MACQUARIE ASSET MANAGEMENT

Perspectives

Direct lending: Uncovering the strategic edge

Private credit | August 2024

Ben Taylor, CFA | Private Credit Product Specialist

Hugh Brady | Private Credit Investment Solutions and Strategy

Daniel McCormack | Head of Research

Executive summary

- When it comes to seeking financing for leveraged merger and acquisition activity, large corporates generally have two markets to tap into: broadly syndicated loans (BSLs) and direct lending (i.e. non-bank lending).
- Direct lending has significantly grown its share of the leveraged loan market over the past 15 years, with its assets under management (AUM) now comparable in size to that of the BSL market.
- This paper explores how, even with sufficient liquidity in the market, direct lending has fundamental advantages that should help it continue to keep share from BSLs, despite borrowers having to pay higher interest rates to lenders.
- Investors can take advantage of the structural benefits of direct lending to optimise capital deployment opportunities, manage risk, and access additional return premias.

Mapping the leveraged lending universe

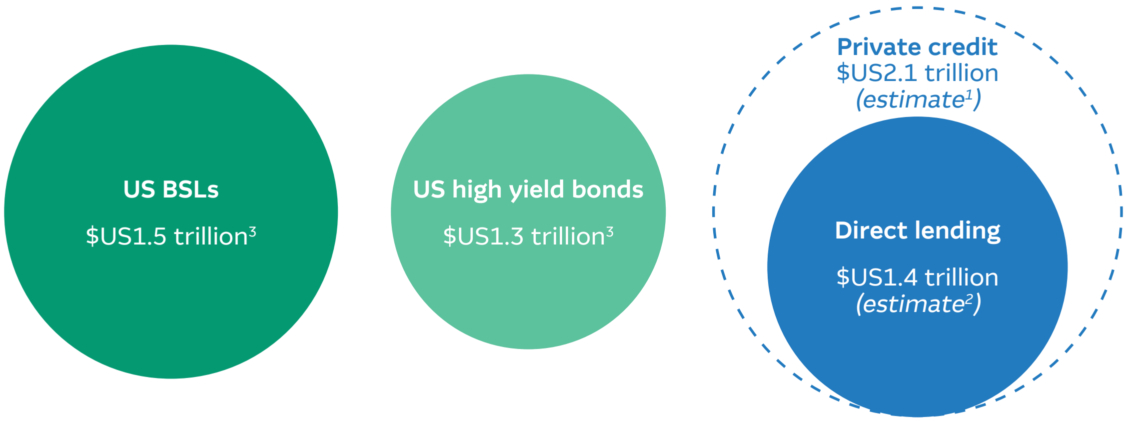
Prior to private credit's emergence as a niche asset class in the US in the mid-1990s, borrowers seeking to finance their mergers and acquisitions (M&A) activity would be required to issue loans into the syndicated market through banks.

Since then, regulations following the global financial crisis have acted as a catalyst to banks' retrenchment from the market, significantly growing the demand for private credit. The market is now estimated to be valued at $US2.1 trillion globally and comprises a diverse range of strategies, including corporate credit, real asset credit, and specialty finance.[1]

Within private credit, the most prominent asset class, direct lending (i.e. non-bank corporate lending), has an estimated $US1.4 trillion[2] in AUM, which nears the size of the BSL market[3] (Figure 1).

Direct lending has established its market presence due to the various benefits it provides to borrowers, including greater deal certainty, faster speed of execution, direct relationships with lenders, and more tailored solutions available. In addition, private credit has offered investors an attractive premia to BSL market returns leading to further interest in the space.

Figure 1:
Leveraged loan universe – private credit vs public credit market size



Sources: IMF, Fast-Growing $2 Trillion Private Credit Market Warrants Closer Watch (April 2024), KBRA, DLD Monthly Insights & Outlook U.S. Sponsored Deals (March 2024), Private Debt Investor, US BSL and US HY market size estimates as at 4Q23.

