Direct Lending: An Investment Opportunity Within Private Debt

March 2018

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Executive Summary

- This paper discusses direct lending, a growing segment of the private debt market, which Aon Hewitt Investment Consulting, Inc. (AHIC) believes could be a potential fit for certain portfolios.
- Private debt includes a wide range of illiquid credit strategies, including distressed debt, direct lending, mezzanine debt, special situations, and venture debt.
- U.S. banks have significantly scaled back their middle-market lending activities post-2008 and the subsequent introduction of more stringent banking regulations. Since the beginning of 2009, we have seen European banks restrict their middle-market lending activities as well. The lack of "traditional" bank lending in this space has created the opportunity for attractive risk-adjusted investment opportunities.
- Direct lending strategies are typically accessed by investors through closed-ended vehicles with an expected life of seven to 10 years. Because of the illiquid nature of small- and middle-market loans—which are the segments of the market primarily targeted by direct lending strategies—our capital market assumptions for a typical leveraged direct lending fund has similar expected returns as public equity.

Market Overview

What Is Private Debt?

Private debt can be broadly defined as any non-publicly traded debt financing of a company and typically references companies in the small- and middle-market segment. The debt of large-market companies is more commonly traded in the public markets. Private debt includes a wide range of investment strategies, which offers investors access to a broad opportunity set that is capable of meeting varying risk/return goals. While private debt may be considered a stand-alone asset class today, many of the underlying investment strategies are not new to institutional investors and have historically been classified under different asset classes such as private equity, hedge funds, and real estate. Investment strategies that fall within the private debt asset class include distressed debt, direct lending, mezzanine debt, special situations, and venture debt. This paper will focus on direct lending, which is defined as the origination of loans by nonbank lenders to primarily non-investment-grade small- and middle-market companies.

Macro Trends Impacting Private Debt

Within the U.S., we see increased demand for alternative investments among institutional investors, including driving growth across the private debt segments. Historically, distressed debt investment strategies have accounted for the largest portion of annual fundraising within the private debt asset class. This trend has shifted over the past several years as direct lending strategies have accounted for a larger portion of fundraising. As shown in Exhibit 1, Preqin[1] reported that private debt funds raised an aggregate $92.6 billion of capital globally in 2016 with direct lending funds accounting for $23.2 billion of the aggregate capital.[2] Demand for capital from nonbank lenders continues to increase as private equity dry powder has reached unprecedented levels. In contrast to the U.S., European middle-market lending remains a bank-dominated market with approximately 80% of the lending market share held by banks. However, direct lending has grown significantly as an asset class in Europe over the past several years as banks have reduced lending volumes, particularly to middle-market companies.

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[1] Preqin provides data and information on the private equity, real estate, hedge fund, infrastructure, private debt, and natural resources asset classes at preqin.com.
[2] 2017 Preqin Global Private Debt Report.

