EXPERT COMMENTARY

Direct lending is intended to deliver durable yield but investors need to look carefully to understand how to evaluate the opportunities, say Tree Line Capital Partners founders and managing partners Tom Quimby and Jon Schroeder

Five key themes to consider in direct lending

The direct lending landscape has changed dramatically over the last decade which makes it imperative to understand the state of the current environment as things look much different than they did following the last major correction, the Great Financial Crisis.

At Tree Line, our team has been focused on direct lending since 2002 and has invested through multiple market cycles which include, fund structure evolution, product innovation and rapid expansion of the private credit asset class. Through those cycles the value proposition for private credit, with a specific focus on direct lending, remains intact. Investors continue to seek yield through economic cycles without sacrificing principal protection. However, in a rapidly growing asset class, investors need to acknowledge that the blueprint for success in the last decade will be less relevant in the current decade.

We break down five key topics we think every investor should consider when evaluating direct lending opportunities and managers.

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1 Bank consolidation is 2010's pitch

Direct lending's rise, in large part, can be directly attributed to the trend of bank consolidation in the 2000s which was accelerated by the GFC. Following the GFC, it was all but a requirement for direct lenders to include a chart showing the steep decline in the number of commercial banks in the US.

Between 1990 and 2010, the FDIC reports that commercial banks in the US declined from around 15,000 to 8,000. Clearly, a relevant trend that created dislocation in the lending market that enabled private credit firms to

flourish. However, those still making that pitch in 2021 may be missing the plot. In 2010, it was valid to highlight the void left behind by banks being filled in by private credit firms.

It took years to rebuild the lending infrastructure and capacity to replace the banks but today the private credit asset class sits at around $1 trillion and is projected to reach $1.5 trillion by 2025. Bank consolidation was certainly an important chapter in direct lending's history but making the fundraising case on this basis ignores the true question of how a manager competes in the current competitive landscape that has been built over the last decade.

2 Private credit will ride the coat-tails of private equity's growth

The growth and maturation of private credit has given many pause to evaluate the state of the market and if the growth is justified. You do not need to look much farther than the growth of private equity to begin to feel some comfort. The private equity asset class is estimated to stand at $4.4 trillion in 2021 and is projected to reach $9 trillion by 2025 significantly outpacing the projected growth of private credit. Private equity headlines are dominated by the mega-funds raising record levels of capital with Hellman & Friedman raising $24.4 billion in its latest fund and Carlyle reportedly targeting $27 billion.

However, Tree Line is much more interested in the sheer number of private equity firms focused on the lower middle-market, or LMM. According to PitchBook, private equity firms have raised $186 billion in funds less than $500 million since 2016. The LMM private equity segment simply did not exist a decade ago with this level of capital or sophistication. The LMM offers a large and fragmented addressable market for direct lenders to cover and extract favourable terms relative to the crowded and commoditised middle-market, or MM, and upper middle-market, or UMM.

3 Allocation by segment is trending

While the pitch to deliver investors alpha as a result of what the banks left behind may be a bit stale, that doesn't mean there isn't value to be found within the asset class. Investors that build an allocation strategy by segment will have an edge in the next decade. Simply assuming that all direct lending is created equal overlooks the maturation of the private credit asset class and the underlying trends within each segment.

The market is more than ever being segmented into the UMM, the MM and LMM each offering unique characteristics. While the dollars have channelled into the UMM and MM, the LMM offers investors many of the attributes that brought so much interest to direct lending a decade ago. LMM lenders are structuring senior secured loans with a focus on the fundamentals, such as low leverage, full covenants and tight documents. While the UMM and MM have been forced to capitulate to commoditised terms following rampant growth, the LMM remains an attractive complement to portfolios historically built around large platforms.

4 Size or structure?

If we look at where fundraising dollars are pointed, one could conclude that investors are most interested in size when it comes to direct lending. Size of platform and size of company to be specific. However, investors consistently communicate a desire for private credit to deliver yield and capital preservation which does not correlate with size as the largest platforms lending to the largest companies are offering depressed yields, high leverage, cov-lite structures and loose credit documents. This approach abandons the fundamentals and the very purpose credit is intended to play within a broader portfolio.

The LMM and niche strategies continue to gain attention as the erosion in terms becomes a consistent trend in the UMM and MM. Size is a very hard barrier for many to get past as larger companies intuitively feel more durable. However, those willing to study default rates, loss rates and total return will conclude that structure consistently outperforms size.

5 Was covid a litmus test?

It had been a decade since the markets were last meaningfully tested by the GFC so many were watching private credit performance closely as the pandemic set in. Distressed capital was quickly raised and began circling a highly anticipated fallout in direct lending that ultimately never came to pass.

Overall, direct lending did pass the litmus test while those taking amplified risk were exposed. Investors now have the ability to utilise this data to differentiate managers and separate the outperformers from the underperformers.

Measuring metrics quarterly, such as default rate, non-accrual rate, unrealised loss rate and realised loss rate will be key indicators to understanding a manager's actual performance. While most portfolios climbed back to pre-pandemic valuations by 2021, the volatility that occurred along the way should be at the very least of interest if not a concern. Direct lenders are predominantly back to pre-pandemic conditions with some extending even more aggressive structures and terms.

The quicker than expected financial recovery may simply reinforce bad habits for those with the most volatile portfolios. Winning in direct lending has and always will be about the fundamentals. Those able to remain disciplined and focused on the fundamentals at the peak of the cycle will inevitably outperform. The upside in direct lending is capped after all, so the risk-reward simply does not pencil out for lenders moving out on the risk spectrum and we're reminded of this every time the cycle shifts. Direct lending is intended to deliver durable yield but it's up to investors to understand what matters most in the current environment and, more importantly, their portfolio. ■

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