How senior is your debt?

Uncovering hidden risk and opportunity in Direct Lending

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Within private credit, direct lending offers a wide range of options for investors seeking the right balance of risk and reward for their particular needs. However, recent market developments have created anomalies which can result in sub-optimal risk-adjusted returns – understanding these incremental risk factors is vital to ensure your investments align with your intended approach.

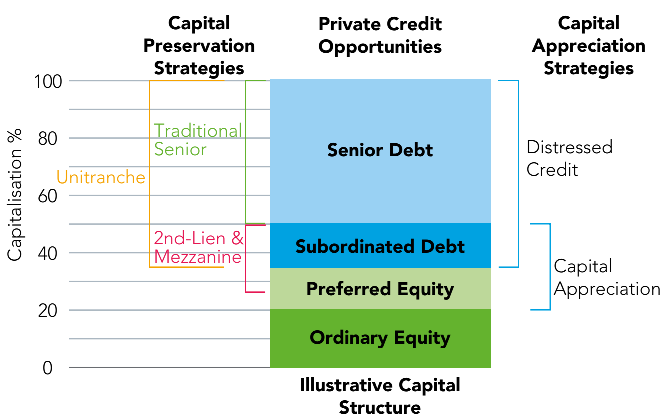
In this report, we propose a framework for analysing risk-adjusted returns for different direct lending strategies within private credit. We also discuss current market pricing and analyse whether investors are being fairly compensated for incremental loss factors such as leverage, subordination, and covenant light (cov-lite) documentation. We begin the discussion by looking at developments in the types of strategies widely acknowledged to make up direct lending as a subset of private credit.

Part One: An introduction to private credit strategies

Private credit: capital preservation vs. capital appreciation

Private credit is broadly described as non-bank lending where the debt is not issued or traded on public markets. An array of opportunities exist within private credit, each with its own unique set of risk-return characteristics. These can be loosely categorised according to where they sit in the capital structure, as well as whether the ultimate objective is capital preservation or capital appreciation. Figure 1 shows the position of various credit strategies within the capital structure, along with where in the stack private credit funds tend to invest depending on whether they are seeking capital preservation or capital appreciation.

Figure 1: Credit strategies according to capital structure



Source: Federated Hermes.

> **An array of opportunities exist within private credit, each with its own unique set of risk-return characteristics.**

Returns from capital preservation strategies (the primary focus for direct lending funds) are non-normal and negatively skewed. This is due to the high proportion of small gains, low number of unexpected gains, and low proportion of outsized losses involved. Investors in these strategies are usually seeking a predictable income yield. Loss mitigation is also fundamental to this type of approach, since opportunities for making unexpected gains are limited.

By comparison, capital appreciation strategies offer greater upside potential due to equity participation. Strategies include distressed debt and certain forms of subordinated debt as well as preferred equity. Returns are positively skewed, with a small number of large gains but with more frequent expected losses due to the riskier nature of investments.

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Direct lending strategies

In terms of risk/return, direct lending is situated between high-yield bonds and mezzanine debt on the fixed income spectrum. Typical direct lending strategies include senior secured debt, which sits at the top of the capital structure, and subordinated debt in the form of second lien and some types of mezzanine debt, as well as a hybrid approach known as unitranche. In the event of default, expected losses (measured as a percentage of exposure at default) are not uniform across the capital structure. Subordination determines the order in which recovery proceeds are distributed among lenders and increasing financial leverage is associated with increased default risk.

Senior secured debt: This sits at the top of the capital structure – in the event of default, senior lenders' claims are prioritised ahead of other types of investors sitting beneath them. Only after senior secured claims have been fully redeemed will other creditors recover any debt owed to them from enforcement proceeds.

Subordinated debt: The level below senior debt in the capital structure is called subordinated debt – sometimes referred to as junior debt. This offers a higher yield than senior secured debt in exchange for the higher risk of losses implied by the lower position in the capital structure. Types of subordinated debt include second lien and mezzanine:

- **Second-lien debt** is a type of subordinated debt that includes a subordinated claim to the pledged security.
- **Mezzanine debt** is a type of subordinated debt that is unsecured, making it lower priority than second-lien debt.

Mezzanine debt can be employed in either capital preservation or capital appreciation strategies, depending on the exact nature of the loan. For example, mezzanine loans often include equity warrants which allow the investor to convert their loan (or preferred stock) into common equity and assume control if the business runs into difficulty. If a mezzanine fund has a longer-term investment horizon and its performance is dependent upon the manager's ability to influence restructuring outcomes, then its strategy is likely to have a capital appreciation focus.

The rise of unitranche

Over the past decade a hybrid loan structure that combines senior and subordinated debt into one instrument has risen to prominence. Known as unitranche, it, in theory, pays a blended interest rate that reflects the spread of risk between senior and subordinated debt tranches.

Unitranche has rapidly become the most popular strategy in direct lending. According to Deloitte's Alternative Lender Deal Tracker (Spring 2021)[1], unitranche made up half of all European transactions over the previous 12 months, while an even higher proportion of UK transactions (63%) used the structure. By comparison, senior loans made up 33% of deals in Europe and only 27% of UK transactions, with the remainder of transactions comprising subordinated loans.

One of the main drivers for unitranche's rise in popularity is its convenience and certainty of execution. There are generally fewer lenders in unitranche structures (usually one or two), with the borrower receiving one set of pricing and a single loan agreement. In addition, although unitranche is usually more expensive, it is simpler and, crucially, facilitates greater leverage. Companies owned by private equity (the primary market for direct lenders) are particularly attracted by unitranche's higher leverage as it enhances internal rates of return if the investment performs well. Meanwhile, from the investment manager's standpoint, unitranche is appealing because it widens the distribution of expected returns and can supercharge deployment rates over a small number of large loans. Unitranche also offers higher yields than traditional senior debt, albeit with additional risk.

