July 2024

Privately seeking yield

Secular trends supporting US direct lending appear intact despite changing landscape

Fidelity INTERNATIONAL

Audie Apple
Senior Vice President, Direct Lending Institutional Portfolio Manager, Fidelity Investments

Matt Barron, CFA
Director, Direct Lending Institutional Portfolio Manager, Fidelity Investments

Key takeaways

- US direct lending has produced attractive returns for yield-seeking investors over the past two decades.
- Private equity deal financing has supported growth in direct lending.
- Borrowers pay a premium to direct lenders, which boosts cash yields for investors.
- Certain features of direct lending, such as its floating-rate structure, helped to benefit investors during one of the fastest interest rate hiking cycles in recent times.
- As direct lending continues to attract capital, we believe the risk-return characteristics of middle market loans are particularly attractive.

Direct lending: Private opportunities at a crossroad

The direct lending market, which is composed of privately negotiated loans made directly to privately owned companies, has experienced asset growth of roughly 10X over the past decade.[1] Over this period, the asset class has produced compelling returns versus competing yield-oriented asset classes such as broadly syndicated loans and public market high-yield bonds (Exhibit 1).

This long period of outperformance—coupled with an increase in capital directed towards private loans[2]—might be viewed as signs that the window of opportunity for direct lending could be closing, especially as the interest rate hiking cycle peaks.

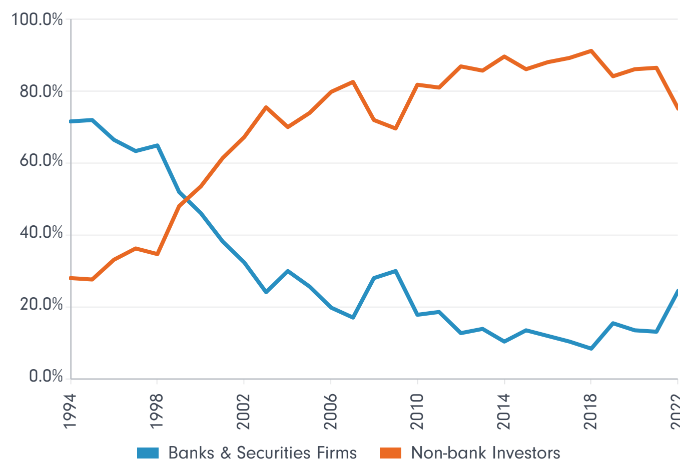
In this paper, we examine the structural features supporting US direct lending's attractive risk-return potential and how they may fare in a changing investment climate.

Fuelling the growth of private equity: The "L" in LBOs

One of the pillars supporting direct lending is the private equity (PE) boom that began in the early 1980s, requiring debt capital in scale to finance the leveraged buyout transactions. Debt generally represents 40%–60% of the total purchase price for PE buyout deals.

Prior to the 2008-2009 global financial crisis, banks played a leading role in providing the finance required. However, the market dislocation and the bank regulatory reforms that followed accelerated the already established trend of banks ceding shares to private capital sources. An indication of this trend is the decline in the share of the leveraged loan market funded by banks over time (Exhibit 2).

