The Frontier Line

Thought leadership and insights from Frontier

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Direct lending.
What are you banking on?

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About us

Frontier has been at the forefront of institutional investment advice in Australia for over twenty five years and provides advice over more than $400 billion of assets across the superannuation, charity, public sector, insurance and university sectors.

Frontier's purpose is to empower our clients to advance prosperity for their beneficiaries through knowledge sharing, customisation, technology solutions and an alignment and focus unconstrained by product or manager conflict.

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Nam Tran joined Frontier as a Consultant in 2017 and is a member of the Debt and Currency team. Previously Nam worked with NAB in the institutional banking area, undertaking industry and credit analysis in the Resources, Energy and Utilities sectors for ten years. Prior to this, he spent three years with KPMG and the Sarbanes Oxley team at NAB, undertaking financial and operational analysis of clients in the financial services industry, and three years with HSBC in Vietnam in corporate and institutional banking. Nam holds a Bachelor of Business from Monash University, a Master of Commerce from the University of Sydney and a CFA charter holder.

INTRODUCTION

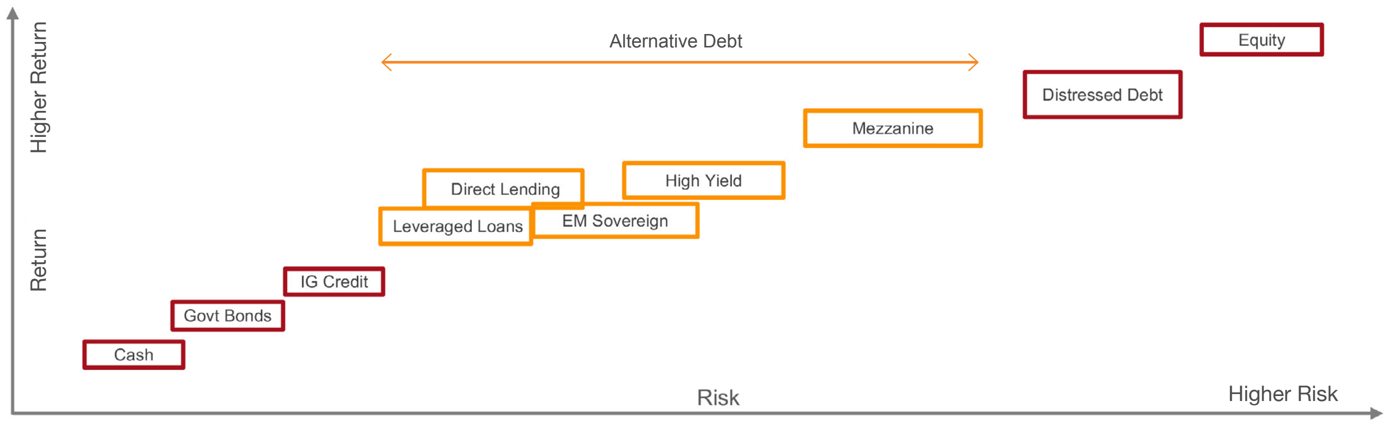
Direct lending. What are you banking on?

Dislocation induced by COVID-19 brought stress to the credit markets in early 2020 with credit portfolios suffering material drawdowns across most segments of the market. Pressure on borrowers has risen as access to finance dwindled and defaults have increased. Amid this challenging backdrop for credit investments, direct lending has appeared to be a resilient asset class. In this paper we look more closely at direct lending, highlight how it has weathered the COVID-19 period, and explore why it is worth considering as a strategic allocation in an investor portfolio.

What is a direct lending strategy?

We define direct lending (DL) as a strategy where an investor provides funding to a middle market company (defined as company with EBITDA generally of between $10 million and $100 million) to finance its existing and/or new business operations, including acquisition activities.

