Arcmont
ASSET MANAGEMENT

DIRECT LENDING VS LIQUID MARKETS
A RISK/RETURN COMPARISON

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Introduction

While market dislocations often present opportunities to generate attractive returns, investors should be wary of short-term decisions which rely on timing the market.

This note examines and compares the returns characteristics of the European Direct Lending market in comparison with the liquid Leveraged Loan and High-Yield markets, particularly in the context of the rising yield environment we have seen over recent months.

Between Dec-21 and Apr-22, yields in the European Leveraged Loan market have risen from 3.4% to 4.4%[1], and from 3.1% to 5.4% in the European High-Yield market. Despite these increased yields in the liquid markets, we believe that the European Direct Lending market remains a significantly more attractive opportunity for credit investors.

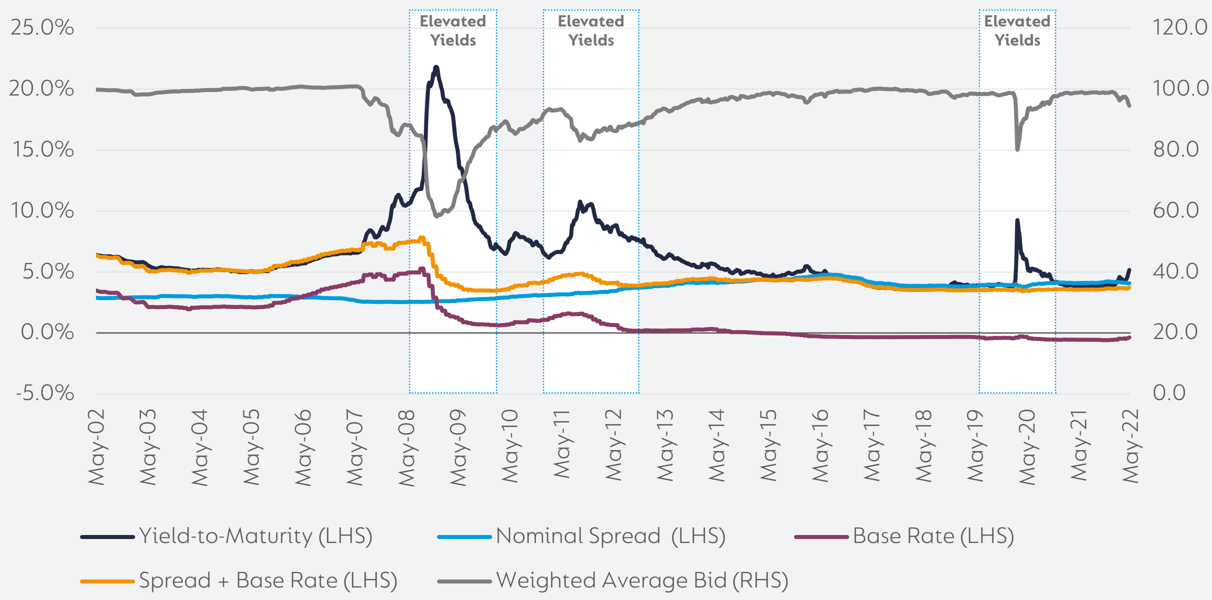
To summarise our conclusions:

- Periods of excess yield in the liquid markets are driven overwhelmingly by secondary trading prices of securities (average weighted bid), as opposed to the fundamental return characteristics of these securities (margin, base rate).
- Capturing excess yield in the liquid markets requires the investor to time entry and exit from the market precisely, making it a short-term, opportunistic strategy rather than one with a long-term focus.
- Over a longer time-frame, Direct Lending returns remain at a premium to liquid market returns, even through periods of market volatility.
- We believe Direct Lending can deliver these higher returns on lower risk than the liquid markets, due to the ability to carry out more thorough due diligence, a focus on less cyclical industries, better investor protections and longer term funding structures.

1. Leveraged Loan data refers to S&P LCD European Leveraged Loan Market Index ("ELLI"), High Yield data refers to Bloomberg Pan-European High-Yield Total Return Index.

1. What have been the drivers of European liquid market yields over the long term?

European Leveraged Loan Market Yield and Components[2]



In the above chart we show long-term yields and drivers in the European Leveraged Loan market. Yield-to-Maturity ("YTM") above is calculated assuming an investor buys into the European Leveraged Loan Index ("ELLI") at any given point in time at the Weighted Average Bid price, and holds the underlying index of loans to maturity.

