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Relative Attractiveness of Direct Lending: Term and Credit Risk

The low-rate environment that characterized the past decade or so led many investors to seek a replacement for fixed-income securities. Many found a solution in direct lending, which provided them with higher yields while being less volatile than public securities. According to Preqin, direct lending has been one of the fastest-growing asset classes in private markets, with AUM growing at a CAGR of about 24% between 2010 and 2021.

The recent spate of rate hikes, however, has brought fixed-income securities back into the spotlight. Now that bond yields are expected to be higher than they have been, some investors may be tempted to rethink whether direct lending is as compelling a value proposition. Yet even as the gap between direct lending and other bond yields narrows, there are several other reasons why we find direct lending more compelling than traditional fixed-income investments.

Figure 1 | Debt Investments Overview

Feature	Direct Lending	High Yield	Investment Grade
Market	Private	Public	Public
Floating Rate	Yes	No	No
Secured	Yes	No	No
Liquidity	Limited	Conditional	Conditional
Duration	**0.25**	**4.14**	**7.07**
Historical Loss Rates	**0.7%**	**1.8%**	**0.1%**
Current Max. Drawdown	0%	-14%	-17%
GFC[1] Max. Drawdown	-8%	-28%	-9%
Annualized Volatility[2]	3.7%	9.5%	6.2%
Annualized Return[2]	9.3%	5.7%	4.4%
Current Yield[3]	11.4%	9.1%	5.4%
Current Coupon	11.1%	5.8%	3.7%
Correlation with DL	1	0.44	0.12

Sources: StepStone Group, CS HY Index, Barclays US IG, Moody's, Cliffwater, Refinitiv LPC as of December 2022.

[1]Great Financial Crisis 2008/2009. [2]Annualized volatility and return based on the period between 2005 and 2022. [3]Current Yield defined as yield to worst for HY and IG bonds and gross asset yield for direct lending.

Lower Duration Risk

Bond investors know all too well that bond prices and interest rates are negatively correlated. When rates rise, prices fall, and yields increase. Some bonds are more sensitive to rate fluctuations. In other words, they have greater duration risk.

Because direct lending uses rates that "float," cash coupons have been increasing as interest rates have been increasing while the prices of the underlying loans have remained stable. So even as bond yields have risen in recent months, direct lending's floating rate has allowed it to deliver superior yields while

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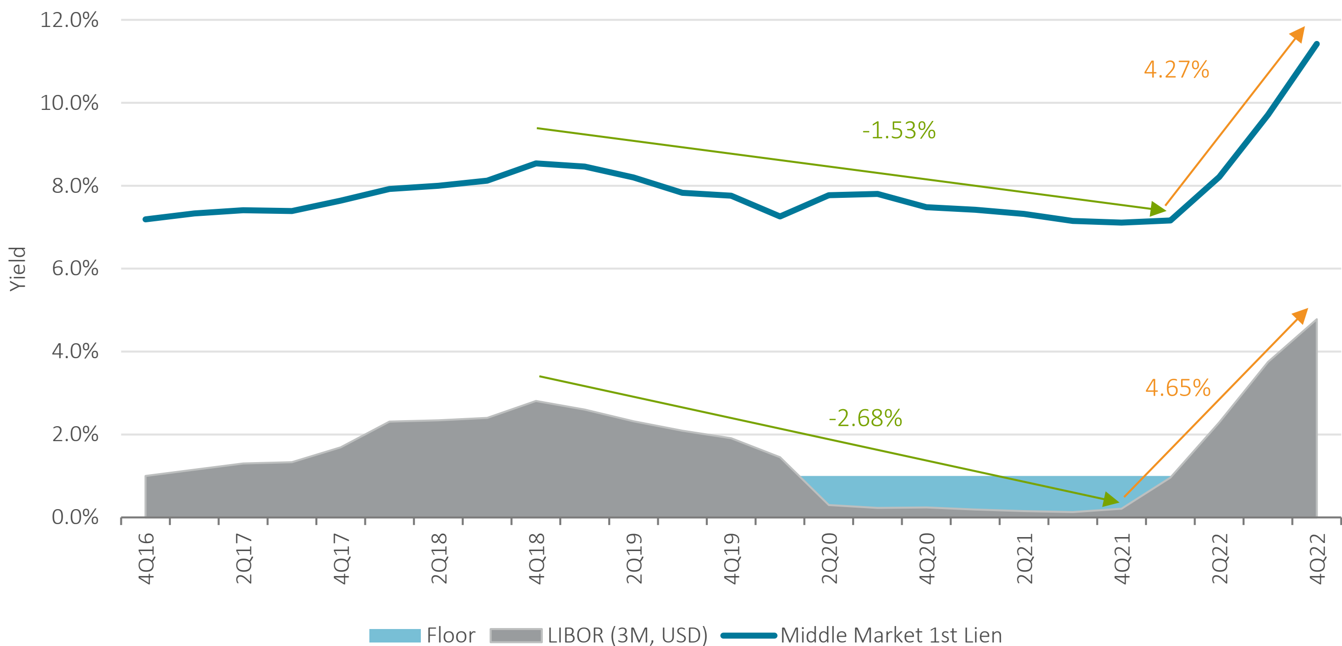
maintaining low volatility. Thus, floating rates offer several advantages relative to other asset classes:

