



Barwon Global Investments The Case for Middle Market Direct Lending

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Barwon Research



Introduction

For years Australian wealth managers have had a limited range of income investment options when structuring client portfolios (term deposits; listed hybrid securities; property and listed REITs; mortgage trusts; bond funds). Notably missing from the list have been corporate bonds (including investment grade corporate bonds and sub-investment grade or high yield bonds) and corporate loans. Deloitte notes that only 16% of High Net Worth Investors (HNWIs) hold corporate bonds and corporate loans (Syndicated Leveraged Loans and Private Credit).¹

In this paper we profile the opportunity available in Private Credit and why investors should look to allocate to this asset class.

The past 15 years has seen banks and other traditional providers of private credit reduce and dramatically scale back their direct lending in response to a raft of regulatory reforms. This has led the way for private debt funds to fill the void and provide flexible capital to borrowers. Direct lending offers attractive yields (circa 7-9%), floating-rate interest exposure and compelling risk-adjusted returns to investors.

¹ Deloitte Access Economics - **The Corporate Bond Report: Australia's growing appetite for corporate bonds**

Compared to traditional high yielding investments such as high-yield bonds, REITs and utilities, which are trading at very tight yields (and are exposed to duration risk) private debt funds offer an attractive intermediate risk/return proposition.

Key tailwinds supporting private debt are:

- **Attractive Risk/Return** – total return of 7-9% p.a. delivered primarily through quarterly distributions.
- **Floating Rate Exposure** – loans generally pay floating interest rates (priced as a spread over the base rate) resulting in income increasing as interest rates increase.
- **Retreating Banks** – the opportunity set for private credit funds is increasing as traditional providers of loans to middle-market companies (banks, hedge funds and insurance companies) continue to retreat from the sector because of punitive capital requirements and heightened

regulatory restrictions imposed following the Global Financial Crisis (GFC).

- **Growing Demand** – private debt offers borrowers greater ease, greater certainty of close, and rapid execution compared to public markets. Moreover, loans can be structured in a more flexible manner, allowing the loan to scale with the needs of the borrower. In the past, borrowers tended to utilise private loans when they couldn't access public markets. Today, many borrowers see the benefits and flexibility offered by private credit funds; and they can be especially valuable in challenging markets.



Private debt markets are set for continued strong growth with yields of circa 7-9% p.a.

Private Debt Funds

Private credit or direct lending funds typically invest in non-traded, non-syndicated, hold-to-maturity, self-originated loans, not highly traded credit securities such as corporate or government bonds, mortgage-backed securities, or widely syndicated tradeable debt. This allows investors to earn an additional illiquidity premium.



Make a majority of their income from cash interest



Do not rely significantly on leverage to earn returns



May earn some origination or prepayment fees



Do not rely on trading gains and are more focused on "buy and hold" strategies



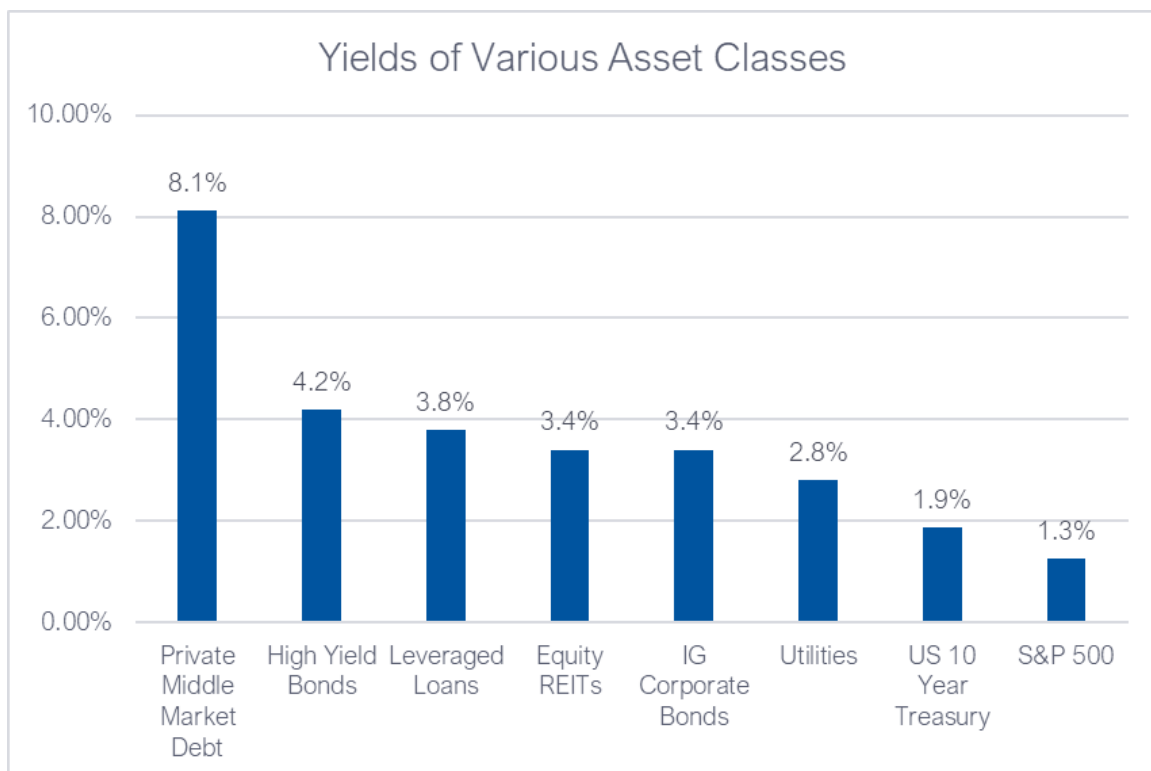
Loans tend to be senior in the capital structure, often secured by the assets of the borrower

