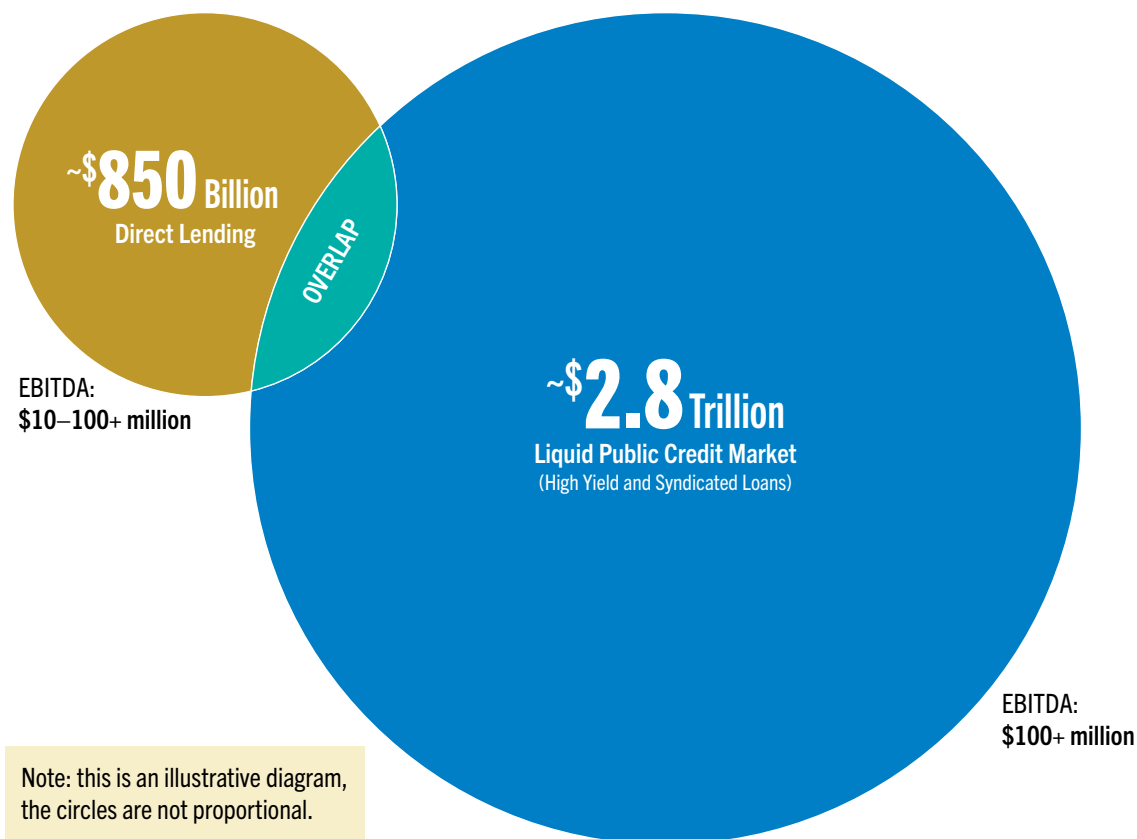


Distinction Versus Overlap: Respecting the Private–Public Divide

Middle market direct lending focuses on smaller companies with more modest financing needs; as company and deal size grow, the loan may take on characteristics more common to public syndicated debt.

Mind the Gap: Private and Public Credit Have Important Distinctions

Estimated market (and deal) size of public and private credit markets



Fundamentally Unlike

- The median middle market firm (with a value of around \$0.5 billion) is unrated and smaller than most public borrowers (~\$4.6B) which are subject to oversight from well-known credit rating agencies.
- Core middle market companies tend to have EBITDA in a range of \$10–\$100 million, compared with public borrowers that are generally far larger in size.
- Middle market lenders buy and hold the debt after extensive diligence done in conjunction with sponsors; syndicated loans are widely traded among banks and other investors on the basis of a marketing term sheet.
- Middle market loan documents are heavily negotiated with strong lender protections and less “flex;” they tend to offer more certainty and faster speed to close.
- Direct lending involves fewer participants at the negotiating table and tends to offer better terms, lower leverage and higher spreads than publicly syndicated loans.

