Introduction to Private Debt and Direct Lending

FMA Annual Meeting 2023

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October 2023

Outline

1. Definitions. Key Features. Performance.
2. Why the Increase? Observations and thoughts for future research.

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Private Debt a.k.a. Private Credit

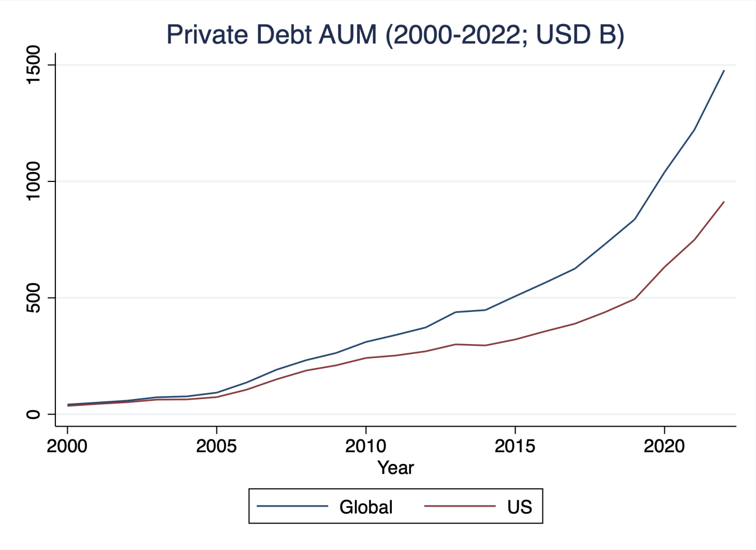
- Definitions in flux. What is it not?
  - Not traditional bonds. Not traditional bank debt.
- Private refers to instrument, not borrower.
  - Public firms can use private debt. But private firms do use private debt more.
- What does it include?
  - Private debt (PD) funds: Direct lending (DL), mezzanine, distressed debt, etc.
  - Business development companies (BDCs)
  - Collateralized loan obligations (CLOs)
  - Focus today: PD funds (DL funds in particular) and BDCs, collectively referred to as Direct Lenders
    - Top PD funds: Antares, Barings, Blackstone, Carlyle, Oaktree, etc
    - Top BDCs: Ares, Apollo, Golub, Owl Rock, New Mountain etc
    - Many are affiliated with Private Equity (PE) firms

Direct Lenders

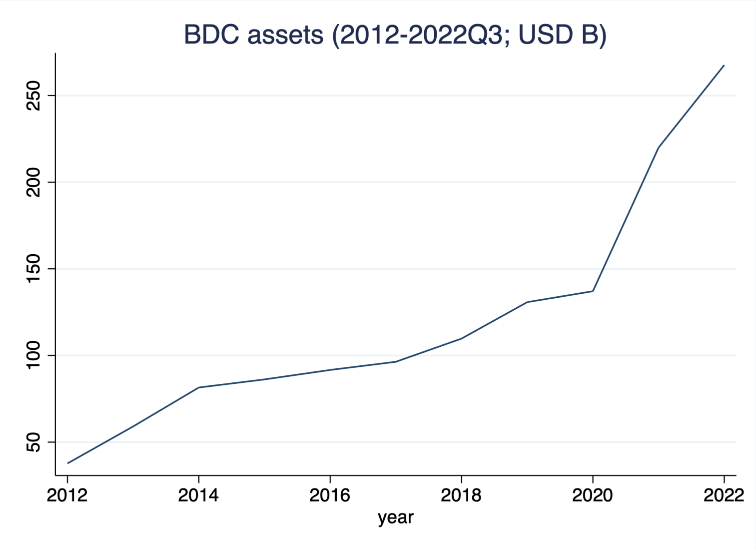
- Financing: PD funds and BDCs
  - PD: closed-end + limited partnership with fixed life (like PE funds)
  - BDC: a special type of closed-end fund created by legislation
    - Must invest mostly in private firm debt
    - SEC-mandated quarterly fair value disclosure requirements
    - Corporate tax-exempt if $>90\%$ investment income distributed
    - Can be publicly listed
  - Both PD funds and BDCs use fund-level leverage
    - PD funds typically use less than 1:1 in D:E / BDCs capped at 2:1
  - Total AUM in the US: PD $\approx$ \$914B and BDC $\approx$ \$268B as of 2022

- Direct Lending: Bilateral loan negotiation *without bank intermediation*
  - Low syndication and secondary market trading