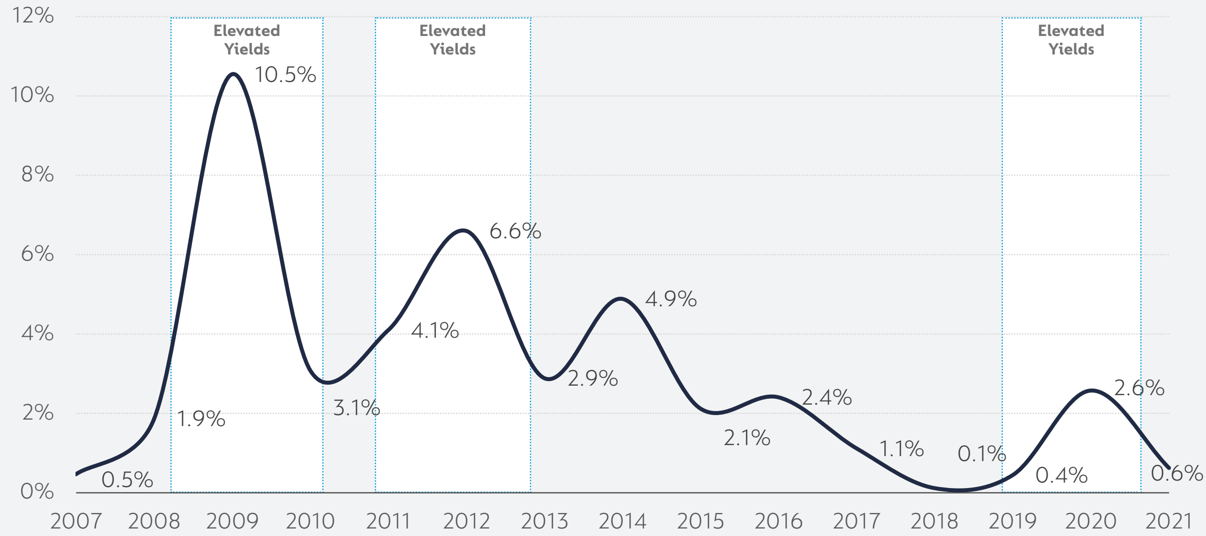
The key observation is that **significant spikes in yields are largely the result of declines in Weighted Average Bid, the pricing of the loans in the secondary markets**. These are temporary dislocations due to the broader macro environment and provide a window of opportunity for traders to buy into the market and potentially achieve a yield above that of the long-term trend. Movement in base rate has not had a meaningful impact on returns since the Global Financial Crisis, because of the consistently low absolute base rate. The spike in yields in early 2020 following the onset of the Covid-19 pandemic was overwhelmingly due to Weighted Average Bid in the market – base rates and spreads did not see meaningful changes. Similarly, the increase in yields over recent months is a product of secondary market pricing activity.

Moreover, when comparing yields and default rates over time, it is clear that **periods of excess yield are often accompanied by elevated default rates**.

2. S&P LCD European Leveraged Loan Market, Euro-denominated debt only, Base Rate refer to 3-month EURIBOR.

For instance, 2008-09, when the European Leveraged Loan Market realised yields rose to 15-20%, the default rate spiked to 11% vs an average of 3% for the 2007-21 period. Similarly, yields of c.12% in 2012 were accompanied by a 7% default rate in the same year. Periods of excess yields therefore tend to accompany periods of stress in the economy. Investors anticipate macroeconomic stress that will impact their underlying positions and sell their positions, which results in lower bids in the market and therefore higher yields. We therefore believe **the current increase in yields is a reaction to a negative economic forecast, as opposed to a structural upward repricing of the liquid markets**.

European Leveraged Loan Default Rates[3]



2. How have liquid market returns evolved over time?

The above analysis looks at point-in-time YTM, whereas a long-term investor would look at returns over a period of years.

Below we show annual returns for the each of the European Leveraged Loan and High-Yield markets. The analysis assumes the investor "buys" the index at the beginning of the year and sells at the end of the year – the returns are comprised of income received over the course of the year, and any capital appreciation / depreciation. Note the slightly different picture vs the prior data – the recent increase in yields presented in the chart above was due to a decline in Weighted Average Bid (a decline in valuations). Therefore, while yields rose, returns in the YTD-22 period for Leveraged Loans and High-Yield were -1% and -7%, respectively, as a result of a decline in Average Bids.

