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Direct lending: Finding a niche beyond the hype

Tim Johnston
Senior Originator

Nina Flitman
Senior Writer

Investor interest in direct lending has exploded over recent years, but this surge in appetite has meant that on some transactions the tastiest elements have been diluted. We think the idiosyncratic benefits of direct lending are still there; you just need to know where to look.

Just as the best grapes for wine are grown in the poorest soil, so the finest deals to grace the direct lending market may yet emerge from the toughest economic environment.

This is no secret – private debt markets have exploded over the past few years as investors sought the relative safety of a secured debt product with a floating rate structure positioned at the most senior point of the capital structure. Rising interest rates have only accelerated this trend. And this popularity seems to be well-timed - there are clear indicators that the coming vintage of deals will be a good one thanks to a shift to a more lender-friendly borrowing environment with lower leverage levels, higher yields, and more attractive documentation on deals.

But just as the finest vineyards are often found in hard-to-reach terroirs that offer suitable (usually difficult) soils for the grapes to flourish, so it is only in specific parts of the market that the best direct lending deals can be found. Stiff competition to deploy capital at the very largest segment of the direct lending market overshadows many of the potential upsides, and it is at the tucked-away heart of the mid-market where the greatest benefits of direct lending can truly be found.

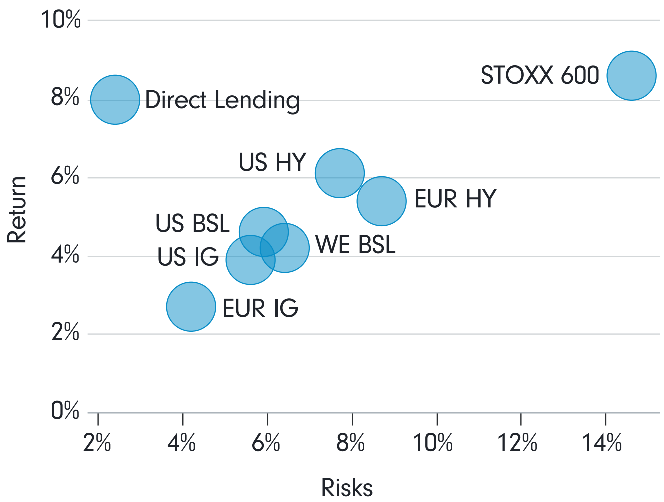
The Goldilocks zone

It is at the middle of the mid-market, where companies with EBITDA of around €5 to €30m operate, that the core, idiosyncratic benefits of the direct lending market are still available to investors. At this size, deals are more likely done on a bilateral basis, meaning that lenders have a greater level of control to negotiate terms, docs, and structure. Although these deals may be more difficult to source, the close relationship between borrower (and its sponsor) and lender can not only provide investors with a greater insight into a firm's financial performance but also an opportunity to engage on its approach to ESG.

These sort of benefits are likely to e present at the very smallest end of the market too on loans to firms with an EBITDA of less than €5m, but at this size it becomes more difficult to deploy capital efficiently. Here is where economies of scale come into play given the amount of credit work that goes into every direct lending transaction before a deal is confirmed.

Not only is the Goldilocks zone at the middle of the mid-market perhaps the most exciting segment to explore for direct lending investors, now could also be one of the most attractive times to do so. The direct lending product has an interesting capacity for returns – particularly during times of wider economic stress. The product offers investors a regular income with an attractive yield and is less susceptible to the short-term volatility of public markets, while its floating rate structure means that it can mitigate the impact of a rising rate environment. Additionally, senior secured direct loans sit at the very top of the capital structure while generally retaining conservative leverage ratios.