Source: Golub Capital, Preqin and KBW, as of December 31, 2023.

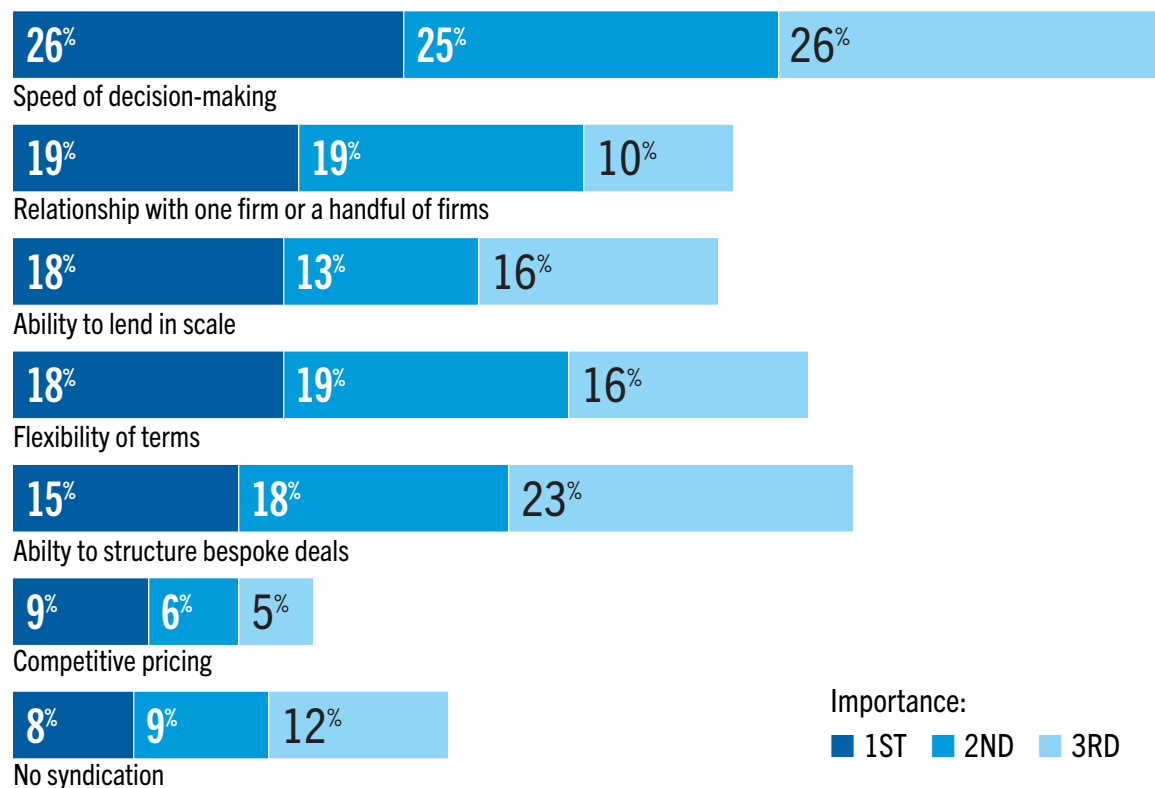
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Win—Win: The Happy Marriage of Sponsor and Lender

Lending to sponsor-backed companies entails less risk; private equity sponsors seek to help lenders select better credits, maintain better performance and achieve better problem resolution.

What Private Equity Sponsors Want in a Lender or... Why Do Borrowers Value Private Credit?



