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# DIRECT LENDING

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## DEFINITION & HISTORY

### Introduction

The term "direct lending" has grown considerably in popularity over the past ten years. However, as with "smart beta", "hedge funds" and other industry jargon, its definition is somewhat ambiguous. As direct lending has become more widely accepted by investors, its meaning has evolved and there has been a proliferation of different strategies and approaches. Terms such as "senior lending," "private credit," and "private debt" are frequently used as synonyms for direct lending which can create even more confusion.

The broadest definition of direct lending is all lending executed *exclusively* between a debtor and a non-bank creditor. This paper uses the term direct lending to refer to an investment manager (i.e., non-bank creditor) lending capital directly to a company (i.e., debtor/borrower). Direct lending transactions typically take place with smaller or middle market borrowers. This lending looks similar to that which occurs with larger companies in the bank loan[1] and high yield markets, with the major difference being that the direct lending loans are bilaterally negotiated transactions and not freely traded. Finally, traditional bank lending (where the bank retains the loan) and direct lending are not mutually exclusive, as many middle market companies utilize both sources of capital financing.

### Changes to Traditional Bank Lending

After the Global Financial Crisis, U.S. banks and financial institutions underwent many changes. Many banks failed or were consolidated, and increased regulation[2] put stricter limits on bank lending. Further, new regulation also impacted non-bank finance companies that were large participants in direct lending. For example, GE Capital and CIT were among the largest finance company lenders that either unwound or reduced many of their underlying lending businesses. All of these changes significantly reduced the supply of debt capital available to middle market companies, which created the opportunity for direct lending.

It is important to note that while banks have retrenched, they are still active lenders in the middle market. Their level of activity will vary based on, among other things, the regulatory environment, the overall health of their own businesses, and the overall health of the economy. Banks will continue to impact pricing in the direct lending market, but direct lending will remain a viable source of capital for borrowers as a bank alternative.

[1] In this paper we refer to "bank loans" as large-company, broadly syndicated loans.

[2] Changes to regulation that impacts banks and non-bank financial institutions includes limits on leverage multiples in leveraged lending, changes to capital treatment of bank risk capital and required coverage ratios, and the introduction of "too big to fail" and "systemically important" criteria.

## DIRECT LENDING BACKGROUND & CHARACTERISTICS

Direct lending in the U.S. is not a new phenomenon and has existed in various forms for decades. Direct lending is implemented by investment managers that raise capital from private institutional investors, public markets, or securitization markets. Institutional investors such as pension funds and insurance companies invest in direct lending through private funds and separately managed accounts. These private investment funds that are formed to participate in direct lending and will hereafter be referred to as "direct lending funds." Business Development Companies ("BDCs") are either publically or privately traded closed-end vehicles that invest primarily in direct loans to middle market companies. Retail investors favor the BDC structure due to its liquid nature and high dividend distribution (see appendix). Collateralized Loan Obligations ("CLOs") have become a prominent vehicle to fund the purchase of bank loans over the past 15 years by using leverage from securitization markets. They are focused on larger broadly syndicated loans but are also formed to participate in direct lending.

### Direct Lending versus Large Company Leveraged Lending

Large companies, generally those with EBITDA above $100 million and revenues above $1 billion, are able to borrow capital by accessing the liquid high yield and bank loan markets. Due to their larger size, banks typically underwrite and distribute (syndicate) larger company debt to several lenders such as high yield bond and bank loan funds who can freely trade the debt. When smaller companies need debt financing and either cannot or choose not to rely solely on banks, they look to borrow from direct lenders. Similar to bank loans and high yield bonds, direct lending is a source of capital for highly levered[3] companies. To compensate lenders for the added risk of a more leveraged capital structure, direct lending loans have high interest rates and are structured to have unique lender-friendly protections and covenants. The following table shows the typical pricing, terms, and structure of direct lending versus bank loans and high yield.