Direct lending continues to have a key role in servicing corporates

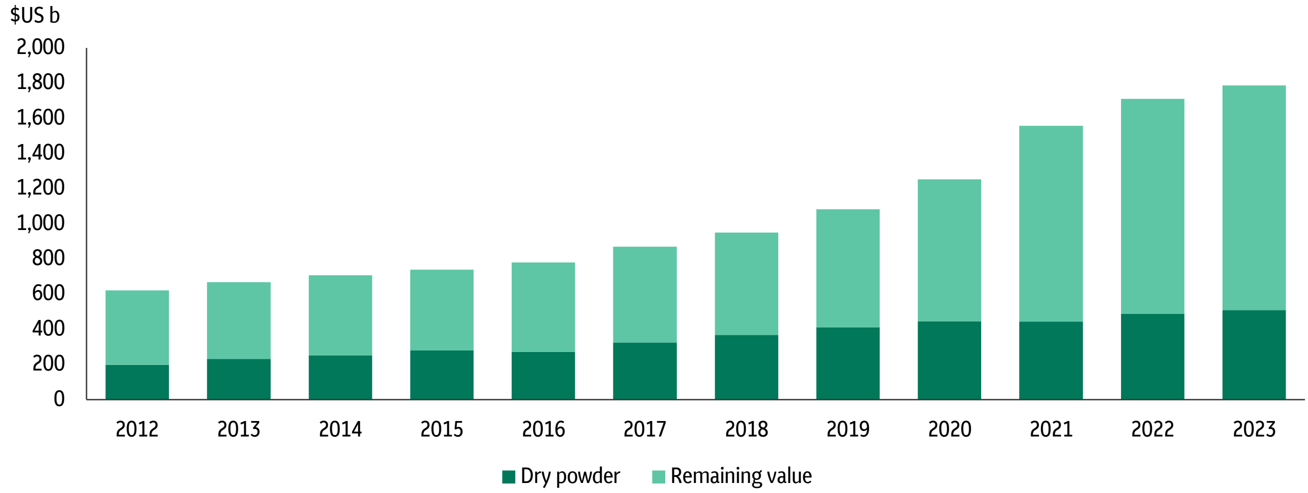
Despite the challenges, borrowers and direct lending managers have successfully managed the shift to a world of higher interest rates and heightened economic uncertainty. We believe direct lending is well positioned to continue to capture leveraged lending deal flow given the tailored solutions and structural advantages it may provide to borrowers in all market environments. Investors with a greater tolerance for illiquidity are able to take advantage of these structural benefits in exchange for better protections, active management, and additional return premia.

1. IMF, Fast-Growing $2 Trillion Private Credit Market Warrants Closer Watch.
2. KBRA, DLD Monthly Insights & Outlook (U.S. Sponsored Deals 1Q24/March Report).
3. Private Debt Investor, US BSL and US HY market size estimates as at Q423.

Direct lending provides execution certainty and tailored solutions to fuel M&A activity

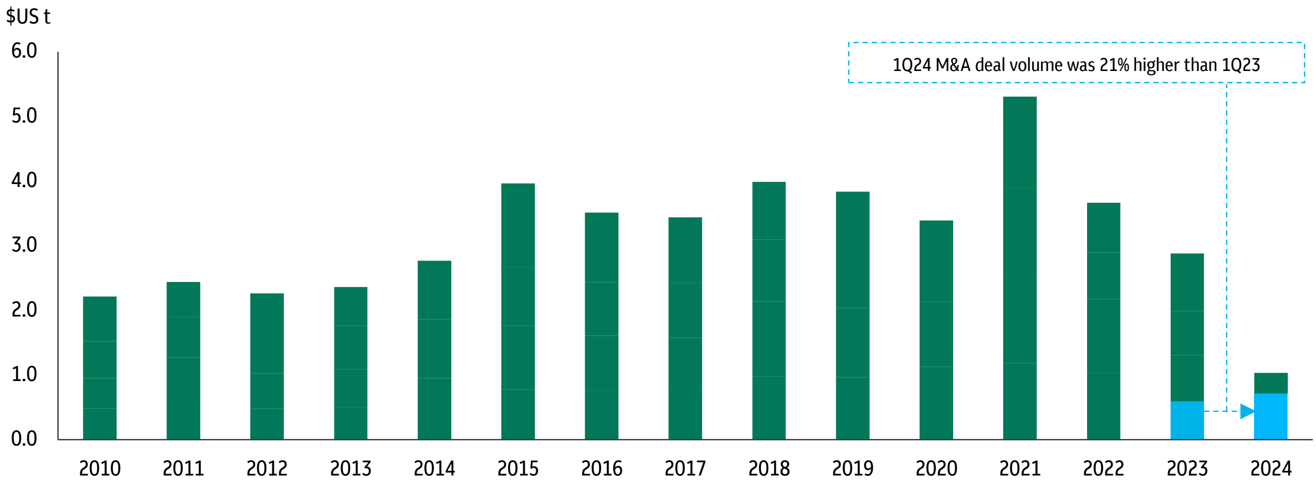
Although M&A activity has been relatively subdued recently, the accumulation of middle-market private equity (PE) dry powder has reached record levels of $US1.8 trillion in 2023 (Figure 2). This capital reserve has positioned PE firms to seize opportunities as market conditions improve, in turn fuelling the pipeline of opportunities for leveraged lending as PE sponsors seek financing to complete buyouts.

