Collectors vs. selectors & the growing presence of direct lending megadeals

Where does the direct lending market end and the broadly syndicated market begin? With the growing prevalence of mega direct lending deals, the answer is less straightforward than it was even a few years ago.

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Asset Collectors

There are a few key drivers behind direct lending's disintermediation of the lower end of the broadly syndicated market. For one, deal flow has continued to come down in recent years after peaking in 2021 around $1.2 trillion.[1] At the same time, M&A volume has also decreased. With less supply of deals in the market, and still-strong demand to invest, some managers have had to reconsider their approach to deploying capital.

One trend that has come about as a result is the rise of "asset collection." Asset collectors can include smaller lenders or new entrants to the market, which tend to be less experienced in originating assets. Often, the most cost-effective way for these managers to build portfolios is by purchasing small pieces of other managers' deals—and while this can result in diversified portfolios, it affords less influence over deal terms.

Asset collection also extends to the lenders in the market that have continued to raise larger and larger funds, in some cases upward of $10 billion. In the direct lending market, capital needs to be deployed over a set time period before it begins to weigh on returns. For lenders financing traditional middle market deals, this can pose a challenge—deploying tens of billions of dollars into deals in increments of $100-$200 million is both inefficient and difficult to execute in a timely manner. As a result, many managers have chosen to move up-market, ramping large funds by making bigger investments in upper (upper) middle market companies ($100+ million in EBITDA), rather than patiently deploying capital into more traditional middle market opportunities. For managers, executing these large transactions can certainly have advantages from a profit standpoint. But more often than not, there are implications for LPs, particularly around returns, documentation, and structuring.

One of the main implications of pursuing ever-larger deals is that direct lending managers are no longer competing only against other managers—they are also competing against market optionality. With deals of this size, borrowers often are in a position to choose between tapping public markets via broad syndication or raising funds through private markets in sole lender or club-style transactions. In some cases, this has resulted in lenders consenting to less favorable terms in order to secure a deal, leading to what is essentially public-market style documentation in a market that lacks public-market liquidity. In certain transactions, spreads have narrowed as well, inching closer to those in liquid markets—meaning the premium that has traditionally stemmed from the illiquid nature of the direct lending market has in some cases begun to fade.

Not All Covenants Are Created Equal

Compounding this, financial maintenance covenants have become more diluted in the upper part of the middle market. Technically speaking, covenants in some form exist in almost all debt transactions. However, there is an important distinction between covenants that "check the box" and financial maintenance covenants that can help ensure a company's performance issues are well-telegraphed. Specifically, financial maintenance covenants give managers a way to not only track a company's performance, but also test its financial health to ensure it is complying with specified performance metrics. In the event that performance falters, financial maintenance covenants also ensure that lenders have a seat at the negotiating table and the ability to exercise their rights and remedies to proactively protect principal.

Asset Selectors & The "True" Middle Market

Amid the growing prevalence of upper (upper) middle market deals, there is a strong case to be made for "asset selection" and remaining disciplined in the traditional middle market. While this segment of the market has stayed largely out of the limelight, it continues to offer strong potential for attractive risk-adjusted returns, particularly in the more conservative parts of the capital structure.

Traditional, mid-market, first lien senior debt has been relatively insulated from some of the risks associated with the growth of large private market deals. Leverage in this area of the market has remained modest, for instance, while documentation and covenant protections tend to be more robust. Historically, private middle market loans have also offered a premium of roughly 200-400 bps over broadly syndicated loans—stemming from the illiquid nature of the market as well as the value that the asset class provides to sponsors via flexible and tailored financing solutions.[2] Today, while that potential premium is closer to 150-200 bps, it remains favorable relative to the 0-100 bps premium typical of the upper (upper) middle market.[3]

Accessing the Opportunity

When it comes to accessing the opportunity in the traditional middle market, experience, scale, and a longstanding presence are key differentiators. A stable and permanent capital base, particularly one aligned with a large and diversified portfolio of invested assets, can also provide an advantage, enabling managers to continue deploying capital at attractively priced opportunities, even if (or as) deal volume fluctuates. Often, the most attractive deals from a risk/return perspective are add-on transactions, where managers have an existing relationship with a company and sponsor who need additional capital to fund the next leg of their growth journey. In this respect, lenders with a large book of portfolio companies look particularly well-positioned given their ability to continue investing in new originations through portfolio M&A activity.

The benefits of a "buy-and-build" investment thesis extend to PE sponsors as well, offering them a strategic way to add value and reduce their cost basis with add-ons at lower purchase price multiples. Increasingly, 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 (and especially) as financing needs evolve and change.

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[1]Global LBO deployment, excluding add-ons. Source: Pitchbook, Global Private Debt Report (2023). [2]Source: Based on historical market observations. [3]Source: Based on Barings' current market observations.

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