BLOG

# Non-sponsor, asset-based direct lending alive and well in private credit

April 19, 2022

By Dimitri Cohen | Raven & Company

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**Direct lending strategies that focus on providing leverage to private equity sponsors to facilitate acquisitions are the core of the private credit markets, but non-sponsor demand has been rapidly growing. How does this unique market stand out from the broader asset class?**
Much of the growth in the private credit markets since the end of the Global Financial Crisis (GFC) has been driven by investors continuing their search for yield in an unprecedented low-interest-rate environment. Sponsor-backed leveraged buyouts account for most of the private credit deal activity with Preqin data showing significant growth in leveraged buyouts over the past 10 years, peaking in 2021 at $834bn, globally in total deal value, up from $483bn in 2020, and $287bn a decade earlier. While new sponsor-backed managers continue to enter this competitive market, there exists an immense middle market – defined by Raven in two ways: 1) size of borrower and 2) size of facility to any sized borrower – with the need for valued-added, customized financing solutions.

Private credit managers that focus on these middle market, asset-backed, non-sponsor, directly sourced deals are unique and thus still can deliver attractive risk-adjusted returns. This is where Raven specializes: direct lending to non-private-equity backed businesses, targeting 10-12% unlevered returns at 40-60% LTVs, filling the void formerly occupied pre-GFC by local and regional banks, small BDCs, SBICs, and special situation groups.

**What are your clients looking for with exposure to this corner of the market?**
Investor interest in the private credit space is universal and has a long way to grow as the asset class matures. Superior risk-adjusted returns with the ability to generate current income is a significant draw, but what our clients value most is access to truly unique deal flow where the terms are driven by the lender to protect downside and not by the private equity sponsors to achieve higher equity returns or financial engineering flexibility.

Raven is further differentiated by the firm's specialization in the primary origination, execution, and management of a wide range of esoteric and solution-driven direct asset-backed investments. In contrast, most of the market is facing increasing competition resulting in cash flow-based loan portfolios with compressing yields, increased leverage, and relaxed covenants driving a convergence toward the standard-leveraged-loan and high-yield markets.

By creating deal flow from direct relationships, our investors benefit from unique investment opportunities that primarily focus on principal protection through bespoke structuring and robust operational and asset-backed covenant packages that do not fluctuate with the tides of the broader markets. Our borrowers choose us to solve their capital needs because, ultimately, they care most about having a trusted partner who can customize deals for their specific requirements.

**With higher interest rates as a near certainty for 2022, what is your outlook for the private credit market?**
While we certainly agree that we are in a rising-rate environment, the situation in Ukraine will significantly influence the Fed's path. On the other side of the coin, inflation continues to grow and the global sanctions on Russia will certainly add uncertainty to the heightened demand for goods and services, at a time when supply chains for many of these goods are already disrupted due to the uneven recovery of the systemically connected global markets from the COVID-19 pandemic. This issue may persist for some time and the resulting interest rate environment will impact fixed-rate portfolios. Conversely, floating-rate lenders in the ensuing higher-rate environment will benefit from higher yields on current investments and the universe for higher-returning new opportunities will grow. In addition, assets that have benefited from exuberant valuation growth should re-price to more attractive levels for value-oriented investors such as Raven.

**Will rising rates hurt the credit quality of the overall private credit market?**
It depends on the pace and depth of the rate increases. Significantly higher rates will negatively impact the profit and loss of a business, but they will also put stress on the highly leveraged transactions that have recently flooded the market. Leverage levels have approached historical valuation levels as multiples have expanded because of low rates, thus if valuations return to historical levels while leverage levels remain constant, the result will be very negligible levels of equity cushions. This scenario could lead to stress or distress in the sponsor-backed private credit market, exacerbated by the fact that lenders will have little control of what happens next, as the covenants needed to control their destinies have also been forfeited.

*About Raven & Company*
***Institutional Investment Management and Platform Ownership***
*Raven is a proven institutional investor with a distinct focus on credit, private equity, real estate, and related growth equity. Founded in 2008, Raven has deployed billions of dollars across multiple funds and affiliated investment vehicles. Through its established Registered Investment Advisor (RIA) and managed operating platforms, Raven is both a valued partner and formidable presence in selected strategic industries. Raven's unique expert capabilities in deep value as well as growth opportunity investing, bonded to a pristine reputation and integrity, propels its team and partners to great success.*

***Dimitri Cohen*** *is a Principal, Portfolio Manager and leads the Firm's Credit Strategies. Mr Cohen has over 15 years of experience sourcing, analyzing, and managing investments across a variety of industries and asset classes. Mr Cohen's responsibilities include oversight of investment origination, underwriting, execution, and portfolio management. Prior to joining Raven, he was a Senior Research Analyst at DDJ Capital Management, where he was responsible for investments in the gaming, lodging and leisure, food and consumer products industries across the loan, high yield, mezzanine, private placement, and distressed strategies. Prior to joining DDJ Capital Management, he was a Senior Research Analyst at Seawall Capital Management, a long-short credit-focused hedge fund. Mr Cohen began his career in the investment banking division of Wells Fargo Securities, where he advised clients on public and private offerings and mergers and acquisitions. Mr Cohen received his BS from the California Polytechnic State University, where he currently serves on the Finance Advisory Board for the Orfalea College of Business.*

*This article originally appeared in the Preqin Quarterly Update: Private Debt, Q1 2022. The opinions and facts included within the above do not constitute investment advice. Professional advice should be sought before making any investment or other decisions. Preqin and Raven & Company providing the information in this content accept no liability for any decisions taken in relation to the above.*