Private Markets Insight

Locating the sweet spot in direct lending

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On top of a compelling return, the northern European lower mid-market senior secured segment offers less downside risk and one of the best legal environments to negotiate any restructurings.

- **An allocation to direct lending, focused on the right strategy, can provide an investor with low volatility, limited correlation to other asset classes, diversification to underlying industries, quarterly cash income and an element of inflation protection.**
- **Out of three main categories of underlying debt – mezzanine, unitranche and senior secured – we believe the latter offers investors the best risk-reward profile at the present time.**
- **In the lower mid-market, significant improvements can be seen in lender protections in loan documentation. Lenders also have greater negotiating power in terms of loan documentation, creating space to negotiate the inclusion of ESG-linked clauses.**
- **In northern Europe, investors are lending into the most creditor-friendly jurisdictions, as opposed to pan-European or the US. These are geographies where lenders have tried and tested the legal systems regarding insolvencies.**

Direct lending may be classified as an 'alternative' investment, but in many ways it's now part of the mainstream. Since 2013, direct lenders have raised US$250bn[1], as investors sought yield in a low interest rate environment; attracted by its low volatility, limited correlation to other asset classes, and the cash income provided by underlying loans.

The macro backdrop today is, of course, uncertain, as the market frets over rising rates and high inflation. Does an allocation to direct lending still make sense?

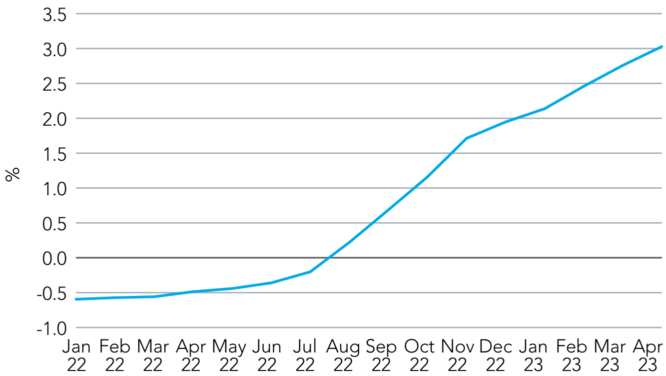
At Federated Hermes, we believe it does – if investors focus on the right segment. And in this paper, we are going to outline the arguments why.

We believe the best opportunities in the asset class can be found in the northern European[2] senior secured lower mid-market segment[3]. It's an area where investors can reasonably anticipate an all-in yield of approximately 848bps[4].

When calculating the yield of a loan, there are three core income components: the base rate, the margin and the upfront fees – all of which feed through to the underlying gross return of a direct lending fund.

The base rate for European loans (EURIBOR) was 304bps as at 31 March 2023[5]; up from negative 46bps at the same time a year earlier[6].

Figure 1: Three-month EURIBOR rate



Source: Euribor rates as at April 2023.

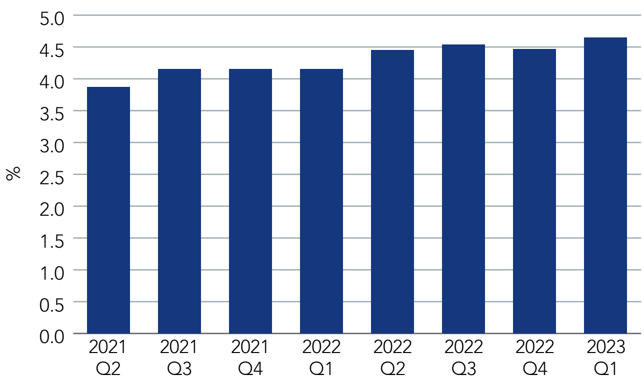
As central banks have hiked interest rates, the floating rate component of the yield has followed suit, up 350bps year-on-year[7], allowing investors a level of protection against rising inflation levels. It's a trend that should continue as interest rate rises persist.

