EXPERT Q&A

An over-reliance on upper mid-market deals may leave some platforms exposed as liquidity dries up, warns Barings' Ian Fowler

Portfolio diversification is key to weathering the storm

Direct lenders, flush with fundraising success, became increasingly prone to striking $1 billion-plus deals during the post-covid boom. In recent months, however, market conditions have deteriorated significantly. Ian Fowler, co-head of global private finance at Barings, questions whether these lenders will be able to exit the mega-deals they entered into, given the absence of liquidity. But Fowler is more sanguine about the asset class as a whole. Firms that have focused on building a diversified mid-market portfolio, he says, are well positioned to emerge stronger from the looming downturn.

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Q At least until recently, we were seeing more upper mid-market deals. What was driving that trend?

While there does seem to be a pause on these larger deals right now, at a high level, the story has been about private credit disintermediating the lower end of the liquid market. Private credit has been attractive for the issuer because dealing with a direct lender, compared to getting credit from the liquid markets, tends to be faster, more efficient, and can offer greater certainty and allow the issuer to bypass rating agencies.

Direct lenders who have raised enormous funds logically have to move up-market to put that money to work. The window for investing that capital is usually between 18 and 36 months, and it's challenging to do that if you're financing traditional mid-market deals of $10 million to $50 million EBITDA. In the upper mid-market, you can put more money to work – that means more fees, which direct lenders like. It can also be more profitable, as deal costs for the direct lender are typically the same whether it's a $100 million deal or a $1 billion deal.

Q What is most attractive about the current market?

Volume has clearly been down this year, and the quality of deals has not been as attractive as it was last year. This largely reflects the headwinds facing markets, namely inflation and increasing interest rates, but also geopolitical risk.

However, on the positive side, for those platforms that have portfolios, while there is not much new platform activity, we are seeing a lot of M&A activity within the portfolio. This is why we think sponsored deals are more

attractive than non-sponsored deals in the current environment. With private equity-backed deals, you have the potential for an additional layer of protection against the risks in the market.

There is also some great origination as PE firms continue to do add-on acquisitions. In addition to enabling managers to put money to work, these add-on acquisitions are helping to bolster portfolio companies – they're essentially becoming bigger, stronger and more diversified.

Q And what are the risks?

Many direct lenders in the upper mid-market deals are using leverage to generate higher returns. As institutional lenders, banks are looking at the macroeconomic and geopolitical risks, some are scaling back and being more selective about which direct lenders to give capital to. In many cases, they're repricing facilities as well, which makes it more difficult for direct lenders to put money to work in deals at today's terms, when their cost of borrowing has gone up.

As a result, some lenders are experiencing capital issues. Whether they're out of capital or they can't use their capital because they can't generate the returns, the point is that they're not putting capital to work. We have seen situations where lenders have not followed through on commitments on deals or have materially changed the dollar amount they're willing to hold in deals.

Looking at these upper mid-market deals from a capital perspective, there has been a fair amount of recycling going on over the last three or four years, with sponsor-to-sponsor buyouts. This entails doing a deal and then getting refinanced out two or three years later, at which point the lender can recycle that money.

However, if firms are having capital issues on the back of doing some of these large transactions, there is very real potential for them to get stuck in the deals – until either the liquid markets reopen, or the headwinds fade and capital begins to flow back into the market so they can get refinanced out.

The question is whether the strategy of moving up-market is situational or sustainable, which we won't know until we go through a full cycle. For us, when we think about investing in this asset class, we focus on asset selection, underwriting, and portfolio management. But portfolio construction, and having good diversification, is equally important. One question to ask of these managers that have been doing some of the larger market deals, is how diversified their portfolios are – because if they are not well-diversified, and they experience issues, it will very likely impact returns.

Q How can LPs determine the best managers?

Investors can benefit from partnering with managers that take a more conservative approach and have a diversified portfolio. A manager's track record is also critically important. Beyond that, it's paramount to look at a manager's platform, and question whether it is sustainable through a cycle particularly given that there are not many platforms out there that have been tested by a conventional recession.

For instance, if a platform is having issues through the cycle, it may need liquidity or rescue financing, or it may be taken over. For stronger platforms, this can create opportunities to pick up portfolios and pick up people. At the end of the day, stronger managers look much better-positioned to survive through this dislocation, and many of the weaker ones will likely go away.

Q What is the outlook for private debt?

We believe that this asset class is, generally speaking, better situated for a downturn than it was before the last recession – if you have covenants. We are still strong believers in covenants. Many market participants point to the fact that covenant-lite transactions performed fine during the last recession. But the only deals that were cov-lite during that period were some of the top performing and highest rated broadly syndicated liquid loan credits.

It's a different story in the illiquid private markets, where covenants are a critical part of managing losses given that investors don't have the ability to sell out of assets. At the most basic, covenants give managers the ability to track the performance of a company. They also give lenders a seat at the negotiating table if a company runs into trouble, allowing lenders to exercise their rights and remedies in order to protect principal before it is too late. And at the end of the day, we haven't had a conventional recession to test the durability of cov-lite transactions in the illiquid markets.

Loan-to-value ratios are, on average, 40-50 percent right now, compared to 60 percent in the last recession. And the interest coverage ratio, on average, is around 3x-plus, versus being under 2x in the last recession.

Investors have to put their money somewhere. Private debt has historically been less volatile than the liquid markets, an attractive characteristic. In the middle market, because less capital is required, we are not as worried about getting out of deals. The duration of our deals should extend during the downturn – that's typical. But we're not as worried about getting our money back.

Now, if we're in an environment where the music has stopped for private equity firms in large deals – as well as for the direct lenders on those larger deals because capital is dislocated in a downturn – I don't know where the liquidity will come from to refinance those managers out so they can lock in their return and get their money back. Valuations may be adversely impacted for private equity firms and they won't want to sell their portfolio companies, leaving direct lenders with portfolios of large, bumpy investments through a cycle. ■