Private credit: Why Invest in Direct Lending?

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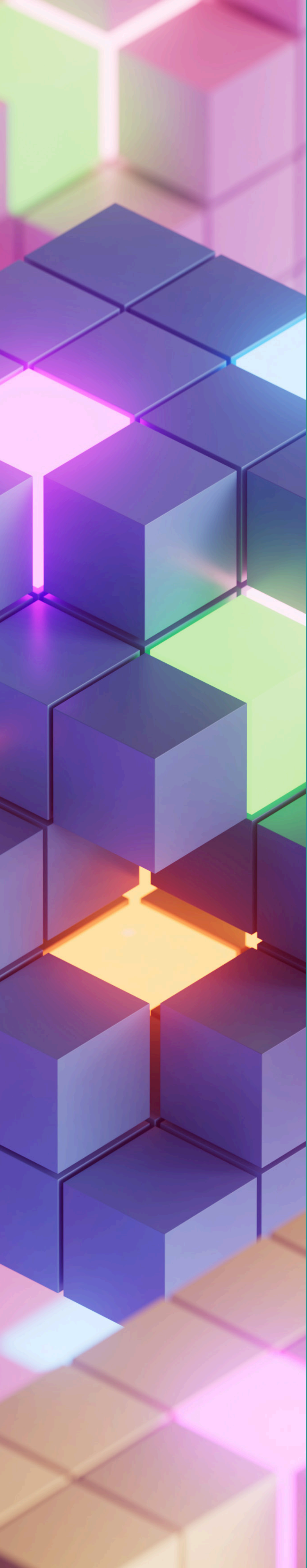

Key Points

- Direct lending, the largest subset of private debt, refers to the business of non-bank lenders (often an alternative asset manager) providing loans to companies that are usually owned by a private equity sponsor.
- The asset class has grown exponentially over the last 15 years thanks to structural tailwinds in the form of tighter bank regulation after the GFC, as well its intrinsic features such as speed and certainty of execution.
- Direct lending has historically generated attractive risk-adjusted returns and has recorded lower volatility and loss rates compared with high yield and other public fixed income alternatives.
- Although initially available only through closed-ended drawdown vehicles, direct lending is now available through evergreen open-ended funds, enabling previously excluded investors to deploy in this strategy.
- The largest markets for direct lending are the US and Europe, but differences between the two regions justify having exposure in both markets.
- Direct lending should continue to offer attractive spreads and returns, and act as a compelling fixed income supplement in investors' portfolios, providing stable yields and robust distributions.

Foreword

Acute observers and investors in financial markets have probably noted that private debt – and direct lending in particular – has grown in popularity. But why exactly is this strategy making the headlines and how does it work?

Direct lending is the lending activity initiated by non-bank lenders such as specialised funds, asset managers or other non-bank entities, to companies usually owned by a private equity sponsor.

This paper explores the mechanisms of direct lending, its market footprint and how investors can benefit from it.

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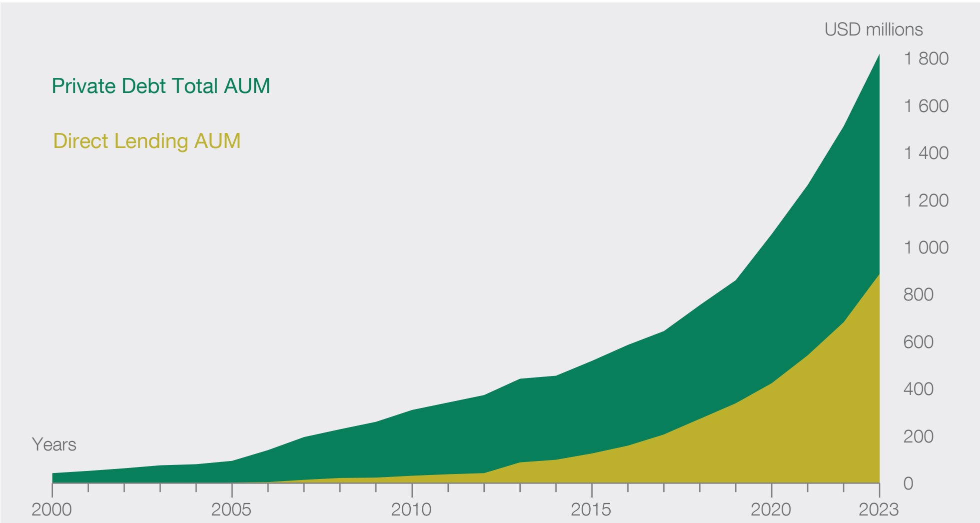
WHAT IS THE MARKET SIZE OF PRIVATE DEBT AND DIRECT LENDING?

