Diversifying Direct Lending portfolios through sponsor-less lending

Damien Hedderwick
Director, Private Credit

Q3 2025

Federated Hermes
Private Markets

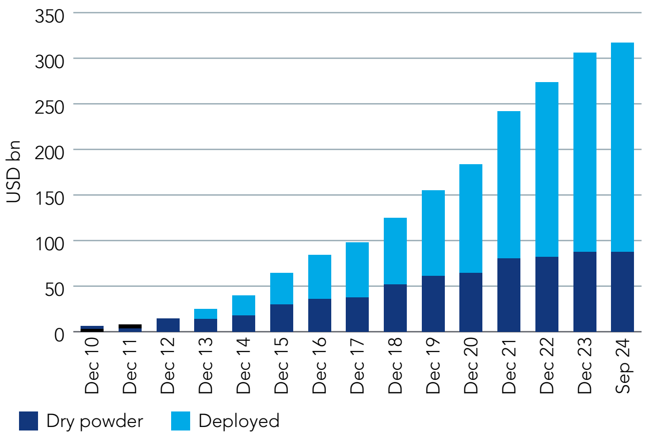
Fast reading

- **An increasingly crowded Direct Lending landscape, combined with sluggish buy-out activity, has raised competition, and led to mounting pressure on lenders to deploy.**
- **The recent tariffs war initiated by the US has further clouded the global macro environment, weighing on the rebound of the buy-out activity.**
- **Traditionally, sponsor-backed lending has been the preferred route for direct lending expansion, with buy-out M&A activity supporting the rapid deployment of direct loans to sponsor-backed borrowers, considered as higher quality credits.**
- **At Federated Hermes, we believe that, in this increasingly uncertain climate, investors should direct their focus towards the northern European lower mid-market, and broaden their scope to include sponsor-less loans.**
- **Sponsor-less transactions in the lower mid-market space have the benefit of providing portfolio diversification, along with the potential for enhanced risk-adjusted returns.**
- **In this article, we discuss the challenges of sponsor-less lending – such as the absence of the financial sponsor, a labour-intensive underwriting process, transaction complexity and deal sourcing – and how these can be overcome.**
- **We believe that private debt funds, such as Federated Hermes, which has co-lending agreements in place with local and regional banks, are in the best position to capitalise on sponsor-less opportunities in the lower mid-market.**
- **At Federated Hermes, our strategy focuses on lending to conservative, stable businesses in the northern European lower mid-market, across both sponsored and sponsor-less borrowers.**

Direct Lending is, today, a well-established asset class and one of the fastest growing of the past decade. During the period, the European Direct Lending market has grown by an average of c.20% per annum since 2015. With assets under management of USD317bn, this segment accounts for nearly two-thirds of the Private Credit asset class.[1] Enthusiasm for Direct Lending remains strong among asset managers on account of its potential to deliver a steady income stream, some protection against inflation along with superior risk-adjusted returns. It's also seen as a strong diversifier from the traditional equity and fixed income portfolios.

> **Direct Lending is, today, a well-established asset class and one of the fastest growing of the past decade.**

European Direct Lending – Assets under management



Source: Prequin

Sponsor-backed lending: the preferred route for direct lending expansion

Direct lending is predominantly extended to sponsor-owned borrowers, therefore, mirroring the rapid expansion of private equity (PE) buy-out activity of the past decade. This dynamic has been a key driver of the continued strong pace of direct lending issuance over recent years. According to Deloitte, sponsor-owned deals represented 89% of direct lending transactions in 2024.[2] This share of the market has remained consistent, at +80%, over the past decade.[3]

Sponsor lending has been the favoured route of deployment for direct lenders, for a number of reasons. First, the speed of origination and deployment: Through targeted sponsor coverage, lenders can access a sustained pipeline of opportunities that have been sourced and selected by reputable private equity firms. Second, the presence of a financial sponsor in the driving seat, enhances the credit quality. The PE firm may bring reputation, expertise, business networks, the commissioning of comprehensive third-party due diligence, and the ability to bring in top management teams. In addition, the contribution of liquidity to a portfolio company in turmoil has the potential to provide downside protection to their loan exposure.

