Introduction to Direct Lending

October 24, 2022

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Introduction

- Extensively covered in BUSN 35214: large firms with traditional debt (bonds/bank loans)
- Not much covered: middle-market firms increasingly reliant on alternative/private debt
  - 1/3 of US jobs and private sector GDP (National Center for the Middle-Market)
  - LSTA: Total US middle market (MM) loans outstanding ≈$1T as of 2022
    - Comparable to $1.2T HY & Leveraged Loan markets (Ares)

LARGE CORPORATE (MORE THAN $50M OF EBITDA)				
	Average	**Max**	**Min**	**StDev**
Deal Size ($MM)	$1,300.3	$14,800.0	$100.0	$1,388.0
Pro Rata Spread (L+)	345.8	650.0	125.0	142.7
Pro Rata Tenor (Yrs)	4.9	6.0	1.7	0.4
Revenues ($MM)	$2,649.0	$92,100.0	$92.7	$7,077.5
EBITDA ($MM)	$480.5	$12,405.0	$51.3	$1,028.6
Debt / EBITDA	4.92	9.87	0.98	1.56

MIDDLE MARKET ($50M OF EBITDA OR LESS)				
	Average	**Max**	**Min**	**StDev**
Deal Size ($MM)	$258.2	$450.0	$55.0	$86.9
Pro Rata Spread (L+)	477.8	900.0	190.0	164.6
Pro Rata Tenor (Yrs)	5.0	5.0	4.1	0.2
Revenues ($MM)	$269.5	$1,028.0	$74.7	$218.1
EBITDA ($MM)	$40.1	$49.4	$17.5	$8.8
Debt / EBITDA	4.85	7.29	2.03	1.33

Source: S&P Global Market Intelligence

Introduction

- Today:
  - What is private debt/direct lending? Who are major players? Recent trends?
  - Why the increase? How do direct lenders compare with banks, CLOs, and PE funds? US vs Europe?
  - Performance and Outlook

- Combination of industry reports and academic findings including my own
  - Jang and Kaplan (2020), “Some Thoughts on Private Debt”
    - Video link: 2020 AFA panel session on private debt
  - Jang (2022), “Five Facts about Direct Lending to Middle-Market Buyouts”
  - Block, Jang, Kaplan, and Schulze (2022), “A Survey of Private Debt Funds”

Roadmap

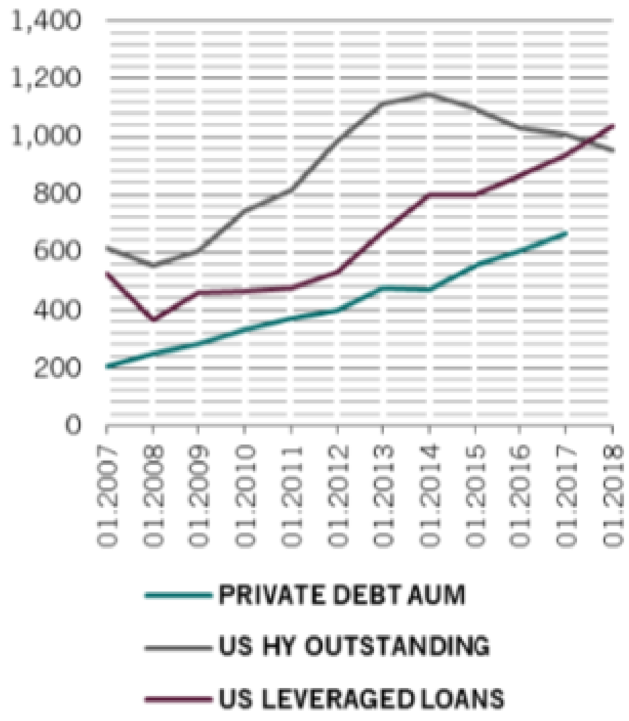
1. **What is private debt/direct lending? Who are major players? Recent trends?**

2. Why the increase? How do direct lenders compare with banks, CLOs, and PE funds? US vs Europe?

3. Performance and Outlook

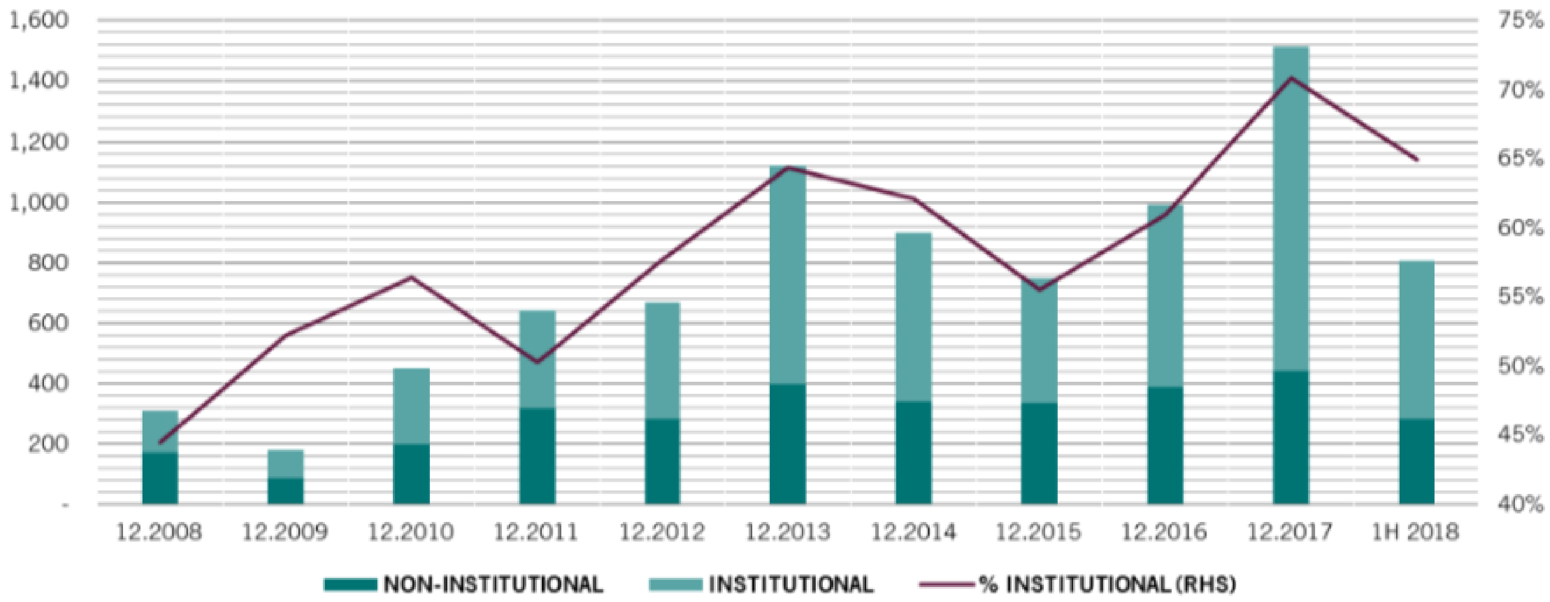
High Yield Bonds ↓ , Leveraged Loans & Private Debt ↑ Leveraged Loans have become less bank driven.

Figure 2: Institutional AUM by asset class



Source: Prequin, Dealogic, S&P/LSTA, Pictet

Figure 3: US issuance of leveraged loans, banks and institutional, USD billion



Source: Bloomberg, Pictet

What is Private Debt / Private Credit?

- Definition somewhat opaque. What is it not?
  - Not traditional bank debt. Not traditional bonds.