1. Because direct lending coupons rise as interest rates rise, they generate a higher current income thus providing a buffer against the higher loss rates that usually accompany higher rates.
2. These coupons tend to reset every three months, which reduces interest rate risk.
3. If interest rates fall, the income generated from direct lending is protected by floors that limit how low the coupons can fall.

To summarize, direct lending can offer downside protection, while offering attractive upside opportunities through monetary policy cycles.

This mechanism is demonstrated in **Figure 2**, which shows that after the Federal Reserve slashed its policy rate in early 2020 to support the economy, primary first-lien middle market yields did not drop as sharply. When the Fed started increasing rates in late 2021, yields followed a similar trajectory—demonstrating the upside potential benefits that floating rate coupons, which reset every quarter, can deliver.

Figure 2 | Middle Market Primary Yields



Source: Refinitiv LPC, Bloomberg as of December 2022.

In the current environment of elevated inflation, high-interest rates and potential recessions for many economies, the higher coupons provide a buffer against potential increases in the loss rate during a recession. Moreover, in an inflationary environment, floating rates protect against principal devaluation by compensating the lender with higher interest payments.

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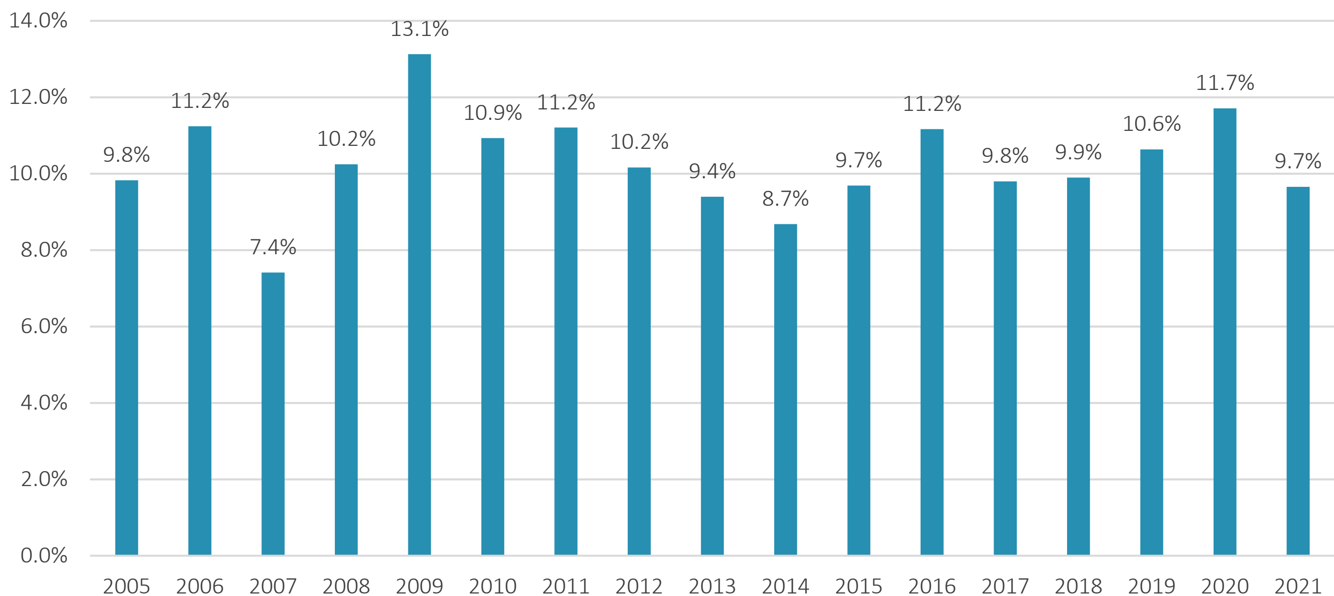
Credit Risk

