Alternative Credit: Let the Circle Be Unbroken

Although middle market direct lending volumes have firmed relative to a moribund 2022–23, easier financial conditions have yet to unleash the massive wave of mergers and acquisitions (M&A) activity needed to truly open the floodgates.

Shifting market dynamics in recent years highlight the importance of flexibility in a nonbank capital provider. Not only are nimble lenders able to deliver creative financing solutions to borrowers across liquidity environments, they also may be well positioned to provide investors with differentiated and complementary sources of return by leveraging the countercyclical interplay between directly originated loans and asset-based loans.

Even as competitive pressures have eroded negotiating power on larger cash flow-based loans, lower middle market borrowers continue to represent a sweet spot for lenders, in our view, particularly if they have a private equity sponsor. Meanwhile, asset-based loans—which are secured by specific collateral of the borrower—remain what we consider an all-weather source of competitively priced funding for asset-rich but cash-constrained companies. Private lenders able to offer exposure to multiple financing solutions may help drive attractive risk-adjusted returns for investors.

KEY TAKEAWAYS

- Though the volume of large M&A transactions has remained muted, lower middle market companies—particularly those businesses with private equity sponsors—may represent a sweet spot for nonbank lenders.
- ABL facilities have long served as an all-weather financing option for asset-rich but cash-constrained companies whose access to traditional capital market channels is often limited.
- Given the low correlation between direct lending and ABL returns, lenders with the experience and flexibility to opportunistically toggle between the two may be positioned to potentially provide investors with complementary sources of return across credit cycles.
- The ability to provide borrowers with flexible lending solutions while maintaining disciplined underwriting standards underpins consistent access to deal flow and may help drive attractive risk-adjusted returns for investors.

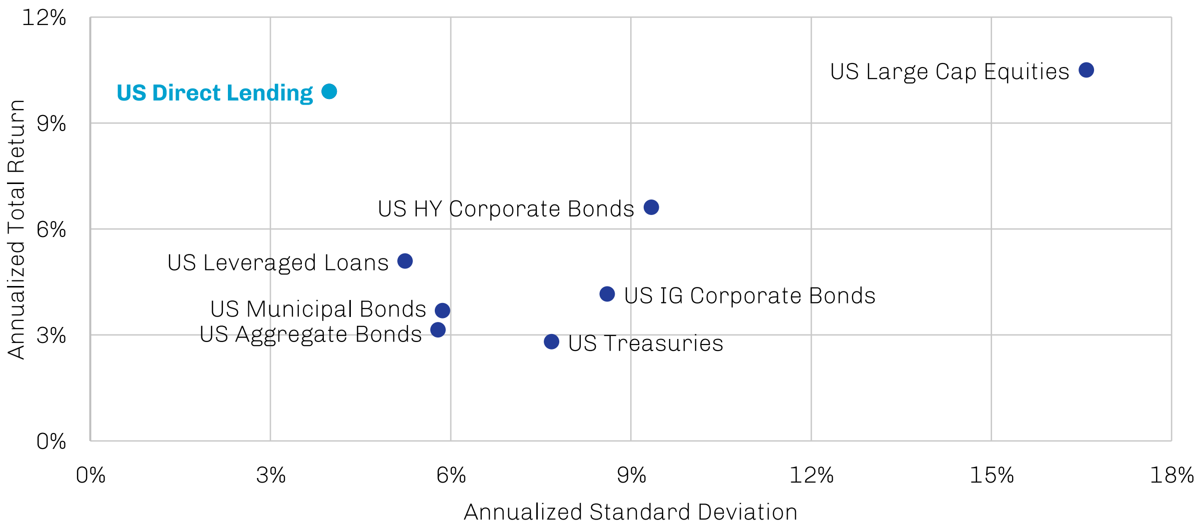
The Lower Middle Market Direct Lending Trifecta: Yield, Leverage and Structure

Unrated and without a secondary market, middle market loans offer investors complexity and illiquidity premia alongside credit premia, risks that can potentially be mitigated through vigorous underwriting and structuring. Typically positioned at the top of the borrower's capital structure, these senior-secured loans provide lenders first recourse on the borrower's assets in case of default/restructuring, and a conservative loan-to-value ratio—often 30–50%—seeking to provide a substantial equity cushion. Strong documentation and traditional financial covenants are standard, and a floating interest rate minimizes duration risk. Additionally, directly originated senior-secured loans historically have exhibited low to negative correlations with traditional fixed income and only moderate correlation to equities, as shown in Exhibit 1, offering potential portfolio diversification benefits.

