CAIS IQ

FOUNDATIONS OF PRIVATE CREDIT:

Direct Lending

Seeking to Fill the Gap in the Middle

Direct Loans are loans that are directly negotiated between a lender and a borrower

The Rise of Direct Lending

Historically, a company in need of money would typically borrow it from a mainstream bank. After the Global Financial Crisis (GFC) of 2008, US regulators – seeking to avoid what led to the GFC in the first place – restricted how much money mainstream banks could lend to companies.

Enter direct lenders, who came onto the scene to seek to fill that void. Direct lenders form a part of private markets, and therefore are generally not subject to the same regulations as mainstream banks.

Demand took off, with more and more borrowers turning away from the mainstream banks[1] – especially among small and medium-sized enterprises (SMEs), otherwise referred to by the industry as 'the lower-middle market'.

It became punitive[2] for banks to issue loans that are more than **3x** a borrowing company's EBITDA.

Regulated Banks' Market Share of Leveraged Financing[3]

Borrowers are categorized based on their size

SIZE	EBITDA	LOAN SIZE
Small 'Lower-Middle Market'	$3 - $35 Million	$25 - $200 Million
Medium 'Traditional Middle Market'	$35 - $100 Million	$200 - $350 Million
Big 'Upper Middle Market'	> $100 Million	> $350 Million

THE U.S. MIDDLE-MARKET

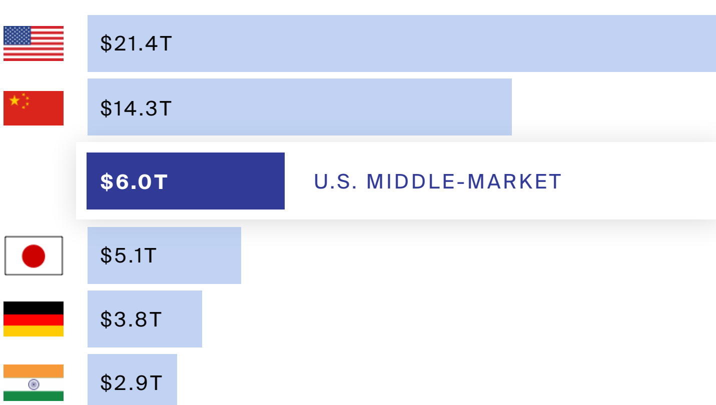
If the US middle-market were a country, it would be the third-largest in the world.

200K
COMPANIES

1/3
OF PRIVATE SECTOR GDP

48M
PEOPLE EMPLOYED

Gross Domestic Product (GDP)



Source: National Center for the Middle Market | The World Bank | Umpqua Bank & DHM

How Direct Lending Works

The lender commands the terms

Due to the demand for capital, it is often the lender – and not the borrower – who is able to command the terms.

Investors took note: according to early reads, **private credit was the fastest-growing allocation** among institutional investors in 2020.[4]

Direct lending is a subset of Private Credit, however the two terms are often used interchangeably given their high degree of overlap.

Types of Direct Loans

Direct loans are generally categorized based on **seniority**, in the event a company goes into default:

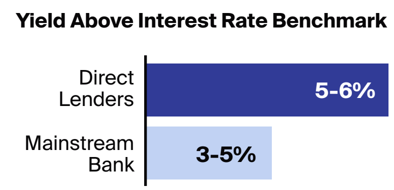
Senior (or 'first lien')	First priority in the event of a default
Junior (or 'second lien')	Lower priority in the event of a default
Unitranche	A hybrid of senior and junior loans, with hybrid characteristics in the event of a default
Mezzanine	A hybrid of debt and equity financing that affords the lender the right to convert to an equity interest in the company in the event of a default

How Might a Direct Lender Define a Successful Loan?

A successful loan for a direct lender is generally the same as a successful loan for a mainstream bank. The goal is to get back the money that was lent out – plus interest and fees.

▲ Higher Interest

For the lower-middle market, direct lenders are usually able to command between 5-6% above an interest rate benchmark, usually the London Interbank Offered Rate (LIBOR) or a LIBOR replacement.[5] This is 2-3% more than what a mainstream bank could normally command.[6]



▲ Higher Fees

For the lower-middle market, direct lenders are able to command more in fees than mainstream banks due to the highly customizable nature of direct loans, as well as the direct lender's ability to underwrite complex transactions that mainstream banks traditionally have no appetite for.[7]

Through a combination of higher interest and fees, direct loans have the potential to generate a **higher overall return** than loans originated by mainstream banks.

Some will rightly ask: "In an unregulated market, couldn't anyone who lends out any money to anyone call themselves a direct lender?" Indeed – anyone can lend money and call themselves a direct lender. However, having an experienced direct lender with a proven track record of strong covenants is key to generating high-quality alpha to institutional investors and high-net-worth individuals.[6]

Contact your CAIS Representative at info@caisgroup.com

Notes

1. Pitchbook. Accessed 31 March 2021., 2. OCC. Accessed 31 March 2021., 3. S&P Global Market Intelligence, as of 2H2020., 4. Private Debt Investor. Accessed 31 March 2021., 5. Refinitiv, as of 2H2020., 6. Refinitiv, as of 2H2020., 7. Reuters. Accessed 31 March 2021., 8. Cambridge Associates. Accessed 31 March 2021.