While all unitranche loans share some fundamental characteristics, the product is far from standardised. As a result, investors need to analyse incremental loss factors carefully to understand whether increased risks are fully compensated for by the improved yield.

Part Two: Incremental risk factors in Direct Lending

This section describes three incremental risk factors to consider when investing in direct lending:

1. Higher leverage

2. Bifurcated unitranche

3. Cov-lite loans & weak documentation.

1. Higher leverage means higher expected losses

Whilst higher leverage is attractive to borrowers and their private equity owners, it brings higher risk in the form of higher expected losses (EL). EL is the cornerstone risk measure for any credit investor and forms the basis for assessing risk-adjusted returns. It is calculated as the product of probability of default (PD) and loss-given default (LGD), both of which are impacted by higher financial leverage.

Multiple studies have highlighted the central role that leverage plays in the assessment of EL.[2] Traczynski (2017) has also shown that, when predicting corporate defaults in private markets, leverage (as measured by the ratio of total liabilities to assets) is the only financial measure correlated with defaults across all industry sectors.

The Merton model[3] suggests that a borrower will default if the value of its assets is less than the value of its liabilities at the point its debt matures. Under this model, all credit risk components, including default and the recovery rate, are directly linked to the capital structure of the borrower, with increasing leverage driving higher PD scores.

[1] https://www2.deloitte.com/content/dam/Deloitte/lu/Documents/private-equity/lu-deloitte-alternative-lender-tracker-spring-2021.pdf

[2] For example Merton, 1974, Collin-Dufresne and Goldstein, 2001, Vassalou and Xing, 2004, Bharath and Shumway, 2008.

[3] The Merton model, developed by Robert C. Merton in 1974, is an analytical model used to assess the credit risk of a company's debt.

To illustrate how LGD is impacted by higher leverage, consider an enforcement scenario resulting in the recovery of 50% of capitalised value of the firm's capital structure presented in Figure 1. In this scenario, mezzanine providers would suffer a 100% loss, while unitranche holders would incur a 30% loss. Conversely, traditional senior secured lenders would see 100% of their investment returned with zero losses.

Remembering that EL is the product of PD and LGD, we can see that, since leverage impacts both PD and LGD, increased financial leverage will result in non-linear increases to EL.

2. Bifurcated unitranche

Unitranche loans come in two different types: straight and bifurcated.

If an investment manager holds the entire loan, it is considered to be 'straight unitranche' and can usually be described as a senior secured loan. 'Bifurcated unitranche', on the other hand, is presented as a single facility but is split into two separate constituents. These elements are known as first-out (FO) and last-out (LO), and are divided among at least two or more lenders.

The FO tranche (referred to as super senior, where the facility is non-term debt) typically involves a revolving credit facility (RCF) but may also include a certain portion of the term loan. If a manager sells the first-lien portion of a unitranche loan to a third-party lender and retains the LO piece, the retained portion becomes a riskier subordinated loan.

Risk associated with bifurcated unitranche loans

Typically, FO and LO loans are equally ranked in the payment waterfall in the ordinary course, so the senior secured label is retained. Importantly, however, in the event of default or acceleration the waterfall transforms, FO lenders are paid ahead of LO obligations.

It should be noted that the European mid-market has seen a proliferation of bifurcated unitranche structures which include 'subordination' features that only crystalise at the point of enforcement. For these loans, the 'senior secured' classification is only valid on a technicality – the reality is that bifurcated unitranche loans are commercially subordinated loans.

As a result, when considering unitranche as a capital preservation strategy, investors should be clear about whether the manager holds the entire loan or bifurcates its position by selling FO tranches to third-party lenders.

Investors should also consider that undrawn super-senior facilities (i.e. working capital or capital expenditure facilities) will often be drawn at the first sign of financial distress to minimise cashflow pressure. This tendency was observable throughout 2020 as cashflow pressures arising from Covid-19 resulted in super-senior RCFs becoming fully drawn. As a result, many unitranche investors unexpectedly found themselves in a first loss position, suddenly subordinated to a third-party lender at the point of enforcement.

3. Cov-lite: another hidden risk for credit investors

We have already seen how a bifurcated unitranche structure can unexpectedly put lenders in a first loss position and explored the higher EL created by increased leverage. However, these are not the only incremental risks that investors should consider.

The prevalence of cov-lite loans is becoming widespread at the upper–mid and larger end of the deal spectrum and sponsors are seeking increasing flexibility in the packages they put in place. According to S&P Global Market Intelligence Leveraged Data & Commentary, at the end of 2018, a record proportion – 87% – of new issues of leveraged loans in Europe were covenant lite. These loan agreements do not contain any protective covenants that allow lenders to intervene if the financial position of the borrower deteriorates.

[4] https://www.lma.eu.com/application/files/9015/5619/1956/Fitch_Unitranche_Versus_Syndicated_Leveraged_Loans_10063891.pdf

To complicate matters, some understanding of the calculations that govern covenants should be sought when making a direct lending allocation. In particular, the level of covenant headroom that a fund manager grants to its borrowers (for net leverage) should be understood. At the international business of Federated Hermes, our track record is 31% headroom at loan origination across all funds, demonstrating our strict adherence to tight documentation controls.

The rise of cov-lite structures is the result of rising assets under management among direct lenders with increasing competition for the same volume of deals, resulting in more flexible terms being offered to borrowers. The vast amounts of money searching for a return has resulted in borrowers being able to dictate terms, and hence most syndicated loans are now cov-lite, or covenant free – 88% in 2018 and 95% in H1 2019.

According to Fitch Ratings[4], while leverage is higher for unitranche than for syndicated loans, covenant protection for lenders remains stronger (as indicated by the presence of financial covenants) however unitranche documentation shows significant covenant erosion between 2014 and 2018 with only a third of unitranche deals having a full set of covenants in 2018.