> Direct lending in the lower middle market can provide private lenders and their investors the potential for an attractive combination of yield, leverage and structure.

Exhibit 1. Private Credit Can Provide Attractive Risk/Reward Characteristics and Potential Diversification Benefits

Annualized Total Return per Unit of Risk, January 2005 through March 2024



Correlation, January 2005 through March 2024

	US Treasuries	US Aggregate Bonds	US IG Corporate Bonds	US HY Corporate Bonds	US Large Cap Equities
US Direct Lending	-0.51	-0.16	0.22	0.74	0.68

Note: US Direct Lending = Cliffwater Direct Lending Index; US Leveraged Loans = Morningstar LSTA US Leverage Loan Index; US Treasuries = ICE BofA Current 10-Year US Treasury Index; US Aggregate Bonds = Bloomberg US Aggregate Bond Index; US Municipal Bonds = Bloomberg Municipal Bond Index; US IG Corporate Bonds = Bloomberg US Corporate Bond Index; US HY Corporate Bonds = Bloomberg US Corporate HY Bond Index; US Large Cap Equities = S&P 500 Index.

Source: Bloomberg, Cliffwater, Morningstar; data as of March 31, 2024. Index definitions are on final page.

While competitive pressures in recent years have eroded lenders' negotiating power on larger loans, we believe lending to the lower middle market—companies with annual EBITDA (earnings before interest, taxes, depreciation and amortization) of $5–$50 million—may represent a sweet spot, particularly those businesses with private equity sponsors. Direct lending in the lower middle market can provide private lenders and their investors the potential for an attractive combination of yield, leverage and structure, while smaller deal sizes facilitate diversification across borrowers and industries. In addition, such loans tend to facilitate greater access to management teams, allowing for more comprehensive due diligence by lenders as well as closer collaboration that can help contain default exposure and maximize recoveries during challenging times.

Asset-Based Lending: Differentiated Return Profiles Secured by Pledged Collateral

Asset-based lending (ABL) facilities have long represented a differentiated, if somewhat unheralded, source of return in a private debt portfolio and a strong complement to traditional loans, given the low 0.25 correlation between the two.[1] Borrower demand for financing via ABL has grown in recent years as retrenchment in bank lending and reduced investor appetite for certain types of credit assets have predominated, thanks to tightening liquidity conditions and asset impairments that accompanied the onset of the Fed's rate-hike cycle in early 2022.

> Asset-based lending facilities represent a differentiated, if somewhat unheralded, source of return in a private debt portfolio and historically have been a strong complement to traditional loans.

The traditional middle market loans referenced in the previous section typically are underwritten based on an assessment of the borrower's cash flows and governed by a range of maintenance covenants tied to those cash flows; asset-based loans, in contrast, are secured by specific assets of the borrower and feature provisions designed to maintain collateral coverage and loan-to-value ratios. Providers of ABL facilities seek to generate attractive returns while taking advantage of market dislocations and transitions within companies or industries.

As a result, collateral is the primary focus of lenders' initial ABL underwriting and ongoing oversight. Valuing collateral on the basis of net orderly liquidation value (NOLV) rather than current fair-market value can provide lenders an element of risk mitigation, as can a focus on collateral assets expected to retain value across a range of economic conditions. Loan term sheets outline frequent and detailed monitoring requirements for collateral, along with a variety of triggers intended to mitigate downside impact and keep the loan within formula. While liquidating collateral assets is an option for a nonperforming loan, it typically is a last recourse; backed explicitly by assets that are expected to retain value and bolstered by tightly structured loan terms that preserve the lender's interests, ABL facilities historically have had low loss-given-default rates.

Borrowers in the ABL space often are companies that have high working-capital needs and substantial assets but sometimes inconsistent or seasonal cash flows, such as retailers that maintain large inventories or industrials renting high-capex equipment. With limited access to more traditional capital market channels as a result, these borrowers often turn to ABL for competitively priced funding for a variety of purposes, from expanding their senior debt capacity, to monetizing assets while retaining control of them, to serving as a source of acquisition capital for a private equity sponsor.

