Product Strategy

FIDELITY INSTITUTIONAL INSIGHTS

Searching for Yield

The tailwinds supporting direct lending

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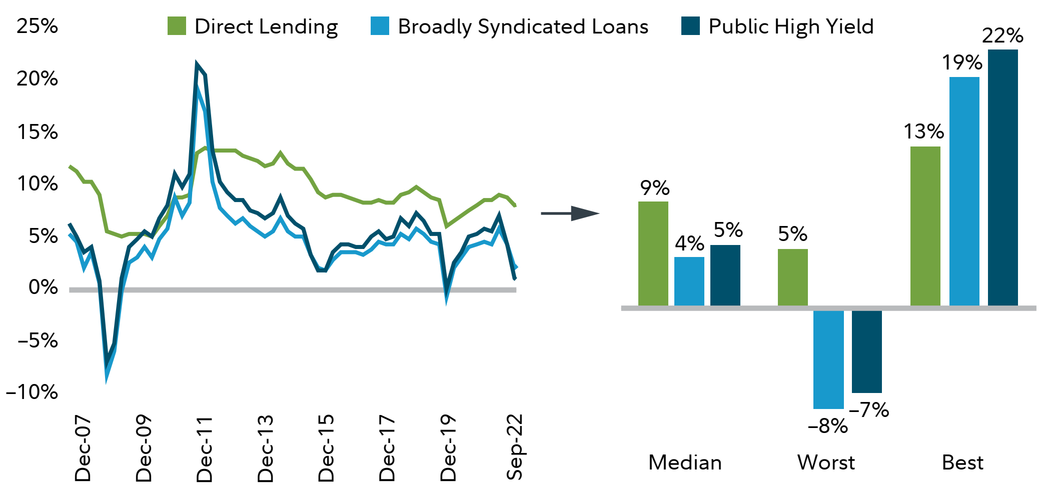
KEY TAKEAWAYS

- Direct lending has produced attractive returns for yield-seeking investors over two decades.
- Borrowers pay a premium to direct lenders, which boosts cash yields for investors.
- Structural tailwinds portend continued growth for direct lending and suggest the attractive return history may persist.

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

EXHIBIT 1: Rolling Three-Year Returns (2004 through Sept. 2022)



Past performance does not guarantee future results. Source: Bloomberg, as of 9/30/22. 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.

This long period of outperformance—coupled with an increase in capital directed toward private loans[2]—might be viewed as signs that the window of opportunity for direct lending could be closing.

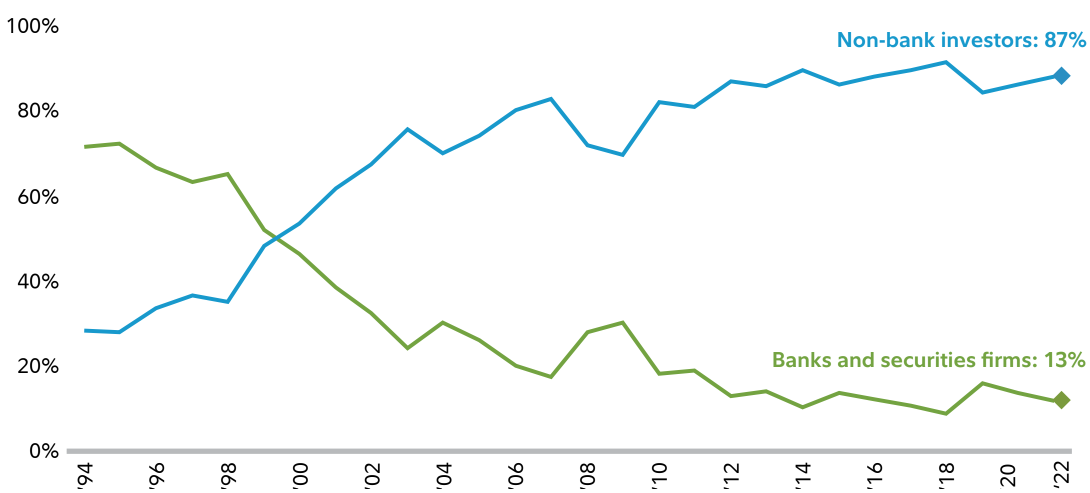
A close examination, however, reveals structural features supporting direct lending that suggest the attractive performance history may persist.