In addition, macroeconomic uncertainty, driven by geopolitical tensions and inflation concerns, has encouraged lenders to adopt a 'risk-off' approach. Many lenders now command an additional premium of approximately 40bps[8] on the margin charged on a loan of equivalent risk levels 12 months earlier. As a result, the average European senior secured margin is approximately 465bps[6].

There are, of course, a range of 'average' margins depending on which geography you analyse, but the aforementioned figure is a blended northern European margin.

Typically, you would expect to obtain the highest margin level in the UK, followed by Scandinavia, Germany, the Netherlands and then Belgium.

Figure 2: Average northern European senior secured margin



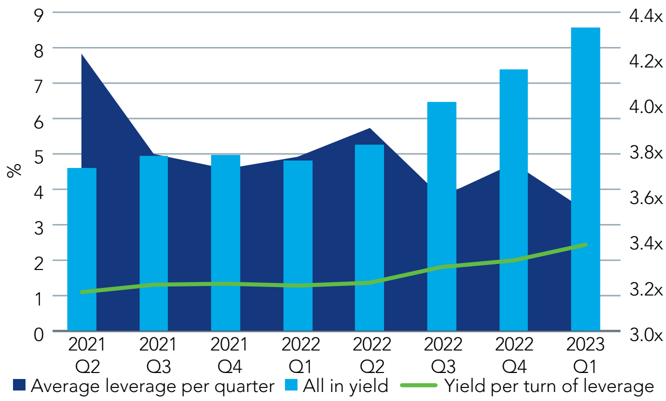
Source: Federated Hermes Origination List as at May 2023.

[1] (Deloitte Private Debt Deal Tracker Autumn 2022; pg. 24; notes Preqin as source).
[2] Northern Europe equates to Denmark, Sweden, Finland, Norway, UK, Ireland, Belgium, Netherlands, Germany.
[3] The lower mid-market segment typically involves loans less than €35m EBITDA.
[4] **Indicative or anticipated performance is not a reliable indicator of future performance.**
[5] Noted prior to the 25bps interest rate hike announced by the ECB on May 4th, 2023.
[6] Euribor 2022 (euribor-rates.eu).
[7] Euribor 2022 (euribor-rates.eu).
[8] Following the ECB 25bps rate increase, this is more likely at c. 860bps when going to print.

Further to this, the upfront fee, a 'work fee', received by lenders on the day they fund a loan, has increased steadily, and lenders are now receiving an average of 239bps[9].

What makes this level of return more compelling in the current market environment, is the potential for a reduced risk-return profile; as well as the improved protection mechanisms for senior secured direct lenders operating in the lower mid-market.

Figure 3: Yield per turn of leverage

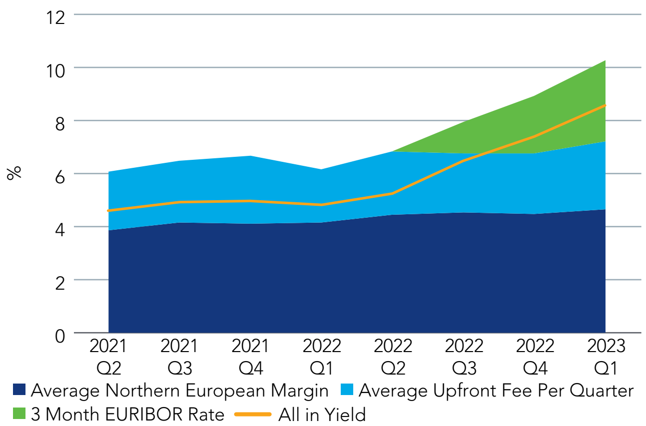


Source: Federated Hermes Origination List as at May 2023.

Past performance is not a reliable indicator of future performance.

This can be seen in the increased yield per turn of leverage, which shows that lenders are yielding substantially more at a lower risk entry point. Over the last 12 months[10], we can see that the yield per turn of leverage[11] has increased almost two-fold from 1.2% to 2.4%. While yields have increased materially, the risk-off nature in the market has also seen the average leverage levels come down from 3.9x to approximately 3.5x.

