Invesco

Strategy Insights | Direct Lending

Current bank headlines a potential tailwind for direct lending

Overview

- The collapses of Silicon Valley Bank and Signature Bank as well as UBS' purchase of Credit Suisse have intensified fears of a global banking crisis.
- Given direct lending is not reliant on banks, impact has been relatively minimal and in fact, likely stands to benefit.
- The asset class continues to offer attractive yields on an absolute basis, as well as relative to liquid credit while middle market companies continue be solid fundamentally.

The events of the last few weeks have elevated focus on the banking industry and its perceived role as primary financier to companies across the globe. Despite swift and strong efforts by government agencies and central banks to boost confidence and quell liquidity concerns, the collapses of Silicon Valley Bank and Signature Bank as well as UBS' purchase of Credit Suisse have intensified fears of a global banking crisis. The natural question for many institutional investors is how do these recent events impact private credit, including direct lending?

Direct lending background

As the name implies, direct lending involves asset managers directly making loans to middle market companies without an intermediary investment/commercial bank. To be clear, direct lenders are not lending to banks nor working through banks to finance company needs — direct lenders are the financier or lending institution.

As an asset class, direct lending has evolved over the last decade as a result of two significant dynamics that shifted traditional bank providers away from middle market financing. First, was the wave of bank consolidation beginning in the 1990s resulting in fewer (50% less),[1] larger banking entities focused on servicing larger companies that garner more profitable and scaled relationships. Second, was the enactment of several post Global Financial Crisis regulations that increased complexity and cost for banks, materially cutting into the profitability middle market financing once offered. To fill this void, asset managers began developing direct lending strategies providing institutional investors access to unique deal flow. These investments are senior in the capital structure, are secured by a company's assets, and provide attractive income potential — which compares favorably relative to liquid credit markets.

The impact of recent events and direct lending outlook

Given direct lenders are not reliant on banks to implement their investment strategies, impact to direct lending has been relatively minimal. In fact, the asset class likely stands to benefit from a continuation of bank retrenchment. While a net reduction in overall lending would have broader economic implications if companies on average have less access to capital with which to maintain and/or grow their businesses, it may also enhance the direct lending opportunity set in the form of attractive yield levels with lower leverage levels and more protective documentation.

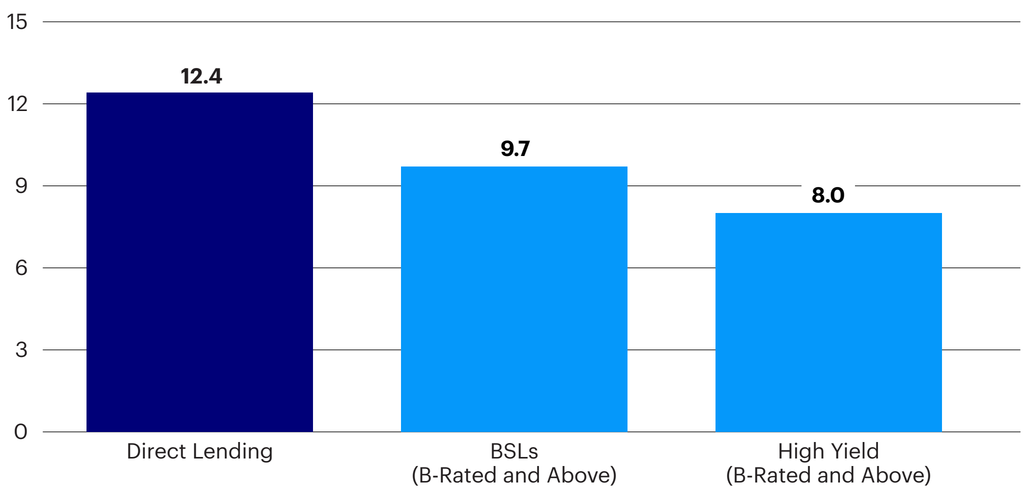
Either way, we continue to believe it will be key for direct lenders to operate with a risk mitigation/capital preservation focus. This includes originating loans that are:

- To industry-leading companies with demonstrated history of stable and visible cash flow.
- Senior in the capital structure.
- Secured by company assets.
- Underwritten with conservative leverage levels and well-supported by private equity sponsors.

- Accompanied by protective documentation (including maintenance covenants).
- Extensively stress-tested both prior to investment and during the monitoring process.

Importantly, the asset class continues to offer attractive yields on an absolute basis, as well as relative to liquid credit including broadly syndicated loans (BSLs) and high yield bonds. As seen below, direct lending transactions are now being underwritten with yields north of 12% — offering 270 basis points of yield above BSLs and 440 basis points above high yield.

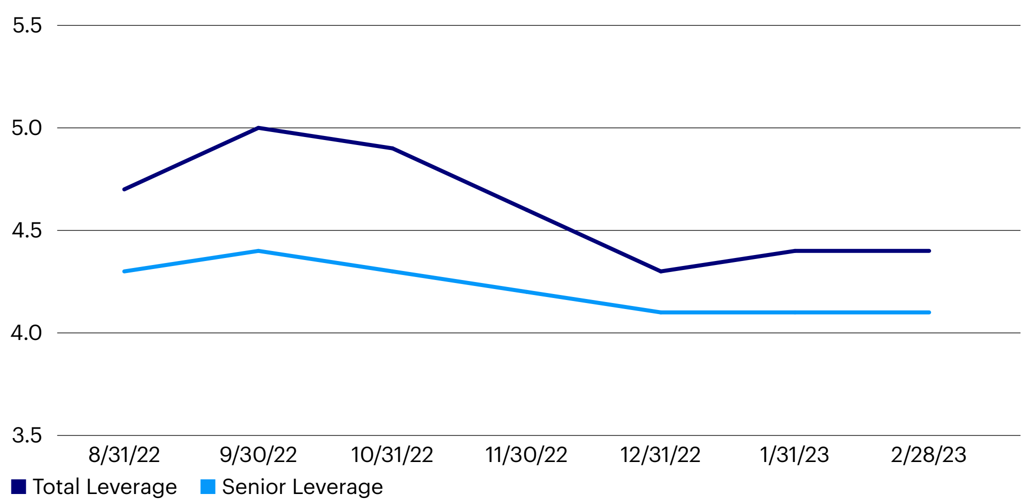
Figure 1: Asset class yields (%)



Source: Invesco and JP Morgan research, as of February 28, 2023. Direct lending yields represent directly originated senior secured first lien term loans.

Meanwhile, middle market companies continue be solid fundamentally with relatively healthy balance sheets and sufficient cash flow to cover debt service. Further, the tightening of monetary policy and prospect of broader US economic challenges that have characterized the broader market over the last several months have provided a backdrop for continued conservative lending structures and protective documentation. Indeed, recent direct lending transactions have been underwritten at lower leverage levels with large equity cushions and lower debt to enterprise values. Importantly, maintenance covenants continue to be a mainstay in the core middle market.

Figure 2: Direct lending average leverage multiples



Source: KBRA DLD, as of February 28, 2023. Direct lending yields represent directly originated senior secured first lien term loans.

Conclusion

While global banking fears have intensified, we believe recent events have minimally impacted direct lending investment strategies. Interestingly, a continued reduction in mid-size/regional bank lending to middle market companies may further enhance the direct lending opportunity set, especially for those lenders who emphasize risk mitigation/capital preservation in approach. Ultimately, we continue to believe direct lending remains well-positioned as an asset class given transactions should offer attractive income potential within more conservative structures and accompanied by protective documentation.

1. Federal Deposit Insurance Corporation, November 2022.

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