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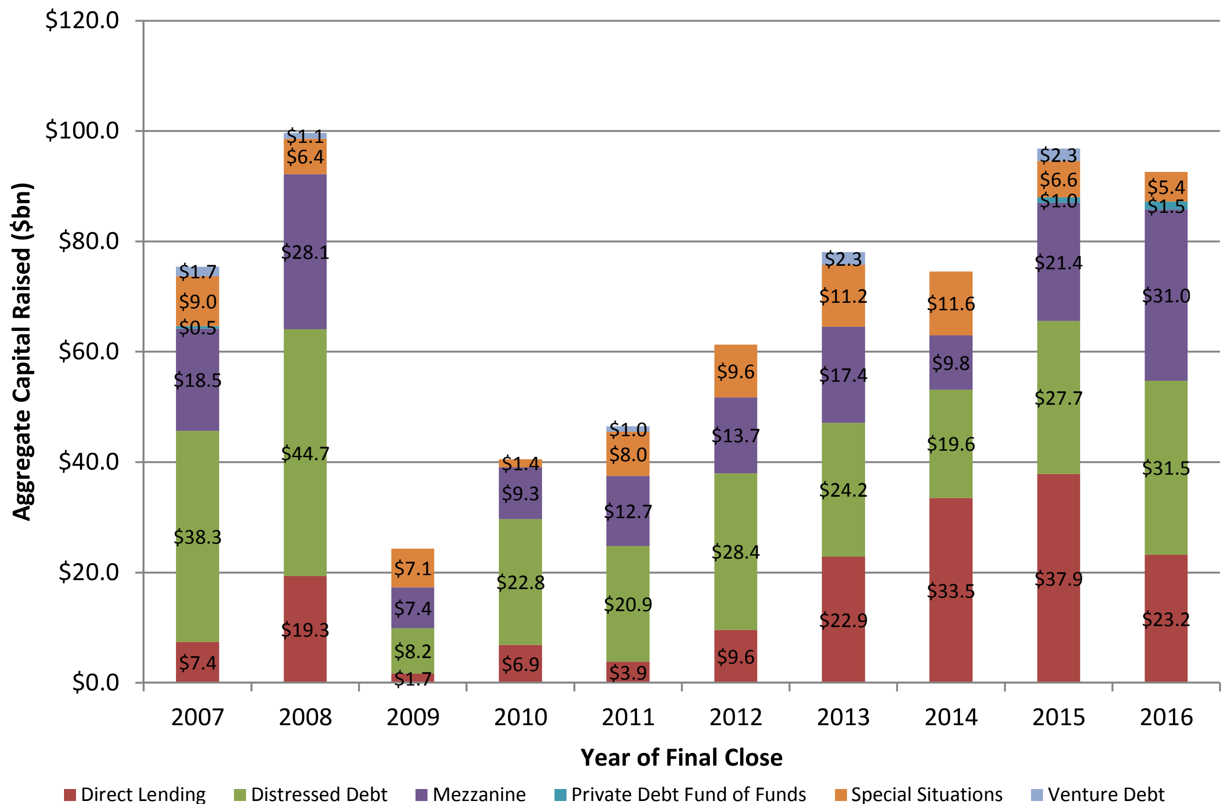
Exhibit 1: Annual Private Debt Fundraising by Type



Source: 2017 Preqin Global Private Debt Report

Direct lending experienced significant growth in capital raised between 2009 and 2015. While capital commitments to direct lending funds declined significantly in 2016, the fundraising outlook remains promising for this segment of private debt. Preqin reported that 129 direct lending funds were in the market targeting an aggregate of $50 billion of capital as of the beginning of 2017.[3]

The political, economic, and regulatory backdrops point to nonbank lenders maintaining or growing market share in the U.S. and particularly in Europe.[4] However, banks have not disappeared entirely from middle-market lending. As shown in Exhibit 2, banks remain active in senior debt lending despite being constrained by the size of loan they can make.[5] Some banks work with direct lenders to co-originate loans, while others have developed loan referral arrangements with direct lenders as they look to retain profitable nonlending relationships with borrowers. Still other banks have sold loan portfolios to direct lenders, enabling the latter to build scale quickly.

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[3] 2017 Preqin Global Private Debt Report.

[4] Governments and regulators globally have introduced rules to make the financial system more robust and stable coming out of the recent financial crisis, including implementing the Dodd-Frank Act (U.S.) and Basel III (Europe).

[5] European Central Bank.

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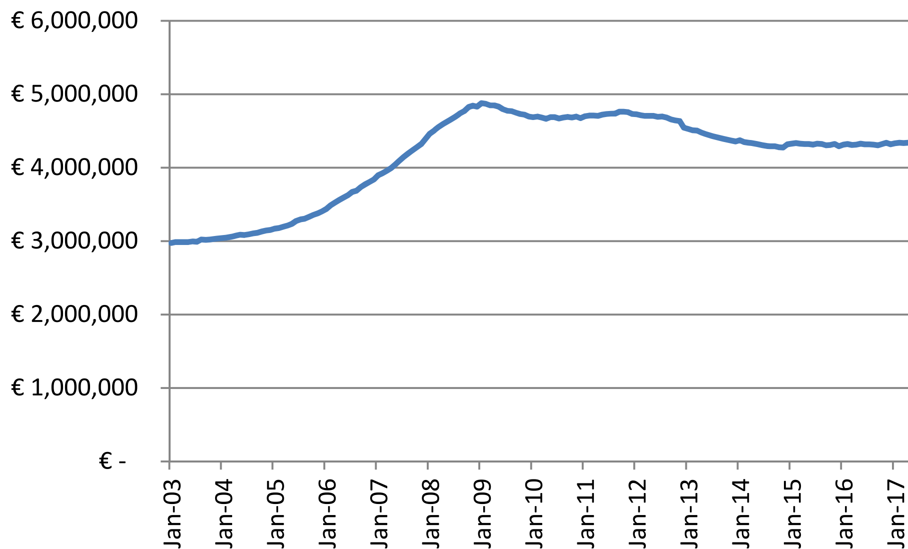
Exhibit 2: Eurozone Bank Lending to Nonfinancial Corporates (€mn)



