DIRECT LENDING: CAN THE MARKET SUPPORT EXPANSION?

Strong fundraising and a record level of new funds in market will see the direct lending explosion continue into 2018. With dry powder already at historic highs, will the opportunities exist to put this money to work effectively?

THE GROWTH OF DIRECT LENDING

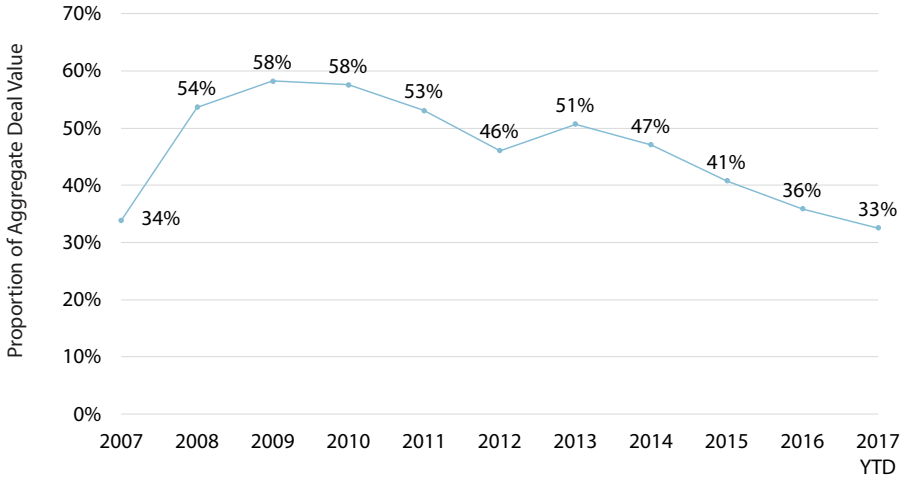
Private debt fund managers have enjoyed a wave of fundraising success in recent years, driven by the strong performance of private lending funds and the resulting investor appetite. Since 2007, positive risk-adjusted returns throughout the credit cycle, contrasting with lacklustre results from traditional fixed income products, have attracted record numbers of investors to direct lending, while existing backers have increased allocations. 2017 is set to be another strong year for new fundraising; with $39bn raised through 49 funds, dry powder is at a record $74bn, and there are an additional 153 funds in market seeking an aggregate $65bn. With so many firms now active with significant levels of capital available to deploy, is there a danger that competition for opportunities could drive down future returns? We examine the growth of the industry and analyze key indicators from the buyout market to place the dry powder reserves in context.

Increasing numbers of commitments have led direct lending fund managers to up their fundraising efforts, seeing bigger and more aggressive funds expand into larger markets and larger loan facilities across the board. Direct lending specifically has seen growth in transaction sizes in recent years, as deals that were once the territory of banks, broad syndication or high-yield fixed income are now on the radar of direct lending fund managers. Additionally, there are outstanding credits that stand to be refinanced in the years to come, which offer another avenue of opportunity for alternative lenders.

The types of deal entered into by direct lending managers can vary between sponsored and non-sponsored transactions, the former involving a private equity sponsor providing, on average, 40% equity to a deal where the direct lending manager traditionally provides around 60% debt to a buyout. The percentage of equity used in buyout deals has ranged from 30% to more than 50% since 2000.