Figure 2:
US PE middle-market AUM



Source: PitchBook | LCD, Data through March 31, 2024. Direct lending analysis is based on transactions covered by LCD News.

Figure 3:
Global M&A activity

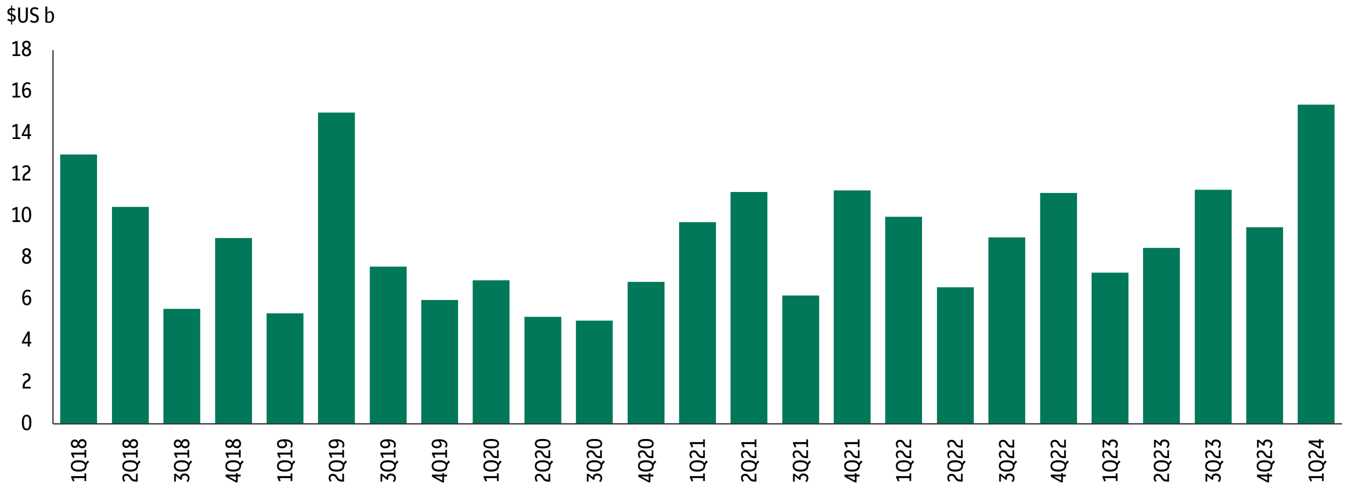


Sources: PitchBook | LCD Transactions covered by LCD News (March 31, 2024), Bloomberg, All pending and completed mergers and acquisitions (announced between January 1, 2010, and May 14, 2024).

We are already seeing this come through, as total middle-market loan issuance reached its highest level in 1Q24 since mid-2019 ($US15.4 billion versus $US15.0 billion), partly driven by the surge in leveraged buyout (LBO) issuance year-over-year.[4]

4. Fitch, U.S. Middle Market Chart Book: 1Q24.

Figure 4:
Quarterly total middle market loan issuance



Source: LevFin Insights, a Fitch Solutions company (June 2024).

With liquidity returning to the market, borrowers are once again being presented with the option of utilising the syndicated market for financing, which offers the advantages of lower interest costs and access to a broader capital base. However, financing through BSLs tends to be more standarised limiting borrowers' ability to negotiate tailored terms.

Direct-lending financing offers a unique approach, typically negotiated bilaterally or as part of a small club, with a lender that the borrower already knows and trusts. This relationship allows direct lenders to provide flexible, customised solutions tailored specifically to the needs of private equity-backed companies. Unlike BSLs, which require a credit rating and can be slowed down by this process, direct lending moves swiftly without the need for ratings. This streamlined, personalised negotiation process gives borrowers greater deal certainty and faster execution speeds compared to public markets. As a result, we believe borrowers seeking more customisation and quicker execution will continue to prefer private markets over BSLs for their financing needs.

