STEPSTONE

Deployment and sourcing channels in direct lending

Private debt | MAY 2024

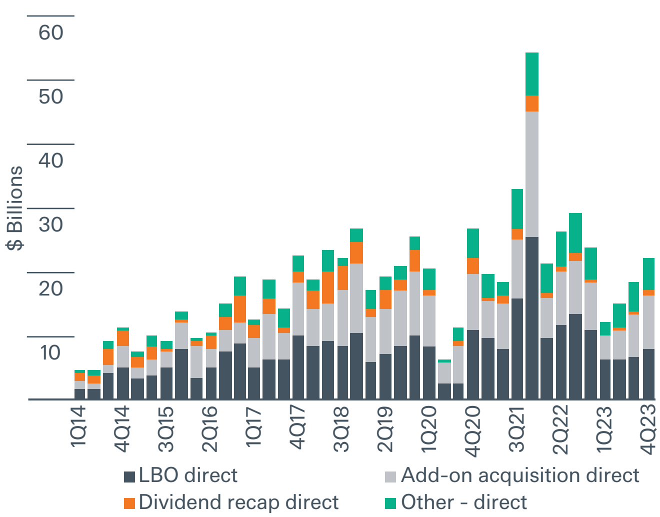
During 2023, direct lending witnessed lower deployment levels relative to previous years. The high interest rate environment challenged valuations, which in turn limited private equity activity.

Because private lenders provide a material amount of loans for M&A, decreased activity in the private equity market translated into lower origination volume in the private debt market. However, when overall activity is muted, investors have tools to mitigate deployment shortfalls by leveraging the three different deployment channels available in direct lending: primaries, co-investments and secondaries.

How much did deployment slow down in 2023?

Deployment volumes in direct lending experienced a notable slowdown at the start of 2023 with a 43% decrease in activity when comparing 1H23 to 1H22. The low volumes experienced in early 2023 are reminiscent of those seen during the beginning of the Covid-19 pandemic in 1H20. However, toward the year's end, direct lending volume rebounded: 2H23 levels were 50% higher than H1 marks. If the recent uptick in LBO volume is any indication, 2024 might see more deployment opportunities for direct lenders.

FIGURE 1: US DIRECT LENDING NEW MONEY



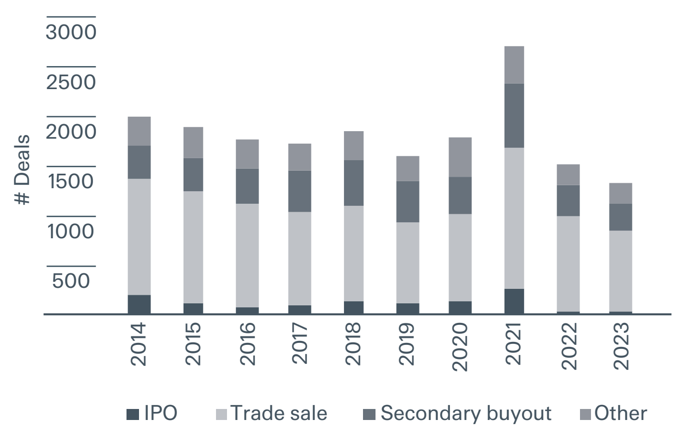
Source: Refinitiv LPC, as of Q4 2023.

Deployment was subdued due to the high interest rates and uncertain macroeconomic environment, but recent data suggests that activity might improve in 2024.

Why did deployment slow down in 2023?

Private equity firms faced limited options for exiting their investments due to an uncertain macroeconomic environment and higher interest rates impacting the valuations of their portfolio companies. Buyers and sellers were unable to agree on prices, which led to a significant reduction in M&A activity compared with 2021, as private equity owners were unwilling to accept discounts that would affect their returns. With the IPO market relatively inactive for much of the year, many firms found it difficult to exit their investments and return capital to their LPs.

FIGURE 2: PRIVATE EQUITY EXITS



Source: Preqin, as of March 2024.

What to do when primary deployment slows down?

A decline in activity does not necessarily prevent investors from deploying capital efficiently. For larger investors, the ability to invest through SMAs instead of commingled funds can provide flexibility to redirect capital to better deploying GPs, market segments or sectors. Moreover, higher deployment efficiency can also be achieved by tapping into secondaries and co-investment opportunities. As the primary market saw a decrease in activity in 2023, secondaries experienced robust flows providing attractive deployment avenues. Secondaries and co-investments also enable investors to cultivate relationships with a broader set of GPs. These relationships may help investors solve their deployment needs.

SECONDARIES

The private debt secondary market involves selling an existing LP stake in a private debt fund or portfolio to a third party. This provides LPs with an option to increase their private debt exposure and deploy capital swiftly. Secondaries provide several benefits: instant deployment and diversification benefits, return enhancement due to the potential discount at which the portfolio is being acquired and mitigation of blind pool risk (i.e., the buyer knows which loans are being purchased). The direct lending secondary market is growing fast and is expected to grow further. The increasing number of participants in this market translates into higher deal flow, enhanced price efficiency and more certainty of deal execution.

CO-INVESTMENT

Co-investments are loans that an originating GP offers to its LPs or other market participants to invest in, often on a no-fee basis. This sourcing channel complements the primary channel, allowing investors to collaborate with a wider group of GPs to gain exposure to a greater number of deals while avoiding the need to commit and lock up capital.

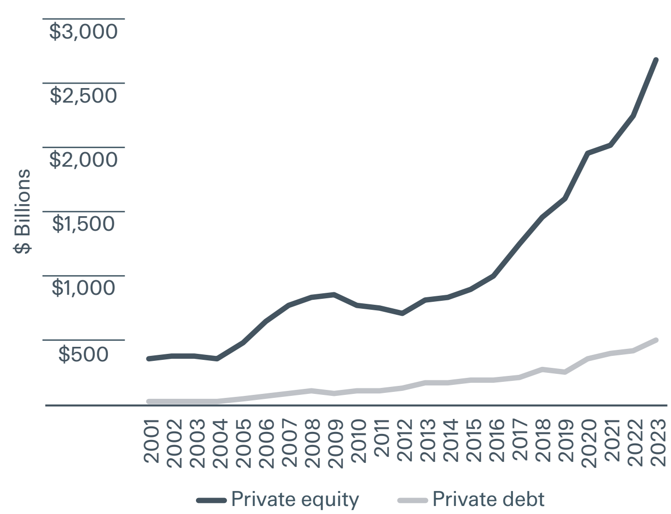
For instance, an investor that is only invested in a single or a few GP primary funds or SMAs may be dependent on their deal flow. But, if the investor complements their portfolio by engaging in co-investment relationships with a wider group of GPs, they can deploy additional capital without worrying about the status of any single GP's deal flow.

What is the expectation for deployment going forward?

Because of the slump in activity, private equity firms accumulated unprecedented levels of dry powder and sought innovative ways to return capital to their LPs, such as through NAV loans or continuation funds. However, as LPs clamor for distributions and the deployment of dry powder, private equity firms are under growing pressure to find deployment opportunities. The consensus view that interest rates will fall suggests this slump might not last much longer if deal flow picks up. Nonetheless, LPs should diversify their deployment channels by exploring opportunities in co-investments and secondaries to deploy capital efficiently and stay on schedule.

> Multi-channel sourcing can facilitate efficient deployment, even when market activity is low.

FIGURE 3: PRIVATE EQUITY AND PRIVATE DEBT DRY POWDER



Source: Preqin, as of March 2024.

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All data is as of May 2024 unless otherwise noted.

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