- What does it include?
  - Collateralized Loan Obligations (CLOs)
    - Securitized pool of investments in bank-syndicated leveraged loans
  - Direct Lending Funds (DLFs), Business Development Corps. (BDCs), Mezzanine Debt, Distressed Debt, Special Situation Debt, and Venture Debt.
  - Our focus today: **DLFs and BDCs**, collectively referred to as **“direct lenders”**
    - Big DLFs: GSO Capital Partners, KKR Credit, First Eagle, Crescent
    - Big BDCs: Ares Capital Corp, Apollo Investment Corp, Oaktree Specialty Lending Corp, etc
    - Many are affiliated with PE firms
  - Unlike CLOs, direct lenders mostly originate their loans.

Private Debt/Direct Lending: DLFs and BDCs

- Investment strategy: Mostly direct lending
  - Bilateral negotiation, hold to maturity by 1-5 lenders (vs bank "originate to distribute")
  - Mostly senior loans (term loan and revolver); 2nd lien and unitranche also common

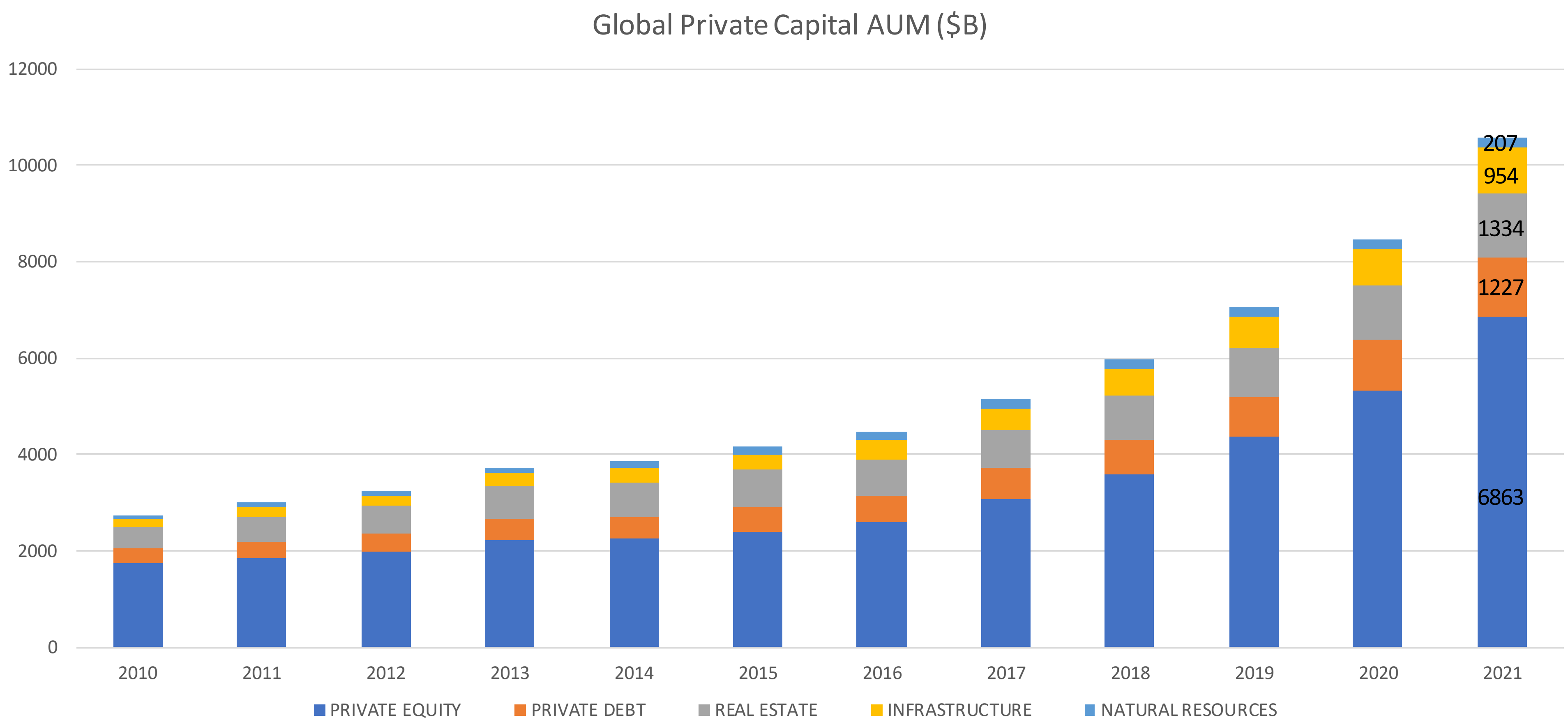
- Borrowers: Middle-market ("MM")
  - No clear-cut definitions: revenue $10M-$1B; EBITDA usually below $50M
  - "Private" refers to the instrument not firm; public firms can borrow with private debt
    - But, typically extended to private MM companies. 78% of US direct lending deals are PE-backed.

- Financing: Closed-end fund structure
  - Similar LPs as in PE funds: Pension, insurance, high net worth, endowments, etc...
  - Fund leverage comes from bank and rarely exceeds 1:1 in D:E

BDCs

- Subject to regulatory requirements:
  - Must invest at least 70% of assets in domestic operating cos. not publicly listed, or exchange-listed with less than $250M in mkt. cap.
  - Quarterly disclosure on asset-level performance.
  - Treated as regulated investment cos. (RICs) for tax purposes – no corporate income taxes if distribute > 90% of taxable investment cash flow as dividends
- Many are publicly traded on exchanges, giving retail investors opp. to invest
- Some are affiliated with PE firms – Apollo, Ares, New Mountain, TPG
- Can be levered 2:1 in D:E (up from 1:1 since Small Business Credit Availability Act).

Private Debt is projected to become 2nd largest Private Capital asset class after PE by 2023 (Preqin, 2022)



Roadmap

1. What is private debt/direct lending? Who are major players? Recent trends?

2. **Why the increase? How do direct lenders compare with banks, CLOs, and PE funds? US vs Europe?**

3. Performance and Outlook

Research evidence

1. **Survey analysis:** Block, Jang, Kaplan, and Schulze (2022), "A Survey of Private Debt Funds"
   - Survey of 38 US & 153 European PD funds with combined assets under management (AuM) $\geq$ \$136B & €180B, i.e., 35% of global private debt market (Preqin)
   - We ask the GPs about pre-investment decisions (deal sourcing, selection, and evaluation), post-investment monitoring, interactions with PE sponsors, outlook, etc

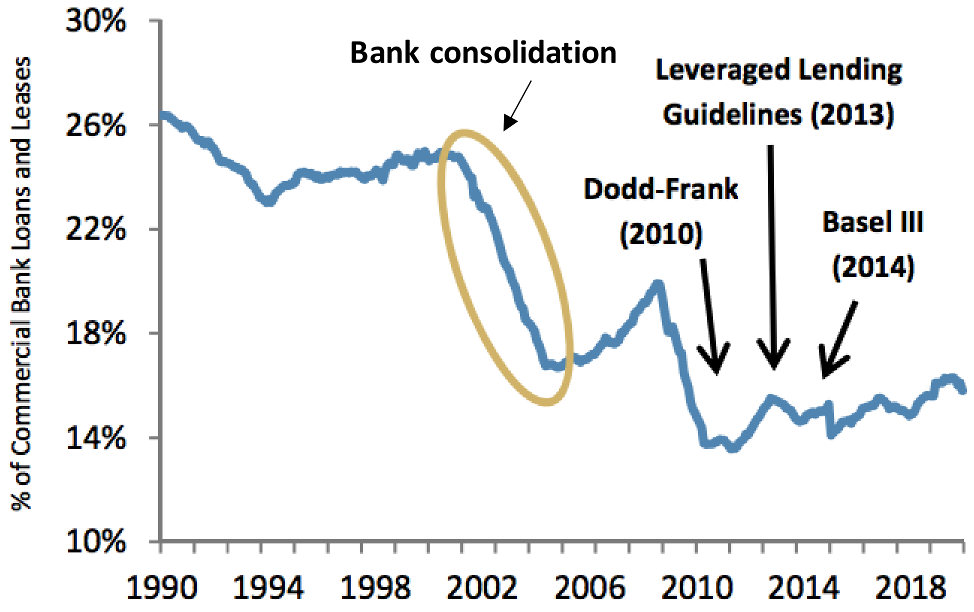
2. **Loan-level analysis:** Jang (2022), "Five Facts about Direct Lending to Middle-Market Buyouts"
   - Detailed data collected from manually reading 1) 800 randomly selected credit agreements and 2) > 400 loan amendments renegotiated during COVID

Why the Increase in Private Debt/Direct Lending?