As at the end of December 2023, private debt AUM stood at a new high of USD 1.75 trillion, with direct lending representing USD 850 billion of this, as shown in Figure 1. Private market database leader Preqin estimates that there are currently over 1,500 active direct-lending fund managers. Blackstone is forecasting the market size to double and reach USD 3.5 trillion by year-end 2028, a small fraction of the USD 40 trillion total addressable private credit market according to Apollo.

FIGURE 1: GROWTH IN AUM: PRIVATE DEBT AND DIRECT LENDING



Source: Preqin Ltd
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WHAT ARE THE MAIN DRIVERS OF GROWTH?

The most significant driver of private debt growth is the tighter regulation of banks that took place after the global financial crisis (GFC); this was implemented to reduce banks' leverage and to shield deposits from systemic risk. The ongoing constraints on traditional banks' ability to lend has created a vacuum which is being filled by private-credit solutions. This generated a rich opportunity set for the private credit asset class to flourish, as the demand for loans persisted while the supply of financing from banks was significantly reduced.

Private debt and private equity are also very closely interconnected, and the growth of the former is conditioned by the growth of the latter. M&A activity and LBOs have been the main drivers of direct lending deals, as the bulk of loans are to sponsor-backed corporates. From the sponsor's point of view, using as little equity as possible is of utmost importance while minimising dilution risk.

Another key factor that has driven the growth of direct lending is the combination of speed and certainty of execution. As direct lending deals are bilateral transactions between borrowers and lenders as opposed to a syndicate of lenders in traditional credit markets, terms are usually negotiated faster, are more bespoke and less dependent on heterogeneous factors such as general market demand and the ability of the lead manager to tap into public demand.

WHAT BENEFITS CAN INVESTORS GET FROM DIRECT LENDING?

Investors tend to consider direct lending as a relatively low-risk private market investment. Loans originated by direct lenders are, for the most part, senior secured and first lien (i.e. they sit on top of the capital structure). In the event of default, direct lenders are usually first in line to be paid back. In the case of extensions or debt renegotiation, direct lenders dictate terms.

In contrast to asset-backed loans, the total value of a loan is not a direct function of a hard asset security package, but rather a more complex function that includes cash flows, receivables, and other assets. Loan agreements typically include two types of covenants to increase lender protections: incurrence covenants, which are triggered when the company intends to undertake actions such as acquiring additional debt, and maintenance covenants, which impose limitations on certain activities and require companies to uphold specific leverage and interest coverage metrics that are regularly assessed.

This contributes to creating a defensive asset with strong downside protection. The low 1.03% historical annualised loss ratio for direct lending is testament to the asset class's robust ability to protect against downside.

Additionally, direct lending is attractive for cash-flow generation, as loans clip regular coupons while offering a stable spread over public market alternatives.

The floating-rate nature of the private loans also means there is reduced interest rate risk. Moreover, floating-rate loans typically include contractual floors, partially hedging against interest rate decline.

Last, directly originated loans offer comparatively shorter terms to maturity. These loans typically have a 5–6-year average term to maturity compared with 7+ years for high-yield bonds, and the average lifespan of these loans is typically between 3–4 years due to early refinancing.

WHERE DOES THE YIELD COME FROM?

The yield of direct lending deals comprises the following elements:

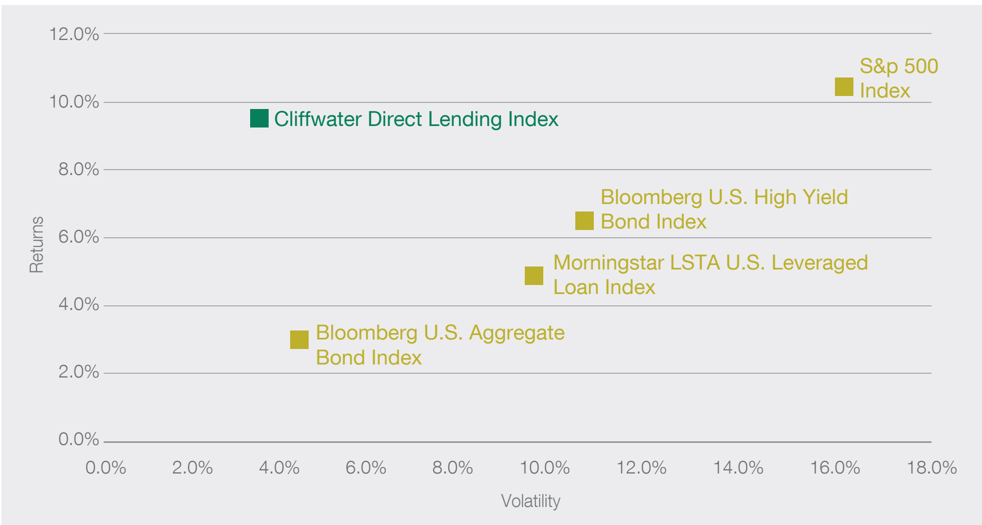
- **Floating-rate coupons**: Direct lenders mostly originate floating-rate loans over the risk-free rate, generating cash coupons that can be distributed to investors. Historically, the margin has traded at between 500 and 700 bps above risk free, depending on market conditions and the broader competitive landscape.
- **Upfront fees**: Arrangement fees that the lender charges for structuring and executing the loan are front-ended.
- **Other fees**: Deals can potentially, additionally, have non-call and prepayment fees, amendment, waiver, and other fees that the borrow pays to the lender.

