UNIVERSITY OF OXFORD

Saïd Business School

PEMBERTON

European Direct Lending
Review and Outlook

The rise of private debt, led by direct lending

Total assets under management (AUM) of private debt funds globally increased from US$275 billion in 2009 to US$887 billion in 2020. The rise of the US private debt market predates the European market expansion, but the European private debt market grew significantly faster during the years after the Global Financial Crisis (GFC), mainly driven by direct lending, a sub-strategy within private debt. Accounting for just 2% of private debt funds raised globally in 2009, direct lending raced to become the dominant strategy, at 34% of private debt funds raised by 2016 (Preqin).

Industry participants and recent academic research attribute this strong growth to four main factors:

- Banks' withdrawal from mid-cap lending due to their inability to lend amid tightened regulatory constraints and ongoing bank consolidation
- PE-induced borrower demand
- Demand from non-PE-owned corporates
- Investors' search-for-yield at a time of low interest rates

The full report analyses these trends and other factors affecting the outlook for direct lending in Europe and can be requested from marketing@pembertonam.com. It has been written by Saïd Business School with the assistance of proprietary data from Pemberton Asset Management (one of the largest European private debt platforms), and contains a legal perspective on the direct lending market by Latham & Watkins (a leading global law firm).

Key Takeaways

1. Reduction in capital supply by banks

- Direct lending in Europe grew particularly quickly after the GFC, a period that saw a simultaneous reduction in bank lending to mid-market firms. Academic research using US data shows that banks' withdrawal due to consolidation and/or regulation is a significant factor fuelling the growth of private credit markets, and it is likely that the same factors were at work in Europe.

2. Borrower demand

- Direct lending has grown on the back of a buoyant private equity industry, although today private equity borrowers are far from the only driver.
- Direct lending offers potential borrowers several benefits compared to traditional debt financing, including certainty in the lending rate (compared to upward re-pricing risk in syndicated lending), relatively quick approvals, and contractual flexibility tailored to specific business models. Borrowers appear willing to pay for this with typically higher interest rates.
- Borrowers may also be shut out from bank lending due to large size (making it more difficult for multiple banks to co-ordinate and club together) and less profitable capital structures (fewer ancillary revenue streams such as interest rate or FX hedging for lenders). As a result borrowers are forced to pay higher interest rates for lack of alternatives.
- Fixed issuance costs (including substantial amounts of management time) such as rating agency fees, marketing roadshows and the legal costs of a public offering are higher in the syndicated loan market compared to private debt. There is also a liquidity requirement for participants in syndicated loan markets (unlike direct lending) that establishes an effective minimum size for borrowers in public markets.

3. Investor capital supply

- Investors are increasingly familiar with direct lending as a strategy within private debt. The low interest rate environment is likely to have contributed to this trend as investors increased allocations to alternatives, including direct lending.
- Covenant protections in direct lending are stricter than in syndicated debt markets, though declining over time.
- While contractual margins are higher, academic work has found no evidence that default rates among direct lending borrowers are higher than for syndicated loans, although this may reflect the limited data available at this stage.

4. Market size and potential

- If market penetration of European direct lending grows in line with current US levels in terms of AUM as % of GDP, European direct lending AUM may grow by up to 50% in the medium term.
- The relative importance of the European middle-market means that the potential for direct lending penetration could well equal that in the US.
- A moderate but continuous wave of European bank consolidation followed the GFC, accompanied by reduced lending. That could reflect declining opportunities as direct lenders competed for deals, but continued withdrawal by banks may further open opportunities for direct lending.

5. Return analysis

- On average direct lending funds with vintages between 2008 and 2016 had a median net IRR of 9.2% (Preqin). This compares to a 4.1% annualised return in the ELLI, the primary proxy for broadly syndicated European loans. (Note the 4.1% is before fees and other expenses, so not directly comparable.)
- Analysis of aggregated pooled IRRs for credit funds back to 2004 paints a very robust picture of historical returns, especially for funds launched during the GFC (Burgiss).
- Direct lending is a relatively young asset class in Europe with limited historical data. The composition of private debt as an asset class has also changed, with even less historical data available on the newest vintages. Academic research to date has therefore been unable to provide reliable risk analyses or calculation of Sharpe ratios for the asset class, and reliable forecasting of risk-adjusted returns remains impossible at this point.
- While European direct lending only really started after the GFC, the asset class performed very strongly in the US through the GFC.
- Contractual returns are typically 200-350bps higher than comparable syndicated loan deals, this compares to 35bps uplift in the US in 2020. Based on research by Chernenko et al, it also seems that non-bank borrowers do not default significantly more than bank funded counterparts.

6. Risk considerations

- The growth of direct lending has mostly been driven by bank consolidation, increased regulation, and a low interest rate environment, and its future is likely to depend on the same factors. But this comes with some caveats. Forecasting future reductions in bank lending is difficult, and the private credit sector's resilience to potentially higher interest rates has not been proven.
- Recovery rates for direct lending loans under distress are largely unproven in Europe. Nonetheless, S&P Leveraged Commentary & Data ('LCD') data suggest that syndicated markets have shown better recoveries for covenanted deals. Given that direct lending transactions typically retain maintenance covenants, unlike the current syndicated market, they may well replicate this better recovery data.
- It remains to be seen how private debt portfolios perform in a market downturn, and how investors react. But through COVID-19 Pemberton portfolios have proven to be resilient and materially less volatile than public markets. Weekly cashflow forecasts and direct discussions with management have also reinforced the mutual benefits of relationship lending.
- Given the difficulty of measuring risk and correlations, it is difficult to assess diversification benefits of private debt. However, there are good theoretical reasons to suspect that including private debt in a portfolio brings the usual benefits of diversification.

7. The future of direct lending

- It is unclear whether the current trends are strong indications of future growth and returns, but there are reasons for optimism.
- Supply and demand-based explanations for the past growth of private debt amid attractive returns have different implications for the future of the asset class. Whereas a reduction of capital supply by banks seems to have been a significant driver in the past, the report suggests reasonable (if unproven) alternative explanations as well. In particular, based on surveys and anecdotal evidence, investors seem to intend to further increase allocations to alternative assets, including private debt.
- Despite the growing amount of capital supplied by institutional investors, direct lending fund managers seem to have been able to deploy that capital. However, it remains to be seen whether the increase in capital was accompanied by lower deal quality. Continued pressure on European bank profitability suggests that the banking sector may continue to consolidate, potentially opening further opportunities for direct lending in Europe. If direct lending can reach a similar market penetration in Europe as in the US there may be a large, untapped potential for future growth.
- Given the relatively early state of direct lending compared to other private debt strategies, the strategy has yet to be tested in a high-default credit environment in Europe, and it remains to be seen how it performs in a down-cycle. Pemberton's experience through COVID-19 suggests superior resilience as compared to the syndicated market. It is also unclear how demand from investors will change if and when interest rate levels increase.

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