Chart 1: Direct lending: a mid-risk proposition



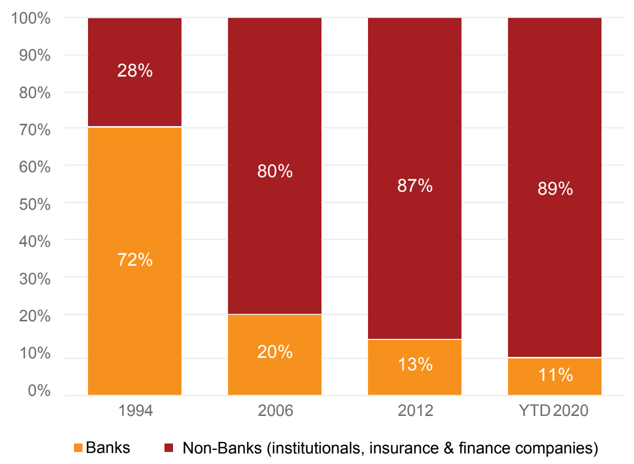
Source: Frontier

DL is generally senior secured lending although a small portion of a DL strategy could include subordinated debt exposures. DL is part of the broader private debt asset class, which includes other strategies such as mezzanine, opportunistic credit and distressed debt. Chart 1 provides a stylised illustration of where direct lending fits compared to other asset classes.

Direct lending here to stay

While direct lending has been around for decades, dedicated direct lending strategies mainly came into existence post the global financial crisis (GFC) as banks retreated from lending to the middle market segment. In the US, the trend of bank consolidation and decreased capital to middle market companies has been established since the 1990s. The GFC further cemented and accelerated the trend in the US. The development of direct lending in Europe occurred post GFC as banks were required to increase capital holdings in response to new regulations. The direct lending market is now well established in both the US and European markets. The Australian direct lending market is small, but growing steadily as new providers of capital look to access attractive opportunities.

Chart 2: US direct lending versus banks' shares of the US leveraged loan market



Source: HPS, S&P LCD, data as at June 2020

Table 1: Direct lending characteristics versus leveraged loans

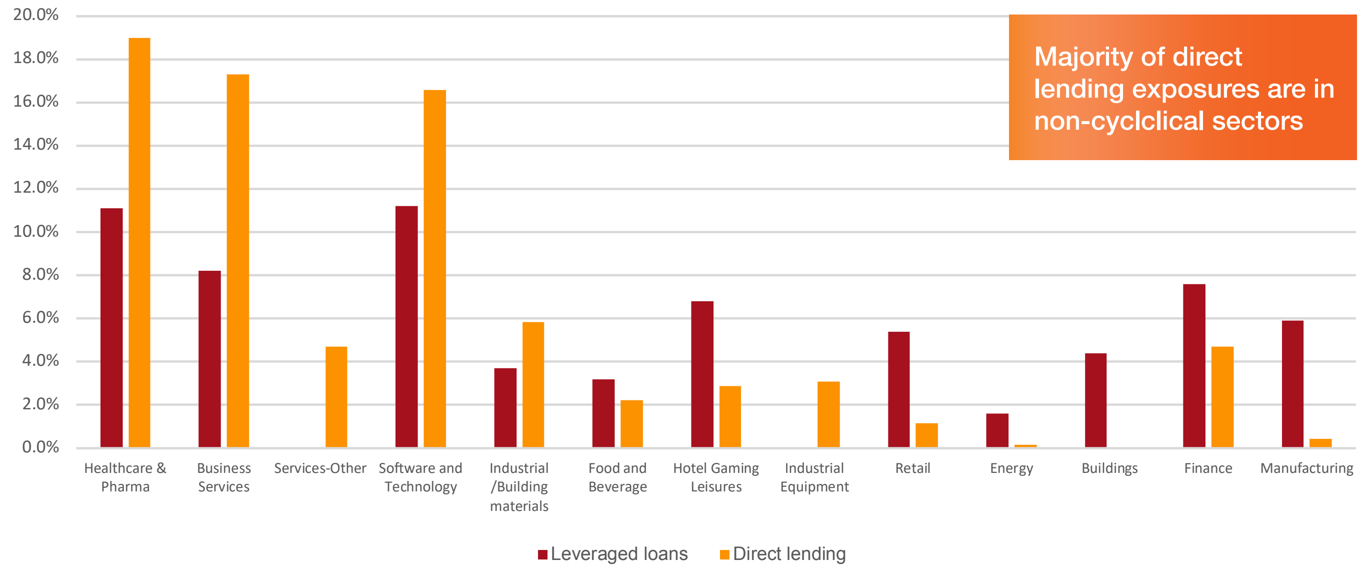
	Direct lending	Leveraged loans
Borrowers type	Middle market private companies, EBITDA generally ~$10m-100m	Larger borrowers (some are publicly listed), EBITDA typically above $100m
Borrower industry	More exposure to non-cyclical industries. Minimal exposure to cyclical industries	Wide range of industries, including cyclical industries like energy, retail
Loan origination	Directly with borrowers and/or sponsors or through debt advisors	Deals are originated by investment banks or commercial banks and distributed to large syndicate
Deal structure and covenants	Higher ability for lenders to structure deals, generally contain covenants	Deals structured by originating banks, normally do not have covenants
Liquidity	Illiquid, mainly buy and hold	Traded OTC, monthly liquidity
Market size	Smaller, less than US$1 trillion	Larger, ~US$1.5 trillion
Market benchmark	Not well established, Cliffwater Direct Lending Index for US market	Established long term benchmarks exist - Credit Suisse; S&P/LSTA;
Lenders composition	Small lenders group, usually up to 6-8 lenders	Larger lenders group, can be 20-30 lenders or more in syndicated deals
Lenders due diligence	More intensive, up to 12-16 weeks	Less intensive, 2-4 weeks
Lenders monitoring / management of underperforming credits	Higher, more proactive, monthly reporting from borrowers with private information. Willing to go through restructuring process to enhance value	Lower, information can be restricted to publicly available information. Less incentive and willingness to go through restructuring process
Portfolio concentration	More concentrated, generally 30-70 names	More diversified, 100 plus names
Fees	Higher fees	Lower fees
Volatility of return profile	Lower	Higher

Source: Frontier. Orange denotes Frontier's view of a more favourable characteristic.

Direct lending: a different exposure to leveraged loans

Leveraged loans are well known to investors either as dedicated strategy or part of a multi-sector strategy. Similarities exist between DL and leveraged loans with both being floating rate senior secured lending typically to sub-investment grade borrowers. However, there are many differences that investors should be aware of, which are highlighted in Table 1.

Chart 3: Direct lending non-cyclical Industry exposure provides a cushion to the default risk



Source: Frontier, Credit Suisse, direct lending managers. Leveraged loans data is based on Credit Suisse Leveraged Loans Index as at May 2020. Direct lending exposure is Frontier's calculation based on an average of seven overseas direct lending managers.

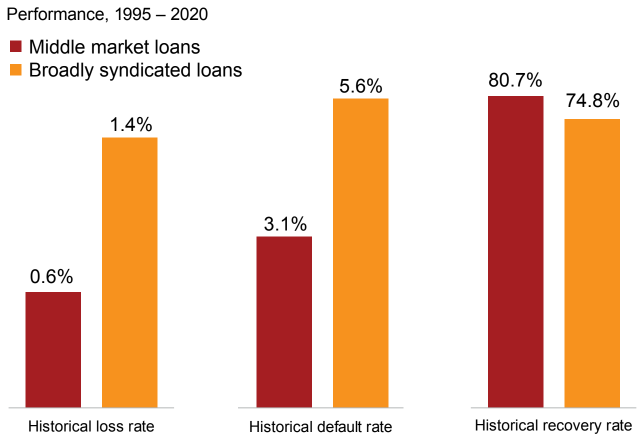
We further illustrate in Chart 3 the difference in industry exposure between direct lending and leveraged loans, which we believe has been a cushion for direct lending against the potential default risk. We believe the preference for non-cyclical industries could be attributed to the following factors:

- The illiquid investment requires the manager to invest with a buy and hold mindset. This means borrowers in non-cyclical industries are favoured as their earnings and valuation are more stable.
- Targeting borrowers in stable industries is an approach used to mitigate against the risk of lending against smaller sized businesses.
- Some DL managers have investment philosophy of targeting borrowers with ability to generate over the cycle earnings and cashflows.

Direct lending – is it worth the risk?

