Direct lending: the power of strategic alliances

Laura Vaughan, CFA
Head of Direct Lending

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Federated Hermes
Private Markets

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For professional investors only

In an increasingly competitive direct lending landscape, deal origination is critical to achieving consistent returns across the asset class.

Fast reading

- Our origination approach is built around a series of bank partnerships that afford us access to some of the most attractive deals in our preferred segment.
- These co-lending agreements sustain a robust pipeline of high-quality loans, which allows us to take a highly selective approach to the borrowers we choose to lend to, including across loans not accessible to any other direct lenders.
- Our direct lending strategy – focused on the northern European lower mid-market segment – coupled with a robust pipeline of deals, means that we can select opportunities that we believe will deliver the most compelling performance for our investors.

As the macroeconomic backdrop shifts, direct lending is coming of age. For many years, the asset class has enjoyed low default rates and recoveries have been solid. The recent surge in interest rates and resultant change in market conditions have, however, increased the pressure on some borrowers. At Federated Hermes, our direct lending strategy prioritises deal quality; our ability to source high-quality deals that are unavailable elsewhere helps ensure long-term performance and gives the strategy an edge in varied conditions.

[1] As of March 2024.

Our origination approach is built around a series of bank partnerships that afford us access to some of the most attractive deals in our preferred segment. These partnerships are governed by legally-binding evergreen agreements in which our bank partners are obliged to introduce us to all transactions they originate that sit within agreed parameters. Our strategy benefits from our right of first refusal with our bank partners, ensuring we are always sourcing high-quality potential loans, rather than seeing transactions turned down by other lenders ahead of us.

We have never experienced a payment default since inception in 2015

These co-lending agreements sustain a robust pipeline of high-quality loans, which allows us to take a highly selective approach to the borrowers we choose to lend to, including across loans not accessible to any other direct lenders. This approach – in conjunction with deals originated by our experienced investment team – is one of the reasons that, to date[1], our direct lending strategy is yet to experience a payment default or loss.

Origination: a power tool for managing risk

We see deal sourcing as a powerful tool for managing risk and sustaining returns, particularly in challenging economic times. As direct lending continues its transition into the mainstream, and the investment landscape grows more competitive as a result, the industry is likely to see more investors target the same pool of deals. In this increasingly concentrated market, the impact of a default by any single borrower could have implications across many direct lenders' portfolios. At Federated Hermes, our differentiated origination approach is designed to mitigate such risks by ensuring we remain credit pickers. This is achieved by selecting the most attractive opportunities from a rich pipeline of high-quality loans – including those unavailable elsewhere in the market.

Access through partnership

When our direct lending platform was being established a decade ago, we found that many of the most compelling opportunities globally were located in the northern European lower mid-market segment. What was also clear was that a significant share of this market was held by banks and the barriers to entry for asset managers and other investors were extremely high.

There were few asset managers operating in this opportunity-filled segment. However, instead of competing against the banks, we developed a strategy that allowed us to partner with them. Today, we work alongside some of the biggest bank lenders in the lower middle market in our target geographies. Our partners include Danske Bank in the Nordics, DZ in Germany, KBC in the Benelux and NatWest in the UK.

Our strategy has helped us maintain a solid portfolio of high-quality loans to issuers in non-cyclical sectors. In addition, our investment team sources opportunities directly through our extensive network of contacts across northern Europe, further bolstering our deal options.

The benefit of being credit pickers

In conjunction with the deals originated by our own team of experts, our partnership approach results in our team being introduced to approximately 300 potential investment opportunities each year.

Our direct lending strategy – focused on the northern European lower mid-market segment – coupled with a wide and varied pipeline of deals, means that we can select opportunities that we believe will deliver the most compelling performance for our investors.

All this allows our investment team to be true credit pickers. We have the scope to reject transactions that fall short of our strategy's thresholds for borrower quality, loan terms or economics. Our average completion rate of approximately 5% per annum since inception is a clear demonstration of our consistent selective appetite.

Partnerships that empower investors

The partnership approach we employ has been designed to deliver a consistent pipeline of potential investment opportunities, whatever the economic backdrop. The effectiveness our approach was particularly evident during H1 2023 when macroeconomic uncertainty and rising interest rates were weighing on M&A activity, leading to a stalemate over appropriate enterprise values between buyers and sellers across the private equity industry.

As a result, many private equity owners were using 'add-on' strategies to generate growth in their underlying portfolio companies (a practice of identifying smaller, complementary businesses with opportunities to create efficiencies, and 'adding' them onto the larger core business).

To finance this incremental buy-out activity, private equity owners returned to their original lenders as a first port of call. Given our partner banks' longstanding leveraged finance

businesses and the sizeable portfolios of loans that they currently hold on-balance sheet, they received numerous in-bound enquiries from borrowers seeking to raise capital to fund add-on acquisitions.

> **The partnership approach we employ has been designed to deliver a consistent pipeline of potential investment opportunities**

While our partner banks may have had the appetite to meet their clients' needs and issue the loan, they remain subject to regulatory constraints. There are limits on the amount of capital a bank can lend to one borrower and hold on-balance sheet. Therefore, other parties are required to issue the loans.

Given the requirement under our partnership agreements that we are granted right of first refusal of the transactions originated by the banks, our funds, and as such our investors, saw substantial benefits by gaining access to loan opportunities that were not being shown to any other market participants (i.e. off-market loans).

Where we had the appetite, as the sole new potential lender, we were able to negotiate opportune economics and attractive loan terms, which regularly included shorter tenors, allowing us the possibility to boost returns by recycling this capital again in the future.

Maximising the benefits for borrowers

Our partnership agreements are designed to not only benefit our direct lending investors, but also the banks and the borrowers we work with.

Our investment team and the partner banks undertake independent credit analysis of potential borrowers. We are both lender of record and lend on the same economics, however, we provide feedback to the borrower with a combined view. For the borrower, this is a more efficient process, and functions as if they are dealing with one party, while benefiting from accessing two balance sheets, including a bank lender who can offer revolving credit facilities (RCFs) and ancillary products and a fund who can provide follow-on growth capital from subsequent fund vintages and managed accounts.

For each transaction, our team and the bank's team undertake separate, closed negotiations to determine our appetite and lending terms with regards to the particular borrower. The combined hold level of Federated Hermes and the bank can result in us having the ability to fund an entire deal together, making our proposition appealing to a borrower.

A competitive advantage for banks

By partnering with Federated Hermes, the banks gain a competitive edge too. They are able to offer an increased debt quantum to their clients, thereby improving their service offering and attractiveness. This is achieved without having to take on syndication risk or partnering with other competitor bank lenders, with whom they may be forced to compete for ancillary business, such as forex, hedging and bank accounts.

Conclusion

The ability to secure high-quality deals through differentiated origination has allowed us to maintain a high-quality portfolio of loans that have never experienced a payment default since inception in 2015[2]. While our partner bank agreements provide us with the right of first refusal to a robust and continued pipeline of potential opportunities, they also grant us access to unique off-market transactions, further broadening the potential investment pool to transactions not accessible to any other direct lenders in the market. Going forward, this approach is designed to allow us to remain credit pickers – not takers – and perform regardless of market fundamentals through selecting the highest-quality opportunities in the market for our investors.

For further information on Federated Hermes' European Direct Lending capabilities, please visit www.federatedhermes.com/private-credit

[2] As of time of writing, March 2024.

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