OPPORTUNITIES EMERGING FROM THE M&A SLOWDOWN

It was a slow year for mergers and acquisitions in 2023. By some estimates, global M&A deal volume was down by roughly 14% from the year before—just one domino to fall as financial markets and the broader economy felt the effects of higher interest rates.[1] But economic uncertainty only underscores the benefits of making allocations toward direct lending and mezzanine debt. Investors will find the current environment to be an attractive entry point, and more opportunities will likely reveal themselves as M&A and refinancing activity begin to thaw.

Direct lending and mezzanine present a strong investment case across economic cycles, offering greater flexibility, less volatility than public credit markets, and direct dialogue with companies that provides the opportunity to help management teams navigate a variety of business environments. In the current cycle, these characteristics are particularly attractive. From a borrower's perspective, direct lending and mezzanine are more compelling alternatives during a period in which senior debt capacity has dried up and higher rates have closed the price gap with other lending options. Businesses are looking for patience and flexibility in the current environment, creating a competitive edge for firms that develop strong relationships with owners. When dislocation and uncertainty dominate, private credit is a compelling option for both borrowers and asset allocators.

Looking beyond the headlines on the lack of large LBO deals, investors can find opportunities in direct lending and mezzanine solutions that are built to weather a cooler M&A market through a reduced reliance on sponsored deals and a focus on the middle market, where M&A activity has been more resilient. Geographic diversification is also an important consideration, given the varied dynamics between dealmaking activity across different regions. Having a selective approach, close relationships with borrowers, and a regional network with local expertise can help direct-lending and mezzanine providers craft resilient debt solutions.

"We've developed our strategy to combat this market environment because of how diversified we are in terms of the types of deals that come through the funnel," said Anthony Ma, Vice President in PGIM Private Capital's Direct Lending Group.

The M&A slowdown in 2023 presents a strong entry point for investors with dry powder. Debt markets face

1 Boston Consulting Group, M&A Is Looking Up After Bottoming Out (August 2023) https://www.bcg.com/publications/2023/m-and-a-outlook-looking-up-after-bottoming-out

a recalibration as interest rates settle into a higher-for-longer pattern and the economic backdrop becomes more challenging. There will be pressure on the sponsored side to exit, which will likely spur more activity in 2024 than the year before.

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The direct lending market has already begun to show signs of adjusting to the new rate outlook with EV multiples coming down. Meanwhile, given how quickly interest rates climbed, lenders are seeing more stress among the companies in their portfolios and are therefore becoming more disciplined about their credit underwriting. A resurgence in deal flows is likely to coincide with stronger underwriting discipline on the mezzanine side as well, laying the foundation for a market that more closely resembles the post-GFC years when leverage and valuations were down—a strong environment for lenders to put money to work.

"These are challenging markets for borrowers to navigate their businesses, but the broader uncertainty tends to create strong opportunities for mezzanine investors and our LPs," said Eric Seward, Managing Director and Co-Managing Partner at PGIM Capital Partners.

Big maturity walls in 2024 and 2025 suggest that corporate debt markets will be more active in the coming years. This creates a potential spillover effect for private credit, which has captured a larger share of the market for sponsored deals. Meanwhile, large banks have retreated from lending markets since the GFC, with private credit filling the void. Regional banks are under pressure as well due to valuation markdowns on existing assets.

Roughly one-quarter of leveraged loans are up for refinancing this year, and rates have risen dramatically since the last time many borrowers tapped credit markets. Mezzanine lenders that work with good companies in bad balance sheet situations can offer a more patient refinancing option for businesses that are facing challenges solely due to a higher cost of interest. More of these situations will reveal themselves should macro headwinds intensify.

With maturity walls approaching and interest rates up, companies are changing the way they look at their capital structures going forward. Direct lending and mezzanine are well positioned to capitalize on demand for flexible debt solutions in this environment. As the M&A market thaws, additional opportunities will arise for asset allocators looking to deploy capital across private credit markets. Investors will benefit from working with asset managers that can offer diversification beyond sponsored deal flows and uncover deals that would otherwise remain off the radar.

"We've been investing in this asset class across many different economic and geopolitical cycles, and pursuing consistent returns for investors," Seward said. "Most investors are seeking diversification of risk-return and unique sourcing. I think those attributes are competitive advantages for us."

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