Increased competition and limited buy-out activity have intensified pressure to deploy

Given its attractiveness, the space has experienced increased competition with new players entering the markets and raising new funds, sometimes with limited track record or apparent differentiation. A lot of unitranche funds targeting the same geographies, sectors and financial sponsors have entered the space. A considerable amount of fundraising has taken place since 2015, with USD391bn of funds raised in aggregate through 447 funds.[4]

[1,4] Source: Prequin
[2,3] Source: Deloitte – Private Debt Deal Tracker Spring 2025. Share calculated by numbers of deals

In parallel, the challenging macro environment of the last few years has impacted portfolio performance, and fundraising has become more challenging. Funds consolidation and asset managers' preference for investment teams that are able to weather market cycles has contributed to a slowdown in fundraising. After peaking in 2022 at a record of USD50bn raised, fundraising declined by 13.6% on average at the end of 2024.[5] However, there have been winners: large brand name funds with solid track records as well as direct lenders offering differentiated strategies have continued to beat record fundings. Despite the slowdown in fundraising, dry powder has consistently increased since the global financial crisis, and today around USD87bn of dry powder[6] is available to be deployed.

On the supply side, M&A buy out activity – the engine of deployment for direct lending – has been sluggish in the past few years. The post-pandemic rise in interest rates, inflation and the war in Ukraine have contributed to a macro environment with little foreseeable stability. The price gap between sellers and buyers' expectations have led to some financial sponsors holding their assets for longer by implementing refinancing or using continuation vehicles for their company portfolios. As a result, with many direct lenders under pressure to deploy and chasing too few deals, competition has risen sharply. Competition for some quality assets has put downward pressure on margins and eroded pricing. This lack of discipline in some parts of the market highlights how much pressure lenders are under to deploy and to win deals by loosening documentation and accepting borrower-friendly terms.

In the lower mid-market in northern Europe, the supply of capital has not gained pace at the rate seen in the upper mid-market and large-cap space. This is not because of a lack of attractive attributes, but a feature of the vast inflows of capital into direct lending. Once a fund surpasses c. EUR2bn, it becomes increasingly burdensome to deploy. Borrowers in this space are seeking loans of c. EUR20-60m, which requires originating a vast number of potential borrowers in order to execute a highly selective strategy that targets the best borrowers for their investors. Rather, to alleviate the burden, most managers will shift out of the lower mid-market and re-home in the upper mid-market where tickets per borrower are significantly higher.

Macro backdrop favours the lower mid-market

The current economic outlook offers limited visibility with the recent tariffs war initiated by the US creating a volatile macro environment that is yet to stabilise. Considering this uncertainty, it is unlikely that buy-out activity will rebound strongly with some deal demand-supply tension likely to continue this year.

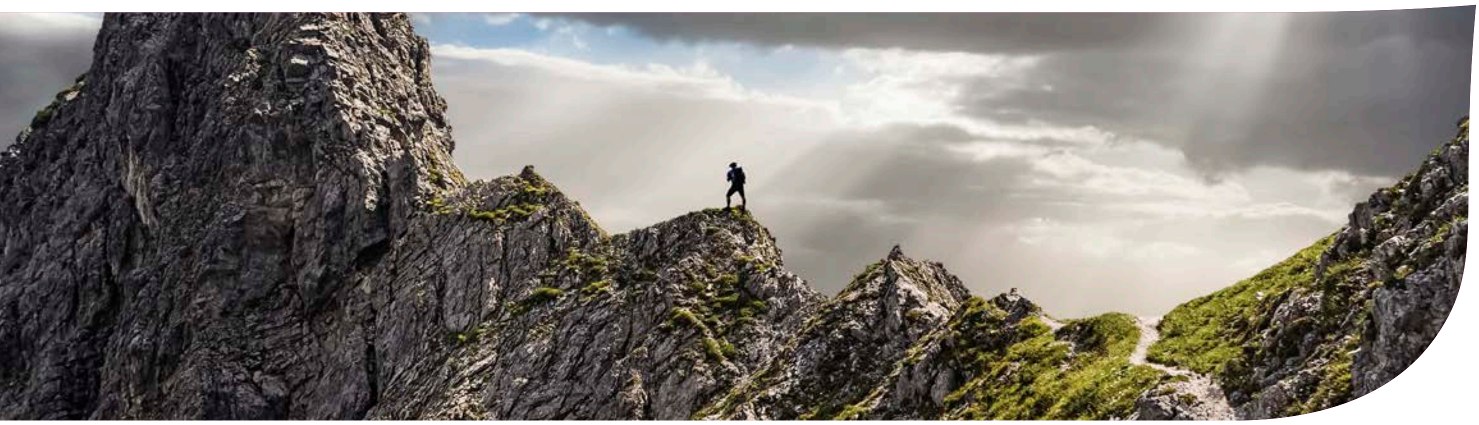
An indirect effect of the tariffs war is that new investors are likely to be attracted into the lower mid-market. It has always been an attractive space as larger funds have emigrated from this segment. In addition, the more conservative nature of the market given banks' dominance in the segment, means that attractive yields at lower leverage are on offer, supported by robust documentation. It is a large addressable market with a broad range of opportunities and it is possible to be selective across sectors and industries. Given that SMEs are often local or regional champions, these businesses are likely to be more immune to tariffs on account of their lower exposure to the US and the complex global supply chain.