Figure 4: Northern European senior secured lower mid-market all-in-yield



Source: Federated Hermes Origination List as at May 2023.

Past performance is not a reliable indicator of future performance.

Support and protection

In the lower mid-market, significant improvements can be seen in lender protections in loan documentation in general. While the large cap market saw a rapid deterioration of loan terms in recent years as lenders competed with the flexibility available in the bond market, the bank-dominated lower mid-market in northern Europe maintained a higher level of pragmatism.

However, the lower mid-market did not remain unscathed, with heightened competition driving an increase in EBITDA add-backs and the capacity for cash to be removed from the borrower, as well as a reduction in the number of financial covenants, albeit not to the same extent as the large cap market where covenant-lite loans – with fewer restrictions on the borrower and fewer protections for the lender – still tend to dominate.

Today, the dislocation in public markets, along with the syndicated market being closed to new issuance, has resulted in the large cap market being increasingly penetrated by private market direct lenders. The number of record direct lending fundraising rounds recently[12], shows that these lenders can write sizeable loans, with some being able to provide a unitranche[13] of up to €1bn[14]. As a result, to be able to deploy such a sizable amount of capital, the larger first-mover direct lenders have migrated out of the middle market and into the large cap domain. Concurrently, turbulence in the banking sector has seen several banks shutter their lending businesses.

[9] Margin and upfront fee data is per the Federated Hermes Direct Lending database of introduced and completed European middle market transactions.

[10] Using the average leverage and yield for all transactions originated by Federated Hermes' mid-market direct lending funds for the last 12 months to March 31, 2023.

[11] Turn of leverage is a financial metric that measures a company's ability to manage and service its debt.

[12] Private Debt Deal Tracker | Deloitte UK (deloitte-uk-pddt-spring-2023.pdf).

[13] Unitranche: a hybrid loan structure that combines senior debt and subordinated debt into one loan.

[14] Ares Management Direct Lending Funds Commit over £1 Billion to UK-Based Daisy Group in One of Europe's Largest Private Credit Financing Transactions To-Date | Business Wire.

A shift in the balance of power

This migration of lenders out of the lower mid-market has presented an opportunity for those who remain. Small and medium-sized enterprises (SMEs) do not have the option of tapping into alternative financing options, such as the bond market, or launching an initial public offering (IPO), in the way larger groups can.

This reduction in the number of suppliers of capital has, therefore, shifted the balance of power from borrowers and shareholders back towards lenders.

Recent improvements to the documentation of loans have included the return of a second covenant, with interest coverage partnering a leverage covenant in most instances, set at a slightly reduced, and improved, average headroom of 30% (from a previous 32.5%)[15].

While on the surface, this tweak may look insignificant, it's an additional aid to lenders, allowing them to act faster in the event of a borrower underperforming. By being able to trigger a covenant default – activating discussions among lenders, shareholders and management earlier – a strategy to preserve the value of the business as a going concern can be put into effect more rapidly.

In comparison, in the more liquid large cap loan market, covenant-lite loans – with no covenants in the loan documentation – remain the default option.

In the upper mid-market, meanwhile, lenders often have to compete against larger credit funds and the bond market – and lender protections can sometimes be sacrificed to win the transaction. As larger credit funds venture into the upper mid-market – in order to deploy via sole lender offerings – competition is likely to intensify further, corroding both yield and loan documentation.

Size and diversification

Rule 101 of investing is 'diversify' and this rule also applies to the construction of a direct lending portfolio. While the volume of deals in the direct lending market has increased materially over the last decade, so too have the number of direct lenders, and therefore the competition for the best loans.

In the present market environment, professional services, software and healthcare are perceived to be among the most attractive sectors to invest in; while entertainment, household durables and retail have been among the least sought after because of their reliance on consumer discretionary spending.

Borrowers that are well established; operate in sectors with high barriers to entry; and generate stable, sticky and predictable cashflows are, not surprisingly, attracting a lot of attention.