For larger borrowers focused on keeping interest costs down and accessing a greater pool of capital, rather than prioritised speed of execution and bespoke terms, the BSL market may be the appropriate choice. However, the direct lending market is catching up, especially with the resurgence of "jumbo" loans (i.e. loans that are larger than $US1 billion in size). In 1Q24, KBRA reported a staggering volume of $US16.8 billion in private jumbo loans, which is more than three times the issuance in 1Q23.[2] Winning mandates of this size, the direct lending market appears to be competing with bank syndications effectively. So while liquidity has recently returned and the syndicated loan market has seen increased activity, we foresee a continued trend towards larger borrowers opting to finance via private credit. This trend is driven by a growing recognition of the substantial benefits and extensive capital resources that direct lenders offer, which are increasingly seen as better aligned with their financing requirements.

Refinancing and upsizes: Direct lending can act as a partner for both

A second source of consistent deal flow in direct lending involves borrowers refinancing their current loan facilities. Refinancings are becoming an increasingly significant and reliable portion of the deal flow in the direct lending market, particularly in times of economic uncertainty when M&A activity may be reduced.

In 1Q24, refinancings contributed to $US17.5 billion of the overall direct lending transaction volume[2], amounting to 36% of the total (Figure 5). Notably, the refinancing of "jumbo" loans represented $US10.2 billion of this figure. This shift underscores a growing preference among borrowers to explore financing options in the direct lending market, avenues that were traditionally pursued through BSLs.

We believe this trend of refinancing loans making up a greater proportion of deal flow is poised to continue. This expectation is fueled by a mix of market dynamics and the significant amount of middle-market direct lending debt approaching its maturity. With over $US100 billion in principal repayments scheduled for 2028 (Figure 6), borrowers are anticipated to actively seek refinancing opportunities to leverage favourable terms and extend loan maturities.

Figure 5:
Private credit deal share by use of proceeds, by volume

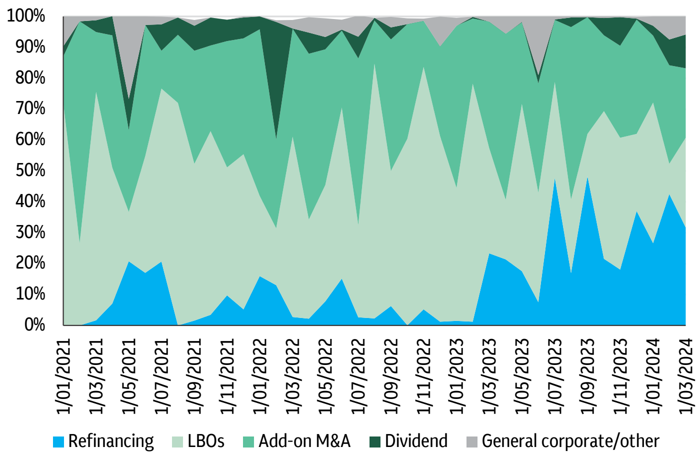
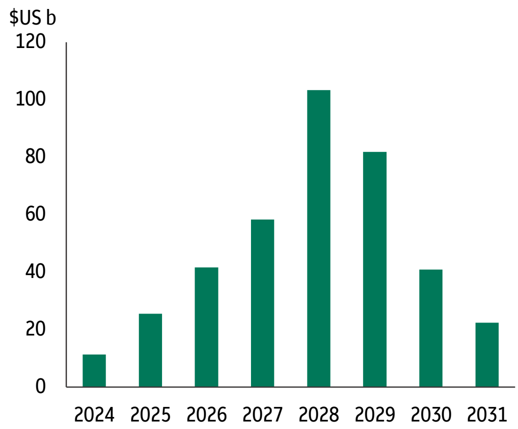


Figure 6:
Middle-market loans by maturity



Sources: KBRA, DLD Monthly Insights & Outlook (U.S. Sponsored Deals 1Q24/March Report).