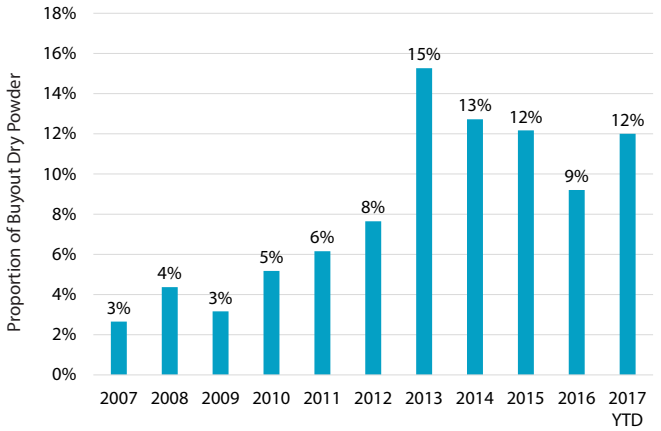
It is clear at this point that non-bank lending has carved out a strong slice of the marketplace and will continue to be a large part of both sponsored and non-sponsored corporate lending in coming years. Using buyout dry powder and sponsored deal statistics, we can examine the fundraising and deal-making opportunities at hand for private debt managers in 2017 and beyond.

Fig. 1: Proportion of Global Aggregate Buyout Deal Value Accounted for by Deals of Less than $1bn in Total Value, 2007 - 2017 YTD (As at November 2017)



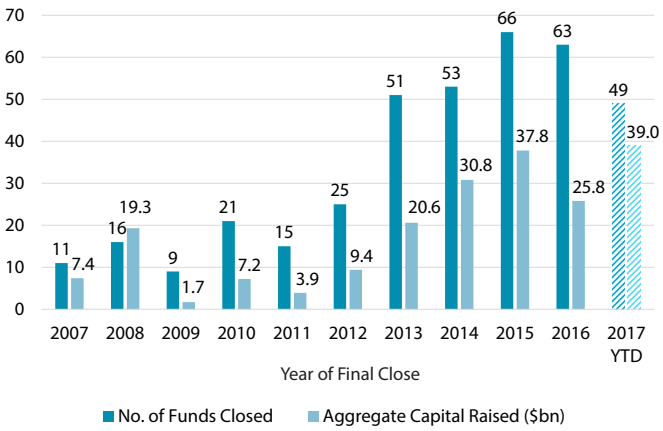
Source: Preqin Private Debt Online

Fig. 2: Direct Lending Dry Powder as a Proportion of Buyout Dry Powder, 2007 - 2017 YTD (As at November 2017)



Source: Preqin Private Debt Online

Fig. 3: Annual Direct Lending Fundraising, 2007 - 2017 YTD (As at November 2017)



Source: Preqin Private Debt Online

BUYOUT vs. DIRECT LENDING DRY POWDER

Since a large proportion of direct lending deal activity depends upon private equity-backed buyout deal activity, we examine the ratio of direct lending dry powder to that of the buyout industry. Currently, direct lending managers hold $74bn in dry powder and buyout fund managers have $603bn – a ratio suggesting plenty of additional capacity. When viewed historically, the ratio of direct lending to buyout dry powder has narrowed slightly (Fig. 2), but still appears to allow plenty of scope for direct lending funds to be selective in the transactions they support. However, not all buyout deals will fall into the sweet spot for direct lending, and it is possible to provide a more specific measurement for direct lending as a proportion of the addressable market.

ADDRESSABLE MARKETS

While the strict parameters of the market segment accessible for financing from direct lenders can vary, the bulk of activity has taken place in the broad "middle market", which includes the lower- and upper-middle market segments.

Typically, the lower-middle market has been defined as enterprises with $5-50mn in EBITDA, with the upper-middle market spanning enterprises with EBITDA from $50mn to above $100mn*. Additionally, several fund managers are expanding above the traditional boundaries of private lending managers by moving into deals requiring larger credit facilities, which used to be exclusively financed by banks, high-yield markets or broadly syndicated loans.

LENDING CAPACITY

Since 2007, an average of 46% of aggregate buyout deal value is accounted for by deals with a total value of less than $1bn, the size range in which private debt managers can effectively compete against traditional debt providers (Fig. 1). By this metric, $277bn of current available buyout capital ($603bn*46%=$277bn) stands to be supported by private debt capital as at November 2017.

