Understanding Private Credit: Sponsored vs. Non-Sponsored Financing

Overview

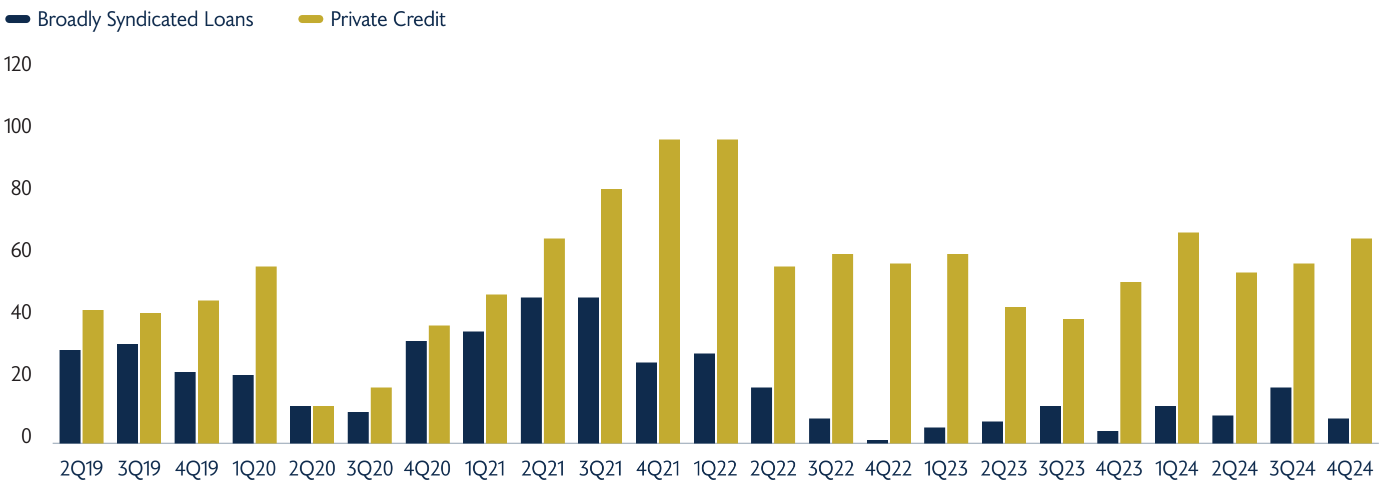
- Banks have become more risk-averse and are making fewer loans, opening an opportunity for non-traditional lenders to extend credit to companies in need of financing.
- In sponsored financing, a non-bank lender provides a loan to a business that is typically owned by a private equity (PE) firm.
- Non-sponsored lenders work directly with borrowers of companies—often founder-owned firms—without a bank or intermediary sponsor.
- Lenders with the ability to originate loans in both sponsored and non-sponsored lending maximize the opportunity set.

Demand for private credit is forecast to continue growing, drawing more investors to the asset class.

Over the past two decades, non-banks have overtaken traditional banks as the largest source of corporate loans, especially to middle-market companies. Investors have followed this trend by allocating to private credit in search of yield. Private credit saw increased deal flow and higher yields than traditional fixed income driven by a confluence of factors, including rising interest rates reaching post-GFC peaks in early 2022 and the retrenchment of banks following regional bank failures.

Figure 1: Direct Lending Has Outpaced Bank Lending

Count of leveraged buyouts financed in broadly syndicated loans and private credit market



Source: PitchBook | LCD. Data as of December 31, 2024.

By the end of 2024, private credit comprised of nearly $2 trillion in assets under management globally from $1.4 trillion in 2022, signaling rapid expansion in the market space. Private credit is forecasted to reach $3 trillion by 2028, an increase from previous expectations.[1]

As an asset class, private credit has obvious appeal; Large leveraged buyout loans offered yields of 11.4% at the end of the third quarter of 2024[3] vs. 6.6% for high-yield bonds.[4] Beyond strong income, private credit also offers the potential for portfolio diversification and inflation protection due to their floating interest rates.

Investors looking to allocate to this asset class should understand the two main types of private credit available—sponsored and non-sponsored—and the characteristics and potential benefits of each. While most direct lenders specialize in either sponsored or non-sponsored lending, we contend that investors can benefit from working with a manager that engages in both sponsored and non-sponsored lending. Why? To capture the widest range of opportunities and potentially boost returns while adding diversification to portfolios.