More interestingly, some direct lending deals can include equity and warrants, bringing some highly sought-after optionality to a fixed income instrument. Upticks in the valuation of loans, early realisations, and investment recycling in funds can also add to returns.

WHAT IS THE HISTORICAL PERFORMANCE OF DIRECT LENDING?

The Cliffwater Direct Lending Index (CDLI) is the primary proxy for the US direct lending market, covering loans to companies with Earnings Before Interest, Taxes, Depreciation, and Amortisation (EBITDA) in the USD 10–100 million range.

FIGURE 2: COMPARING RISK AND RETURN ACROSS SELECT ASSET CLASSES (Q4 2004 THROUGH Q1 2024 ANNUALISED).



Source: Cliffwater LLC
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As shown in Figure 2, direct lending has annualised returns of 9.5% with a volatility of just under of 4%, outperforming public credit indices (investment grade bonds, leveraged loans, and high yield bonds) over the last 20 years. It should be stressed that the volatility for direct lending is artificially low given that these loans are not traded and are therefore marked-to-model.

During the near-zero interest rate period, returns for direct lending funds have evolved in the 6–11% p.a. range. Credit spreads, complexity, and bespoke premiums as well as leverage were the main factors behind this performance.

It is also worth highlighting that yields of direct lending deals – and fund returns as a result – have increased significantly as base rates started to rise, although the relationship is not linear. In 2023, the major direct lending funds posted comfortable double-digit returns.

HOW DOES IT COMPARE WITH TRADITIONAL FIXED INCOME?

Direct lending can be compared to high yield (HY) and investment grade (IG) bonds when benchmarking the private asset class to public fixed income markets.

FIGURE 3: OVERVIEW OF PRIVATE VS PUBLIC DEBT INVESTMENTS.

	Direct Lending	High Yield	Investment Grade
Market	Private	Public	Public
Floating Rate	Yes	No	No
Secured	Yes	No	No
Liquidity	Limited	Conditional	Conditional
Duration	0.3*	3.3	6.7
Max Drawdown	-7.7%(GFC)	-33.2% (GFC)	-20.1% (2021-22)
Historical Loss Rate	1.0%	1.9%*	0.1%*
Annualised Volatility	3.8%	9.2%	6.3%
Annualised Return	9.5%	6.3%	4.1%
Current Yield	11.7%	7.5%	5.4%
Current Coupon	11%*	6.3%	4.3%
Correlation with Direct Lending	N/A	0.3	0.2

Source: Cliffwater LLC Direct Lending Index (CDLI), Bloomberg Finance LP BAML US High Yield (H0A0), Bloomberg Finance LP BAML US Corporate Index (C0A0), StepStone Group LP. All data as at end March 2024 and from inception of CDLI at end September 2004 unless otherwise specified. *As at December 2022.

As shown in Figure 3, direct lending has historically demonstrated several benefits over traditional fixed income, namely:

- Higher returns
- Higher yields
- Lower volatility (although debatable due to mark-to-model vs mark-to-market)
- Lower max drawdown
- Shorter duration

Direct lending has outperformed high yield and investment grade on both returns and risk bases.

A key differentiator between direct lending and high yield/investment grade is that the latter are typically fixed-rate security investments whereas the former is predominantly floating, thus shielding direct lending from sharp revaluations related to interest rate moves.

The covenant component of direct lending is another key feature of the asset class. Covenants are conditional terms in lending agreements to ensure the borrower's financial performance remains steady. Stronger covenants help reduce default rates and improve recoveries. Compared with classic high yield (often dubbed "cov-lite"), direct lending's covenants are usually stricter and more restrictive.

THE US VS EUROPE, WHERE TO INVEST?