Chart 1: Comparing risks and returns across asset classes

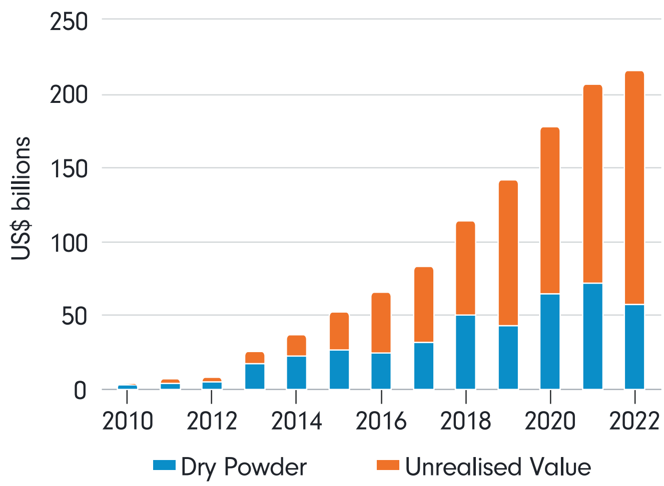


Return is defined as the annualised quarterly (non-overlapping) total returns from September 2010 to March 2022; Risk is defined as the annualised quarterly standard deviation based on quarterly non-overlapping total returns. Direct Lending refers to the Cliffwater Direct Lending Index – Senior (CDLI-S). The Cliffwater Direct Lending Index is an asset-weighted index constructed using quarterly SEC filings of BDCs, whose primary holdings are US middle market loans. CDLI-S is constructed using a subset of US BDCs whose primary assets are senior secured directly originated loans. CDLI-S starts in Sep 2010; US BSL refers to the Credit Suisse Leverage Loan Index; US HY refers to the ICE BofA US High Yield Index; US IG refers to the ICE BofA US Corporate Index; WE BSL refers to the Credit Suisse Western European Leveraged Loan Index hedged to EUR; EUR HY refers to the ICE BofA Euro High Yield Index; EUR IG refers to the ICE BofA Euro Corporate Index; STOXX 600 refers to the STOXX Europe 600 Index inclusive of gross dividends. The indices exclude fees and expenses and it is not possible to directly invest in any of these indices. Fidelity International, May 2023

Bigger isn't always better

But while the middle of the mid-market offers ample opportunities for attractively priced and conservatively structured direct lending deals, on many larger transactions the core benefits of the product are burned away by the glare of competition. Almost $125.9bn was raised by direct lending funds in 2021, with another $75.9bn arriving in the first three quarters of 2022[1]. In Europe alone, $45bn was raised in 2021 and a further $25.7bn in the first three quarters of 2022. Overall in Europe, direct lending assets under management reached $216bn by mid-2022.

Chart 2: European Direct Lending Assets Under Management

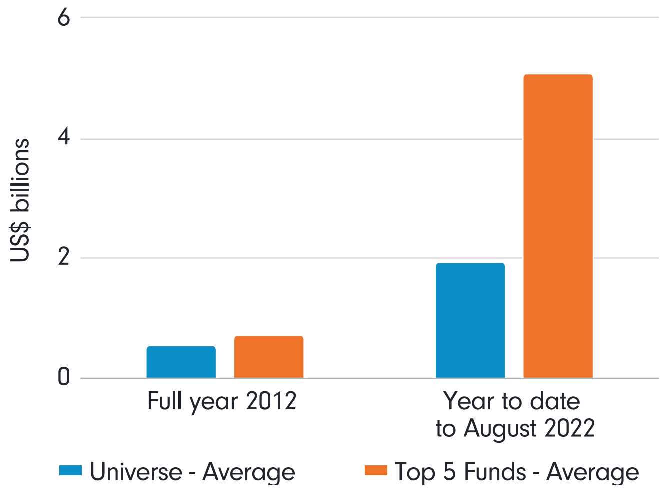


Data for 2022 year-to-date until June. Source; Preqin; Fidelity International, May 2023.

Not only are there a growing number of funds in competition with each other, but there is also an increase in the average size of individual direct lending funds.

[1]Deloitte Private Debt Deal Tracker, Autumn 2022.

Chart 3: European direct lending fund size

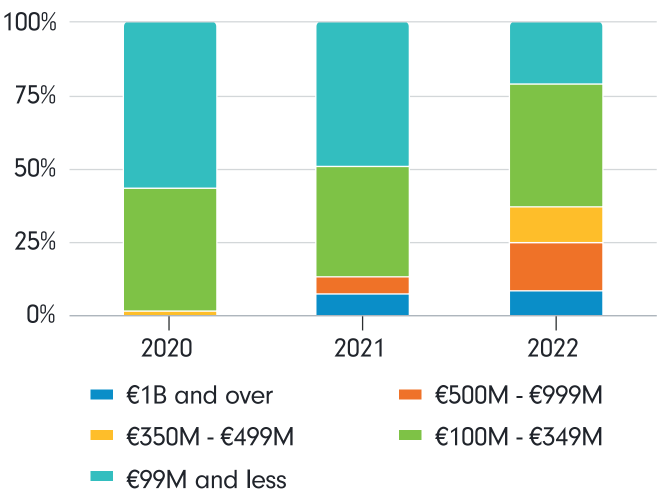


Source: Preqin; Fidelity International, May 2023.

This flood of money has diluted the benefits of the direct lending product across certain segments of the market with some lenders under pressure to deploy their investments with larger and larger deals. As individual funds grow, managers are having to ensure their capital is put to work efficiently by submitting bigger tickets to deals, pushing the size of the average direct lending deal ever higher.

Chart 4: Deal size diversification of direct lending transactions

By deal count



Analysis based on transactions covered by LCD News. Share calculated based on deals where size information is disclosed. Source: Leveraged Commentary & Data (LCD); Fidelity International, May 2023.