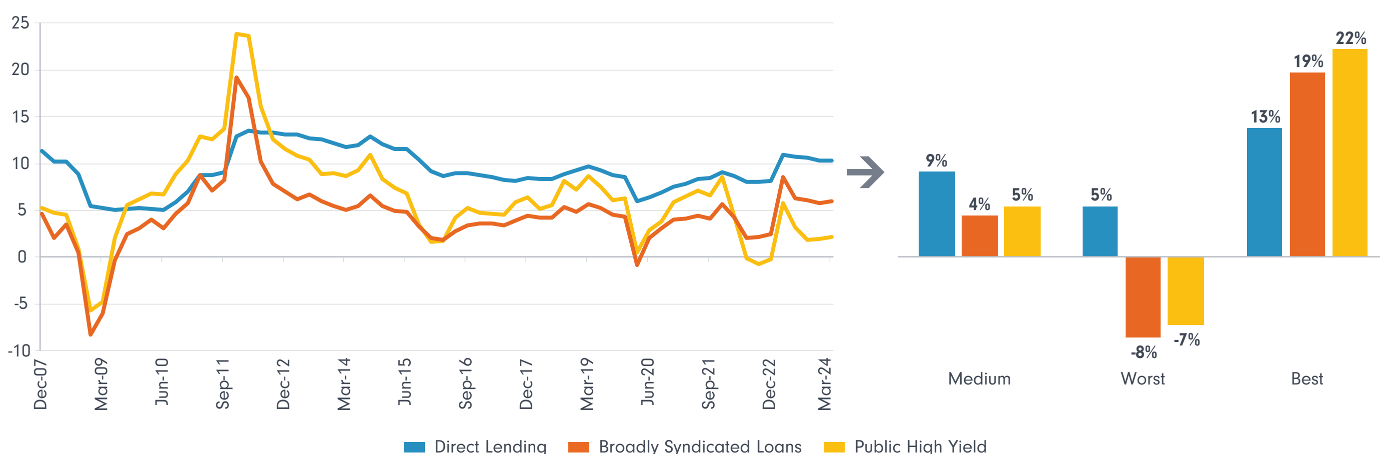
EXHIBIT 2: Non-bank Investors Fill the Void



Source: Pitchbook®, as of Dec. 31, 2022.

The retrenchment of banks, coupled with the strong rebound in PE deal volume, catapulted private credit from about US$100 billion in assets in 2007 to about US$1.8 trillion by the end of 2023 (Exhibit 3).

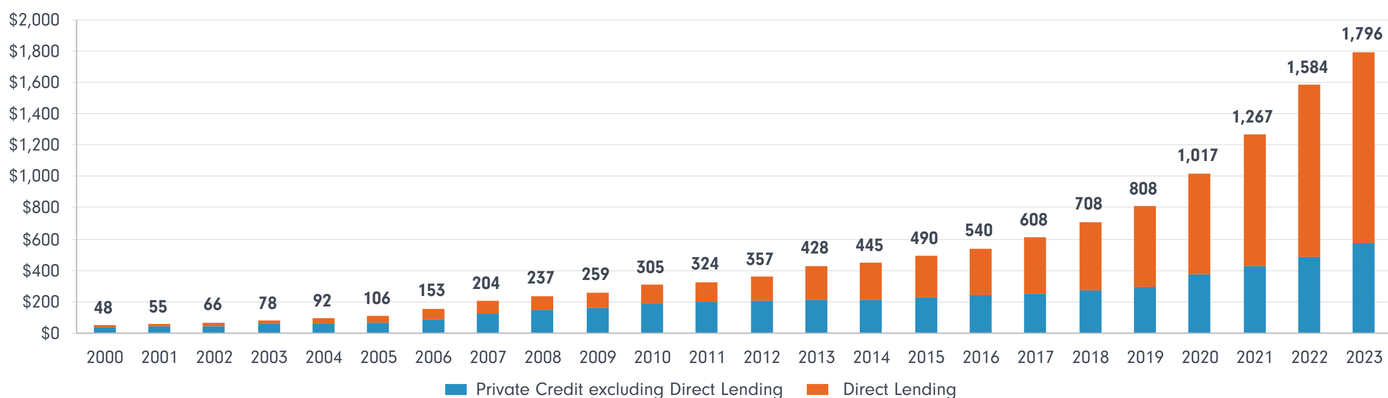
EXHIBIT 1: Rollling Three-Year Returns (2004 through March 2024)



Past performance does not guarantee future results.

Source: Index providers, as of March 31, 2024. Direct lending, broadly syndicated loans, and U.S. high-yield performance measured by the Cliffwater Direct Lending Index, the S&P/LSTA Leveraged Loan Index, and the ICE BofA US High Yield Index, respectively.

EXHIBIT 3: The US$1 Trillion+ Private Credit Market



Source: Pitchbook®, Preqin, Cliffwater, Bloomberg, and Fidelity Investments, as of Dec. 31, 2023.

