CRESCENT

Delivering Differentiation in Direct Lending Amid Evolving Markets

Q1 2024

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Written in collaboration with Institutional Investor

Whenever you have periods of volatility, flexibility is how you capture value and aim to create outsized returns.

There's a growing differentiation between asset gatherers and true credit investors.

The value proposition of private credit, and direct lending specifically, has been well documented in recent years. Attractive yields and conservative structures have created the conditions for what many are calling a golden era of private credit and more recently, a goldilocks moment. But amid all the newfound attention, how should LPs navigate the direct lending market today to capitalize on attractive opportunities in changing markets? More importantly, how can LPs get differentiated exposure in direct lending without overlapping in the same deals across managers?

In a recent discussion, two industry experts shed light on the evolving landscape, emphasizing the importance of experience and flexibility to deliver differentiation and offered their views on where private lending is heading in the years ahead. Key insights were shared by Chris Wright, Managing Director and Head of Private Markets and Chris Wang, Managing Director, both with Los Angeles-based private credit firm Crescent Capital. Crescent has over 30 years of experience lending to the private middle market, wherein Wright and Wang see significant opportunity for cycle-tested lenders in the next several years.

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We have provided private capital to the core middle market across multiple cycles for over 30 years.

We attribute our success because we have hewed closely to our cycle-tested investment strategy and focus without straying or taking on additional risk just to deploy capital or chase that extra return.

Institutional Investor: As more and more borrowers have turned to private lending, the assumption is that competition is increasing between private debt and traditional banks. This next cycle is sure to be an interesting one – what is your outlook?

Chris Wright: We have always had competition with syndicated markets, but the value proposition of private lending has been communicated very well to investors: private lenders can offer certainty of financing, speedy execution, and close relationships that limit investors' downside risk.

Chris Wang: That's right. Private credit also delivers tangible value to borrowers in providing bespoke, flexible capital solutions; delivering that tangible value allows investors to capture outsized returns. And on top of that, borrowers are able to select exactly which lenders are in their capital structure.

Chris Wright: Here on the private credit side, we also have matched up the time frames of our investments with those of our capital base. This timing mismatch has always been an issue in the syndicated markets and as a result, public investors see a lot of volatility. As we on the private side are better matched, investors experience less volatility. That said, the environments where the syndicated markets are functioning well are generally better for investors as you see more M&A and other market opportunities.

If you look back over the last three quarters, private credit has accounted for about 85% of overall LBO financing. Our view is that is not going to be sustained. It will come down, but there will be a continued secular shift toward private credit, and I think we're going to see private lenders and the banks work together more and more going into the future. So I think the key point is that this is not a winner take all market, there is a symbiotic relationship.

Institutional Investor: Do you believe demand for capital is high enough that private credit investors will be able to deliver on expectations without taking on too much risk?

Chris Wright: I believe the sustainable market share of the private debt asset class is growing, despite the potential decline from the 85% share I mentioned earlier. When you look at dry powder available in private markets globally, it's around $4 trillion today, and the biggest portion of that is in private equity. That private equity capital when invested is what drives demand for private credit, and that demand far outstrips the dry powder available in private credit which stands at around $200 billion today.

Meanwhile, we have never gone through a period in which interest rates are rising this rapidly and borrowers will hit a significant

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maturity wall in the next few years. Many, if not most of these loans, sit in the syndicated markets, and that refinancing will be a huge opportunity for private lenders.

Institutional Investor: Can you elaborate on why flexibility is important in direct lending?

Chris Wright: Whenever you have periods of volatility, flexibility is how you capture value and aim to create outsized returns. We're going through this period of volatility and at the same time, we're going through a period where there's a retrenchment in capital structures. They're getting more conservative, and that spans across senior as well as non-senior investments. What flexible capital allows you to do is more appropriately cater the structure to meet the specific needs of the borrower.

If the specific need is for M&A, you can have a bespoke structure that creates and captures value for the lenders. If it's for refinancing, you can create that structure in today's current rate environment. You'll see things like better call protection and higher coupons allowing lenders to capture maximum value. Should rates decline, you can add fixed rate coupons, which creates value and differentiation and ultimately why we believe having a flexible mandate to navigate between senior and non-senior debt is very attractive. Having the flexibility to use all those tools at your disposal allows lenders to capture value in a volatile period.

Chris Wang: If you look at the supply/demand dynamic for flexible capital today, there is a significant imbalance in favor of lenders. That imbalance can create attractive opportunities. For example, many high-quality, high-growth businesses need to right-size their capital structures that were put in place during a zero-interest-rate environment. Flexible capital can be used to help transition those capital structures into more sustainable ones. Flexible capital can also help generate liquidity, adjust cash-pay requirements, or be used to make accretive acquisitions.

