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Investment perspectives

Direct Lending: A Decade On

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Hymans Robertson was one of the first consultants in the UK to recognise the attractiveness of the direct lending market, where alternative lenders lend to mid-market corporates. Now over a decade on, most of our Defined Benefit clients have exposure to the market. This article looks at how the market has evolved over the period and revisits the argument for investing in the asset class and discusses the main considerations now for our clients.

Direct lending has exploded with many investors allocating to the asset class. And it's still growing, with more investors expecting to further increase their allocations over the coming years. While the asset class evolved in the US before the Global Financial Crisis ("GFC"), in Europe it was mainly borne out of the GFC. However, the European market is quickly catching up to the US in terms of alternative lender market share.

The evolution of direct lending

Historically, banks were the main lenders in the middle market as borrowers were unable to access the public capital markets due to their size. Now, bank retrenchment from the market is a commonality on both sides of the Atlantic, historically in the US and persisting today in Europe where some banks are still active. Pre-GFC in the US there was a lot of banking consolidation, leading to the now-large banks focusing more on their larger relationships and pulling back from the middle market; whereas in Europe at the time, the middle market remained dominated by commercial bank lending. Then, following the GFC in both markets, banks further retrenched from active lending due to balance sheet issues and a desire to focus on lower risk lending, but also increasing regulatory capital requirements such as the Basel III Accords, soon to be Basel IV.

A mainstream asset class

Direct lending as an asset class started as a niche market with the small number of alternative lenders typically issuing mezzanine debt behind traditional bank loans; however, the market has evolved to focus on senior or unitranche debt (also known as whole loan debt which combines both senior and junior debt), now replacing the banks. Ten years ago, direct lending AuM was estimated to be c$370bn but is now reaching $1tn (although various sources do differ in their estimates), quickly closing in on the leveraged loan and high yield market sizes. What isn't debated, however, is that direct lending is no longer an "alternative" credit product with many institutional investors having exposure. An active secondary market for fund interests is developing on both continents but remains relatively nascent compared to the private equity secondary market.

Mergers and acquisitions activity continues to drive most direct lending deal flow in both the US and Europe. In both markets, private equity sponsors are the largest borrower segment. In the US, because banks have all but withdrawn completely, there are more non-sponsored opportunities versus Europe where there is still some bank activity targeting these companies.

In Europe, there were a handful of alternative lenders who were active during the GFC, but there have been many new entrants in the years following. The last large entrant to the market was in 2014 although smaller lenders continue to launch funds.

What about performance?

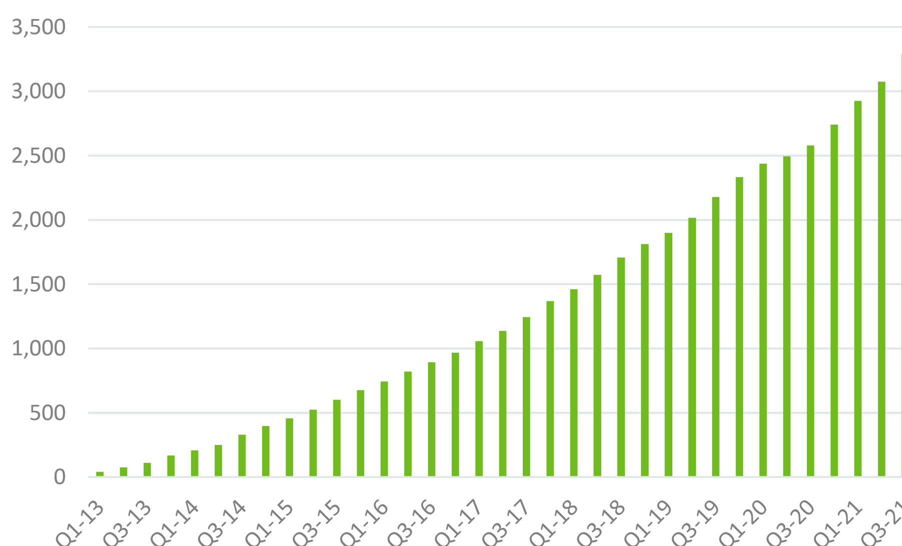
As the asset class has grown and direct lenders have shifted focus to replacing the senior bank debt rather than providing the mezzanine financing, returns have trended downwards overall. But, returns still offer a premium through a material and persistent illiquidity premium compared to publicly traded debt. The target returns being offered by typical direct lenders in the market today are in the 6-8% p.a. range net in Europe and the US in the respective currencies for mostly unitranche debt (slightly lower for those who focus solely on senior, low leverage loans).