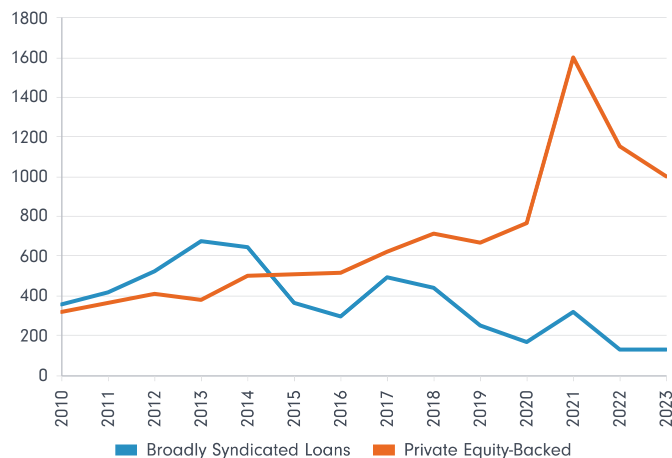
Over roughly the past decade, assets invested in PE funds experienced more than 3X growth while PE fundraising has continued to increase.[3] PE managers had about US$1.5 trillion in dry powder, which is capital available to make additional investments, as of December 2023 (Exhibit 4). We believe deploying this capital will drive parallel demand growth for debt to support portfolio company acquisitions. By comparison, private debt (PD) managers had only about US $270 billion of available committed capital, portending the need for additional debt capital to support future PE deals.

PE managers tend to invest in private companies across various sizes. Disaggregating the PE buyout universe by scale, we find the middle market—companies on the smaller end of the PE universe ranging in enterprise values from about US$100 million to US$1 billion—particularly attractive.

Companies in this segment often do not have the scale to access less costly liquid debt capital markets. As a result, most middle market PE-sponsored deals secure financing by negotiating private loans with direct lenders that can capture a premium associated with the bespoke nature of these loans and their inherent illiquidity.

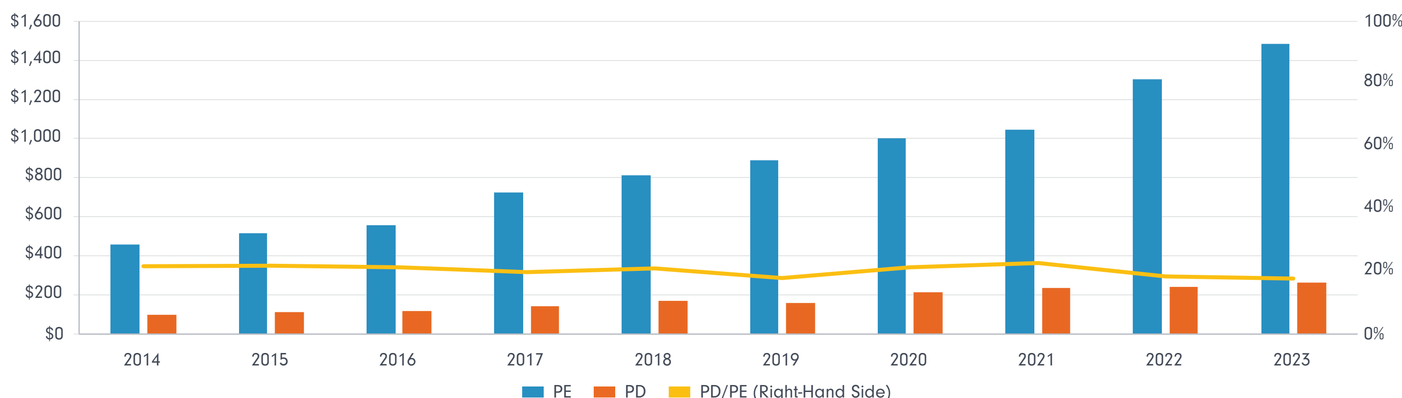
The continuing trend towards the use of private direct lenders in the middle market can be seen in the decline of smaller broadly syndicated loans and the comparable increase in PE acquisitions associated with credit facilities of that scale (Exhibit 5).