Source: European Central Bank

We believe direct lending will continue to be a significant portion of private debt moving forward given the shift from banks to nonbanks that has occurred within the U.S. middle-market leveraged lending market and is occurring within Europe as well. In addition, we believe direct lending will be less cyclical in nature when compared to distressed debt, mezzanine debt, and special situations. The remainder of this paper focuses on direct lending as an investment opportunity.

Rise of Direct Lending

There has been significant growth in interest for private debt over the past decade as shown in Exhibit 3, with assets under management increasing from approximately $90 billion in 2005 to approximately $590 billion in 2016.[6] Private debt assets under management accounted for approximately 13% of all private capital assets under management as of June 30, 2016.[6] We have seen a significant increase in fundraising for direct lending investment strategies, which accounted for slightly more than 25% of all private debt assets under management as of June 30, 2016. In 2007, direct lending accounted for less than 10% of all private debt capital raised.[6]

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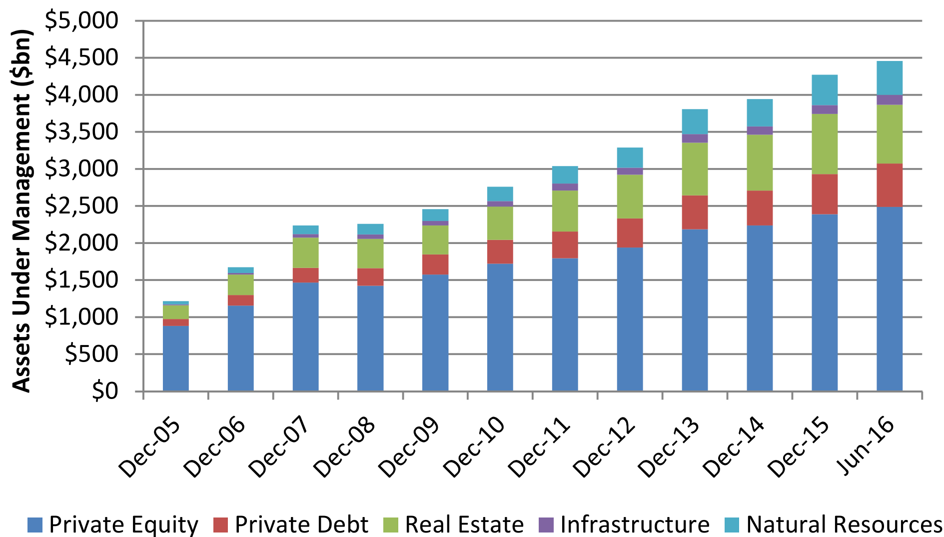
[6] Preqin.

Exhibit 3: Private Market Assets Under Management by Asset Class



Source: Preqin

Direct lending has existed for decades in the U.S., and it has been slowly growing in scale since the 1990s as banks' share of corporate loans began to shift to nonbank financial sources.[7] As a result, small- and middle-market companies have increasingly been able to look toward nonbank lenders to finance their business needs. We saw a tremendous jump in this trend post-2008 and the global financial crisis as banks quickly retreated from their lending businesses, which allowed nonbank lenders to significantly gain scale in a short period of time. Flexibility is one aspect of direct lending strategies that should allow nonbank lenders to keep hold of their market share gains in the future.[8]

Loan Structures

There are various loan types targeted by direct lending strategies, including the following:

- First lien loans (or senior secured loans)
- Unitranche loans (or one-stop loans)
- Second lien loans
- Mezzanine debt (or subordinated debt)

The most common loan type originated through a direct lending strategy is a senior secured loan, which pays a floating rate coupon and matures in five to seven years. Borrowers typically pay upfront fees or issue at a discount to par, which enhances returns for investors. Senior secured loans often will include a covenant package, which gives the lender specific rights of action should a borrower's financial profile deteriorate. Financial

[7] "The Importance of the Nonbank Financial Sector", remarks by Stanley Fischer, Vice Chairman, Board of Governors of the Federal Reserve System, March 27, 2015 (federalreserve.gov).