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

The private equity (PE) boom that began in the early 1980s required debt capital in scale to finance the leveraged buyout transactions by which PE managers acquire controlling stakes in private companies. During this period, banks played a leading role providing the financing required. Debt generally represents 40%–60% of the total purchase price for PE buyout deals.

Private equity enjoyed strong and steady growth over the years leading up to the global financial crisis. The market dislocation during this period brought buyout deal volume to a standstill in 2009. By the time markets recovered in 2010, further consolidation in the banking sector, coupled with bank regulatory reform, accelerated the already established trend of banks ceding share 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).

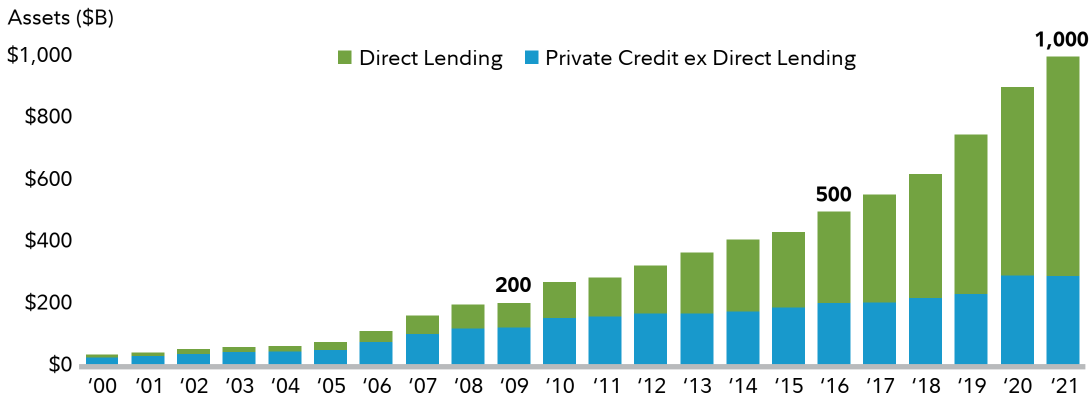
EXHIBIT 2: Non-bank Investors Fill the Void



Source: Pitchbook®, as of 9/30/22.

The retrenchment of banks, coupled with the strong rebound for PE deal volume, catapulted private credit from about $100 billion in assets in 2007 to more than $1 trillion in assets by 2021 (Exhibit 3).

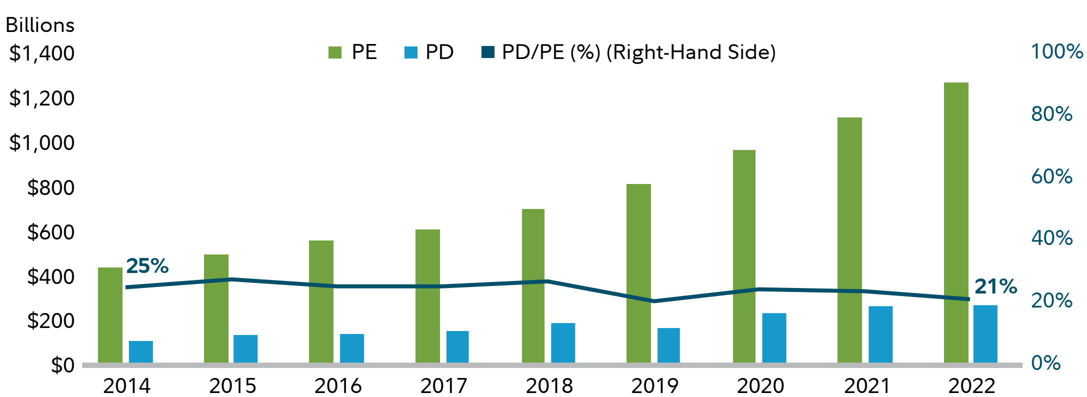
EXHIBIT 3: The $1 Trillion+ Private Credit Market



Source: Pitchbook®, Preqin, Cliffwater, Bloomberg, and Fidelity Investments, as of 12/31/21.

Over roughly the past decade, assets invested in PE funds, experienced more than 3X growth and PE fundraising continues to increase.[3] PE managers had about $1.1 trillion in "dry powder," or capital available to make additional investments, as of August 2022 (Exhibit 4). We believe the deployment of this capital will drive parallel demand growth for debt to support portfolio company acquisitions. By comparison, private debt (PD) managers had only about $270 billion of available committed capital, portending the need for additional debt capital to support future PE deals.

