BlackRock

Taking stock

Direct lending for the long run

Key points

Over the last decade, pension funds have increasingly taken advantage of the growing direct lending opportunity in Europe. Many were initially drawn by the appealing investment characteristics of the asset class, however, as the market develops and matures, we see a growing recognition of direct lending's structural merits. This in turn is driving a desire to build strategic exposures that are resilient to mid-to-late cycle dynamics and can support their specific outcomes. We explore how to build such exposures with a focus on UK defined benefit pension schemes, but we believe the over-arching principles apply more broadly. Three conclusions stand out:

1. **A consistent potential for better risk-adjusted returns.** Our analysis, based on the average allocation of UK pension schemes over the last ten years, suggests that the inclusion of direct lending delivers a meaningful enhancement in return / cash flow without introducing additional risk, underscoring the merits of a long-term allocation.

2. **The importance of an explicit focus on resilience.** It involves a range of considerations from using prudent return assumptions that are stress tested for adverse scenarios to targeting more defensive market segments and sectors. Above all, it entails fundamentals-based due diligence and on-the-ground experience. We illustrate this with two case studies.

3. **The crucial role of modelling.** Achieving close alignment with journey plans involves detailed modelling, taking on board considerations such as evolving funding status, cash flow needs, and the ultimate end goal. We propose an illustrative outline as a starting point for such modelling.

About the authors

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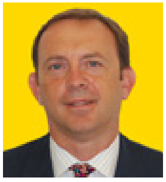

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An increasingly established market

Despite the significant growth seen to date, fundraising and capital deployment flows suggest that investor appetite for direct lending remains healthy, reflecting the inherent attractiveness of the asset class. Absolute yields have fallen, but they are still appealing on a relative basis in today's lower-for-longer environment as illustrated by Figure 1, which compares direct lending to syndicated bank loans and high yield bonds. Given the absence of reliable direct lending data we use leveraged mid-market loans as a proxy. In practice, loss rates are likely to be lower for diversified direct lending portfolios where managers generally have a greater ability to negotiate and enforce covenants, which can improve investment outcomes in the event of underperformance.

Direct lending's superior return potential as compared to syndicated bank loans and high yield bonds is underpinned by senior positioning within the capital structure, maintenance covenants and floating rate pricing. Moreover, a carefully diversified direct lending portfolio may be less sensitive to the business cycle than public debt markets as exposures tend to be more idiosyncratic in nature.

At the same time, we still see a strong supply of middle market companies looking for financing – for instance, in Europe, KPMG Investment Advisory estimates that as of 2018 companies had financing needs totalling two trillion euros over the next five years.

The structural drivers supporting direct lending also remain firmly in place. Most notably, we observe a continued reduction in bank lending as a result of regulatory and economic pressures. The impact of this regulatory squeeze is most pronounced in Europe where banks have traditionally been the main channel for mid-size company financing. Figure 2 highlights both the extent and the persistence of that decline.

We also see signs that the market is maturing with increased reach and segmentation between investment categories and players. For instance, we now see a growing distinction between 'upper-middle market', where the borrowers are usually larger companies (some of which may also be able to access the syndicated debt and high yield bond markets for financing), 'core middle-market' and 'lower middle-market', the latter two categories involve a continuum of smaller companies typically looking to finance growth and M&A activities.

The geographic reach of the market has also grown significantly from being primarily UK focused to including France, Germany, Benelux, Spain, Italy and, increasingly, the Nordic region. In response, we already see some of the larger players starting to specialise by specific region, sector or company size. This evolution has reduced competition for some transactions and allowed managers to secure better lender protections and / or returns.