Leverage levels measured by EBITDA multiples over the years have been slowly rising in the direct lending market but valuation multiples have been increasing at a much more rapid pace reducing total leverage (as a proportion of total value). These increasing valuation multiples are being driven by increasing competition in the private equity market. As a result, the amount of equity sitting behind direct lending loans has been increasing, which reduces the loan-to-value of the loan and ultimate risk to the lender.

Continued opportunity

In both the US and European markets, there is demand for loans from middle market borrowers. In Europe, direct lending volumes have rapidly increased over the years (Chart 1), with the exception of the initial shock of the pandemic, and they are expected to continue this growth trajectory.

Chart 1: Cumulative alternative lending transactions in Europe since Q4 2012



Source: Ares, Deloitte Alternative Lender Deal Tracker as of September 2021

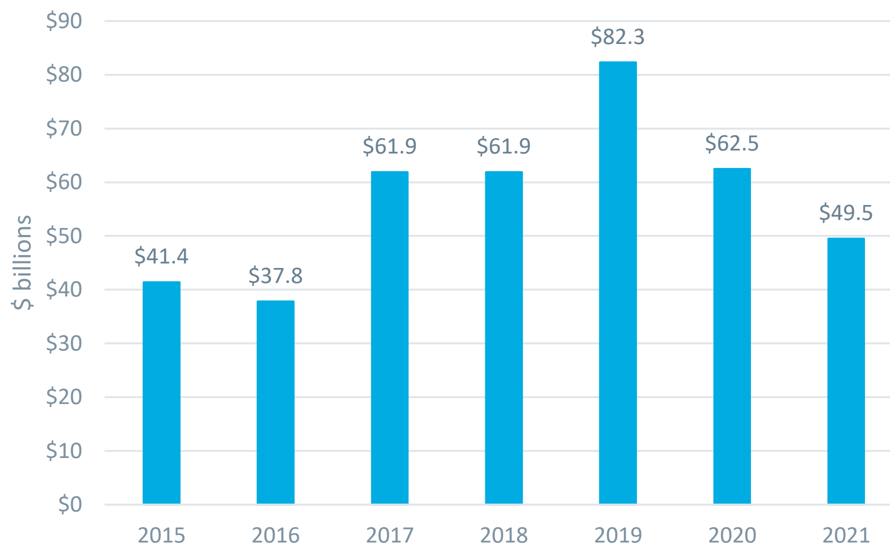
However, dry powder[1] in private equity has been increasing. With more private equity players looking to deploy capital across the middle market, they will typically turn to direct lenders to provide their financing. There is also a growing trend of public companies going private and, again, they will typically look to direct lenders over the public loan market for the ability to meet complex debt requirements and surety of execution. As such, direct lending volumes remain supported by demand.

Direct lending fundraising also activity remains strong (Chart 2) with the first half of 2021 showing above average fundraising. In Europe, the market is dominated by the more established players and, although there

[1] Dry powder is the amount of committed but undrawn capital waiting to be deployed.

has been some consolidation, the larger funds have the lion's share of deal flow creating barriers to entry to the market, particularly in the mid to upper-mid market space.

Chart 2: Global direct lending fundraising (shown as of June 2021)



Source: Preqin, Deloitte Alternative Lender Deal Tracker

Conclusion

Over the years, direct lending has evolved into a well-established credit asset class that is now mainstream for many institutional investors, with capital continuing to be allocated. The illiquidity premium over public markets remains and the asset class offers a superior risk-adjusted return compared to publicly traded debt due to better downside protection and diversification benefits. This premium should continue as demand from predominately private equity sponsors increases.

Relative value between the US and Europe does change. Currently Europe represents better relative value, with better terms and less aggressive leverage in general. There is also the impact of hedging to GBP from USD which does vary over time.

Direct lending is an illiquid asset class and we are seeing fund terms getting extended beyond the initial fund maturity (typically 6-8 years). This has a potentially negative knock-on impact for pension schemes targeting their end game in the near future, and it should be a consideration for those considering investment. There are, however, open-ended solutions in the market which may be suitable for some schemes, and it is an area we see growing. Some managers have even made direct lending accessible to DC investors by allocating alongside a more liquid asset class, another trend that is sure to persist.

We continue to have a positive view on the long-term outlook for direct lending.

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