The Private Debt Opportunity

Post the GFC, the credit investment landscape changed dramatically, opening up the opportunity for investors to participate in private debt. Coupled with much stricter banking regulations imposed including the increased capital requirements under the Dodd Frank and Volcker rules, this resulted in increased cost of capital for banks to hold leveraged loans.

Many private debt lenders have greater flexibility compared to traditional lenders. The flexibility of the debt provided, and the speed of execution makes direct lenders very compelling sources of debt capital for private equity sponsors seeking debt for leveraged buyout (LBO) transactions. This ability to execute in short timeframes has also generated substantial repeat business for the well-established private lenders in the US middle-market. This has created an opening for non-bank lenders such as private debt funds to become a much greater source of capital. Ironically, as the direct lending asset class has grown, larger players have benefited from their scale and ability to offer direct loans of a size that historically would have required complex syndications.

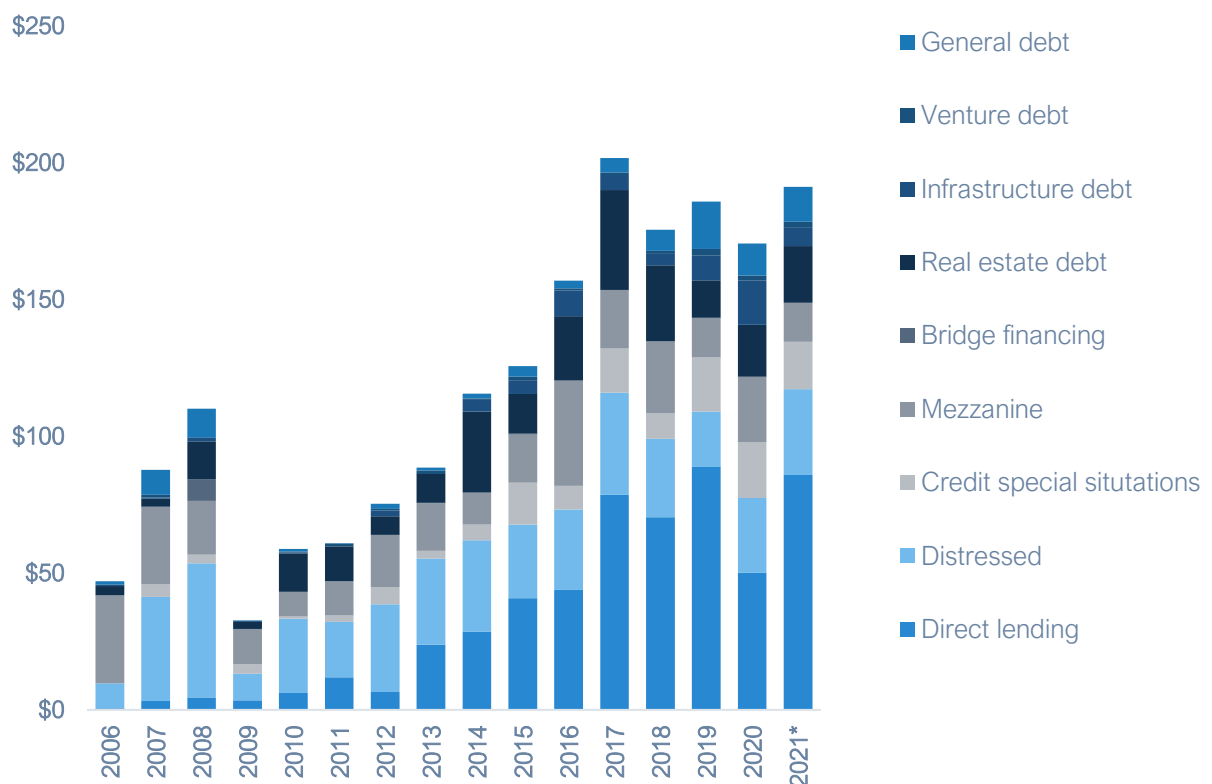
With traditionally higher yielding asset classes trading at very low spreads and yields, private debt offers an opportunity for investors to generate higher yields.



