BARINGS CONVERSATIONS

December 2018

SEEKING VALUE IN TODAY'S PRIVATE CREDIT MARKET

*This piece was adapted from an interview with Eric Lloyd. The full audio podcast can be found here.**

IN THIS Q&A, BARINGS' ERIC LLOYD DISCUSSES HIS TEAM'S APPROACH TO NAVIGATING THE RISKS AND CAPITALIZING ON THE OPPORTUNITIES ACROSS THE GLOBAL PRIVATE CREDIT MARKETS.

ERIC LLOYD
HEAD OF GLOBAL PRIVATE FINANCE

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Private credit, or middle market lending, has many different names. How does Barings define the asset class?

At the most basic level, we're investing in and lending to companies that are too small to access the liquid capital markets but large enough that they need capital for growth. At Barings, we consider private credit to be a global asset class, and we have offices around the world to accommodate that. Of all the regions in which we invest, the U.S. middle market is the largest and most developed. In Europe, private credit is a somewhat newer phenomenon.

The size of the companies in this space can differ by region, depending on the manager. While some managers may consider the middle market as consisting of companies with $2–$10 million of earnings, others view middle market companies as those with up to $100 million of earnings, or even more in some cases. For us, a U.S. or European middle market company is one with $10–$50 million of earnings. In Asia, middle-market companies tend to be a little bit larger, as the capital markets in that region are less developed relative to Europe and the U.S.

What types of opportunities can private credit offer investors from a risk-reward standpoint, and how can those change over time or from region to region?

Private credit transactions can be structured to offer a range of risk-adjusted returns and yields through allocations to different parts of the corporate capital structure. For instance, senior secured loans, which sit at the top of the capital structure, have historically delivered returns ranging from 6%–8%.[1] Mezzanine/junior capital, on the other hand, has historically looked attractive for its potential to deliver higher average returns—typically from 10%–15%[1]—with lower volatility than some public market asset classes.

When investing in private credit, it is important to keep in mind that value shifts over time—there will be times when mezzanine is more attractive than second-lien and there will be times when second-lien is more attractive than mezzanine. Other times, first-lien may be the most attractive. Against this backdrop, we believe a flexible approach is prudent, as it can give managers a holistic view of where the best relative value is at any given time.

*Full podcast URL: https://www.barings.com/podcast/assessing-todays-private-credit-landscape
1. Based on Barings' market observations. There is no guarantee that stated returns will be achieved. As of October 2018.

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A flexible approach can also benefit borrowers, which in our case refers primarily to private equity firms. If a private equity firm is acquiring a company, for example, there may be benefits to working with a manager than can structure that company's debt in many ways—from a first-lien piece of debt with mezzanine below it or a first-lien piece with a second-lien behind it.

This flexibility also allows a manager to structure the debt based on the private equity firm's plan for the company. If it's an acquisition strategy, the debt structure requirements will likely be different than if the strategy is to quickly pay down debt, for instance.

The bottom line is that this isn't a one-size-fits-all asset class, and we believe that having a more diverse opportunity set allows us to better accommodate both investors and borrowers.

There has been a lot of discussion around the increased competition in this market and how that might impact potential returns. Can you talk about competition, and how you're looking at returns across the U.S. and Europe?

In terms of competition, we've definitely seen an increase over the last several years. There has been a large amount of institutional capital raised in the asset class, and the supply of M&A volume has not increased at the same rate. This equates to more capital chasing the same amount of deals, and the creation of a supply/demand imbalance that has led to a generally more challenging environment. That's not to say there aren't attractive opportunities—it just means managers have to work harder and source more opportunities to get the same amount of volume.

While competition is fairly high across the globe, there is some variation from region to region. As a global manager, we frequently hear questions about whether Europe is more attractive than the U.S., or vice versa. In our view, the relative value of one region versus another depends largely on what currency an investor is invested in. If you compare the U.S. and Europe, while absolute returns are pretty similar, the composition of the returns is actually quite different. With this asset class, returns are made up of two components—the base rate and the credit spread. Today, the credit spread makes up a much higher percentage of the return in Europe because base rates in the region are so low. In the U.S., credit spreads are lower but the base rate is higher. As a result, on balance, we think Europe, today, is more attractive on a senior secured basis.

Looking at headlines today, there are a number of potential market risks on the horizon. Let's start with the credit cycle—ten years in, do you think we're near the end?

While we certainly seem to be in the later stages of an elongated credit cycle, it's impossible to predict when things might turn. When considering investing in this or any environment, it's important to remember that you're looking at an illiquid asset class—once you invest in an asset, your ability to sell that asset is limited. As a result, at Barings, we underwrite every deal assuming we will own the deal from the day we originate it until the day of maturity. The typical loan for us is five to seven years in length, and with that in mind, we underwrite every deal assuming there will be a credit and an economic cycle during the course of that investment's tenor.

Brexit is another factor on many investors' minds. How is Brexit impacting the portfolio—are you less likely to invest in U.K. companies?