We believe this is partly driven by the structural benefits of tailoring direct lending deals to align with PE strategies for growth. In "Buy and build" strategies, where PE sponsors use debt financing to grow a business organically or complete an add-on acquisition, direct lending plays a crucial role. These deals are typically structured to provide the necessary capital to strategically support these businesses through the different phases of growth. A deep understanding of a business's growth plan can enhance deal flow through loan upsizes and refinancing within a private credit portfolio, benefitting direct lenders with established relationships. This has been a key focus for PE sponsors seeking financing while new buyout opportunities in the M&A market have been more subdued.

Different types of borrowers will access different types of financing

As highlighted, larger borrowers seeking large, cost-effective financing are likely to first look at the BSL market. However, large-cap direct lending deals are increasingly competing with BSL to finance large, sponsor-backed companies, which have substantial equity stakes and the financial resources to support their portfolio companies during challenging periods. The appeal of direct lending extends beyond just the large-cap sector, encompassing a diverse spectrum of borrowers. This includes middle-market and lower-middle-market companies, each with their unique, nuanced financing requirements and less standardised operations. Such companies often find the bespoke, tailor-made solutions offered by direct lenders particularly valuable. This versatility positions direct lenders as a powerful alternative, capable of meeting the distinct demands of a wide array of businesses.

This versatility of direct lending underscores its position as a formidable alternative to traditional financing routes, capable of accommodating the varied demands of businesses across the size spectrum. For investors, understanding the distinct opportunity sets and risk-return trade-offs presented by each lending solution is crucial. This knowledge allows them to navigate the complex financial landscape effectively, making informed decisions that align with their investment strategies and risk appetites. As the financial markets continue to evolve, the role of direct lending in offering competitive, flexible financing solutions is likely to grow, further solidifying its importance in the broader financing ecosystem.

How can investors benefit from these structural differences? Unlocking the yield premia puzzle

Let's now explore how the different characteristics of BSL, large-cap direct lending, middle-market direct lending, and lower-middle-market direct lending can create value for investors. Each market has a different return premia and type of borrower, but also has an alternative way to manage risk.

Structural protections and tailoring create a "complexity premia"

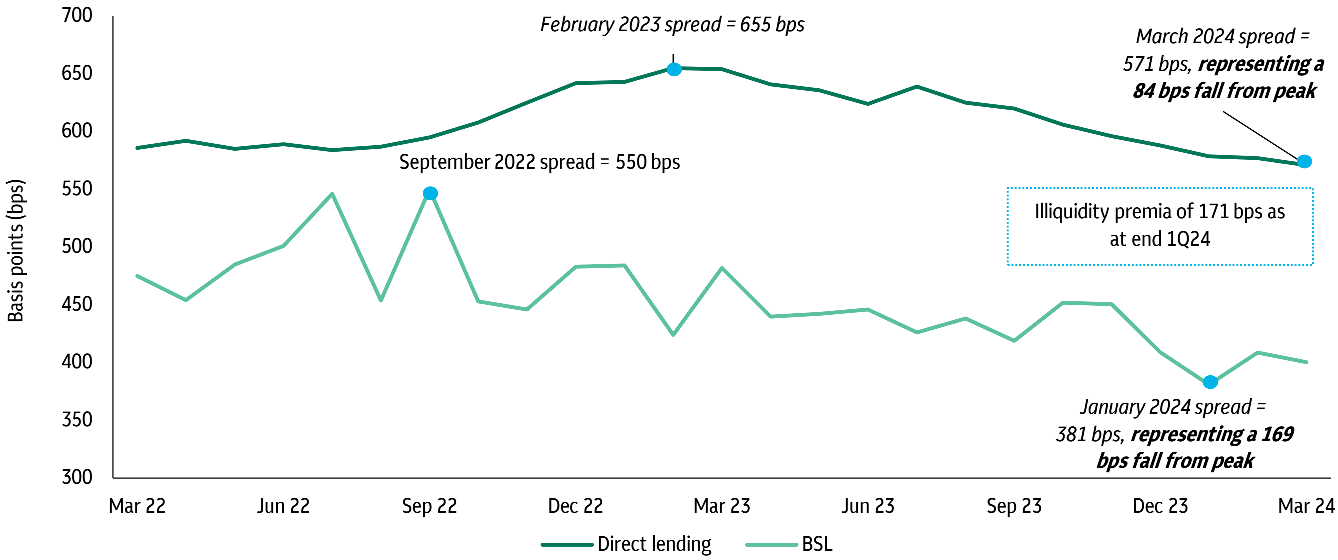
As mentioned, one of the reasons direct lending has experienced notable growth, is largely due to the flexibility it offers in structuring financing solutions. This customised approach allows lenders to establish financial maintenance covenants, bespoke protections, and other provisions unlikely to be found in the more rigid syndicated loan market. This translates into enhanced risk management and a "complexity premia", providing investors with the potential for higher returns while offering borrowers the precise terms they need to succeed.

