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Q&A: Barings BDC's Freund says inbound deal activity strong, pricing may tighten

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Matthew Freund, president of Barings BDC, recently shared his thoughts on the current state of the private credit market with PitchBookLCD. Barings BDC's strategy targets corporate issuers in the core middle market, which the company defines as EBITDA of \$15 million to \$75 million.

LCD: What are you doing to defend your portfolio of loans, both from the encroaching broadly syndicated loan market and competing private credit lenders?

One of the things we like about the middle market compared to large cap buyouts is that there is definitionally less competition from BSL. While we invest in leading companies with a lot of growth potential, a \$30M EBITDA business isn't likely to go BSL, so compared to some other direct lenders, the BSL market hasn't been as much of a direct headwind to us.

On the competition from other lenders point, you have seen increased interest in the space, which we view as others realizing the attractiveness of a market that we have been leaders in for 30-plus years. We view our experience, the deep sponsor relationships we have forged over three decades, our expertise, and our position as part of a \$400-plus billion AUM manager as differentiators that position us as a long-term partner for borrowers and make us a lender of choice for many top-tier sponsors in our market. Additionally, much of the capital entering the sector in recent years has focused on that upper end of the market, which, as I mentioned, we view as less attractive than the core middle market.

Now, of course the proof is in the numbers and BBDC's portfolio increased \$23 million on a net basis during the quarter, which we think reflects that ability to continue driving growth during a quarter in which many BDC portfolios have shrunk. At the same time, weighted average yields in our portfolio on a fair value held steady at 11.3% when median yields across the sector dropped 10 bps.

As we look ahead, we have seen strong inbound deal volume and hear lots of talk of LBOs meaningfully increasing in the quarters to come. So, we're excited about the opportunity in middle market direct lending right now, and even more so looking into the back half of the year.

How are you managing the increased refinancing opportunities for your borrower companies? What is a typical non-call structure for a new issue in the current market?

As I touched on earlier, we've seen the most pressure in larger companies, especially those above \$75M in EBITDA. So, while refinancing activity is present throughout the market, we think we are well-positioned there on a relative basis.

Non-call is evaluated in the context of the overall loan package so it's tough to paint with a broad brush there, but it can range between a full non-call for a period of time to a transaction not being subject to non-call in certain circumstances. More important than the quoted call protection is the structure of the call protection itself, as events such as change of control and transformative acquisition carve-outs often eliminate the payment of call protection if triggered.

Can you outline typical pricing and structure on a "plain vanilla" private credit loan, including OID, spread, maturity, DDTL, RC, and leverage? What about covenants? How does this compare to conditions in late-2021 (the recent peak), or one year ago?

Private pricing and leverage are issuer and situation dependent, and we always look to structure our loans accordingly. Barings Global Private Finance deals have maintenance covenants which are typically structured around the total amount of leverage the borrower can incur. Late-2021 represents a "high watermark" in terms of the issuer favorability of credit terms. While we are not at that level today, should M&A activity not increase, we anticipate seeing aggressive financing terms such as those of late-2021 again in 2024.

What is your attitude toward PIK interest in the higher-for-longer interest rate environment, and has this changed?

In the US, we generally prefer transactions where borrowers can service the debt on a full cash-pay basis, as we look to take first-lien type risk, and believe PIK is more often associated with a junior or stressed type of situation. In select situations, we will allow for some PIK at the outset if it's going to be value accretive to us by letting the company better execute what we think is a promising growth strategy, and in cases where we need to make an amendment we'll be collaborative, but always prioritize protecting our investors.

What is your approach to non-accruals, and taking control of companies, if needed?

The core of our approach to non-accruals is to make the right credit decision on the front end to avoid them as often as we can, and we think we have been doing a decent job there with our non-accrual rate for 1Q at 0.3%. Now of course, companies run into problems. We take a conservative approach to placing loans on non-accrual, as we think that's what's right for shareholders, and then a proactive, constructive approach to managing situations to realize the best possible outcome. We have a broad range of workout capabilities we can deploy to do that, which does include taking control of companies and turning them around to maximize value for our investors if that's what we think is necessary. Most often, though, we work collaboratively with the sponsor, many of whom we have gone through this with before, to arrive at a commercially reasonable outcome for all parties.

Based on your experience acquiring loan portfolios from MVC Capital and Sierra Income, with a goal of rotating them into “compelling Barings-originated positions,” how likely are you to use the approach again (of acquiring whole portfolios)?

We are always looking at ways to improve our portfolio and have had success acquiring and integrating loan books in the past, so it’s certainly a tactic that remains in our playbook. I also want to highlight that when we did that, we did it in an extremely shareholder-friendly way with Credit Support Agreements to protect shareholders from losses as we rotated the portfolios, and that focus on the shareholder is at the core of all we do. While we do not have any plans to acquire another portfolio at this time, we remain flexible and will continue to be opportunistic.

Based on your experience in rotating out non-core-strategy loans, how far away is the potential development of a robust and liquid secondary market for private credit loans?

It’s not something we see on the near-term horizon. The bid-ask spreads on illiquid assets remain significant given meaningful information asymmetries. It’s hard to imagine sponsors and management teams agreeing to creating a semi-liquid market, because one key element of private credit is that it remains private.

What are your immediate hiring plans, if any?

We believe that private credit is an asset class with a long runway for growth and tremendous opportunity to capitalize on behalf of our clients. We are as focused as ever on growing our business, which means that we’re always looking to add talent.

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