| | Direct Lending | Bank Loans | High Yield |
|---|---|---|---|
| Fixed/Floating | Floating | Floating | Fixed |
| Coupon/Spread[4] | 5-10% | 2.5-6.5% | 5.5-8.5% |
| OID/Fees to lender[5] | Yes | Occasionally | Occasionally |
| PIK, equity participation, other | Varies | None | None |
| Maturity | 4-8 years | 4-8 years | 5-10 years |
| Call Protection | Some | None | Some |
| Covenants | More | Some | Less |
| Seniority | 1st lien, unitranche, and 2nd lien | 1st lien and 2nd lien | Subordinated |
| Secured Financing | Yes | Yes | Occasionally |

[3] Leverage is typically expressed as a multiple of total debt-to-EBITDA (Earnings before interest expense, taxes, depreciation, and amortization). Highly levered companies generally have debt-to-EBITDA of at least three times.

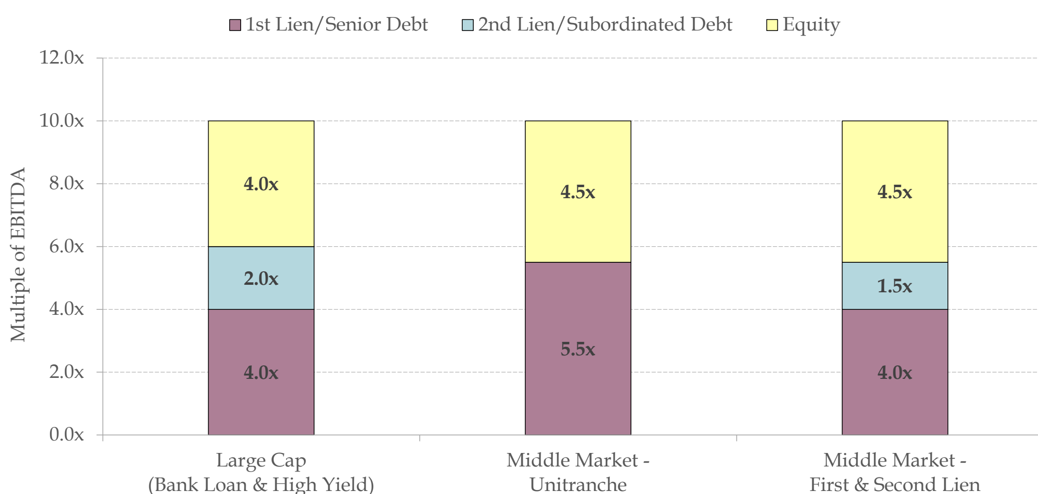
[4] Because they are floating rate, direct lending and bank loans are priced using a spread over LIBOR, while the fixed coupon rate is used for high yield.

[5] The OID, or the original issue discount, is another source of return for lenders. A 1% OID means that the lender only actually lends 99% of the total principal amount but the borrower must pay back the full amount. For example, a 1% OID on a $100 loan would mean that the lender only actually gave the borrower $99 but the borrower agreed to pay back $100 of principal at the loan maturity.

Direct lending is structured similar to bank loans as both tend to be senior secured debt at the top of a company's capital structure. Capital structure positioning is significant as it determines the priority of claims should the company restructure or file for bankruptcy protection. If a company files for bankruptcy, the senior debt gets paid back first before other creditors lower in the capital structure. Debt security is also important as it gives lenders a legal claim or lien on certain assets that are pledged as collateral. Structuring loans as secured debt is another way that direct lending managers seek to protect their capital from loss. Debt below senior debt tends to be unsecured.

Direct lending can take the form of a first lien, second lien, or unitranche loan. A first lien loan sits at the very top of the capital structure and a second lien loan is between the first lien and equity. Unitranche is very similar to a first lien loan in that it is also at the top of the capital structure; the difference is that it is usually made at higher leverage multiples and it tends to be the only debt in a company's capital structure (i.e., there is no second lien or subordinated debt). Unitranche is a relatively new market phenomenon that has grown in popularity due to factors that include a borrower's preference for the simplicity of one lender, as well as the growing flexibility and fund size of direct lending funds.