$1.7T

Private credit AUM globally, data as of 2024.[2]

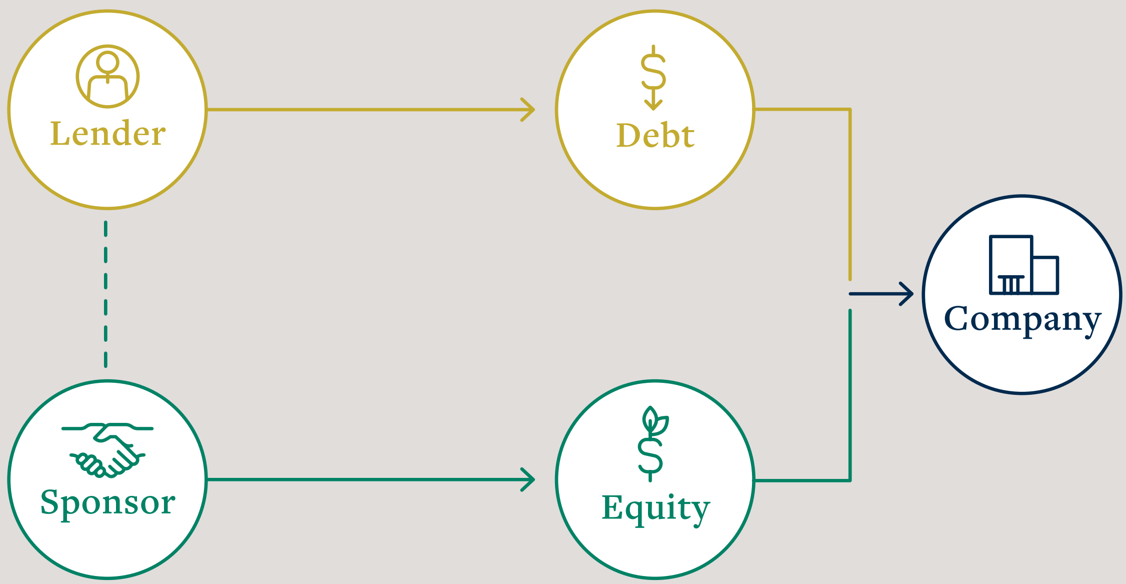
$3T

Forecasted by 2028 based on Moody's.[1]

Sponsored Financing

In sponsored financing, a non-bank lender provides credit to a business that is either wholly-owned or majority-owned by a private equity (PE) firm. The PE firm uses its network and experience to identify the appropriate lender, push the transaction through its various stages, and provide an equity cushion that can help protect the lender. There is an assumption with these loans that the PE sponsor stands ready to inject more equity later, if needed. Because the PE firm has completed due diligence research on the business, it can share this information with the lender to speed up the underwriting and execution of the loan.

How Sponsored Financing Works



Sponsored financing allows companies to secure larger loans and more creative deal structures compared with traditional bank lending and typically results in higher leverage. Because direct lending pays a premium versus traditional fixed income, sponsored financing is a crowded market and lenders often must make price concessions.

For example, a public company controlled by a PE firm borrows from a non-bank lender to fund a share buyback to go private. The PE firm provides the due diligence package and uses its relationships with lenders to negotiate a competitive loan.

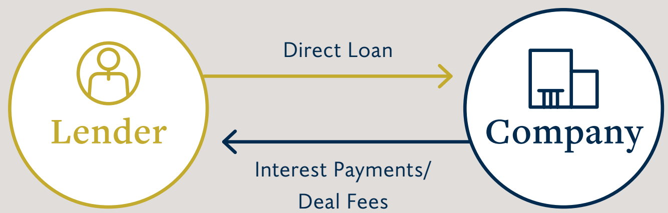
Non-Sponsored Financing

Non-sponsored financing has no PE sponsor and so is inherently more complicated and often takes longer to execute. In return, lenders can potentially capture more upside. Non-sponsored deals typically offer yields of about 1-2%[5] above comparable sponsor-backed transactions.

How Non-Sponsored Financing Works

Lenders work directly with borrowers without a bank or intermediary. Lenders assume a role akin to a sponsor, responsible for all aspects of due diligence and underwriting.

For example, an emerging life sciences company needs a loan to support new product development and approaches a lender that has industry expertise and a track record of working with similar firms. The company negotiates a bespoke loan on more favorable terms than might be available from a traditional bank with little understanding of this particular industry.