A Powerful Partnership

- A sponsor-focused origination model helps filter for quality borrowers alongside a lender's own diligence.
- Sponsor firms specialize in creating equity value at their companies and take a significant personal stake in the success of their companies.
- Private equity sponsors support their portfolio companies with a range of manager and operational resources to help avoid downside scenarios.
- Sponsors are able to invest additional equity in borrower firms to overcome temporary setbacks.
- Private equity sponsors are adept at onboarding new management to implement turnaround plans and tend to approach workouts with professionalism.
- The average annual default rate of sponsor-backed companies is about half that of non-sponsored transactions.¹

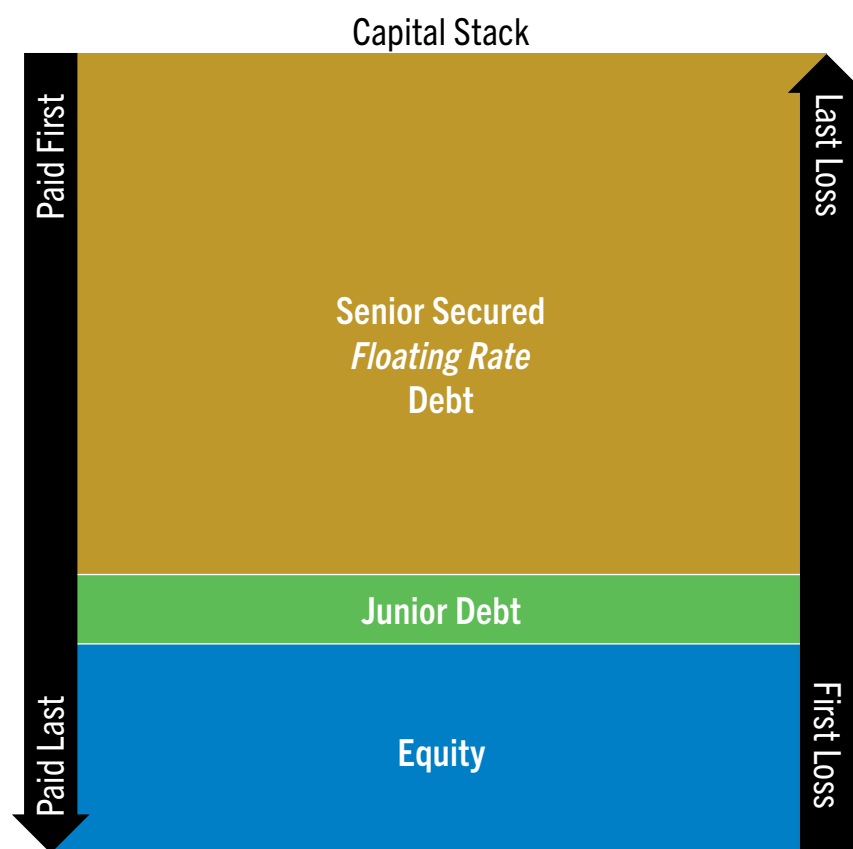
Source: The Proskauer Private Credit Survey 2024; Trends in Private Credit.

1. KBRA as of August 2024

Senior, Secured (and Floating Rate) for Preservation of Capital

Core direct lending managers use mostly senior loans that “attach” at a higher point in the capital stack, enabling greater lender protections and higher preservation of capital for investors in the event of default.

Senior Loans Help Preserve Capital



No Juniors, No Subordinates, No Insecurities

- The most important characteristic in a credit fund is capital preservation; managers seek to avoid credit losses and, in the case of default, to retain as much principal as possible.
- Senior loans provide “seniority” relative to other subordinated financing in the capital stack.
- Senior loans are both structurally senior and secured or collateralized by strong cash flows and defensive assets.
- During instances of default, senior loan holders have priority claim on company assets and are repaid first.
- And in the case of actual default, senior secured loans historically recover about 60–70% of principal on average, compared with 40% for unsecured high yield bonds.¹
- Finally, the floating-rate nature of most senior loans also helps insulate them from interest rate risk.