1. Source: Nomura Capital Markets; data as of September 30, 2024.

Nimble Providers Can Potentially Benefit from the Countercyclical Interplay between Direct Loans and ABL

Given the low correlation between direct lending and ABL, comprehensive lenders able to offer borrowers both cash flow-based loans and ABL facilities may be well positioned to provide their investors with differentiated, complementary sources of return throughout credit cycles.[2]

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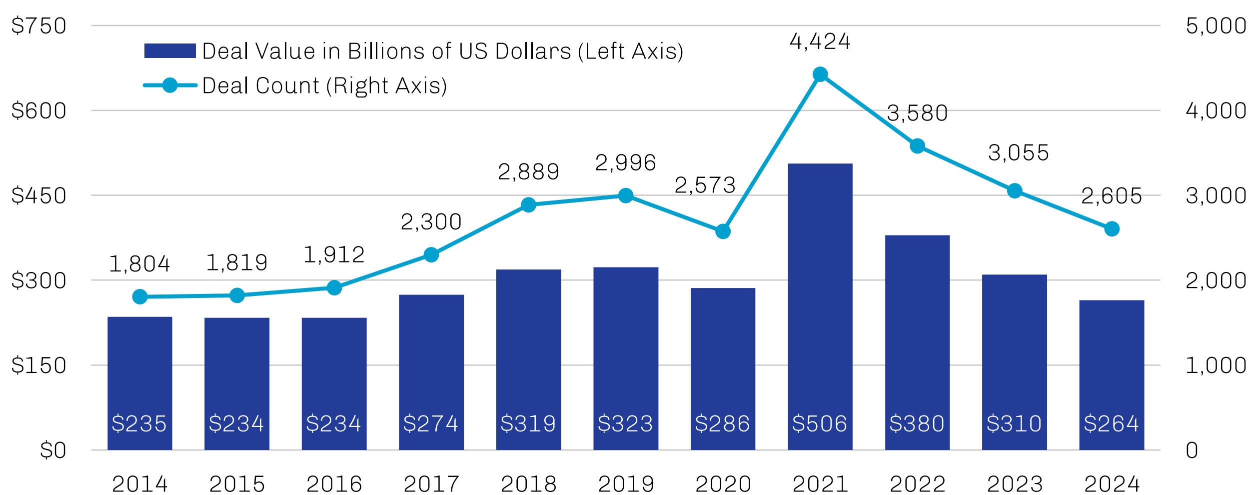
M&A activity—the primary driver of lending volume across the middle market—slowed considerably in conjunction with the start of the Federal Reserve's rate-hike cycle in early 2022, as shown in Exhibit 2. With the central bank now having turned to rate cuts as it continues to negotiate a soft landing for the economy, and interest rates having receded in response, a rebound in M&A activity could be a potential tailwind for direct lending demand in 2025, particularly as private equity sponsors eventually unleash $2.7 trillion in dry powder.[3] Though improved from the low levels of 2022–23, the rebound in M&A activity was somewhat muted in 2024, and refinancings have underpinned demand for lower middle market direct loans.

Exhibit 2. Decreased Private Equity Deal Flow Has Weighed on Direct Lending Volumes

US Private Equity Middle Market Deal Activity, 2014 through September 2024



Source: Pitchbook | LCD; data as of September 30, 2024.

Although the need for ABL facilities is persistent, demand strength historically has been countercyclical to direct lending; borrower interest in ABL tends to increase when rates rise and cash flow-based loans become less affordable or accessible. While stricter requirements for cash-flow loans are the norm during periods of economic uncertainty or tightening credit—as tougher credit standards challenge coverage ratios and other credit metrics—the backstop of collateral may allow ABL providers to take advantage of attractive risk-adjusted opportunities, a dynamic that was particularly evident in the aftermath of 2023's regional bank failures.