[8] Flexibility in this instance references the ability of nonbank lenders to provide financing solutions to borrowers that encompasses the entire debt portion of the capital structure, including first lien loans, unitranche loans, second lien loans, and mezzanine debt.

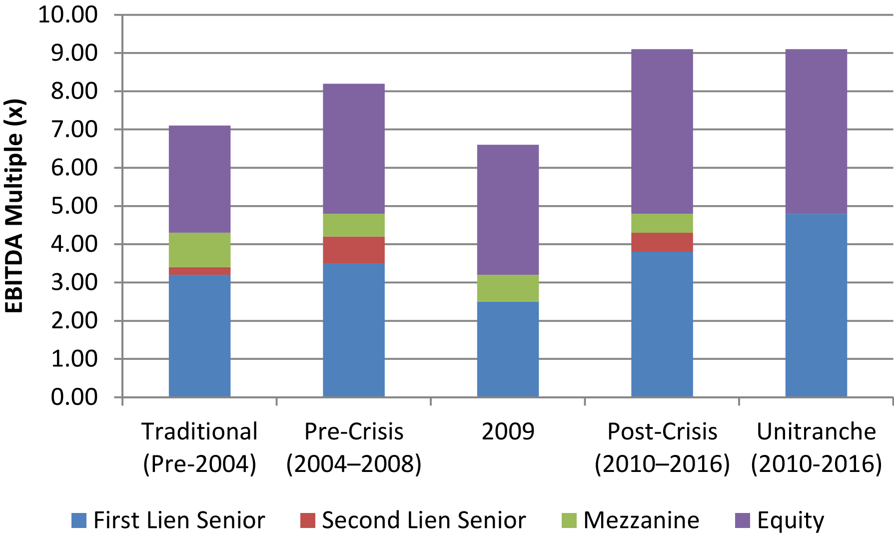
covenants may incentivize a borrower to focus on financial discipline and prevent them from pursuing business strategies that may result in an increase in leverage on the balance sheet.

Mezzanine debt and second lien loans do not offer the same structural protection as senior loans, are issued at higher leverage multiples, and, consequently, are issued with significantly higher coupons relative to senior loans. In some cases, mezzanine loans are issued with a combined cash pay and payment-in-kind coupon. Some direct lending strategies that focus on senior secured loans also will permit investment in non-senior secured loans to a limited extent.

Historically, the capital structure of a middle-market company would have included a strip of mezzanine debt below the senior debt tranche; however, we have seen an evolution in the market to unitranche structures in recent years. Unitranche loans are becoming an increasingly popular route of financing middle-market companies. These are senior secured loans that are issued at higher leverage multiples compared to “traditional” senior loans and effectively blend a combined senior and junior loan structure into one loan.

In our opinion, there are advantages for borrowers to go down the unitranche loan route. These include the lower administrative burden of having to issue just one loan (potentially to one investor) and the speed of executing a transaction. Unitranche loans typically offer higher coupons compared to traditional senior loans on account of higher leverage levels. Illustrative capital structures are shown in the chart below. The chart shows that post-crisis capital structures exhibit lower leverage (on a percentage basis) on average as compared to pre-crisis capital structures.

Exhibit 4: Evolution of Middle-Market Capital Structures



Source: S&P Global Market Intelligence, Leveraged Commentary & Data M&A Stats, December 2016.

Competitors

Historically, nonbank lending has been dominated by several types of players, including collateralized loan obligations (CLOs), specialty finance companies, business development companies (BDCs), and hedge funds.

