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How fund managers can make money from lending

In the seven years that have elapsed since the financial crisis, the number of funds raising capital to lend to the real economy has increased significantly. Fund administrators have had to adapt their services to a new class of client, and a new range of investors too. With regulation continuing to shrink the appetite of banks and investment banks to lend, direct lending funds look set to grow further and faster.

According to alternative fund industry data provider Preqin, the private capital raised for direct lending worldwide increased from $38.8 billion in 2010 to $74.4 billion last year. So far in 2015, a further $62 billion has been raised. Growth is especially strong in Europe, where funds raised have increased four-fold since 2010 to $12.3 billion last year.

In the more mature market of the United States, the value of direct lending funds has more than tripled in the same period, to $21.4 billion in 2014, and another $13.2 billion so far in 2015. Preqin surveys also suggest institutional investors are now almost as enthusiastic about direct lending as mezzanine debt, and a clear majority believe it is going to outperform public debt in terms of returns.

There is a strong correlation between the rise of direct lending since the crisis and the retreat of the banks from the lending markets. According to a Brookings Institution study of the four largest banks in the United States, deposits on bank balance sheets have significantly exceeded loans in every year since 2007, and had by the end of last year reached a record high of nearly $1.4 billion.

This reflects not only the surge of liquidity created by quantitative easing, but also the regulatory pressure on banks to restrict lending as a proportion of equity capital, and match their liabilities more closely to their assets. This appetite is evident in the rising size of the average direct lending fund, which has now hit $828 million in the United States and $1.7 billion in Europe.

Where is the private capital coming from?

The growth in fund size suggests that institutional investors such as pension funds and insurance companies understand and appreciate the ability of the direct lending sector to generate decent returns, but without leverage. They are currently allocating to direct lending funds mainly out of their alternative asset allocations. A Preqin survey found a majority of the sums raised came from private equity allocations (52 per cent), and a further 11 per cent from a general alternatives allocation.

However, some investors are now making separate (10 per cent), specific (15 per cent) or opportunistic (2 per cent) allocations. Only a minority (7 per cent) regard direct lending as part of a fixed income allocation, which suggests the sector is establishing itself as a separate asset class within alternatives, if not yet within investment portfolios as a whole. Investment consultants are starting to promote direct lending to their institutional clients.

Crowd funding platforms are becoming another important source of funding for direct lending. They have proved especially effective in sourcing funds directly from retail investors. They also have regulatory approvals and up-to-date technology, and distribution networks which make their businesses scalable, and some direct lending managers see them as attractive acquisition targets.

For direct lending managers - most of which originated in the private equity and hedge fund sectors – crowd funding platforms have already become an interesting source of opportunities as well as loyal funds, notably for commercial real estate projects. Some direct lending managers have already acquired equity stakes in crowd funding platforms.

Fund-raisers are finding that return matters more to lenders than liquidity. This is especially true of retail investors, which are prepared to lock up money for several years in return for a higher yield. Even some institutional investors are willing to take on the illiquidity risk, though they often insist on some form of credit enhancement.

What loan and corporate structures do lenders prefer?

There is as yet no strict pattern in terms of the structure of direct loans, even in the more mature American market, except in the sense that the assets and liabilities of the fund need to match. Funds have lives of five to seven years at the most, and the majority of funds are restricted to two to three years, though there is an implicit expectation that – if all goes according to plan - the investment will be rolled over into a new fund.

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Managers from private equity backgrounds tend to demand the longer lock-ups they are familiar with, while hedge fund managers are comfortable with a higher degree of liquidity for investors. This variation is part of the appeal of the sector: it creates opportunities to customise loans in ways that are simply not available in orthodox corporate lending. Lenders can insist on terms, collateral, covenants and event of default triggers that suit them.

However, much depends on the sector and the collateral that is available to back the loan. In most cases, borrowers concede senior status. But lenders are content to accept subordinated rather than senior status, in return for yield. In commercial real estate, on the other hand, loans tend to take the form of senior mortgages or bridging loans. In residential lending, straightforward mortgages are commonplace. Equity kickers are now being used to reduce coupons.

One sign that direct lending is an increasingly mature sector is the emergence in the United States of specialty finance companies. These take a variety of forms, ranging from publicly listed venture capital companies, through community banks, to FinTech enterprises. They attract investors prepared to make longer term commitments with the option to become an equity partner in a business sourcing direct lending opportunities.

Obviously, specialty finance companies also offer a degree of liquidity to investors. But the majority of direct lending funds are structured, like the majority of hedge and private equity funds, as limited partnerships between the managers (as general partners) and the investors (as limited partners). Alternative fund administrators are experiencing a growing stream of requests to develop bespoke valuation and investor services to support direct lending funds.

How are direct lending opportunities sourced?

Thanks to the withdrawal of the banks from a range of sectors and client types, there is no shortage of opportunities to invest. The challenge is to source them. Attractive propositions entail working with the specialists that intermediate loans in most industrial and commercial sectors. Banks shedding entire portfolios of under- or non-performing loans worth billions are another source, though they are large enough in terms of size to require groups of direct lending funds to collaborate on the purchase.

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The steady progress in cleaning up American bank balance sheets also means this source is drying up in the United States, though there is still business being done in commercial and residential mortgage portfolios. In Europe, on the other hand, where cleaning up bank balance sheets has scarcely begun, there is ample growth to come. This is one reason why Preqin has recorded a faster growth of direct lending in Europe than North America.

