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JULY 2019

An asset class for all seasons

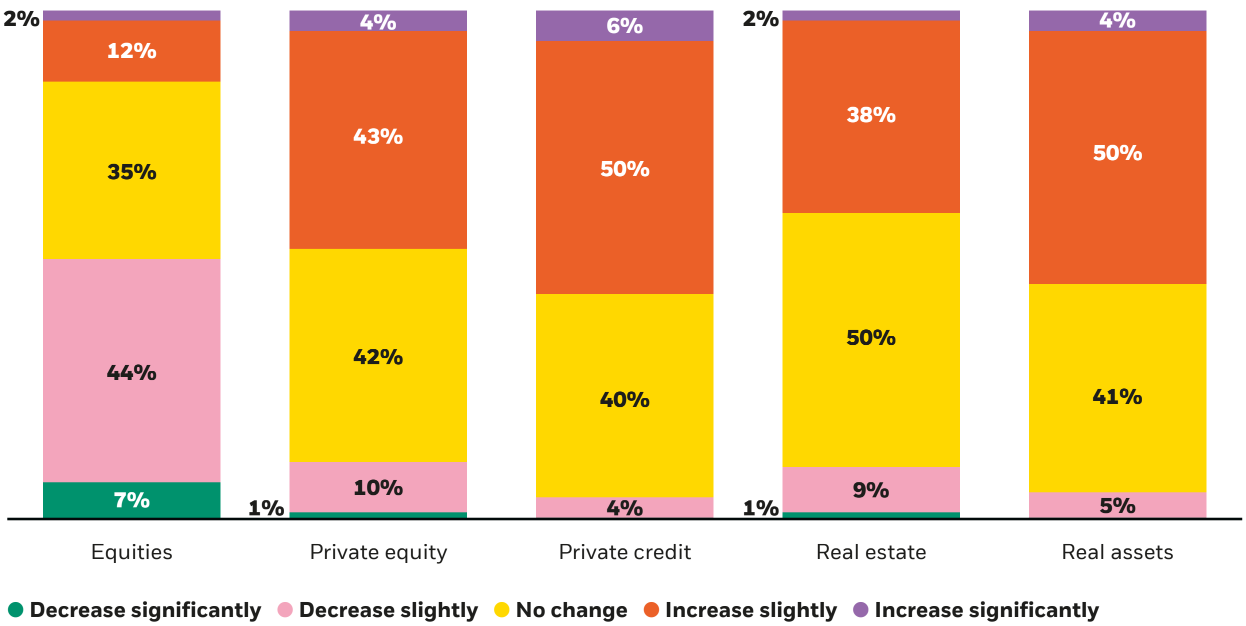
Seeking income throughout the cycle with direct lending

Middle-market direct lending

has evolved significantly over the last 20 years, developing from a cottage industry into a distinct asset class with an increasingly mainstream strategic portfolio allocation. Growth in private credit generally, and direct lending specifically, has been fueled by factors that include strong capital demand from middle-market companies, growing use of leveraged loans for private equity buyouts, and an increased institutional appetite for the asset class' attractive investment characteristics — namely floating rate income streams, senior secured position in the capital stack, and relative lack of correlation to other assets. Private credit is well suited to investing across business cycles and is particularly attractive in the later stages of a cycle. That said, it is increasingly critical for investors to understand the differences among private credit strategies and current market players in order to achieve attractive returns.

Investor interest in middle-market direct lending, a subset of the private credit assets class, has increased significantly since the early 2000s and continues to grow. More than half of the 230 institutions participating in BlackRock's 2019 Global Institutional Rebalancing Survey expected to increase their allocation to private credit strategies including direct lending:

Chart 1: 2019 target asset allocation by survey respondents



Source: BlackRock's 2019 Global Institutional Rebalancing survey, January 2019.
Note: The bars show the proportion of investors surveyed that indicated a preference to increase, decrease or make no change to allocations to respective asset classes in 2019. The sample size by asset are as follows: equities (225); private equity (188); private credit (160); real estate (203); real assets (173). The private credit allocation intentions refer to responses among global fixed income clients.