3. S&P LCD - ELLI Default Rates by par amount outstanding in a given year. "Elevated Yields" time periods coincide with the same areas shaded on the prior graph.

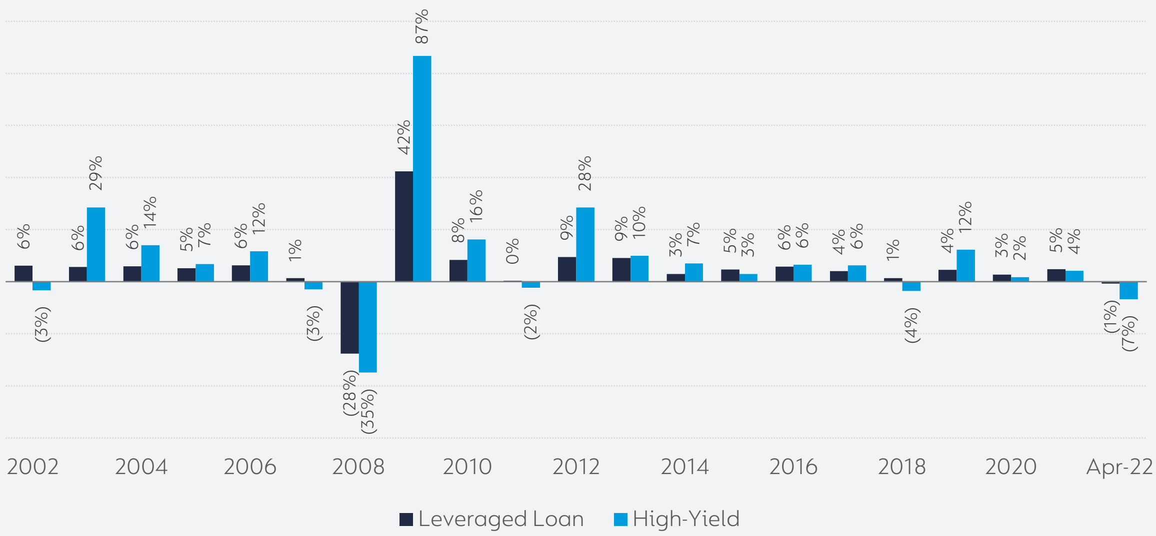
Average returns are as follows:

Leveraged Loan Market:
4.9% since 2002, and 4.4% since 2010;

High-Yield Market:
9.0% since 2002, and 6.4% since 2010.

There are clear outlier years where returns were well above the average. **However, capturing this excess over the average requires being able to trade in and out of the index at the correct time.** Years of significant excess return (2009, 2012), usually follow years of declining or flat returns.

European Leveraged Loan and High-Yield In-Period Returns[4]

