Proskauer

Talking Trends with MidCap

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In **Women in Private Credit: Talking Trends**, we dive into the world of private credit through the lens of eminent women in the field — from professionals at the forefront of industry leadership to our own lawyers. Together, we navigate the trends and topics influencing private credit against the backdrop of today’s ever-evolving geopolitical landscape.

In our latest edition, Proskauer private credit partner Michelle Iodice sits down with MidCap Vice Chair, Clare Bailhé and Managing Director, Puja Parekh to discuss the drivers of private credit’s growth, challenges to the industry, and potential trends for the market.

Private credit continues to perform well, despite economic and geopolitical headwinds. What are the main drivers of this?

Puja Parekh (MidCap): Several trends are driving the growth of private credit. While we have observed some modest spread compression, the key takeaway is that the overall total return of this asset class remains robust, exceeding levels seen between 2019 and 2021. The relative value of private credit compared to the broadly syndicated loan market remains strong, and we anticipate that both private credit and BSL markets will coexist. These products are fundamentally different, each offering unique advantages to borrowers and PE sponsors. Private credit deals tend to be more customized and flexible than traditional bank loans or bonds, offering easier execution and accommodating larger delayed draw term loans. There will be times when banks are more aggressive and syndicated markets are more risk-on, leading us to lose some share, and the opposite will also occur. This cyclical dynamic is nothing new. However, given the continued growth and depth of the private credit space, we anticipate private credit will contribute 10-20% of overall leveraged finance activity in a normalized market.

Additionally, private credit funds usually benefit from long-term capital commitments from institutional investors, such as pension funds and insurance companies. This patient capital allows private credit to maintain a long-term perspective, even amid market volatility, providing stability to the sector. Finally, private credit investments are often diversified across various industries, which helps mitigate risk.

Proskauer: We also agree that private credit and BSL markets will continue to coexist. Each product has its relative advantages and disadvantages as it relates to any particular transaction, and PE sponsors often choose to dual-track negotiations on both structures before ultimately determining which is the best path forward. Another differentiating factor for private credit is the level of access to due diligence information during deal underwriting and documentation, which helps private credit lenders be thoughtful in selecting investment opportunities. On the legal side, we see how this process leads to informed decisions and deal structuring. Private credit lenders typically have a greater measure of control over documentation than you would see in a BSL credit. They will either lead the negotiations in cases where they assume the agency role or have the opportunity to voice material concerns as a lender in a small club, the result being that deal terms are tailored to the risks of each particular credit.

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Puja Parekh, Managing Director, MidCap

What are the biggest challenges for lenders in today's market?

Parekh (MidCap): In the current environment, with increased competition, tighter margins and rising risks, maintaining the same levels of returns without assuming additional risk has become more challenging. We're also seeing a shift in documentation, with more borrower-friendly terms emerging, particularly around incremental debt, restricted payments and covenant cushions.

However, our primary focus has been on portfolio management. We believe the worst is now behind us, and, frankly, the challenges we've faced were not as severe as expected. We haven't observed any signs of widespread credit stress across our portfolio, nor have we experienced a significant rise in non-accruals or defaults. Sectors that previously faced headwinds, such as healthcare companies dealing with labor shortages and wage inflation or industrials affected by customer destocking, have generally returned to growth. The limited number of underperforming names in our portfolio are isolated, idiosyncratic cases. Additionally, the average LTV in our portfolio is well below 50%, providing substantial equity support beneath us. We believe this strong equity cushion offers significant protection in the event of a downturn or during challenging market cycles. Interest coverage ratios across our portfolios have bottomed out at manageable levels in the first half of 2024, and we expect gradual improvement in coverage metrics as interest rates continue to stabilize.

