



The different risk-return flavours of direct lending

Within the direct lending space, investors have the choice between different segments and risk/return profiles. Financial Investigator spoke with Robin Challis from Pemberton Asset Management about the strategic or opportunistic segment of direct lending, its complexity, market dislocations, and potential for premium returns.

By our editorial team

What characterises the strategic or opportunistic segment of direct lending?

‘Opportunistic investing is often seen as secondary market stressed and distressed debt purchasing, however, our strategic credit strategy predominantly focuses on primary debt and seeks to invest through the cycle, providing first-lien focused solutions in primary transactions to performing companies while resolving complexity. In terms of credit complexity, the strategy seeks to provide bespoke first-lien solutions to performing mid-market companies, to fund carve outs, CapEx projects and M&A. In addition, its flexible mandate is able to pivot in periods of market dislocation to identify the best relative value through the cycle – for instance, hung syndications and secondary market opportunities.

The strategy is able to generate an attractive pick-up versus both public markets and vanilla mid-market direct lending strategies through a broad origination network and by resolving complexity while preserving a focus on first-lien solutions (~75% of the portfolio).

The strategy’s flexible mandate also allows PMs to pivot towards pockets of attractive relative value. The strategy typically performed well through periods of market dislocation – notably by purchasing hung syndications at material discounts and exiting in the secondary market – complemented by selective investments in subordinated instruments that are backed by diversified pools of collateral.’

Are portfolio companies prepared to pay a substantial higher interest to your fund?

‘Yes, Private Equity firms are typically happy to pay a little more for the flexibility that gives them certainty on being able to execute their investment thesis and, as discussed above, our strategy is primarily focused on resolving complexity in performing credits. As a general comment, we typically see sponsors opt for higher-cost, flexible financing during the initial period of their ownership, with the financing subsequently refinanced by core direct lenders. The strategy is also able to spend time undertaking due diligence on complex credits and to look through to underlying credit quality, which attracts a premium. The core of the portfolio is in first-lien, senior secured, facilities, and this is complemented by subordinated positions that are backed by diversified

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pools of collateral with attractive risk-adjusted returns.’

Can you give an example of typical deals you are doing in your fund?

‘Our fund will seek to invest in loans of € 50 million to € 250 million to target investments with the following characteristics:

- Market-leading positions;
- EBITDA typically between € 15 million and € 100 million;
- Average equity cushions of 40 - 60%;
- Leverage in the range of 3.0 - 6.0x EBITDA;
- Geographical focus on Western Europe, particularly on the largest economies in the region.

As a result, the investment opportunities targeted by the portfolio are expected to have credit ratings equivalent to B-/B/B+.

Examples of transaction types include acquisition financings, growth financing, LBOs and add-ons. M&A-driven financing are attractive opportunities as these will generally be made alongside fresh sponsor equity which ensures strong alignment of interests between lenders and borrowers.

Recapitalisations and refinancings also present attractive opportunities in the current context as long as care is taken to ensure the interests of borrowers and lenders remain aligned, and cash-outs are limited to ensure sponsors remain incentivised to support their portfolio companies in times of stress.

Secondary transactions and hung syndications tend to come up in times of important market dislocations – such as Covid and the Ukraine invasion – and are

therefore not expected to arise in the context of a standard economic recession.

Finally, opportunities can be found in strategic risk transfers (SRT) and CLOs. Whilst the strategic credit strategy is primarily focused on making senior secured first-lien investments, we believe that our broad mandate enables us to target the best relative value at different times in the cycle and across different investment/tranche types.’

How do current macroeconomic dynamics affect the deal flow and return potential in the opportunistic segment of direct lending?

‘The first half of the year finished with a significant increase in M&A-driven volumes as markets stabilised and market participants enjoyed an execution window post tariff volatility. In particular, there has been a strong focus on M&A transactions involving European companies with limited exposure to US markets.

The strategy saw increased deployment levels through the second quarter of 2025 with several new direct lending platforms and a number of add-ons for existing portfolio companies.

In addition, the flexible mandate allows our strategy to invest where we see attractive relative value with selected investments through the second quarter of 2025 in both SRT notes and CLO equity, backed by diversified collateral pools.’

How do you assess and manage the risks associated with this segment?

‘Our strategy has an emphasis on Western European companies in defensive sectors. We have a robust underwriting process, led by our independent credit team, that assesses key due diligence items, including: (1) market & competitive positioning, (2) financial performance and cash generation under various scenarios, (3) management quality and governance structures, and (4) structural protections.

Our due diligence process encompasses diligence reports from reputable third-party providers, complemented by our in-house sector expertise and expert networks. We also make use of proprietary technology to monitor and assess portfolio company performance after the initial investment, alongside engaging closely with sponsors and management teams.’ ■



Robin Challis

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SUMMARY

Opportunistic direct lending offers opportunities through first-lien solutions to performing European mid-market companies.

Premium returns are achieved by resolving credit complexity and exploiting market dislocations.

Portfolio companies often accept higher interest because of bespoke financing needs, including M&A, recapitalisation, et cetera.

A flexible mandate allows pivoting to SRT notes and CLO equity when relative value is considered attractive.