Direct lending Q&A with Dylan Cox, Lead Private Equity Analyst

Direct lending is a sub-strategy of private debt where senior loans are made to mid-market companies without an intermediary. For this Q&A, we talked to Dylan Cox, Lead Private Equity Analyst at PitchBook. He has published work on private debt, private equity deal multiples, first-time managers, and long-dated funds. Prior to joining PitchBook, Dylan was an analyst at real estate investment firm Core Capital.

Dylan Cox
Lead Private Equity Analyst
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Q: Private debt continues to grow as an asset class of its own. What is causing this?

A: Although private debt has existed for at least a couple of decades, it really took off following the global financial crisis. New banking regulations left a void—particularly in leveraged lending—that closed-end direct lending funds and business development companies (BDCs) were happy to fill. More recently, continually depressed (and in some places, negative) interest rates on government borrowing have created a "reach for yield," driving institutional investors into leveraged loans and other alternative asset classes.

Q: What are the major trends happening in the direct lending space right now?

A: Fundraising has been on a tear in the last few years, creating more competition for existing managers. Escalating deal flow in private equity has created plenty of business for direct lending funds, many of which deal

exclusively with sponsor-backed companies. We've also seen growing interest in European direct lending strategies and alternative structures such as the unitranche facility, which combines different debt instruments under a single umbrella.

See which firms are leading the private debt market in our recent blog post.

Q: What risks do investors face?

A: With the inflow of capital, funds are now competing on both price and terms. It's not uncommon to see debt/EBITDA of 6x or more on sponsor-backed deals. What's more, these deals are often underwritten based on adjusted EBITDA, which factor in growth or synergies that may never materialize.

At the same time, we've seen a proliferation of covenant light (cov-lite) loans, which afford fewer protections to creditors in the case of financial difficulty. Interest rates have been stubbornly low, and while a rise in rates would mean more income generation, it would also mean a higher risk of default for floating rate loans. Combined, these factors have drawn the attention of central bankers and other regulators, some of which have expressed concern about the state of leveraged lending.

Q: Where is the market heading? Where will we be a year from now?

A: Barring a broader slowdown, we expect direct lending funds (and private debt funds more generally) to continue garnering huge sums of capital for new vehicles. Interest rates should remain low in the near term, reinforcing the "reach for yield" that has benefited fundraising for higher yielding strategies.

Institutional portfolio managers are also becoming more comfortable with

private debt as an asset class of its own, whether it takes allocation from traditional fixed incomes or a broader set of alternatives such as private equity, real estate and hedge funds.

Finally, we expect to see more innovative structures—such as using permanent capital instead of a closed-end fund structure—as GPs seek more flexibility in timing their investments and exits. A few private credit managers, namely Apollo and Ares, are already using insurance companies as a source of permanent capital.

Interested in Dylan's work? Download our analyst note about private debt performance.