Cov-lite plus weak credit quality: a volatile combination

Adding to the issue of cov-lite structures is the problem of weakening credit quality. The proportion of B-rated facilities in the European Leveraged Loan Index doubled between December 2017 and April 2019 to hit 12%. In a bear market, where secondary market liquidity may be hard to find, this is a recipe for high-price volatility.

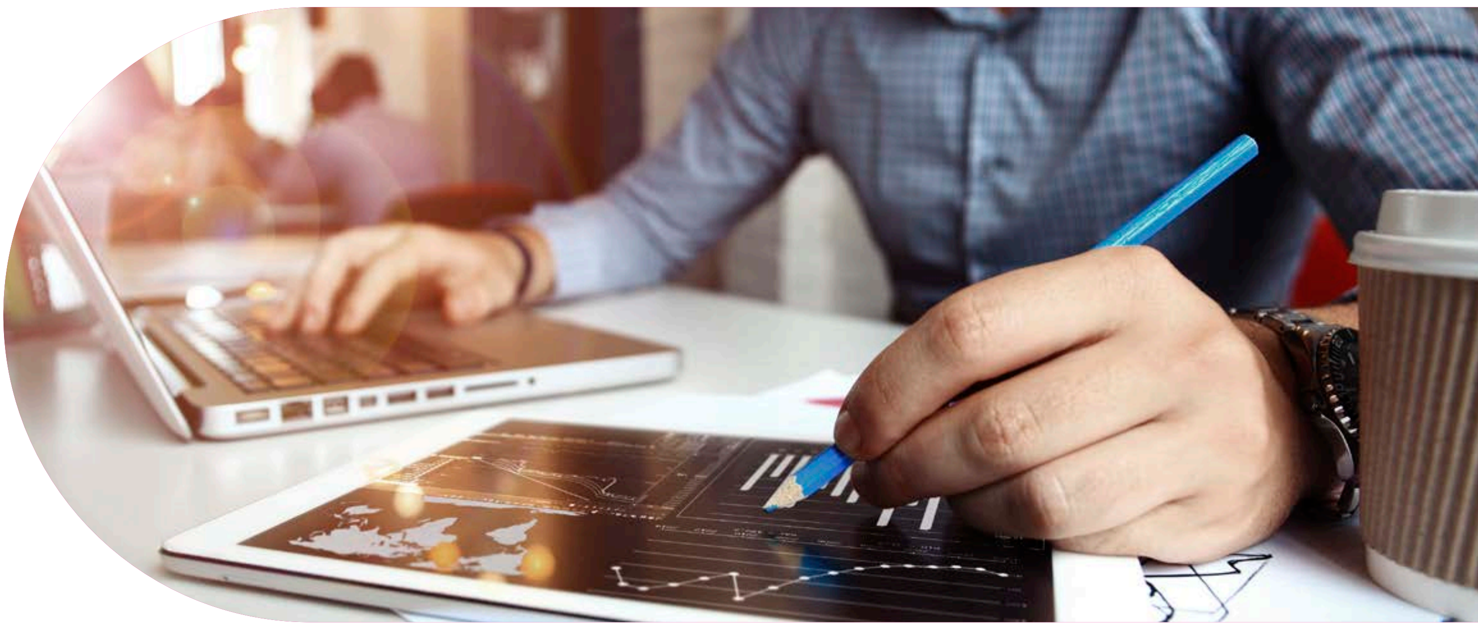
S&P recently reviewed recovery rates for both cov-lite and non-cov-lite first-lien term loans for over 67 entities that emerged from Chapter 11 bankruptcies between 2014 and the first half of 2020. Their analysis showed that cov-lite loans (excluding the oil & gas sector) recovered on average c.61.8% of par, well below the c.75.8% average realised by non-cov-lite.

Our view is that an absence of maintenance covenants reduces the timescale for lenders to affect restructuring outcomes, thus eroding value for investors. With this in mind, the international business of Federated Hermes prefers to target the European middle-market where cov-lite features remain extremely rare. Investors should expect that, going forward, recoveries in cov-lite loans will be lower than long-term recovery averages would predict. Indeed, we expect that with investors in cov-lite instruments more heavily exposed, first-lien recoveries in general will be lower than the historical average through the next credit cycle. We would point to historical secured bond recovery rates as a decent proxy for how cov-lite loans will perform through the next down cycle.

Part Three: Comparing risk-adjusted returns

We have created a framework to compare risk-adjusted returns for differing direct lending strategies within private credit, as well as understanding the impact of incremental risk factors. To do this, we have collected observable market pricing for both unitranche and traditional senior secured loans. We have then modelled a typical enforcement scenario, where variability in credit quality is explained solely by the capital structure.

It is important to note that this analysis is not intended to show (indicatively or otherwise) expected returns for a given strategy. Rather, the intention is to create a means of benchmarking the relative performance of each strategy as a function of expected yield and default risk.This section is split into three parts. The first discusses how the capital structure, including leverage and equity contributions, vary according to loan type; the second part discusses current market pricing; and the third part describes a quantitative approach to measuring 'risk' in private credit using PD and LGD scores.



1. Capital structure

The first-step in building this framework is to understand how enterprise values (EVs) have evolved in recent years and compare these valuations to leverage multiples across unitranche and senior secured loans.

EVs are often expressed as a multiple of EBITDA (i.e. EV / EBITDA), much in the same way as leverage (i.e., net debt / EBITDA). S&P Market Intelligence data shows the average EV multiple for LBO transactions was 12.0x in 2020 and EVs have steadily increased between 2014-20, with 10x EBITDA being the average EV/EBITDA multiple over this period.

Unitranche's higher total leverage tolerance allows private equity sponsors to meet rising enterprise values in their LBO transactions while keeping equity contributions to a minimum, therefore, protecting the sponsor's return targets.