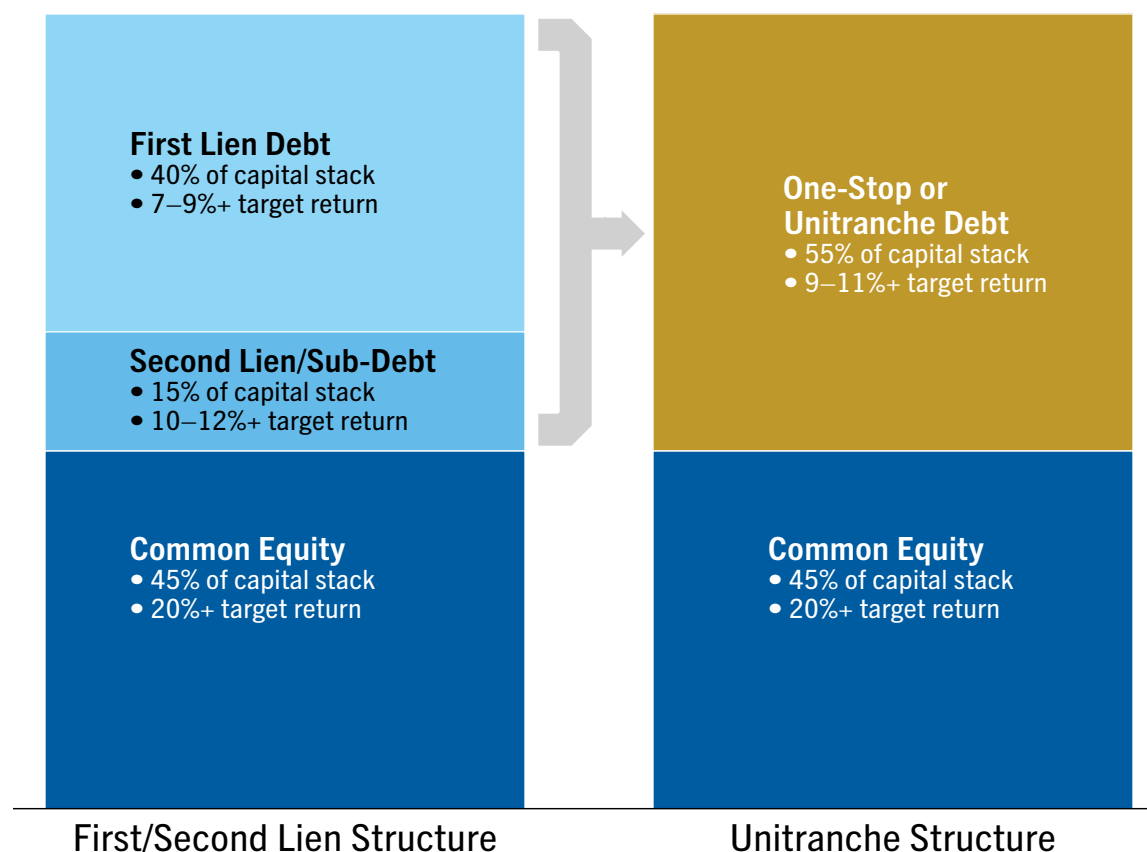
Source: Golub Capital.

1. Golub Capital, Cliffwater, and JPMorgan Markets, as of June 30, 2024.

One Loan, One Lender, One Stop: The Unitranche Innovation

The unitranche or one-stop loan brings real efficiencies to private credit financing, addressing key sponsor needs and enabling a more effective private debt solution.

Traditional vs. Unitranche (or One Stop) Structures



Do You Unitranche?

- A single lender combines several layers of debt, typically a first and second lien loan or subordinated debt, into a single loan facility with a blended rate.
- The borrower signs one set of documents and pays interest to a single lender; negotiation of terms is bilateral and confidential.
- This enables quicker (and more certain) closing with little execution or syndication risk.
- One-stop loans eliminate intercreditor agreements; they are easier to scale than the “1–2” structure.
- One-stop loans have less complexity for borrowers and offer a better risk and return profile for lenders.
- This allows better alignment of stakeholder incentives across borrower, sponsor, lender and investor.

Leadership

The designation of lead lender confers significant advantages upon a core private credit manager.