**Sample Capital Structures for Leveraged Buyouts**




The sample capital structures above are meant to illustrate the different ways debt can be used in a corporate capital structure. It is important to understand that these are just examples, and each capital structure differs from company to company in terms of total company value, leverage and the proportion of senior to junior debt. The key takeaways from above are:

- Larger companies that access the syndicated debt markets tend to have higher leverage (lower equity contribution).
- While unitranche is still considered senior lending, it has higher leverage levels than traditional first lien debt.
- Subordinated debt has the highest leverage in the capital structure and also tends to be the smallest overall component.

**Types of Direct Lending Strategies**

Beyond capital structure positioning, direct lending strategies can also be further separated in other ways:

- Borrower Ownership: Private Equity Sponsored or Unsponsored
- Type of Lending: Cash Flow/Enterprise Value-Backed or Asset-Backed
- Use of Proceeds: LBO/Acquisition, Refinancing, Growth/Capital Expenditure, or Dividend Recapitalization
- Company Size: Small (< $5 million EBITDA) to Large Middle Market ($100 million EBITDA)
- Other: Regional or Sector Focus

Some direct lending managers will focus on certain segments of the market where they feel there are inefficiencies or where they believe they have a particular competitive advantage in sourcing, underwriting, or managing loans. Few managers focus solely on one market segment though, as deal flow can be sporadic and most seek to build diversified portfolios.

The unique strategy pursued by each direct lending manager will create a distinct risk and return profile. A deep understanding of each strategy is needed – beyond just an assessment of their high level portfolio characteristics – as one cannot generalize a strategy's risk profile based on surface level information (e.g., a borrower with a higher level of leverage may actually be less risky than a lower levered borrower if the former's business has better cash flow generation and higher recurring revenues).

**Historical Loss Profile**

Like with other private market asset classes, it is very difficult to track market activity and performance. While there is some published data for direct lending performance, default, and recovery rates, the universes they track often capture very small samples of the overall direct lending market. Both S&P LCD and Thomson LCP track portions of direct lending activity, but they do not follow the entire market nor do they closely follow the performance of a loan after it is issued. In 2015 Cliffwater introduced the Cliffwater Direct Lending Index ("CDLI") that tracks the performance of the actual loans in all applicable BDCs from 2004. This index captures both mark-to-market volatility (based on quarterly loan valuation changes) as well as realized gains and losses, but it only includes loans in BDCs, which is a subset of the direct lending market estimated to be approximately 20%.

| Loss Ratios (%)[6] | 2005 | 2006 | 2007 | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 | 2014 | 2015 | 2016 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| **CDLI** | 0.9 | 0.6 | 1.7 | -0.6 | -6.9 | -3.0 | -1.8 | -0.6 | -0.2 | 0.0 | -0.7 | -1.4 |
| **Bank Loans (1st lien)** | -0.5 | -0.1 | -0.1 | -1.6 | -6.6 | -0.5 | -0.1 | -0.6 | -0.5 | -1.1 | -0.9 | -0.6 |
| **High Yield** | -1.2 | -0.4 | -0.2 | -1.7 | -8.0 | -0.5 | -0.9 | -0.6 | -0.3 | -1.5 | -1.3 | -2.5 |

Similar to high yield and bank loans, direct lending experienced its greatest losses (as defined by defaults less recoveries) in 2009 as actual company defaults lagged behind the mark-to-market losses in 2008. Note that the loss ratio was better than bank loans or high yield in 2008, but worse in 2010 and 2011, this is likely due to the difference in loss rate calculation methodology between bank loans and high yield, and direct lending.

Due to the issues with each data source, one cannot draw firm conclusions from these data. The primary takeaway is that direct lending losses have been similar to the broadly syndicated bank loan and slightly lower high yield markets. Potential explanations for this are that while smaller companies may face more volatility to their businesses, stronger covenants and a stable, concentrated lender base in direct lending allows lenders to identify problems earlier and work with the borrower to limit impairments.

## DIRECT LENDING RISKS

Investors in direct lending must understand the risks in order to evaluate whether an allocation to the asset classes fits their objectives. The main risks are described below:

**Credit Risk —** Credit risk is the primary risk associated with direct lending as by definition, it is lending to highly leveraged middle market companies. Smaller companies may present a greater risk of default, as they tend to have fewer business lines and potentially more customer concentration. In the event of a default, lenders often take control of a company and need to be much more involved in its management than they were as creditors.

