# 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. There was a modest uptick in bank lending throughout 2022 and into this year; however, we believe that bounce will likely prove short-lived as higher interest rates and recent bank failures once again cause banks to retrench **(Figure 1)**.

**Figure 1: Non-Banks Are now the Largest Source of Corporate Loans**

Primary Market Corporate Loan Participation

Source: S&P LCD, as of December 31, 2022.

By the end of 2022, private credit comprised $1.4 trillion in assets under management globally, rivaling U.S. high yield bonds, and private credit is forecast to total $2.3 trillion by 2027.[1]

Private credit AUM globally, end of 2022

As an asset class, private credit has obvious appeal; Large leveraged buyout loans offered yields of 12.4% at the end of 2022[2] vs. 8.9% for high-yield bonds.[3] Beyond strong income, private credit also offers the potential for portfolio diversification and inflation protection due to their floating interest rates.

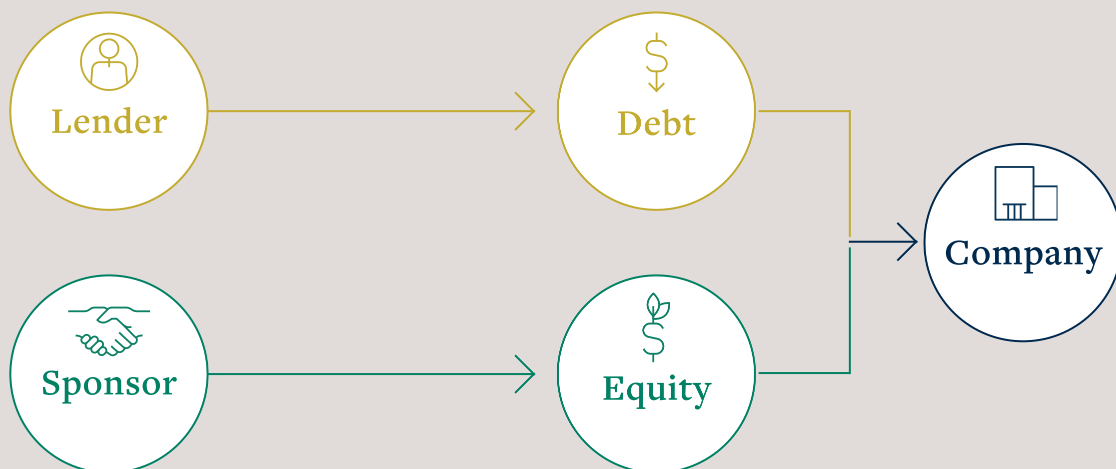
Private credit AUM forecast, 2027

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.

## 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.

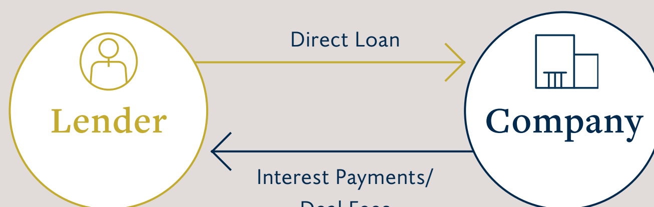
# Non-Sponsored Financing

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%[4] above comparable sponsored credits.

## 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.

For these reasons, investors seeking to allocate to private credit should, in our view, seek out investment managers with 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

[1] Bloomberg News, January 13, 2023.

[2] Preqin, SIFMA Research (2022 Capital Markets Fact Book), Pitchbook LCD, as of December 31, 2022. Large LBO loans defined as $50 million or more of EBITDA.

[3] High Yield Bonds represented by the ICE BofA U.S. High Yield Index, as of December 31, 2022.

[4] Based on Oaktree's observations of market conditions, as of March 31, 2023.

[5] 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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