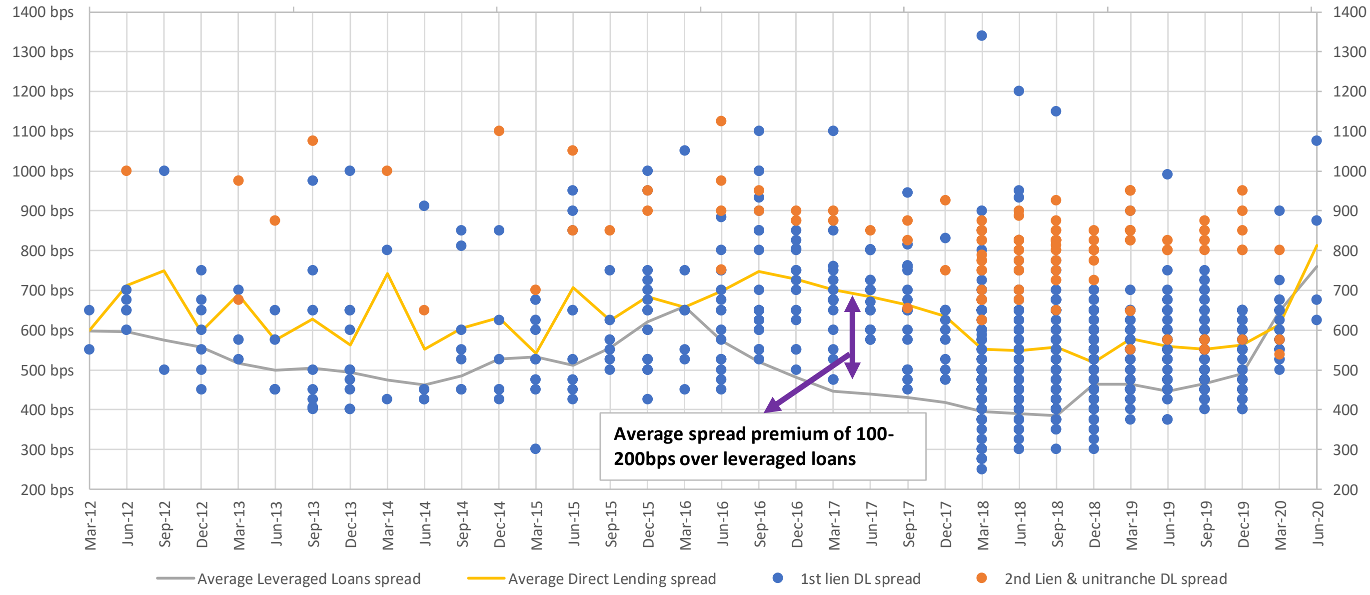
A key concern about direct lending relates to the exposure to smaller companies, which may have higher business risk compared to larger borrowers that would typically borrow in the leveraged loan market. Data on default and loss from the direct lending market is hard to obtain given the private nature of the market and its shorter history. S&P data however suggests smaller companies do not necessarily result in larger losses for lenders should a credit event occur. We think differences in industry exposures play an important part in middle market loans having lower historical default rate compared to broadly syndicated loans, and such businesses tend to utilise lower leverage than bigger companies who access public capital markets. Defaults in the past 20 years have tended to concentrate in sectors such as hospitality, retail, automobile, telecom, and energy, which generally are not the prevalent industry exposures for middle market loans.

Chart 4: Smaller companies have experienced lower historical loss rate



Source: Nuveen, S&P LCD, data from January 1995 to June 2020. Broadly syndicated loans reference S&P/LSTA Leveraged Loan Index. Middle market loans are loans to companies with EBITDA of $50 million or less within the S&P/LSTA Leveraged Loan Index.

Chart 5: US senior direct lending - spread premium of 100-200bps over leveraged loans



Source: Credit Suisse, Frontier's direct lending manager survey. Leveraged loans spread is calculated as average of the 3-year discount margins of Credit Suisse Leverage Loans Index over the quarter. Excludes upfront fees.

Why direct lending can be attractive

We view direct lending as attractive to investors for the following reasons:

- Stable, low volatile return pattern, with high contractual income component.
- Exposure to middle market companies that are not accessible through liquid credit markets such as leveraged loans or high yield bonds.
- Loans are typically senior secured with strong covenant protection. Lenders have access to frequent information and lenders have more control in the event of borrowers being in default or distress situation.
- Continued medium to longer term favourable supply/demand dynamics where banks participation in middle market lending is expected to remain low or trend lower.
- Expected premium net of fees over similar liquid credit alternatives. The premium is available due to not only illiquidity and size, but also deal structuring, flexibility and the certainty that direct lenders can provide to borrowers.

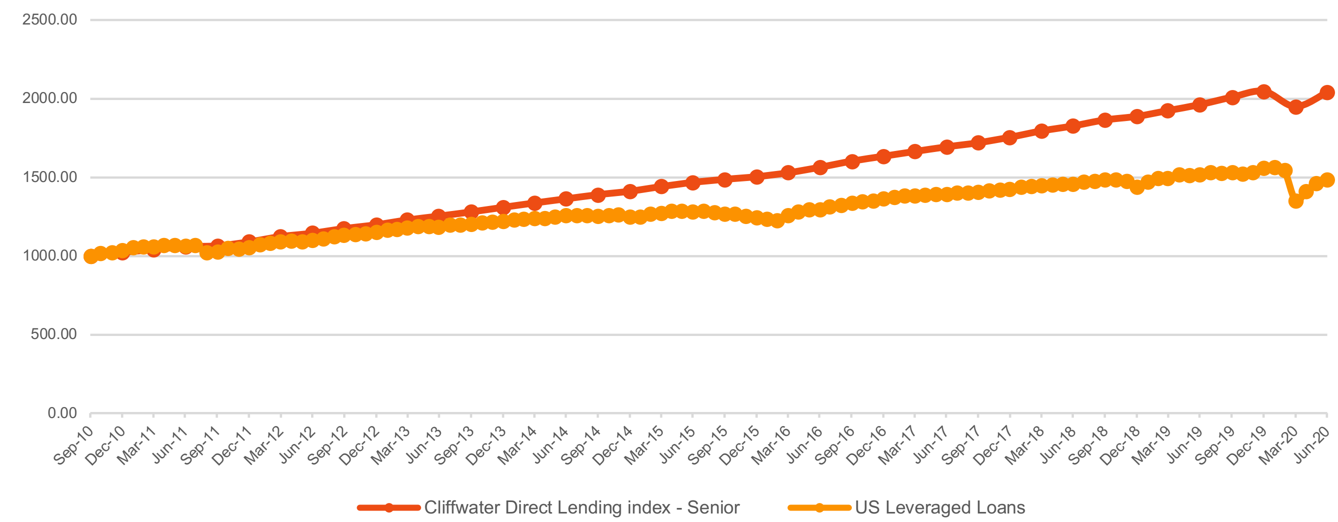
Frontier conducts an annual survey of about 20 direct lending managers. The survey responses highlight deal level metrics which help to quantify the spread or illiquidity premium over leveraged loans.

It must be noted that in addition to higher spread, direct lending offers a one-off upfront fee of between 200-300 basis points, which is generally amortised over the life of each loan, which further improves the return profile.

Chart 5 highlights:

- The DL spread is generally more stable compared to the leveraged loans market
- The gap in spread between DL and leveraged loans narrows in a stressed credit environment (such as the energy crisis in 2015 and COVID in 2020) as spread in leveraged loan widens.
- Once spreads in leveraged loans have normalised, the spread premium would likely expand (as seen 2016 and 2017). This suggests deploying capital to DL immediately after a stressed credit environment could be a good way to capture the spread premium.

Chart 6: US direct lending has outperformed leveraged loans



Source: Frontier, Bloomberg. US leveraged loans represented by Credit Suisse Leveraged Loans Index.
Direct lending is CDLI-S, Cliffwater Direct Lending-Senior Only Index.

As shown in Chart 6, US direct lending (as represented by Cliffwater Direct Lending-Senior Only index (CDLI-S) has generated return of approximately 7.5% per annum over the past 10 years, outperforming the US leveraged loans market. This is consistent with the spread premium shown above. The return drawdowns for US direct lending tend to be relatively modest and significantly less than the drawdown observed in the price of the listed business development companies (the US listed vehicles that own the loans).

What is the COVID-19 impact on direct lending

Similar to all credit driven strategies, direct lending valuations were impacted by COVID-19. In March 2020 performance was negative for most strategies.

The following details highlight the various approaches taken by managers (attained from Frontier's discussions with a number of direct lending managers).

- Impact of COVID-19 on direct lending performance in Q1 2020 varies by manager and their strategies. The typical performance impact was a mid to high single digit negative return, which is below the drawdown in leveraged loans, which was about negative 13% in Q1 2020. Overseas direct lending strategies were typically more impacted compared to Australian strategies which typically fell less than 5% in Q1.
- The managers commented that the impact of COVID-19 on their existing investment portfolios has been manageable to date. The proportion of borrowers classified as high risk varies by manager, but typically accounts for up to 15%-20% of the overall portfolio.
- During initial months of COVID crisis, most of the managers' focus was on reviewing and managing their existing portfolios, especially the exposures most directly impacted by COVID-19.
- In some instances, credit restructuring was required but potential loss is expected to be acceptable given the strong equity cushion available.
- The managers believe somewhat limited impact of COVID-19 on their portfolios can be partly attributable to the focus of lenders on non-cyclical borrowers. In addition, the senior secured positions of lenders, together with strong covenant protection, allow them to have good control of the challenged credits.

Against a volatile credit backdrop, new deal activity (i.e. primary market transactions) was significantly reduced for a few months in late Q1/early Q2 2020. However, more opportunities have arisen since late Q2 2020. Compared to pre-COVID, new transactions appear to be more favourable to lenders as they can negotiate more favourable loan documents and the transactions offer better economics. This suggests potentially a better time to deploy capital in this asset class for investors with capacity to add illiquid exposures, particularly now that liquid credit markets have rallied so hard. Due diligence is however more important than ever to ensure that your investments will stay "COVID-proof" given the buy and hold nature of direct lending.

Table 2: Direct lending has become more attractive

	Direct lending post COVID versus pre COVID
Financial covenants	Tighter covenants
Leverage	0.5-1x lower
Pricing	Margin: 100-300bps higher Upfront fees: up to 50bps higher
Terms	More favourable to lenders

Source: Frontier

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Where does direct lending fit in your portfolio

Liquid versus illiquid

We believe portfolios should blend both direct lending and liquid credit. While direct lending has the potential to give a better return, generally the fees are higher, and investments are locked up for a number of years. Liquid credit, whilst more volatile, gives the flexibility to adjust the allocation based on a market view (Dynamic Asset Allocation), and this can be an important “up in quality” exposure to target during periods of market stress relative to listed equities.

Unlike liquid credit, direct lending investments are not actively traded, and investors therefore need to pay close attention to how the investments’ valuations are determined. Frontier has observed a divergence of valuation approaches adopted by the direct lending managers, as noted below. We believe a level of marking to market is prudent and the use of independent third-party valuation is generally preferred.

- Some managers use a combination of marking to market and testing for credit impairment to value the investments, whilst others treat credit impairment as the main driver of valuations (i.e. without marking to market).
- Some managers use internal valuation approaches whereas some rely on independent third- party service providers to conduct valuations.

Australian or global direct lending

The difference between Australian and global direct lending strategies is quite meaningful and worth considering.

For investors considering an initial investment in direct lending, we believe Australia is a good first step because of its structural simplicity and fee advantage, subject to a portfolio having acceptable diversification. Adding global direct lending broadens the opportunity set and improves portfolio diversification away from Australia provided a suitable fee arrangement can be negotiated.

Table 3: Comparing Australian and global direct lending funds

	Australian	Global
Fees	Management fees typically less than 75bps.	Management fees generally above 100bps.
	Performance fees generally not applicable.	Performance fees generally 10% or more over a hurdle rate, often with a catch-up mechanism.
Product structure	Simple, AUD unit trust.	Complex, requiring tax consideration.
Currency hedging	Not required.	Needs to be considered where AUD hedged vehicles are not available.
Fund format	Generally open-ended with 2-3 year lock up period.	Generally closed-ended with a fund life of 5-7 years.
Portfolio concentration	Portfolio likely having 25-40 names.	Portfolio can be more diversified at 40-70 names.

Source: Frontier

The final word

In this paper we have explained what direct lending is and its characteristics.

We also highlight that direct lending has many appealing characteristics which warrant a strategic allocation within an investor portfolio, subject to fee budget and illiquidity considerations. COVID-19 has created an attractive environment for new allocations to direct lending although robust due diligence is important to ensure your investments will stay “COVID-proof” given the buy and hold nature of the asset class.

For investors contemplating an initial allocation, we prefer Australian direct lending strategies over global due to its structural simplicity and lower fees, subject to acceptable diversification. Global direct lending nevertheless can be beneficial for those looking to expand portfolio diversification and access a wider opportunity set.

Want to learn more?

Please reach out to Frontier if you have any questions or visit frontieradvisors.com.au for more information.

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