In order to compare leverage available to borrowers through unitrache and traditional senior secured loans, we refer to Fitch Ratings' leveraged credit portfolio which shows, on average, that unitranche provides over a turn and a half of additional leverage compared to the syndicated loan market.

At around 7.0x total debt to EBITDA (fully drawn), the median figure for the 32 Fitch deals shows that unitranche can stretch leverage and requires relatively smaller equity contributions from the Private Equity sponsor (see Figure 2 opposite), thereby reducing the 'safety buffer' available to lenders under a downside scenario.

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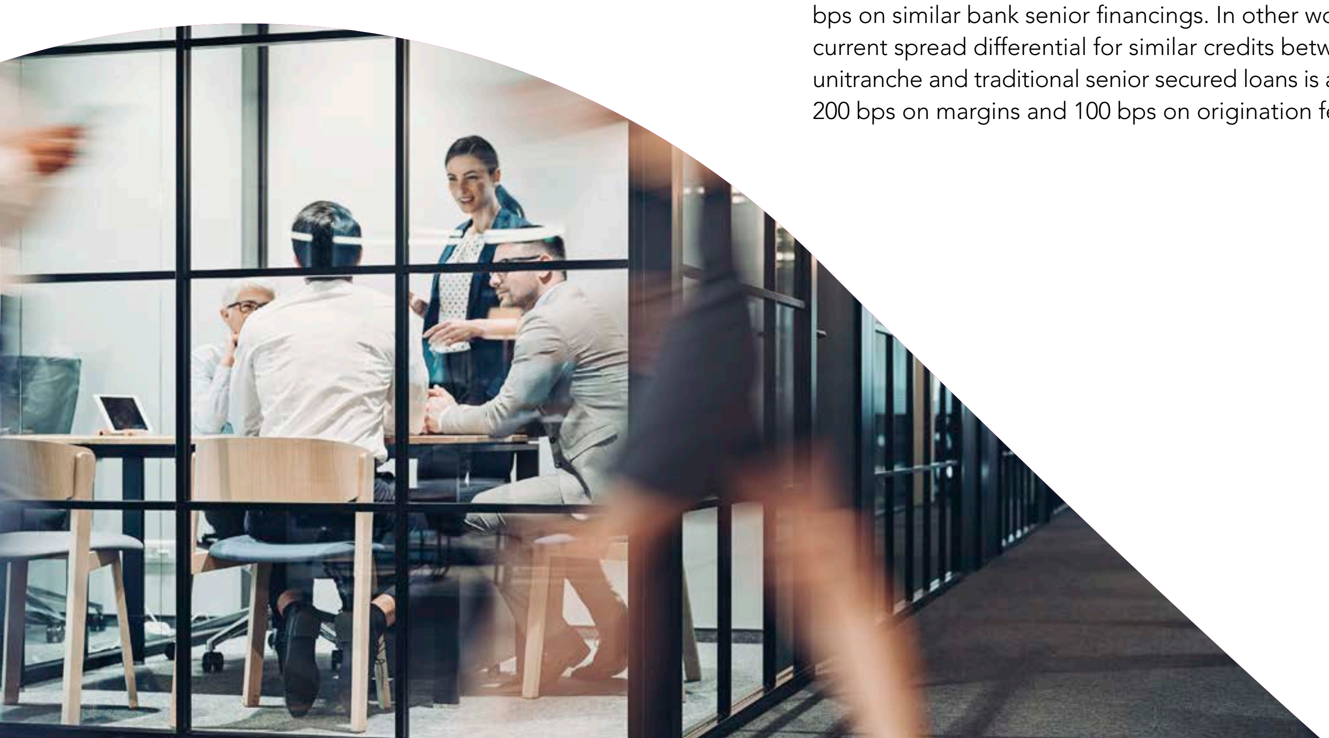
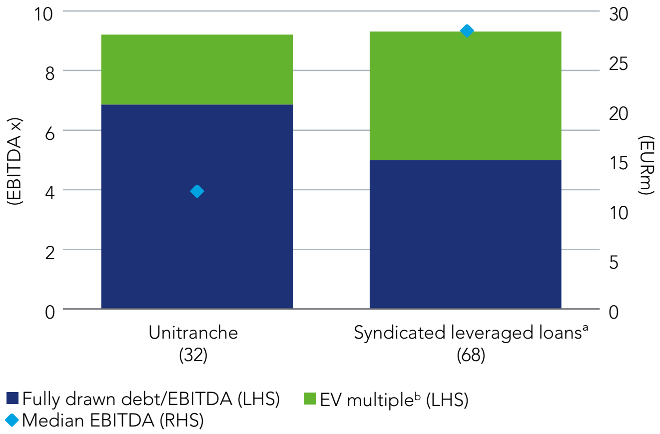


Figure 2: Median EBITDA, leverage and EV multiple in deals below €200m debt
2013-2018, primary market LBO/SBO/TBO/QBO and refinancings



[a] Includes a few club deals.
[b] Applies to LBO, SBO, TBO, QBO only.
Source: Fitch Credit Opinions Database, as at February 2019.

2. Market pricing

Historically, returns on leverage in excess of traditional senior secured risk would provide a coupon similar to a mezzanine loan. Unitranche would thus approximate the weighted average of senior secured and mezzanine pricing. However, the recent push to deploy capital has created a new paradigm, with blended pricing edging lower to reflect second-lien pricing on incremental leverage. This makes sense if unitranche leverage is below that of a traditional mezzanine loan. However, at higher leverage investors should expect pricing closer to mezzanine debt, especially if a lender holds the LO position in a bifurcated unitranche deal.

We observe margins of 575 – 650 basis points (bps) with origination fees of 325 – 375 bps on recent European unitranche transactions for the best credits, as compared to a margin range of 375 – 450 bps with origination fees of 225 – 275 bps on similar bank senior financings. In other words, the current spread differential for similar credits between unitranche and traditional senior secured loans is approximately 200 bps on margins and 100 bps on origination fees.