- Borrowers: "Middle-Market" firms (sales \$10M-1B)
  - Primarily PE buyouts: 78% of PD & 63% of BDC (Block et al 2022, Jang 2023)

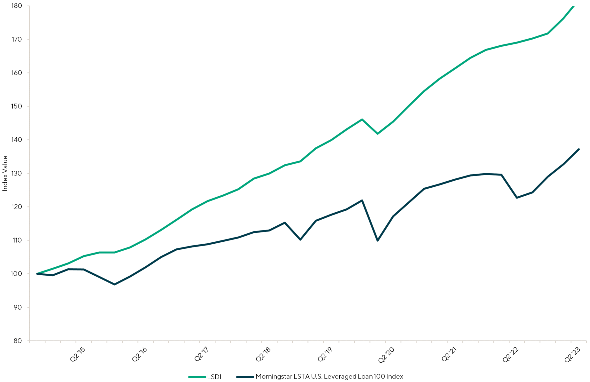


Private Debt AUM (2000-2022; USD B)
1500
1000
500
0
2000
2005
2010
2015
2020
Year
Global
US


BDC assets (2012-2022Q3; USD B)
250
200
150
100
50
2012
2014
2016
2018
2020
2022
year

Direct Lending Performance

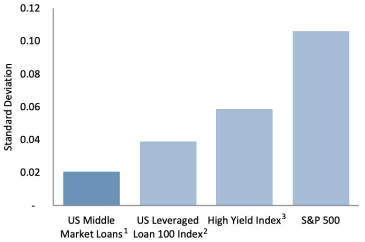
- Cliffwater: Annualized 9.37% return, unlevered and gross of fees (2004-2023)
- Block et al (2022): Unlevered IRR of 8.16% and levered IRR of 11.18%
- Munday et al (2018): Outperformed leveraged loans and HY bonds
- Lincoln International: Outperformed leveraged loans (below)



Direct Lending Performance

Higher return and *lower volatility* than leveraged loans and HY bonds. How to reconcile?

Figure 14. Lower Volatility –
Standard Deviation over 7 Year Period*



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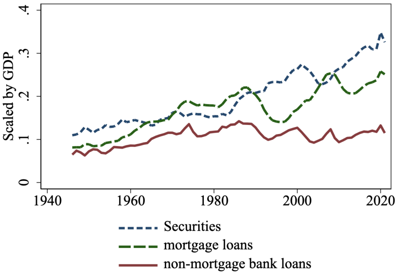
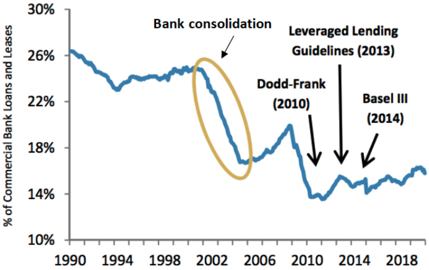
Why the Increase?

- Bank consolidation & increased banking regulation
- Banks' reluctance to certain types of firms
- Rise in PE deal flow and PE-PD synergies
- Direct lenders' advantage in providing customized needs

Bank consolidation & increased banking regulation

Bank corporate lending has not kept pace with other banking activities since 2000, possibly due to bank consolidation and post-2008 regulatory tightening.





Banks' reluctance to certain types of firms

According to direct lenders surveyed by Block et al (2022), banks avoid lending to small firms with lack of tangible assets and low transparency.

Panel B: Why firms cannot get bank financing

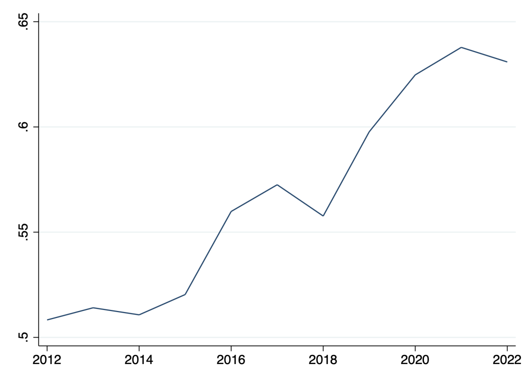
Reasons for not getting a bank financing	Europe			US		
	N	% of respondents	% of responses	N	% of respondents	% of responses
Firm has low amount of tangible assets as quality collateral	79	55.2%	22.2%	16	53.3%	19.8%
Cash flow is too low or unstable	43	30.1%	12.1%	8	26.7%	9.9%
Firm size is too small for bank syndication	75	52.4%	21.1%	21	70.0%	25.9%
Due diligence is messy due to less clean financials or a lack of sophisticated internal systems	65	45.5%	18.3%	15	50.0%	18.5%
Firms operating in niche sectors	54	37.8%	15.2%	7	23.3%	8.6%
Other/s	40	28.0%	11.2%	14	46.7%	17.3%
Number of respondents	143			30		
Number of responses	356			81		