Why consider sponsor-less transactions in the lower mid-market?

While most of direct lenders are focused on the sponsor lending part of the lower mid-market, the sponsor-less segment continues to represent a vast opportunity for investors to diversify their private debt portfolio with attractive risk-adjusted returns. A lot has already been said on the hurdles to complete sponsor-less transactions, however, the recent macro environment and trends in the private debt landscape may serve as a catalyst for investors to look at these opportunities differently, provided those investors are equipped with the right set up and skill set.

The sponsor-less segment continues to represent a vast opportunity for investors to diversify their private debt portfolio with the potential for attractive risk-adjusted returns.

[5, 6] Source: Prequin



For seasoned and resourceful investors there are ways to overcome the hurdles inherent in sponsor-less transactions, as outlined below:

The absence of a financial sponsor: A financial sponsor, as main shareholder, is always seen as a credit enhancement. Reputation, sector expertise and track record constitute an important element in the credit process of a sponsor deal. From the point of view of lender downside protection, the assumption is often made that, should the borrower underperform, the financial sponsor will inject additional liquidity to support their investment. While it should be the case, it is not always guaranteed that the portfolio company will be supported at all costs. The post-pandemic period has shown that some financial sponsors, depending on the situations, will 'hand over the keys' to lenders. In a sponsor-less transaction, the potential liquidity issue shortage may be addressed upfront with appropriate structuring:

1 Adequate incentivisation of the founders / managers to ensure they will have sufficient 'skin in the game' not to let the business down should things go wrong;

2 Prudent use of leverage to allow the business to operate with ample liquidity to weather a potential storm;

3 The set up of tight covenants and monitoring tools on the borrower to ensure decisions will be made in a timely manner to avoid the business running into a wall;

4 A low loan-to-value on a prudent valuation, with possibly a superior collateral package for downside protection and enhanced recovery prospect in a worst-case scenario; and

5 Robust constraints on cash leakage in the loan documentation.

Credit underwriting: In sponsors deals, the first layer of credit underwriting is actually done by the financial sponsor itself to a certain extent. When financial sponsors are looking at financing their bids, they have already mostly completed their due diligence, and the lenders can review and benefit from a nicely packaged set of due diligence reports prepared by third-party consultants. On that basis, the credit process for direct lenders could be expedited to as little as a few days. For non-sponsor deals, the due diligence process is not as structured or formalised. While it is possible to have some commissioned due diligence materials from consultants, a good part of the due diligence will be led by the direct lender, requiring a pro-active and hands-on approach to what needs to be diligenced. A thorough assessment of management, extensive Q&As on the business, the review of raw financials and data are among some of the workstreams that will require time and resource. Similar to that of an equity investment, the sponsor-less direct lending due diligence process will be bespoke, requiring significant expertise and experience. This path could be long and intense, therefore, appropriate internal resources must be allocated, along with sound judgment as the probability of getting the deal over the line could end up being low. In addition, post-investment monitoring will require some work with the borrower to establish an appropriate level of reporting and communication.

> **The sponsor-less direct lending due diligence process will be bespoke, requiring significant expertise and experience.**

Deal complexity: No two sponsor-less transactions are the same and ensuring the lender gets appropriate protection will likely add to the complexity of the deal. Investors will certainly have to go beyond the 'standard' terms that lenders see in sponsor deals. Issues that are usually a given in sponsor deals – i.e. ways of repaying or refinancing the loan at maturity, change of control construct or querying the need for an additional non-standard maintenance covenant – will have to be well considered and require bespoke documentation and structuring, along with extensive negotiations. This will also require having the adequate resources and expertise to engage in such transactions.