**Liquidity Risk —** Private direct lending funds have multi-year investment periods with longer legal lives. The underlying loans are not freely traded and usually only held by just one or a few lenders. If an investor chose to sell a loan, they would likely need to accept a price much lower than the current fair value of the loan.

**Interest Rate Risk —** Because direct lending loans are relatively short term and pay floating interest rates, they will have much lower interest rate risk than other fixed income investments.

**Valuation Risk —** Direct lending loans do not have broker quotes so they rely on private asset valuation methods. Loans can be valued based on various methodologies that are conducted internally and/or by third parties. Even third party valuations can rely on inputs or assumptions provided by the manager. As a result

[6] The loss rate is calculated by multiplying the default rate by one minus the recovery rate. It is important to note that the recovery rate calculation for direct lending is *realized* (and includes realized gains) but it is unrealized for bank loans and high yield. The realized gains for Direct Lending can include accrued interest, which explains the positive loss ratio in the early years. Despite this difference it is still reasonable to compare recovery rates of these asset classes.

there can be a high level of subjectivity in valuations, and certain loans may maintain high valuations even if the borrower begins to underperform.

**Borrower Concentration —** Compared to traditional high yield bond and bank loan portfolios, direct lending portfolios can be much more concentrated with total positions ranging from 20 to 40 loans, and the largest positions sometimes approaching 10%. This concentration adds to the risk of the investment. Because of this, it is beneficial for direct lending investors to allocate to more than one strategy to achieve further issuer diversification.

**Vintage Year Concentration —** Direct lending funds tend to invest over the course of a two-to-four year investment period due to lack of a secondary market (i.e., the portfolio needs to be built piecemeal through new loan origination). To minimize vintage year risk, investors generally diversify their portfolio by committing capital to funds across multiple vintage years.

**Leverage —** Many direct lending funds use leverage to augment returns. Though levered strategies increase credit risk and introduce counterparty risk, it has been an effective component of some managers' strategies. Crucial to the execution of a levered strategy is the manager's ability to limit credit losses, attain attractive pricing, and structure a long-term facility with favorable terms (no mark-to-market triggers). Leveraged direct lending strategies borrow 50% to 300% of net asset value (equity) to add an additional return, which will range from 1.5% to 5%, net of fees and leverage costs.

## THE ROLE OF DIRECT LENDING IN AN INSTITUTIONAL PORTFOLIO

There are different approaches to incorporating a direct lending allocation in a portfolio. Since credit risk is the most prevalent risk, it is best to include it as a piece of the credit allocation alongside bank loans and high yield bonds. These three asset classes are exposed to the same credit cycles, so we expect their returns will be correlated. A key difference of direct lending is that the underlying investments do not freely trade like bank loans and high yield, so their mark-to-market volatility may appear lower. An allocation to direct lending will also reduce the interest rate risk of the overall fixed income portfolio as direct lending loans are floating rate and have relatively shorter-term maturities.

Due to the higher coupons paid by borrowers, direct lending funds have higher current income than bank loan and most high yield portfolios. This reduces the J-Curve effect[7] that many other private strategies face as investors will receive interest payments from borrowers soon after their initial capital is called. Though income can be reinvested during the investment period, many funds offer investors the option to receive it in the form of regular distributions that can be used to fund investor cash flow needs such as pension benefit payments, annual spending requirements, or funding capital calls for other private market strategies.

[7] The J-Curve effect is an occurrence with private markets investments when the IRR for the fund is negative in early years primarily due to fees exceeding the initial income and gains from investments.

While some open-end fund vehicles exist, the traditional closed-end or drawdown-style vehicle is the most prevalent fund structure for direct lending investors. This is due to the illiquidity of the direct lending market and irregular nature in which managers make new loans. Similar to other private markets investments, direct lending closed-end funds typically have a multi-year period to gradually call capital to fund new investments. This makes the timing of investing in the asset class much more difficult than in a more liquid asset class where an investor can establish or eliminate their full exposure on a monthly or even daily basis. For this reason, a strategic approach to allocating to direct lending is favored over one that is tactical. Maintaining a strategic allocation will also allow the direct lending investor to achieve vintage year and issuer diversification, as well as a consistent allocation to the asset class over time.