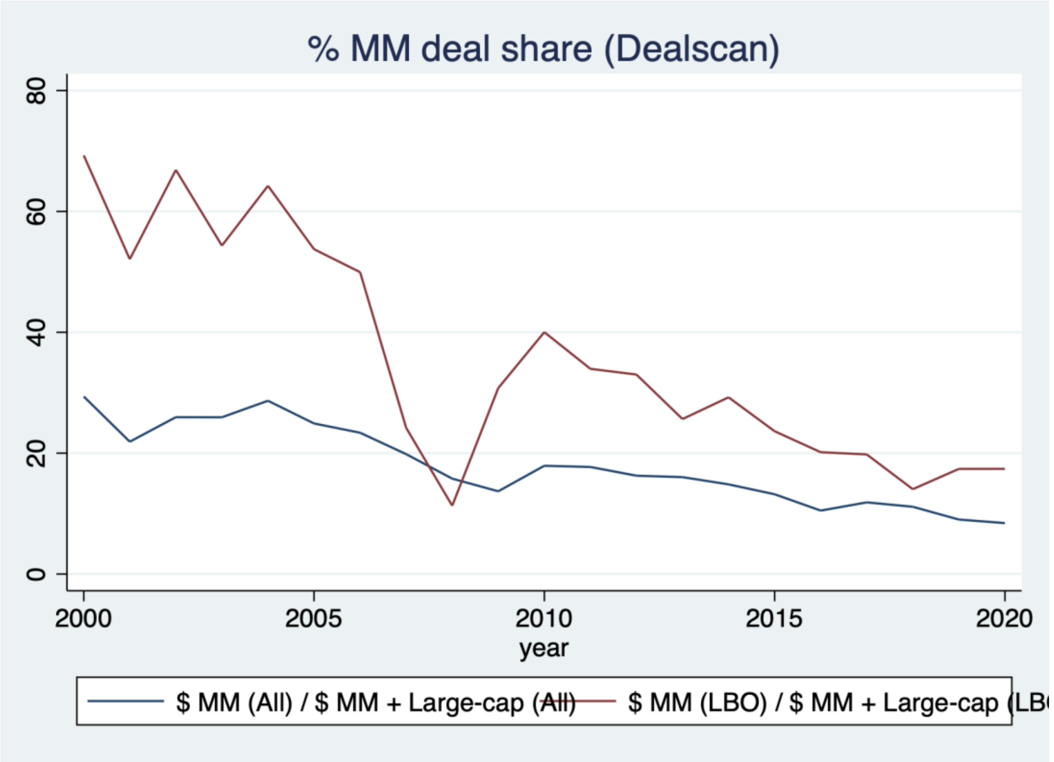
- Bank consolidation & increased banking regulation
    - E.g. 2013 Leveraged Lending Guidance warned against debt/EBITDA > 6 or EBITDA < 0

Commercial banks “forced” out of middle market

Figure 2: Commercial & Industrial (C&I) Loans as a Percentage of Bank Holdings



Source: Federal Reserve H8 data, December 31, 2019.



Why the Increase in Private Debt/Direct Lending?

- Bank consolidation & increased banking regulation
  - E.g. 2013 Leveraged Lending Guidance warned against debt/EBITDA > 6 or EBITDA < 0
- Banks' reluctance to certain types of firms
  - Small size for bank syndication, low tangibility, low transparency
  - Preference for asset-based loans if lend to small firms

Why do banks would not want to finance companies that are reliant on private debt?

Answer choices	Europe		US	
	% of respondents	% of responses	% of respondents	% of responses
Tangibility: Firm has low amount of tangible assets as quality collateral	55.2%	22.2%	53.3%	19.8%
Profitability: Cash flow is too low or unstable	30.1%	12.1%	26.7%	9.9%
Size: Firm size is too small for bank syndication	52.4%	21.1%	70.0%	25.9%
Transparency: Due diligence is messy due to less clean financials or a lack of sophisticated internal systems	45.5%	18.3%	50.0%	18.5%
Specialization: Firms operating in niche sectors	37.8%	15.2%	23.3%	8.6%
Other/s	28.0%	11.2%	46.7%	17.3%

Banks avoid lending to small firms with lack of tangible assets and low transparency

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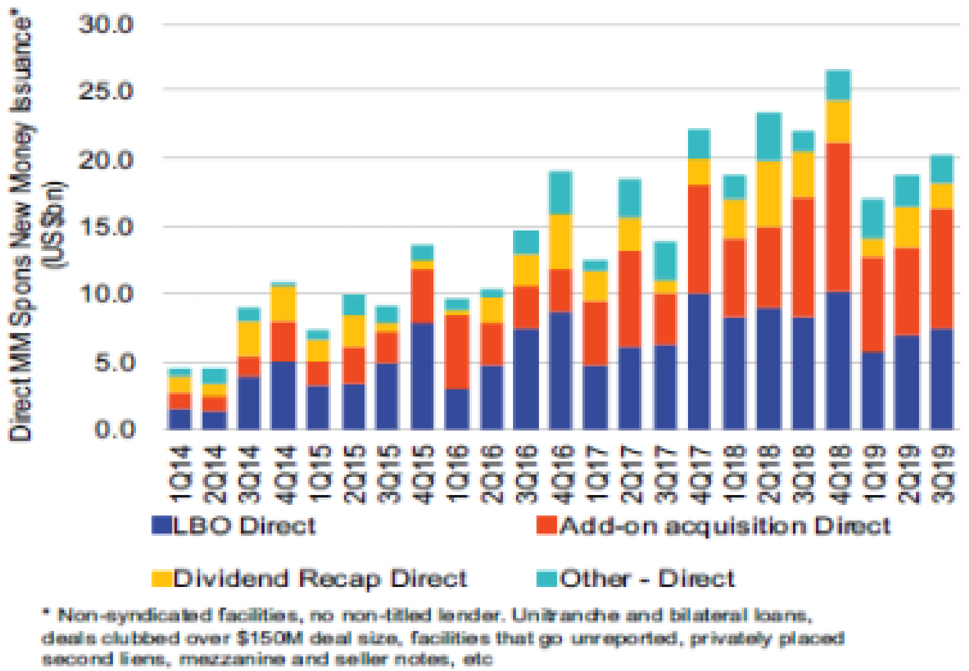
- Importance of PE sponsorship for direct lenders' deal flow

Rise in direct lending largely fueled by middle-market buyouts

Figure A2: Direct Lending Middle-Market Sponsor-backed Deal Issuance



Source: Refinitiv

Block et al (2022): 78% of US direct lending deals are to PE-sponsored MM LBOs!

Why the Increase in Private Debt/Direct Lending?

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  - Small size for bank syndication, low tangibility, low transparency
  - Preference for asset-based loans if lend to small firms
- Importance of PE sponsorship for direct lenders’ deal flow
- Direct lenders’ advantage in providing customized needs
  - Stronger commitments, higher leverage, and more flexible covenants
  - Willingness to lend against cash flow to small firms

Why do firms choose private debt over bank debt?