Sourcing: One of the biggest challenges to overcome is structural. While the sponsor-driven market is well structured with direct lenders potentially having access to a strong pipeline of opportunities, the corporate SME market is highly fragmented. This makes it difficult to connect the SME in need of a loan with a matching provider. If a direct lender wants to generate a decent pipeline, it requires having a deals team based locally with established infrastructure and networks that favour long-established direct lending platforms.

The advisory eco-system has followed the growth of the Direct Lending asset class. A decade ago, only a few corporate finance boutiques would have a dedicated debt advisory platform. Today, there is a myriad of debt advisors of various sizes and specialties with the ability to source local or regional businesses and can facilitate those sponsor-less transactions. A direct lender with an existing deep network could rely on these intermediaries to source opportunities. While debt advisors can ensure a pipeline of sponsor-less opportunities, the referrals remain on an opportunity-by-opportunity basis.

For some time, on a larger scale, there has been some formal collaboration between private debt funds and banks. This has taken the form of partnerships/JVs or co-lending agreements where a bank provides the pipeline and the fund provides the capital with credit underwriting selection, such as the approach Federated Hermes has pioneered with European commercial banks. Beyond sustained deal flow access, a partnership with a bank means the Direct Lender can leverage the long-term relationship of the bank with the SME, gaining privileged access to Management and a more bespoke due diligence process than in a rigid sponsor-driven auction. The Direct Lender will also likely benefit from the trust of the SME from the bank introduction. These collaborations are now increasingly popular. Although mostly set-up in the US for now, some bank-fund partnerships are solely focused on a sponsor-less pipeline and are likely to emerge in Europe for lenders interested in the space and willing to scale up on this strategy.

> **Beyond sustained deal flow access, a partnership with a bank means the Direct Lender can leverage the long-term relationship of the bank with the SME**

Benefits of sponsor-less transactions

Despite some challenges, sponsor-less transactions present significant benefits. The main one is bringing diversification to a private debt portfolio with the potential for superior risk-adjusted returns. While the risk could be lowered through prudent leverage, enhanced due diligence, collateral package and bespoke structuring, sponsor-less deals attract premium economics and some would qualify as a complexity premium vs sponsor deals. There is limited comparable data given the wide spectrum of transactions, but we believe that pricing is likely to yield 1-2%+ above comparable sponsored deals.

CASE STUDY

- In 2025, Federated Hermes partnered with a northern European borrower in a context of a sponsor-less M&A transaction by providing term debt.
- We liked the company for its position in a structured and stable market, long history and track record, its robust cash flow profile and the quality of its management.
- We were able to overcome the challenges of governance, due diligence and the complexity related to the sponsor-less transaction.
- Our risk was managed through bespoke structuring and documentation, and we took account of the constraints related to the nature of the transaction and the operational needs of the borrower.
- This included tight cash flow sweep[7] construct leading to rapid amortization of the loan based on the actual cash flow generation of the borrower.
- The transaction was moderately leveraged on a very conservative valuation with our term debt benefiting from highly valuable collateral.

Conclusion

In the current environment, adding sponsor-less investments to an existing private debt portfolio that is focused on sponsor-owned borrowers could optimise portfolio diversification and enhance overall returns. The success of this approach is, however, predicated on the strength of direct lender's expertise, the appropriate set up and the sourcing, be it through internal capabilities, an advisor network or a partnership with a bank. We believe the latter is a particularly efficient path to accessing the sponsor-less space.

[7] A cash flow sweep is a mechanism in loan documentation that aims at using the excess cash generated by a borrower to repay the debt. The sweep is mandatory and not optional.

For professional investors only. The value of investments and income from them may go down as well as up, and you may not get back the original amount invested. Any investments overseas may be affected by currency exchange rates. Past performance is not a reliable indicator of future results and targets are not guaranteed. Direct lending portfolios contain illiquid assets. Due to the nature of these assets, being typically private, unique and bespoke, these portfolio investments will not be as easily sold in the market as publicly traded securities. Ability to redeem from direct lending portfolios is limited.