We find that the level of tailoring and negotiation, and therefore complexity premia, associated with bespoke financing is often greater than loans issued on the syndicated market. Middle-market companies often have idiosyncratic financing needs and less standardised operations, therefore requiring more tailored solutions from lenders. In the lower-middle market, opportunities often demand highly detailed and specific terms due to their less established track records of cash flow and profitability. This raises concerns about their ability to service debt, making the risk higher. However, these challenges come with the potential for greater returns, attracting investors willing to engage in more intensive due diligence and stringent governance. By navigating these complexities, lenders can unlock significant value while ensuring that these companies receive the tailored support they need to thrive.

What is the illiquidity premia?

Direct lending diverges from BSLs in that it lacks a formal secondary market, primarily due to the private, bilateral nature of these hold-to-maturity investments. This characteristic means lenders are more committed to their investments for the long haul, often remaining engaged with the business post-deal completion. As a result, direct lenders typically command an illiquidity premium, which has historically ranged between 150-200 basis points above that of BSLs (Figure 7).

Figure 7:
Illiquidity premia over time



Source: KBRA, DLD Monthly Insights & Outlook U.S. Sponsored Deals (March 2024).

For investors, recognising and setting an appropriate level of illiquidity tolerance within their strategic asset allocations is crucial. Similarly, direct lenders must exercise discernment in their investment choices. Engaging with a top-tier direct lending manager can provide access to high-caliber credits, featuring tailor-made structural protections. These elements combined have the potential to offer superior risk-adjusted returns compared to that of traditional BSL investments.

Where do we think the attractive opportunities are in leveraged loans right now?

Looking across the leveraged loan universe, where can investors find the most attractive opportunity? When considering the points discussed, and if an investor can tolerate some illiquidity, we think a broad mandate across the large-cap and middle-market opportunity set is worth exploring. This section of the market grants investors access to a broad opportunity set, competitive positioning for consistent deal flow, and attractive return premia with structural protections.

Figure 8:
We believe having the ability to deploy across the large-cap and middle-market direct lending segments of the market offer the best risk-return balance and deployment opportunities.

Leveraged lending types	Broadly syndicated loans	Large-cap direct lending	Middle-market direct lending	Lower-middle-market direct lending
Spread over risk free rate	350-450 bps	500-600 bps	525-650 bps	575+ bps
Deal sourcing	Bank intermediated	Direct origination	Direct origination	Direct origination
Borrower typical credit rating	Companies rated B+ or lower	Not rated	Not rated	Not rated
Company size (EBITDA)	>$US250m	$US75-250m+	$US25-75m	$US5-25m
Sponsor	Publicly traded, large sponsor	Sponsor fund size $US5b+	Sponsor fund size $US1-5b+	Sponsor fund size <$US1b
Hold size	Smaller hold size in syndicate	Typically a portion as part of a club	Controlling position, up to 100%	Controlling position, up to 100%
Tenor	6-7 years	6-7 years (behaviourally 3-5)	6-7 years (behaviourally 3-5)	5-6 years (behaviourally 3-5)
Covenants	Covenant-lite	Covenant-lite	Maintenance covenant / Covenant-lite	Maintenance covenant
Due diligence	Limited	Extensive	Extensive	Most extensive
Monitoring rights	Limited	Strong	Strong	Strongest
Liquidity	Liquid	Less liquid	Less liquid	Illiquid

Note: Shows typical spread ranges expected over the life of a direct lending investment strategy. For illustrative purposes only.

The versatility to deploy capital across both middle-market and large-cap opportunities also allows lenders to adapt to market conditions and meet diverse borrower needs. However, it requires the investment manager to possess the expertise to navigate both segments effectively. Hence, it is beneficial to access this opportunity through managers with broad platforms and a track record that demonstrates an existing foothold in the market. Understanding the appropriate terms and pricing for each market segment ensures that lenders can offer competitive and tailored solutions, maximising returns while managing risks.