EXHIBIT 5: Full Year Private Equity Deals Volume <US$1B vs. BSL Issuance <US$500M



Source: Pitchbook®, as of Dec. 31, 2023.

EXHIBIT 4: Capital Raised That Has Not Been Invested (Dry Powder)



Source: Preqin, as of Dec. 31, 2023.

The overall value proposition of direct lending supports premium pricing relative to other capital sources. Specifically, PE sponsors value speed and certainty of execution, which can be critical to support their efforts as they compete with other PE managers for attractive portfolio companies. Direct lending also offers better pricing visibility, since terms are negotiated directly between the sponsor and a small group of lenders (one to four generally). These benefits, coupled with the compensation for the illiquidity of these loans, have contributed to a persistent yield premium of 200– 400 bps relative to broadly syndicated loans (Exhibit 6).

EXHIBIT 6: Typical Pricing and Leverage

Leveraged Buyout Debt Financing

Key Features and Benefits of Direct Lending

- Speed and certainty of execution.
- Pricing visibility.
- Illiquidity premium associated with privately negotiated bespoke credit structures.
- Direct lenders have historically earned 200–400 bps premium over broadly syndicated loans.

Past performance does not guarantee future results.

Source: Cliffwater and Fidelity Direct Lending Team based on observed direct lending deal flow from Jan. 3, 2022 through Dec. 31, 2023.

Negative skew: A closer look at defaults and losses

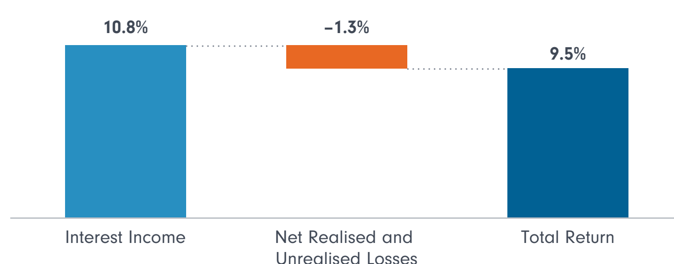
While direct lending has historically outperformed other asset classes, including high yield, there are some warning signs ahead. Investors would be wise to disaggregate net returns to better understand the impact of defaults and recovery rates on headline yields. Credit investments benefit from the certainty of contractually determined returns in the form of a stated yield. However, the upside on the investment is contractually capped by a combination of negotiated terms, including stated coupon and original-issue discounts. On the downside, investors could experience a complete loss of their initial investment.

As a result, a credit portfolio experiencing a loss would not have benefitted from any single holding that surprises to the upside to make up for that loss. This feature of credit investments creates a return distribution with negative skew—a fatter "left tail" and a truncated "right tail," with the left representing adverse outcomes and the right representing favourable outcomes.

Understanding this feature of credit portfolios can help investors evaluate the trade-off when investing in direct lending. Relative to competing yield-oriented asset classes such as broadly syndicated loans and public high yield, investors in direct lending have kept comparably more of the headline contractual returns (see Exhibit 7).

EXHIBIT 7: Default and Recovery Comparisons

Direct Lending Loss Experience: Sept. 2004–Dec. 2023



Direct Lending Features	
Equity Investor	Concentrated: 1 control investor
Lender Base	Typically 1–4 lenders
Liquidity	None to limited
Lender Protection/Covenants	Negotiated/commonly maintenance-based
Lender Workout Control	Strong

Past performance does not guarantee future results.

Source: Cliffwater and Fidelity Direct Lending Team based on observed direct lending deal flow from Jan. 3, 2022 through Dec. 31, 2023.

Other structural features of middle market direct lending suggest its appeal may persist. Direct lenders are often able to negotiate maintenance-based covenants, which provide meaningful safeguards. These covenants often position direct lenders to strongly influence negotiated workouts if portfolio companies encounter difficulties.

Also, the senior position direct lenders occupy in the capital structure helps guard against losses. Equity holders, which often represent 40%–60% of the total capital, must absorb losses first (Exhibit 8). Only then will the debt be impaired.