Note: This panel presents the reasons for why some firms which are reliant on private debt might not be able to secure money through a bank. The question asked is "Why do you think banks would not want to finance companies that are reliant on private debt?" We report the results separately for the European and US respondents. The respondents were allowed to make multiple choices; hence, we report the results separately as a fraction of the number of respondents and responses. The respondents that chose the answer choice "0%" in the previous question on Panel A were not asked to answer this question.

Rise in PE deal flow and PE-PD synergies

PE buyouts are the main marketplace for private debt.

- Block et al (2022): 78% (42%) of US (Europe) private debt in PE buyouts
- Jang (2023): BDC-held debt in PE buyouts $51\% \Rightarrow 63\%$ from 2012 and 2022



Rise of PD could mirror rise of PE, as PE may prefer non-banks over banks.

- Jang (2023): Prior relationship with PE sponsors predicts greater credit supply by direct lenders in times of stress

Direct lenders' advantage in providing customized needs

According to direct lenders surveyed by Block et al (2022), they provide greater commitment, higher leverage, and more flexible covenants than banks do.

Panel C: Why firms choose private debt of bank debt

Reasons for choosing private debt over bank debt	Europe			US		
	N	% of respondents	% of responses	N	% of respondents	% of responses
Certainty and speed of execution (vs long / uncertain bank syndication process)	127	83.0%	23.8%	31	91.2%	23.1%
Stable relationship with lender's expectation to hold to maturity (vs bank originate-and-distribute model)	53	34.6%	9.9%	22	64.7%	16.4%
More flexible covenant structure	81	52.9%	15.2%	26	76.5%	19.4%
Diversification of financing sources	61	39.9%	11.4%	8	23.5%	6.0%
Longer investment horizon than banks are willing to support	60	39.2%	11.2%	9	26.5%	6.7%
Higher leverage than banks are willing to support	83	54.2%	15.5%	28	82.4%	20.9%
Did not approach banks due to fear of rejection	10	6.5%	1.9%	3	8.8%	2.2%
Bank loan application was rejected	44	28.8%	8.2%	2	5.9%	1.5%
Other/s	15	9.8%	2.8%	5	14.7%	3.7%
Number of respondents	153			34		
Number of responses	534			134		

Direct lenders' advantage in providing customized needs

According to Jang (2023), direct lenders exhibit greater flexibility in resolving distress and induce more skin-in-the-game from PE sponsors than banks do.

		Direct			Bank		
	N	Mean	SD	N	Mean	SD	Mean Diff.
Distress severity							
COVID revenue growth	168	-0.153	0.212	56	-0.176	0.190	0.023
I(Payment default)	168	0.363	0.482	56	0.375	0.489	-0.012
I(Covenant default)	168	0.768	0.423	56	0.696	0.464	0.071
Resolution outcomes							
I(Payment & Interest deferral)	168	0.250	0.434	56	0.089	0.288	0.161***
I(Restructuring)	168	0.125	0.332	56	0.304	0.464	-0.179***
I(Bankruptcy)	168	0.030	0.170	56	0.143	0.353	-0.113**
I(Sponsor injection)	168	0.399	0.491	56	0.232	0.426	0.167**
I(Sponsor exit)	168	0.113	0.318	56	0.232	0.426	-0.119*

* $p < .10$, ** $p < .05$, *** $p < .01$

- Distressed = payment/covenant default (March 2020 – March 2021)

Observations and thoughts for future research

1. Higher returns and lower volatility than leveraged loans and HY bonds
    - How to reconcile? Are returns smoothed or just smooth in nature?
    - How are the valuations done? How often do DLFs/BDCs outsource to 3rd parties? Are marks given by 3rd parties always used and unbiased?
2. Direct lenders resemble banks on assets and PEs on liabilities.
    - i.e. Monitored debt financed by locked-up capital & long-term bank debt
    - How to reconcile with banking theories that emphasize the need of fragile capital structure for intermediation?
    - Why do banks lend to direct lenders (and not to firms directly)?
    - Given similar funding sources, would flows into PD be pro-cyclical as PE?
3. Direct lending deals are getting much bigger.
    - e.g. Finastra raised $5.3B direct lending deal in August 2023.
    - Is direct lending taking over public markets? Would terms eventually converge?