We examined the current state of middle-market direct lending to assess how the asset class has performed and its outlook, given its growing popularity. It is our view that:

1

Direct lending has consistently outperformed other income-oriented strategies on a risk-adjusted basis for the last 15 years.[1]

2

Managing downside risk is essential to outperforming throughout the business cycle.

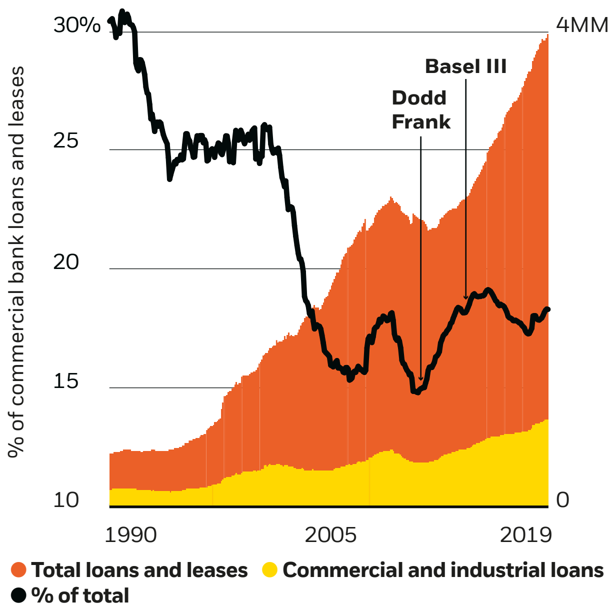
1 Source: BlackRock as of December 31, 2018. Refers to Cliffwater Direct Lending Index outperformance of U.S. Aggregate since inception of the Cliffwater Index in October 2004.

Commercial banks retreat from the middle market

Throughout most of the 20th Century, commercial banks were the primary lenders to small and medium-sized enterprises (SME), but two major events reshaped credit broadly and direct lending specifically. Those events were the regional bank consolidation beginning in the 1990s, and the 2008–2009 global financial crisis (GFC).

As regional banks consolidated to create national institutions, their management teams increasingly focused on cultivating larger corporate relationships. In the process, SMEs were crowded out of the bank financing market and often forced to source credit elsewhere.

Chart 2: Commercial and industrial loans owned by U.S. banks



Source: Federal Reserve H8 data as of June 2019.

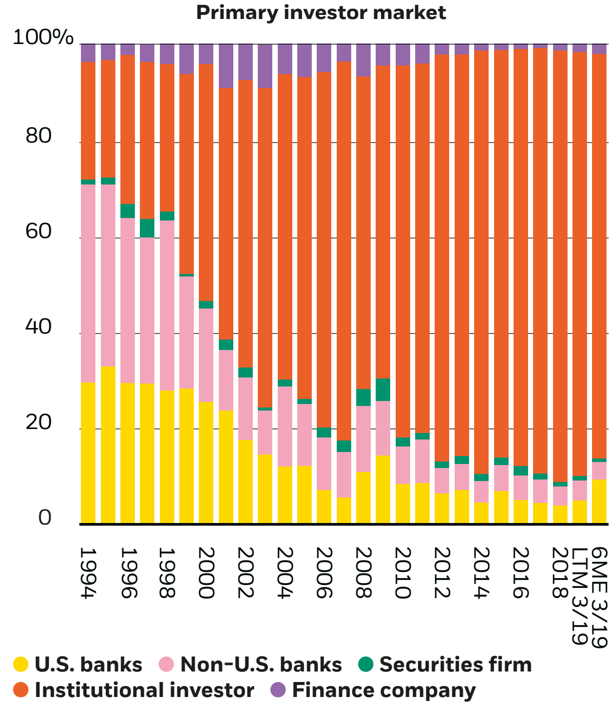
The already tight middle-market lending conditions were exacerbated by post-GFC regulations (e.g., Dodd-Frank, Volcker and Basel III), which required banks and broker-dealers to deliver by reducing both the size of their balance sheets and their holdings of largely corporate credit assets.