EXHIBIT 4: Dry Powder

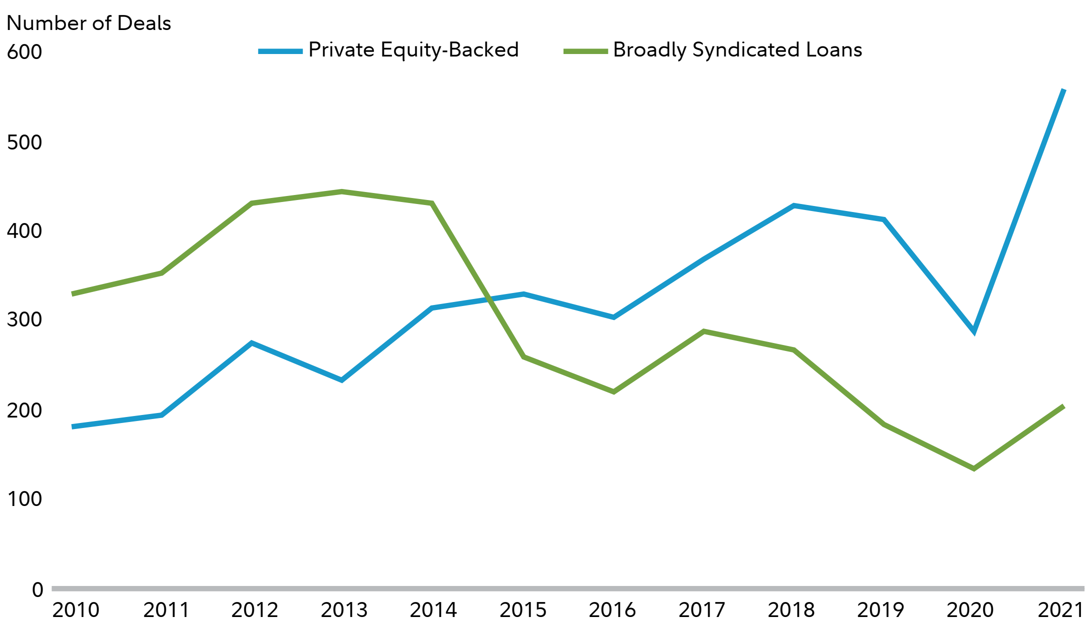


Source: Preqin, as of 8/31/22.

The opportunity in the middle market

PE managers tend to invest in private companies across a broad range of sizes. Disaggregating the PE buyout universe by scale, we find the middle market—companies on the smaller end of the PE universe roughly ranging in enterprise values from $100 million to $1 billion—to be 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 are able to capture a premium associated with the bespoke nature of these loans and their inherent illiquidity. The continuing trend toward 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 <$1B vs. BSL Issuance <$500M



Source: Pitchbook®, as of 9/30/22.

EXHIBIT 6: Typical Pricing and Leverage

LEVERAGED BUYOUT DEBT FINANCING

Leverage	Security Type	Pricing
3.5X–5X EBITDA	**1st Lien** Senior Secured Debt	SOFR[4] + 500–750 bps
1X–2X EBITDA	**2nd Lien** Subordinated	SOFR + 700–1200 bps

Key Features and Benefits of Direct Lending

- Speed and certainty of execution
- Pricing visibility
- Illiquidity 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 1/3/22 through 11/30/22.

For borrowers, the overall value proposition of direct lending supports premium pricing relative to other capital sources. Specifically, PE sponsors value speed and certainty of execution that 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).

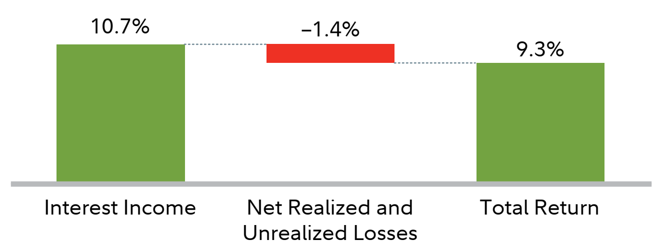
Negative skew: A closer look at defaults and losses

Notably, the trailing returns in Exhibit 1 are net of realized losses. That said, we believe 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. In contrast, on the downside, investors could experience a complete loss of their initial investment. As a result, a credit portfolio that experiences a loss would not benefit from any single holding that surprises to the upside to make up for a 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 favorable outcomes.

