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The road less travelled: The case for non-sponsored lending

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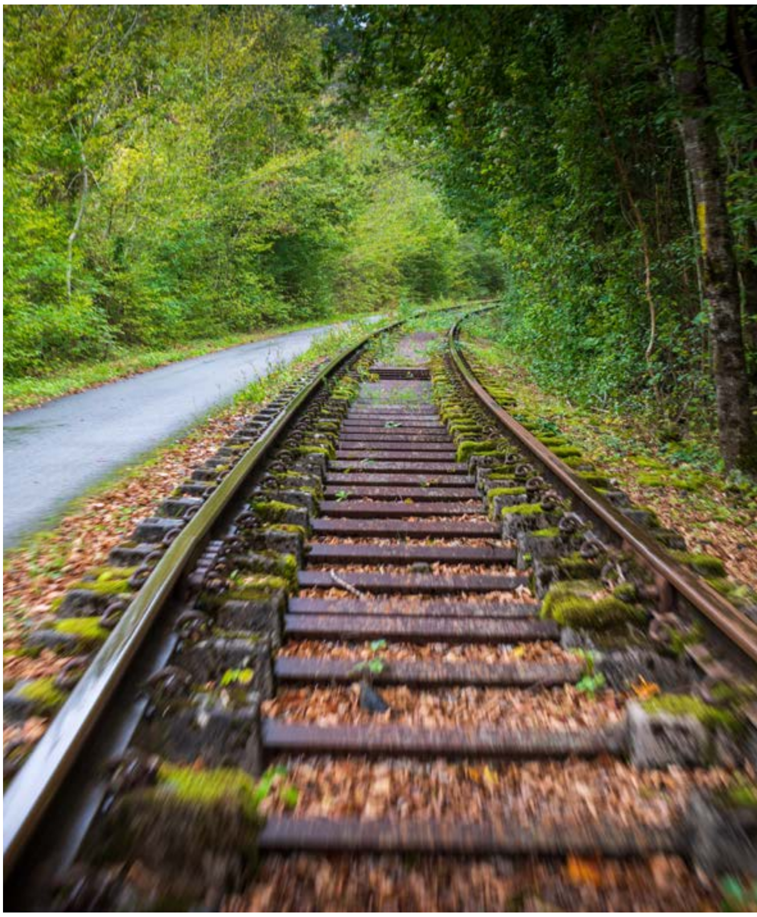


Executive summary

- Lending to sponsored borrowers currently makes up the bulk of private credit transactions. Lenders are attracted to sponsored lending due to perceived better credit quality and faster capital deployment.
- However, as private equity adjusts to a higher rate environment, sponsored lending faces several challenges. Meanwhile, non-sponsored lending offers a less competitive space with high-quality borrowers.
- Non-sponsored lending requires a different origination approach and tends to be more labour-intensive and complex.
- For investors who can undertake the necessary analysis and forge the right partnerships, investing in non-sponsored lending could offer valuable portfolio diversification and potentially attractive risk-adjusted returns.

Sponsored lending dominates the private credit market

The majority of private credit borrowers are sponsored: i.e. backed by private equity owners. Data from Pitchbook and Deloitte put the proportion at around 75%-85% in US and Europe.[1]

Many private credit lenders believe a private equity sponsor enhances credit quality, since the sponsor can offer support in the form of a well-defined business strategy, a strong management team, and access to its expertise and network. The recovery rate may also be higher in times of stress, as private equity owners can inject additional equity.

Sponsors can also offer greater exposure to the fast-growing sectors that dominate private equity investments. For example, the top three sectors in US BDC holdings are professional and business services, technology, and healthcare.[2]

1. Source: Pitchbook, Deloitte as at December 2023
2. Source: Pitchbook/LCD as at December 2023

Jargon buster

Private credit
For this article, we have adopted the definition of private credit widely used in the asset management industry: sub-investment grade lending to primarily middle-market companies. These borrowers are generally too small to issue bonds in the public market and have pivoted to private credit after the credit available from banks was reduced after the global financial crisis. Recently, there has also been an increase in large LBO transactions financed by private credit.

Sponsored
Companies owned by private equity.

Non-sponsored
Public or private companies not owned by private equity.

LBOs
Leveraged buyout: an acquisition of a business using debt as the main funding source. A common private equity strategy.

BDCs
Business development companies: closed-ended investment companies in the US that invest in small and medium-sized firms, typically through debt financing.

