Direct Lending

Direct lenders are non-bank creditors that extend loans to businesses directly, bypassing the need for intermediaries like investment banks. Private equity sponsors typically arrange these loans in conjunction with leveraged buyout (LBO) transactions, although proceeds can also be used to fund M&A transactions, refinancings and general corporate needs. Despite potentially higher costs, borrowers favor direct lending due to its enhanced flexibility, quick decision-making, and greater certainty of execution when compared to the potentially more volatile broadly syndicated loan market.

Why invest in Direct Lending

- Source of attractive and less correlated incomew
- Protection from Rising Interest Rates
- Higher Seniority and Security
- Greater lender protections than syndicated loans
- Lower Potential Losses in a Default
- More Upside Potential
- More Control
- Lower Volatility
- Greater Diversification

What are the main risks of Direct Lending

- Credit Risk
- Portfolio Concentration
- Origination Volume
- Restructuring

What characterizes Direct Lending?

Industry/Sector:	Typically, generalist across all industries and sectors, though some managers have an industry/sector focus.
Instruments:	First Lien, Second Lien, or Unitranche term loans, which blend elements of senior and subordinated debt into a single loan with a unified interest rate.
Maturity Profile:	Generally, ranges between five and seven years although given refinancings, the average time outstanding typically falls within the three to four years. In contrast, fixed rate High Yield bonds usually have maturities exceeding seven years resulting in credit and duration risk.
Credit Quality:	Moderate/Higher risk. Borrowers typically have credit ratings that are below investment grade.
Interest Rate risk:	None (floating rates) / Moderate (floating/fixed rates). Typically, interest rates for these loans are priced as a spread above a floating rate reference rate. Up until mid-2023 in the US, this rate was the London Interbank Offering Rate (LIBOR) and today is Secured Overnight Financing Rate (SOFR).
Borrower Size:	Middle Market. Direct lending primarily involves providing senior debt to lower (EBITDA: $5mm-$25mm), middle (EBITDA: $25mm-$75mm) and upper (EBIT-DA: $75mm plus) middle-market borrowers. More recently, the upper end of the borrower size has increased, nearing the lower end of the syndicate loan market.
Return Profile:	Derived from contractual yield, arrangement fees, original issue discount (OID), prepayment and covenant- reach fees. Gross yields have historically been 100 to 200 basis points wider than broadly syndicated loans.
ESG:	Impact / Positive Screening / Negative Screening. Depends on the strategy though most managers will not lend to borrows in the weapons, munitions, sin, and energy sectors.

Manager Q&A

“What is driving the evolution of the opportunity set in Direct Lending?”

AlbaCore Capital Group

The market is evolving beyond its historic mid-market focus to become an important source of funding for larger corporates, an area of the market that the AlbaCore team have over twenty years' experience lending to. In contrast to the syndicated market, private credit can provide sponsors with greater flexibility in terms and certainty of execution, making it a compelling alternative for sponsors. While M&A activity, the primary driver of the market, has been limited on the back of the economic backdrop last year, AlbaCore expects activity to pick up. Sponsors, according to S&P Global Market Intelligence, are sitting on a record level $2.59 trillion of dry powder and a record $2.8Tn in unsold investments. Banks continue to retreat and unless loan and bond market participation recovers to pre-Covid levels, there is likely to be a large funding gap that private lenders can capitalise on.

Apera Asset Management

Since 2010, the alternative financing market for mid-market companies in Europe has grown significantly, driven by structural changes. Basel II & III reduced bank appetite for lending activities, whilst Solvency II has increased institutional investor demand for private loans. The AIFMD of 2011 gave scope for alternative lenders to provide financing without a banking licence, enabling them to step in where the banks were pulling back, to give institutional investors the exposure they sought. Regulatory capital pressures have had most impact upon reducing bank lending activity in the European Lower Mid-Market (“LMM”) . The absence of a bond market as an alternative funding source has reinforced private credit managers as the core supplier of finance in the LMM space in particular.

Private debt in Europe has been growing at a CAGR of >20% from 2010-2022 with significant scope for further growth - bank loans still represent 86% of the European financing market compared to just 21% in the US.

Invesco

Direct lending involves providing loans directly to middle-market corporate borrowers. In the U.S., it's a significant segment of the economy, offering a robust opportunity for investors. With a decrease in banking entities, direct lending has become a newer source of capital, particularly for stable middle-market companies. Private equity activity around these businesses has further enhanced this opportunity. Currently, direct lending in the U.S. offers compelling returns, with transactions underwritten to 11-12+% yields at ~50% loan-to-values. Given macro uncertainties, credit selection is crucial.

Focusing on stable borrowers with non-discretionary products/services and flexible cost structures is a priority. The signaled rate cuts from the Federal Reserve are expected to ease debt burdens and potentially increase transactional volume. The forward curve suggests a higher 'normalized' rate environment, making direct lending an attractive means for long-term investors to generate high levels of income.

