

E X P E R T Q & A

Scaled lenders backed by institutional capital are positioned to succeed in the next cycle as sponsors prioritise certainty of execution, say Churchill Asset Management's Derek Fricke and Jill White



Consistency is key

Q Despite a wave of negative headlines surrounding private credit this year, where are you seeing opportunity?

Jill White: The sector has attracted no shortage of negative headlines this year, from redemptions and retail vehicles to potential AI distortion, particularly in software. Nonetheless, we experienced a record first half for our firm and our senior direct lending platform, including new leveraged buyout opportunities and incremental portfolio financing. That momentum continues to build in the second half.

It is important to note, however, that this activity hasn't come at the expense of taking on more risk. Our deal selectivity in the first half sat at the low end of historical ranges, meaning

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we are only closing on what we believe are the most attractive opportunities. The fundamentals of the core mid-market also remain sound.

We continue to see revenue and EBITDA growth across the vast majority of our borrowers, and liquidity, which we monitor using revolver metrics, remains strong. Compared to the volatility that syndicated markets experienced following software headlines earlier in the year, our private equity clients continue to view private credit as a stable and dependable source of capital during periods of dislocation.

Q What is the health of your borrowers telling you about the broader condition of the mid-market economy?

Derek Fricke: The vast majority of our borrowers, across both the senior lending and junior capital platforms, are performing at or above initial underwriting expectations. We primarily invest in service-orientated, US-centric companies, which mitigates geopolitical risk.

That said, we continue to monitor the downstream effects of those events, which can influence customer purchasing power and behaviour. But loss ratios remain very low, in line with historic norms and, overall, we believe the US mid-market economy to be healthy.

Q Some parts of the private credit market have faced liquidity pressures this year. What does that mean for sponsors, borrowers and the competitive landscape?

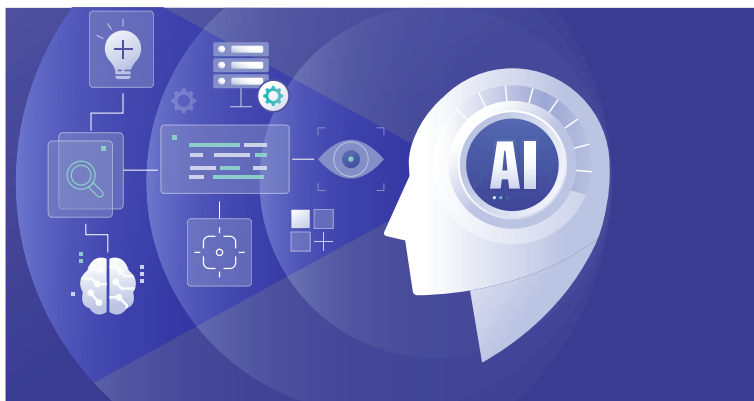
JW: Consistency of capital matters more to sponsors than ever, and as lenders facing redemption pressures continue to pull back, sponsors are scrutinising retail exposure within lenders' capital bases far more closely. An overwhelming 96 percent of our capital is institutional, which is a distinct competitive advantage in a market where borrowers place a premium on certainty of close.

Q Sponsors are increasingly seeking more tailored financing across the capital structure. How are borrower needs evolving, and what does flexible capital look like in practice?

DF: Use of proceeds for our dollars has historically skewed towards new LBO transactions, but we are currently seeing more opportunities to finance follow-on M&A, as well as to refinance out existing capital structures, providing additional liquidity and extending maturities as sponsors hold assets for longer.

Against this backdrop, the customisation of solutions is paramount. You can't take a one-size-fits-all approach. Sponsors want to align capital structures with their growth thesis.

That can take the form of a unitranche, a bifurcated first or second lien, or – particularly when sponsors are paying double digit multiples – it can mean customised solutions in the middle of the balance sheet, in the form of preferred equity tranches, holding company or operating company payment-in-kind (PIK) notes. Bespoke capital solutions are also particularly compelling for high-quality businesses whose complexities place traditional credit financing out of reach.



Q Artificial intelligence is reshaping many industries. How is it influencing the way you underwrite deals and monitor portfolios?

JW: On the senior lending side, we started doing a borrower-by-borrower analysis last year to assess AI risk across the portfolio. We believe, platform-wide, that AI will create winners and losers, not just in software but in all industries. Within our senior lending strategy, however, our exposure to high-tech industries currently stands at just 5 percent. Those are performing companies, where we hold a senior position in the capital structure and where a strong equity cushion and competitive moat provide meaningful downside protection.