Non-bank lenders enter the market

As banks retreated, non-bank financial intermediaries (NBFIs), funded by institutional investors (e.g., insurance companies, pension funds, endowments, and sovereign wealth funds), emerged to fill the void. Since the late 1990s, the U.S. lending landscape has changed dramatically, with institutional investors now originating approximately 84% of primary leveraged loan issuance, compared with 42% in 1999.

NBFIs have increased their lending activities because of the potential attractiveness of the investment. In addition to interest income, direct lending may generate fees for sourcing, underwriting and structuring loans, and generally provides downside protection in the form of lender-friendly structural features (e.g., covenants).

Chart 3: Institutional investor share of leveraged loan issuance has increased steadily



Source: LCD's Quarterly Leveraged Lending Review: 1Q 2019
Highly leveraged loans only (pre-1996: L+250 and Higher; 1996 to date: L+225 and higher). Excludes left and right agent commitments (including administrative, syndication, and documentation agents, as well as arranger). Excludes RC-only ABLs.

Typical features of direct lending

Security
Direct loans are typically secured by defined combinations of real assets, intangible assets, and enterprise value.

Structural seniority
First- and second-lien positions provide repayment priority in the event of default, and potentially protects principal, which may lead to outperformance in a downturn.

Contractual yield and amortization
Quarterly principal and interest payments provide both current income and a periodic resetting of the reference interest rate, while mandatory amortization uses excess cash flow to pay down debt, potentially reducing overall risk.

Floating-rate pricing
Direct loans have adjustable coupons that increase when interest rates rise and provide a floor when they decline.

Financial covenant protections
Legal agreements regulate a company's financial performance by restricting its activities, its ability to incur additional debt, its ability to make distributions and payments to affiliates, and its right to liquidate assets.

Management access
Direct lenders generally receive substantial access to a borrower's management team during the diligence and underwriting process, which provides an informational advantage that potentially improves decision-making and loan structuring.

Characteristics of private credit

Direct lending is characterized by flexible and creative financing solutions that are unique to each opportunity. However, there are certain structural features that are common to most loans: security, structural seniority, floating rate pricing, contractual yield and amortization, financial covenant protections, and management access.

Additional direct loan features may include warrants or other equity-linked structures that potentially provide capital appreciation in certain situations. In aggregate, these qualities contribute to direct loans' markedly different risk-return profile from conventional fixed income securities. Consequently, direct lending may be a source of meaningful portfolio diversification and risk-adjusted return when added to stock and bond holdings.