As mentioned earlier, buyout transactions have typically involved about 40% equity and 60% debt, with the percentage of equity used in these deals having ranged from 30% to above 50% since 2000. Using $277bn of current buyout dry powder as the 40% equity portion of future middle-market buyout deal value, the private lending portion can be projected at $416bn. In other words, there is an estimated maximum of $416bn in alternative financing capacity, as dictated by the $277bn of buyout dry powder which is likely to be allocated towards transactions within the deal size range addressable by private debt.

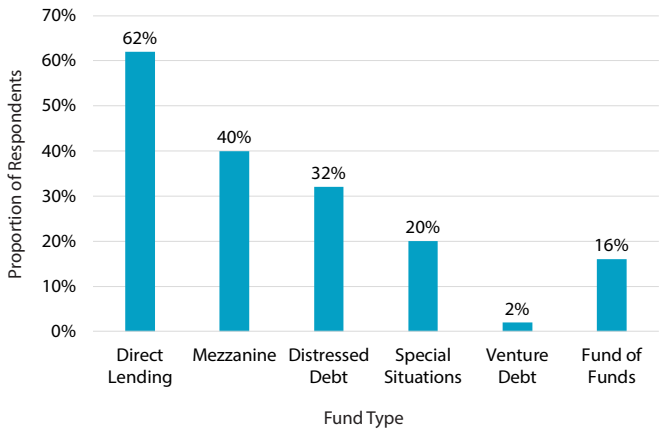
OUTLOOK

Direct lending dry powder sits at $74bn (compared to $416bn in estimated capacity) as at November 2017, so there would appear to be significant runway for the continuation of strong deal flow and fundraising cycles within the private debt environment, especially given lenders with larger platforms expanding into formerly high-yield and syndicated loan territory, which requires the writing of larger checks. Capacity could increase even further: according to Michael Mauer at CM Investment Partners, the debt opportunity which includes both new funds and refinancing exists in the range of $600bn+ in the near future.

Direct lending fundraising has been strong since 2013, peaking in 2015 on $38bn (Fig. 3). With 2017 YTD commitment levels at a record high of $39bn, managers are on pace to finish out the year well above previous fundraising totals. There are clear signals that direct lending, as well as other private debt strategies across the capital stack, is sustaining the momentum gained in the past decade, seeking to fulfil both the current and upcoming potential buyout opportunities.

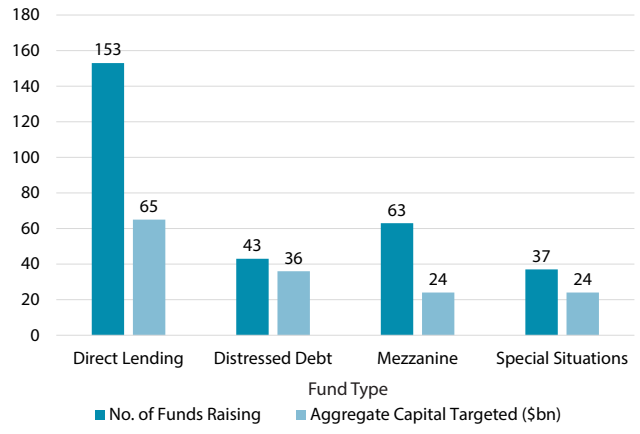
Given estimated lending capacity above $400bn, any concerns about an overheated lending fund environment appear to be unfounded, even as fundraising and dry powder set new record highs. There is space for growing demand to be fulfilled by quality private debt opportunities, due to the consistent opportunity for capital to be deployed into addressable buyout activity in coming years. Strong returns and consistent deal flow throughout debt cycles should be enough to satisfy fund investors and secure continued commitments in the near future, given consistency and growth in the buyout market as well.

Fig. 4: Fund Types Investors View as Presenting the Best Opportunities



Source: Preqin Investor Interviews, June 2017

Fig. 5: Private Debt Funds in Market by Type (As at November 2017)



Source: Preqin Private Debt Online

** Definitions do vary based on the manager and their market preferences.*