



WITH DIRECT LENDING, **DEAL CONTROL** IS WHERE IT'S AT

Private credit is making headlines and seeing increasing demand. The resiliency of the asset class during the pandemic was a proving point for the fundamental qualities of direct lending. The ability to recover quickly and post positive returns despite market volatility, combined with the enhanced yield offered by these types of loans, have proven attractive. An uptick in asset gathering and expanding the market to include more asset managers have followed.

But are more players a good thing? The reasons for the performance are deeply rooted in the structure of the deals and the lenders' competence. The size and number of deals have increased, but often at the cost of loosening deal terms, as lenders compete to deploy "dry powder."

Our current environment of rising rates, economic uncertainty, and sustained market volatility are creating a situation where experience matters as much as access to capital. As the pressure on companies increases, it is even

more essential to take a critical look at what can potentially increase the success of a private credit transaction.

Favorable deal terms aren't just about enhanced yield – the ability to control, monitor, and take action are crucial to ensuring that companies can ride out economic downturns. And only the strongest managers can insist on both and bring deals to close quickly.

# A THRIVING MIDDLE MARKET LOOKS FORWARD

The decline of public companies is well documented. The number of public-company listings in the United States peaked in the mid-1990s, at nearly 6,000, but that number has fallen by about half over the past 20 years.<sup>1</sup>

The number of IPOs has generally remained stable over the last two decades, as companies are able to remain private longer.

The middle market, where most private credit loans are made, refers to companies between \$10 million and \$2 billion of revenue. There are approximately 200,000 of

these companies, and their combined annual revenues total more than \$10 trillion, which is about one-third of the U.S. economy.<sup>2</sup>

The U.S. Chamber of Commerce tracks a Middle Market Business Index, and for the second quarter the index rose to 130.6 up from 126.3 in the first quarter, despite underlying inflationary pressures.

## U.S. Middle Market Business Index



Source: U.S. Chamber of Commerce

A second-quarter survey by the Harris Poll found that three out of five executives, or 58%, said they expect gross revenues to improve during the next six months, and 56% expect net earnings to do the same.

In addition, 42% of respondents said they had increased capital expenditures and 51% expect to do so during the next six months.

This speaks to confidence in these companies' business prospects and a potential need for capital, which is largely sourced through private debt.

# AN UPWARD TRAJECTORY OF ASSET GROWTH

When it comes to private alternative assets, private equity has long led the way. But in the last decade, the credit side of the equation has been scaling massively and rapidly.

The major participants historically were private credit asset managers with long track records in the space who had significant relationships with middle-market companies.

These managers had built deep reserves of capital and created on-the-ground teams across the globe that could underwrite deals effectively, efficiently, and quickly.

These so-called “non-bank participants” transformed what was previously the province of bank lenders into a thriving asset class. As yields on traditional fixed-income assets set new historical lows, the demand for these assets increased beyond institutional investors.

A broad spectrum of new participants, from high-net-worth to retail investors, began to deploy private credit alternatives in their portfolios.

## Capital Raised by Private Debt Managers Reached \$191.2 Billion Last Year



Source: Preqin

The consistency of the capital raises by private debt managers over the last five years, even with the disruption of the pandemic in 2020 and 2021, is evidence of the growing acceptance of the asset class and the strength of demand.

## THE ASSET RAISE ISN'T THE WHOLE STORY: DRY POWDER IS CHANGING DEALS

The rapid growth of the asset class has meant that asset managers are amassing capital.

While deployment has been steady and the amount of invested assets is growing, the levels of capital available for investment have increased.



Source: Preqin

The strong demand has attracted more managers into the space. Deploying capital may be challenging for managers who may not have the long, successful operational and investment history of the original pioneers who have been building relationships for decades.

Instead, they are looking for a competitive edge in attracting borrowers. And they are finding it by loosening deal terms and shifting the balance away from the lender and towards the borrower.

## THE IMPORTANCE OF DEAL CONTROL

Managers who succeed in consistently and effectively deploying capital have a specific profile, often developed over decades of underwriting and investing.



- They have both breadth and depth of presence. The concept of “boots on the ground” matters in making these types of investments, as they must be rigorously and comprehensively researched and analyzed – both before and after investment
- They have reach, contacts, and a reputation for getting deals done – so they are often first choice and see every deal that comes up
- They have the ability to work with a borrower across the entirety of their lending needs. The ability to underwrite 1st and 2nd lien loans, as well as unitranche loans, is a competitive advantage
- They have long track records and work with the same companies multiple times. Companies are four times more likely to work with a lender they have an established relationship with. For lenders, skewing new originations towards companies they know well and that have an established borrowing record can mean higher-quality deals
- They have curated strong relationship with other sourcing partners

Managers who have cultivated these attributes can be very selective in deal choice. They can be nimble, and can craft a portfolio across multiple dimensions and factors. It’s not just about size – while these managers may often participate in very large deals, the overall goal is to create a portfolio with enhanced yield and a manageable risk profile.

It’s about the right size, company, industry, and deal metrics to make an investment for the long-term that will hold up in various environments, while meeting portfolio goals.