This is a marketing communication. The views and opinions contained herein are as of the date indicated above, are those of author(s) noted above, and may not necessarily represent views expressed or reflected in other communications, strategies or products. These views are as of the date indicated above and are subject to change based on market conditions and other factors. The information herein is believed to be reliable, but Federated Hermes and its subsidiaries, does not warrant its completeness or accuracy. No responsibility can be accepted for errors of fact or opinion. This material is not intended to provide and should not be relied on for accounting, legal or tax advice, or investment recommendations. This document has no regard to the specific investment objectives, financial situation or particular needs of any specific recipient.

This document is published solely for informational purposes and is not to be construed as a solicitation or an offer to buy or sell any securities, related financial instruments or advisory services. Figures, unless otherwise indicated, are sourced from Federated Hermes. Federated Hermes has attempted to ensure the accuracy of the data it is reporting, however, it makes no representations or warranties, expressed or implied, as to the accuracy or completeness of the information reported. The data contained in this document is for informational purposes only, and should not be relied upon to make investment decisions. Federated Hermes shall not be liable for any loss or damage resulting from the use of any information contained on this document. This document is not investment research and is available to any investment firm wishing to receive it. The distribution of the information contained in this document in certain jurisdictions may be restricted and, accordingly, persons into whose possession this document comes are required to make themselves aware of and to observe such restrictions.

United Kingdom: For Professional investors only. Distributed in the UK by Hermes Investment Management Limited ("HIML") which is authorised and regulated by the Financial Conduct Authority. Registered address: Sixth Floor, 150 Cheapside, London EC2V 6ET. HIML is also a registered investment adviser with the United States Securities and Exchange Commission ("SEC").

European Union: For Professional investors only. Distributed in the EU by Hermes Fund Managers Ireland Limited which is authorised and regulated by the Central Bank of Ireland. Registered address: 7/8 Upper Mount Street, Dublin 2, Ireland, DO2 FT59.

Australia: This document is for Wholesale Investors only. Distributed by Federated Investors Australia Services Ltd. ACN 161 230 637 (FIAS). HIML does not hold an Australian financial services licence (AFS licence) under the Corporations Act 2001 (Cth) ("Corporations Act"). HIML operates under the relevant class order relief from the Australian Securities and Investments Commission (ASIC) while FIAS holds an AFS licence (Licence Number – 433831).

Japan: This document is for Professional Investors only. Distributed in Japan by Federated Hermes Japan Ltd which is registered as a Financial Instruments Business Operator in Japan (Registration Number: Director General of the Kanto Local Finance Bureau (Kinsho) No. 3327), and conducting the Investment Advisory and Agency Business as defined in Article 28 (3) of the Financial Instruments and Exchange Act ("FIEA").

Singapore: This document is for Accredited and Institutional Investors only. Distributed in Singapore by Hermes GPE (Singapore) Pte. Ltd ("HGPE Singapore"). HGPE Singapore is regulated by the Monetary Authority of Singapore.

United States: This information is being provided by Federated Hermes, Inc., Federated Advisory Services Company, Federated Equity Management Company of Pennsylvania, and Federated Investment Management Company, at address 1001 Liberty Avenue, Pittsburgh, PA 15222-3779, Federated Global Investment Management Corp. at address 101 Park Avenue, Suite 4100, New York, New York 10178-0002, and MDT Advisers at address 125 High Street Oliver Street Tower, 21st Floor Boston, Massachusetts 02110.

Issued and approved by Hermes Investment Management Limited ("HIML").

BD016084 0019034 06/25

Federated Hermes
Private Markets

Federated Hermes

Federated Hermes is a global leader in active, responsible investing.

Guided by our conviction that responsible investing is the best way to create long-term wealth, we provide specialised capabilities across equity, fixed income and private markets, multi-asset and liquidity management strategies, and world-leading stewardship.

Our goals are to help people invest and retire better, to help clients achieve better risk-adjusted returns and, where possible, to contribute to positive outcomes that benefit the wider world.

Federated Hermes Private Markets

With a Private Markets track record spanning four decades, we have developed capabilities that bring investors closer to the companies, assets, communities and environments in which they invest.

Through a combination of heritage and innovation, we seek to connect investors to the industry's leading Private Markets opportunities in pursuit of delivering relevant, resilient investment returns over the long term.

Since our first Private Markets investment in 1983, our close connections, partnership mindset and deep understanding of client needs continue to define our client-focused approach across the asset classes and capabilities.

Private Equity | Private Credit | Real Estate | Infrastructure

Closely Connected
For enhanced outcomes

For more information, visit **www.federatedhermes.com/private-markets** or connect with us on social media: