The Frontier Line

Private debt: value improving in global senior direct lending

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Frontier Advisors | Forefront Thinking

About us

Frontier Advisors has been at the forefront of institutional investment advice in Australia for over 25 years and provides advice on over $600 billion of assets across the superannuation, charity, public sector, insurance and university sectors.

Our 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.

Nam Tran

Senior Consultant

Nam Tran joined Frontier Advisors in 2017 as a Consultant, was promoted to Senior Consultant in 2021. He is a senior member of the Defensive Assets and Private Markets Team with a focus on Private Markets.

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 is a CFA charterholder and CAIA charterholder.

Jill Guan

Consultant

Jill joined Frontier Advisors as a Consultant in 2021 and is a member of the Defensive Assets and Private Markets Team.

Jill was previously at Citibank Australia where she provided relationship and credit coverage to institutional clients. She has also spent time in China with Citibank as a credit analyst. Prior to that, she worked at HSBC Australia and ANZ within institutional banking across various client coverage teams.

Jill holds a Bachelor of Law and a Bachelor of Commerce from the University of Melbourne.

Introduction

Frontier has been undertaking extensive research on private debt since its infancy. Since 2018 a key part of our research has been undertaking an annual direct lending survey which collates data from key Australian and global direct lending players in the market.

The survey collects data points at the fund level and extensive deal metrics at the loan level. Our coverage of the market, supported by the direct lending survey, helps us validate trends, interrogate areas of concern, and understand its evolution.

As the direct lending market cements its position as a key source of financing for sub-investment grade borrowers alongside high yield bonds and leveraged loans, there is also a material growth in the number of players and products, transaction complexity, and product differentiation. This paper provides an update on the direct lending market, including insights from our most recent survey and highlights some changes that have occurred in direct lending market in recent years, as well as implications for investors in managing and growing their direct lending portfolios.

What has changed?

Two significant observations stand out from the results of this year's survey.

Private financing now used by businesses of all sizes

Traditionally used for small and mid-sized borrowers, direct lending has become an alternative financing option for large sized borrowers who historically used the liquid credit market and banks. In the second half of 2022 and early 2023, amid the public credit market dislocation where leveraged loan issuance ground to a halt, large sized borrowers turned to the direct lending market to supplement their borrowing requirements. Further analysis of how direct lending to large sized borrowers differs from direct lending for small and mid-sized borrowers and whether investors should allocate to this segment, is provided later in this paper.

Offshore senior secured direct lending has become more appealing

Between 2019 and early 2022, offshore direct lending was less attractive compared to Australian direct lending due to higher fees and generally lower return per unit of risk. In the past 12-15 months, offshore direct lending deals have become more attractive with higher credit spreads and stable or declining leverage multiples. Together with improved fee proposition and strong diversification, offshore direct lending currently represents an attractive option for many investors.

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Market segmentation – quantifying the size premium

As direct lending becomes more mature as an asset class, we have seen a clearer segmentation of the market where players look to differentiate their product offerings and target different segments of the market. Of note is the prominence of dedicated direct lending strategies targeted at large sized borrowers who traditionally use traded credit (leveraged loans and high yield bonds) for financing. This is most notable in the US direct lending market, the largest and most developed market, and to a lesser extent in Europe and Australia.

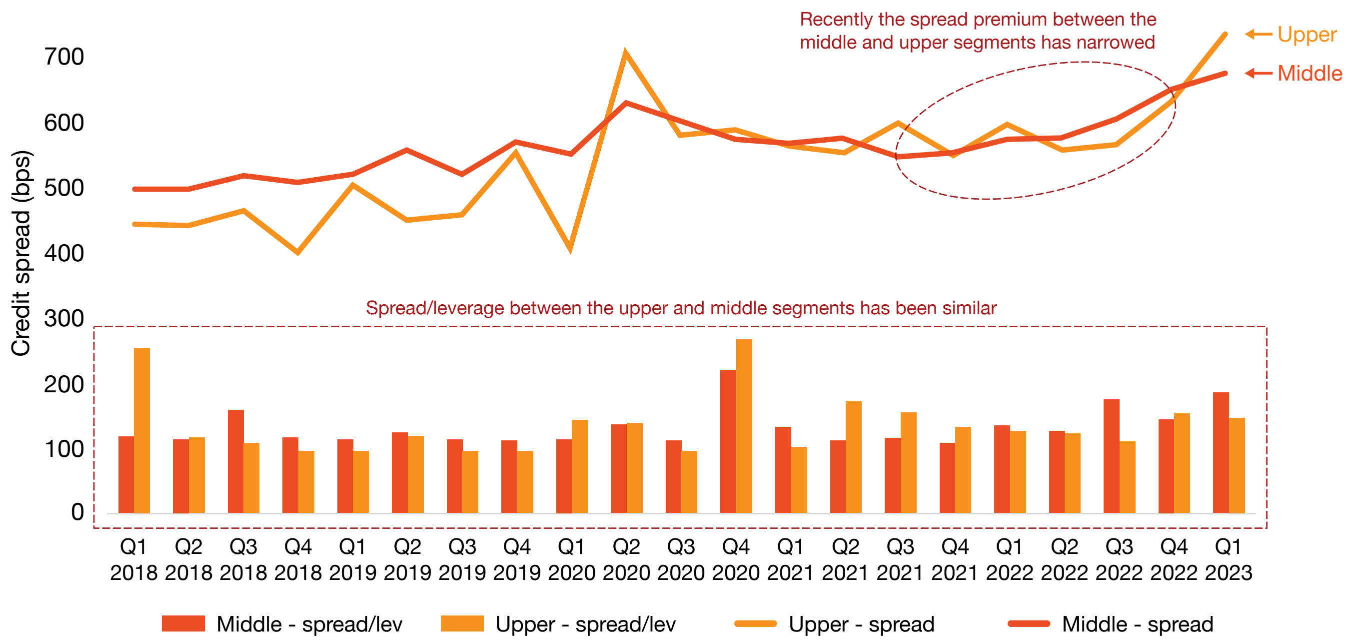
Based on a borrowers' EBITDA, the direct lending market can be segmented into lower, middle, and upper market. While these definitions can vary, for the purpose of this paper, Frontier has defined the lower market segment as borrowers with EBITDA of $25m or less, the middle market segment as borrowers with EBITDA between $25m and $100m, and the upper market segment as borrowers with EBITDA of $100m and above. Some direct lending strategies focus on one segment and may specialise in lending to small businesses for instance, whilst others will take a flexible approach and invest across different segments.

Chart 1 shows a comparison of credit spreads and spread per turn of leverage among different markets. The amount of debt a business has relative to its earnings measures a company's ability to pay off its incurred debt and is a key comparative ratio used to assess risk across all credit markets. Credit spreads (top section of the chart) in the upper market have historically been lower than the middle market as greater compensation for risk has been available for smaller businesses in the past. This relationship has changed since Q3 2020. Interestingly, the credit spread of the upper market were the highest in Q4 2022 and Q1 2023. This can be attributed to the dislocation in the liquid credit markets, where large sized borrowers were unable or unwilling to access liquid markets for financing. Credit spreads in the upper market have also been more volatile compared to the lower and middle market. This is expected to remain the case going forward as financing in this market is more correlated to events and conditions in the liquid markets.

On a spread per leverage basis as a measure of return per unit of risk (lower section of the chart), there is no clear trend among the different markets and therefore no segment appears to be more attractive than the other. Spread per leverage in the upper market was higher than the middle market in Q4 2020 and 2021, however since 2022 it has been slightly lower compared to the middle market. This is due to higher leverage accepted by lenders in the upper market.

The question of which segment to lean into is a complex one. While in general, lending to larger businesses might appear to be a safer option, investors need to ensure they take into account the level of leverage and other important factors such as volatility, product structure, financial structure and fees before making investment decisions.