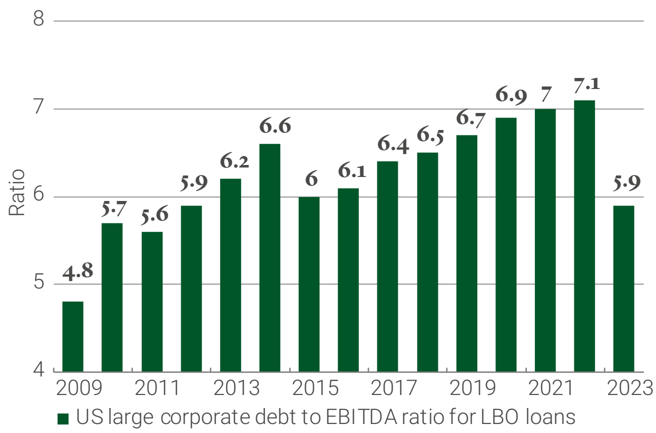
Building relationships with private equity sponsors can make deals easier to find and accelerate capital deployment. They can often provide multiple borrowers each, so a lender may only need relationships with a handful of sponsors. Lenders can also leverage the professional due diligence already carried out by the sponsors, which reduces the resource requirement and complexity of the transaction process.

What are the challenges?

However, investors also need to be mindful of some issues that are less widely considered.

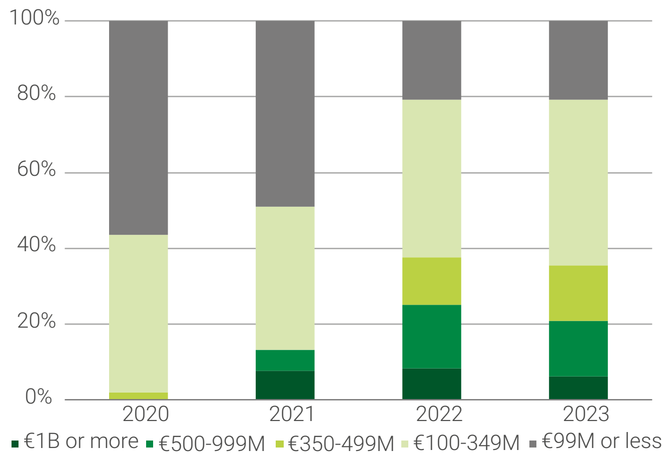
From a credit quality perspective, private equity returns in recent years (up to 2022) can be largely attributed to multiple expansion and leverage. There is a risk of frothy valuations if the assets have not been fully marked down in the recent downturn, making loan-to-value appear artificially healthy. Higher rates and weaker macroeconomic conditions also pose severe tests to borrowers that have taken on excessive leverage or do not have strong cashflows.

Debt multiples for LBOs have increased in recent years before dipping in 2023



Source: LSEG LPC, Bain as at April 2024

Private credit transactions are getting bigger



Source: Pitchbook, based on European direct lending deals as at April 2024

In terms of recovery, while anecdotal evidence suggests private equity sponsors have historically injected capital when needed, this is not guaranteed. The sponsors may take an unemotional view and decide to walk away from assets they do not believe they can exit profitably. Private equity investments are also exposed to a concentration in sectors, some of which are asset-light, such as technology.

An over-reliance on sponsors for origination can impact the lender's ability to negotiate and enforce covenants. This is one of the factors behind the increase in covenant-lite transactions in recent years. Deal flow is also beholden to the M&A environment: in 2023 private credit transaction volume fell notably as M&A activity fell by 25%.[3]

Lastly, there has been a significant increase in competition, with several mega funds raised over 2022 and 2023. The record level of dry powder elevates the risk of aggressive underwriting driving down credit protection and overall asset quality.

