BARINGS

PRIVATE CREDIT

Understanding Style Drift in Perpetual BDCs

How style drift and allocation decisions are clouding the picture for perpetual BDC investors.

INSIGHTS

The popularity of perpetual BDCs and speed of capital raise for some has made it harder for certain managers to selectively deploy capital into true middle market deals—leading to "style drift" that can expose investors to unwanted risks.

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Private credit is becoming more accessible. Once squarely the domain of institutional investors, the asset class has seen its investor base expand significantly in recent years to include a growing number of wealth channel participants. This democratization of private credit has been enabled in large part by the emergence of investment fund structures like business development companies (BDCs). There are a few different types of BDC structures, and when determining how to access the market, investor preference around liquidity and stock price volatility play a significant role:

- **Public BDCs** are BDCs that trades on public stock exchanges. Public BDCs can offer investors meaningful liquidity, but they also come with a high level of investment volatility because publicly traded stocks move up or down with the markets.
- **Private BDCs** are another type of structure. Private BDCs resemble a drawdown structure where an investor makes a commitment, and that investment is drawn down like a private fund. This structure tends to offer lower investment volatility than a public BDC because it is not affected by the technical movement of the stock market. But, there is limited liquidity as investors have limited to no ability to sell shares.
- **Perpetual BDCs** are fund structures that allow investors to step into fully ramped and diversified portfolios with lower minimums, positioning them to earn quarterly (or monthly) cash dividends right away. Semi-liquid perpetual BDCs, in particular, have become an increasingly popular way for wealth investors to access the market with the opportunity for quarterly liquidity via tender offer.

The increasing prevalence of perpetual BDCs in particular has been somewhat of a doubled-edged sword for some managers. On the one hand, they have allowed more investors to access the potentially attractive yields, historically strong risk-adjusted returns, and low relative volatility characteristic of private credit. But their growing popularity has also made it more challenging for some managers to generate a sufficient number of quality deals to satisfy demand—leading to a degree of "style drift" that can expose investors to unwanted risks.

Broadly Syndicated Loans in BDCs

Perpetual BDCs are typically marketed as private credit vehicles that invest in traditional, middle market, first lien senior debt. Middle market companies are generally defined as those with EBITDA between $15 and $75 million, and often are limited in their ability to tap public markets via broad syndication given the size requirements for a bank-led syndicated loan offering. For perpetual BDCs that raise capital beyond their opportunity sets, challenges can and do arise when it comes to deploying that capital into "true" middle market deals.[1] In private credit, capital needs to be deployed within a certain time frame before it begins to weigh on returns, exacerbating the pressure on these managers to put the raised capital to work.

1. Based on Barings' observations of publicly available quarterly or monthly filings and market trends.

"... an over-reliance on syndicated loans can negatively impact performance in ways that investors may not anticipate."

As a result, some managers may have to incorporate a larger portion of broadly syndicated loans into their BDC portfolios or, in some cases, large corporate/mega cap private loans that more closely resemble public loans than private loans. While perpetual BDC managers with significant broadly syndicated loan exposure may describe this exposure as a so-called "liquidity sleeve," significant liquid loan exposure is more likely the result of a manager outraising their opportunity set in the private credit market. Fully seasoned private credit portfolios generate organic liquidity through staggered maturity profiles—thus a liquidity sleeve may only be relevant for a new entrant. Moreover, investors seeking broadly syndicated loan exposure can generally find this exposure through a lower cost access point with a public market fee structure.

To be sure, the degree to which syndicated loans in BDCs affect performance depends on the amount of the holdings—but an overreliance on syndicated loans can negatively impact performance in ways that investors may not anticipate. Specifically, although broadly syndicated loans, like private loans, are floating-rate and sit at the top of an issuer's capital structure, they generally offer lower spreads, do not include financial covenants, and can introduce public market volatility into a private credit offering.

RETURNS

For many investors, while past performance is not necessarily indicative of future results, one of the key draws of private credit is the potential spread premium over public markets. This premium has traditionally stemmed from the market's illiquid nature, or the fact that there is limited to no ability to sell out of an asset during its typical five-to-seven-year life cycle. Private loans also cannot be sourced from a bank trading desk. Rather, transactions must be locally originated and privately negotiated.