Direct lending benefits from its focus on first-lien loans, which sit at the top of the capital structure. First-lien lenders tend to be repaid before other debt holders, limiting potential losses from defaults. In addition, direct lender syndicates typically include only a few lenders, making workout negotiations easier to navigate.

Unlike high-yield and investment-grade bonds, direct lending loan contracts also usually include financial maintenance covenants, which are typically tested quarterly based on the financial performance of the borrower. They protect lenders by imposing certain limits such as maximum leverage, minimum EBITDA or minimum fixed charge coverage levels. Covenants help lenders spot early signs of financial stress and address them before they lead to more serious challenges. These attributes allow investors to maximize the recovery value of the investment in a default scenario.

Finally, a significant portion of borrowers in the direct lending space is backed by one or more private equity firms. In times of financial stress, the private equity sponsor may provide an equity injection to help the borrower stay afloat, thus reducing credit risk. Historically being "sponsor backed" has helped direct lenders generate relatively stable returns for their investors. All the aforementioned characteristics have contributed to the robust performance of the asset class throughout the years. (**Figure 3**).

Figure 3 | Direct Lending Vintages Weighted Average IRR



Source: StepStone Group, as of December 2021
For illustrative purposes only. All information provided is at an industry level, no StepStone investments are included in any of the above metrics. All information provided here is based on research related to third party managers.