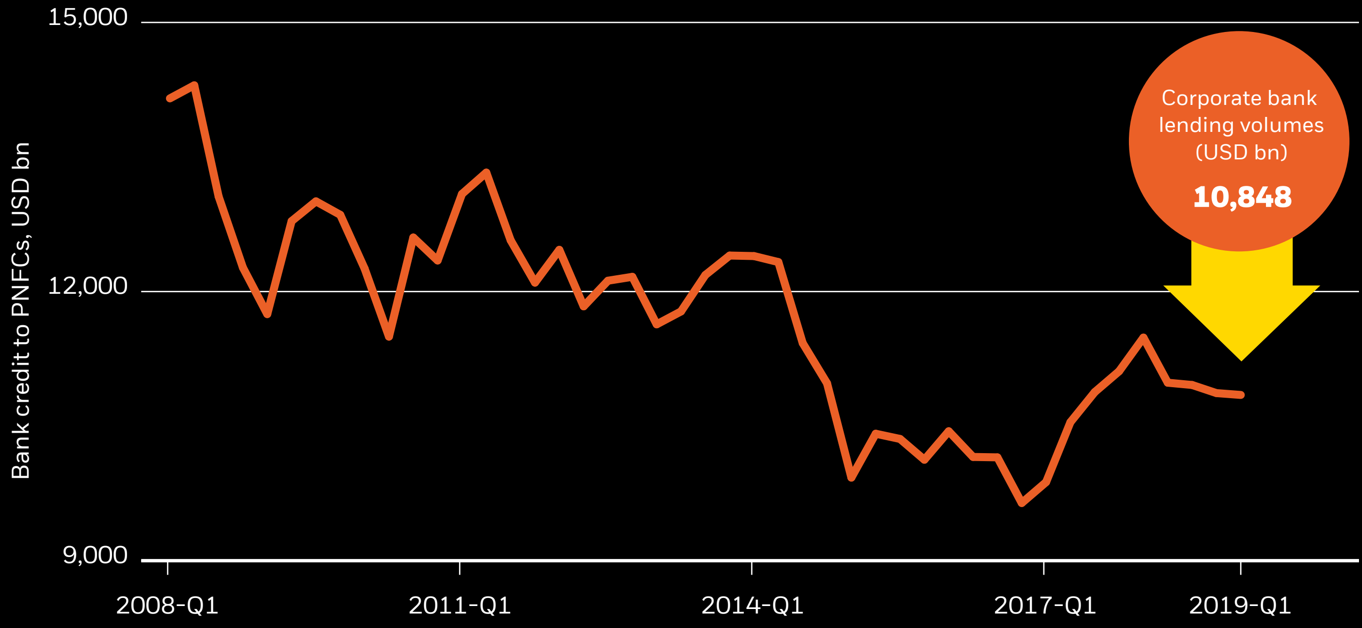
Signs of consolidation are also linked to the relatively high levels of 'dry powder', yield compression as well as the changing nature of lender protections or covenants. Upper-middle market companies, particularly those on the cusp of obtaining public financing (through leveraged loans or high yield bonds), appear increasingly able to negotiate favourable covenants. However, the core- and lower-middle market remain largely unaffected.

Figure 1 – Still attractive
Direct lending (proxied by leveraged mid-market loans) relative to the syndicated and high yield sector.

	Mid-market loans	Syndicated bank loans	High yield bonds
Annual default rate	**2.1%[1]**	2.7%[2]	1.2%[2]
Recovery rate	**80%[3]**	57%[2]	44%[2]
Annual loss rate[4]	**0.4%**	1.2%	0.7%
Spreads over Libor	**500 to 700bps[3]**	381bps[5]	494bps[6]
Libor floor	**0 to 50 bps[7]**	6bps[8]	N/A
Call protection[6]	**101 to 102%**	100 to 101%	Typically, 50% of coupon after 3 years

Sources: **1.** Fitch Leveraged Credit Database, average annual default rates for European issuers with debt <Eur500mm over period 2011-2018, as of December 2018. **2.** Credit Suisse, Average 12-month par default and recovery rates for European high yield and leveraged Loans 2011-2018, as of December 2018. **3.** Mid-market loan recovery rates are based upon two data points: 1) 75-85% from BlackRock estimate (December 2018) and 2) 76-100% from S&P 2016 European Empirical and Recovery Rating Performance Update, covering period 2003-2016. **4.** Loss rate is calculated as default rate x 1- recovery rates. **5.** S&P LCD, 3- months' average for new issues for bank loans as of December 2018. **6.** Barclays, Average OAS of Pan-European High Yield Index as of December 2018. **7.** BlackRock as of December 2018. **8.** S&P LCD, Quarterly European Leveraged Lending Review: 4Q18, as of December 2018. There is no guarantee that a positive investment outcome will be achieved.

Figure 2 – A structural decline
Corporate bank lending volumes across the eurozone and the UK



Source: Bank of International Settlements. Loans to private non-financial corporations (PNFCS) data as of September 2019.

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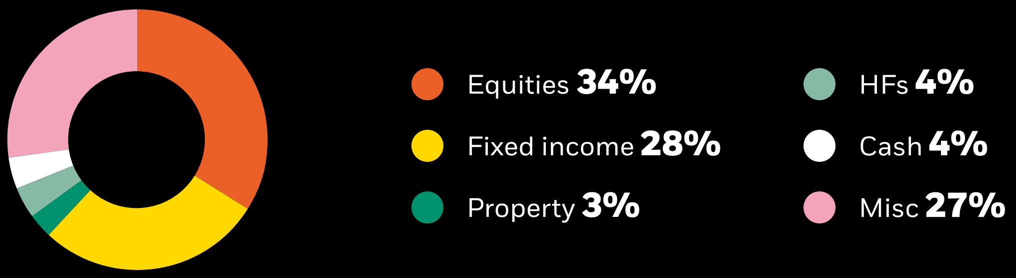
A rewarding endeavour?