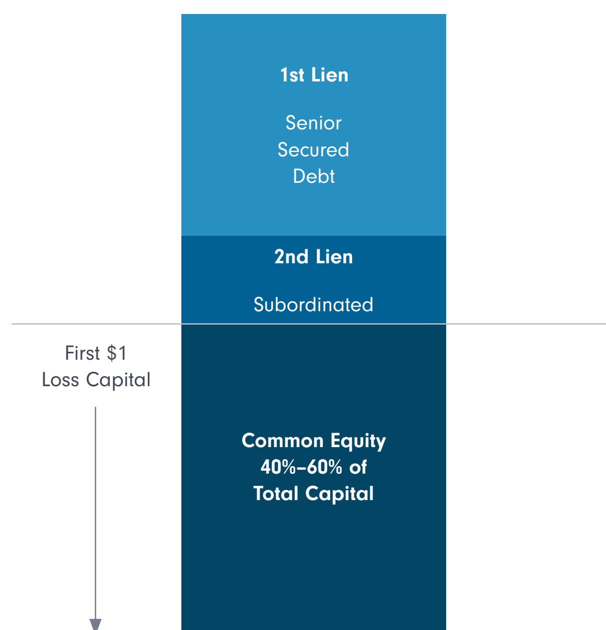
Another key factor is that PE sponsors acquire a controlling stake in each portfolio company. This empowers those PE sponsors with deep operating experience and resources to drive improvements in operational efficiency. Sponsors also bring support to growth initiatives—both in charting a strategic path to drive organic growth and in providing capital to support acquisitions, the latter of which can quickly scale a business and drive further improvements in margins and financial performance.

Importantly, the additional capital reserved by PE sponsors for growth initiatives may also be used to further support companies when challenging periods arise. In stress scenarios—with fewer lenders at the table—there is less chance of conflicting interests among lenders. This can facilitate collaboration to selectively support the portfolio company and PE sponsor in workouts.

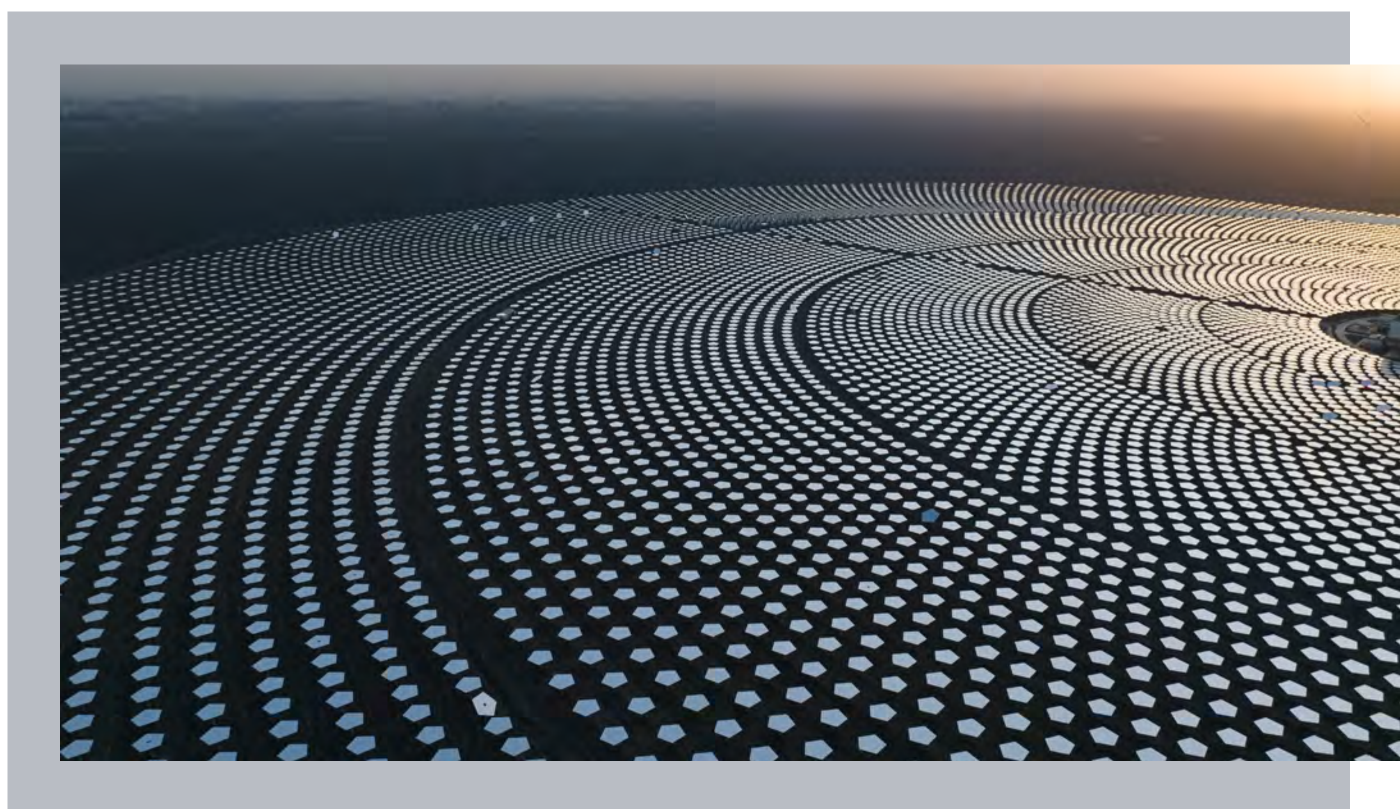
Furthermore, private companies tend to face a lower risk of business disruption in workout scenarios. Stakeholders can address their challenges beyond the view of competitors, suppliers, and customers, allowing them to take a more balanced, longer-term view as they chart the path forward.