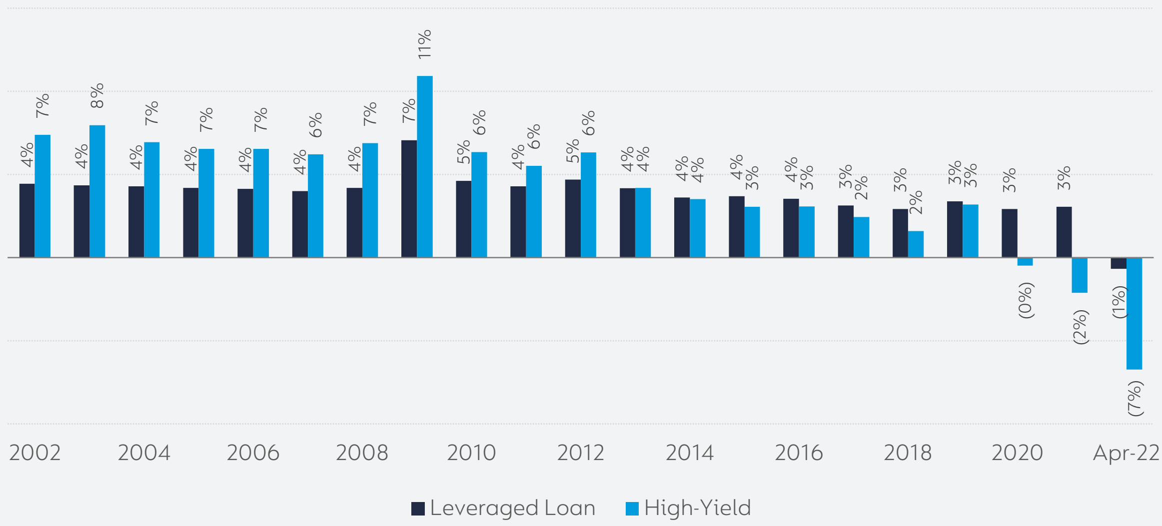


4. In-year returns of S&P LCD ELLI / Bloomberg Pan-European High-Yield Total Return Index (Source: Bloomberg), assuming investor buys into index at the start of the year and sells at the end of the year.

The returns data in the following chart assumes the investor buys the index at the start of a given period and holds it to Apr-22. Clearly, the returns profile is smoother as outlying years, both high-return and low-return years become less significant over time.

On this basis, and prior to the current decline in asset prices, **Leveraged Loan returns have been in the 3-5% range.** The High-Yield market has been more volatile, **but returns have generally fallen from c.7% to 3-4%** prior to the current decline.

European Leveraged Loan and High-Yield Returns to Apr-22 from Start of Period[5]



3. How have Direct Lending, Leveraged Loan, and High-Yield returns evolved in the US?

The European Direct Lending market is relatively nascent and therefore opaque. In the US market, Business Development Companies ("BDC"), which are public vehicles through which investors can access the Direct Lending market, ensures that returns are publicly available. The Cliffwater Direct Lending Index ("CDLI") captures performance in this market[6].

The CDLI outperformed the two liquid markets in 12 of the 17 calendar years. In four of the five years that CDLI did not outperform, High-Yield and Leveraged Loans were rebounding from stressed credit conditions in the prior year.

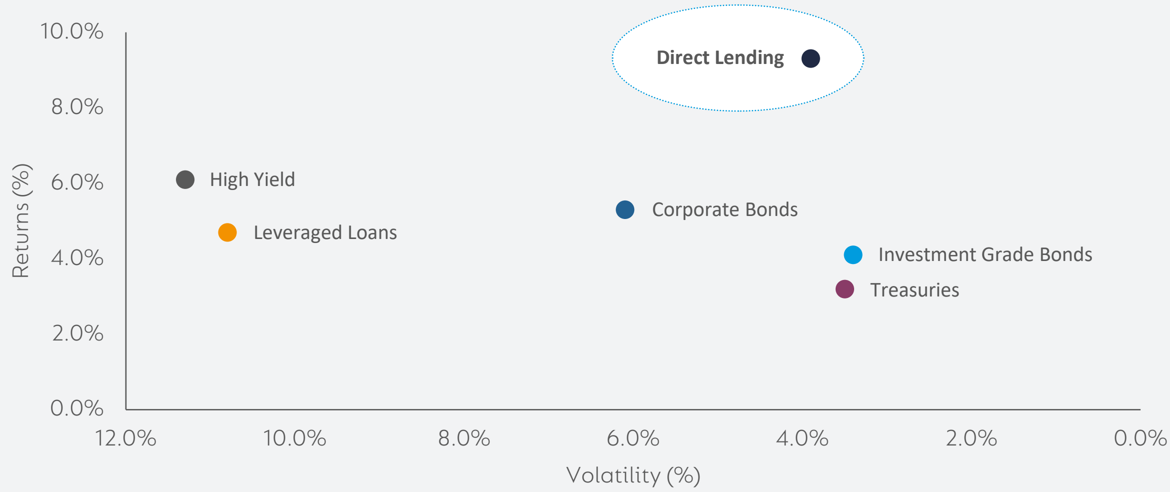
5. S&P LCD ELLI / Bloomberg Pan-European High-Yield Total Return Index returns, assuming investor buys into index in a given year and sells at the end of Apr-22. Returns are annualised.
6. Data taken from Q1-22 Cliffwater Report on US Direct Lending.