And the biggest deals are bigger than ever: Europe's largest ever unitranche transaction completed last year was a £3.5bn debt financing package backing Hg and TA Associates' investment in software firm The Access Group[2]. In the US, the acquisition of healthcare firm Cotiviti by the Carlyle Group and Veritas Capital was intended to be funded with a $5.5bn transaction – the largest ever buyout financing arranged with private credit – before the deal collapsed[3]. Press reports suggest that the pricing on the Cotiviti transaction was tightened while it was being sold down because of the strength of demand for the deal.

In both of these transactions, the debt was provided by a small club of lenders rather than just a single investor. While this is understandable given the size of the deals involved, it means that investors do not enjoy one of the key benefits of direct lending – namely the potential to have one-on-one access to borrowers, and the flexibility and engagement opportunities that this typically provides.

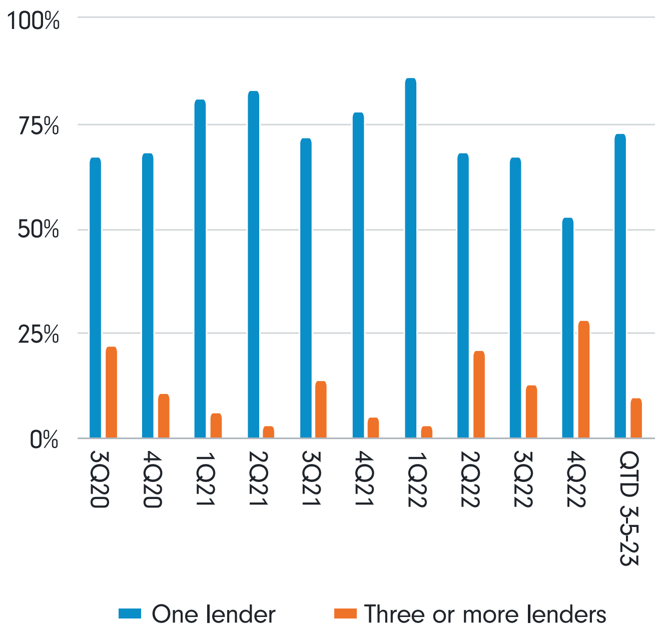
In a related trend, an increasing number of deals sized between €200m and €300m are being arranged on a clubbed basis as lenders steer away from taking on the full risk of a deal. Certainly, some sponsors may prefer to secure deals with a club of investors, enjoying the assurance that one of the lenders is more likely to be available to them at a later date to fund an add-on or to provide any additional debt. But, for investors to enjoy the benefit of a bilateral arrangement, they must look further still down the scale of the mid-market.

[2] 'The Access Group's £3.5B debt financing details emerge', Leveraged Commentary & Data, June 16, 2022.

[3] 'Veritas, Carlyle end talks on Cotiviti stake purchase', Leveraged Commentary & Data (LCD), April 12, 2023.

At the large end of the market, not only is there more competition amongst direct lenders looking to put capital to work, but they are also competing with the syndicated loan and high-yield bond investors who have traditionally served this space. By contrast, in the lower mid-market, direct lenders have been taking up the slack left by retreating banks, resulting in less competition for deals and more favourable terms for investors.

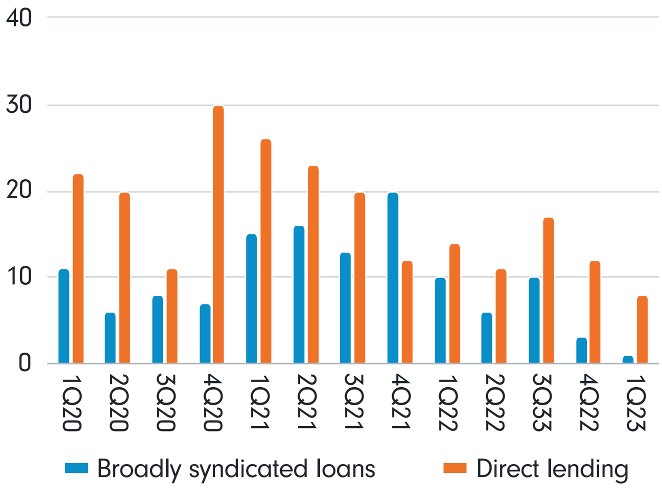
Chart 5: Proportion of LBOs financed in private credit market



Data through March 5, 2023. Analysis is based on transactions covered by LCD News. Source: Leveraged Commentary & Data (LCD); Fidelity International, May 2023.