Net loss-adjusted expected returns will vary significantly for direct lending, generally ranging between 5% and 12%, depending on manager strategy and if fund-level leverage is used. A careful assessment of an investor's return target, risk tolerance, and required illiquidity premium must be conducted to determine whether a direct lending investment is appropriate and if so, which type of strategy to use and whether to incorporate leverage.

The lowest risk direct lending strategies have less credit risk than traditional high yield bonds and likely even bank loan portfolios. However, some investors may not believe that the expected return target (generally around 5%, net) for these more conservative strategies does not adequately compensate them for the illiquidity of the investment. We believe that for most institutional investors, a 3% return premium relative to bank loans sufficiently compensates for the illiquidity, because we expect the investments have similar credit risk. Relative to high yield, this should represent a smaller return premium but with less credit risk.

Using fund-level leverage can increase expected returns, though it also increases risk. We believe that the best way of controlling this increased risk is to only add leverage to conservative direct lending strategies (even strategies that may appear unattractive on an unlevered basis as mentioned above). Using leverage in a portfolio that has a higher potential for loan impairments, or even just more borrower-level volatility, can be very challenging for a manager to successfully implement. The leverage facility should have further structural protections including: 1) a limit on the overall leverage level in the portfolio, 2) a term facility structure where the maturity of the facility is similar to the maturity of the loans in the portfolio (with a gradual payback period versus a bullet maturity, where possible), 3) only non-mark-to-market tests to assess the collateral, and 4) the ability to swap underperforming or non-performing assets out of the leverage facility for performing assets.

## SUMMARY AND RECOMMENDATION

The dynamics between bank and non-bank lending have changed since the Global Financial Crisis, due to regulatory changes affecting banks and historically low interest rates pushing investors out on the credit risk and illiquidity spectra. While pricing and expected returns in direct lending will fluctuate based on these dynamics as well as the underlying manager strategy, we expect it to continue to offer a return premium to liquid credit, with similar loss ratios, making it a potentially attractive investment.

Investors' approach to allocating to direct lending will vary based on their risk tolerance, target returns, and liquidity needs. It is important for investors to understand the risk and return attributes of each unique direct lending manager as there will be differences from strategy to strategy, and also from loan to loan. We believe that a strategic allocation to the asset class should be favored as the illiquid nature makes timing investments difficult. We believe that for a typical institutional investor, depending on their size, a target allocation to direct lending of up to 5% is appropriate.

## APPENDIX A: BUSINESS DEVELOPMENT COMPANIES

Business Development Companies ("BDCs") are a type of investment company created by the Small Business Investment Incentive Act of 1980, an amendment to the Investment Advisors Act of 1940. From their start, the objective of BDCs was to give small private companies access to capital.