In an era marked by economic uncertainty and fluctuating market conditions, direct lending has emerged as an attractive alternative to BSLs. But the strength of direct lending lies in its ability to tailor solutions and maintain flexibility, offering significant advantages to business during challenging markets and attractive risk-adjusted returns for investors.

IMPORTANT INFORMATION

In April 2025, Macquarie Group Limited and Nomura Holding America Inc. (Nomura) announced that they had entered into an agreement for Nomura to acquire Macquarie Asset Management's US and European public investments business. The transaction is subject to customary closing conditions, including the receipt of applicable regulatory and client approvals. Subject to such approvals and the satisfaction of these conditions, the transaction is expected to close by the end of 2025.

The opinions expressed are those of the author(s) are as of the date indicated and may change based on market and other conditions. The accuracy of the content and its relevance to your client's particular circumstances is not guaranteed.

This market commentary has been prepared for general informational purposes by the team, who are part of Macquarie Asset Management (MAM), the asset management business The opinions expressed are those of the author(s) are as of the date indicated and may change based on market and other conditions. The accuracy of the content and its relevance to your client's particular circumstances is not guaranteed.

This market commentary has been prepared for general informational purposes by the team, who are part of Macquarie Asset Management (MAM), the asset management business of Macquarie Group (Macquarie), and is not a product of the Macquarie Research Department. This market commentary reflects the views of the team and statements in it may differ from the views of others in MAM or of other Macquarie divisions or groups, including Macquarie Research. This market commentary has not been prepared to comply with requirements designed to promote the independence of investment research and is accordingly not subject to any prohibition on dealing ahead of the dissemination of investment research.

Nothing in this market commentary shall be construed as a solicitation to buy or sell any security or other product, or to engage in or refrain from engaging in any transaction. Macquarie conducts a global full-service, integrated investment banking, asset management, and brokerage business. Macquarie may do, and seek to do, business with any of the companies covered in this market commentary. Macquarie has investment banking and other business relationships with a significant number of companies, which may include companies that are discussed in this commentary, and may have positions in financial instruments or other financial interests in the subject matter of this market commentary. As a result, investors should be aware that Macquarie may have a conflict of interest that could affect the objectivity of this market commentary. In preparing this market commentary, we did not take into account the investment objectives, financial situation or needs of any particular client. You should not make an investment decision on the basis of this market commentary. Before making an investment decision you need to consider, with or without the assistance of an adviser, whether the investment is appropriate in light of your particular investment needs, objectives and financial circumstances.

Macquarie salespeople, traders and other professionals may provide oral or written market commentary, analysis, trading strategies or research products to Macquarie's clients that reflect opinions which are different from or contrary to the opinions expressed in this market commentary. Macquarie's asset management business (including MAM), principal trading desks and investing businesses may make investment decisions that are inconsistent with the views expressed in this commentary. There are risks involved in investing. The price of securities and other financial products can and does fluctuate, and an individual security or financial product may even become valueless. International investors are reminded of the additional risks inherent in international investments, such as currency fluctuations and international or local financial, market, economic, tax or regulatory conditions, which may adversely affect the value of the investment. This market commentary is based on information obtained from sources believed to be reliable, but we do not make any representation or warranty that it is accurate, complete or up to date. We accept no obligation to correct or update the information or opinions in this market commentary.

Opinions, information, and data in this market commentary are as of the date indicated on the cover and subject to change without notice. No member of the Macquarie Group accepts any liability whatsoever for any direct, indirect, consequential or other loss arising from any use of this market commentary and/or further communication in relation to this market commentary. Some of the data in this market commentary may be sourced from information and materials published by government or industry bodies or agencies, however this market commentary is neither endorsed or certified by any such bodies or agencies. This market commentary does not constitute legal, tax accounting or investment advice. Recipients should independently evaluate any specific investment in consultation with their legal, tax, accounting, and investment advisors. Past performance is not indicative of future results.

This market commentary may include forward looking statements, forecasts, estimates, projections, opinions and investment theses, which may be identified by the use of terminology such as "anticipate", "believe", "estimate", "expect", "intend", "may", "can", "plan", "will", "would", "should", "seek", "project", "continue", "target" and similar expressions. No representation is made or will be made that any forward-looking statements will be achieved or will prove to be correct or that any assumptions on which such statements may be based are reasonable. A number of factors could cause actual future results and operations to vary materially and adversely from the forward-looking statements. Qualitative statements regarding political, regulatory, market and economic environments and opportunities are based on the team's opinion, belief and judgment.