Answer choices	Europe		US	
	% of respondents	% of responses	% of respondents	% of responses
Certainty and speed of execution (vs long / uncertain bank syndication process)	83.0%	23.8%	91.2%	23.1%
Stable relationship with lender's expectation to hold to maturity (vs bank originate-and-distribute model)	34.6%	9.9%	64.7%	16.4%
More flexible covenant structure	52.9%	15.2%	76.5%	19.4%
Diversification of financing sources	39.9%	11.4%	23.5%	6.0%
Longer investment horizon than banks are willing to support	39.2%	11.2%	26.5%	6.7%
Higher leverage than banks are willing to support	54.2%	15.5%	82.4%	20.9%
Did not approach banks due to fear of rejection	6.5%	1.9%	8.8%	2.2%
Bank loan application was rejected	28.8%	8.2%	5.9%	1.5%
Other/s	9.8%	2.8%	14.7%	3.7%

Direct lending provides greater commitment, higher leverage, and more flexible covenants than bank-syndicated lending

Cash flow-based loans vs Asset-based loans

- Cash flow (“CF”)-based loan restricts firm’s debt capacity to its earnings
  - E.g. most corporate bonds and bank-syndicated loans with EBITDA-based covenants

- Asset-based loan restricts firm’s debt capacity to liq. value of specific assets
  - E.g. loans backed by real estate, equipment, accounts receivable, or inventory

- Banks typically provide CF-based loans to large firms and asset-based loans to small firms. Why?
  - Small firms typically have low and unstable CF => low CF verifiability and difficulty of restructuring (Lian and Ma, 2021)

Direct lenders lend against CF to small firms

Relative to bank loans, direct loans exhibit (among buyouts; Jang, 2022):

- Higher prevalence of cash flow-based loan features
  - More EBITDA-based covenants & less likely to include asset-based borrowing base
  - Delayed draw facility: useful for PE “Buy-and-Build” strategy
- Greater flexibility in distress situations
  - More likely to renegotiate out-of-court and avoid bankruptcy
    - Fewer lenders => hold-out less likely
    - More frequently require PE sponsors to inject equity => let PE sponsors resolve distress
  - Condensed structure and strong PE relationship help preserve going-concern value

Borrowers seem to pay extra borrowing cost for these

- Direct loans more expensive than bank loans by ≈192bps on avg
- Firm features & leverage explain ≈74 bps, CF-based lending features explain ≈75 bps

Direct lenders vs Banks and CLOs

Table A: Key attributes by lender type

	Private Debt Funds	Commercial Banks	CLOs
Company size	Mostly middle-market	All	Mostly large-cap, some middle-market
Loan characterstics			
Syndication	Sometimes, but not frequent	Frequent	Always
Loan type	Term loan / Revolver	Term loan / Revolver	Term loan
Cash flow-based vs asset-based	Mostly cash flow-based	Cash flow- and asset-based	Mostly cash flow-based
Covenants	Maintenance & incurrence	Maintenance & incurrence	Typically only incurrence, i.e. "Cov-lite"
Origination / liquidity	Mostly self-originated & held to maturity	Self-originated & sold off to institutional investors	Bought through primary market syndication or secondary market trades
Typical use of leverage (debt to total capital	< 50%	> 90% (FSB, 2021)	> 90% (Kundu, 2022)
Source of financing	Most equity, some bank debt	Mostly deposits and other short-term debt	Long-term bonds, tranched by seniority

- Like banks & CLOs, PD funds monitor using covenants (financial & negative)
- Unlike banks & CLOs, PD funds provide CF-based loans to small firms and use much less fund leverage.

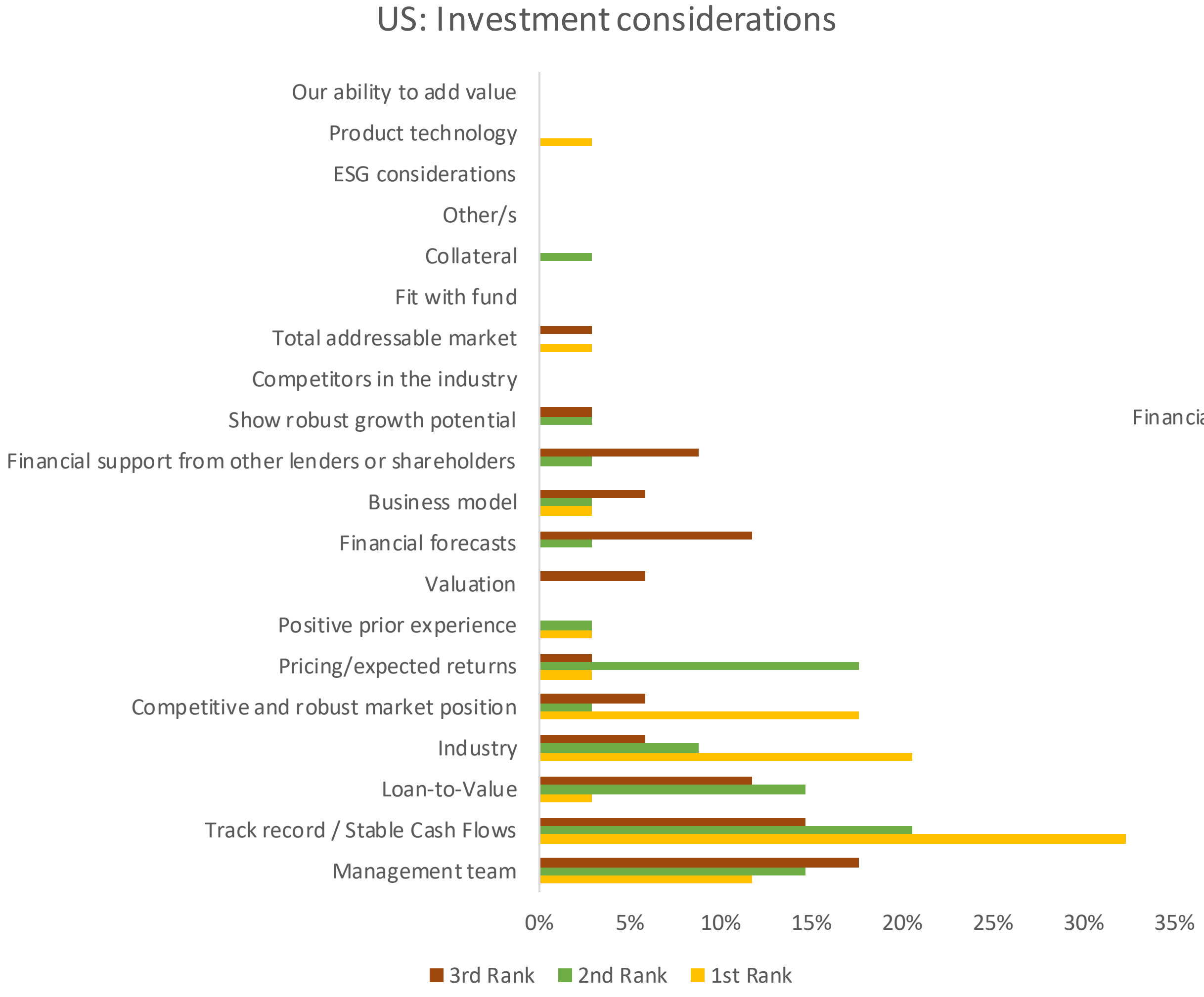
Direct lenders are similar to PE funds in terms of:

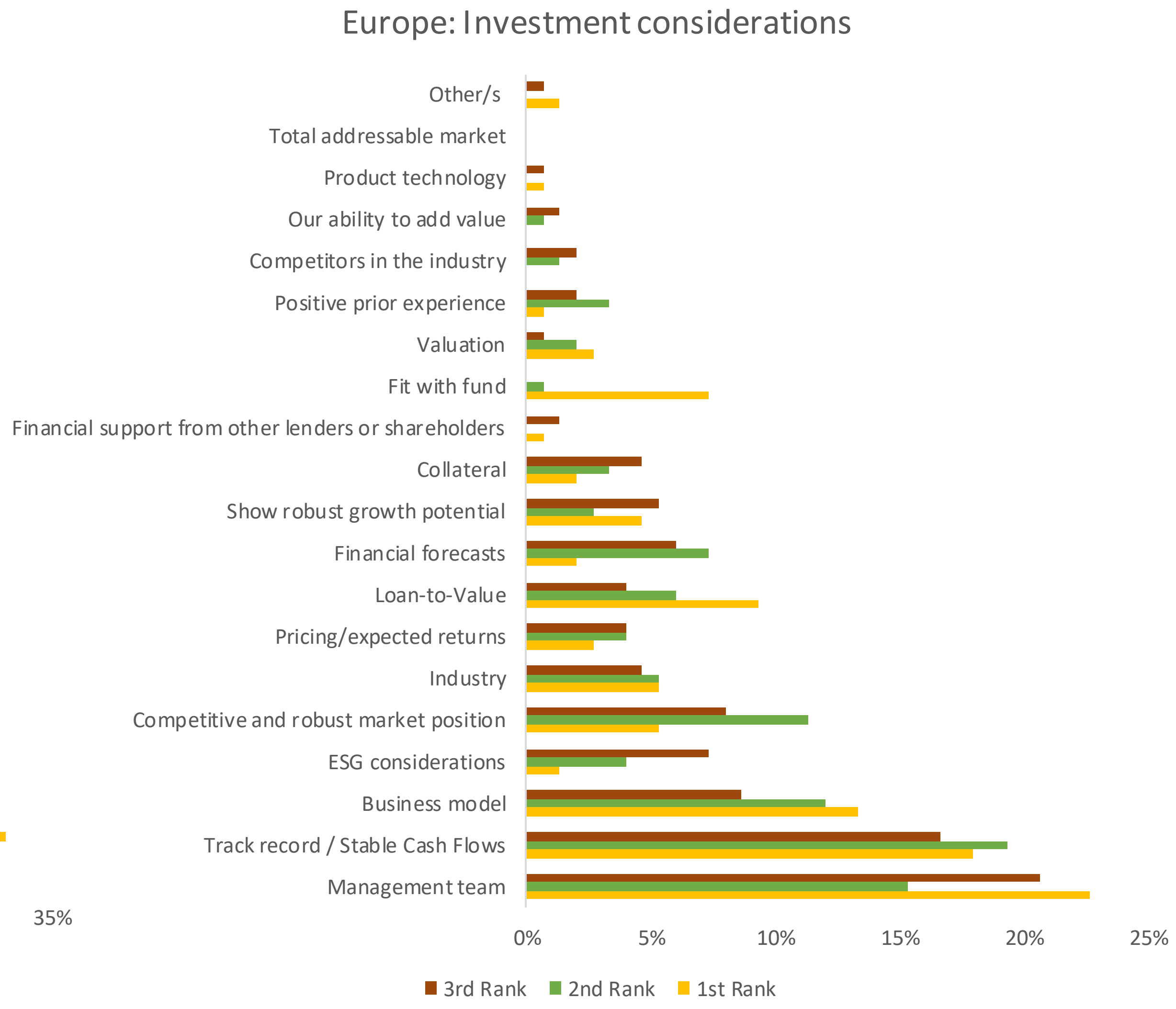
1. LP base: insurance, pension funds, high net worth
2. Spend lots of time on deal sourcing & due diligence (avg 100 hrs per deal)
3. Use low fund leverage and target "equity-like" returns
   - Interest rates at time of survey: German 5-yr: -0.7%; US 5-yr 0.8%; US BB: 3.2%.
   - Even unlevered (9.4% EU & 7.4% US), risk premium exceeds that of public mkt ($\approx$6%)

PD firm characteristics	Europe		US	
	Mean	Median	Mean	Median
Levered IRR	9.55	9.5	11.18	11.5
Unlevered IRR	8.7	7.5	8.16	7.5
Fund level Debt to Total Capital	0.11	0	0.40	0.25

- Munday et al (2018): Burgiss PD data shows that direct lending have outperformed leveraged loans and HY bonds on risk-adjusted basis.

Direct Lending: US vs Europe





Direct Lending: US vs Europe

- Outsourcing due diligence to 3rd party more common in Europe (58% vs 32%)

- Investment criteria:
  - US: Stable cash flow most important
  - Europe: Management team and competitive position as important as cash flow

- Likely because PE sponsorship is less common in Europe (42% vs 78%)
  - Lenders benefit from accessing sponsors' due diligence info (Twin Brook interview)
  - PE sponsor presence may also mitigate concerns over mismanagement

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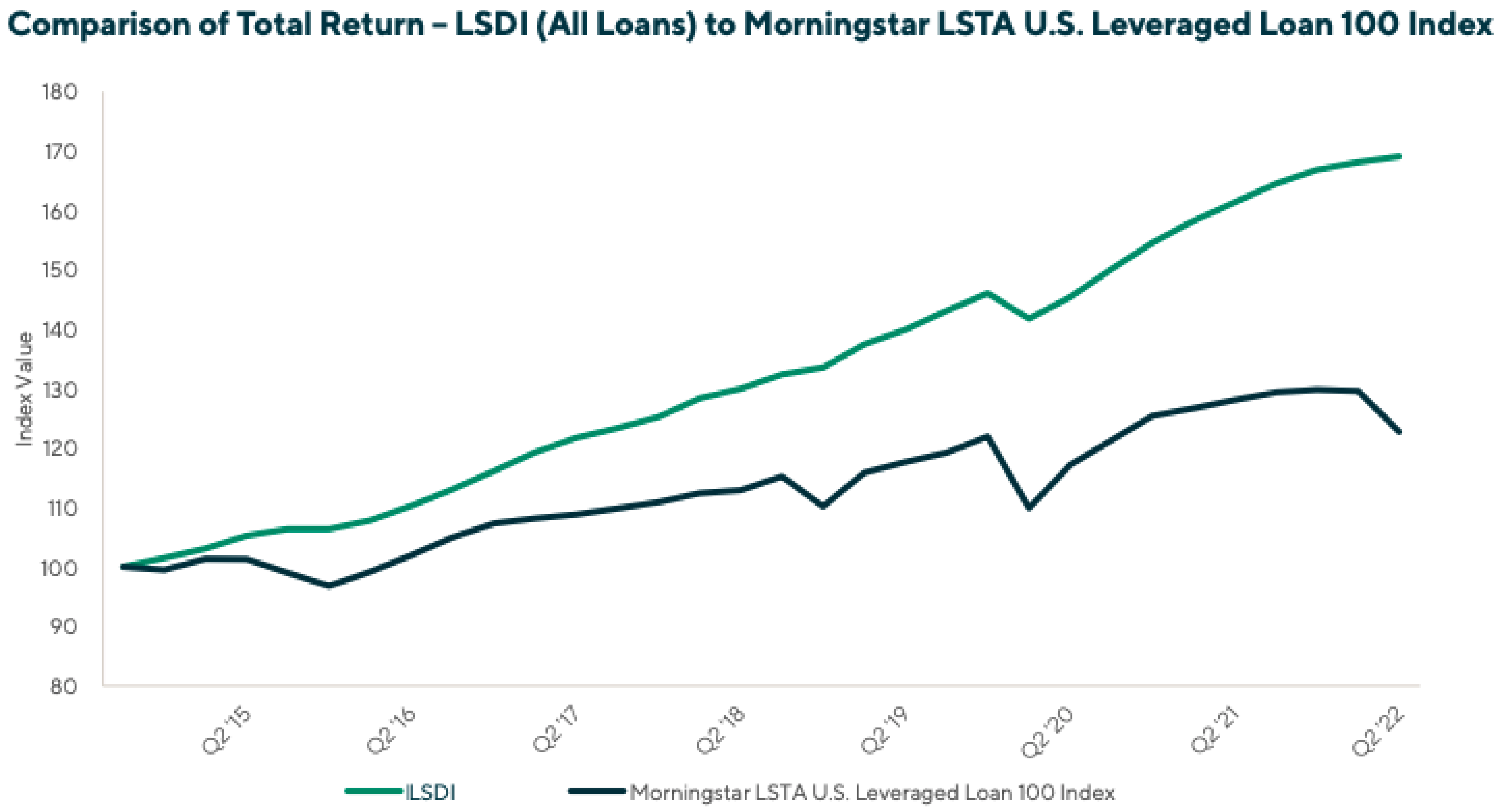
Direct Lending performance