US Direct Lending, High Yield, and Leveraged Loan Returns

Year	CDLI	US High Yield	US Leveraged Loans
2005	10.1%	2.7%	5.1%
2006	13.7%	11.9%	6.7%
2007	10.2%	1.9%	2.1%
2008	(6.5%)	(26.2%)	(29.1%)
2009	13.2%	58.2%	51.6%
2010	15.8%	15.1%	10.1%
2011	9.8%	5.0%	1.5%
2012	14.0%	15.8%	9.7%
2013	12.7%	7.5%	5.3%
2014	9.6%	2.5%	1.6%
2015	5.5%	(4.5%)	(0.7%)
2016	11.2%	17.1%	10.1%
2017	8.6%	7.5%	4.1%
2018	8.1%	(2.1%)	0.5%
2019	9.0%	14.2%	8.7%
2020	5.5%	7.1%	3.1%
2021	12.8%	5.3%	5.2%

The below chart shows the risk/return profile of various US fixed income asset classes – Direct Lending is a clear outlier with higher returns at lower volatility versus High-Yield and Leveraged Loans. We see no structural reasons why this dynamic should not be the same the European market, particularly in the context of a limited number of competitors at the upper end of the European Direct Lending Market.

US 15-Year Annualised Returns and Volatility by Asset Class[7]



7. Source: Morningstar, Cliffwater Direct Lending Index, as of December 31, 2021. Volatility is measured using standard deviation. "Direct Lending" is represented by the Cliffwater Direct Lending Index. "Leveraged Loans" is represented by the S&P/LSTA Leveraged Loan Index. "High Yield" is represented by the Bloomberg US Corporate High Yield Index. "Corporates" is represented by the Bloomberg US Corporate Bond Index. "Investment Grade Bonds" is represented by the Bloomberg US Aggregate Bond Index. "Treasuries" is represented by the Bloomberg US Treasury Index.

4. What are other features of the European Direct Lending market that make it attractive for investors?

In addition to superior returns, we believe that the Direct lending market has a number of structural features that make it more attractive than the liquid alternatives:

(i) The nature of private transactions means that prior to executing a transaction, it is possible to do far **more detailed due diligence and analysis** based on private, confidential information than in executing liquid market trades.

(ii) the Direct Lending market in **Europe is largely a covenanted market**, offering investors better protections.

(iii) The selection bias of Direct Lending transactions results in portfolios that are exposed to a **more defensive set of industries**.

(iv) The long-term, locked up nature of Direct Lending funds provides for **less market volatility** (e.g. the redemption pressures witnessed during the Global Financial Crisis) and time for corrective action to be taken by management teams or market recoveries to facilitate par realisations.

(v) With the larger end of the Direct Lending market in Europe continuing to grow its track record as an attractive substitute to the liquid public markets, there is an upward trajectory in the **quality of borrowers** turning to Private Debt financing solutions on a more consistent basis.

(vi) In a rising interest rate environment, the floating rate nature of Direct Lending products offers investors a **hedge against inflation risk**, with downside protection measures not present in the Broadly Syndicated Loan market.

(i) Due Diligence:

Direct Lending transactions benefit from a much richer and more meaningful diligence package than liquid market investments. A primary issuance in the liquid market offers investors limited access to sponsor and management, with presentations from sponsor and/or management sometimes pre-recorded, an Information Memorandum, and often no third-party diligence reports. A secondary liquid market acquisitions will have even fewer materials – investors need to rely on public materials and their own industry expertise.

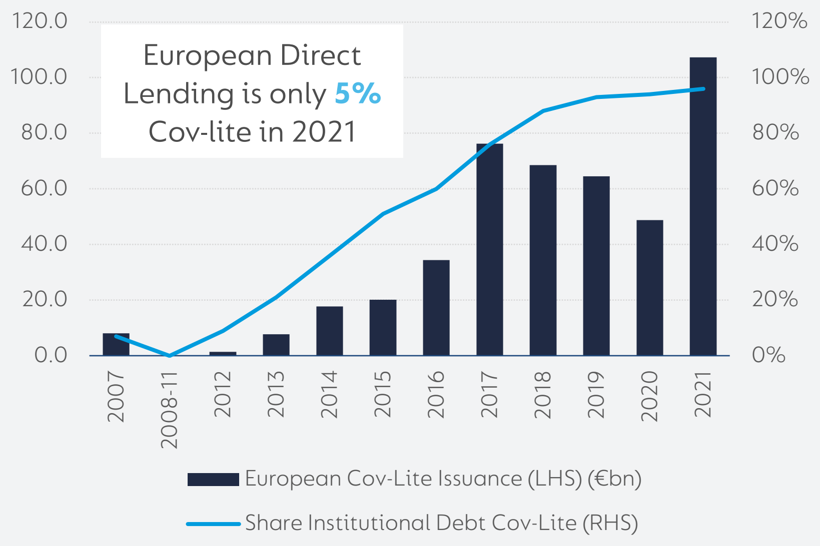
A private market transaction will include much more meaningful access to sponsor and management, and a full suite of both vendor and buy-side diligence. Diligence reports include Commercial and Financial reports, as well as often more detailed reports such as Legal, Environmental, Insurance, and other specific reports relevant to the particular investment. Arcmont supplements this work with input from both third-party and proprietary networks of industry experts.