Despite the negative impact on recovery expectations of incremental risk factors such as cov-lite documentation and bifurcation, there is little or no evidence to suggest that investors are compensated for such features (over and above standard unitranche pricing). Instead, pricing and terms are largely driven by supply and demand dynamics, with increasing competition among direct lenders resulting in deteriorating credit standards.

3. Expected loss

The final component that is needed to devise a methodology for comparing risk-adjusted return is expected loss (EL) which is the product of loss given default (LGD) and probability of default (PD).

Loss Given Default

LGD expresses the magnitude of loss following an event of default. It is calculated as the exposure at default less the recovery rate (RR).

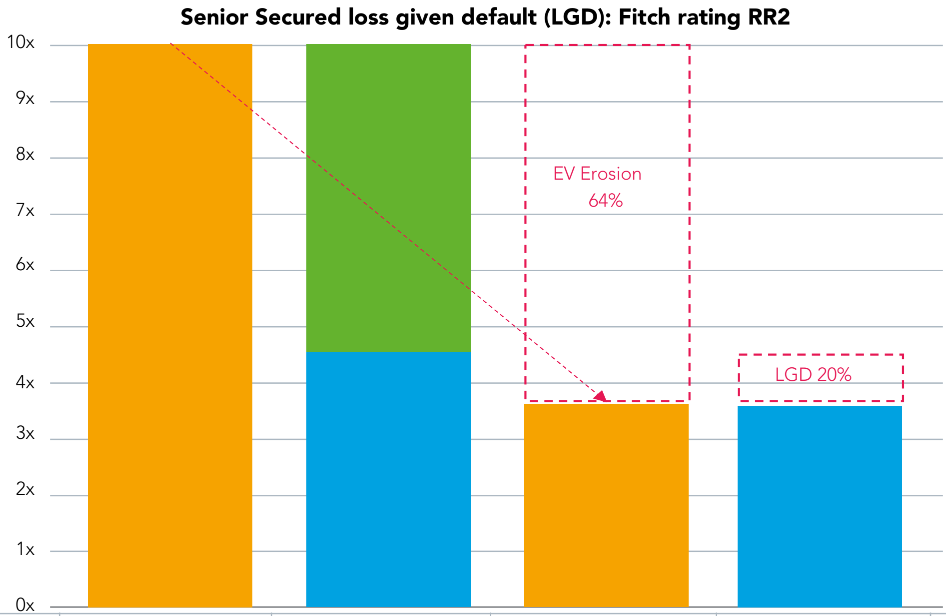
Fitch employs a recovery rating system ranging from R1 (highest probability of recovery) to R6 (lowest probability of recovery) which is applied to corporates with ratings of B+ or below (see the recovery ratings matrix in Figure 3 below).

Figure 3: Fitch recovery ratings matrix

Fitch Recover Ratings	
R1	91-100%
R2	71-90%
R3	51-17%
R4	31-50%
R5	11-30%
R6	0-10%

Source: Fitch Ratings: CorporatesRecovery Ratings and Instrument Ratings Criteria, as at April 2021. https://www.fitchratings.com/research/corporate-finance/corporates-recovery-ratings-instrument-ratings-criteria-09-04-2021.

Figure 4: Senior secured recovery rates



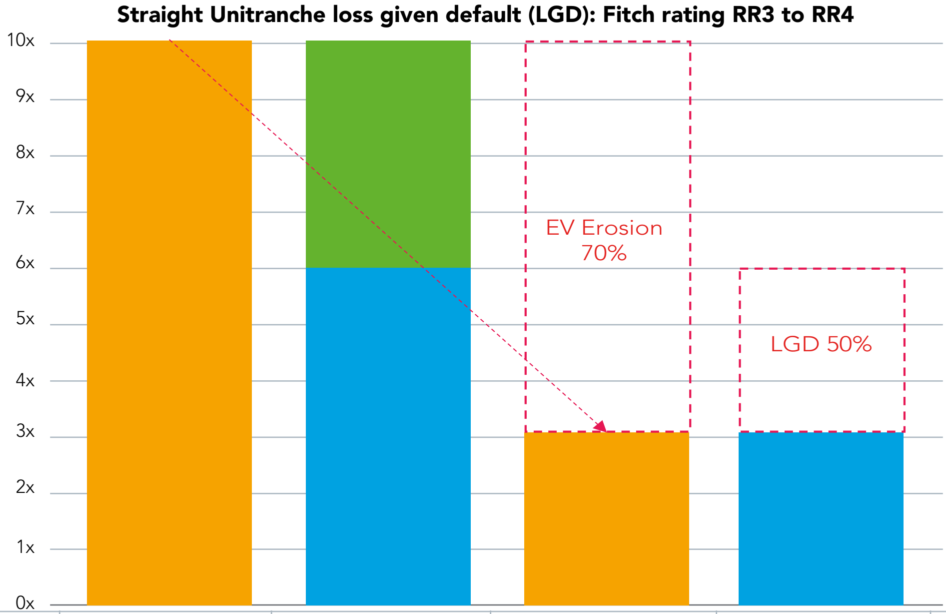
Loan type	Enterprise value (EV) at origination	Capital structure at origination	EV at default	Capital structure at default	LGD %
Enterprise value	100	–	36	–	64%
Equity value	–	55	–	Zero	100%
Loan value	–	55	–	36	20%

Source: Federated Hermes, as at August 2021.

Data published by Fitch covering petitions between 2003 and 2019[5] shows an average LGD of 22% for first-lien senior secured term loans, putting senior secured loans in the RR2 band (i.e. recovery of 71-90% of value) which is illustrated in Figure 4.