HSBC Asset Management

2023 saw sponsors coming to terms with the cost of debt and adjustment to company valuation expectations, coupled with a slowdown in activity across the private equity deals market. As such, there has been a higher volume of add-on transactions, and a trend towards sponsors seeking out lower leveraged debt options for their transactions. Deal activity picked up slightly in Q4 both in terms of our immediate deal pipeline but also earlier stage discussions on deals likely to come to market during 2024. Based on conversation with sponsors, advisers, and our portfolio companies, we expect that 2024 will see higher levels of market activity with pent up demand for sponsor exits feeding through into deal pipelines.

KKR

The unreliability of the syndicated market has seen private credit taking market share over the past ~2 years. Issuers that previously would have used the syndicated market have begun to use the private credit market for the reliability of capital at only marginally more expensive rates. This has been most prominent in the upper middle market (EBITDA of €50m+). There has been a large increase in jumbo (€1bn+) private loans completed during 2023, with over half of all historical jumbo loan issuance coming to market in 2023 alone. As a result, we have seen the average EBITDA across our portfolios increase, with the weighted average EBITDA for our latest European Direct Lending Fund now at over €200m. Looking ahead in 2024, we expect to see high quality deals continuing to come to market with a pickup in M&A activity given the large levels of PE dry powder.

Thoma Bravo

The evolution of the private credit market has been driven by increased bank regulation, changing macroeconomic conditions, increasing investor appetite and shifting borrower needs. Private credit has grown over the past decade into a mature, $1.6T asset class and is expected to continue to grow at more than 20% per year (per Preqin).

Today's market is providing a compelling value proposition for both the users of direct lending solutions and investors. Private equity sponsors continue to value the certainty of execution, confidentiality and faster deal execution a smaller club of direct lenders provides versus a broadly syndicated deal. This trend has been exacerbated by continued volatility due to macro and geopolitical uncertainty, higher interest rates and increased regulatory scrutiny on underwriting banks.

“Given the rise in Private Credit funds and competition from major LPs like CPPIB and GIC in direct credit investments, along with reduced M&A activity from Private Equity, have you observed notable shifts in terms and pricing in your operating market?”

Apera Asset Management

Apera focuses upon businesses in the lower mid-market which offers the largest pool of investment opportunities in Europe, with >700 deals on average per year. As these companies do not have access to liquid debt markets, the main traditional provider of financing in the LMM has been the banks, who have de-emphasised this financing space creating a supply-demand imbalance. LP activity as described above also tends to be focused on larger deals so does not impact competition in our segment.

These dynamics result in a market that is structurally undersupplied, which means LMM terms and pricing tend to be more stable, allowing us to achieve a consistent contractual returns across each of our fund vintages, and a minimum of 2 financial maintenance covenants on every investment. Even during the period of reduced M&A activity in 2023, we continued to see a strong pipeline of deals including both new transactions, and add-on activity from our existing portfolio of >50 obligors. Thus the kind of pressure upon pricing levels and leverage terms in larger cap transactions has not been a feature of LMM financings.

HSBC Asset Management

The increasing scale of fundraising for Private Credit funds, and the level of AUM managed by major LPs seeking to participate in direct credit investments, has driven an upward shift in target deal sizes for most of these competitors, given their need to deploy larger and larger funds. These funds also typically focus on unitranche strategies targeting higher leverage. This has resulted in competitors deprioritising deal sizes below €100m. At the same time, local banks are retrenching from sponsor financing due to regulatory pressure. These factors have together created a gap in the market which we are seeking to address, targeting deal sizes in the underserved €30-100m space for which there is a scarcity of financial solutions. This provides a high degree of pricing defensibility, and we see pricing holding firm or trending up as competition in this market segment decreases.

Invesco

In our segment of the market, which we call the ‘Core Middle Market’ in the U.S. (i.e. companies with EBITDA typically between $20-50m at entry), pricing tends to be fairly stable. The reduction in transactional activity has not led to significant spread change in our deployment. If anything, we have observed spread expansion for much of the last 2 years along with the ability to structure the transactions with lower debt leverage, lower loan-to-value and stronger creditor protections. Volume has certainly been lower across the market as private equity transactional activity reduced in the context of higher interest rate burdens. Nonetheless, within our pipeline, we observed a quality bias amongst transactions completed as stronger borrowers have been best positioned for new loans. Thus, the opportunity to lend at higher rates to strong borrowers with lower amounts of leverage remains quite attractive.

AlbaCore Capital Group

The team have observed pricing adjustments in private credit, as funds have grown and major LPs have entered the market. Reduced M&A activity and lukewarm IPO markets have also impacted market dynamics. However, AlbaCore takes a partnership approach to lending. AlbaCore's senior investment team developed our strategy while at CPPIB, and we see LPs as partners rather than competitors and have placed over $2.8 billion in co-invest.