- CLOs use funds received from the issuance of debt and equity to acquire a diverse portfolio of senior secured bank loans. U.S. CLO issuance tends to be cyclical and has declined significantly from its high in 2014 as new banking regulations around risk retention have made investing in the middle-market less appealing for many CLO managers.
- Increasing banking regulations have also impacted the ability of specialty finance companies, such as GE Capital, to lend to middle-market companies.
- BDCs provide financing for small- and middle-market companies and generally provide investors, who purchase shares in the BDC, more liquid access to private credit than the traditional private equity-style funds through either publicly traded vehicles that are listed on an exchange or unlisted, nontraded vehicles. BDCs are dependent on equity markets to raise growth capital, and the vast majority of the vehicles are facing share prices that trade below their net asset value (NAV), which leaves them unable to raise new capital from investors.
- Poor performance and redemptions from hedge funds during the global financial crisis resulted in many managers stepping back from direct lending as the asset/liability mismatch with the open-ended vehicle forced hedge managers looking to remain active in direct lending to shift to a more private equity-style closed-ended vehicle. All together, this adds up to less competition for private, equity-style direct lending vehicles in the current environment.

Investment Considerations

Return Expectations

Middle-market loans typically offer a spread premium as well as higher upfront fees (or original issue discount) compared to broadly syndicated leveraged loans. The spread premium comprises (1) an illiquidity premium as middle-market loans are typically buy-and-hold investments; and (2) a “smaller company” risk premium. Loans sometimes have LIBOR[9] floors, which may bolster returns in a low-rate environment, as well as call protection features. Some managers have the ability to purchase broadly syndicated loans if attractive investment opportunities present themselves. For example, some direct lenders have taken “anchor” stakes in hung syndications (where the underwriting investment banks have been unable to sell a deal) buying broadly syndicated loans at a significant discount.

Performance is difficult to benchmark for direct lending managers as currently there is no public index that tracks the middle-market private loan space. Most middle-market loans are extended to companies that are too small for U.S. market analysts to efficiently cover and track. As well, most of the loans originated through direct lending strategies will be held by the lenders and not made available on the secondary market—essentially there is no secondary market for middle-market loans today.

The industry has used the public market indices tracking broadly syndicated loans as a proxy for direct lending strategies. While the broadly syndicated loans are similarly focused on the senior tranches like middle-market loans, the companies included in the indices are much larger (generally borrowing greater than $100 million) and the loans are typically traded on the open market and not held to maturity. We certainly recognize the differences between the broadly syndicated loans and middle-market loans—but with correlations greater than 0.9, there is enough similarity to warrant the comparison.

[9] The London Interbank Offered Rate (LIBOR) is a benchmark rate many of the world’s leading banks charge each other for short-term loans.

Exhibit 5: Actual Correlation Matrix (10 Years Ending June 30, 2017)

	Cliffwater Direct Lending Index	S&P/LSTA Leveraged Loan Index	Credit Suisse Leveraged Loan Index	Bloomberg Barclays U.S. Aggregate Bond Index	BofA Merrill Lynch Global High Yield Index	Russell 3000 Index + 300 bps
Cliffwater Direct Lending Index	1.0000					
S&P/LSTA Leveraged Loan Index	0.7751	1.0000				
Credit Suisse Leveraged Loan Index	0.8043	0.9966	1.0000			
Bloomberg Barclays U.S. Aggregate Bond Index	(0.3119)	(0.2112)	(0.2307)	1.0000		
BofA Merrill Lynch Global High Yield Index	0.7081	0.9155	0.9130	(0.0456)	1.0000	
Russell 3000 Index + 300 bps	0.7049	0.6882	0.7177	(0.2914)	0.7819	1.0000

Source: Aon Monthly Benchmark and Index Report and Cliffwater Direct Lending Index Report (cliffwaterdirectlendingindex.com).

Our current long-term (10-year), forward-looking assumptions for a typical leveraged direct lending fund have similar net-of-fee expected returns as public equities.[10] This reflects a 1-2% illiquidity premium (yield spread over bank loans), which is lower than it has been historically. We believe private debt remains attractive relative to broadly syndicated loans.