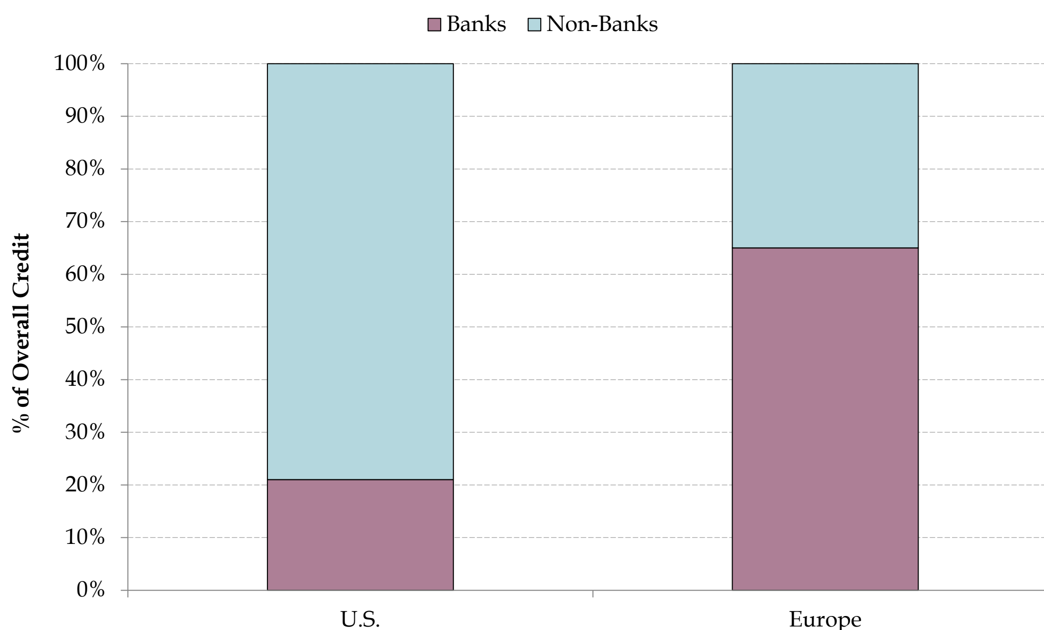
- As of 2017, there were more than 45 BDCs with over $65 billion of total loan assets.
- BDCs are closed-end investment vehicles whose equity can be either private and not traded freely, or publically traded on a large stock exchange.
- Similar to other '40 Act investment vehicles, BDCs have strict guidelines they must adhere to:
    - **Reporting:** Quarterly reporting of all holdings and performance. They must submit to quarterly third-party valuation.
    - **Governance**: BDCs must have independent directors and adhere to certain governance guidelines.
    - **Distributions**: Similar to REITs, at least 90% of taxable income must be distributed to investors for the BDC to avoid corporate-level taxes.
    - **Investment Guidelines:**
        - **Leverage:** BDCs will use varying amount of borrowing to increase their investment activity in an effort to increase potential return. Leverage is capped at 1:1 ($1 of debt for every $1 of equity).
        - **Diversification**: There are restrictions on investment type (at least 70% in BDC eligible investments) as well as a 5% maximum position size.

BDCs tend to attract investors due to their high yield and dividend distribution. Many investors believe that public BDCs can be a good alternative to a direct lending strategy; however, they should also understand that they are owning public companies (i.e., stocks) that will trade with a high correlation to public equity markets. Because of this, BDC performance will likely be much more volatile than a private direct lending fund. Further, BDCs can trade at either significant discounts or premiums to the fair market value of their portfolio of loans. Also, overall fees and expenses for public BDCs can be much higher than for traditional direct lending strategies. Hence, for institutional investors who are willing and able to accept liquidity risk, we recommend private direct lending strategies over BDCs.

## APPENDIX B: EUROPEAN DIRECT LENDING

The European direct lending market was much less mature than the market in the U.S. prior to the Global Financial Crisis. Europe had traditionally been a much more bank-driven market with much less non-bank capital available to borrowers.

**US & EU Breakdown of Capital Markets Activity**[8]




Similar to in the U.S., the European market significantly changed after the Global Financial Crisis as banks were limited in new lending activity due to large non-performing loan balances and new regulations that increased the cost of holding loans on their balance sheets.

In Europe, private debt capital traditionally came in the form of senior debt from CLO investments or mezzanine debt from private funds, as there were no BDCs or direct lending funds. After 2008, however, CLO issuance essentially stopped and mezzanine investors sought to move up the capital structure. The direct lending market emerged to fill the void created by the banks leaving the market, led by traditional mezzanine investors moving into senior loans and bank lending teams spinning out to form independent direct lending organizations. Over the past five years the market has grown significantly to include many of the types of investment strategies offered by direct lenders in the U.S., with the prominent investment vehicles being private funds and separately managed accounts.

Some nuances of European direct lending relative the U.S. are driven by company and country differences. Each European country has its own unique bankruptcy laws that, all else equal, can significantly alter the risk of loans from one country to another. Also, the ability to do cross-border and multi-currency transactions can be an advantage for direct lending funds over some banks.

[8] Shows average for the U.S. from 2002-2012 and Europe from 1999-2012.