Understanding this feature of credit portfolios underscores the importance of the attractive loss history observed in middle market direct lending (Exhibit 7). The benefit is that investors in direct lending have kept comparably more of the headline contractual returns relative to competing yield-oriented asset classes, such as broadly syndicated loans and public high yield.

EXHIBIT 7: Default and Recovery Comparisons

DIRECT LENDING LOSS EXPERIENCE: SEPT. 2004–SEPT. 2022



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. Note: Return components may not add to Total Return due to compounding effects. Source: Cliffwater and Fidelity Direct Lending Team based on observed direct lending deal flow from 1/3/22 through 11/30/22.

There are structural features of middle market direct lending that suggest the attractive loss history may persist. Direct lenders are often able to negotiate maintenance-based covenants, which provide meaningful safeguards. These covenants often position direct lenders to have strong influence in 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.

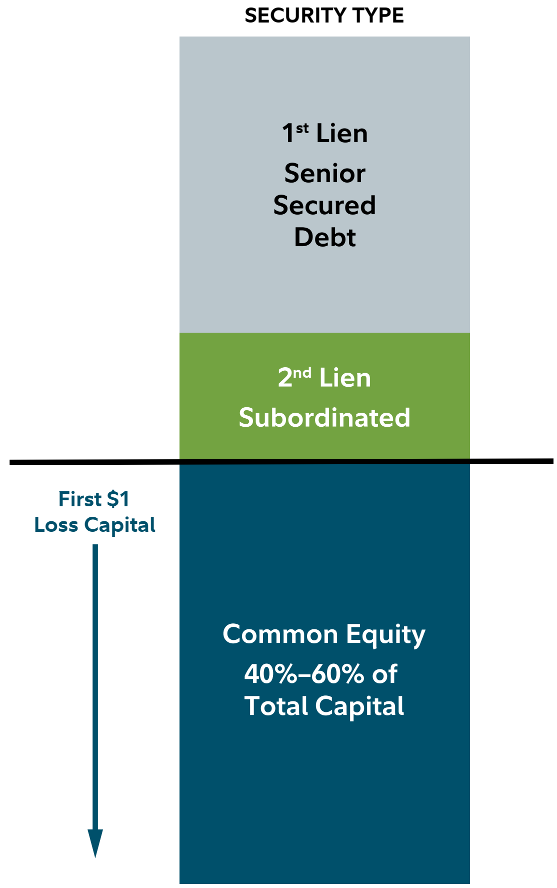
Another key factor is that PE sponsors acquire a controlling stake in each portfolio company. This empowers PE sponsors that bring deep operating experience and resources to drive improvements in operational efficiency. Sponsors also provide support for growth initiatives—both in charting a strategic path to drive organic growth and 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.

Additionally, in stress scenarios—with fewer lenders at the table—there is less of a chance of conflicting interests among lenders. This can facilitate collaboration to selectively support the portfolio company and PE sponsor in workouts.

Further, private companies tend to face a lower risk of business disruption in workout scenarios. Stakeholders are able to address their challenges beyond the view of competitors, suppliers, and customers, which affords an opportunity to take a more balanced, longer-term view as they chart the path forward.

EXHIBIT 8: Capital Structure for a PE Portfolio Company



Source: Pitchbook and Fidelity Direct Lending Team based on observed direct lending deal flow from 1/3/22 through 11/30/22.

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 the middle market, we believe direct lenders are well positioned to continue to capture much of the opportunity. 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, together have contributed to an attractive historical risk/return profile for middle market direct lending.[5] Understanding the structural features supporting premium pricing and favorable default and recovery rates suggest that the relative return advantage of middle market direct lending versus competing yield-oriented asset classes may persist.

All factors considered, we believe middle market direct lending may be an attractive and scalable asset class that warrants consideration in a thoughtfully constructed portfolio.

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	500–750 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 1/3/22 through 11/30/22.

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Fidelity Thought Leadership Vice President Mike Tarsala provided editorial direction for this article.

Endnotes

[1] Asset growth measured from 1/1/11 to 12/31/21 using data from Pitchbook®, Preqin, Cliffwater, Bloomberg, and Fidelity Investments, as of 12/31/21.

[2] See Exhibit 3.

[3] Source: Preqin, as of 12/31/21

[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.

[5] Past performance is no guarantee of future results.

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