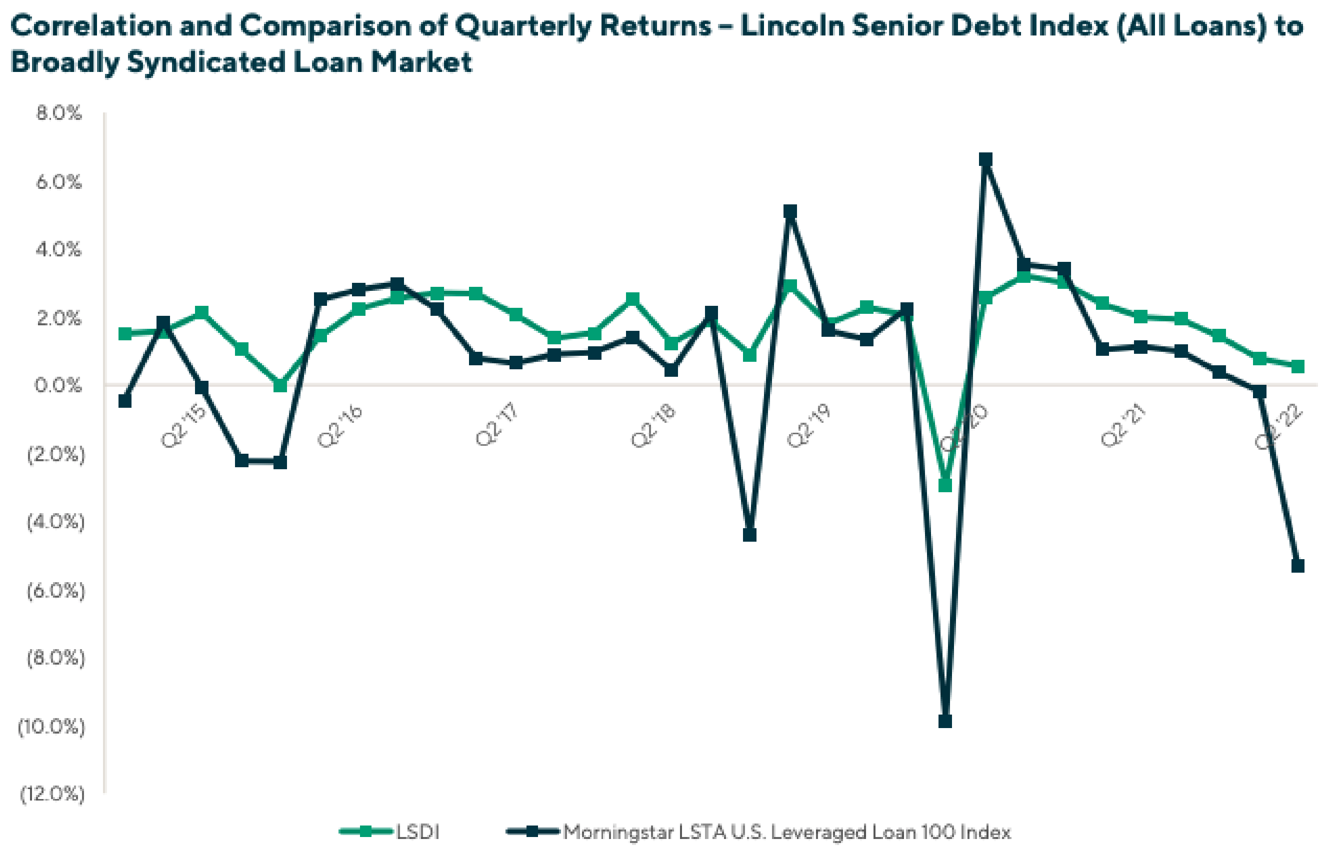
Compared to leveraged loans, higher total return



Lincoln Senior Debt Index tracks performance of direct lending deals (Source: [Lincoln International]())

Direct Lending performance

Compared to leveraged loans, higher total return with less volatility!



Lincoln Senior Debt Index tracks performance of direct lending deals (Source: [Lincoln International](#))

Is PD here to stay?

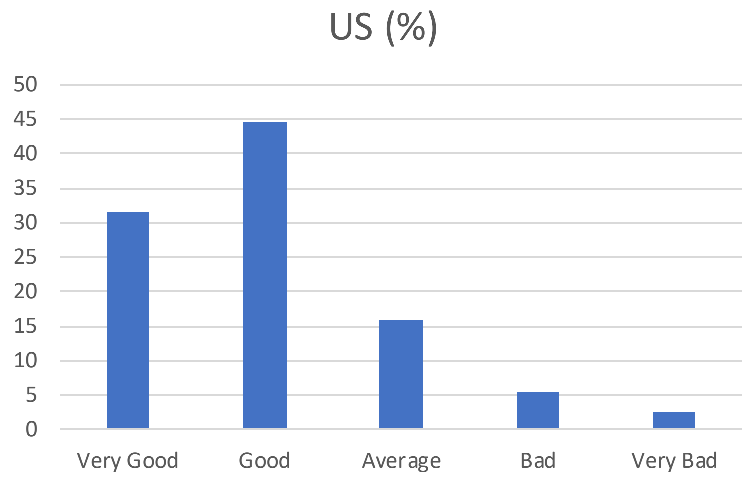
Is PD here to stay?

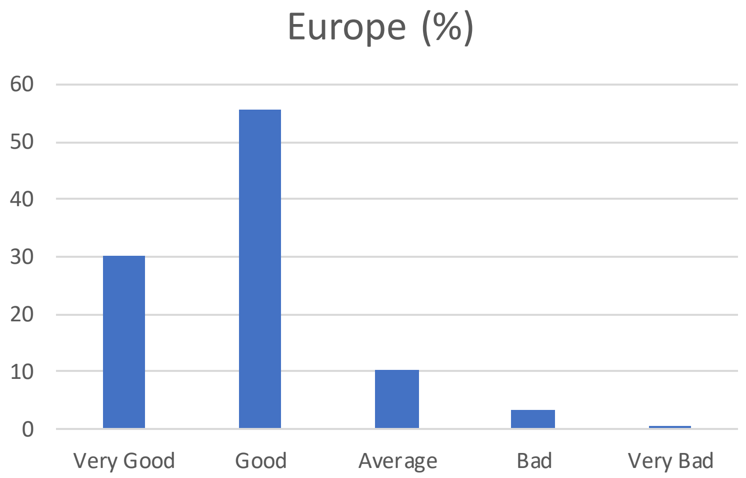
Survey responses on current and long-term outlook of the PD business:

- COVID impact seemed short-lived
- Respondents remained quite bullish in the long run

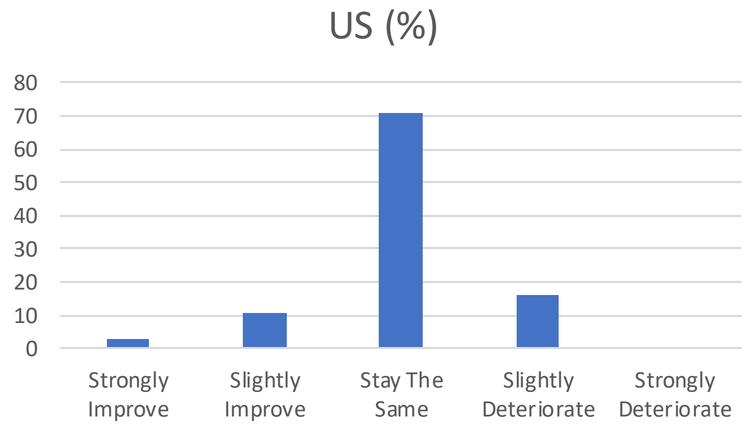
PD managers said COVID impact was low, and Europeans viewed it would be shorter-lived (asked in Aug 2021)

