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What does the Fed rate cut mean for direct lending?

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The last two years have been favorable for direct lending, offering high returns driven by three key factors: high base rates, wide spreads, and strong business performance. With a rate-cutting cycle ahead, it's important to understand how each of these components might be impacted, and how businesses and consumers benefit from lower interest rates.

Base Rates

Base rates are the simplest to understand. They represent what you earn just for lending your cash without taking on extra risk. The primary benchmark for middle market loans is the Secured Overnight Funding Rate (SOFR), which has stayed above 5% since May 2023.

When the Fed cuts rates, SOFR typically follows and drops as well. As a result, investors will earn less interest from the base rate, meaning lower total returns. However, borrowers will benefit as their interest payments decrease.

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Spreads

Spreads, the extra interest lenders charge to cover risk, depend more on supply and demand. If base rates fall, lenders might demand higher spreads on new loans. Conversely, lower base rates could result in capital shifting towards higher-yielding asset classes, such as direct lending, which could pull spreads tighter due to the additional supply of capital.

Borrower Performance

Finally, underlying borrower performance will have a meaningful impact on direct lending results. Remember, it's not just how much you charge, but how much you get (re)paid that determines ultimate returns. Across the wide range of industries we cover we are seeing small signs of a pullback in

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consumer spending, hiring, and pockets of weakness. We believe that the Fed has noticed some of these early warning signals as well and may be trying to get ahead of a slowdown in the economy by starting with a 50bps cut.

While we are hopeful that this will have its intended effect of reducing borrowing costs and easing financial conditions, we think adopting a more conservative posture and maintaining vigilance with respect to covenants and documents is vital. With SOFR above 5%, returns have been supported by higher rates, but borrower viability is the key for long-term results. One private market study showed that as of 6/30/24, ~20% of borrowers had interest coverage ratios below 1.0x[1]. As rates come down, we would expect coverage ratios to improve for the vast majority of borrowers. Further, small short-term cuts are not expected to materially impact returns nor change the portfolio benefits of the asset class.

Conclusion

Declining base rates may lower returns, but we do not see base rates collapsing. Lower rates ease pressure on borrowers and the consumer, so should reduce risk. Additionally, we think direct lending in the core middle market will continue to offer attractive spreads. Successfully assessing borrower viability and maintaining strong loan documentation are expected to ultimately generate strong relative and absolute performance.

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[1] Source: Lincoln International Private Market Perspectives: U.S. Edition. August 2024.

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