In order to be an effective credit picker able to produce a diversified portfolio for investors, a direct lending manager needs to be the first point of call for debt advisors and private equity firms that are bringing lending opportunities to market.

A fund manager with a weak origination strategy – and therefore an unpredictable deal pipeline – may find itself forced into certain lending scenarios; accepting weak loan terms or lending to borrowers that have previously been refused by the market, in order to deploy capital.

This is where established direct lending funds – with a reputation for speed and reliability of execution – have a significant advantage over recent market entrants or lesser-known fund managers.

> **[The] reduction in the number of suppliers of capital has shifted the balance of power from borrowers and shareholders back towards lenders.**

Large established direct lenders with sizeable existing portfolios of deals can also benefit from the recent rise in add-on activity, fuelled by private equity owners seeking to drive growth through buy-and-build strategies.

At Federated Hermes for example, we have a unique origination strategy via four legally binding origination agreements with a top-tier middle market lending bank in each of our target jurisdictions (the Nordics, Benelux, Germany and the UK). Coupled with our own self-origination, this allows us to filter through upwards of 350 potential investments each year. The Federated Hermes funds benefit from a large volume of off-market transactions introduced by their partner banks, i.e. loans no other direct lender sees. These opportunities tend to present themselves via the partner bank's existing portfolios when the bank is full on a certain name, and the borrower is seeking additional capital to pursue their growth strategy. These can often be shorter maturity loans, to align with the maturity of the partner bank's original loan, potentially providing Federated Hermes with an opportunity to recycle this capital once repaid and boost returns by generating a subsequent upfront fee upon redeployment.

[15] Federated Hermes calculations.

While the liquid large cap space, and at times the upper mid-market, may benefit from loan liquidity – a secondary market exists to trade in and out of loans – when a loan is in distress, the exit value available through this avenue can dissipate rapidly.

An additional consequence of having a market for your assets is that you are bound to value your loans at market prices, and therefore you invite a level of market price volatility into your portfolio. Due to smaller transaction sizes and fewer market participants, the lower mid-market is absent of an active market and therefore has limited exposure to mark-to-market volatility. Valuations are reflective of the borrower's forecast cashflows, for example, and therefore remove any 'market noise' from the valuation.

On top of this, in less extraordinary times, an investor would typically be compensated with an illiquidity premium on their yield. This upside is typically 75bps or above.

> **A direct lending strategy that aims to protect against downside risk is where we believe investors should be seeking to allocate in light of the likely uptick in corporate distress.**

ESG-linked clauses

An allocation to a direct lending fund can also help meet investor demands for Article 8 classifications or other environmental, social, and governance (ESG) requirements (Federated Hermes' most recent European direct lending fund is classified as Article 8). The nature of the lower mid-market, as mentioned above, allows lenders in this space to have greater negotiating power in terms of loan documentation than in the upper mid-market and large cap space. This permits lenders to negotiate the inclusion of ESG-linked clauses into the documentation, which can include (i) an ESG margin ratchet, i.e. the borrower benefits from a small margin reduction if they achieve prescribed ESG targets, for example a reduction in carbon emissions; and (ii) undertakings, i.e. actions to be completed by a borrower by a set deadline or the borrower triggers an event of default, for example improvements in social characteristics, such as a health and safety record or the implementation of environmental standards into the borrower's operating facilities.

Alongside implementing actions for a borrower to impart, the flexibility of the documentation also allows for bespoke reporting requests including ESG-related key performance indicators (KPIs) relevant for a fund and its investors.

> **The lower mid-market [segment] allows lenders to have greater negotiating power in terms of loan documentation than in the upper mid-market and large cap space.**

Uncertain backdrop

We can't ignore the fact that we are investing in an environment with several large unknowns: At what level will interest rates peak, for instance, and how long will they remain at these levels; when will consumer confidence improve and with it, discretionary spending; are there further 'shock' events on the horizon that will drive inflation higher or have an adverse impact on global supply chains?

