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Supercharged Fixed Income - Direct Lending

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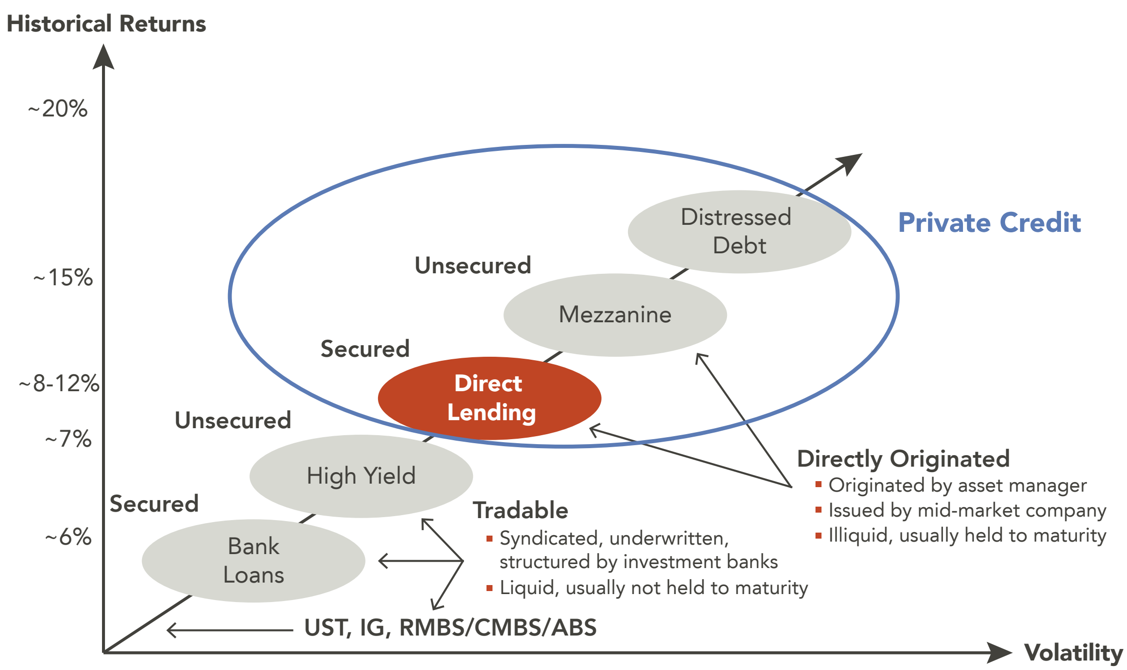
Abstract

Direct lending is an established asset class that provides a total return to investors typically between that of high yield bonds and mezzanine debt. It is considered private credit because the assets in a direct lending portfolio are loans originated privately between the direct lending fund manager (acting as lender) and the borrowing company. Due to the private nature of direct lending, the asset class produces attractive risk-adjusted returns supported by reduced competition, lower volatility and favorable negotiation leverage for the direct lender. Since the financial crisis of 2008, direct lending as an asset class has featured unprecedented growth in deal volume as well as assets under management. This growth is attributed largely to post-crisis regulations that effectively forced banks, the traditional direct lenders of the past, to shed their direct lending operations. Non-bank direct lending asset managers have in turn benefitted from the significant rise in direct lending opportunities.

The Direct Lending Asset Class

Direct lending is situated between high yield bonds and mezzanine debt along the fixed income risk/return spectrum. As shown below in Exhibit 1, direct lending is within the group of asset classes considered private credit, which also includes mezzanine debt and distressed debt.

Exhibit 1: Fixed Income Spectrum



The loan assets in direct lending and mezzanine debt portfolios are originated by the asset manager directly with a middle-market company borrower, and are illiquid. Generally speaking, the loans are held to maturity or until they are refinanced. The difference between direct lending and mezzanine debt is that direct lending is secured by the assets of the borrowing company, such as plant, property, equipment, inventory and/or accounts receivable, while mezzanine debt is unsecured. The corollary of direct lending as a secured asset and mezzanine debt as an unsecured asset for the public markets is bank loans and high yield bonds. Similar to direct lending, bank loans are secured by the assets of the borrowing company; likewise, similar to mezzanine debt, high yield bonds are unsecured. However, bank loans and high yield are considered tradable credit, while direct lending and mezzanine debt are directly originated. Bank loans and high yield bonds are syndicated, underwritten and structured by an investment bank and purchased by a large number of investors. Hence, bank loans and high yield are by definition liquid instruments and usually not held to maturity, as the asset manager typically aims to sell when a target price is reached. Other bonds such as U.S. Treasury bonds, investment grade corporate bonds, residential or commercial mortgage-backed securities and asset-backed securities are considered tradable fixed income as well.

