Investment
INSIGHTS

SEPARATING THE WHEAT FROM THE CHAFF IN DIRECT LENDING

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Institutional investors have continued to flock to direct lending for diversification and return throughout the post-GFC era. The current market environment, however, is starting to highlight that a rising tide does not necessarily lift all boats. Against this backdrop, many have come to recognize that managing through today's complex environment requires the hand of an experienced direct lender that can consistently — across market cycles — maintain robust origination, disciplined underwriting and conservative capital structures in order to deliver the return stability expected from the asset class.

When it comes to what has been attracting investors to direct lending, macro dynamics to date have generally served the asset class well. "As the space has grown over the past 10-plus years, we've seen greater awareness that the appeal of direct lending isn't just about the prospect of higher returns — it's higher returns coupled with characteristics of the asset class that we believe help minimize volatility and support the stability of those returns over time," said Trevor Clark, founder and managing partner of TPG Angelo Gordon's middle market direct lending business, TPG Twin Brook Capital Partners. "Not only is it a non-mark-to-market asset that is third-party reviewed, it's also a floating-rate asset class. As interest rates have moved up, direct lending has benefitted while other parts of the fixed-income spectrum have suffered."

That said, not all direct lenders are the same, and — for some — achieving the steady performance that has historically been characteristic of the asset class may be becoming easier said than done. The credit market had been relatively benign over much of the last decade, thus "a lot of different managers — regardless of their experience, consistency or discipline — were printing returns, which had made it more challenging to gauge differentiation," Clark pointed out. "But in today's marketplace, you're starting to see greater dispersion in default rates and returns. Not every market participant is going to be able to produce the same type of return — not only from an absolute level, but also from a durability standpoint."

"In this context, we're seeing investors renew their focus on underwriting processes, loan structuring, and the experience and infrastructure that teams already have in place. We believe all these factors will drive manager differentiation in the direct lending space over the coming years," Clark said.

SHIFTING DYNAMICS

Market and industry dynamics have shifted, with many borrowers feeling the pressure of persistently high interest rates that increase their cost of financing. "The looser underwriting standards and more aggressive capital structures that some lenders applied over the past several years may come back to haunt them," Clark said. "Given the stress that's being brought to bear on companies today, you can no longer get away with a looser view. Whether it's in the form of lending to companies that don't have the required stability of cash flows, increasing leverage without the appropriate interest coverage, or a lack of lender protections — all of those things are going to undermine a manager's portfolio, and eventually losses can occur."

Market indicators show that inflation is starting to ease and the cost of human capital for businesses is increasing at a slower pace. Nevertheless, direct lenders need to ask themselves, "Does the borrower have the pricing power to be able to maintain margins in this environment? That's going to play a part in sifting out the winners and losers in terms of credit selection, as well as structuring lender protections," Clark said.

STRONG UNDERWRITING & STRUCTURES

Asset owners need to identify lenders that have a history of return stability with a focus on consistently diligent underwriting and conservative loan structures. When it comes to structuring, in addition to accounting for things like leverage levels and where a manager sits in the capital stack, ensuring the appropriate lender protections are — and long have been — in place is important, Clark noted. "For example, it is worth evaluating financial covenants over the past five to 10 years; through that more borrower-friendly period, many lenders had been making covenant-lite loans."

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"Our view has never been that a good company doesn't get covenants," Clark said, as covenants really have more to do with the borrower-lender relationship. "We are only going to lend to companies we view as highly profitable and high performing. Covenants are not an indicator of the quality of a borrower but are instead a tool that gives the lender the ability to reprice risk," he said. "Well before the risk of nonpayment, a financial covenant enables a lender to have a dialogue with a borrower and assess underperformance. This is especially valuable if you are the lead lender and can thus drive repricing. With the right covenants in place, you have the ability to both come to the table before underperformance is material and to reprice the loan so you are paid for the company's current risk profile."

"Covenant defaults take place before payment defaults, so your ability to get involved, to take appropriate action, is going to prove to be very important going forward," Clark said.

ROBUST SOURCING & CAREFUL SELECTION

For managers in this space, the ability to deploy capital on a consistent basis is as important as the sourcing of that capital. "We've seen some managers that have proven to be very successful in raising capital in other parts of credit enter the world of direct lending, but they are much less experienced in deploying capital," Clark noted. When it comes to deployment, it is critical to consider whether a direct lender has access to a wide opportunity set so they can avoid potential selection bias.

Origination capabilities matter because they are key to creating a differentiated return, Clark explained. "You don't create a return just because the broader market goes up. You create a return by deploying your capital to the most attractive opportunities. You need to look at a large number of potential transactions, select the very best, do a significant amount of due diligence, and put an appropriate capital structure in place."

TPG Twin Brook looks at between 1,000 and 1,500 transactions in a typical year, selects approximately 9% that pass its criteria to achieve sustainable cash flows, and — following a two- to three-month due diligence process — moves forward with 3% to 4% of that subset.

For TPG Twin Brook, the ownership dynamic is another critical aspect of credit selection, as the team works solely with private equity-backed companies. "Our view continues to be that the value of the PE group — their operational oversight and capital support — more than outweighs the fact that you might get paid slightly less upfront," Clark said. "We think that's critical not only in terms of how these companies grow, but also in protecting our downside."

CONSISTENCY IS KEY

Asset owners looking to enter or expand into direct lending can assess potential managers by considering a variety of qualitative and quantitative factors. "First, it's important to understand the direct lender's strategy. Is it as attractive today as it was historically? Or has the manager had style drift?" Clark said. "The lender's team – including their historical experience, scale and turnover – is also key to look at."

To evaluate a manager's origination and underwriting capabilities, investors can ask a range of questions, he noted, including, "How are you sourcing deals? Is your capital formation in line with your deployment pacing? When you think about how you're producing a return, has that remained consistent?"

When it comes to successfully navigating through the current macro environment, Clark concluded, "We believe lenders that have maintained a long-term view — keeping their strategy consistent, origination capabilities robust, underwriting disciplined and loan structures conservative — will be among those best positioned to deliver stable performance and continue gaining market share moving forward." ■

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