Institutional Investor: Why is the middle market the current sweet spot for investors? Which segments by industry size or other characteristics are most attractive?

Chris Wang: We have provided private capital to the core middle market across multiple cycles for over 30 years, so this is a market that we know well. In fact, we launched our first direct lending strategy serving the core middle market in 1992. We have stuck to the same investment profile in the middle market: recession-resilient businesses providing a mission-critical product or service. We're cash-flow lenders, so we like businesses that have been operating for a long time that have a history of being able to generate cash flow consistently. These are market leading business services, software, healthcare, and financial services companies with annuity-like revenue characteristics and strong cash flows.

Chris Wright: Another benefit is that middle market companies don't gain access to the capital markets as easily as other companies. They're often in growth mode, so having a true partner allows us to offer a higher value proposition to the middle market as opposed to the upper market of ultra-large companies. We think that creates a better, mutually beneficial relationship.

Institutional Investor: Let's talk a little bit about covenants. What do you view as the role of covenants in the market today?

Chris Wang: I think a common misconception is that a covenant provides meaningful protection. What's missing is that covenants aren't all created equal. Some covenants are structured appropriately and provide access to improved company

monitoring and a mechanism to gain control. Other covenants are structured purely for marketing purposes only, and when the rubber meets the road, they amount to little more than just window dressing.

There are several details around covenants that aren't typically discussed. First, covenants are typically measured from a lagging perspective – that is, they're a lagging indicator. Financials come out on a quarterly basis, companies have 60 to 90 days to get those financials out, and by that time, the company could have already run out of cash. We saw this happen a lot during the early days of the pandemic. Covenants can also be set too liberally – for example, if they're set off of an EBITDA that is defined too broadly with too many add-backs – and as a result those covenants may actually never be triggered even though the company has underperformed or run out of cash.

We have a cycle-tested approach to how we protect our capital. First, when appropriate, we pursue covenants that actually matter. We don't want cash leaving the borrower, so we focus on limitations on restricted-payments. We also want to limit the ability of a borrower to incur additional debt, so we link incremental debt to performance and restrict the use of proceeds. We believe hands-on monitoring is very important. If we can monitor performance and have a seat at the table, we can see if there are any negative changes coming long before a covenant is tripped. We are board observers for a lot of our companies, and we also have access to monthly reporting, which allows us to have an ongoing dialogue with borrowers' management teams. So we don't rely on just what you believe a covenant will provide, but we actually get under the hood to make sure the company is performing.

Institutional Investor: Can you comment on the lending backdrop for the private debt market and how it will ultimately shape how you and others will look at deals in this environment?

Chris Wright: We're in a dramatically different base rate environment today compared to three or four or five years ago, and that has allowed us to develop attractive yields for our investors. At the same time, that yield is coming from somewhere – the borrower. Against this backdrop, it's clear that experience matters in this lending environment. In a benign credit environment, asset gatherers are just paid to take risk. In an environment like this, you must drive to a low default rate, and you have to make sure you're making the right buy decisions. I think that's where we're going to have a bit of a fallout in the industry, because there's a growing differentiation between asset gatherers and true credit investors.

Institutional Investor: Many LPs already invested in private credit are looking to increase their exposure. How can LPs achieve differentiated exposure to private credit?

Chris Wang: The topic of differentiation is coming up a lot in discussions these days. The primary benefit of hiring multiple managers is to achieve diversified loan exposure and having portfolios that are complementary as opposed to overlapping. This is one of our proudest points – We believe we have been able to construct bespoke portfolios and deliver differentiation in direct lending to our LPs for over 30 years.

Chris Wright: And we attribute our success in this because we have hewed closely to our cycle-tested investment strategy and focus without straying or taking on additional risk just to deploy capital or chase that extra return. Again, we have the luxury of staying true to our strategy as true credit investors and not asset gatherers. At the end of the day, it's actually quite straightforward: we marry our robust origination platform with our fine-tuned credit process to lead deals in the core middle market.

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Crescent Capital is a leading specialist focused exclusively on corporate credit. We invest across the debt capital structure of companies of all sizes, in both private and tradeable markets, with a track record spanning more than three decades of market cycles. We target consistent, attractive returns with less volatility, lower default rates and higher recovery rates than the market average.

ABOUT CRESCENT CAPITAL

Crescent is a global credit investment manager with over $40 billion of assets under management as of September 30, 2023. For over 30 years, the firm has focused on below investment grade credit through strategies that invest in marketable and privately originated debt securities including senior bank loans, high yield bonds, as well as private senior, unitranche and junior debt securities. Crescent is headquartered in Los Angeles with offices in New York, Boston, Chicago and London with more than 200 employees globally. Crescent is a part of SLC Management, the institutional alternatives and traditional asset management business of Sun Life. For more information about Crescent, visit www.crescentcap.com.

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