Exhibit 2 below highlights the key advantages of direct lending. First, due to the post-crisis Dodd-Frank/Volcker regulation in the U.S. and Basel III regulations in Europe, many banks have exited the direct lending market, reducing competition for non-bank direct lending asset managers. Second, in contrast to high yield bonds for which the asset manager must accept the terms of the deal and has very little influence on structure and terms, the direct lender has significant negotiation leverage in structuring terms with a direct borrower. Often, the borrower does not wish to source financing from a large number of lenders, prefers the private nature of the deal, and/or needs to obtain quicker financing in order to make a time-sensitive acquisition. Third, forthcoming debt maturities in the overall direct lending market are expected to provide strong deal flow going forward. Lastly, direct lending provides a substantial yield premium to the broadly syndicated bank loan asset class.

Exhibit 2: Direct Lending Key Advantages

Reduced Competition
- Tighter bank financial regulations have created opportunities for non-bank lenders
- Middle market deal sourcing is highly relationship driven, creating a barrier to entry

Negotiation Leverage
- Direct contact with the borrower provides the opportunity to structure deals with tailored covenant packages
- Minimum return thresholds can be achieved through favorable call protection

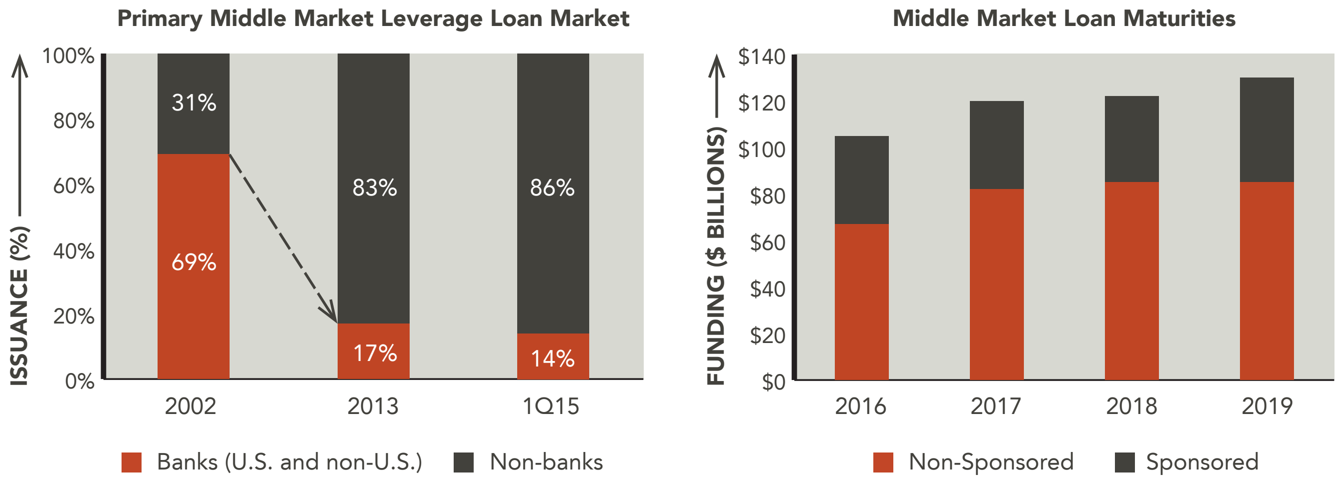
Direct Lending

Strong Deal Flow
- A strong supply of middle market debt opportunities is expected from the combination of numerous forthcoming debt maturities and significant strategic funding needs

Strong Risk-Adjusted Returns
- Significant yield premium relative to broadly syndicated loans, even with lower leverage levels
- Historically lower default rates and higher recovery rates relative to large corporate loans

The market opportunity for direct lending is substantial on an unprecedented scale. Driven by the abovementioned post-crisis regulations, the share of direct loans issued by banks dropped from 69% in 2002 to 14% today, while the share of direct loans issued by non-bank asset managers rose from 31% in 2002 to 86% today; both of these trends are shown in Exhibit 3. The exhibit also shows that loan maturities from both non-sponsored (borrower is not owned by a private equity firm) and sponsored (borrower is owned by a private equity firm) deals continue to rise, from $100 billion expected this year to $130 billion expected in 2019. These maturing loans need to be refinanced, and are expected to be refinanced largely by non-bank direct lending asset managers.

