

RETURNS

How direct lending's growth is changing returns

Jess Larsen of FIRSTavenue charts the evolution from 'idiosyncratic alpha' to cost-efficient beta, and the impact this is having on fees

Private credit continues to grow strongly. Surveys show private debt will hit \$1.4 trillion by 2023, passing real estate to become the third-largest alternative investment asset class after hedge funds and private equity. This growth is coinciding with LPs broadening their focus beyond direct lending to credit opportunities and asset-backed lending.

It's vital to realise what's driving this. A good example is provided by how the private equity market grew via allocations from public equity portfolios. With private credit, we are still in the early stages of a much bigger allocation out of public fixed income portfolios.

Unsurprisingly, rising capital flows have coincided with an influx of new managers. Yet it is apparent the industry's long expansion is beginning to change the dynamic of how investment returns are generated. Simply, private credit is moving from a period when returns were a product of idiosyncratic 'alpha' to an era characterised by a more cost-efficient direct lending beta-type performance stream.

BIGGER AND BOLDER

What is driving this transformation is straightforward. Despite the emergence of hundreds of new debt managers, capital inflows have disproportionately benefited the largest GPs. In 2017, for example, the top 10 private debt firms received nearly one-third of the new capital deployed – leaving over 600 managers to share the rest.

Inflows of capital to private credit continue to rise even though growth is moderating. This is altering the private



"INVESTORS WILL INCREASINGLY PERCEIVE DIRECT LENDING RETURNS TO BE A BETA PLAY, FURTHER PRESSURING FEES" Jess Larsen

credit industry's competitive dynamic as lenders increasingly become price takers rather than value-adding packagers of complex negotiated loans in the sponsored sector. In fact, GPs' underwriting skills are becoming more critical than their structuring skills. The result is a more price sensitive and efficient, but less customised, market where GPs produce 'alpha by avoidance'.

This is putting persistent pressure on fees. Management fees have moved to a levy on invested capital, not committed funds. The preferred rate has also inched up to 7 percent from 6 percent. Origination fees are now either shared or fully passed on.

An added challenge is tightening monetary policy beginning to impose itself on the credit cycle. First Avenue expects the current default rate to rise with a reversion

to average historical default rates of 3-4 percent (compared with 1.5-2 percent now) – a reasonable base case scenario.

Given the potential for greater return volatility, we believe LPs will gravitate towards larger and more established managers that provide scale, longer track records and brand recognition. We expect this flight to safety to tighten direct lending spreads and reduce risk-adjusted returns. In sum, further compression of the performance differentials among top-quartile and median-quartile funds is expected.

All this makes it likely that investors will increasingly perceive direct lending returns to be a beta play, further pressuring fees. This will impact other areas. We think consultants and LPs will prioritise track records extending over multiple cycles. The preference for low loss rates over an outperforming track record will enhance the tendency towards uniform performance. The investment outcome will be a more cost-efficient and predictable direct lending beta-type performance stream.

Yet, even though direct lending and private credit performance will be increasingly comprised of beta characteristics, investors will still need to choose how much risk they want to take and what level of diversification will be needed to ensure this. The upshot of alpha being pushed to the margin as the private credit asset class matures is likely to be greater competition among GPs and sophistication among LPs in selection of debt instruments with varying risk profiles. ■

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