While pricing adjustments have been noted in larger private credit deals, the majority of the market remain focused on the mid-market. Currently we see pricing for regular senior secured direct lending for larger corporates commanding a E + 575 to E + 625bps coupon. Given the defensive features of larger corporates, we believe this represents attractive risk adjusted returns but remain highly selective, focusing on company fundamentals alongside pricing.

KKR

In the upper middle market in Europe, there is a limited number of lenders that can drive transaction terms due to the scale required. Given the limited number of players, pricing remains attractive, and we believe better risk-adjusted returns are available versus other, more crowded parts of the European direct lending market. Throughout 2023, we observed some tightening in terms from peak levels in early 2023. Spreads have compressed ~25-50bps to ~575-600bps but yields remain attractive given the current reference rate environment.

Thoma Bravo

Private credit is a growth industry. While more capital has been raised in recent years, the addressable market has also continued to grow as more issuers have chosen private versus broadly syndicated financings. Market share gains of direct lending solutions partially mitigated a decline in 2023 LBO volume. The software industry, in particular, has seen more resilience, both from a deal volume as well as continued strong company operating performance, than other sectors.

As the market adjusted to the higher interest rate environment and changing economic and geopolitical environment, confidence among market participants started to return during the back half of 2023. That momentum is carrying into 2024 and as a result, spreads have tightened from the wide spreads seen in late 2022/early 2023 but the all in returns, documentation protections and leverage levels for direct lending continue to remain attractive.

"How does your team approach deal structures and collaboration in sponsor-backed vs. non-sponsor-backed transactions? Are there specific considerations or challenges with private equity sponsors compared to non-sponsored deals, and how does this impact your decision-making in structuring loan agreements?"

KKR

Our credit team has strong, long-standing relationships with over 250 sponsors globally and over 200 advisors and intermediaries (i.e. banks, consulting firms, law firms, etc.). We generally prefer to lend to management teams and sponsors with whom we have an existing lending relationship within industries we know well. This gives us greater confidence in our underwriting and helps to minimize risk factors that are challenging to underwrite, quantify and mitigate. We believe incumbency is an important value proposition to our origination and diligence and is an area which we are highly focused on growing as we continue to scale our credit business.

Our European Direct Lending platform is predominantly sponsor backed. We look for high quality sponsors with good alignment of interest that can inject additional capital if required.

Invesco

Our strategy focuses on lending to sponsor-backed transactions. We believe this is an important risk mitigation tool in our conservative approach to lending. By partnering with sponsors with whom we have worked for decades, we develop an understanding of their operational expertise, their behaviours in the unlikely event a company becomes challenged, and their ability to support a business which might require incremental liquidity. This approach has continued to lead to favourable outcomes for our team across their multiple decades of experience lending to middle market businesses.

Apera Asset Management

In essence, whether a potential investment is either private equity-owned or non-sponsored, all of our investments have to demonstrate high quality credit fundamentals underpinned by sustainably strong business models and growth potential. The business quality and debt service capacity will be the primary driver of the investment decision and debt financing structure, with ownership also representing an important element in the risk analysis. In general, non-sponsored transactions are perceived as having a higher risk in respect of governance, availability of committed capital to support the business in challenging situations and duration. For this reason, we would normally require a risk premium and tighter covenants in non-sponsored transactions.

AlbaCore Capital Group

AlbaCore focuses on large-cap sponsor-backed companies as we believe these offer investors better relative value versus non-sponsor deals. These companies are typically market leading with diverse revenue streams, have strong management teams and governance process and with access to capital markets have greater financial flexibility. As such all else being equal, the pricing differential on non-sponsor transactions may not be sufficient to compensate for the additional underlying risk.

The European market is relationship led, with sponsors partnering with just a small group of trusted lenders. AlbaCore's experience and deep relationships in the market has given the team a strong understanding of sponsor behaviour and preferences. The team utilises this to create bespoke solutions that fit a sponsor's requirements while also providing strong downside protection and potential upside.

HSBC Asset Management

The team utilises a well-established screening criteria across all its investments, and focuses on businesses led by strong management teams operating in what we believe to be attractive sectors, with consistent financial performance, growth momentum, sustainable cash flow and strong downside protection. Sponsor-backed transactions are the focus of the strategy, given the ability of well-funded, professional equity investors to drive growth and protect value, and with whom we can leverage longstanding relationships to achieve the best outcomes for our investors. Sponsor deals also involve significant amounts of structured third-party due diligence which support our credit analysis. For non-sponsored deals, which are not core to the strategy, the focus is on larger opportunities at lower levels of leverage relative to sponsor transactions, with a more hands-on approach to the scoping of due diligence.