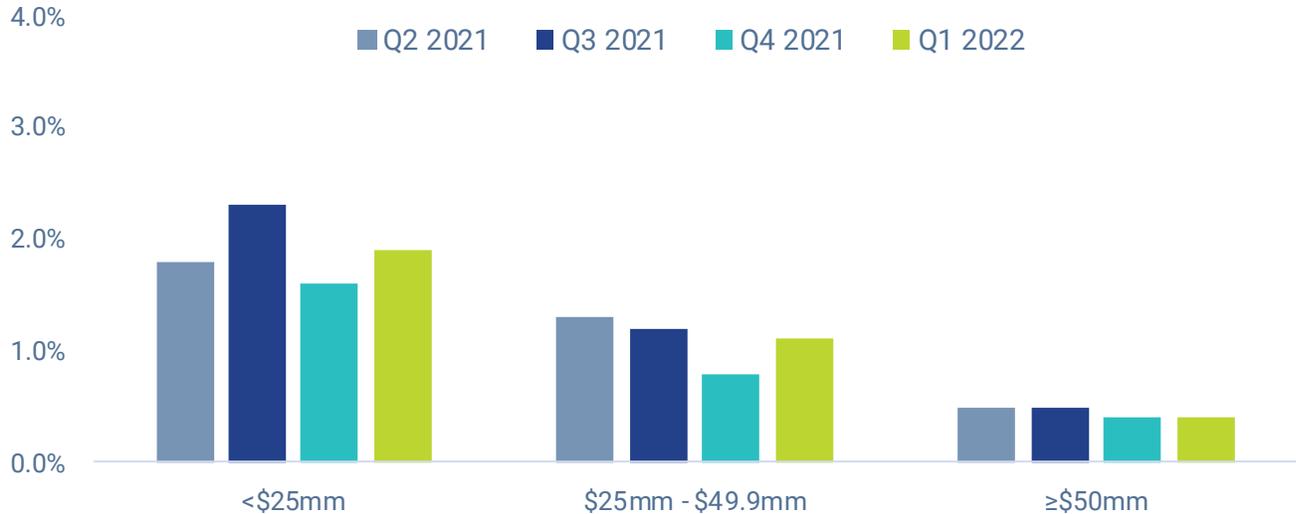
## WHY THE DEAL STRUCTURE MATTERS

Private debt deals are governed by “covenants” on the loan. These are specific deal terms that limit the actions of a borrower and allow the lender to have oversight and a degree of enforcement. If a company (borrower) breaches or violates a covenant, it can trigger other provisions or even penalties.

Covenants are put in place to ensure that the interests of the lender and the borrower are aligned.

Why are they important? A look at what happened to private credit during the pandemic is instructive. While default rates reached 8.1% in Q2 2020, they rapidly recovered as lenders worked with borrowers. Recent default rates for private credit, separated by EBITDA, are as follows:

### Default Rate by EBITDA



Source: Proskauer Private Credit Default Index, May 19, 2022.

One reason for the performance is that direct lenders often hold the loans on their own balance sheets. They don't originate deals and then syndicate them to the capital markets. A robust underwriting process is critical, and firms that performed well during the pandemic reflect that.

One of the criticisms of the growth in private credit prior to the events of 2020 was that the asset class had never been tested by a broad-based credit event that would ripple the entire economy. The resiliency of private credit throughout the pandemic put that line of criticism to rest.

*Institutional Investor* took a look at why private credit was able to navigate so successfully through the pandemic, and found several common reasons among private debt managers.

## Successful Managers Have Some Common Themes

<b>Stable Businesses</b> 	<b>Favorable Terms and Enforcement</b> 	<b>Private Equity Backing</b> 
<p>Private credit deals are usually completed with stable businesses, and managers are generally defensive players who avoid heavily cyclical industries. These industries, such as airlines, hospitality, oil and gas, movie theatres, and cruise lines, were among the hardest hit during the pandemic.</p>	<p>Deal covenants were firmly in favor of lenders. This allowed lenders to help company management teams solve pressing problems, such as managing costs, deciding on cuts, managing cash, or raising more equity.</p>	<p>Private equity firms have increased acquisitions in the middle market in recent years. These private equity firms often have the ability to support a business in a downturn by adding more capital to the balance sheet. Some lenders focus on firms with private equity backing for this reason.</p>

But these were managers who had already deployed capital, based on strong underwriting procedures, knowledge, and expertise on how to structure and manage direct lending deals. They had the ability to select the strongest companies and quickly close larger deals with companies on the upper range of the middle-market spectrum.

## WHAT DO COVENANTS DO?

Covenants are written into deals to help lower the risk for lenders in two ways:

- 1. They limit the actions the borrower can take**
- 2. They specify the amount of oversight that the lender has**

Breaching a covenant can result in penalties—and even default.

The goal of a manager, however, is to work effectively with a borrower to prevent defaults. Covenants are essential to creating a legal structure to monitor company finances, prohibit taking on additional debt, and provide the ability for the manager to work with the company to mitigate problems if financial distress occurs.

## Full Covenants Mitigate Risk for Lenders



Provide early warning signs of potential default



Limit additional borrower debt



Create priority over junior lenders



## SOME MANAGERS ARE UNIQUELY POSITIONED TO CAPITALIZE ON RISING RATES

As we head into a period of economic uncertainty, companies face new pressures as the Federal Reserve pursues an aggressive rate policy to combat rising inflation. Managers who stick to direct lending principles that emphasize defensive non-cyclical industries may perform better in an environment of inflation and rising rates.

Private credit loans are generally structured as floating rate notes, which means they have low duration, which mitigates interest rate risk – and can add value as rates rise.

For the borrowers, the companies will pay increasingly more for debt. As a result, credit selection becomes even more paramount.

Investment managers must choose borrowers in a strong position to manage their liabilities, while also underwriting these loans with protective features such as covenants, call provisions, and low debt-to-EBITDA multiples.

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### Footnotes

1. McKinsey & Company. Insights. October 21, 2021.
2. Keybank Survey: In 2022, middle market businesses are cautiously optimistic. Middle Market Business Sentiment Report 2022.

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