Note: Figures as at 31 March 2022 unless otherwise stated. Sources: Bloomberg, S&P Dow Jones Indices, Private Middle-market Debt: Cliffwater Direct Lending Index, High-yield bonds: Bloomberg Barclays Global High Yield Index, Leveraged Loans: S&P/LSTA U.S. Leveraged Loan 100 Index, REITs: DJ US Select REIT Index, Utilities: DJ Utilities Index, IG Corporate Bonds: S&P 500 Investment Grade Corporate Bond Index Total Return

The flexibility of the debt provided, and the speed of execution of direct lenders makes them a very compelling source of debt for private equity sponsors seeking debt for LBO transactions. This ability to execute in short timeframes has also generated substantial repeat business for the well-established private lenders in the US middle market. This has created an opportunity for non-bank lenders such as private debt managers to become a much greater source of capital. Interestingly, as the direct lending asset class has grown, the larger players have benefited from their scale, and the ability to offer direct loans of a scale that historically would have required complex syndications.

Professionally managed private debt funds have grown significantly since the GFC, particularly within direct lending over the past decade.



Source: Pitchbook, as at 31 December 2021

Increasing banking regulation has created opportunities for non-bank lenders such as private debt funds

Defining Direct Lending

Direct lending describes a transaction where the lender provides a loan to the borrower without the use of an intermediary. Generally, the lender goes directly to a private equity sponsor or an owner of a business to originate the loan. The loan is held to maturity and the lender will typically assume control in any workouts.

The table below breaks down some of the key terms of directly originated private loans compared to leveraged loans and high-yield bonds. Both leveraged loans (<BB+) and high-yield bonds (<BBB-) have below investment grade credit ratings, whilst private debt loans are not rated. Leveraged loans are secured by assets of the borrower and amortise over the life of the loan. Comparatively, high-yield bonds are unsecured and have a bullet repayment at maturity. Private debt loans – similar to leveraged loans – are typically secured by assets, but typically do not amortise.

	Private Debt “buy-and-hold” (c.\$800 billion)	Leveraged/ Syndicated Loans (\$1.2 trillion)	High Yield Bonds (\$2.1 trillion)
Lenders	Non-bank institutions (specialty finance, private debt funds)	Syndicated by banks to finance companies, institutional investors (mutual funds, CLOs, hedge funds)	Insurance companies, mutual funds, pension funds
Deal sourcing	Direct origination. Full underwrite	Direct origination. Full underwrite	Participant
Borrower credit rating	Non-rated middle market companies, EBITDA \$10-\$100M (shadow rating BB-)	Companies rated BB+ or lower	Companies rated BBB- or lower
Hold size; tenor	Nearly 100% ; 3-7 years	A portion or none; 3-7 years	Dependent on allocation received from lead arranger; 7-10 years
Security; interest rates	Secured Floating rate	Secured Floating rate	Subordinated to loans Fixed rate
Covenants	Maintenance covenants	Maintenance covenants; but increasingly covenant-lite	No maintenance covenants
Due diligence	Direct relationship, consistent dialogue, access to financials, control in workouts	Direct relationship, access to financials, limited control in workouts	Limited relationship, information distributed by lead arranger, no control
Secondary liquidity	Illiquid; hold-to-maturity	Secondary markets exists	Liquid

Characteristics of private debt strategies can vary significantly from the indicative terms presented above

Source: Barwon Investment Partners

Private debt gives the lender more control in workouts compared to traditional liquid credit markets

Middle Market Loans

US middle-market corporate direct lending is a large and rapidly growing segment of the global direct lending market. These middle-market corporate borrowers are generally defined as companies with EBITDA of between US\$10 million to US\$100 million (the S&P LCD definition) or with sales between US\$50 million to US\$1 billion and represent a large part of the global economy. Such loans to middle-market companies are often too small for high-yield bond issuance or general syndication, and therefore are held by the originating lender.

