PGIM PRIVATE CAPITAL

DIRECT LENDING AND THE SHIFT TO NON-SPONSORED DEAL FLOW

Traditional models of how companies raise capital have been substantially disrupted in recent years. The impact of the global financial crisis and the advent of enhanced rules and regulatory requirements lessened banks' ability (and willingness) to issue loans to small and mid-size companies, and the result has been a rapid ascent of direct lending.

Middle-market companies typically don't have access to the same depth of capital market solutions as do larger companies, and the GFC helped change the face of leveraged mid-market lending from one driven largely by banks to one that is now dominated by non-bank, institutional lenders. Those lenders have a longer-term, more asset-driven approach to underwriting risk, so the relative market share for direct lending and non-bank investors will likely increase over time, particularly if the economy continues to slow.

While many smaller companies have not yet utilized direct lending, when they do it's usually for a handful of purposes, including growth, recapitalizations, acquisitions, sponsored leveraged buyouts, and non-sponsored management buyouts. "Sponsored" can be a financial investor, commonly a private equity fund, while "non-sponsored" may be a family owner or management team.

Typically, the agenda of the company, the strategy, the timeline to achieve that strategy, and the financial leverage to help achieve it are driven by the ownership. Sponsored private equity funds have a more finite horizon with a return over a three- to five-year period, so financial leverage is important to generating return expectations over that period. Non-sponsored-owned companies, on the other hand, typically have a more permanent or longer-term horizon.

"Where I see a lot of opportunity is in the non-sponsored world, because as we head into a potential recession—or at least an economic slowdown—if the banks start getting tighter again you can find good opportunities calling on companies directly," said Dianna Carr-Coletta, Managing Director and Partner in PGIM Private Capital's Alternatives Direct Lending Group.

Of the hundreds of thousands of mid-market firms in the US and Europe, only a small portion are involved with private equity firms. The non-sponsored side makes up most of the rest. While these smaller firms do potentially present some company and credit risks, direct lenders in this segment are able to be selective about the companies they lend to, and having an enduring track record with these businesses allows lenders to identify and mitigate those risks.

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"The lower middle-market companies that aren't sponsor-owned have not accessed the direct-lending market to the same extent PE-sponsored firms have," Carr-Coletta said. "There are tons of these companies out there, and while most are being serviced by their banks, some may need to take on a capital project and lever up a bit more. For a firm like ours that has been talking to them for years through our regional office network, we may be able to help them and provide the capital their banks may no longer be able to provide."

Direct lenders with a willingness to build relationships with owners, understand their business strategy and carry out bespoke underwriting—with specialized covenants and custom terms—can create attractive debt solutions. Experienced teams with strong track records through multiple credit cycles can deliver more consistent investment performance. That's even more true should the economy experience the slowdown many are expecting. For borrowers who have seen their floating-rate interest rates move from the mid-7% range to above 10%—particularly those who may not have had a financial cushion to begin with—there will be pressure.

The investment philosophy of PGIM Private Capital, established nearly 100 years ago, is straightforward: it views its business through a long-term lens, leveraging its scale, relationships and experience while providing a consistent investment process.

"We tend to do well when there is a bit of disruption in the markets because we've been very consistent in our underwriting strategy and how much we will push when it comes to leverage," Carr-Coletta said. "There are others in the market that don't do that. And given the relationships we have with these companies, if they are going through a rough patch, we're at the table with them, working through the issues. That happened in 2008-2009, when companies couldn't find liquidity and we were there for them, and we may experience a similar environment if we enter a significant downturn in 2023."

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