Exhibit 6: Manager Survey of Market Yields (As of December 31, 2016)

	U.S.	**Europe**
Senior Debt	LIBOR+475-600 bps	LIBOR+500-650 bps
Unitranche Debt	LIBOR+650-800 bps	LIBOR+700-800 bps
Mezzanine Debt	LIBOR+850-1300 bps	LIBOR+850-1100 bps

Source: AHIC surveyed four direct lending managers that had either been Buy rated previously or selected to manage separately managed accounts on behalf of Aon clients for their market pricing experiences as of December 31, 2016.

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The table below highlights historical performance of direct lending relative to several public market indices. As shown, direct lending has consistently generated alpha relative to the broadly syndicated loan indices and the broad fixed income markets.

Exhibit 7: Comparative Performance (as of June 30, 2017)[11]

	1 Year	3 Years	5 Years	10 Years	15 Years
Cliffwater Direct Lending Index	10.41%	8.28%	10.13%	9.01%	8.24%
S&P/LSTA Leveraged Loan Index	7.42%	3.35%	4.58%	4.49%	5.03%
Credit Suisse Leveraged Loan Index	7.49%	3.49%	4.83%	4.16%	5.00%
Bloomberg Barclays U.S. Aggregate Bond Index	-0.31%	2.48%	2.21%	4.48%	4.48%
BofA Merrill Lynch Global High Yield Index	12.40%	3.34%	6.88%	7.37%	9.14%
Russell 3000 Index + 300bps	22.01%	12.35%	17.98%	10.46%	11.90%

Source: Aon Monthly Benchmark and Index Report and Cliffwater Direct Lending Index Report (cliffwaterdirectlendingindex.com).

Risks Associated With Direct Lending

The primary risks associated with direct lending strategies are credit, interest rate, illiquidity, and regulatory risk.

Credit Risk

Credit risk references the likelihood that a borrower will default in the payment of principal and/or interest. Credit risk is something that many fixed income investors face, particularly those investing in lower-quality investments. Credit risk is higher for direct lending strategies compared to traditional broad market fixed income strategies given that the focus in direct lending strategies is on below-investment-grade issuers. Credit risk will vary depending on the loan type. For example, a traditional first lien senior loan would have less credit risk associated with it than a unitranche loan (a combination of the first lien and second lien debt tranches), which carries less credit risk than a mezzanine debt or subordinated loan. Credit risk will also be driven by underlying business risks such as customer concentration, cyclicality, product obsolescence, quality and experience of management, etc. As part of the underwriting process, direct lending managers assess financial and business risks and seek to structure their loans in a manner that appropriately aligns the expected return from the loan with the perceived risk.

Direct lenders, and especially those taking a controlling stake in a loan, can structure a loan that affords them certain rights should a borrower's financial condition deteriorate. Direct lenders may also be able to negotiate a board seat or board observer seat with the borrowing entity, which gives the lender additional oversight. In the event of a default, the senior lender may be able to take control of the restructuring and equitize their position within the company's new capital structure with a view toward selling the business rather than being forced to liquidate the underlying assets. S&P Capital IQ's Leveraged Commentary & Data (LCD) has produced default statistics for the U.S. leveraged loan market that show a lower default rate and higher recovery rates for middle-market borrowers compared to the broadly syndicated loan market. In Europe, default statistics are not widely available largely due to this being a nascent strategy.

[11] Past performance is no guarantee of future results. Unmanaged index returns assume reinvestment of any and all distributions and do not reflect our fees and expenses. Your actual returns will be reduced by your advisory fees and other expenses you may incur as a client.

Interest Rate Risk

Interest rate risk (also known as duration risk) references the measure of sensitivity to valuation changes from interest rate movements. As interest rates change, they may affect the value of outstanding debt. Generally, rising interest rates will negatively impact the price of a loan, and falling interest rates will positively impact the price of a loan. Floating rate debt, which is the most common approach used by direct lending managers, reacts to interest rate changes in a similar manner, although typically to a lesser degree. Floating rate debt reduces the duration risk associated with a rising rate environment. Interest rate sensitivity is generally larger and less predictable in debt with uncertain payment or prepayment schedules. In addition, direct lending strategies are not actively traded portfolios; therefore, duration risk is less of a factor as it would be in a more liquid fixed income portfolio.