The Advantages of Leadership

	Lead Lender	Club Member	Participant
Sponsor Contact	High	Moderate	Limited
Ability to Influence Structure and Terms	High	Moderate	None
Underwriting Period	30–60 days	15–30 days	<10 days
Depth of Diligence Information and Access	High	Moderate	Limited
Control in a Restructuring	High	Moderate	Limited
Typical Upfront Fees	1.5–2.5%	0.75–1.25%	0.5–1.0%

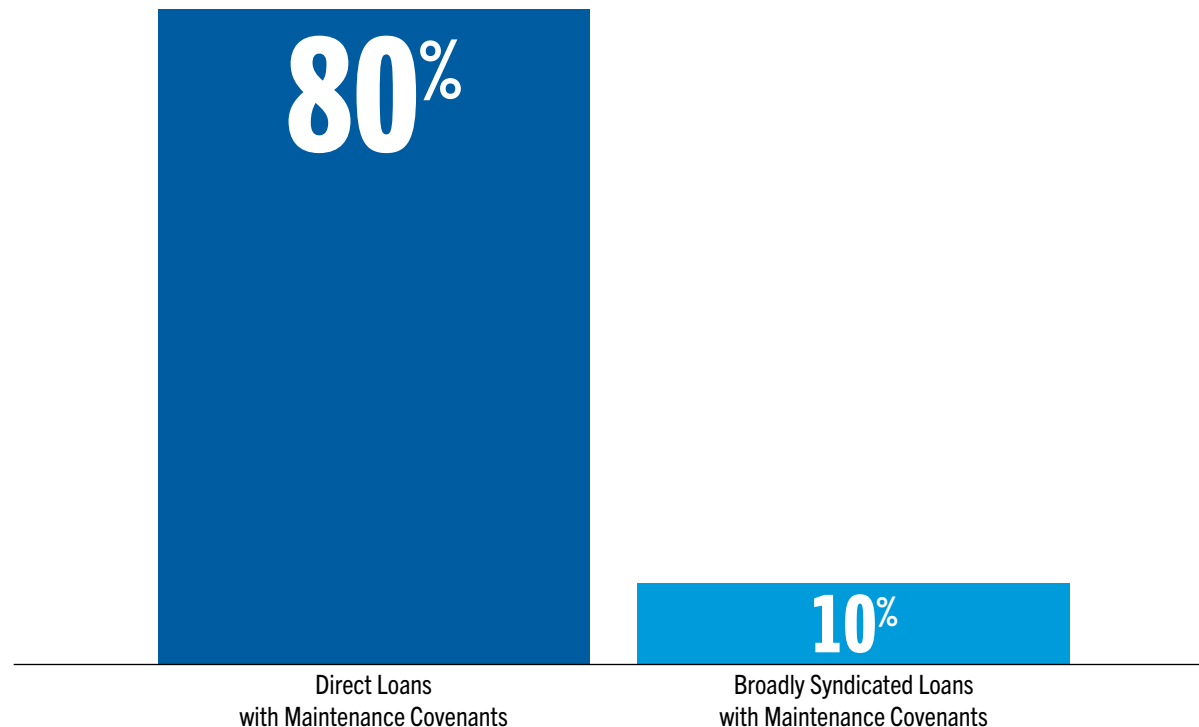
Shall I Lead?

- The lead lender negotiates directly with sponsor, has greater influence over capital structure, covenants, and loan terms, and has majority vote.
- The lead lender has an information advantage: they get privileged access to company data, senior management, and third-party consultants throughout the full underwriting process.
- Lead lenders may provide greater certainty of financing to better position sponsors in a competitive auction.
- Lead lenders may receive incremental economics for committing their balance sheet, with superior risk-adjusted returns and less risk of loss.
- The lead lender is typically the company's first call for additional capital or business updates and plays a controlling role in any restructuring.

A Matter of Control: Covenants Maintain Vigilance

Private direct lending takes a far more “covenanted” approach than public loans, enforcing greater discipline on borrower firms and enabling early warning to intervene and avert potential credit stress.