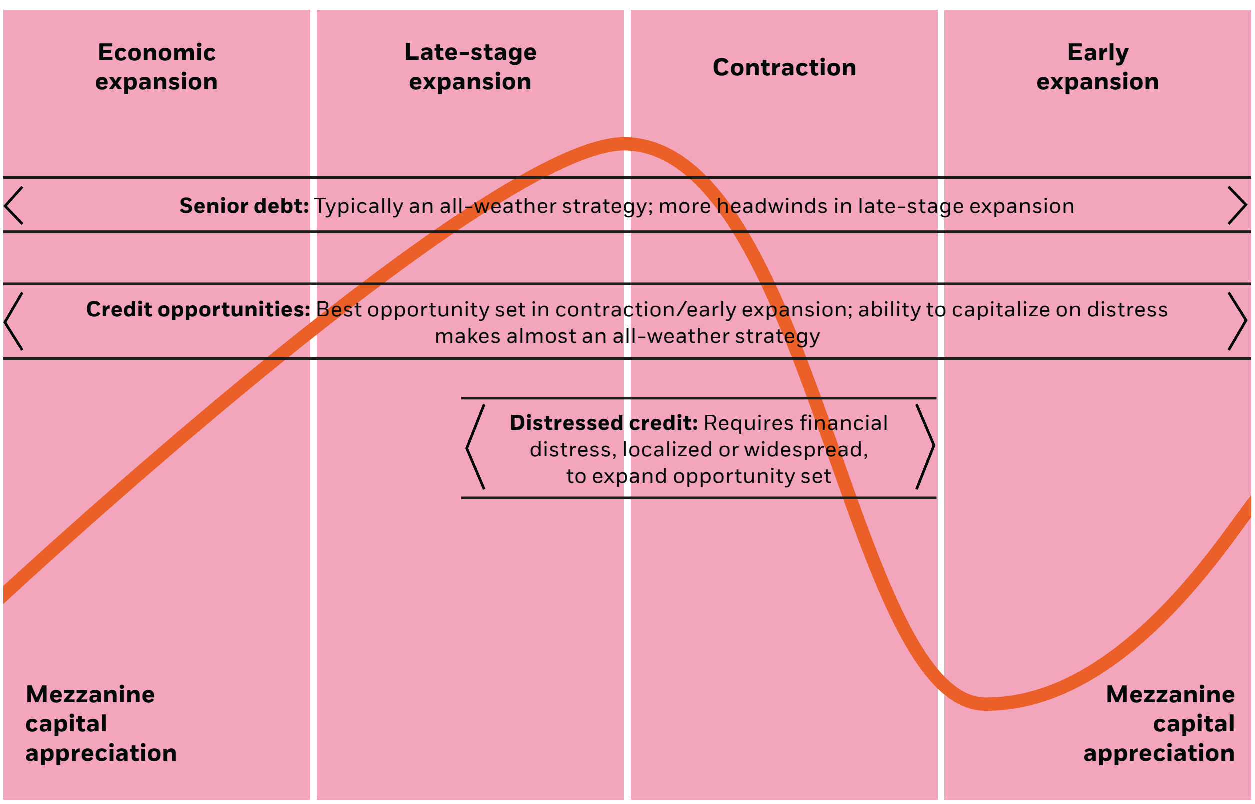
Opportunities across market cycles

Direct lending may offer opportunities to generate income during both economic contractions and expansions. Certain strategies within private credit are better suited to periods of macroeconomic stress, such as distressed credit or special situations. These strategies tend to be less active during periods of persistent economic growth and low interest rate environments.

By contrast, direct lending is largely business-cycle agnostic, supporting credit deployment in favorable business conditions (e.g., financing growth-oriented capital expenditures) as well as during economic slowdowns (e.g., funding an acquisition of a distressed competitor). Consequently, direct lending can be considered an "asset class for all seasons."

Direct lending's attractiveness across business cycles derives from its structural flexibility and the ability of skilled direct lenders to underwrite tailored solutions that support borrowers in both good times (e.g., financing to fund growth-oriented capital expenditures) and bad times (e.g., financing to support the acquisition of a distressed competitor with good assets). Identifying relative value across a company's capital structure, leveraging fundamental diligence, and applying structuring acumen are key to generating compelling returns throughout corporate and macroeconomic lifecycles.

Chart 4: Private credit strategies across the economic cycle



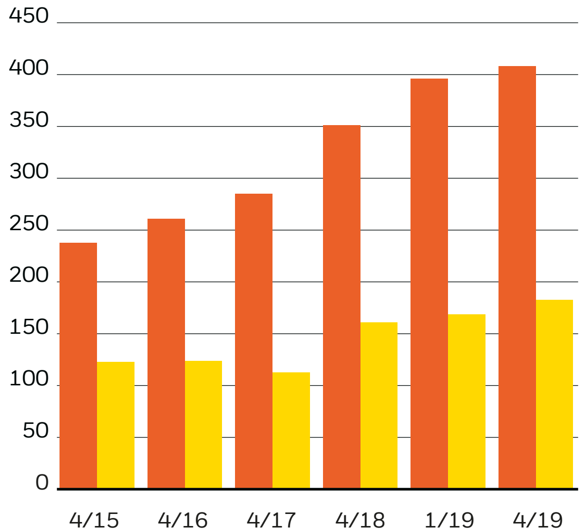
Source: Cambridge Associates LLC
Note: Illustration does not take into account relative value across credit, or relative value between credit and other asset classes. Specialty finance strategies will have different experiences during the credit cycle depending on the type of asset in which they are invested. Committing to draw-down strategies requires a longer investment horizon than investing in open-ended strategies that allow for immediate capital deployment and regular liquidity.