What does this mean for pension funds who, along with insurers, are probably best placed to take advantage of this long-term opportunity? Taking the UK as an example, we find that for a typical pension scheme – we use 2018 average allocation data – a 10% direct lending allocation taken from an existing allocation to equities would have meaningfully increased returns over the past ten years, while the additional diversification would have kept risk at broadly similar levels. If the assets were sourced from the fixed income , rather than the equity portion of the portfolio, it would have resulted in even higher risk-adjusted returns. Figure 3 illustrates both points. The usual caveats in relation to past performance and averages apply, but it nevertheless suggests a relatively consistent potential for return / cash flow and diversification enhancement.

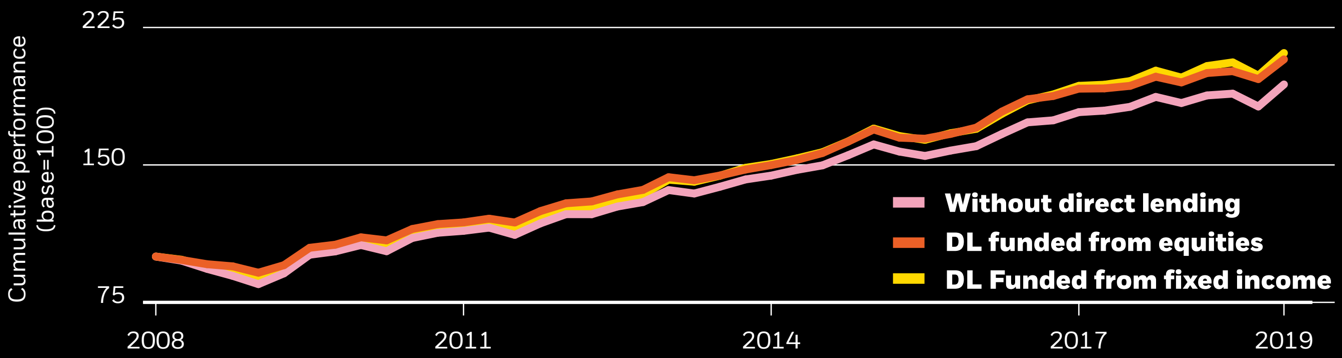
Figure 3 – The case for direct lending

3.1 Average UK pension scheme allocations in total assets from 2006-2018 – excluding notional exposures



Source: BlackRock as at 29 March 2019 using data from the Pension Protection's Purple Book, 2018 edition. Chart 3.1. shows the average allocations of UK pension funds, including LDI collateral, swaps etc. using the following indices denominated in GBP: FTSE All Share TR, MSCI Global ex UK TR Unhedged, S&P Listed PE index, Bloomberg Barclays Sterling Gilts Total Return Index Value unhedged GBP, Bloomberg Barclays Global Aggregate Corporate Total Return Index Value Hedged GBP, Bloomberg Barclays UK Comparator Inflation Linked Bonds All Maturities, MSCI UK IMI Net Liquid Real Estate CMBR GBP, JPM Cash Index GBP 3m, Bloomberg Barclays Sterling Gilts TR index Value unhedged GBP, HFRI Fund of Funds Composite Index and JP Morgan GBI UK 10+ year total return index GBP. The average allocations shown are simple averages and may not sum to 100% due to rounding. Miscellaneous includes annuity policies held in schemes' name, also referred to as 'buy-ins'.

3.2 Hypothetical performance comparison based on average UK scheme allocation



Source: BlackRock as at 29 March 2019 using data from the Pension Protection's Purple Book, 2018 edition. Chart 3.2 shows a comparison between the historical performance of the average UK pension fund allocation shown in chart 3.1 (yellow line) and the hypothetical performance of that average allocation with 10% direct lending funded from equities (red line) and fixed income (green line) respectively. The analysis uses the following indices denominated in GBP: FTSE All Share TR, MSCI Global ex UK TR Unhedged, S&P Listed PE index, Bloomberg Barclays Sterling Gilts Total Return Index Value unhedged GBP, Bloomberg Barclays Global Aggregate Corporate Total Return Index Value Hedged GBP, Bloomberg Barclays UK Comparator Inflation Linked Bonds All Maturities, MSCI UK IMI Net Liquid Real Estate CMBR GBP, JPM Cash Index GBP 3m, Bloomberg Barclays Sterling Gilts TR index Value unhedged GBP, HFRI Fund of Funds Composite Index, JP Morgan GBI UK 10+ year total return index GBP, Cliffwater Direct Lending Index Total Return. Please note that is not possible to invest directly into an index. Returns shown are unlevered, gross of fees and take into account income return, realised and unrealised gains / losses. Please note that past performance is not a reliable indicator of current or future results and should not be the sole factor of consideration when selecting a product or strategy. Likewise the hypothetical allocations are purely for illustrative purposes and should not be interpreted as advice or recommendation.