With so many lenders competing for deals at the larger end of the market and making terms more attractive for issuers, it is no surprise that direct lending deals are outstripping those in the broadly syndicated loan market - and the gap is growing:

Chart 6: European count of LBOs financed via broadly syndicated loans vs. direct lending markets

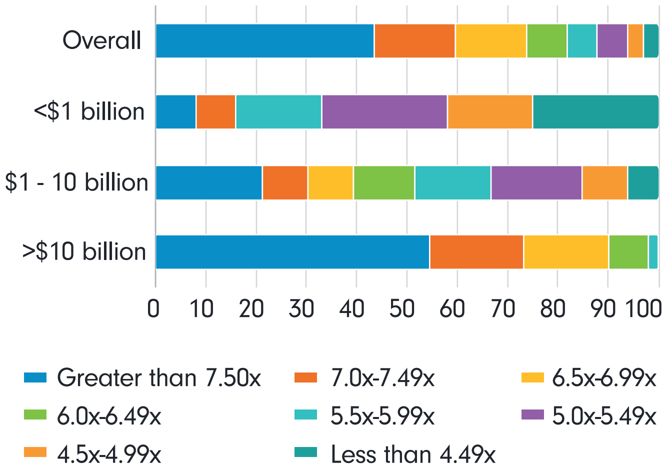


Data through March 10, 2023. Direct lending count based on deals covered by LCD News. Source: Leveraged Commentary & Data (LCD); Fidelity International, May 2023.

As larger direct lending deals begin to supplant syndicated loans or high-yield bonds on sponsor-backed, large-scale financings, the terms in this part of the market are beginning to lose their edge compared to their public counterparts. For example, direct lenders on larger deals are becoming more aggressively competitive on the amount of total leverage they will support on a deal: two fifths of fund managers responding to a private credit survey from Proskauer last year said that they would underwrite a maximum total leverage ratio of 7.5x, almost double what the survey had found just a year before[4]. Larger fund managers competing at the top end of the market are likely to push this figure higher, although those overseeing smaller deals and leverage levels are more likely to remain in a conservative range.

[4]The two surveys were completed in a similar, stable interest rate environment.

Chart 7: Maximum underwriting leverage
Responses to 'What's the maximum total leverage that you will underwrite today?' by US AUM



Source: Trends in Private Credit: The Industry Speaks, Proskauer, 2022; Fidelity International, May 2023.

Similarly, it is at the smaller end of the market where a growing proportion of larger direct lending deals are now being done on a cov-lite or cov-loose basis, without the full package of traditional protections once enjoyed on direct lending deals. Proskauer found that 22 per cent of transactions in 2022 had no financial maintenance covenants or a springing financial covenant, up from 15 per cent in 2021. More than half (51 per cent) of loans with EBITDA equal to or greater than $50m were cov-lite, while only 45 per cent of deals of this size had a leverage ratio[5].

In the US market, 30 per cent of fund managers would complete a deal on a cov-lite basis if EBITDA was more than $50m, while only 12 per cent would do so for borrowers with EBITDA of $30m to $39.9m, and a further 3 per cent for firms with a profile under $30m. Only 32 per cent of respondents would never do a deal without a covenant.

In an increasingly pressured financing environment the protection of covenants becomes even more key. Lincoln International reported size-weighted covenant breaches of 3 per cent of portfolio companies in the second quarter of 2022, noting that it expected an upward trend into the third quarter.

And size matters when it comes to the protection offered by covenants. DLA Piper's market research illustrates that smaller deals are more likely to retain more lender-friendly terms in their packages: for deals with a debt size below £50m, only 21 per cent of leverage covenants flatline from either the first test date or less than two years from closing, while deals with a debt size of above £150m, some 43 per cent of respondents see the leverage covenants flatline over the same period.

Other terms that may be deemed as unattractive to lenders are also becoming more prevalent when deals get bigger. The prepared record-breaking Cotiviti transaction, for example, would have allowed sponsors Carlyle Group and Veritas Capital to pay up to half of the interest with fresh debt. This payment-in-kind element is the sort of borrower-friendly structure that is rare across those sources considered more natural for a funding package of this size, such as leveraged loans or high-yield bonds. Its emergence in the private sector is a direct result of the level of competition at the largest end of the direct lending market.

[5]2022 Private Credit Insights, Proskauer

A strong vintage

With the banking system under pressure and only likely to pull back further from corporate lending to the core mid-market on the back of rising capital costs, new opportunities are already emerging for direct lending funds. After the bank collapses in the US and Europe, the regulatory backdrop for bank lenders could tighten further, limiting banks' access to the market. This could open swathes of new borrowers to funds that have until now relied on bank lenders for their financing needs: of all the unitranche deals agreed in Europe in 2022, banks still provided some 45 per cent of deals in Germany, 52 per cent of those in France, and 77 per cent of those in Austria/Switzerland[6].

Against this backdrop, the direct lending market is likely to offer some delicious opportunities for investors in the years ahead. For the best vintages though, buyers may just have to go a little off the beaten track for the perfect growing conditions.

[6]Houlihan Lokey MidCapMonitor, Q4 2022.

Important Information

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