Market Commentary
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English Version

Insigneo Weekly Dispatch

The Golden Age of Direct Lending

Private credit has gained much recognition after outperforming during the last two calendar years. What beholds this asset class for the remainder of 2024?

Guidance on investments and the major structural factors behind your clients' portfolios.

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The Golden Age of Direct Lending

2022 and 2023 marked a golden age for private direct lending. As interest rates rose steeply in a matter of months, banks stepped out of the corporate lending business, prompting direct lending funds to fill some of the void left in their absence. At the same time, the incorporation of investor-friendly private structures, such as perpetual "Evergreen" funds, allowed more retail and affluent investors to participate in the space. In 2023, our available universe of direct lending funds both returned and made cash distributions that in some cases were north of 10%, reporting double-digit results that are more akin to the space's main borrower, the private equity industry.

Amidst the steep rise in interest rates in the United States, fears emerged surrounding the likelihood of a substantial jump in corporate defaults of debt issued by private funds. So far, these concerns have not materialized. In fact, default rates have remained under control and for most, if not all, the funds that we review, have remained comfortably below the level of the LSTA index, an index that measures the performance of the leveraged loans industry[1].

These figures are the result of the underwriting practices of direct lenders, which embed profit

[1] The LSTA index, is a market-value weighted index that measures the performance of the US leveraged loan market.

margins, equity cushions, and covenants into the Loans' indentures, requiring ongoing monitoring of the lender's financials, as well as specific debt to earnings ratios. Loan book performance can also be attributed to a strong economic environment, which has propelled a steady growth of corporate profits while offsetting higher debt burdens.
On the flipside, and perhaps subject to criticism, direct lending funds have averted higher default rates by having the flexibility to privately renegotiate terms with the borrower during the life of the loan, an option that is not available with other forms of credit, such as high yield bonds. These practices include mechanisms like "Payment-in-Kind", which would permit companies to roll some of the interest expense into maturity.

Concerns are not recent:

The direct lending industry is not a new construct. In fact, some direct corporate lenders have been in business since the early 2000's. However, the Great Financial Crisis and the incorporation of stricter capital requirements for banks as a result of the Dodd-Frank Act, placed additional restrictions on the banking sector's capacity to lend to companies. The private lending industry was a direct beneficiary of the new rules, paving the way towards its current form. Today, the private lending market is estimated to be close to the size of the High Yield bond industry, with more than one trillion dollars of outstanding loans. Having grown so quickly, concerns over weak underwriting practices were already being highlighted by the financial media long before 2020, when the risk-free rate remained close to zero percent. The industry, however, proved resilient and kept non-payment events at bay, even after being tested by Covid shutdowns.

The PE industry and banks:

Most direct lending funds are focused on financing leveraged buyouts -or LBO's- sponsored by private equity funds. This means that the borrowing companies are in fact being "bought out" by a PE sponsor, with the lender supplying debt capital for the purpose of financing a part of the acquisition price, also known as the enterprise value. This characteristic is by design. Most direct lenders prefer to work with private equity funds given a more fluid origination pipeline, as PE funds typically close on multiple deals every year, in addition to the fact that they usually keep capital in reserves to rescue portfolio companies that may be going through temporary, yet remediable, financial distress.

LBO's have been used by the PE industry since the early eighties and banks have always played an important role as a supplier of capital. However, these transactions have naturally evolved with time. Nowadays, with the growth of direct lending, an important part of LBO financing is being undertaken by private funds. Although better known for financing smaller deals, the direct lending industry has entered the realm of large deals in the billions of dollars, which contrary to popular belief, is no longer the sole purview of commercial or investment banks. In fact, with the rise of interest rates in 2022, banks effectively took a break from lending to LBO's through Broadly Syndicated Loan -

or BSL- origination, pushing much of capital demand towards private credit funds, who eagerly supplied what they could.

It is worth exploring why banks were largely absent from corporate lending in 2022 and 2023, as well as the impact that this dynamic had on the industry. In the first place, as treasury bill yields jumped to 5%, banks had the opportunity to derisk their balance sheets without a negative impact on profitability. At the same time, the downfall of regional banks such as Silicon Valley and First Republic, pushed banks to increase liquidity in preparation of further contagion risk, which fortunately was abated thanks to government intervention. Other reasons include the lack of leverage loan demand from institutional investors, including traditional mutual fund managers, as banks only keep a small fraction of these loans on their balance sheets and syndicate the rest out.

The fact that banks slowed down their issuance of BSL's speaks to the role that the direct lending industry plays in today's financial ecosystem. Whereas banks can retrench or shift their attention to other types of yielding assets and daily liquidity asset managers are subject to fund redemptions, private lending funds do nothing else but lend to companies. Contractually, investor capital in this industry is long-term oriented, whereas time deposits are not, aligning with the duration and illiquid nature of the underlying loans.

Let us explore 2024

After two very strong calendar years for private direct lending in terms of capital formation and overall performance, this year the industry is facing some challenges. First, banks have reengaged in lending activity and are again underwriting leveraged loans through the BSL market. Second, the outperformance of direct lending has not been missed, and a substantial amount of capital has flowed into private funds. To top everything off, the current slowdown in the private equity industry has pushed direct funds to aggressively compete by refinancing loans and supporting add-on acquisitions by existing portfolio companies rather than by financing new acquisitions.

The current dynamics at play have clearly led to spread compression. Both direct loans and bank leveraged loans are issued at SOFR[2] + spread. In the middle market lending business, specifically loans issued to companies that generate between $50 and $90 million in free cash flow, that spread reached 650 bps (6.50%) for senior-secured loans during the 2022-2023 peak. However, it has since retreated to the "normal" historic range of 475-500 bps, according to conversations with different direct lending funds. This spread compression is certainly being felt by the markets, as distribution yields have decreased in a corresponding manner.

It is also interesting to look at the competition

[2] The Secured Overnight Financing Rate (SOFR) is a broad measure of the cost of borrowing cash overnight collateralized by Treasury securities.

between banks and private funds. Private lending funds reiterate that they hold certain competitive moats including speed, simplicity, willingness to write smaller checks and alignment of objectives relative to a bank loan. For instance, BSL's require an agency rating, whereas a direct loan does not. Additionally, direct funds can issue revolvers to finance day-to-day activities and can structure delayed draw term loans, which allow the funds to be drawn in tranches, whereas BSL's do not provide these facilities.

On the other hand, and from the perspective of PE funds, the opinion on who is the preferred partner differs. BSL's can accommodate larger transactions, are less costly in terms of interest rate spread, and include weaker covenants, implying less control. As a result, larger PE funds typically regard the BSL industry as its preferred source for financing M&A activity.

Under these circumstances, the industry's distribution yield has so far been able to maintain a healthy spread relative to high yield bonds. Although the high double-digit yields of 2023 are in the rear-view mirror, 2024 is turning out to be an overall positive year for private lending. Certainly, last week's interest rate cut by the Fed will have an impact on distributions; however, this affects yields for every fixed income category. On the other hand, lower interest rates have a plethora of benefits for direct lending, including a lower debt-servicing burden, as well as the expectation that private equity activity and financing will pick up relative to the first half of 2024.

The golden era of private credit may be over, but the asset class is still shining.

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