More broadly across the portfolio, we have only identified a small handful of businesses that we believe face a high risk of negative AI distortion. We deem the vast majority of the portfolio to be low risk, primarily because the businesses we finance tend to be service-orientated market leaders more insulated from binary AI-based outcomes.

Nonetheless, our deal teams remain deeply engaged across sectors to stay ahead of this rapidly evolving landscape. We have established taskforces leveraging consultants, private equity relationships, management teams and industry experts, allowing us to be proactive with our portfolio management. We have also maintained a highly diversified portfolio to avoid over-indexing to any one sector, which provides additional protection.

DF: Our philosophy is that the only wrong answer when it comes to AI is to do nothing. AI will impact every business in one way or another, and the smart approach is to leverage AI as a tool, whether to enhance revenue growth or drive margin expansion. Every new investment we make is subject to our AI evaluation framework, and it is a topic of discussion at every board meeting.

Q How do today's market dynamics differ across the core mid-market, upper mid-market and large-cap segments?

DF: Our junior capital programme predominantly provides capital to core

mid-market borrowers, skewing to sub-\$50 million of EBITDA. That part of the market remains relationship-based. Pricing is stable, documentation is tight and we believe that only a limited number of scaled platforms can provide the solutions that we aim to deliver.

JW: The senior lending platform plays a little more broadly, at between \$10 million and \$100 million of EBITDA. Importantly, we focus on US companies, which provides insulation from geopolitical and tariff risks because our borrowers' revenues, labour pools and supply chains are all US-based. We like this space because these are substantive companies, with operating histories and levers that can be pulled in a downturn, yet they avoid much of the spread compression and looser credit terms that characterise the upper mid-market.

Right now, cross border exposure in the upper mid-market and large-cap segment is particularly challenging given geopolitical conflicts and supply-chain disruptions, with elevated currency risk compounding the picture. Finally, I would add that mid-market companies tend to have more exit options, which provides lenders with additional downside protection.

"Sponsors value partners that have been consistently present through market cycles, rather than those that chased the asset class at its peak only to exit when prices fell"

JILL WHITE

Q What are your expectations for M&A activity, leverage and financing conditions throughout the remainder of the year?

DF: We are optimistic that the momentum we saw in the first half will continue, or even accelerate. I realise sponsors and bankers have made this claim for the past two years now, but the activity is now genuinely materialising. Smaller sponsors are bringing their portfolio companies to market, which then presents a great opportunity for core mid-market sponsors to engage. For well-capitalised, institutionally backed groups, I expect ample dealflow, enabling us to be highly selective about the small percentage we consider the most attractive.

JW: I would also add that we anticipate a higher-for-longer environment and potentially even rate hikes. That could temper leverage, but I expect it to be offset by competitive processes among scaled managers looking to deploy. While credit conditions have improved, with spreads widening in recent quarters, the backdrop of rising oil prices and supply-chain disruption leads us to expect competitive financing processes for quality assets for the rest of the year.

Q As private credit matures, what will distinguish the managers best positioned to succeed over the next cycle?

JW: Consistent, institutional backing is clearly top of mind right now, as it can offer reassurance to private equity clients who want confidence that capital will be there when they need it. Depth of relationships is equally important. Our multi-strategy platform allows us to offer a broad range of solutions for our clients and, coupled with what we believe is a solid execution track record, we feel this positions us well for the next cycle.

Scale is critical for senior lending in the core mid-market. For us, that means

"You can't take a one-size-fits-all approach.

Sponsors want to align capital structures with their growth thesis"

DEREK FRICKE

being able to underwrite and hold \$400 million or more in a single name – a threshold that narrows the field considerably, given the appetite for diversification in this asset class. Additionally, sponsors value partners that have been consistently present through market cycles, rather than those that chased the asset class at its peak only to exit when prices fell.

Finally, I would point to the importance of a seasoned team with deep sector knowledge as a key differentiator for sponsors seeking an efficient, thoughtful partner that can enhance their own due diligence process.

DF: Ultimately, it comes down to relationships. Sponsors want to work with lenders they know to be good partners in good times and bad. We do not act aggressively. We are flexible in terms of the capital structures we can put in place, and we have been doing this now for more than 20 years. It is all about being recognised as a reliable solutions provider. ■

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