Exhibit 3: Market Opportunity – Issuance and Maturities

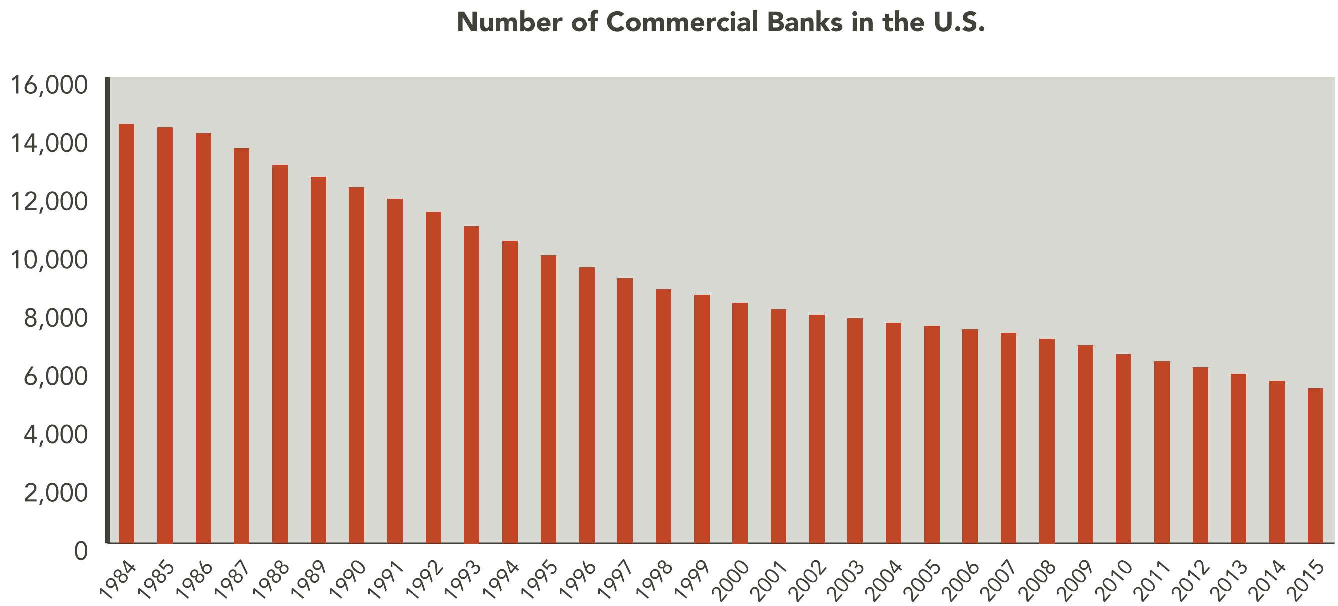


Notes: Middle market is defined as issuers with EBITDA of $50 million or less. Data reflects share of non-bank investors in middle market leveraged loans.

Source: "1Q 2015 High-End Middle Market Lending Review," S&P 500 LCD, March 2015; First Avenue.

Exhibit 4 below shows the decline in the number of commercial banks in the U.S., as a result of both consolidation and post-crisis regulation. The net result is less competition and a greater market opportunity set for direct lenders.