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Building long-term allocations

Having established that direct lending offers a good strategic fit for the average UK pension scheme, the challenge is to construct a long-term allocation that not only delivers throughout the business cycle, but also a scheme's own lifecycle. The first objective involves building in greater resilience, the second requires detailed analysis and modelling of the allocation against a scheme's journey plan.

Incorporating resilience

As highlighted in Figure 1, we find that – using December 2018 data from Fitch, Credit Suisse, S&P LCD and Barclays – historic default rates for mid-market loans and, by extension, direct lending, tend to be relatively lower: 0.4% compared to 1.2% for syndicated bank loans and 0.7% for high yield bonds. History is of course not a guide to future performance. However, our experience in the US market where direct lending has a longer track record suggests that it is feasible for experienced teams to preserve both capital and yield generation throughout the cycle. Since 2000, we have invested over USD 19 billion in more than 650 direct lending transactions and by focusing explicitly on resilience, we were able to achieve a gross internal rate of return (IRR) of 12.0% (9.0% net) in dollar terms with an annualised loss ratio of only 0.06% (BlackRock data as at 30 September 2019).

This example is for illustrative purposes only, but it highlights the importance of:

Scenario based risk management

Building resilient portfolios starts with ensuring that the underlying return assumptions used are reflective of the late-stage environment and the maturation of the market. Modelling and stress testing assumptions and resulting allocations for a range of adverse scenarios are central to this. Technology is now available to support such detailed scenario analysis.

Specialist experience

Another important consideration is the ability of direct lending managers to monitor and manage default risk pro-actively. Indeed, in a worst-case scenario where the equity cushion is wiped out (which typically would be 50-60% of the loan's value) managers may be able to get involved directly in the company to recover the capital. This requires, however, that the manager has a major stake in the loan (generally 50% or above), and, above all, specialist workout skills. It also means having seasoned practitioners to run these companies and sufficient resources to avoid any impact on deployment and management of other opportunities.

Cycle-aware portfolio positioning

Direct lending offers investors a high degree of flexibility to tailor their exposures in line with the economic cycle. For instance, investors may shift from financing growth orientated capital expenditure at the start of the cycle to supporting borrowers' acquisition of distressed competitors with good assets at the end of the cycle.

Experienced managers will also be focused on identifying relative value across companies' capital structures, as an additional means of ensuring portfolios are truly diversified and aligned with the cycle. At the current stage of the cycle, this means an emphasis on established, performing companies with strong market positions, but also more defensive sectors such as healthcare and information technology that have strong cash flows and are generally more resilient to cyclical downturns.

Geographic diversification is another mitigation mechanism, but it requires local sourcing capabilities and in-depth understanding of the specific regulatory and legal regimes across Europe.

Growing role for sustainability

Sustainability is an increasingly central factor in investors' manager selection decisions and an important contributor to greater resilience. At a minimum, investors expect managers to have robust environmental, social and governance (ESG) policies in place and to ensure that these policies are integrated with their investment processes. Sustainable, well-run businesses are inherently attractive to cash flow lenders and direct lending offers significant opportunity to focus on these long-term orientated companies.

Focus on fundamentals

Ultimately the robustness of a portfolio is only as good as the quality of the credit underwriting standards applied to each single asset. This means that the due diligence approach needs to be based on a real understanding of the fundamental drivers of the business, but also the market dynamics and regulatory framework of the sector in which the business operates. Having the experience and networks to assess the quality of management and governance is also paramount. In practice, this is only feasible by having on-the-ground experience and knowledge of the targeted markets and sectors, as illustrated by two case studies based on BlackRock's experience and data:

Case study 1

We were approached by a private equity sponsor needing finance to acquire a healthcare provider specialised in supporting complex patient needs. We were able to capitalise on a long-term relationship with the sponsor and being the only counterparty with in-depth knowledge of the sector to secure the mandate as sole financing provider. We subsequently negotiated a robust deal with a senior secured facility with maintenance covenants and a +8% contractual internal rate of return.