Maintenance Covenants are More Prevalent in Direct Lending



Covenants Against Misbehavior

- Financial maintenance covenants are embedded in direct lending documents and may include thresholds for interest coverage ratios, debt to EBITDA, and other measures of liquidity and net worth—they are actively monitored on a quarterly basis.
- Covenants vary in their intensity (their number) and their tightness or “slack”—(the current level versus the maximum allowed by the covenant).
- The average middle market loan has two financial maintenance covenants, which are deployed to monitor companies and incline them toward more conservative investment and financial behavior.¹

Source: Golub Capital and JP Morgan, as of March 2024

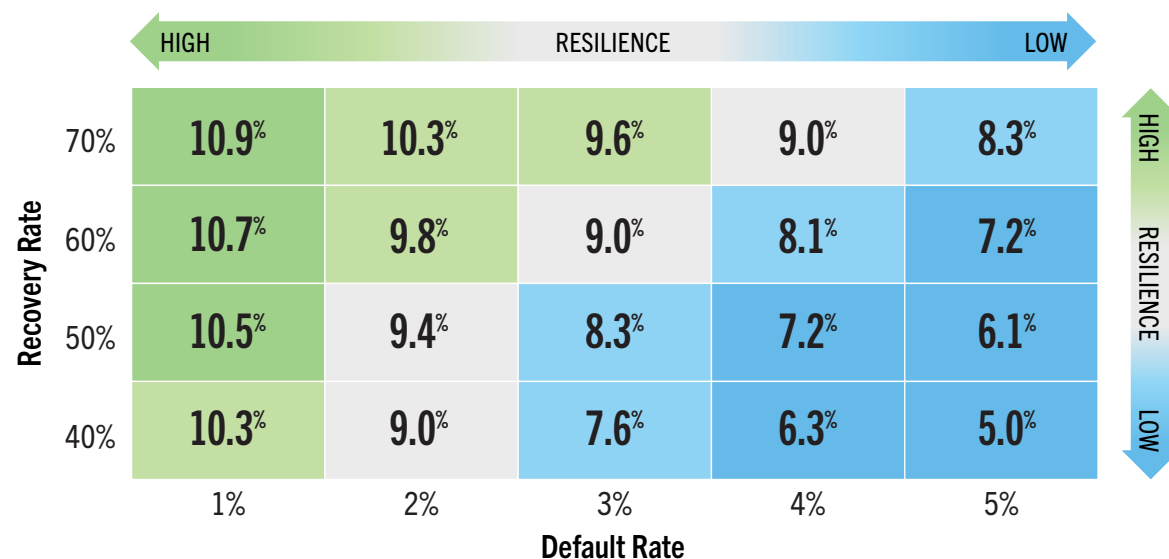
1. Jang, Young Soo, *Are Direct Lenders More Like Banks or Arms Length Investors*, January, 2024. SSRN.

Work It Out: Resilience Through Recovery

Higher recovery rates help mitigate losses and provide resilience in rising default rate environments

Recovery Rate: A Bulwark Against Default Rate in Managing Credit Portfolios

Net IRR under various default and recovery rate scenarios*



The average recovery rate for senior direct loans is ~60–70% versus ~40% for unsecured high yield bonds.

Recovery Limits Losses

- Recovery rates, alongside default rates, play a critical role in determining a manager's ability to deliver capital preservation and income stability.
- Unlike lenders in more liquid markets, direct lenders cannot trade in and out of positions to preserve value—they hold the debt on their balance sheet.
- To minimize loss in the case of default, lenders need to “work it out” through direct negotiation with borrowers, through operational and financial restructuring, or by “taking the keys.”
- In a low-default rate environment, portfolios with poor recovery rates experience only modest return erosion, but as default rates rise, these managers' ability to navigate stressed credits becomes increasingly important.
- As default rates climb from 1% to 5%, managers with high (70%) recovery rates experience a modest reduction in IRR, from 10.9% to 8.3%, but managers with lower recovery rates (40%) see returns cut in half, from 10.3% to 5.0%.

Source: Golub Capital.