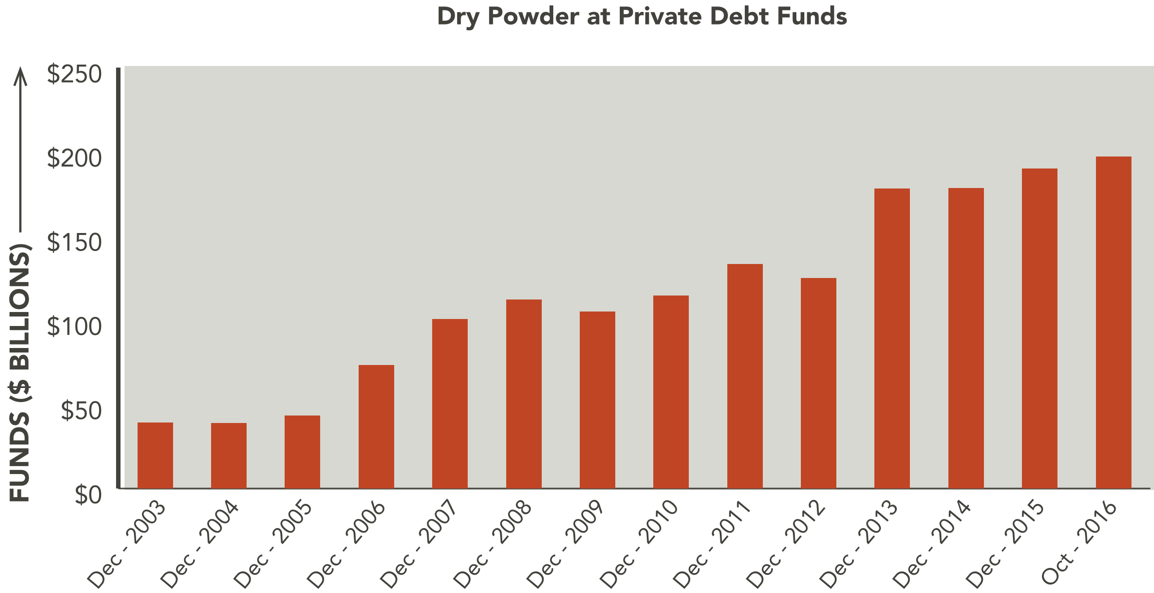
Exhibit 4: Market Opportunity – Fewer Commercial Banks



Source: Federal Financial Institutions Examination Council (US) – Commercial Banks in the U.S., First Avenue.

Finally, the amount of dry powder from private debt funds has increased from less than $50 billion in 2003 to nearly $200 billion today, as shown in Exhibit 5, due to the market dynamics mentioned above. This is another tailwind for the growth of the asset class.

Exhibit 5: Dry Powder



Source: Preqin.

The direct lending asset class is a viable investment option for investors seeking a risk/return profile between that of high yield bonds/bank loans and mezzanine debt/distressed debt. Direct lending provides the key advantage of loan investments secured by the assets of the corporate borrower, as opposed to high yield bonds and mezzanine debt, which are both unsecured. In addition, direct lending loan investments are privately negotiated between the asset manager and the corporate borrower, which enables the investor to benefit from negotiation leverage as well as customized deal structures with detailed covenants that protect the investor's assets. Further key advantages include reduced competition as banks have largely exited this asset class due to post-crisis regulation and strong deal flow as a result of numerous forthcoming direct lending maturities. Finally, the direct lending asset class is expected to provide strong risk-adjusted returns given the unique market dynamics mentioned above.

Characteristics

This section highlights the key characteristics of the loan assets held in a direct lending portfolio, and thus how direct lending funds may differ in their focus. A common private debt capital structure for a middle-market company is shown below in Exhibit 6. Yield on private debt is typically floating rate, based on LIBOR plus a spread of 400 - 1,200 basis points. Direct lending encompasses senior 1st lien loans, stretch senior/unitranche loans, and senior 2nd lien loans, while mezzanine debt encompasses subordinated loans.

Exhibit 6: Private Debt Capital Structure

Tranche	Typical Target Pricing	Historical Target Underwritten Yield	Commentary
Senior 1st Lien	LIBOR + 400 - 575bps	6.0 - 9.0%	• Replaces traditional senior lenders that are de-levering • Attractive terms at the top of the capital structure • Top priority claim against collateral
Stretch Senior / Unitranche (1st Lien)	LIBOR + 600 - 900bps	8.0 - 11.0%	• Newer lending structure that replaces senior and subordinate tranches with a single loan agreement • Increasingly common for companies requiring flexible loan solutions
Senior 2nd Lien	LIBOR + 700 - 950bps	9.0 - 12.0%	• Provides customized financing • Secured and ahead of subordinated debt, but second in debt stack
Subordinated	LIBOR + 1,000 - 1,200bps	11.0 - 15.0%	• Unsecured and most junior capital • Different risk profile than senior capital

Source: Marquette Research, First Avenue.