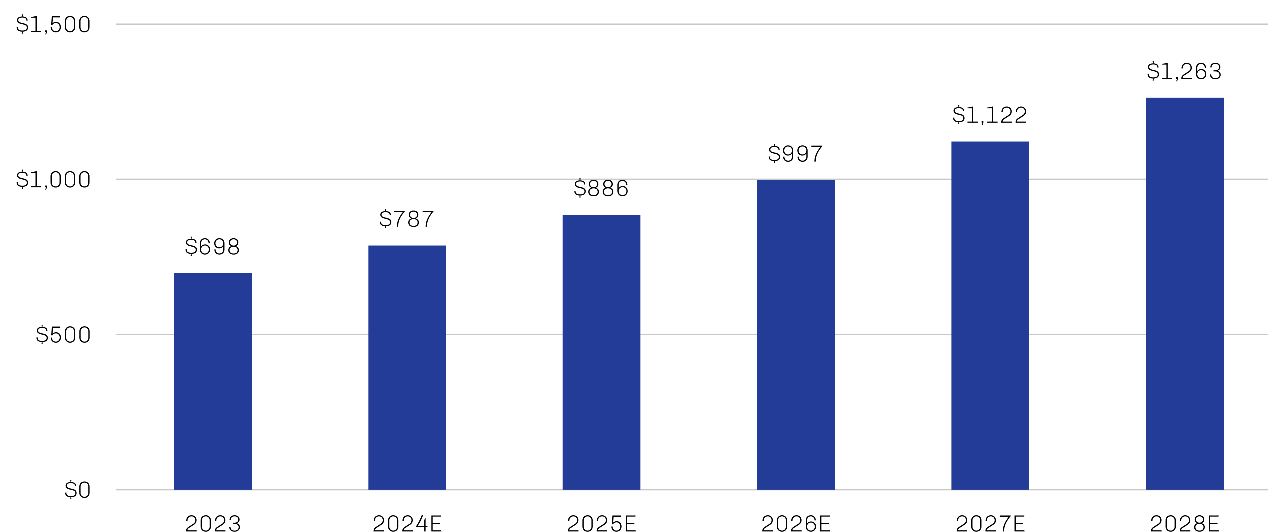
2. Source: Preqin, Cliffwater; data as of December 31, 2024.
3. Source: Pitchbook | LCD; data as of September 1, 2024.

While the direct lending market awaits a resurgence in M&A activity to fuel a significant pickup in demand, ABL facilities serve as what we consider an all-weather alternative financing option for asset-rich but cash-constrained companies. As shown in Exhibit 3, ABL activity has picked up in recent years as higher rates have weighed on direct lending origination, and demand for these facilities is projected to grow at a 12.6% compounded annual rate between 2023 and 2028.

While the direct lending market awaits a significant pickup in demand, ABL facilities serve as an alternative financing option for asset-rich but cash-constrained companies.

Exhibit 3. Demand for ABL Is Expected to Increase Through the Decade

Projected Size of Global Asset-Based Lending Market in Billions of US Dollars, 2023 through 2028



Source: EvaluServe; data as of December 31, 2024.

In our view, the playing field for experienced, disciplined ABL providers is wide open. Regional and midsized banks—traditional providers of ABL facilities to middle market borrowers—remain highly selective and risk-averse following the regional bank failures of 2023, and in many cases are more focused on their liquidity profiles and capital reserves than on writing new business. Meanwhile, $2.2 trillion of commercial real estate loans, anticipated to come due by 2027, could create an additional source of demand for financing options.[4]

4. Source: S&P Global; data as of August 19, 2024.

Underwriting and All-Weather Relationships Underpin Success in Private Credit

A successful, full-cycle lender must be creative and flexible—toggling between cash-flow loans and ABL as risk-adjusted opportunity dictates. Committed capital, with the promise of certainty to close, is a prerequisite. Beyond that, true success in the lower middle direct lending and ABL markets ultimately comes down to quality underwriting, loan structuring, portfolio composition and relationships.

> A lender able to provide flexible financing solutions across credit cycles may drive attractive risk-adjusted returns for some investors.

In direct lending, creditworthiness can reliably be found in borrowers with stable historical earnings, strong cash flows and, ideally, private equity sponsorship, often in growth industries with resilient businesses and deep management insights into broader industry trends. A first-lien position in the borrower's capital structure—complemented with financial covenants—provides potential mitigation of idiosyncratic risk.

ABL facilities usually focus first and primarily on the collateral available to secure the loan, with all other considerations flowing from there. While the highly structured nature of ABL is a key element of risk management, it is also a double-edged sword; while disciplined underwriting, proper controls and diligent monitoring can mitigate potential loss, the complexity of these tasks can expose inexperienced lenders to considerable risk.