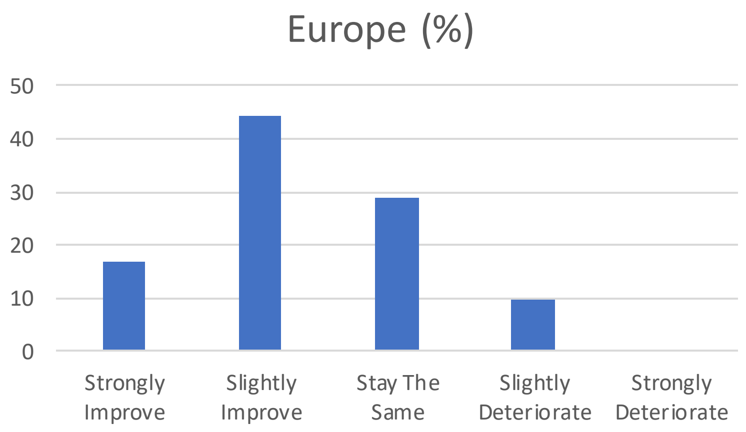
How would you assess the current environment for private debt?





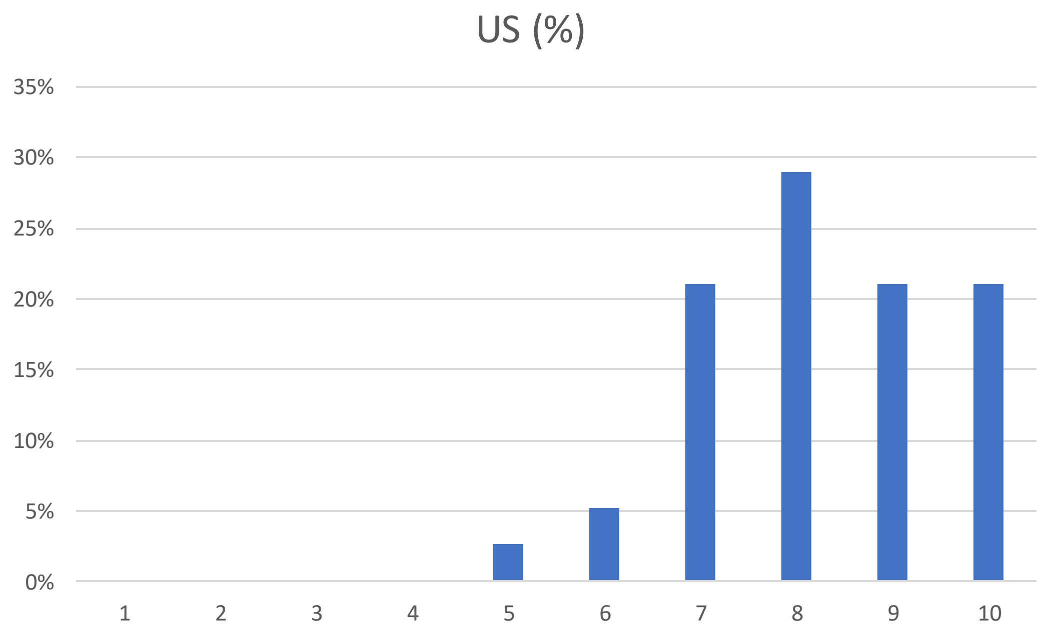
Over the next 12 months, how do you expect the environment for private debt to develop?



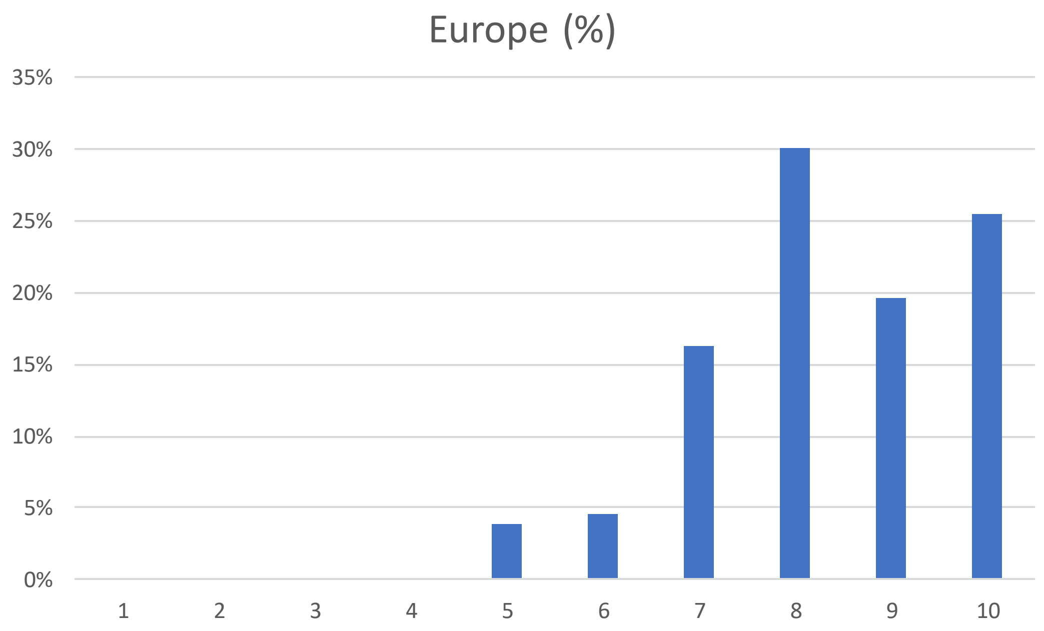


PD managers were generally optimistic in the long run

Confidence in long-term prospects of PD industry (1 to 10)



Mean: 8.3, Median: 8



Mean: 8.24, Median: 8

Is PD here to stay?

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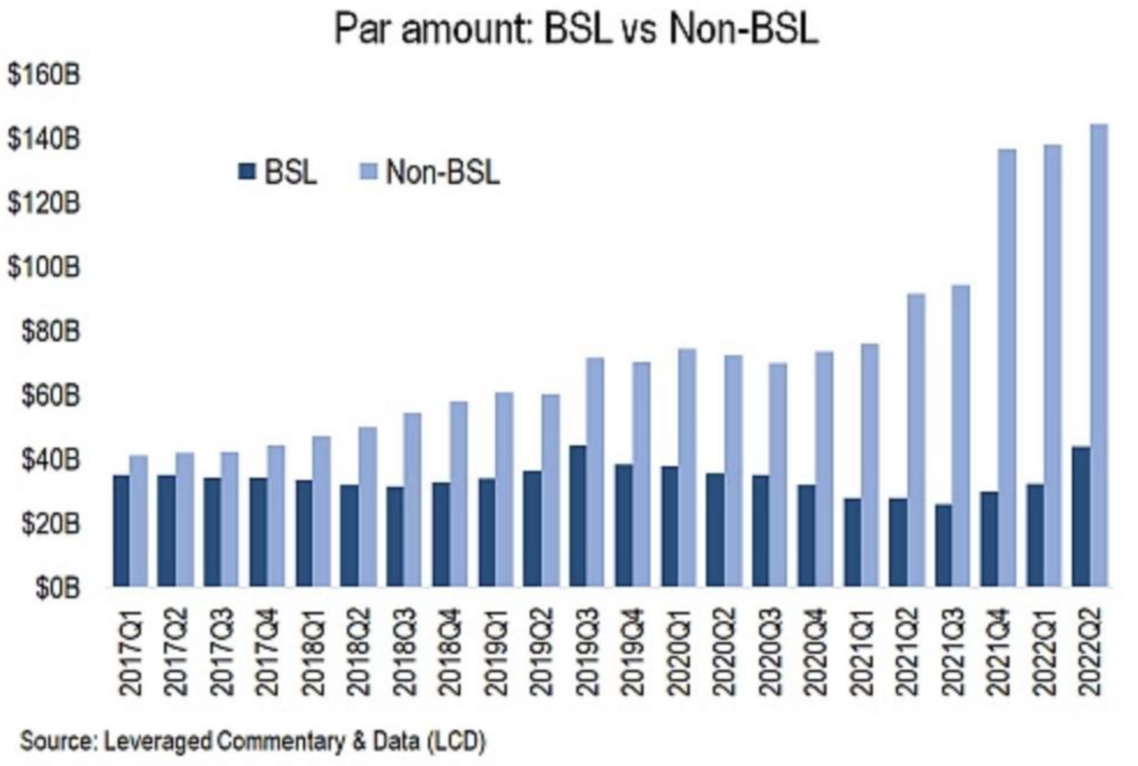
In fact, banks seem to still struggle to keep up with PD!