[5] The full report, "Ultimate Recovery Rate Study: Solid First-Lien Term Loan Recovery Rates," is available at www.fitchrtaings.com. https://www.fitchratings.com/research/corporate-finance/most-first-lien-term-loans-see-strong-recoveries-01-10-2019.

Figure 5: Straight unitranche recovery rates



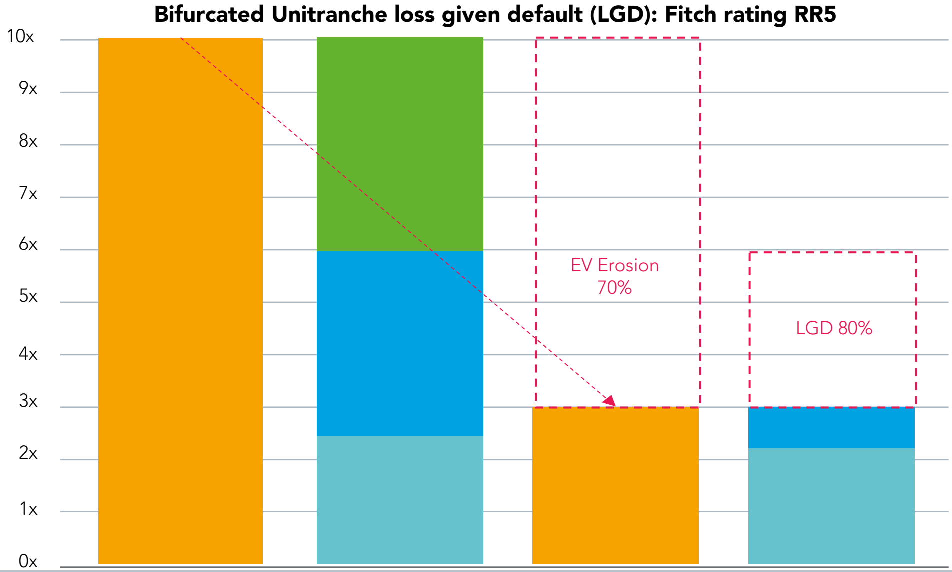
Loan type	Enterprise value (EV) at origination	Capital structure at origination	EV at default	Capital structure at default	LGD %
Enterprise value	100	–	30	–	70%
Equity value	–	40	–	0	100%
Loan value	–	60	–	30	50%

Source: Federated Hermes, as at August 2021.

As illustrated in Figure 5, Fitch's research for unitranche loans (published in February 2021) puts recovery rates for first lien unitranche in the 'RR3' to 'RR4' range[6].

[6] https://www.fitchratings.com/research/corporate-finance/first-out-lenders-see-strong-recoveries-03-02-2021.

Figure 6: Bifurcated unitranche recovery rates

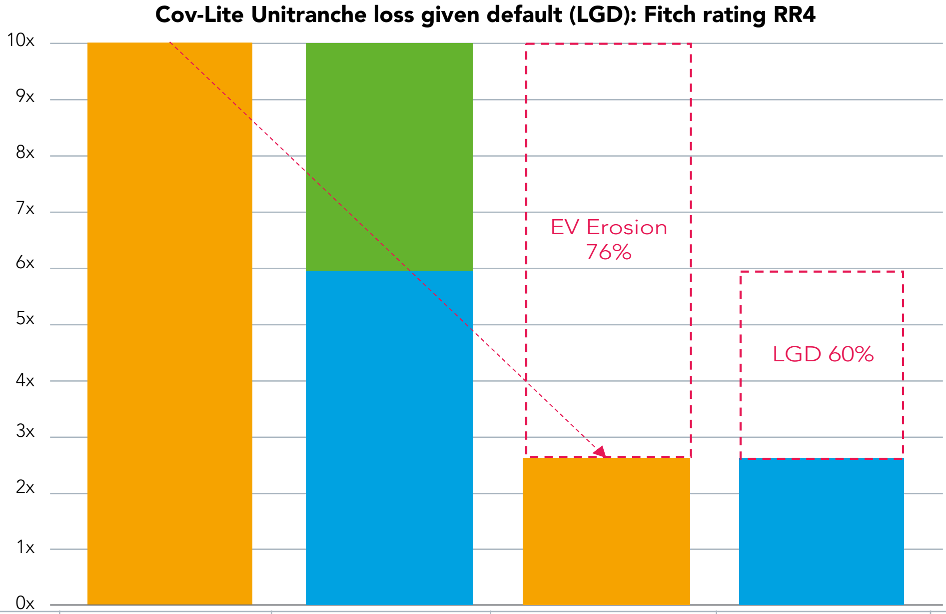


Loan type	Enterprise value (EV) at origination	Cap structure at origination	EV at default	Cap structure at default	LGD %
Enterprise value	100	–	30	–	70%
Equity value	–	40	–	0	100%
Loan value	–	35	–	7	80%
Higher ranking items	–	25	–	25	0%

Source: Federated Hermes, as at August 2021.

Fitch assigns last out (LO) pieces a rating of 'RR5', indicating that limited residual value available to LO lenders after first-out claims have been satisfied.

Figure 7: Cov-lite unitrache recovery rates



Loan type	Enterprise value (EV) at origination	Capital structure at origination	EV at default	Capital structure at default	LGD %
Enterprise value	100	–	20	–	76%
Equity value	–	40	–	0	100%
Loan value	–	60	–	24	60%

Source: Federated Hermes, as at August 2021.

All else being equal, covenants increase recovery rates loans because they allow creditors to intervene early. S&P published data[7] supports the anecdotal evidence, showing 66% average recovery for senior secured cov-lite term loans, compared to 75.5% for non-cov-lite. Based on available evidence, unitranche loans combined with weak documentation should be placed in Fitch's lower RR banding for unitranche loans (RR4).

Probability of default

The probability that a borrower will default (i.e. the probability of default (PD) score) increases over time and defaults are highly correlated to the credit cycle. The longer a loan is outstanding, the higher the probability it will default.