There are a few different elements to take into account when considering the potential impacts of Brexit. In terms of the companies we're invested in, Brexit has had some impact. Pre-Brexit, we were generally more open to businesses that had a very strong U.K./pan-European type profile. Today, we're primarily investing in U.K.-oriented businesses. While those companies may have some pan-European elements to them, it's less of a focus that it was four years ago, as we don't know what the outcome of Brexit will be—and that uncertainty makes it very difficult to underwrite and price risk.

How about rising rates? A concern for fixed income markets generally, is this an issue for private credit?

The rising rates question is a bit of a double-edged sword. The positive for investors is that if they're invested in floating rate assets, the return generally goes up. The negative side is that for the companies we're invested in, rising rates can make it more difficult to pay interest or repay debt. In this environment, we're very focused on a company's cash flow. While we're certainly looking at EBITDA, cash is what pays back a loan.

Against the backdrop of rising rates, a big concern in the market right now relates to higher leverage multiples being justified by adjustments that are being made to EBITDA. The private markets tend to be less transparent than the broadly syndicated loan and bond markets, which can be challenging, as companies typically do not file public financial documents that investors can review themselves. This has led a lot of investors to question what's behind the curtain, so to speak.

For us, maintenance financial covenants are an important part of mitigating the risk of investing in a less transparent market. At the most basic level, maintenance covenants give managers the ability to track the performance of a company on a quarterly basis. With these deals, we receive company financials every quarter that help us ensure a company is in compliance with certain performance metrics.

Speaking of covenants, we've seen some concern lately about covenant-lite transactions, both in your market and in the broadly syndicated markets. How are you thinking about that?

This is a good question, as I think there is a bit of a misunderstanding that covenant-lite is broadly bad. What I think a lot of investors don't realize is that covenant-lite in the liquid part of the market is very different than covenant-lite in the middle market.

In the broadly syndicated loan market, if an investor doesn't like the performance of an investment, they have the option to sell that asset. In the private middle market, you don't really have the ability to sell that asset. In that respect, a covenant can function as your liquidity, in that it gives you a seat at the table with the borrower to make sure the risk-return stays in check.

In this environment, how are you and your team finding companies to invest in?

It really comes down to origination, and the ability to source assets in order to create attractive investments. At Barings, in every region where we operate, we have people on the ground calling on clients—we don't believe in doing transactions in Australia from London or New York.

Health care is a good example. In the U.S., there is a presidential election every four years, and health care is always a topic of discussion, leading to uncertainty around how health care may evolve or change over the life of a five- to seven-year investment. As a result, we tend to avoid doing heavy reimburse-based health care deals in the U.S. In Australia or parts of Europe, on the other hand, the health care plan tends to be much more stable and consistent over time, making it a more attractive investment, in our view. But the key, ultimately, is having people on the ground that understand those nuances.

The second point worth making on origination relates to the importance of sourcing transactions from a broad network of private equity firms. In this space, selectivity is critical, and key to this is having people who are consistently in front of private equity clients, sourcing deals.

Related to private equity sponsor relationships, can you touch on the benefits and drawbacks of sponsored transactions versus non-sponsored transactions?

We tend to prefer sponsored deals over non-sponsored deals, for a few reasons. For one, sponsored transactions are often stronger on corporate governance, which means the company involved is typically more willing to make a change in management to the extent that it's needed.

Ultimately, we're through-the-cycle investors—we don't try to time the markets. As we think about investing in the markets today, we believe that from a return perspective, sponsored deals will outperform non-sponsored deals coming out of an economic cycle.

From an investor standpoint, what are the choices when it comes to accessing this asset class?

At Barings, we manage North American, European and global strategies, and invest up and down the capital structure—from first lien debt to mezzanine. This breadth allows us to take an objective view of relative value and mispriced risk. Rather than telling investors they should only invest in this geography or that product, we believe our first job is to ask investors what they're looking for, or trying to solve for, when it comes to portfolio construction. Maybe it's geographic allocation, maybe it's an allocation relative to fixed income, or it could be an allocation relative to private equity. Each investor and each region is different.

In this respect, manager flexibility—as opposed to a one-size-fits-all approach—is paramount to providing investors with a range of solutions.

ERIC LLOYD
HEAD OF GLOBAL PRIVATE FINANCE

Eric Lloyd is Head of Barings' Global Private Finance Group and Chief Executive Officer of Barings BDC, Inc. (NYSE: BBDC). He is responsible for managing all aspects of Barings' global private finance enterprise, which includes global middle market direct lending, infrastructure, private placements, private asset-backed securities, equipment finance and whole loan residential mortgage. Eric has worked in the industry since 1990 and his experience has encompassed leadership positions in investment management, investment banking, leveraged finance and risk management.

Prior to joining Barings in 2013, Eric served as Head of Market and Institutional Risk for Wells Fargo, was on Wells Fargo's Management Committee and was a member of the Board of Directors of Wells Fargo Securities.

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**As of September 30, 2018*

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