Navigating increasing competition...and a late cycle

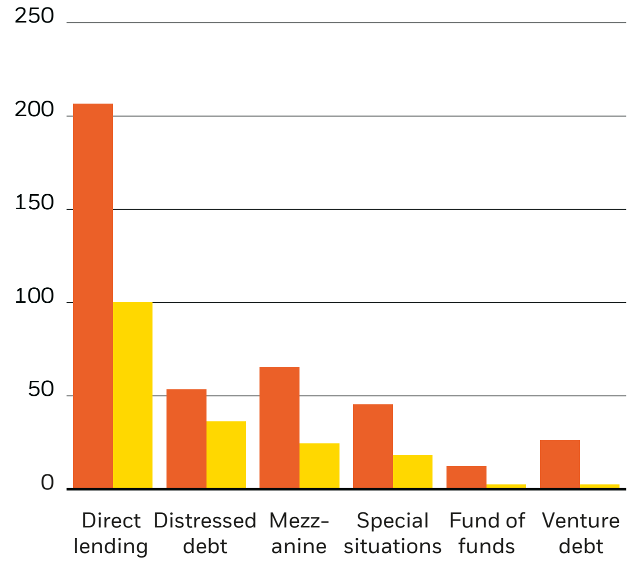
Direct lending has become an increasingly important part of the U.S. corporate lending landscape. An estimated 407 private credit funds are currently seeking to raise a collective USD $182 billion, with more than 50% of this targeted at direct lending strategies (based on Preqin's 2018 estimate).

Chart 5: Competition has increased within private credit and direct lending, in particular

Private debt funds in market over time, 2015–2019



Private debt funds in market in 2018 by fund type

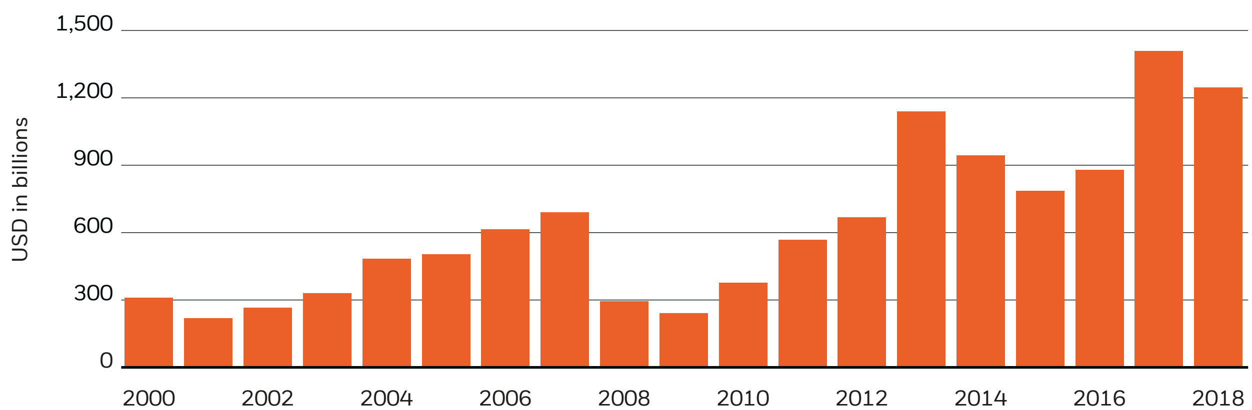


No. of funds raising **Aggregate capital targeted ($bn)**

Source: Preqin Quarterly Update: Private Debt (Q1 2019).

The significant amount of capital raised, coupled with continued economic growth in the United States, have led to continually high leveraged loan issuance, which reached approximately USD $1.2 trillion in 2018.