The resulting deal is underpinned by a strong investment thesis – the borrower enjoys a leading position in a fragmented market and its innovative model delivers a recurring and visible income stream –, and extensive protection, including sound covenants, an index rate floor and call protections.

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Case study 2

We were offered an interesting opportunity to lend to a family-owned business in Southern Europe. The company was a global market leader in business services with very attractive growth and credit profiles. As part of our extended underwriting process for sponsor-less transactions, we had identified specific risks with regards to governance and performed additional third-party due diligence on the management team.

The conclusion of the due diligence report confirmed significant risk with regards to the robustness of governance, which ultimately could have affected the quality of financial information. As a result, our Investment Committee decided to walk away from this interesting opportunity at the final stage of our process.

X

Source: BlackRock. As at 31 December 2019. Case studies are for illustrative purposes only; they are not meant as a guarantee of any future results or experience and should not be interpreted as advice or recommendation.

Aligning with journey plans

For pension schemes, a rewarding long-term exposure to direct lending entails close alignment with their specific circumstances and journey plan, be that self-sufficiency or buy-out. Over time, the allocation will have to evolve depending on changes in the schemes' cash flow profile, funding status, member composition – particularly in the case of buy-in or partial buy-out – and, potentially sponsor covenant.

Changes in the cash flow profile are probably the area that warrants the most frequent attention given 73% of pension schemes now consider themselves to be cash flow negative, according to the Mercer European Asset Allocation Survey July 2019. This can be addressed through rigorous and regular cash flow modelling.

The appropriate proportion of the total portfolio a scheme can allocate to direct lending will differ depending on its specific circumstances, such as the strategic asset allocation (e.g. exposure to other illiquid assets, including buy-outs), its journey plan and end goal. However, one thing to bear in mind is the need to over-commit capital because of the way cash is deployed and distributed. For instance, we find that allocating 10% of the portfolio to direct lending will typically not equate to 10% exposure for any significant period (if at all). While the actual experience of investors will differ on a case-by-case basis, in many instances we would assume that only 5-7% of the 10% target exposure will be invested at any given point in time.

It is also important that any modelling fully takes on board the yield premium offered by direct lending, which, after all, is the main purpose for pension schemes to allocate to the asset class.

We believe the below framework offers a useful starting point to model the profile of the direct lending allocation that would fit a specific scheme's needs. It also highlights that, in our view, the only schemes that should not be considering direct lending are those that are within touching distance of a buy-out.

Figure 4 – Illustrative scheme allocations

Scheme status	Open	Closed	Closed	Closed	Run-off
	Long-term focus on growth	**Focus on growth & Introducing LDI**	**Focus on LDI & selective growth**	**Accelerated de-risking & Focus on end game**	**Complete buy-out**
Funding level (on a prudent basis)	Open	< 75%	75-90%	90%+/ fully funded	NA
Key investment focus	Return	Return	Return		NA
		Risk mitigation	Risk mitigation	Risk mitigation	NA
			Cash flow	Cash flow	NA
Approach	Focus on growth	Focus on growth with recognition for the need of risk management	Diversify away from equity, increase yield to account for cash outflows	End game of a) self-sufficiency b) buy-out	NA
Direct lending					NA
Opportunistic					NA

Appropriate Potentially appropriate Not appropriate

Source: BlackRock. Data as at January 2020. For illustrative purposes only. Indications of appropriateness and allocation percentages are illustrative only and should not be interpreted as advice or recommendation.

Direct lending as an alternative to buy-in

- As schemes mature, a growing proportion of them undertake buy-ins to immunise some of their liabilities. While buy-ins are an appropriate response in many instances, they are not always the best solution as they curtail schemes' ability to react to changing circumstances.

- Direct lending alongside a gilt allocation to protect against interest rate and inflation risks can be a more flexible and cost-efficient alternative.

- Lack of direct longevity protection can be replaced by a buffer through additional returns generated from direct lending, while overall returns may be higher as there is no insurance premium to be paid.

- As cash is returned/re-deployed within direct lending, this structure can offer greater flexibility to tailor the level of risk and return to account for changes in the wider scheme.

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The essence

We find that the growth in European direct lending remains supported by strategic drivers even as we move further into the cycle.

Our analysis suggests that the still expanding asset class is a strategic fit for most pension schemes, with the potential to enhance returns and cash flows for similar levels of risk.

The key to building long-term exposures is a real understanding of the asset class, coupled with thoughtful portfolio construction based on scheme-specific needs and an explicit focus on resilience.

Achieving that resilience entails greater selectivity – with a focus on more defensive market segments and sectors, extensive risk modelling and, above all, fundamentals-based underwriting underpinned by on-the- ground presence and knowledge of the different European markets.

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