EXHIBIT 8: Capital Structure for a PE Portfolio Company

Security Type



Source: Pitchbook and Fidelity Direct Lending Team based on observed direct lending deal flow from Jan. 3, 2022 through Dec. 31, 2023.

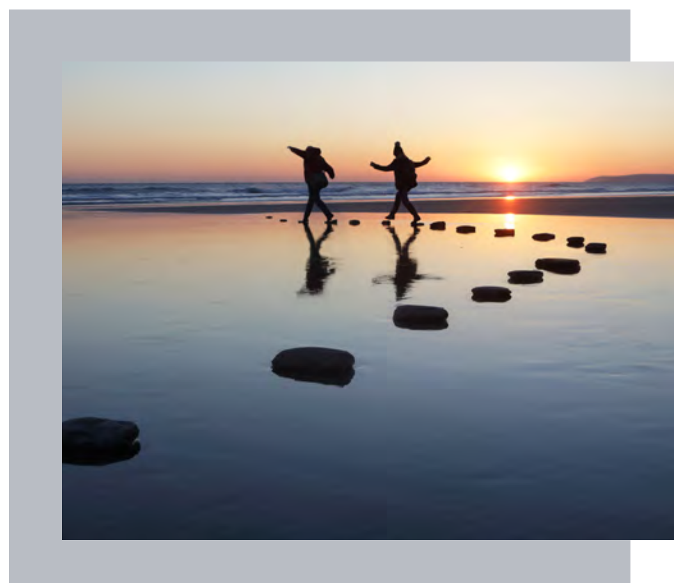


Conclusion

We believe secular trends driving investor appetite for PE may continue to produce outsized growth for private markets relative to public markets. A growing supply of debt capital will be required to support growth in this scenario.

In our view, direct lenders are well-positioned to continue to capture much of the opportunity in the middle market. PE sponsors value the speed and certainty of execution, along with the pricing visibility from negotiating credit facilities with a select group of lending partners. These benefits, coupled with the illiquidity premium associated with bespoke privately negotiated loans, have contributed to an attractive historical risk-return profile for direct lending.