Chart 6: U.S. leverage loan issuance



Source: Refinitiv, Leveraged Loan Monthly, Year-End 2018 Report.

This scenario has, in some cases, led to a loosening in underwriting standards as lenders make accommodative decisions to increase volume. Some are willing to forego structural protections to grow their asset base. This trend is further evidenced by an increase in the number of deals that lack traditional financial covenant packages (colloquially referred to as “covenant-lite” or “cov-lite” deals). Notably, in 2018, an estimated 85% of broadly syndicated leveraged loans issued in the United States could be classified as cov-lite. Among broadly syndicated U.S. leveraged loans issued with covenants in 2018, the majority were structured with one or two covenants at most. We have seen a similar trend of covenant deterioration in certain (but not all) segments of the U.S. middle market.

Chart 7: Average number of covenants

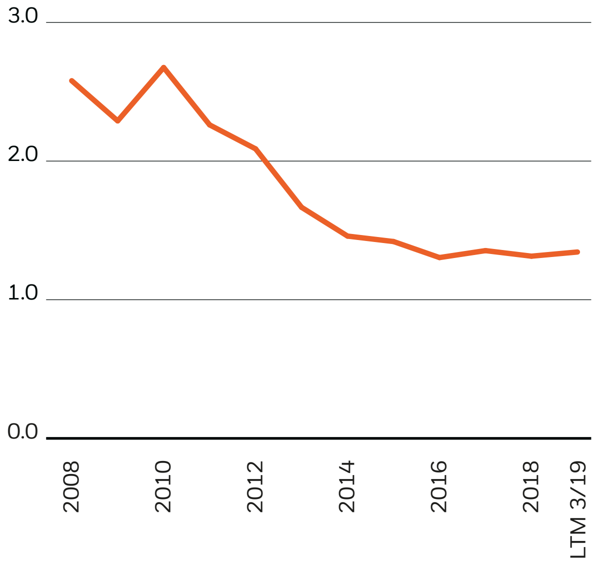
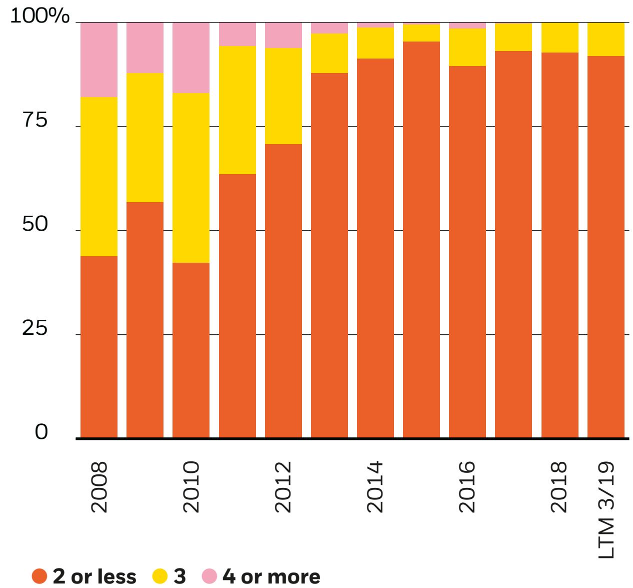


Chart 8: Distribution by number of covenants



Source: LCD’s Quarterly Leveraged Lending Review: 1Q 2019.