Senior 1st lien loans have the top priority claim in the event of a bankruptcy liquidation of the borrowing company. Stretch senior/unitranche loans are structured as a single (hence "unitranche" or a single tranche of debt) loan that spans the entire debt stack from 1st lien through subordinated. Senior 2nd lien loans are behind 1st lien loans in priority claim against collateral. Finally, subordinated loans are behind 2nd lien loans and do not have any stated claim in their loan documents over any collateral. Equity ownership in the business is then behind subordinated loans in the capital structure. Certain direct lending managers, depending on transaction, may make a small equity co-investment in the borrower, typically at about 10% of the loan size.

As mentioned earlier, the corporate borrowers in a direct lending loan transaction may be either sponsored, meaning owned by a private equity firm, or non-sponsored, meaning not owned by a private equity firm. Exhibit 7 below shows the characteristics of large syndicated loans found in a typical bank loan or senior secured credit allocation that is considered public tradable credit, versus sponsored direct lending and non-sponsored direct lending.

Direct lending funds typically focus on either sponsored deals or non-sponsored deals. The participants in the deal-structuring phase as well as the final holding phase are far fewer in the direct lending transaction versus the large syndicated loan transaction, while non-sponsored loans typically have fewer participants versus sponsored loans. This is because in sponsored deals, the private equity owner usually has multiple direct lending relationships and is in the business of obtaining the best terms for equity owners. On the other hand, non-sponsored deals often feature the corporate borrower, typically a family-owned business, which is directly in contact with a very small number of lenders.

Sponsored transactions usually take place at the time of the leveraged buyout when the private equity firm works with the direct lender to obtain financing for the purchase of the borrowing company. In such a transaction, the acquiring private equity firm becomes the majority equity owner in the borrowing company, and the direct loan is assumed on the borrowing company's balance sheet as a liability. In contrast, non-sponsored transactions typically take place when the owning family requires capital for growth or to recapitalize the company by allowing one or more family members to buy out one or more of the other family members.

Exhibit 7: Sponsored vs. Non-Sponsored

	Large, Syndicated Loans	Direct Lending "Sponsored"	Direct Lending "Non-Sponsored"
Primary Participants	Large banks, regional banks, CLOs, Mutual Funds, ETFs	Regional banks, Finance Companies, BDCs*, Mezzanine Funds	Regional banks, Private Funds
Typical Number of Primary Participants Contacted	50+	5 - 15	1 - 5
Number of Lenders in the Tranche	10 - 50+	3 - 5	1 - 3
Examples	Bank loans, high-yield bonds	Financing for sponsor backed buyouts	Family owned, growth capital, recapitalizations, late venture
Covenants	Limited / covenant-lite	Traditional maintenance covenants	Traditional maintenance and bespoke covenants
Scope of Due Diligence	Limited	Moderate (1 month)	High (3 months)

Source: Marquette Research, First Avenue.

**BDCs stand for business development companies, which are unregistered closed-end investment companies that invest in the debt and/or equity of small, private companies.*

