GLOBAL MID-MARKET

Maintaining discipline in a maturing credit cycle

With competition high and signs of mispricing of some assets, **Eric Lloyd** of Barings stresses the importance of a global and diversified approach to portfolio construction

Q What trends are you seeing in global mid-market private credit markets?
The most consistent trend we've seen is increased competition. Across Barings' global private investment platform, we saw strong volumes in the first half of this year in the US, Europe and developed Asia, but the amount of dry powder, or capital that needs to be put to work, also continues to increase. Those factors are leading to greater competition among direct lending capital providers.

As purchase prices stretch higher and leverage multiples rise, we have also seen documentation become a bit looser from a terms perspective. In this environment, it is critical for managers to maintain discipline. Rather than focusing on how much capital is being deployed this quarter or next quarter, we believe a focus on robust, long-term, through-the-cycle performance will be a big differentiator.


Eric Lloyd

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Q Are you seeing many new entrants into the middle-market space?
There are some new entrants in the market but, in many cases, their capital base and scale tend to be smaller than the more established participants. We are also seeing firms enter the market that have traditionally only played in liquid credit – they are not necessarily new entrants but they are new to our market. These firms tend to take more of a capital markets approach, working indirectly with private equity sponsors, usually through an intermediary. At Barings, we focus on directly originating assets primarily through private equity firms, a fairly different approach.

Q Is there investor confusion over the definition of this type of strategy?
Much of the terminology used in this market – private credit, direct lending, middle market, for example – is very general but can have materially different meanings. A middle-market strategy could mean unleveraged first lien assets with a high single-digit return, and it can also mean mezzanine, second lien, or even a special situations strategy, with a double-digit return.

For us, the first step is to understand how private credit fits within an investor's portfolio construction. For some investors, it may be an alternative to liquid non-investment grade credit. For others, it may be comparable to other illiquid strategies. The goal of the allocation within the context of the portfolio should help narrow the scope of where to invest on the spectrum of middle-market private credit investments.

Q Why are investors allocating to these strategies and what should return expectations be?
This is an illiquid asset class – it's not one you can dynamically change each week or month – so the first question for an investor is whether this is a core allocation. If the answer is yes, it's important to then consider what the investor is trying to

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achieve from a return perspective. Many investors turn toward this asset class for the potential credit spread or illiquidity premium versus the broadly syndicated bank loan and high yield bond market.

Today, the return component is very interesting. The return on a typical first lien, senior secured middle-market loan transaction is generally consistent with what we were seeing 18-24 months ago. However, on a US dollar deal, the proportion of the absolute return that is driven by the base rate has increased, while credit spreads have become compressed, and ultimately, credit spread is what is important.

In this environment, a global strategy that offers access for clients in their domestic currency, via a hedged share-class, can be particularly beneficial to investors. Choosing what currency to invest in can have a meaningful impact on returns. For an unleveraged, senior secured strategy targeting a high single-digit return, for instance, the currency component could mean a difference of one to two percentage points.

Q Where are we in the credit cycle and what are the implications of that?

Regardless of where we think we are in the cycle, and given the illiquid and longer-term nature of this asset class, we think it's important to underwrite every deal assuming there will be an economic and credit cycle during the life of that asset. Right now, we don't see anything that tells us the economic or credit cycle is coming to an end, but we are a long way into the recovery.

In this environment, we believe a well-diversified portfolio can help limit downside risk. It's hard to guess what the catalyst to the next downturn will be, or what industries will be most impacted, so it's important to look at the correlations of the assets and industries you're invested in and try to achieve portfolio diversification.

This is one area, among others, where a global strategy can be advantageous. In addition to the fact that a global strategy can diversify investors' exposure across different economies that go through cycles at different times, it can also offer investors access to a much wider opportunity set.

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Q How would you break down the opportunity set in the US, Europe and developed Asia?

The relative value of private credit investments tends to shift over time from region to region, depending on supply and demand dynamics. If you look back four years, returns for first-lien senior secured loans in Europe were generally more attractive than those in the US. Today, although first-lien leverage is a little higher in Europe than in the US, risk-adjusted returns are much more in line.

In terms of the more junior capital opportunity set, there has been no real development of a mezzanine or junior capital market in the European markets we operate in. In the US, we're seeing more second-lien opportunities as well as some mezzanine.

We continue to see select opportunities in developed Asia, although the market has become quite competitive compared to three or four years ago. We believe we have a strong team there, and the main takeaway is that as underlying market dynamics shift and change, it's important to be in a position to capitalise on relative value as it emerges.

Q How do you go about assessing the best relative value?

We never say to investors that they should only invest in this geography or that product; at Barings, we take an objective view of relative value and mispriced risk. One example of mispriced risk that we've seen is highly leveraged second-lien loans to companies on the smaller end of the spectrum, which should really be priced as mezzanine risk but often are not. Another example is some of the more deeply leveraged unitranche deals in both the US and Europe, in which the leverage is increased in order to meet the capital provider's required return, which increases the risk of the investment.

We take the opposite approach, investing our capital where we believe discipline is being maintained. If that means returns are slightly lower, we're fine with that – for us, it's about risk-adjusted returns.

Q How would you summarise the global mid-market opportunity today?

Given the current economic and credit environment, I would again emphasise the word "discipline". At Barings, we have a large team and deep platform that takes a disciplined and selective approach, a critical part of investing in an illiquid asset class like private credit. We truly believe that performance in this asset class is determined largely by avoiding mistakes, and that's about having the credit discipline and the willingness to say "no" when the opportunity isn't right. ■

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