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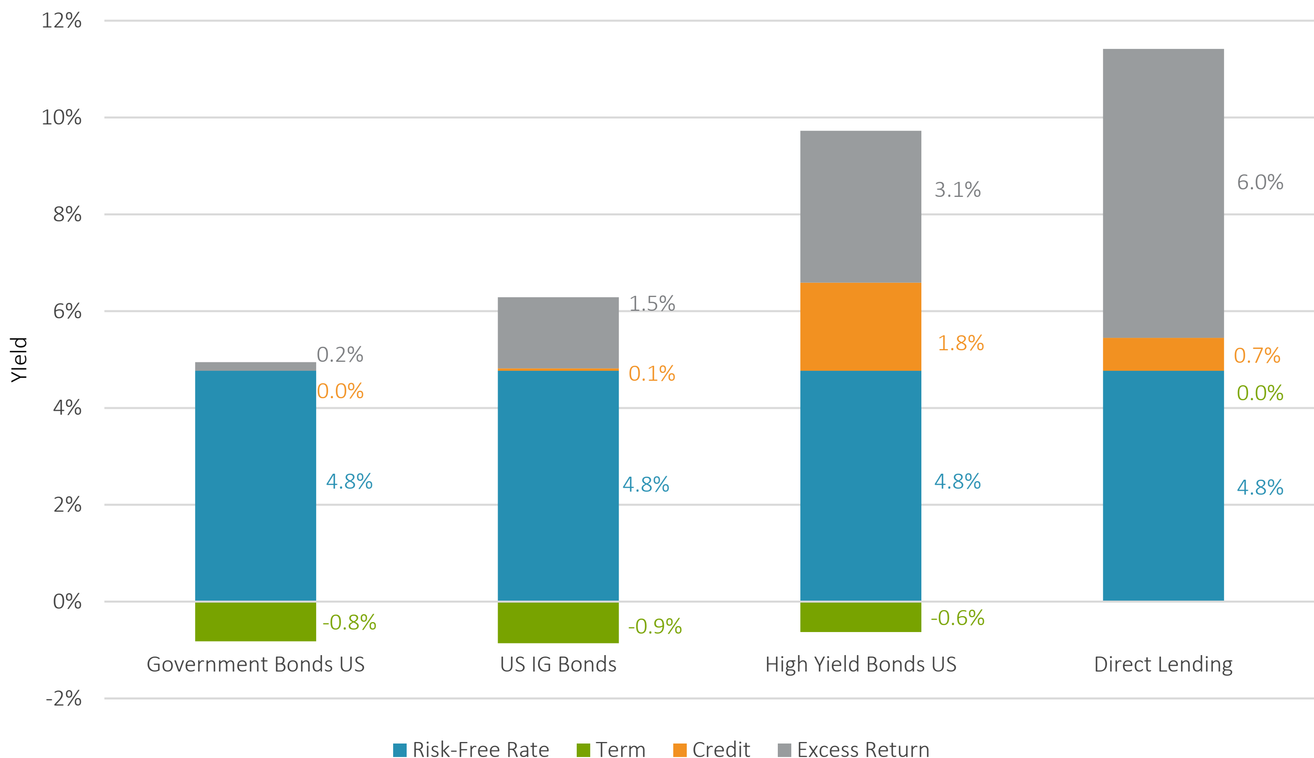
Excess Return—Return Adjusted for Duration and Credit Risk

Figure 4 explores the direct lending's comparative advantage over high-yield and investment grade-bonds by decomposing the risk premia into four elements:

1. The risk-free rate is defined as the 3-month USD Libor.
2. Term risk, which depends on the security's duration. When yield curves are inverted (as they are now) the term component turns negative and drags down bond yields as investors are charged to take on duration.
3. Historical loss rates are a good proxy for credit risk. Here, direct lending displays a much lower credit risk than high-yield bonds thanks to the characteristics detailed above.
4. Finally, the rest of the yield is considered excess return and comes on top.

Figure 4 gives a clear picture as to why direct lending is still relatively attractive as it provides nearly twice the excess return of high-yield bonds and more than four times the excess return offered by investment grade. An upcoming paper will provide additional insights into the components of the excess premium for private debt.

Figure 4 | Risk Premia Breakdown



Source: StepStone Group, as of 4Q2022.
Source for the US Market: "Government Bonds US" Data based on Barclays US Aggregate Treasuries Index. "US IG Bonds" Data based on Barclays US Aggregate IG Corporate Index (Yield & Duration) and Moody's Annual Default Study (Loss Rates). "High Yield Bonds US" Data based on CS US High Yield Index. Direct Lending" based on StepStone Group (Loss Rates & Duration) and Refinitiv LPC (Yield).

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Thus, looking at duration and credit risk side by side, relative to other fixed-income securities, direct lending offers attractive yields without adding duration risk or large undesirable credit risk.

Conclusion

Despite the recent increase in yields from public fixed-income securities, direct lending's relative value remains attractive. The floating-rate component of direct lending returns offers a unique advantage, protecting coupons from duration risk while offering a buffer against potential increases in loss rates. In addition, first-lien loans' senior position in the capital structure combined with covenants that public debt securities don't have, offer protection against credit risk. As a result, we believe direct lending offers attractive expected risk-adjusted returns compared with most direct competitors.