Chart 1: Credit spreads (bps) and spread per turn of leverage - US direct lending segments



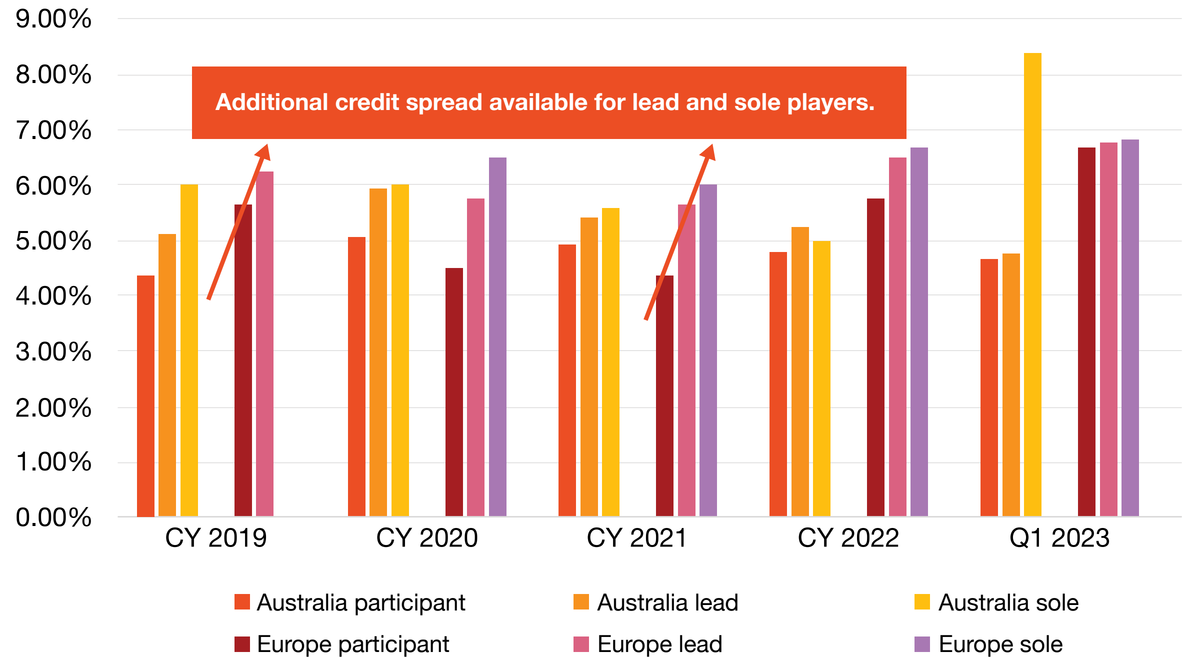
Source: Frontier Advisors direct lending survey

Who originates the deal matters – the benefits of lead and sole lenders

In line with market growth and higher investor allocation to the asset class, the number of direct lending players has also increased markedly. Given this, it is important to consider their role in a deal. Some direct lenders act as the lead or sole lender in a transaction, giving them the ability to influence or control the terms of the deal, including the lender's economics and protection. The ability to lead or act as sole lender usually is reserved for established, often larger players that have a strong reputation and capability, together with a good relationship with borrowers/ sponsors and dry powder to deploy.

Chart 2 illustrates that credit spreads earned by lead and sole lenders have been stronger than those earned by lenders that are simply a participant in a transaction. While the chart shows Australian and Europe focused managers, the same pattern is observed in the US. Consequently, it is highly beneficial for investors to partner with managers that can act as lead or sole lender.

Chart 2: Lead and sole lenders achieve better credit spreads than participant lenders



Source: Frontier Advisors direct lending survey

The lead or sole role can also be crucial when a deal is not progressing as originally expected, because those lenders have more control on how to manage an underperforming credit situation. In our view, the ability to act as lead or sole lender coupled with relevant workout experience, is something investors should carefully assess as part of the due diligence process. This is even more pertinent in Australia where we see the highest percentage of direct lenders not acting as a sole or lead lender.