At this stage of the credit cycle, funds that have been less disciplined around credit analysis will encounter more portfolio issues as higher interest expenses, cost inflation and reduced consumer confidence start to bite.

A direct lending strategy that aims to protect against downside risk is where we believe investors should be seeking to allocate in light of the likely uptick in corporate distress.

At Federated Hermes, we believe we have invested in the right place within direct lending to maximise the protections available for our investors while providing them with an attractive yield.

Loan categories

Looking at the array of options available to investors considering direct lending, there are three main categories of underlying debt to choose from: senior secured, mezzanine and unitranche, which is a blend of senior secured and mezzanine. Historically, when interest rates were negative, the expected yield across these types of direct lending strategies was approx. 5% for senior secured, 13% for mezzanine and 9% for unitranche[16,17]. The broad variance was primarily driven by the level of risk investors were exposed to due to the seniority of the debt, and how far down the capital structure it went.

Senior secured: the lowest risk of the three, sits at the top of the capital structure, which means that in the event of a default, these lenders are the first to be repaid through proceeds from the sale of the business etc.

[16] Private Debt Deal Tracker | Deloitte UK.

[17] **Indicative or anticipated performance is not a reliable indicator of future performance.**

Mezzanine lenders: sit below senior secured, – i.e. are subordinated – and would be the first group of lenders to be impacted in the event of value erosion at the borrower. Typically, a majority of mezzanine interest is non-cash pay, i.e. it accrues and is paid to the lender when the debt is fully repaid. Therefore, cash income to investors may not be dissimilar between senior secured and mezzanine funds, in a performing environment.

Unitranche lenders: quite often classed as 'senior secured' lenders, despite key variances between unitranche and senior loans. Firstly, there is likely to be a revolving credit facility (RCF) which ranks ahead of the unitranche in the event of a restructuring. While this facility is normally used for the borrower's working capital needs, in times of distress, a borrower will draw on this to support the liquidity of the business. Depending on the size of the RCF, this can be a sizeable amount which would need to be repaid before the unitranche lenders during a restructuring. This compares to senior secured where the RCF ranks on a 'pari passu basis', i.e. on the same level to other senior debt loans.

Secondly, as unitranche is a blend of senior and mezzanine debt, it extends further down the capital structure than senior debt lenders, i.e. as the value of a business reduces, unitranche lenders would begin to have their value eroded earlier.

Thirdly, as unitranche lenders can't compete with senior lenders on price, in recent years the deterioration of loan terms in order to be competitive has been greater in the unitranche market. Therefore, there is a risk of greater value erosion at times of distress due to cash leakage and a delayed ability to call a default due to a covenant breach as headroom is normally set higher than senior debt deals.

> **While unitranche lending typically provides investors with greater yield opportunity, at a time of rising interest rates, it is less attractive to borrowers.**

Lastly, as the quantum of debt provided by a unitranche relative to senior debt is larger, these borrowers will be under a higher burden as interest rates increase than a senior debt borrower would. As such, these borrowers have a higher likelihood of defaulting on their interest payments earlier.

While unitranche lending typically provides investors with greater yield opportunity, at a time of rising interest rates, it is less attractive to borrowers. For an additional turn of leverage a borrower has to pay materially more, and borrowers are not seeing the value in that right now. Therefore, opportunities to deploy are reducing for unitranche lenders, while senior lenders are seeing an uptick.

Given the weaker loan terms, and the fact that at present, interest costs are increasing for borrowers, and defaults are generally on the up, being closer to the bottom of the capital structure is not where most investors want to be.