Illiquidity Risk

In the majority of cases, private debt investments either directly originate from or are purchased through a secondary transaction and held until maturity (or a repayment event). In a distressed situation, loans are typically held until bankruptcy or a restructuring event occurs that provides an exit opportunity either through the debt or because of a newly structured equity position. There is limited ability to trade these loans on the public market due to the fact that issuers are generally small and consequently not well-known. Lenders have to perform lengthy due diligence to familiarize themselves with an issuer as there will typically not be third-party research (e.g., rating agency or investment bank credit reports) available to assist them as part of their investment process. Moreover, loan documentation can be complex and differ considerably across the middle-market loan universe.

The typical private debt strategy will be structured such that its fund life terminates after 10+ years due to the illiquid nature of the hold-to-maturity style of the underlying strategies. In situations where there is an event prior to the loan reaching maturity, private debt strategies are designed to maximize value for investors through operational and/or financial support that may take several years to result in a desirable outcome. Direct lending strategies are typically structured such that the fund life terminates within six to eight years, on average. The shorter lifecycle for direct lending strategies is yet another reason why their popularity has increased in recent years.

Exhibit 8: Direct Lending Terms vs. Other Private Debt Terms

	Direct Lending	Other Private Debt (Distressed/Special Situations)
Fund Term	6–8 years, on average	10 years, on average
Investment Period	1–3 years	3–5 years
Liquidity Provision	None; underlying loans mature in 5–7 years; underlying loans typically repaid within 1–3 years	None; underlying investments vary in terms of maturity
Distributions	Income distributed quarterly; principal distributed as investments mature or repayment occurs	Income distributed quarterly; principal plus proceeds distributed as investments mature or an event occurs
Recycling Provision[12]	Yes; during the investment period	Yes; applies only to investments returned within 18–24 months of the date of acquisition
Leverage Usage	Yes; typically 0.5:1.0 to 2.5:1.0	Yes, typically up to 1.0:1.0

Source: Summary of market intelligence gathered by AHIC research team through normal course of diligence.

Regulatory Risk

Regulatory risk refers to the potential impact that legislative or regulatory changes involving the U.S. or European capital markets, banking industry, and investment fund industry could have on direct lending strategies. Any changes that could potentially impact income tax rates with respect to income expected to be generated by direct lending strategies may have a material effect on the after-tax returns of investors in direct lending strategies. Typically, there is a period of time allowed before any legislative or regulatory changes take effect that provides investors some time to consider whether the impact would offset the potential attractiveness of an investment in a direct lending strategy.

Role in Portfolios

While strategies such as direct lending may offer returns with relatively low levels of market risk compared to equities, the lower return target can be a drag on returns within a traditional private equity portfolio. That said, investors have typically funded private debt allocations from their private equity or other alternative strategy allocations. We are aware of a number of large institutional investors who have classified their direct lending strategies either as an illiquid fixed income allocation or as part of a stand-alone private debt or opportunistic credit portfolio. Investors should give careful consideration to the timing of investments given the closed-ended nature of the asset class.

In terms of how direct lending should be categorized within portfolios, we believe lower-return target strategies (e.g., senior only or unitranche direct lending) are best considered as fixed income-alternative strategies that should be bucketed in a separate private debt or opportunistic credit portfolio or as an illiquid fixed income allocation. Whereas, we believe higher-return target strategies (e.g., mezzanine, distressed debt, and special situations) are best bucketed within a more traditional private equity portfolio.

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[12] A recycling provision is intended to allow a general partner to recycle (or reinvest) the capital invested in an investment that is exited within a defined period of time.

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Before committing to a direct lending fund, investors need to give some thought to the liquidity profile of the assets that will be liquidated to fund drawdowns during the investment period. The nature of those assets will, to some extent, depend on tolerance to risk (e.g., if risk tolerance is low, drawdowns could be funded from cash accounts or low-risk absolute or total return bond funds). If investors fund direct lending drawdowns directly from more volatile asset classes such as equities, they could be subject to increased market risk and, hence, the possibility that they could be forced to sell equities during an unfavorable period of time.