(ii) Protections:

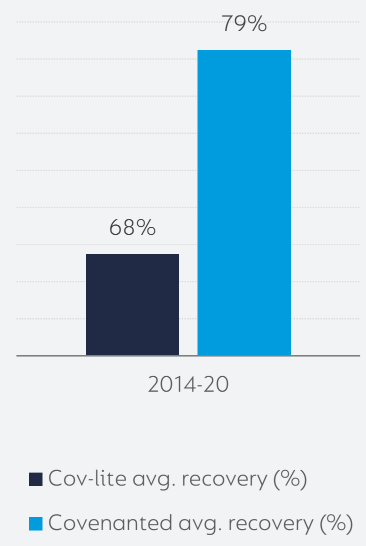
The European Leveraged Loan market has become an overwhelmingly cov-lite market – in 2021, **96% of Leveraged Loan issuance was cov-lite[8], compared to just 5%[9] of Direct Lending issuance**. Covenants provide the lender an ability to step in and renegotiate terms of the lending agreement, force changes in the company, and, if necessary, take enforcement action. Without this ability, the lender is left relying on payment default (when the Company is simply no longer able to service its debts), before they can step in and take action. At this point, the condition of the company will likely have deteriorated significantly, resulting in a lower recovery.

Historical recovery data supports this argument – cumulative recovery rate (i.e. the share of principal recovered by lenders in the event of default) in US cov-lite loans in 2014-20 was 68%, compared to 79% amongst covenanted deals – an 11% premium.

European Leveraged Loan Market
Cov-Lite Issuance and Share[10]



US Cov-Lite Recovery Rates[11]

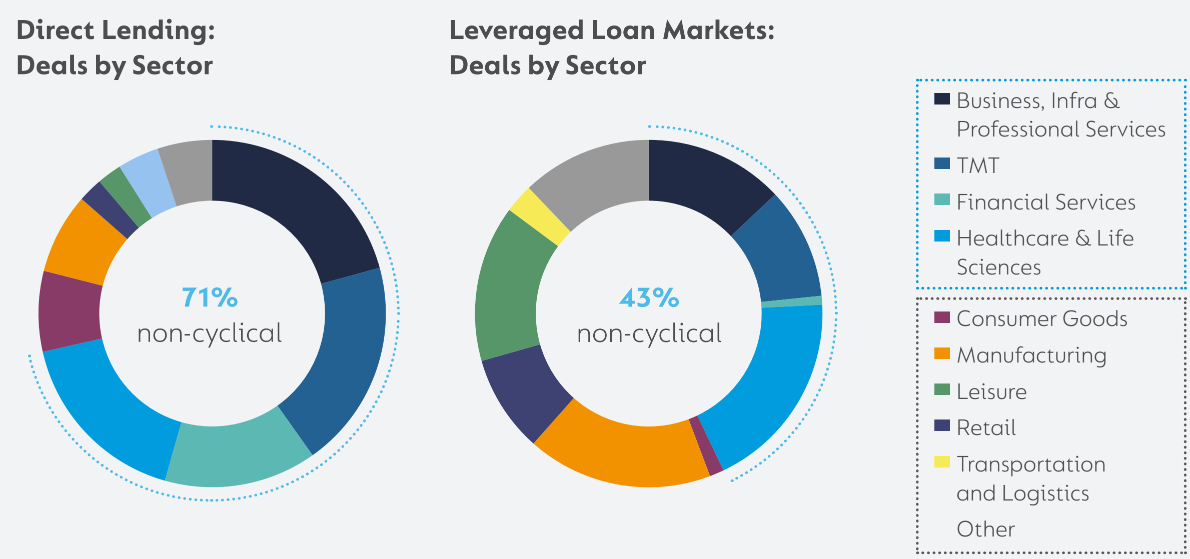


8. S&P LCD.
9. Proskauer Private Credit Insights 2021.
10. S&P LCD.
11. S&P – "Settling for Less: Covenant-Lite Loans Have Lower Recoveries, Higher Event And Pricing Risks", October 2020.