Frontier's survey indicates that in Australia, direct lending managers are neither lead nor sole lenders in about 60% of the deals, whereas that percentage was around 30% in the US and 15% in Europe.

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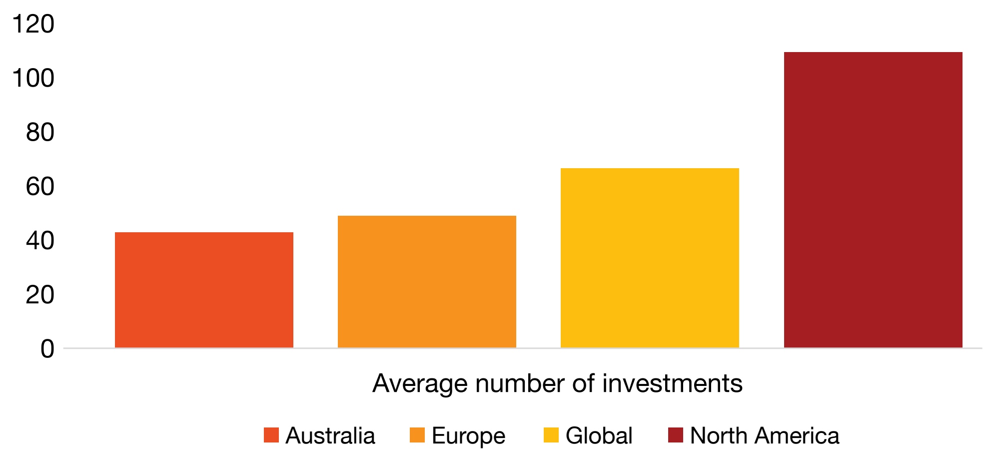
Australian versus offshore direct lending – pros and cons

Offshore direct lending is likely to offer better portfolio diversification

The Australian direct lending market has continued to grow yet remains small relative to the US and European markets. There can also be periods of lower activity which can be a problem for strategies trying to deploy capital. This means in general an Australian strategy is likely to be less diversified in terms of number of investments.

As shown in Chart 3, on average, global strategies including regionally focused strategies (e.g. North America or Europe), hold a higher number of investments compared to Australia, reflective of a larger opportunity set and deeper market. All else being equal, offshore strategies would therefore offer investors a more diversified portfolio, reducing the risk of potential loss when problem credits occur. It is important to note that within each geography, the level of diversification can vary materially among specific strategies, requiring careful consideration from investors.

Chart 3: Average number of investments across geographies



Source: Frontier Advisors direct lending survey, data collected between 2017-2022

Access method – easier access to newly originated loans for offshore direct lending

Australian direct lending is normally offered in an open-ended structure, which presents a simpler and easier mechanism for investors to remain invested in the asset class. This can be contrasted with offshore direct lending, which is typically accessed via closed-ended structures, requiring the need to continually consider and assess the investment level in a new vintage.