Other than Macquarie Bank Limited ABN 46 008 583 542 ("Macquarie Bank"), any Macquarie Group entity noted in this document is not an authorised deposit-taking institution for the purposes of the Banking Act 1959 (Commonwealth of Australia). The obligations of these other Macquarie Group entities do not represent deposits or other liabilities of Macquarie Bank. Macquarie Bank does not guarantee or otherwise provide assurance in respect of the obligations of these other Macquarie Group entities.

In addition, if this document relates to an investment, (a) the investor is subject to investment risk including possible delays in repayment and loss of income and principal invested and (b) none of Macquarie Bank or any other Macquarie Group entity guarantees any particular rate of return on or the performance of the investment, nor do they guarantee repayment of capital in respect of the investment.

Past performance does not guarantee future results.

Diversification may not protect against market risk.

Natural or environmental disasters, such as earthquakes, fires, floods, hurricanes, tsunamis, and other severe weather-related phenomena generally, and widespread disease, including pandemics and epidemics, have been and can be highly disruptive to economies and markets, adversely impacting individual companies, sectors, industries, markets, currencies, interest and inflation rates, credit ratings, investor sentiment, and other factors affecting the value of the Strategy's investments. Given the increasing interdependence among global economies and markets, conditions in one country, market, or region are increasingly likely to adversely affect markets, issuers, and/or foreign exchange rates in other countries. These disruptions could prevent the Strategy from executing advantageous investment decisions in a timely manner and could negatively impact the Strategy's ability to achieve its investment objective. Any such event(s) could have a significant adverse impact on the value and risk profile of the Strategy.

Credit risk is the risk of loss of principal or loss of a financial reward stemming from a borrower's failure to repay a loan or otherwise meet a contractual obligation. Credit risk arises whenever a borrower expects to use future cash flows to pay a current debt. Investors are compensated for assuming credit risk by way of interest payments from the borrower or issuer of a debt obligation. Credit risk is closely tied to the potential return of an investment, the most notable being that the yields on bonds correlate strongly to their perceived credit risk.

Assets under management (AUM) is the market value of the investments managed by a person or entity on behalf of clients.

Broadly syndicated loans (BSL) are loans issued by below-investment grade companies and purchased by institutional investors. Broadly syndicated loans are senior secured and have a floating rate coupon that adjusts with short-term interest rates.

Dry powder refers to cash or marketable securities that are low-risk and highly liquid and convertible to cash. Funds held as dry powder are kept in reserve to be deployed in case of emergency. The term is often used in terms of venture capitalists, where dry powder allows them to invest in opportunities as they arise.

The global financial crisis (GFC) refers to the period of extreme stress in global financial markets and banking systems between mid-2007 and early 2009.

A jumbo loan, also known as a jumbo mortgage, is a type of financing that exceeds the limits set by the Federal Housing Finance Agency (FHFA). Unlike conventional mortgages, a jumbo loan is not eligible to be purchased, guaranteed, or securitized by Fannie Mae or Freddie Mac.

Liquidity refers to the efficiency or ease with which an asset or security can be converted into ready cash without affecting its market price. The most liquid asset of all is cash itself. Consequently, the availability of cash to make such conversions is the biggest influence on whether a market can move efficiently.

Macquarie Group, its employees and officers may act in different, potentially conflicting, roles in providing the financial services referred to in this document. The Macquarie Group entities may from time to time act as trustee, administrator, registrar, custodian, investment manager or investment advisor, representative or otherwise for a product or may be otherwise involved in or with, other products and clients which have similar investment objectives to those of the products described herein. Due to the conflicting nature of these roles, the interests of Macquarie Group may from time to time be inconsistent with the Interests of investors. Macquarie Group entities may receive remuneration as a result of acting in these roles. Macquarie Group has conflict of interest policies which aim to manage conflicts of interest.

macquarie.com/mam

Contact us by region

Americas

Market Street
Philadelphia
215 255 1200
mim.americas@macquarie.com

Australia

Martin Place
Sydney
1 800 814 523
mim@macquarie.com

EMEA

Ropemaker Place
London
44 20 303 72049
mim.emea@macquarie.com

Asia

Harbour View Street
Hong Kong
852 3922 1256
macquarie.funds.hk@macquarie.com

PERS-NO6-2024 | (4538235-05/25) V2. For institutional investors and investment professionals only.