LCD (May 2022): From 2019Q4 to 2022Q2,

- BDC debt growth 73% vs syndicated debt growth 20%
- Within BDC: number of direct loan issuers grew from 4026 to 5576 (g = 38%); bank-syndicated loan issuers remained flat at $\approx$ 1200 (g = 2%)

“Private lender share of loans outpaces syndicated debt in BDCs” (LCD, Oct 2022)



Banks continuously struggle to keep up with PD

Blackstone-Led Group Provides $5 Billion of Debt for Zendesk

- Financing will help fund the buyout by H&F and Permira
- Apollo, Blue Owl and HPS are also providing debt for deal

Bloomberg, June 24 2022

Credit Suisse, JPMorgan Take Cue From Goldman in Battle With Private Credit

- Banks are setting up direct lending funds, imitating Goldman
- Wall Street has lost ground in lucrative leveraged business

Bloomberg, August 18 2022

PDs buy up bonds & bank-led loans at discount

Private lenders step in to salvage struggling public bond deals

Uptick in 'hybrid' financings comes as other investors shun riskier debt amid market volatility

Financial Times, May 10 2022

'Bloodbath': Citrix buyout debt sale casts shadow over pending deals

Deep discounts to offload bonds and loans in software maker's LBO cost banks $600mn

Financial Times, September 24 2022

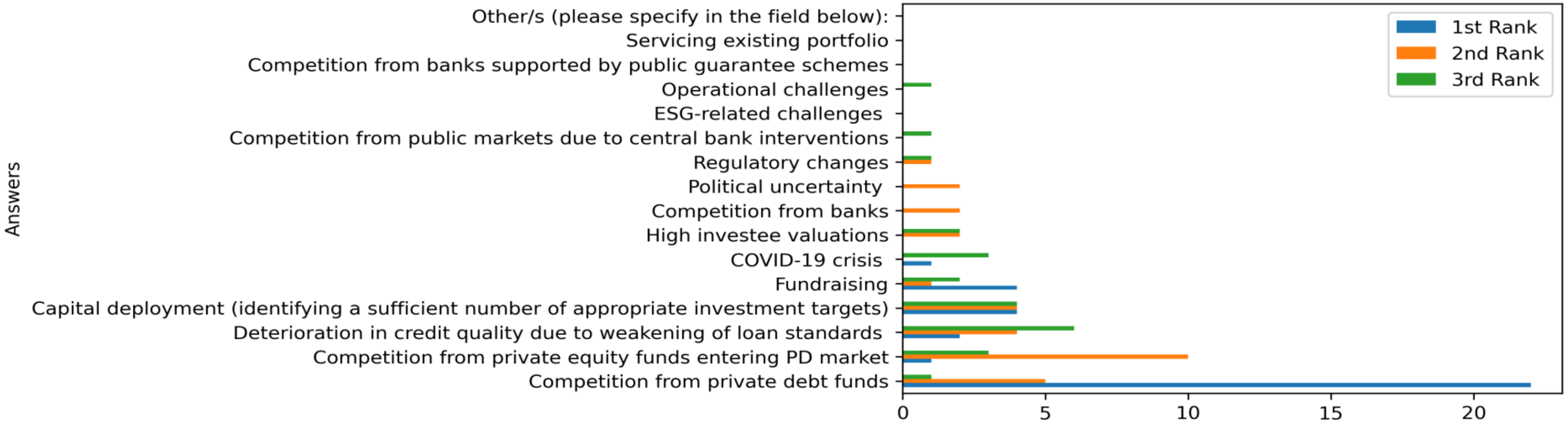
Carlyle Credit Arm Makes $1.5 Billion Wager on Citrix, Nielsen Buyout Debt

- Firm bought about $750 million of Citrix debt, preferred stock
- Carlyle also part of group with Ares that bought Nielsen loan

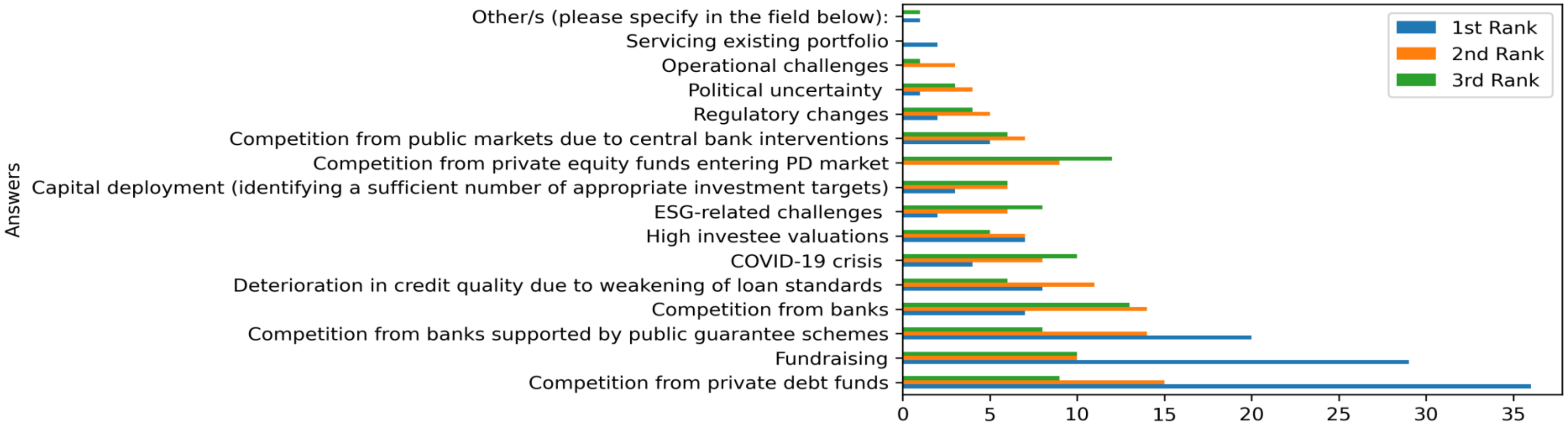
Bloomberg, October 11 2022

Biggest foreseeable challenges: increased competition with the influx of money coming from existing and new funds

US



Europe



Concluding Remarks

- Private credit/direct lending is an important source of financing for MM firms
- Recent growth in direct lending can be explained by:
  - Bank consolidation and regulation
  - Bank reluctance to small firms
  - Direct lender advantage in providing leverage, CF-based loans, and workout flexibility
  - Direct lender reliance on PE-sponsored deals
- Direct lending is both different from, but shares characteristics with banks, CLOs, and PE funds.
  - Direct lenders are basically PE funds doing bank-like activity (i.e. monitored lending)!
- Direct lending historically outperformed leveraged loans and HY bonds on risk-adjusted basis

Useful References

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