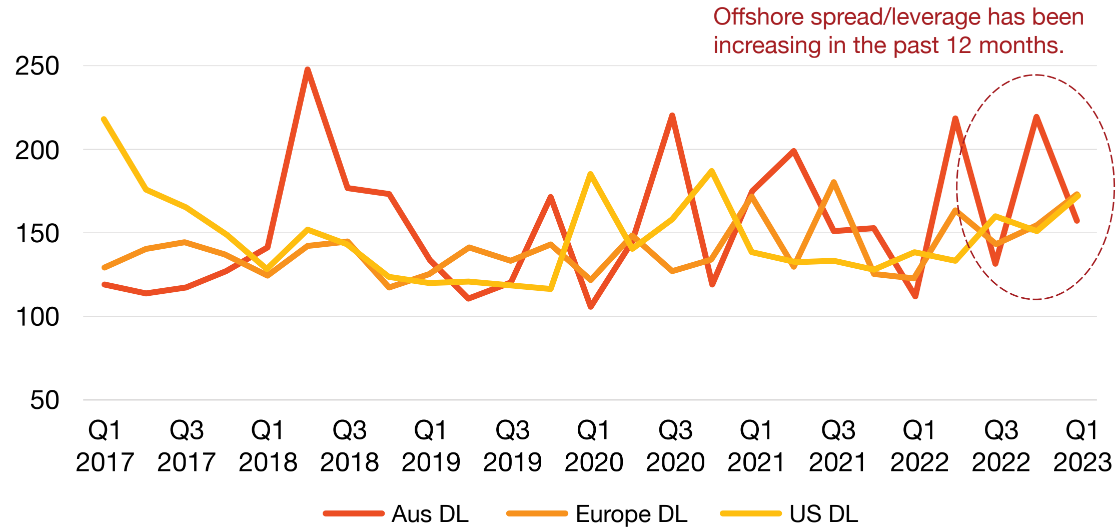
At present, there is a clear advantage in accessing direct lending in a new vintage. In a new vintage, investors can benefit from newly originated loans that have a higher return compared to historic levels but are underwritten to a newer and potentially stricter lending standard reflective of a higher interest rate and the higher cost/inflation environment. Additionally, any valuation uncertainty of pre-existing deals is minimised and risk of having exposure to deteriorating credit quality of deals transacted in a low interest rate world for instance, is avoided. Consequently, it is highly beneficial for investors considering new allocations to access direct lending via a new vintage, which is more commonly found in offshore direct lending.

Australian direct lending has a lower risk profile but similar spread per turn of leverage (return per unit of risk) versus global direct lending

While the Australian market has attracted more capital from non-bank lenders recently, many deals are still anchored by banks. This has created a level of conservatism in the deals. Leverage has typically been lower in Australian deals relative to the US and Europe, resulting in lower risk and lower return potential.

Chart 4 shows that over the medium term spread per turn of leverage is broadly similar in all direct lending markets. In the past 12-15 months, while there has been no clear trend in Australia, offshore direct lending appears increasingly attractive as spread widening has been observed alongside stable and slightly lower level of leverage, resulting in increasing spread per turn of leverage. As such, offshore direct lending is likely to be a more suitable allocation at this juncture for investors seeking a higher return but with correspondingly higher risk.

Chart 4: Average spread (bps) per turn of leverage



Source: Frontier Advisors direct lending survey

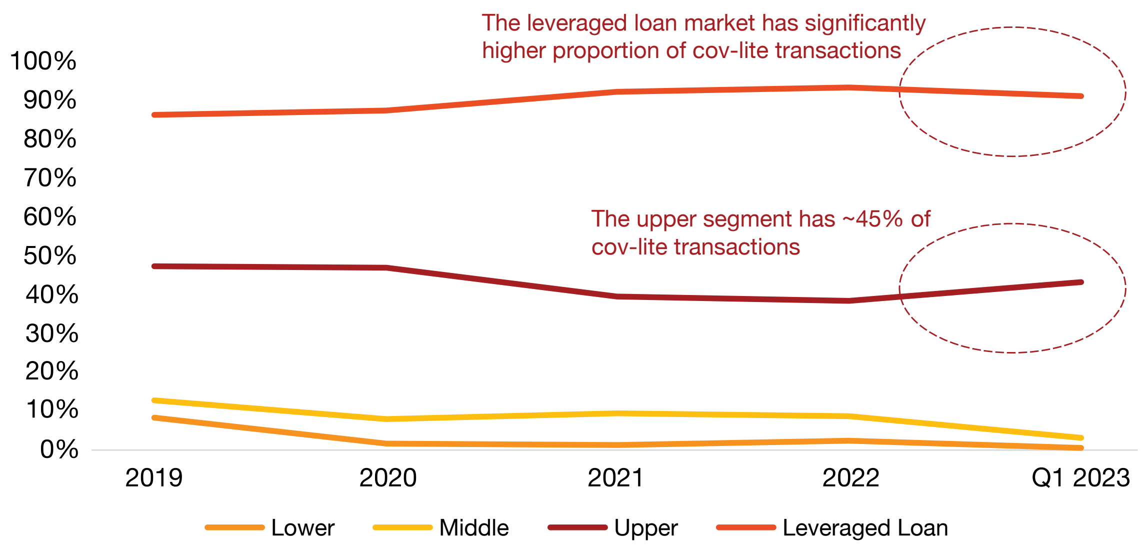
Fees – Australia remains more attractive