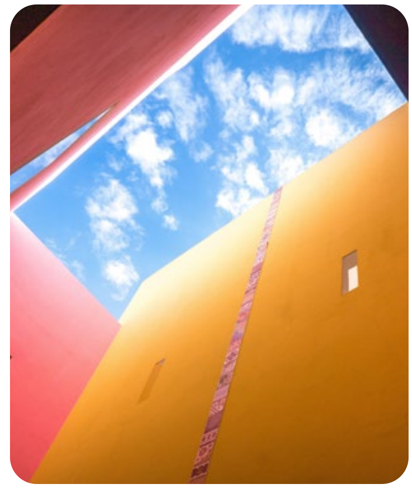
Securing additional returns also requires additional work, a private credit lender that has robust sourcing capabilities to identify suitable borrowers, and the industry expertise to efficiently complete due diligence. Because of this additional complexity, there is a perception that this type of financing is riskier. However, that may not be the case, because experienced private credit lenders can tailor loans with stronger covenants[5] and can garner better prices since fewer lenders are in a position to compete for this business.

These loans, however, are not necessarily less creditworthy. A rigorous non-sponsored due diligence process should identify in advance whether borrowers have a durable business model and sufficient liquidity cushion to support the business through tough times.

Characteristics of Sponsored/Non-Sponsored Financing at a Glance

Sponsored	Non-Sponsored
Sourced via relationships with private equity firms	Sourced via lender's network and in-house industry expertise
Sponsor streamlines due diligence, enabling faster funding	Lender needs more time to conduct due diligence and to execute the deal
Sponsor negotiates terms/provides equity cushion that can help protect the lender	Lender negotiates bespoke agreement with strong covenants and can often earn a premium
Lower target yield	Higher target yield
Higher leverage	Lower leverage

For illustrative purposes only.



Embracing the Best of Both Worlds

Demand for private credit is forecast to continue growing, drawing more investors to the asset class. Experience shows that certain market environments may lead to crowding in sponsored lending, so the ability to source and negotiate non-sponsored deals can provide a lender with the flexibility to consistently deploy capital and avoid the risk of specializing in sponsored-only loans where too much money can be chasing too few deals. Firms that avoid non-sponsored lending may also struggle with diversification because they are limited in the deals they can source. On the other hand, firms capable of working in both areas can maximize the opportunity set across both types of lending, potentially being rewarded with a premium on non-sponsored transactions.

We believe a more favorable regulatory environment and increased private equity activity will drive a resurgence in activity related to mergers and acquisitions (M&A) and initial public offerings (IPO) in the coming years. This dynamic could also improve the supply-demand balance in the private credit market, easing competitive pressures and spread compression, while creating a robust pipeline of both sponsored and non-sponsored investment opportunities. In this evolving landscape, we believe it is important for investors to work with managers who have a demonstrated track record of strong performance at all stages of the market cycle with the ability to explore the best opportunities in both sponsored and non-sponsored lending.

Endnotes

brookfieldoaktree.com

info@brookfieldoaktree.com

855-777-8001

[1] Source: Moody's, as of January 31, 2025.

[2] Source: Preqin, as of December 31, 2024.

[3] Preqin, SIFMA Research (2022 Capital Markets Fact Book), Pitchbook LCD, as of September 30, 2024. Large LBO loans defined as $50 million or more of EBITDA.

[4] Preqin, SIFMA Research (2022 Capital Markets Fact Book), Pitchbook LCD, as of September 30, 2024. Large LBO loans defined as $50 million or more of EBITDA.

[5] Based on Oaktree's observations of market conditions, as of January 31, 2025.

[6] Covenants are promises or agreements entered into by a borrowing party to comply with the terms agreed upon in relation to a loan agreement.

Private credit risks

All investing involves risk. The value of an investment will fluctuate over time, and an investor may gain or lose money, or the entire investment. Past performance is no guarantee of future results.

As an asset class, private credit is comprised of a large variety of different debt instruments. While each has its own risk and return profile, private credit assets generally have increased risk of default, due to their typical opportunistic focus on companies with limited funding options, in comparison to their public equivalents.

Because private credit usually involves lending to below-investment-grade or non-rated issuers, yield on private credit assets is increased in return for taking on increased risk.

Diversification is the process of owning different investments that tend to perform well at different times in order to reduce the effects of volatility in a portfolio, and also increase the potential for increasing returns. Diversification does not guarantee a profit or protect against loss.

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