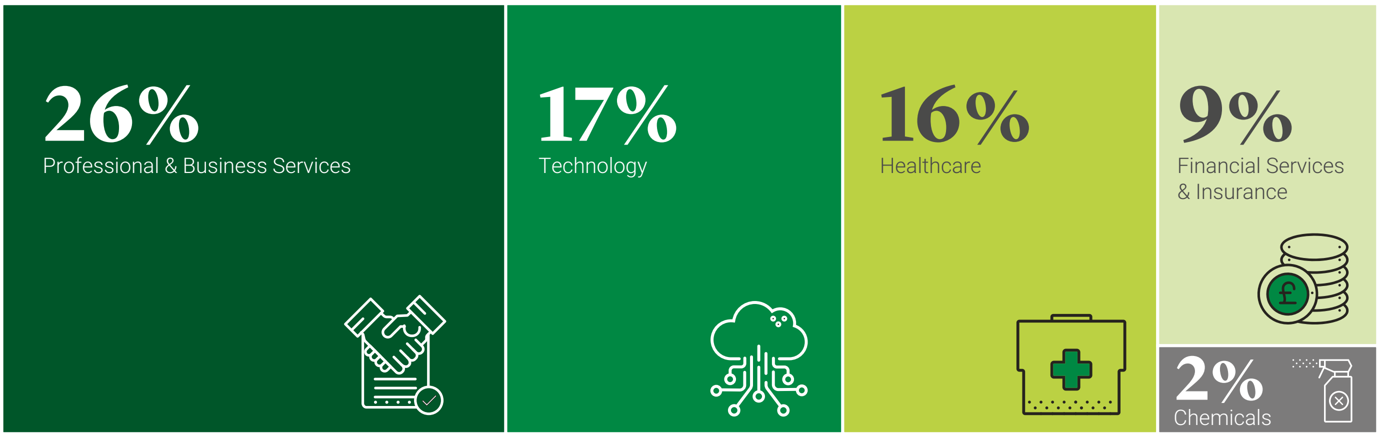
Non-sponsored lending

Non-sponsored companies constitute a much bigger part of the economy than their sponsored counterparts. For example, in the US there are in total around 18,000 private equity owned firms, versus over 100,000 medium-sized firms with 100-2000 employees alone.[4] The latter include public and private companies, many of which are founder or family-owned.

The sector make-up of non-sponsored companies is therefore a much closer representation of the actual economy. Traditional sectors feature prominently, complementary to the high-growth sectors typically targeted by private equity.

Sector comparison between sponsored lending (represented by BDCs) and the wider economy in the US

Top five sectors in BDC holdings



Top five sectors in US medium-sized companies

Source: Pitchbook, The Census Bureau, as at December 2023. The sector analysis for medium-sized companies is based on US firms with 100-2000 employees.

3. Source: LSEG LPC
4. Source: Ernst and Young, April 2023

For founder-owned and family-owned companies, there is a lot of 'skin in the game'. Their names are often associated with the businesses and they represent their life's work, so these owners take lots of pride in them. This tends to drive sensible business management, long-term decision making and willingness to reinvest in the business. The long-term approach also means more emphasis on social and environmental impacts.

Other common characteristics include financial prudence and aversions to high leverage. As an illustration, the biggest family-owned firms globally are on average 2.8x levered – much lower than the broader global equity market at 4.9x.[5]

The flip side of financial prudence is the potential for underinvestment, which can constrain expansion and innovation. Lenders therefore need to ensure that management has a growth mindset, and the company is well positioned in their industry to face changing market dynamics driven by structural trends like demographics and decarbonisation.

The relationship between the lender and a non-sponsored borrower is generally more akin to a long-term partnership. Often the borrower has not had institutional investment in the past. This gives the lender a strong ability to engage and influence.

A different origination approach

In contrast to leveraging relationships with private equity sponsors, finding non-sponsored borrowers requires a very different approach. The opportunity set is extremely large, but targets are harder to find given the lack of a concentrated network and their lower appetite for debt, particularly in the small/middle market space. Lenders will need to establish a wide network across a number of channels including regional banks, brokers or advisors such as legal firms. Reputations and lenders' brands will be important factors in securing the transaction.

Once suitable borrowers are identified, lenders would need to carry out their own due diligence, which may require more hands-on credit analysis. Often the borrowers are not highly institutionalised, so the quality of reporting and disclosures can make due diligence more complex and labour-intensive. The financing demand could be quite bespoke – since these companies do not raise debt frequently – so the lender may need to work closely with the borrower to develop a tailored solution.

However, in return lenders can expect potentially attractive risk-adjusted returns. Credit quality is often high due to conservative financials, bigger equity cushions and stronger covenant protections. Tight bank lending conditions and less competition from other private credit lenders also tilt the dynamic in favour of investors who put in the effort.

Conclusion

Higher rates, weaker growth and greater competition can together drive private credit investors to review their allocations to sponsored lending and consider adding exposure to non-sponsored lending. Finding the right borrowers and carrying out due diligence can be complex and labour-intensive, but it can bring valuable benefits in diversification, potentially enhanced risk-adjusted returns, and less dependence on the private equity market. In an increasingly competitive private credit market, going down a less well-travelled route could unlock superior results.

Case study

In 2021, LGIM provided £30m in private credit financing to a FTSE250-listed professional services firm. The company operates in different sectors including energy, defence and transport. It already had revolving credit facilities with several UK banks, but was looking for longer-maturity debt to fund strategic growth and the amount of debt was too small for a public bond issuance.

The company was looking to diversify its lender base, so it turned to the private credit market. We liked the company because it had a highly diversified business mix across public and private sectors with a strong fee generation history, the strategic growth plan was well thought-out, and its management had a prudent policy of maintaining leverage in the 1-2x range.

5. Source: Bloomberg as at March 2024, based on the latest available total debt/EBITDA data of the largest listed family-owned companies in the world and MSCI World Index. Family ownership is defined as the family or group of families having at least 30% of voting rights.

Case study shown for illustrative purposes only. The above information does not constitute a recommendation to buy or sell any security.

Contact us

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Key risks

The value of an investment and any income taken from it is not guaranteed and can go down as well as up, you may not get back the amount you originally invested.

It should be noted that diversification is no guarantee against a loss in a declining market. Assumptions, opinions and estimates are provided for illustrative purposes only. There is no guarantee that any forecasts made will come to pass.

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