Understanding the structural features supporting premium pricing and favourable default and recovery rates suggests that the relative return advantage of direct lending versus competing yield-oriented asset classes may persist. All factors considered, we believe US middle market direct lending may be an attractive and scalable asset class that warrants consideration in a thoughtfully constructed portfolio.



[1] Asset growth measured from Jan. 1, 2011 to Dec. 31, 2021 using data from Pitchbook®, Preqin, Cliffwater, Bloomberg, and Fidelity Investments, as of Dec. 31, 2021.

[2] See Exhibit 3.

[3] Source: Preqin, as of Dec. 31, 2021.

[4] `SOFR is the Secured Overnight Finance Rate and it broadly measures the cost of overnight borrowing that is collateralized by U.S. Treasury securities.

EXHIBIT 9: Direct Lending Features Summary

	Direct Lending	Broadly Syndicated Loans	Public High Yield
Seniority	Senior secured	Senior secured	Senior to subordinated
Coupon	Floating	Floating	Fixed
Term Structure	5–7 years	4–7 years	7–10 years
Liquidity	Limited to none	Limited to medium	Limited to higher
Pricing	500–700 bps over SOFR	300–500 bps over SOFR	Varies widely
Interest Rate Sensitivity	Lower	Lower	Moderate to higher
Lender Protection: Covenants	Higher; commonly maintenance-based	Typically covenant-lite	Lower/incurrence- based
Lender Workout Control	Strong	Limited to none	Limited to none
Default History	Lower	Lower	Moderate to higher
Recovery Rates	Moderate to higher	Moderate to higher	Moderate to lower

Source: Fidelity Direct Lending Team based on observed direct lending pricing from Jan. 3, 2022 through Dec. 31, 2023.

IMPORTANT INFORMATION

This document is issued by FIL Investment Management (Australia) Limited ABN 34 006 773 575, AFSL No. 237865 (“Fidelity Australia”). Fidelity Australia is a member of the FIL Limited group of companies commonly known as Fidelity International.

The information included in this document is intended for a restricted specified group of selected institutional investors only. An “institutional investor" is a person who is a "wholesale client" under section 761G of the Corporations Act 2001 (Commonwealth of Australia) and the information in this document must not be distributed, conveyed, or otherwise be made available to any other persons.

Any service, security, investment, fund or product outlined may not be available to, or suitable for, you, may not be available in your area and the provider of a service, security, investment, fund or product may vary. It is your responsibility to ensure that any service, security, investment, fund or product outlined is available in your jurisdiction before any approach is made regarding that services, security, investment, fund or product. This document has been prepared without taking into account any person’s objectives, financial situation or needs. You should consider these matters before acting on the information.

Information included in this document does not constitute an offer or an invitation to subscribe for an interest in any financial product or to be provided any financial service. The information presented in this document on any investment strategy (Strategy) may be subject to change and you should obtain detailed information and final approved documentation regarding that Strategy before taking any investment decision. Any Strategy mentioned is not a financial product. Any performance data provided in relation to a Strategy is provided for illustrative purposes only and does not represent the performance of any specific Australian financial product. The performance figures represent past performance. Past performance is not indicative of future performance. Actual performance experienced by any investor following the Strategy is likely to differ from the performance data provided in this document.

The information presented in this deck may be subject to change. Any forward-looking statements, opinions, projections and estimates in this document may be based on market conditions, beliefs, expectations, assumptions, interpretations, circumstances and contingencies which can change without notice, and may not be correct.

The information and any opinions presented in this document have been obtained or derived from sources which Fidelity Australia reasonably believes to be accurate, reliable and current. However, neither Fidelity Australia nor any member of Fidelity International warrants or guarantees the accuracy, reliability, currency or completeness of this information or accepts any responsibility or liability for any errors or omissions. Fidelity International excludes, to the maximum extent permitted by law, any liability which may arise as a result of the use of this document, including its content and any information that it references or makes available.

© 2024 FIL Investment Management (Australia) Limited. Fidelity, Fidelity International and the Fidelity International logo and F symbol are trademarks of FIL Limited.

Fidelity INTERNATIONAL