Australian strategies remain broadly more attractive on fees. Australian net returns therefore can be more favourable compared to offshore strategies due to lower fees, but this balance has swung toward offshore direct lending strategies where terms have improved for investors in the last few years. With the increasing appetite in direct lending from Australian investors, global managers have become more cognisant to align not only their fee proposition but also their product structures. In many cases, performance fees for offshore direct lending have been removed, particularly for early investors in a new vintage. We recommend investors looking at offshore direct lending consider and take advantage of any early bird fee offers. Additionally, investors can consider other avenues to lower fee load such as co-investment opportunities offered by offshore managers.

Covenant lite creeping in – is this a problem?

Covenant-lite (cov-lite) loans, i.e. loans structured without maintenance covenants to protect lenders, are a common feature of the leveraged loan market with about 90% of loans reported as cov-lite. The direct lending market, which is known for its tighter documentation where loans typically will include maintenance covenants, has seen a level of cov-lite deals creeping in as depicted in Chart 5. We have observed roughly 45% of loans within the upper segment as cov-lite loans, whereas that percentage is less than 10% for the middle segment and almost none for the lower segment. This is reflective of large-size borrowers using direct lending as an alternative source of funding and they can negotiate the types of cov-lite structures normally used in leveraged loan market.

Chart 5: Covenant lite deals as a percentage of total deals by year



Source: Frontier Advisors direct lending survey, leveraged loan data as of March 2023 sourced from LCD.

The emergence of cov-lite structures is less apparent in the lower or middle market which continue to benefit from more covenant protection. Notably, almost all loans in the lower middle market are still structured with at least one maintenance covenant. In Australia, we have observed several cov-lite transactions in loans structured for large sized borrowers.

Notwithstanding the cov-lite existence in parts of the direct lending market, we do not believe it is a concern at this stage. Cov-lite structures, while more borrower-friendly, do not necessarily indicate higher risk or higher probability of default. Default and loss rate across the direct lending market remains low and ultimately default risk is also dependent on a range of other factors including the credit quality of the borrower, capital structure, other terms and conditions and the quality of sponsors (in the case of sponsored transactions). The respective manager's track record and experience in managing credit workouts are also often more pertinent factors in minimising credit losses. However, investors should be aware of the underlying credit quality of cov-lite loans found in their portfolios, how risks are managed, and understand the monitoring processes particularly for borrowers with high leverage with signs of underperformance.

The final word

The direct lending market has grown significantly in recent years and has formed another viable capital market funding source for businesses.

As the direct lending market matures, there has also been a clearer distinction of strategies where managers differentiate themselves based on market segmentation targeting certain sized borrowers. Managers also distinguish their strategies via their role in a deal. Our analysis indicates while investment outcomes may not be determined by market segmentation, it is strongly influenced by lender role. It is important that investors carefully consider a manager's proposition (both target market segmentation and the lender's role) when making allocation decisions as those factors can result in different investment outcomes and in particular investors should aim to partner with managers that have ability to be a lead or sole lender.

The characteristics and nature of the Australian direct lending market are different when compared to offshore markets. We believe both Australian and offshore direct lending strategies can have a place in an investor's portfolio; however investors need to carefully weigh up the pros and cons of each market when constructing a portfolio that is most appropriate for their needs and requirements.

At present, subject to a reasonable fee agreement, investors looking for a higher target return, improved portfolio diversification and the benefit of investing in a new vintage, should consider offshore direct lending.

Want to learn more?

Frontier has extensive coverage of Australian and offshore direct lending strategies, and we will be pleased to share additional insights and engage in further discussions with investors on all matters related to direct lending investments. Please reach out to our Defensive Assets and Private Markets Team if you would like more information.

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