In the final analysis, lending—whether through traditional cash flow loans or ABL facilities—is a collaborative activity, and the "all-weather" relationships that prove most durable are those that enable borrowers to thrive and grow their companies when conventional sources of capital may be scarce. A lender able to provide flexible financing solutions across credit cycles—without compromising their underwriting standards—may solidify relationships with borrowers and support consistent access to deal flow in pursuit of attractive risk-adjusted returns for their investors.

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Risk Disclosures

All investments involve the risk of loss of principal.

Diversification does not guarantee investment returns and does not eliminate the risk of loss.

Alternative investments can be speculative and are not suitable for all investors. Investing in alternative investments is only intended for experienced and sophisticated investors who are willing and able to bear the high economic risks associated with such an investment. Investors should carefully review and consider potential risks before investing. Certain of these risks include:

- Loss of all or a substantial portion of the investment;
- Lack of liquidity in that there may be no secondary market or interest in the strategy and none is expected to develop;
- Volatility of returns;
- Interest rate risk;
- Restrictions on transferring interests in a private investment strategy;
- Potential lack of diversification and resulting higher risk due to concentration within one of more sectors, industries, countries or regions;
- Absence of information regarding valuations and pricing;
- Complex tax structures and delays in tax reporting;
- Less regulation and higher fees than mutual funds;
- Use of leverage, which magnifies the potential for gain or loss on amounts invested and is generally considered a speculative investment technique and increases the risks associated with investing in the strategy;
- Carried interest, which may cause the strategy to make more speculative, higher risk investments than would be the case in absence of such arrangements; and
- Below-investment-grade loans, which may default and adversely affect returns.

Definitions

Asset-based lending (ABL) is corporate borrowing supported by specific assets of the borrower rather than its cash flows.

Direct lending refers to a loan agreement between a borrower and single lender or small group of lenders. Direct lending can also be referred to as “private credit” or “private lending.”

Dry powder is the amount of committed but unallocated capital a private equity fund has available to invest.

Loan-to-value ratio (LTV) compares a loan amount to the estimated value of the asset being financed.

Senior secured loans are commercial loans that have the highest priority claim on a borrower’s assets in the event of a default.

Standard deviation is a statistical measure of volatility that captures the degree to which an investment’s price has deviated from its average over time.

Indexes are unmanaged and one cannot invest directly in an index.

Bloomberg US Aggregate Bond Index (Gross/Total) measures the performance of the investment grade, US dollar-denominated, fixed-rate taxable bond market in the US, including Treasuries, government-related and corporate securities, fixed-rate agency MBS (agency fixed-rate and hybrid ARM passthroughs), ABS and CMBS. A total-return index tracks price changes and reinvestment of distribution income.

Bloomberg US Corporate Bond Index (Gross/Total) measures the performance of investment grade, fixed-rate, taxable corporate bond market. It includes US dollar-denominated securities publicly issued by US and non-US industrial, utility and financial issuers. A total-return index tracks price changes and reinvestment of distribution income.

Bloomberg US Corporate High Yield Bond Index (Gross/Total) measures the US dollar-denominated, high yield, fixed-rate corporate bond market. Securities are classified as high yield if the middle rating of Moody’s, Fitch and S&P is Ba1/BB+/BB+ or below. A total-return index tracks price changes and reinvestment of distribution income.

Bloomberg US Municipal Bond Index (Gross/Total) measures the performance of the US municipal tax-exempt investment grade bond market. A total-return index tracks price changes and reinvestment of distribution income.

Cliffwater Direct Lending Index (Gross/Total) is an asset-weighted index of US middle market direct loans. A total-return index tracks price changes and reinvestment of distribution income.

ICE BofA Current 10-Year US Treasury Index (Gross/Total) measures the performance of US Treasury securities with a remaining maturity exceeding seven years and less than or equal to 10 years. A total-return index tracks price changes and reinvestment of distribution income.

Morningstar LSTA US Leveraged Loan Index (Gross/Total) is a market value-weighted index that measures the performance of the US leveraged loan market. A total-return index tracks price changes and reinvestment of distribution income.

S&P 500 Index (Gross/Total) measures the performance of 500 of the top companies in the leading industries of the US economy and is widely recognized as a proxy for the US market as a whole. A total-return index tracks price changes and reinvestment of distribution income.

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