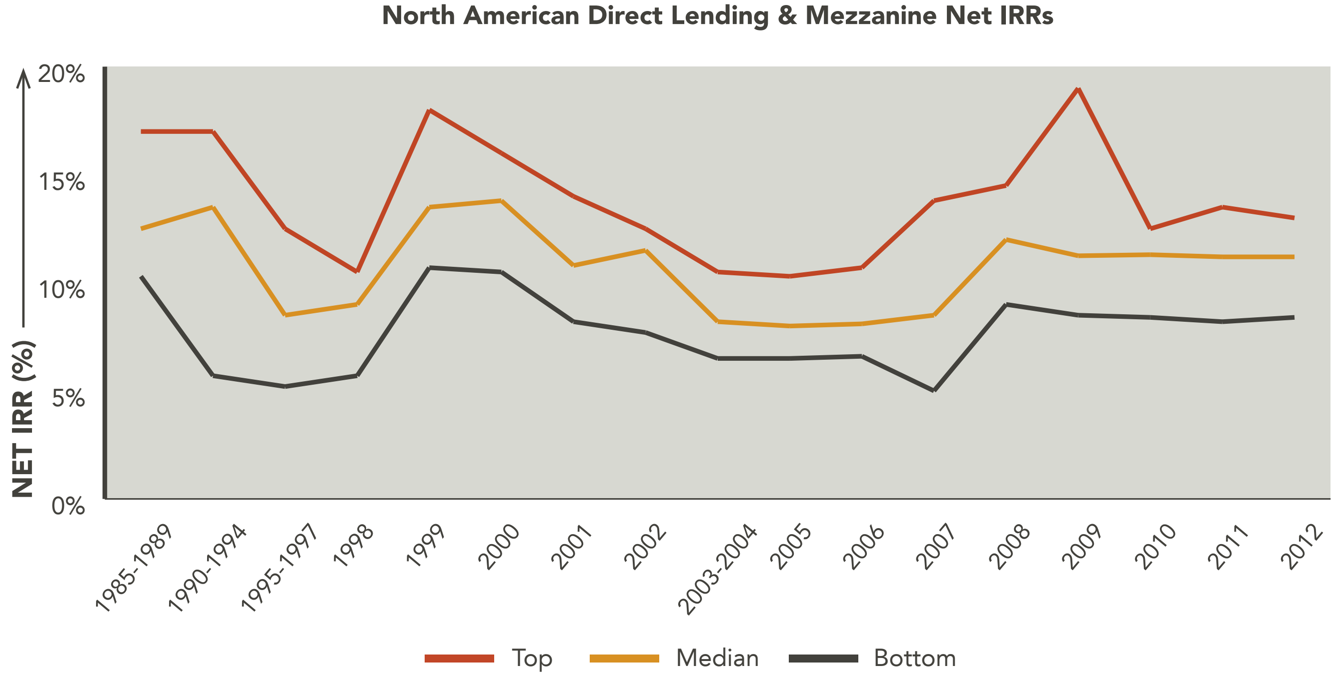
Direct lending funds target a range of loan sizes based on their niche focus and where their general partners may add the most value. Such ranges can vary from below $1 million to over $50 million. The scope of deal size corresponds to the borrower's cash flow, as larger borrowers typically borrow greater amounts. Cash flow as measured by EBITDA (earnings before interest, tax, depreciation and amortization) may likewise vary between these $1 million and $50 million endpoints. The direct lending fund's portfolio diversification and return targets thus depend on underlying loan size and borrower cash flows.

Finally, direct lending funds may have an industry and/or geographic focus. Industry and geographic focused direct lending funds may display large beta to a particular industry or geography, while more generalist direct lending funds benefit from diversification.

Performance

The typical direct lending strategy is expected to generate annual net total return in the high single digits or low teens over the life of the product. Exhibit 8 below shows the top, median and bottom net IRRs of direct lending and mezzanine debt funds tracked by Preqin, ranging from the high single digits to low/mid-teens.

Exhibit 8: Private Credit Performance



Source: Preqin as of Q1 2016, First Avenue.

Terms

Terms of a direct lending fund usually include a management fee, carry, hurdle rate, net IRR target, specification of levered/unlevered vehicles, quarterly distributions, and investment/harvest periods. Management fees for direct lending funds are typically 1% to 2%, assessed annually. Carry, which is the performance fee on the profits from the fund, could range from 10% to 20%, paid after a hurdle is surpassed. Hurdle rates, which are the minimum returns the fund must earn before it can charge the carry, are 7% - 8% in this asset class. Net IRR targets could range between the high single digits to low teens for direct lending funds. Certain direct lending funds can have two structures: levered vehicles (1.25 - 1.5x leverage at the fund level) and an unlevered vehicle. Levered vehicles pursue net IRR targets in the low teens, while unlevered vehicles' targets are in the high single digits. Given the recurring coupon nature of direct lending, most funds provide quarterly distributions that add up to 4 - 8% per year. Finally, the life of the fund is typically structured as an 18-month to three-year investment period followed by a three- or five-year harvest period, with two one-year extension options.

Summary & Recommendations

Given the prolonged low-yield environment, relatively stable U.S. economy, and credit fundamentals that are neither too rich nor too cheap, direct lending is a viable option for investors who can lock up long-term capital for six to eight years and seek strong, long-term returns supported by both an illiquidity premium and unprecedented market dynamics.

As a relatively mature, stable asset class, direct lending offers investors net returns between those of high yield bonds/bank loans and mezzanine debt/distressed debt. The direct lending fund manager originates loan assets within direct lending portfolios by working closely with corporate borrowers. Due to this private structuring and negotiation, direct lending funds have the advantages of less competition and negotiation leverage. Other advantages include less volatility versus public securities and a growing amount of opportunities in direct lending due to banks exiting the asset class as a result of post-crisis regulation. All of these advantages support the investment thesis of long-term attractive risk-adjusted returns for the direct lending asset class.

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