The two main markets for direct lending are the US and Europe. The US is a more homogeneous region and a much larger economic market with more experienced direct lending players. Europe, on the other hand, operates as a multi-country/single-currency bloc, creating a more complex ecosystem to tackle. The flipside is a slight pickup in margins in Europe vs the US and a less competitive landscape on the eastern side of the pond. Furthermore, the bank retrenchment initially took place largely in the US and was later followed by Europe.

FIGURE 4: OVERVIEW OF US VS EUROPE DIRECT LENDING MARKETS.

	US	Europe
Market Structure	Makes up the greatest proportion of direct lending managers: banks have ~10% of the market	Comprising a few big direct-lending fund players (20–30), banks have 30–40% of the market
Market Depth	$1.5tn in size, highly competitive, stable over the last few years	£1tn in size, relationship-driven market, growing as funds gain share
Company Size	Typical target company size of $20mn+ EBITDA	Typical target company size of £10mn+ EBITDA

Source: Ares Management Corporation

By diversifying across regions, investors can reduce their exposure to country-specific risks and potentially benefit from different market dynamics. Additionally, investors with different currency constraints can take advantage of both offerings.

HOW TO INVEST IN DIRECT LENDING AS A UHNWI?

Historically, investors have been accessing direct lending strategies through close-ended, drawdown structures. In a traditional closed-end vehicle, investors face the usual issues of deployment velocity, J-curves, and finite maturity of the vehicle.

More recently, thanks to a combination of a tighter regulatory environment for banks and the greater availability of private market fund structures, the market has evolved and is now offering access to direct lending via evergreen open-ended vehicles.

The advent of evergreen vehicles marks an inflection point for private markets, with these structures opening up the asset class to a swathe of qualified private investors that were previously unable to access such strategies.

Due to its income-generating nature, direct lending is particularly well suited to be packaged in evergreen open-ended vehicles.

WHAT ARE THE MAIN RISKS?

As with any investment strategy, direct lending is subject to both systemic and idiosyncratic risks.

On the systemic side, as direct lending is mostly about originating loans to companies in the context of M&A and LBOs, the pace of the direct lending activity is exposed to the broader economic cycle, with interest rates having a direct impact on the origination pipeline. Although higher base rates will generate higher nominal yields for lenders, it also means increased borrowing costs for corporates which may slow the pace of lending transactions and capital deployment.

On the idiosyncratic side, it all boils down to manager selection. As has been distilled more than once, manager selection is of the utmost importance to deploy capital in this field. As an example, the press recently reported a private equity sponsor “up tiering” assets in a direct lending deal. What happened here exactly? Simply put, the borrower removed valuable assets from the security package of the loan ahead of a default to prevent the lender from foreclosing on this strategic asset. Obviously, it does not happen every week, but it highlights the absolute necessity to select managers taking into consideration this type of risk and hedging it properly. Tier-one managers will have techniques and resources to structure robust loan agreements as they have been able to acid test their agreements across more than one cycle.

Last, one recurring question arises around the systemic risk direct lenders weigh on the real economy. The jury is still out on this one, and, just as for any financial innovation, time will tell. However, all the rules and regulations laid down post-GFC have been designed to protect consumer deposits. This task has been achieved and markets have already experienced a few events evidencing this new reality.

Outlook

Although the future path of interest rates appears to be a downwards one, the era of ultra-low rates is long gone, and rates are set to stabilise at a relatively high level. High rates may have the potential to impact the opportunity set for direct lending in two notable ways.

First, terminal rates stabilising between 3.0% and 3.5% will still exert some pressure on borrowers as refinancing will hurt balance sheets. Companies that borrowed in the 2020/21 era will be most impacted by this new interest rate regime, as they were able to take advantage of the low-rate environment, but are now facing increased interest payment burdens and rapidly approaching debt maturities. This speaks to the importance of credit selection.

Second, and this relates to the macro backdrop, higher rates and high terminal rates have and will have a negative impact on M&A, LBO volume and IPOs. This means that private equity sponsors will face difficulties exiting their portfolio companies. Higher rates also impact valuations. As a result, direct lenders may slow the velocity of capital deployment.

Conclusion

Private credit and, more specifically, direct lending have emerged as a dominant force in the financing world. The strategy has thrived due to a combination of factors, including tighter banking regulations post-GFC, the demand for privately negotiated financing solutions, and the complementary growth of private equity. As the market continues to evolve, one can expect direct lending to become a more competitive place, but demand is set to sustain significant growth thanks to increased financing needs that cannot be supported by traditional lenders. As it now seems clearer that the interest rate hike path started in 2022 is set to be reversed, investors will find direct lending to be an appealing alternative to traditional fixed income, packaged in an investor-friendly open-ended format.

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