(iii) Sector Bias:

European Direct Lending firms typically invest in a less cyclical, more resilient mix of sectors. 71% of underlying industries in which Direct Lenders have invested are non-cyclical, compared to 43% of Leveraged Loan market underlying industries – see detailed split below.

Direct Lending vs Leveraged Loan Market Underlying Industries[12]



(iv) Locked up Capital:

The long-term, locked up nature of Direct Lending funds provides a timeframe during which managers can take corrective actions within their portfolios, rather than selling a liquid position at the market value, often driven by mark-to-mark and redemption pressures. By focusing on sectors and businesses that can withstand downturns, Private Debt should provide more resilient and less volatile returns through a cycle. Having good covenant protections and experienced restructuring teams to deal with issues is an important feature to ensure that trading can recover and losses are avoided.

(v) Quality of Borrowers:

In both volatile and benign market environments, would-be issuers on the liquid public markets are increasingly turning to the more reliable Private Debt market to finance M&A and organic growth. These borrowers are attracted by the speed and certainty of capital provided by Direct Lenders, the flexibility of the structures they provide, and the provisions direct loans allow for access to flexible, follow-on capital required to execute buy-and-build strategies.

12. Leveraged Loan: LCD Research – S&P Global Market Intelligence, S&P European Leveraged Loan Index components as of October 2021 – sector categorisation through Arcmont internal analysis; Direct Lending: Deloitte Alternative Lender Deal Tracker.

This ongoing structural shift in the European corporate finance landscape is benefiting the few Direct Lending funds that have the ability to quickly originate, structure and execute loans at the larger end of the middle-market. This has led to an increase in the quality of borrower large Direct Lending funds invest in, which typically have larger EBITDA, stronger management teams and often market leadership positions that are typically backed by high quality private equity sponsors with significant pools of dry powder.

(vi) Hedge Against Inflation Risk:

To combat inflation, most central banks globally have begun increasing base interest rates with further rises expected across Europe, the UK and the US in the coming months. Unlike fixed-rate debt instruments, such as bonds, the value of which will be negatively impacted by rising interest rates, direct loans have a floating-rate coupon. As such, it is reset periodically and linked to Libor or an alternative benchmark, providing a layer of flexibility and the ability to respond to changing market environments.

While this will generate higher returns for Direct Lenders, the rising cost of capital may impact the ability of borrowers to remain profitable. However, as outlined above, not only do Direct Lenders typically lend to high-quality, non-cyclical businesses which should perform more strongly in challenging environments, they also have a closer relationship with the management team and sponsor of a borrowers. This access, combined with the bespoke and flexible nature of the asset class, means that private lenders can be more proactive in managing issues and providing relief where required. This contrasts with investors in liquid public debt instruments, who have limited access to the issuer and are typically one part of a large syndicate of lenders.

Conclusion

We believe that the current increase in liquid market yields is a reaction to the negative market and economic sentiment in recent months. As we have shown, liquid market returns are volatile, and capturing returns above the long-run average requires investors to time their entry into and out of the market precisely.

In contrast, Private Debt has demonstrated consistent premium returns versus the liquid markets over longer time periods and we believe that many investors, with longer term liabilities, will continue to find these consistent, premium returns attractive.

The experience of the US Direct Lending market, for which we have more consistent long-term data, points to Direct Lending offering higher returns with lower volatility.

The combination of bespoke and tailored transactions, superior investor protections and a positive selection bias towards a more attractive mix of underlying industries suggests to us that the European Direct Lending market may likely exhibit superior default and recovery characteristics versus the liquid markets in the coming years. It is worth noting that over a decade of investing over €21bn in a large number of transactions.

Combined with the premium historical returns exhibited by Direct lending funds such as Arcmont's funds, as compared to liquid market alternatives, we believe that our strategy will continue to offer an attractive risk / return proposition.

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