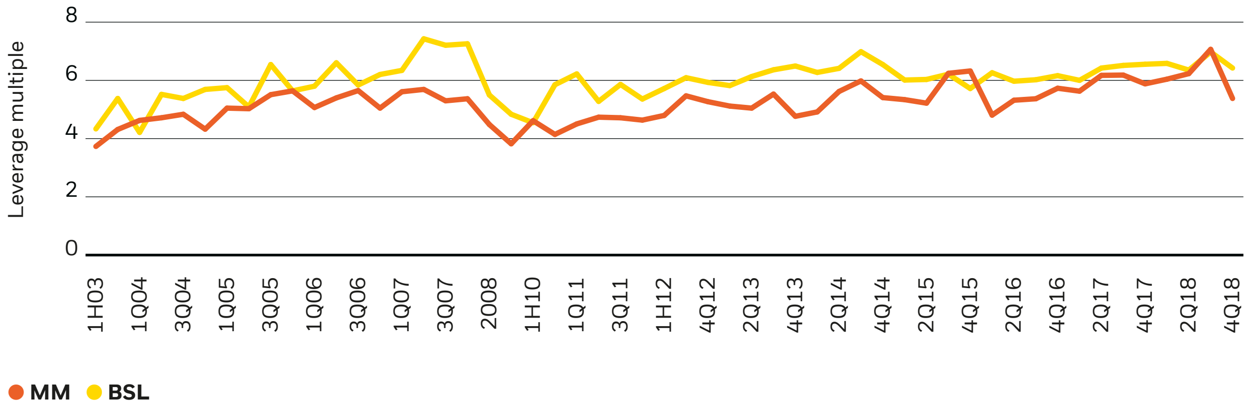
As risks increase, experience will matter

In the face of a U.S. lending market that has expanded rapidly, it is our view that there is still significant opportunity in direct lending. That said, there are also visible risks created by aggressive new lenders and a possible late-stage business cycle. Against this backdrop, experience in direct lending throughout business cycles, deep industry expertise, and a fundamental focus on credit risk management are essential.

We believe investors should be cautious of middle-market loan structures that resemble the borrower-friendly structures of the broadly syndicated loan (BSL) market: no covenants, virtually no amortization, and the ability of sponsors to extract dividends and transfer assets. A new class of well-funded, volume-driven, upper-middle-market lenders have organized around the opportunity to fund these loans, which are generally made in partnership with private equity (PE) sponsors. This is not at all to say that these loans and the deals they support are inherently flawed. Oftentimes, taking a secured position in the capital structure in support of a sophisticated financial and operational sponsor can be quite compelling, particularly with a seasoned sponsor who is willing to invest meaningful equity capital.

What we also recognize, though, is that different parts of the capital structure have economic and fiduciary incentives that are not always aligned. These observations are always front of mind when we evaluate PE transactions, perhaps now more than ever. Global PE assets under management (AUM) rose above USD $3.5 trillion in 2018 (compared with USD $2.5 trillion in 2016), with little slowdown in forward fundraising calendars. This continued expansion in PE AUM has commanded continued growth in deal flow and, as many new direct lending managers have entered the market, greater competition for deals and wallet share with PE sponsors. This competitive pressure has spawned a number of issues for direct lenders, perhaps the most worrisome of which is the continued increase in leverage levels for U.S. LBOs.

Chart 9: BSL vs MM – Debt-to-EBITDA ratio



Source: Refinitiv, Leveraged Loan Monthly, Year-End 2018 Report.

Despite these trends, it is our view that there continues to be opportunity to generate strong risk-adjusted returns in direct lending. Through it all, the focus should remain on the underlying business and creating a structure that protects against the specific risks of the transaction. In addition to structural discipline at the individual investment level, risk management at the portfolio level, industry expertise, and a disciplined focus on industry diversification are essential.

As we have reviewed, a substantial amount of change and growth has taken place in private credit markets, and we expect those trends to continue for the foreseeable future. The basic attraction of the middle market, with its return premium, lender friendly documentation, and low correlation with other fixed income segments, remain intact.

As we continue in a very long business cycle, it becomes increasingly important to structure transactions through the lens of previous workout experience. Having experience with workouts and navigating restructuring and recapitalization, both in and out of bankruptcy, is invaluable when the cycle does turn. Whereas some of the market increasingly accepts cov-lite transactions as the "new normal," robust financial covenants are necessary to weather a downturn.

Despite the challenging competitive environment, we remain firm in two basic convictions:

1

Direct lending is an asset class that has historically generated attractive, risk-adjusted returns through a variety of business cycles, and is one to which investors should have a meaningful allocation.

2

There continues to be an opportunity to generate alpha in direct lending.

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