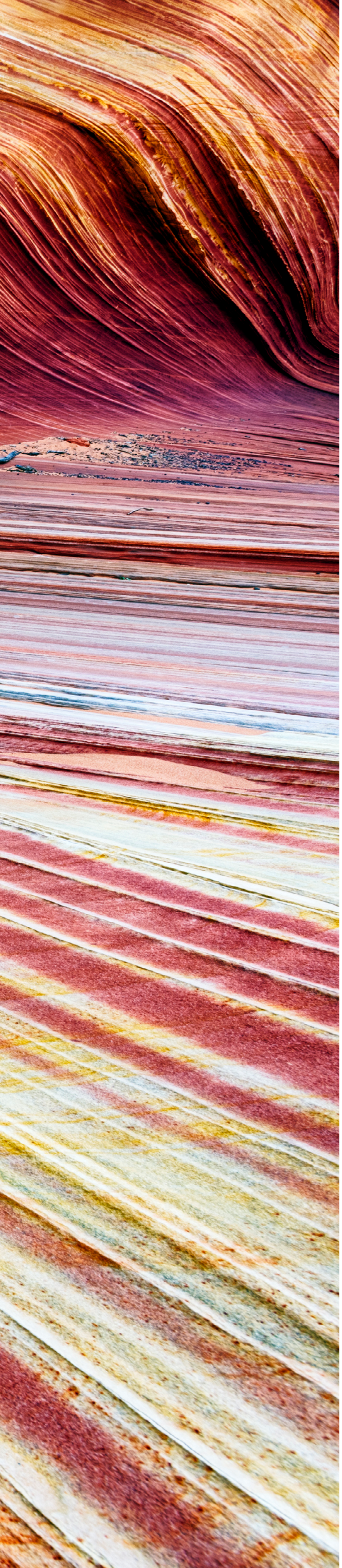
1. Source: Preqin. As of September 2024.

Another interesting consideration with regard to incremental future returns is how the capital bases behind new entrants have grown. Two capital suppliers in particular have experienced significant growth as more managers have entered the market: retail and insurance. The latter represents stable, institutional capital, where private credit is typically considered a long-term relative value play over syndicated markets. The retail capital base, on the other hand, while likely to continue growing, may also be more volatile. When yields peaked around 12%, direct lending was very appealing to retail investors, but what will that demand look like when yields retrace toward the tighter end of historical averages? Retail and insurance investors have very different views of relative value and the attractiveness of the market, and an overreliance on a more volatile investors base could have implications for certain managers going forward.

> "The APAC direct lending market is less mature than the U.S. and Europe, so the increased competition has actually been fairly advantageous."

JUSTIN HOOLEY: The APAC direct lending market is less mature than the U.S. and Europe, so the increased competition has actually been fairly advantageous. A decade ago, this market arguably wasn't large or deep enough to build standalone diversified portfolios. Rather, it was better-suited as a means of adding geographical diversification to a broader global allocation. But as the landscape has evolved and become more competitive, managers have found themselves in a better-position to present PE sponsors with more viable financing solutions, and to more meaningfully fill any financing gaps left by banks.

On the topic of returns, I would also point out that we invest in "developed APAC" markets, including Australia, New Zealand, Singapore, Hong Kong, Taiwan, Korea and Japan. We do not invest directly in emerging economies like China, India and Indonesia. We focus on developed APAC because the economies exhibit similar risk and return profiles as what we would expect to see from a core direct lending strategy in the U.S. and Europe. The regulation and bankruptcy laws in these countries are comparable to those in other developed markets as well, and the sovereign credit ratings tend to be similar to—or in some cases are better than—those in the U.S. and Europe.



BARINGS

> "Bank disintermediation is arguably still in the early stages, and as bank balance sheets continue to shrink, managers that can provide an expanded range of financing solutions will likely be at an advantage."

JULIANNE RUSIE: Our direct lending platform lends almost exclusively to sponsor-backed businesses. What are the insights you're observing and hearing from the sponsor community, and how does that impact the way you're thinking about the future?

TYLER GATELY: Sponsors are increasingly expressing an interest in doing more with fewer managers. Bank disintermediation is arguably still in the early stages, and as bank balance sheets continue to shrink, managers that can provide an expanded range of financing solutions will likely be at an advantage. The question going forward will be: how relevant can an asset manager be to a sponsor, not just in direct lending but also across tangential areas like real estate, infrastructure debt, private placements, portfolio finance, and others. Barings' platform is unique in this sense—we have a wide range of financing capabilities in-house that are fully scaled. Rather than pushing one or two solutions, we're building sector IQ and dedicated teams in each of these areas, making us more relevant to potential borrowers as we're able evolve with them, grow our relationship, and provide capital through a cycle.

STUART MATHIESON: I agree with Tyler, and would add that the discussions we're having with sponsors today aren't solely around their current financing needs, but also their future financing needs looking out two to three years. They are looking for strategic ways to add value and reduce their cost basis over time. For many, 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 as financing needs evolve. As Tyler alluded to, long-term financing needs can 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 partners to sponsors and source differentiated opportunities for investors.

This roundtable was adapted from our 2025 Direct Lending Outlook. Watch the full webinar here.

Barings is a $431+ billion global asset management firm that partners with institutional, insurance, and intermediary clients, and supports leading businesses with flexible financing solutions. The firm, a subsidiary of MassMutual, seeks to deliver excess returns by leveraging its global scale and capabilities across public and private markets in fixed income, real assets and capital solutions.*

LEARN MORE AT BARINGS.COM

**As of September 30, 2024*

24-4092868