In the broadly syndicated loan market, investors have the ability to sell out of assets more readily given the large and active secondary market. As a result, spreads—while at times compelling for investors seeking liquid market exposure—are typically narrower than in private credit. Ultimately, this can translate into lower returns than investors may expect from a private credit vehicle. Because the opportunity to earn higher returns generally is greater in illiquid private credit than in liquid syndicated loans, increasing the exposure of BDC portfolios to syndicated loans can ultimately dampen overall performance. For instance, whereas pure-play private credit BDCs have historically offered a low double-digit return profile, returns for BDCs that rely heavily on broadly syndicated or mega cap private credit loans may more likely be in the high single digits.[2]

2. Based on Barings' observations of publicly available market data.

VOLATILITY

Public loan exposure also adds public market volatility to perpetual BDC portfolios. Generally, investors seeking a private credit allocation are drawn to the low volatility, low correlation to public markets, and diversification benefits of private markets. At times when investor sentiment shifts from risk-on to risk-off, for instance, selling pressure in the syndicated loan market tends to depress the net asset value of BDC portfolios with large loan holdings. For BDC investors who sought to avoid the effects of market volatility by choosing to invest in an illiquid asset class, this consequence of having liquid assets constitute a sizeable part of a BDC portfolio may come as an unpleasant surprise.

DOCUMENTATION

Broadly syndicated loans also generally lack robust structural protections like financial maintenance covenants, which are a critical part of managing losses. In the core middle market, financial maintenance covenants still exist in almost all transactions, helping to protect investors against downside risk. At the most basic, these covenants give managers the ability to step in early and influence the underlying business in the event of modest underperformance. Should challenges arise, financial maintenance covenants also give lenders a seat at the negotiating table, allowing them to proactively protect principal. In the context of a vehicle like a perpetual BDC, the lack of robust protections can leave investors more vulnerable to downside risk that could impact recoveries—particularly in more challenging market environments. While benign environments like we have been in more recently can leave investors less focused on the benefits of conservative documentation, at the end of the day—and when the tide goes out—financial maintenance covenants and structural protections really matter.

Figure 1: Core Middle Market Offers Greater Degree of Structural Protection

	Private Credit		Public Credit	
	Core Middle Market	Large Corp Club/ Mega Cap	Broadly Syndicated Loans	High Yield Bonds
Borrower Size	EBITDA $15–$75M	EBITDA $75M+	EBITDA $100M+	EBITDA $100M+
Privately Negotiated	Often	Sometimes	Rarely	Rarely
Floating Rate	Often	Often	Often	Rarely
Senior Secured	Often	Often	Often	Rarely
Financial Maintenance Covenants	Often	Sometimes	Rarely	Rarely
Leader Influence on Debt Structure	Often	Sometimes	Rarely	Rarely
Call Protection	Sometimes	Sometimes	Sometimes	Often
Control During Workout Process	Often	Rarely	Rarely	Rarely

Often Sometimes Rarely

This chart is illustrative and based on a combination of Barings' market observations and third-party data/observations, including from Moody's and S&P LCD. As of June 2024.

Given the growing presence of large corporate private credit exposure and broadly syndicated loans in BDCs, it critical for investors and their advisors to understand the composition of a BDC's underlying portfolio. One key sign of style drift is the size of issuers in the portfolio. As mentioned, the true middle market has traditionally consisted of issuers with EBITDA between $15 and $75 million. A portfolio where the average issuer EBITDA is above $100 or $200 million may therefore signify some potential risks. For one, it could mean the portfolio, through exposure to a larger percentage of broadly syndicated loans, is exposing investors to return, liquidity or quality attributes that they aren't aware of or expecting. It could also suggest the presence of private credit megadeals, or upper (upper) middle market deals. These loans, while technically private credit, typically exhibit a lower return profile and weaker documentation than traditional middle market loans. Because these mega deals compete directly with the broadly syndicated loan market, they often must also accept the pricing and terms of the broadly syndicated loan market.

Know Your Manager (& Underlying Portfolio)

Vehicles like perpetual BDCs have been a key contributor to the expansion and democratization of private credit into the wealth channel. But because of the speed of capital being raised by some managers, deploying into true middle market transactions has become more challenging. As more managers are moving up-market in response—adding broadly syndicated loans and/or mega private credit deals to their portfolios—there are implications for investors in terms of both risk and return. Private credit investments more broadly also involve risks. Namely, investors may be subject to credit and liquidity risk and in the extreme case, default.

Against this backdrop, it is critical for investors to consider the manager they are partnering with and how that manager approaches portfolio construction. Experience is crucial, as is taking a disciplined approach to portfolio construction. Ultimately, principal preservation, along with conservatism and alignment of interests, are key to investing in the asset class and generating attractive, risk-adjusted returns for investors.

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