Crowd funding platforms are another source of lending opportunities. They attract borrowers directly, because they have built a solid reputation for meeting their needs without the cherry-picking discrimination characteristic of banks. Having focused initially on consumer debt, crowd funding platforms are expanding into funding small and medium-sized corporate enterprises (SMEs) against a range of liquid and illiquid collateral.

In fact, the major growth area in direct lending lies in mid-market SMEs, where the borrowers are either too small to warrant the time and effort or not big enough to interest the banks - loans generally range between $25m and $75m in size. Since the borrowers are restricted to direct lending, the terms can be generous to lenders, especially in terms of collateral and access to equity upside.

That said, direct lenders still operate to banking criteria. They seek businesses with strong cash flow and realisable assets operating in sectors with high barriers to entry. Attractive sectors include oil and gas, mining, minerals, commodities, and commercial real estate, where the banks have recently tired of both the volatility and the declining value of the asset bases.

There are direct loans being advanced below $25 million. At this level, the loans are manifestly uneconomic for banks, and not just because they take as much or more work than a loan of $100 million. Inevitably, the borrowers needing sums of this magnitude have shorter track records, briefer relationships with reassuring professional advisers such as auditors and law firms, and tend to be invested in less bankable or collateral-rich sectors such as entertainment, FinTech and agriculture.

Managers of direct lending funds are also lending to other fund managers, and especially to hedge funds that are being re-priced or even cut adrift by prime brokers rationing their largesse in response to tighter regulation of their capital and liquidity. As the willingness and ability of prime brokers to finance hedge funds outside a narrow set of investment strategies has diminished, an opportunity had arisen for direct lenders to take their place.

However, hedge fund managers cannot simply advance surplus liquidity to their peers. They are constrained by the terms of the investment strategy agreed with their investors. There are hedge funds pursuing orthodox strategies which have put surplus cash into direct lending, but they have encountered objections from their investors.

To lend directly to other fund managers on a permanent basis, managers will have to raise money specifically for that purpose. The quality of the credit and the lengthy maturities make this hard to do for funds with quarterly redemption rights. Private equity fund structures, with lock-ups of two to five years, have proved better adapted to the opportunity.

How do lenders collect returns?

The Preqin data suggests direct lending fund fee structures remain highly diverse. Though the two-and-twenty and one-and-ten fee structures familiar in the hedge fund industry are not unknown, more complex fee structures are evolving as the sector matures. In general, managers from a hedge fund background tend to trade shorter lock-ups for higher fees, while their counterparts from the private equity industry tend to do the opposite.

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A strong relationship is emerging between anticipated returns and fee levels. Returns often reflect the options open to borrowers, and on this score there is a noticeable difference between Europe (where distressed assets are still available) and the United States (where direct lending is creating new credit in sectors banks have abandoned). Borrowers with limited options are in a weak position to negotiate rates, ranking and collateral, and managers can take advantage of this.

This is why returns to direct lenders in the United States, where the borrowers are not attractive to the banks, are never measured in less than high single digits, and sometimes in low double digits. However, with such high returns available relative to risk-free lending, institutional sources are pressing managers to accept lower management and performance fees. Private equity-type structures, in which investors collect a preferred return before the managers earn performance fees, are becoming a commonplace tool.

Is direct lending a temporary phenomenon or a permanent structural change?

The volume of money being attracted to direct lending suggests there is a fundamental shift taking place in the credit markets. That said, there is clearly a cyclical component to the surge in direct lending. Low rates of interest have demonstrably encouraged a search for yield. Direct lending funds exist in part to make that search fruitful.

Yet there is also a growing sense that the risk-free rate of return on cash is not going to rise significantly for many years, so direct lending will continue to offer a yield premium for some time to come. The extraordinary monetary policies of recent years have also raised doubts about the persistence of equity returns, which provides a further boost to direct lending as a reliable and relatively remunerative asset class for investors.

There are also structural changes occurring that underpin direct lending. One is that the regulatory tightening of bank capital regimes under Basel III is not going to be reversed. This is already encouraging banks to exit certain classes of lending. In the longer term, it means banks are not going to reassume the form they took prior to the financial crisis.

Accordingly, the opportunities for private companies to lend to less bankable companies and sectors will persist. Clearly, bank lending is not going to disappear completely, since any organisation lending real savings will struggle to compete with a leveraged balance sheet. In addition, many of the new intermediaries entering the sector will continue to rely on bank-controlled infrastructures.

It follows that even the most permanent of direct lending platforms is not going to disintermediate the banks. Nevertheless, the technology that underpins direct lending has led to a permanent alteration in the nature of intermediation.

The ambition of some new banking intermediaries to build revenues from data they collect about their customers, rather than net interest margin, is one indicator of this. The success of crowd funding platforms, in gathering small pools of money on an economic basis and simultaneously sourcing lendable propositions of relatively small size, is a further indication of a structural shift.

Though direct lending might yet be affected adversely by regulation, technology will for the foreseeable future continue to make it cost-effective for private capital to lend to credits that are no longer or not yet of interest to capital-constrained banks. There is plenty of growth still to come in the markets for direct lending funds.

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