Deal pricing for the middle-market tends to have less “over-bought” or “over-sold” extremes than the more liquid high-yield bond and traded leveraged loan markets. Through the credit cycle, middle-market direct lenders tend to retain greater control over covenants and deal terms such as spread, yield, and term-to-maturity. Furthermore, capital structures for middle-market loans are generally simpler and more conservative.

Middle market loans have simpler and more conservative capital structures while retaining greater control over covenants and deal terms

Key Features & Benefits of Middle-Market Direct Lending

Floating Rate Exposure

Middle-market loans are not subject to duration risk. Private debt loans are principally priced based on a credit spread over a floating benchmark interest rate (most commonly LIBOR) and typically with a 50-150bps LIBOR floor. As such, a rise in interest rates will have a lesser impact on loan valuations and would be accretive to earnings as credit spreads generally widen.

Illiquidity Premium

Given that direct loans to mid-sized businesses are less liquid than high-yield bonds or leveraged loans to larger companies, investors can expect a greater return reflecting the illiquidity premium.

Leverage

Middle-market loans tend to retain stronger covenant packages and lower leverage levels.

Private Equity Backed Borrowers

Middle-market lenders tend to invest mostly in private equity sponsored deals. The private equity sponsors’ ability to provide “top-up” equity in periods of market stress offers better risk-adjusted returns.

Stronger Credit Performance

Historically the middle-market has experienced both lower default rates and higher recovery rates compared to broadly syndicated loans and high-yield bonds.

Business Development Companies (BDCs)

One distinct category of private debt funds is Business Development Companies, or BDCs. The BDC model was created by US Congress in the 1980s to facilitate lending to small and middle-market companies. BDCs are regulated under the Investment Company Act of 1940 and provide a highly tax-efficient structure for investing in the private debt asset class with a straight pass through of eligible interest income.

BDCs invest in direct, hold-to-maturity loans to US middle-market private companies. Many BDCs focus on specialty finance niches such as asset-backed finance, equipment leasing or venture lending, or alternatively focus on the void in corporate lending due to traditional direct lenders downsizing, withdrawing or becoming uncompetitive.

There are both traded and non-traded BDCs which operate under the same regulations however non-traded BDCs are illiquid vehicles where investors pool their capital to a fixed liquidity date.

A few of the key rules governing BDCs are:

- **Leverage:** A BDC's debt-to-equity ratio cannot exceed 2:1.
- **Distributions:** Most BDCs elect to be treated as a Regulated Investment Company (RIC) and are exempt from corporation income taxes provided that they distribute at least 90% of taxable income to shareholders.
- **Income requirement:** At least 90% of a BDC's gross annual income must be derived from dividends, interest and realised capital gains from its investment portfolio.
- **Access to attractive Small Business Administration (SBA) funding:** 10-year fixed low cost loans from the SBA.
- Tax efficient vehicles for non-US investors.

Accessing Middle Market Direct Lending

Historically, access to middle-market direct lending has been limited for Australian investors. With the increase in market share shifting to private direct lending, an opportunity has been created to tap into this ever increasing market and for investors to earn higher yields on loans to this market.

Barwon offers access to middle-market direct lending through two strategies:

Barwon Golub Direct Lending Fund – an Australian open-ended feeder fund (wholesale unit trust) investing in direct lending funds managed by Golub Capital, including Golub Direct Lending Corporation, a US private BDC which specifically invests in the US middle-markets.

Barwon Global High Income Fund – an Australian wholesale unit trust, which invests in a global portfolio of listed private debt funds, with a focus on US listed BDCs.

If you would like more information about these Funds, please email investors@barwon.net.au.



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About Barwon Investment Partners

Barwon Investment Partners is an Australian fund manager with a 15 year track record of generating strong investment returns for institutional and wholesale clients. Barwon is independently owned with an experienced team of 45 investment professionals focused on healthcare property, property finance and global investments.

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