Proskauer: We have also seen a sharp rise in portfolio management activity. There has been significant incremental lending to support add-on acquisitions in existing credits and many repricing and "amend & extend" transactions as PE sponsors hold their portfolio investments for longer. Additionally, we have seen an increase in restructuring transactions over the last couple of years (including capital infusions, debt to equity exchanges, refinancings of existing loans and other material amendments to loan documentation in connection with a default or potential default). These restructuring transactions highlight the advantages of private credit, demonstrating a solution-focused approach, a long-term commitment to the investment, and a durable relationship between lender and PE sponsor. While the private credit market has proven to be resilient generally, these transactions also help to keep default rates low. Our Private Credit Default Index echoes your sentiment, with a 1.84%, 2.71%,1.95% and 2.67% default rate on active deals for Q1-Q4 2024, respectively. In each of these quarters, payment defaults made up less than one third of the total defaults.

How has MidCap optimized deal sourcing and execution in the current macro environment, with M&A volumes well below prior periods?

Parekh (MidCap): M&A volumes have notably declined, and uninvested private equity dry powder has exceeded $1.2 trillion. The median holding period for PE-owned companies is projected to remain at a record high of over five years in 2024. While M&A activity has historically been an important driver of demand for leveraged credit, it is not always the primary factor.

Our portfolio has expanded significantly, now comprising over 250 borrowers, and this has been a significant source of deal flow. In 2024, we saw considerable portfolio activity, including incremental financing needs, refinancings and, when appropriate, dividends for top-performing companies. We also optimized deal execution by offering creative and flexible financing solutions tailored to each borrower’s unique situation. With our partnership with Apollo, MidCap offers a broad range of financing products, such as NAV financing, preferred equity and HoldCo structures, which have seen continued growth, especially as borrowers are trying to optimize capital structures as rates continue to remain elevated.

In today’s competitive and uncertain economic environment, relationship-driven deal sourcing is more critical than ever. We view ourselves as true partners with private equity firms, collaborating to ensure the right decisions are made for investments across market cycles. We primarily act as Administrative Agent and are the largest lender in most of our deals, taking a proactive approach to evaluating requests and balancing flexibility for clients while maintaining strong enterprise value coverage. Our well-established PE sponsor networks consistently provide a robust pipeline of opportunities.

Clare Bailhé (Midcap): One of the things we are most proud of at MidCap is the long tenure of our employees. Many, many colleagues have celebrated five years, 10 years, 15 years! at MidCap. I firmly believe this continuity has propelled MidCap, fostering confidence and certainty with our borrowers and PE sponsors and providing us consistency in spite of macro-M&A trends.

Proskauer: From our vantage point, private credit lenders seem to be looking for creative ways to deploy capital in light of a depressed M&A volume. Some are exploring a shift away from traditional unitranche structures, which have dominated the market in recent years. We have noticed an increase in bank/direct lender partnerships resulting in structures like super-priority revolvers and bifurcated unitranche deals with an agreement among lenders. We are also seeing more interest in products like junior capital, preferred equity, holdco debt and NAV lending.

Parekh (MidCap): While there is, indeed, a rise in creative financing solutions, like preferred equity and HoldCo structures, at least for MidCap Apollo, these products are typically targeted towards larger borrowers with EBITDA over $100 million. Due to excess liquidity, investors and private credit funds are increasingly exploring more complex, customized options, such as bifurcated unitranche, junior capital, preferred equity, HoldCo debt and NAV lending. NAV lending, in particular, has experienced significant growth as private equity firms seek flexible financing for entire portfolios. It's especially valuable for later-stage funds looking to manage liquidity or extend fund life without prematurely selling assets. However, for our core middle-market platform, we continue to primarily focus on traditional unitranche structures, with leverage typically ranging between 4.5x and 6.0x. We've also noticed a rise in super-priority revolvers and first-out/last-out structures, which blend to a lower rate and are appealing for some borrowers, especially as rates remain elevated.

Will we see more favorable M&A activity in 2025?