Access to Opportunity

In the U.S., investors can invest in direct lending through multiple vehicle types, including limited partnerships, CLOs, and BDCs. In addition, most direct lending strategies within the U.S. tend to employ leverage to enhance returns. There is no comparable BDC market in Europe; hence, investors invest mainly through limited partnerships. Limited partnerships are closed-ended vehicles offering zero liquidity, and an investor's capital is therefore locked away for the term of the fund, which is approximately six to eight years (and may be up to 10 years in some instances). Fees comprise a combination of a management fee, which can be based on invested or committed capital, and a performance fee (carried interest), which is paid to the manager once a hurdle rate has been achieved for investors.

Exhibit 9: Private Equity Vehicle vs. Liquid Alternative Vehicle

	Private Equity Vehicle (Less Liquid)	**Liquid Alternative Vehicle (More Liquid)**
Fund Term	6–8 years, on average	5 years or less
Investment Period	1–3 years	1–2 years
Management Fee	1.00%–1.50% on invested capital[13]	1.00%–2.00% on invested capital
Incentive Fee (Carried Interest)	10%–20%	15%–20%
Hurdle Rate (Preferred Return)	5%–8%	5%–8%
Liquidity Provision	None	90-days' notice; liquidity provided as loans are repaid
Distributions	Income distributed quarterly	Income distributed quarterly
Recycling Provision[14]	Yes; during the investment period	Yes; details can vary
Leverage Usage	Yes; typically 0.5:1.0 to 2.5:1.0	Yes, but not typical

Source: Summary of market intelligence gathered by AHIC research team through normal course of diligence.

As direct lending gains acceptance by the institutional investor universe, global funds are becoming more common and offer a wider investment opportunity set for managers. It is important for managers to have sufficient scale and expertise on a global basis to ensure that they are able to source high-quality loans.

[13] Invested capital typically refers to the sum of the aggregate amount of capital contributions made by a limited partner less any capital contribution refunds and less any capital contributions returned with respect to realized investments. Invested capital does not typically include capital contributions for the payment of management fees and organizational expenses.

[14] A recycling provision is intended to allow a general partner to recycle (or reinvest) the capital invested in an investment that is exited within a defined period of time.

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Conclusion

AHIC believes that for many portfolios, investing in private debt—and more specifically in direct lending—could be beneficial. Careful manager selection remains paramount, as is awareness of the potential risks, for building a successful portfolio. In summary:

- The current market dynamics are favorable for direct lending as historical players are leaving the market, driven partially by shifting regulations.[15]
- Certain investors may find that direct lending offers attractive risk-and-return characteristics relative to other private debt strategies.
- Direct lending may provide a stream of current income.
- Middle-market loans have historically generated lower default rates and higher recovery rates than broadly syndicated loans.
- Direct lending offers investors a substitute for traditional fixed income (if current income is a goal), but investors must be willing to accept illiquidity and understand there is little potential for capital appreciation through such a strategy.
- Manager selection is key to success as the market offers a range of risk/return expectations.

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Cliffwater Direct Lending Index: An index that seeks to measure the unlevered, gross of fee performance of U.S. middle market corporate loans, as represented by the asset-weighted performance of the underlying assets of Business Development Companies (BDCs), including both exchange-traded and unlisted BDCs, subject to certain eligibility requirements. The CDLI Total Return Index includes three components: Income Return, Realized Gain/Loss and Unrealized Gain/Loss.

S&P/LSTA Leveraged Loan Index: An index designed to track the market-weighted performance of the largest institutional leveraged loans based on market weightings, spreads and interest payments.

Credit Suisse Leveraged Loan Index: An index designed to mirror the investable universe of the U.S. dollar denominated leveraged loan market.

Bloomberg Barclays U.S. Aggregate Bond Index: A market value-weighted index consisting of government bonds, SEC-registered corporate bonds and mortgage-related and asset-backed securities with at least one year to maturity and an outstanding par value of $250 million or greater. This index is a broad measure of the performance of the investment grade U.S. fixed income market.

BofA Merrill Lynch Global High Yield Index: An index designed to track the performance of USD, CAD, GBP and EUR denominated below investment grade corporate debt publicly issued in the major domestic and Eurobond markets.

Russell 3000 Index: A capitalization-weighted index consisting of the 3,000 largest publicly traded U.S. stocks by capitalization. This index is a broad measure of the performance of the aggregate domestic equity market.

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