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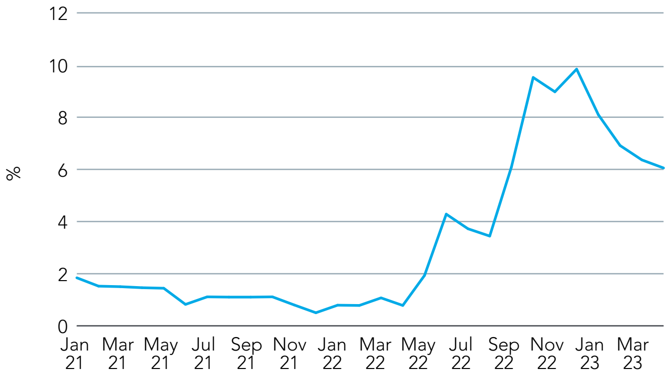
Why northern Europe?

Taking all of the above into account, we believe investing into senior secured direct lending offers a well-protected, high yielding opportunity to investors.

The ELLI Distress Ratio, the percentage of performing liquid loans trading below 80, has been creeping up since early 2021, and currently sits at approx. 6% of ELLI Issuers[18].

Figure 5: ELLI Distress Ratio (based on number of ELLI Issuers)



Sources: Morningstar European Leveraged Loan Index (ELLI) as at April 2023.

The rising levels of distress should come as no surprise. At the height of the Covid-19 pandemic, central banks and governments flooded the market with liquidity. Since then, inflation has soared, and the business landscape has changed materially.

On top of this, aggressive hikes in interest rates have significantly increased the debt burden on borrowers. With the EURIBOR interbank lending rate going from 0% to 3.0% in the space of a year[19], businesses that have borrowed aggressively – already feeling the pinch from cost inflation and lower customer demand – could face a difficult period ahead as cashflows come under strain.

As a result, we believe the number of restructurings and borrower requests for lender support is likely to increase in the short- to medium-term. By allocating to a strategy focused on northern Europe (as opposed to pan-European or the US) investors are lending into the most creditor friendly jurisdictions. These are geographies where lenders have tried and tested the legal systems regarding insolvencies. The swift nature of the courts means that insolvency processes are faster, reducing value leakage from a borrower at a time when cash and asset preservation is paramount.

A key consideration when choosing a fund manager should be around the level of experience within the overall direct lending team. This is pertinent in light of the expected rise in restructuring activity. Should a fund find itself managing a restructuring, in-house expertise as well as breadth of team will allow the fund to work quickly towards a positive outcome for the troubled asset, while continuing to deploy capital and manage the existing portfolio of investments. It's an area smaller direct lenders can struggle to manage effectively.

The sweet spot

A broad range of direct lending fund options are available for investors to allocate towards – and they vary in yield, geography and risk levels. Looking at the medium-term economic outlook for Europe, the state of the banking sector and the various geopolitical issues currently at play, we believe it's a backdrop that plays to the strengths of established direct lenders resourced with experienced teams and a robust origination strategy.

An allocation to direct lending, focused on the right strategy, should provide an investor with low volatility, limited correlation to other asset classes, diversification to underlying industries, quarterly cash income and an element of inflation protection.

At Federated Hermes we believe the best segment of the direct lending market to invest at the present time is the senior secured lower mid-market in northern Europe. In this segment, you benefit from strong lender protections in the loan documentation, yields approaching 850bps[20], more conservative debt structures and quantums than other segments and the best legal environments to negotiate any restructurings.

A number of analyses have suggested 2023 is likely to produce one of the best vintages of direct lending funds to date[21,22]. The reduced number of market participants, the improved lender protections, lower leverage levels and the sizeable yield uplift certainly support this argument.

The key to direct lending and protecting returns is managing any downside risks. We are not naive enough to think that anyone, including ourselves, is above some of the issues currently at play in the economic climate. However, the breadth and experience of our team, the geographies we have chosen to operate in and where we have placed our loans in the capital structure, position us extremely well to ensure we minimise any losses in our portfolios. In every asset class there are winners and losers. For us, in 2023, the smart money, as outlined in this paper, is on the northern European lower mid-market segment.

[18] PitchBook Data.
[19] Euribor 2022 (euribor-rates.eu).
[20] Federated Hermes Direct Lending own data.
[21] The Future of Private Credit (nuveen.com).
[22] The Decade Special Report | Private Debt Investor.

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