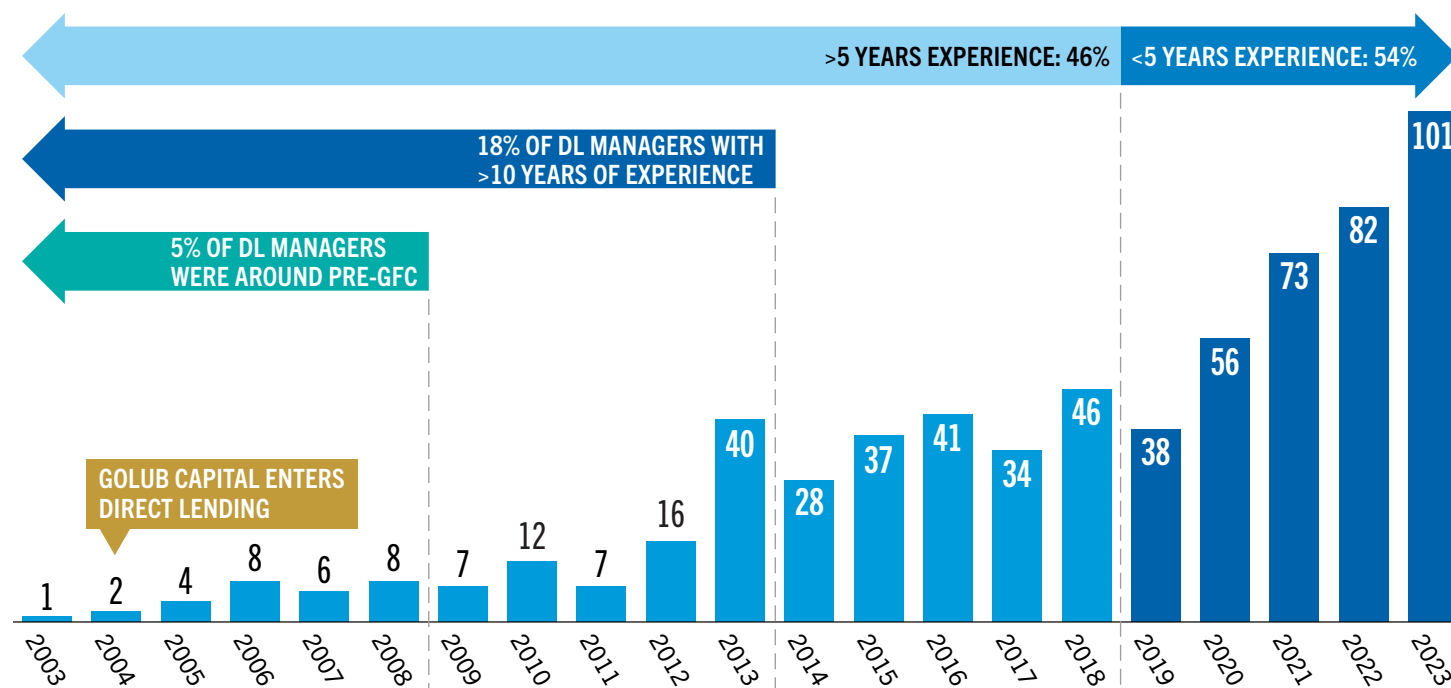
*Modeling represents a typical direct lending BDC operating with an 11.1% total interest income yield, a 5.6% borrowing cost, a 1.2x leverage (debt/equity), a 0.3% G&A expense (on assets), a 1.3% base management fee and a 17% incentive fee.

Are You Experienced?

Few Managers Have Long Tenure

The vast majority of direct lending managers today are untested—most have not experienced a true credit cycle.

New Managers Entering Direct Lending



In 2023, a new manager entered the DL market every 3.6 days.

The Historical Record

- More than half (54%) of direct lenders entered the space only in the last five years (2019–2023).
- Only 18% of managers have more than 10 years of experience.
- About 30 managers, out of hundreds, experienced the global financial crisis in 2007–2009 (and some of those did not survive the experience).
- As new managers rush to join the direct lending ranks and gather assets, it's important to note their history in the category and assess their track record over a full market cycle.

Source: Golub Capital internal analysis and Preqin. Utilizes Preqin's database of first-time direct lending funds launched by an asset manager globally. The dataset includes 650 first-time direct lending funds launched from 1995 to 2023. As of July 1, 2024.

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