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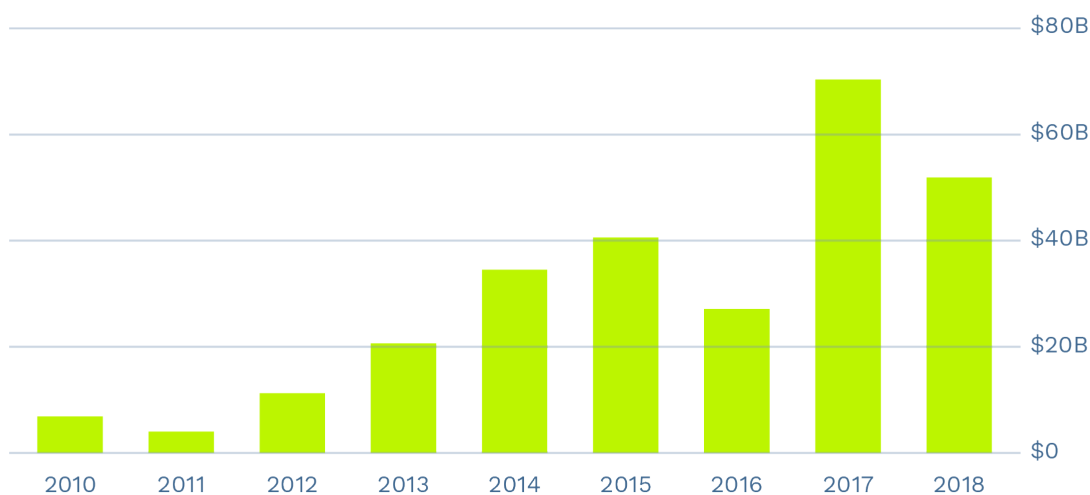
DIRECT LENDING: THE PAST, PRESENT, AND FUTURE

Between 1992 and Q1 2019, the number of commercial banks in the United States decreased from 11,700 to 4,652[1], roughly a 60% decrease across the board. This decrease over the years has been driven by a number of factors including bank mergers, acquisitions, and consolidations, all resulting in the fall of small banks and the growth of large and giant banks.

This has also resulted in an opportunity for other players to enter the space, specifically asset managers. Asset managers, who have been at the core of the boom, now have the ability to not only invest in small-, middle-, and large-size businesses who are seeking alternative sources of financing, but also provide investors, who may be looking for higher yields, with non-traditional options.

And, it's showing in the numbers. Direct lending funds have collected $19.4 billion so far in 2019[2].

Direct Lending Growth Since 2010



Source: Preqin

Global direct lending fund raises

But, how exactly does direct lending work and what's really driving the growth?
We answer a few of the bigger questions on the following page.

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HOW DOES DIRECT LENDING WORK?

The most experienced managers in the direct lending space have a vigorous approach when it comes to the investing process. This means bottom-up, credit-analytical work. Managers spend, sometimes, three to six months plus in due diligence with a company. This enables them to understand the ins and outs of business including their balance sheet, talent, collateral, and growth plans.

Once managers make an investment, they have a tendency to hold the loans long term which allows them to be a part of the growth strategy over many business cycles. Most managers tend to invest in senior loans, which can offer more risk mitigation as they sit at or near the top of the capital structure.

WHO TYPICALLY BORROWS?

Typically, companies who usually borrow from asset managers tend to classify as medium-to-low middle-market companies. These are companies that generally sit between $10-75 million dollars' operational EBITDA. These businesses partner with asset managers because banks have consolidated and tend to focus on larger loans to institutional-size businesses.

WHAT'S DRIVING THE GROWTH?

There are two major factors driving the growth of the asset class: investors and businesses.

Investors are in search of yield and when looking to fixed income, they've seen lower returns than in the past. In fact, the spread between fixed income yields and the inflation rate has been closing for over 3 decades.

There's also demand for funding. Small-medium sized businesses have struggled to get loans from the bigger banks, which in result has driven them toward asset management lenders.

WHAT DOES THE FUTURE HOLD?

Most major players, like Ares Management, are very optimistic about the future of direct lending.

"We're optimistic about the private lending landscape. Banks just don't do what they did two and three decades ago. We've lost 50% of the banks in the United States. We've lost 30% of the banks in Europe. The banks that do exist just don't lend to corporations as they once did." – Mitch Goldstein, Head of Markets at Ares, said in a recent interview.

The supply and demand, combined with imbalance of the banks providing loans, have left the space available for direct lending.

WHAT ARE THE RISKS?

As with any asset class, there are certain risks associated with direct lending strategies. Credit risk is the risk of nonpayment of scheduled interest or principal payments on a debt investment. Because direct lending can be debt investments in non-investment grade borrowers, the risk of default may be greater. Should a borrower fail to make a payment, or default, this may affect the overall return to the lender.

Interest rate risk is another common risk associated with direct lending. Interest rate changes will affect the amount of interest paid by a borrower in a floating rate loan, meaning they move in-step with broader interest rate fluctuations. However, this typically has little to no impact on the underlying value of floating rate debt. Conversely, interest rate fluctuations will have little to no effect on the amount of interest paid by a borrower in a fixed-rate loan but will impact the underlying value of the loan if sold before maturity.

Further, direct lending has exposure to default risk which makes evaluating the creditworthiness of the borrower especially critical. For these and other reasons, direct lending requires special consideration just like any other investment.

To learn more about direct lending, please contact your financial advisor.

(see page 3 for disclosures.)

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1 Federal Financial Institutions Examination Council (US)

2 Bloomberg

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