Leverage is also correlated with higher PD scores. S&P's LossStats database tracks US & European bond and loan recoveries and demonstrates the relationship between leverage and PD ratings. Issuers rated BB and BB- exhibit average leverage of 4.77x and 5.74x respectively, which approximates the leverage differential between the senior secured and unitranche structures discussed earlier.

We have, therefore, adopted these ratings for comparing the PD scores of senior secured loans and unitranche. Both strategies have an average contractual investment horizon of seven years in European direct lending and so, the average PD score across this period is assumed (see Figure 8).

Figure 8: S&P average cumulative global default probability by corporate rating (1981-2020)

S&P Cumulative Default Probability by Corporate Rating								
S&P Rating	1 yr	2 yrs	3 yrs	4 yrs	5 yrs	6 yrs	7 yrs	Avg.
'BB' (senior secured)	0.48	1.52	2.96	4.34	5.76	6.88	7.92	4.27
'BB-' (uni-tranche)	0.96	2.92	5.01	7.15	9.03	10.83	12.34	6.89

Source: S&P Global Ratings Research, as at April 2021.

[7] https://www.spglobal.com/ratings/en/research/articles/201013-settling-for-less-covenant-lite-loans-have-lower-recoveries-higher-event-and-pricing-risks-11687612.

Comparing risk-adjusted returns

By multiplying loss given default scores by probability of default scores, we derive the Expected Loss (EL) for each loan structure. EL is subtracted from the margin to calculate Risk-Adjusted Yield — see Figure 9.[8]

Figure 9: Comparison of risk-adjusted returns for different capital structures

Illustrative cap structures	Senior Secured	Straight Unitranche	Cov-Lite Unitranche	Bifurcated Unitranche	Second Lien
Origination fees*	2.50%	3.50%	3.50%	3.50%	4.50%
Margin	4.50%	6.50%	6.50%	6.50%	8.50%
LGD	20%	50%	60%	80%	95%
PD	4.27%	6.89%	6.89%	6.89%	6.89%
EL	0.85%	3.45%	4.13%	5.51%	6.55%
Risk-Adjusted Yield	4.27%	3.93%	3.24%	1.86%	3.08%

* Yield assumes that origination fees are amortised over a four-year life
Source: Federated Hermes, as at May 2021.

The conclusion we draw from this framework is that traditional senior secured strategies outperform unitranche loans through the cycle on a risk-adjusted basis, offering investors a higher level of return for the level of risk they are taking. Furthermore, relative performance of senior secured loans improves dramatically as incremental risk factors such as cov-lite and bifurcation are introduced into the loan structure.

Part Four: Leveraging private credit strategies

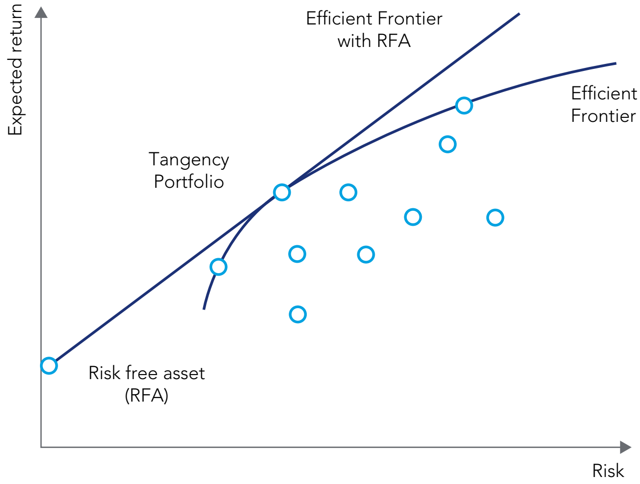
Investors often prioritise their headline return requirements ahead of risk optimisation leading to sub-optimal investments that deliver higher expected returns but at a disproportionately higher level of risk compared to lower yielding, lower risk options.

The capital asset pricing model (CAPM) demonstrates, at a theoretical level, why this approach is flawed and illustrates why rational investors should only hold assets that optimise returns for a given level of risk.

The 'efficient frontier' represents the line along which the most efficient parts of the investable universe lie (see Figure 10). Formally, it is the set of portfolios which satisfy the condition that no other investable portfolio exists with a higher expected return for a specified level of risk.

> **Once the optimal risk-return strategy has been identified, leverage is used to drive up the level of risk and magnify expected returns to the upside.**

Figure 10: Risk versus expected return, showing the efficient frontier



Source: Federated Hermes. For illustrative purposes only

The CAPM is represented by the line that connects the risk-free rate of return with the tangency point on the efficient frontier of optimal portfolios. When investors borrow (lend) at the risk-free rate of return and invest the proceeds into the tangency portfolio, they increase (decrease) expected return while only having exposure to the asset that offers the best and most efficient combination of risk and return.

Applying CAPM to the risk-adjusted framework discussed in this paper, direct lending investors would only invest in senior secured funds because they represent the most efficient risk-return strategy (i.e. the tangency portfolio) within their investment subset.

Once the optimal risk-return strategy has been identified, leverage is used to drive up the level of risk and magnify expected returns to the upside. To demonstrate, imagine an investor has a minimum return requirement of 7% for their direct lending allocation. They are presented with only two investment options, being the senior secured and unitranche structures discussed earlier (see Figure 11).

Figure 11: Gross yield comparison

Illustrative cap structures	Senior Secured	Straight Unitranche
Origination fees*	2.50%	3.50%
Margin	4.50%	6.50%
Gross yield	5.12%	7.37%
Risk-Adjusted Yield	4.27%	3.93%

* Yield calculation assumes origination fees are amortised over a four-year life.
Source: Federated Hermes, as at August 2021.

[8] Notes on the comparison statistics: PD is based on a seven-year cumulative average which does not account for the number of observations per year.