Parekh (MidCap): Yes, I anticipate that M&A activity in 2025 will surpass 2024 levels, driven by PE sponsors seeking liquidity events to support fundraising efforts, which have been challenging over the past 18 months. The pressure to return capital to investors has intensified, as slower distributions have left LPs cash-flow negative, limiting their ability to reinvest in private equity. Record levels of unspent dry powder accumulated during this period, combined with the need to return capital, should foster a more favorable environment for both buyers and sellers.

Additionally, a more stable economic outlook and easing inflationary pressures in 2025 could boost deal flow. Stability in the interest rate environment, or at least a narrower range for rate fluctuations, has also improved confidence in the cost of capital for PE sponsors, making LBO returns more attractive.

Where do you see the private credit market going in the next five years?

Parekh (MidCap): The private credit market is set for continued growth and evolution, fueled by the demand for higher yields, diversification and innovative lending solutions. This asset class has demonstrated resilience across multiple cycles, and I expect its growth trajectory to persist over the next five years. Institutional investors, such as pension funds, endowments and sovereign wealth funds, are increasingly allocating capital to private credit to diversify portfolios and enhance returns. Compared to the broadly syndicated market, private credit offers easier execution, greater flexibility in structuring and documentation, a relationship-driven approach and the ability to speak for size, enabling lenders to underwrite significant facilities.

However, I believe the market will likely experience consolidation or a shift towards more specialized and niche strategies, such as distressed debt, venture lending and industry-specific approaches. The influx of new entrants over the past two to three years has created saturation, with many competing in similar segments, which is not sustainable in the long term. Consolidation will lead to a smaller group of large, diversified players dominating the market, though boutique firms with specialized expertise will continue to thrive in specific sectors.

> “Private Credit has been around for decades and will continue to do so. Its name and focus in the spotlight may have changed (multiple times), but optionality for borrowers is critical, and every situation is unique. Private Credit is ideally suited for bespoke lending solutions.”

Clare Bailhé, Vice Chair, MidCap

We continue to see a growing community of very successful women in private credit. How has the

industry evolved in this respect? And what advice do you have for women looking to succeed in this space?

Parekh (MidCap): “Life isn’t about waiting for the storm to pass; it’s about learning to dance in the rain.” — Vivian Greene. There’s always more to learn, but don’t let that hold you back. Take action, because you will never know everything, and that’s okay.

Building a strong network is invaluable. Cultivate relationships both within your firm and externally — meet management teams, PE sponsors, lenders, lawyers and investment bankers, and consider joining women-focused finance networks, as these can open doors to new opportunities.

One challenge I continue to work on is self-advocacy. I push myself — and encourage others — to confidently highlight their achievements, seek out leadership roles and negotiate for compensation or promotions. Most importantly, as you progress in your career, mentor other women and foster an environment that supports their growth. Empowering others is one of the most impactful ways to drive lasting change in the industry.

Bailhé (Midcap): Banking and Finance have changed over the past decades and it is wonderful to now see so many women in the field — at all levels and all ages! While we have a long way to go, it is important to also acknowledge the accomplishments we have made. Take advantage of all the female-focused conferences and groups, which are terrific ways to network and make lasting friendships.

Proskauer: These are great tips! Thank you. I would also advocate for the value of mentorship. Look to these other women who came before you — they are a wealth of information and perspective on how to navigate the industry. We are lucky to be part of this impressive group, and I think we can support each other in continued success. And take ownership of your career — become an important part of your institution, invest in your network and take on stretch opportunities.

For more than 20 years, the Private Credit Group at Proskauer has been intrinsically involved in the evolution of the industry, working on pioneering structures and products. Our technical strength, combined with our expansive experience, makes us the Firm of choice for first-in-kind transactions. Acting as strategic partners to our clients across industries and jurisdictions, our team of lawyers has expertise in U.S. and Europe-centric transactions, as well as North American and European cross-border transactions.

Proskauer Women in Private Credit offers a knowledge sharing and peer network platform for females active in the private credit market. **Click here to register your interest in receiving future updates**.

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