Based only on this data, most investors would choose the straight unitranche option. However, Figure 12 demonstrates how a fund manager can borrow 50% of the invested capital at current market rates, resulting in a more attractive risk and return profile, satisfying the minimum requirement whilst also providing a superior gross and risk-adjusted yield with lower expected losses.

Figure 12: Comparative leveraged returns analysis

Leveraged Returns Analysis	Senior Secured	Unitranche
Loan amount (€'m)	50	50
Degree of leverage	50%	0%
Investor funds (€'m)	25	50
Borrowed funds (€'m)	25	0
Origination fees*	2.5%	3.5%
Margin	4.5%	6.5%
LIBOR	0.0%	0.0%
PD	4.3%	6.9%
LGD	40.0%	50.0%
Expected loss	1.7%	3.4%
Cost of debt	2.4%	2.4%
RAROC	4.43%	3.93%
Gross Yield	7.85%	7.38%

Source: Federated Hermes, as at May 2021.

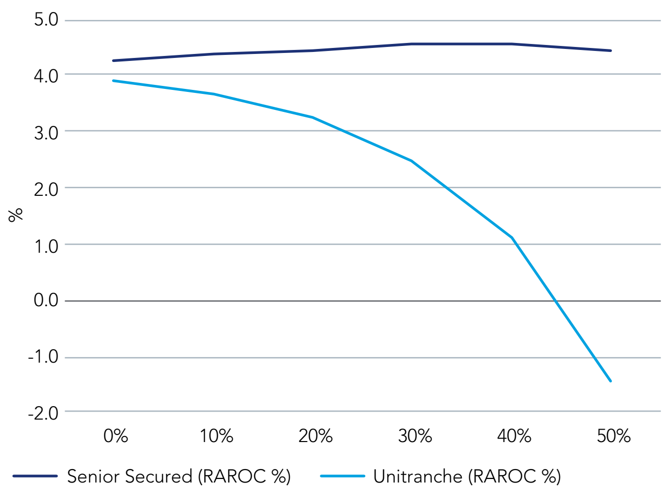
The formula for risk adjusted return on capital (RAROC) is as follows:

$$\text{RAROC} = \frac{\textit{revenue} - \textit{expenses} - \textit{expected loss} + \text{“}\textit{risk free rate}\text{”}}{\textit{invested capital}}$$

Furthermore, Figure 15 shows that the senior strategy outperforms unitranche on a like-for-like basis, irrespective of the degree of leverage employed by the fund manager due to its optimised risk return profile.

Federated Hermes has seen an increasing trend of managers operating middle-market credit funds using leverage in this form, reflecting the desire to boost returns and increase firepower.

Figure 13: Senior Secured vs. Unitranche: a comparison of leveraged returns



Degree of leverage*	0%	10%	20%	30%	40%	50%	60%	65%
Senior Secured (RAROC %)	3.09%	3.15%	3.25%	3.37%	3.53%	3.75%	4.09%	4.33%
Unitranche (RAROC %)	3.06%	2.82%	2.58%	2.34%	2.10%	1.86%	1.62%	1.50%

Past performance is not a reliable indicator of future performance.

*Percentage of capital that is borrowed for investment.
Source: Federated Hermes, as at August 2021.

Federated Hermes has seen an increasing trend of managers operating middle-market credit funds using leverage in this form, reflecting the desire to boost returns and increase firepower. However, leverage is not without risks. In addition to boosting returns to the upside, it can magnify losses to the downside. Thus, investors should only consider this approach where they have confidence in the fund managers' ability to pick the right credits and minimise unexpected losses. The dispersion of performance in direct lending (compared to other liquid credit strategies) highlights the importance of selecting private credit managers with a strong record with proven access to quality direct lending transactions.

Conclusion

It should be noted that this analysis is intended as a framework for comparing direct lending strategies on a relative basis and not as an estimation of expected returns, indicative or otherwise. However, the results highlight clear differences that exist between unitranche and traditional senior secured loans, and demonstrates how unitranche strategies targeting a high gross yield often mask a variety of incremental risk factors that can result in sub-optimal risk allocation.

The right strategy will depend on investment priorities and many investors will continue to be persuaded by unitranche's attractive yield. However, for a significant portion of institutional investors, predictability of income and protection against losses is a primary concern. For these investors, the current range of unitranche funds is likely to be too risk-seeking and/or incompatible with their liability-matching approach.

For investors whose direct lending replaces part of their liquid credit allocation, rather than being an alternative to private equity allocations or growth, a steady low-risk profile with a fair premium over liquid bonds is a commonly used option.

Meanwhile, the utilisation of leverage at the fund level remains an attractive option for investors seeking to enhance their gross yield from traditional senior secured strategies while maintaining a conservative investment approach, which is consistent with capital preservation and optimal risk-adjusted returns.

You can find out more about Federated Hermes' Direct Lending capabilities by visiting www.hermes-investment.com or connecting with us on social media.

Federated Hermes' approach to direct lending

Federated Hermes' Private Debt funds aim to provide investors with a low-risk entry point into direct lending, targeting capital preservation and an attractive level of income throughout market and economic cycles. Focused on the traditional senior secured level of the capital structure, our European portfolio achieved an average equity cushion of 60% at loan origination, with average opening net leverage of 3.8x. Since launching our maiden fund in 2016, we have maintained a 0% default rate which we attribute to our focus on conservatively structured loans, non-cyclical end markets, and high levels of recurring revenue & cash flow conversion. For investors who have a higher return requirement, we also offer leveraged solutions that can provide gross yields that are in line with unitranche whilst retaining the robust lender protection rights and value protection associated with traditional senior secured loans.

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Our goals are to help people invest and retire better, to help clients achieve better risk-adjusted returns, and to contribute to positive outcomes that benefit the wider world.

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