Instant Insights

Syndicated and direct lending strategies

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Rothschild & Co's Wealth Management business in Switzerland offers clients the opportunity to invest in Merchant Banking's private debt strategies. Two of these strategies focus on syndicated and direct lending.

What are the strengths and differences of these strategies? How can they provide complementary approaches to investing in the world of private debt? To find out more, we spoke to Martin Hook, the Co-Head of Rothschild & Co Direct Lending, and Martin Rotheram, one of the portfolio managers from our Credit Management business, which invests in the syndicated loan market.

Before we look at the two strategies, can you briefly remind us: what is private debt?

Martin Hook (MH): Private debt refers to capital provided by non-bank lenders predominantly to privately owned businesses[1] to support their financing needs. Private debt funds raise capital from investors including pension funds, insurance companies and family offices who are looking for investment opportunities that are more compelling than they can find in traditional fixed income markets. These funds have become a critical source of lending for European companies in the wake of the Global Financial Crisis.

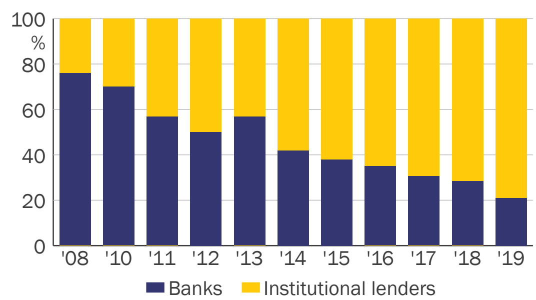
Over the past decade, banks have dramatically reduced their lending appetite (Figure 1) due to increased capital constraints and regulatory restrictions. Their share of the primary syndicated loan market fell from around 50% to 25% in Europe in the ten years since 2008. During this time, assets under management by global private debt funds have tripled in size[2] to fill this gap.

Why are investors interested in private debt now?

Martin Rotheram (MR): Against this backdrop, many investors have turned to private debt as a more attractive source of returns than those offered by traditional fixed income markets. Fixed income as an asset class has not always generated inflation-beating returns for many investors in the face of falling interest rates and record levels of negative-yielding government and corporate debt over the past decade. With annual returns for private debt averaging around 10%[3] since 2008, it is easy to understand why clients have been turning their attention to investing in private rather than public debt markets.

Figure 1: Lenders

Participation in new loans per annum in Europe.



Source: Rothschild & Co

[1] Businesses in this context have a non-investment grade credit rating.

[2] UNPRI Private Debt Overview 2019.

[3] The McKinsey Global Private Markets Review 2019.

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Within private debt, how do you define our direct lending and syndicated loan strategies?

MH: We can differentiate the two strategies principally by **borrower size and role in the company's capital structure.**

Typically, in direct lending at Rothschild & Co we lend to mid-sized[4] businesses with an EBITDA[5] of €10 million to €50 million or above. Within our syndicated loan funds, we focus on businesses with an EBITDA of €75 million or higher (Figure 2).

In direct lending we usually act as the sole lender to a business, meaning our role in the company's capital structure is shaped by our close, direct relationship with the management teams and shareholders of the companies we lend to. This results in a highly selective approach to lending involving a lengthy due diligence process before we issue any loans. It also means we have a more hands-on approach to monitoring those businesses we lend to, similar to that undertaken by private equity funds.

MR: Turning to syndicated lending, this strategy offers groups of lenders (known as syndicates) the opportunity to lend to generally mid- to large-size[6] businesses. Syndicated lending is usually deployed to finance larger loans for mergers, acquisitions and private equity buyouts, and diversifies individual loan risk across a larger number of lenders. As mentioned earlier, private debt funds that invest in syndicated loans tend to deploy this strategy across a greater number of businesses than is commonly found in a direct lending fund, with a small participation taken in each loan. As a result, the strategy is generally perceived as lower risk than direct lending in that it is:

- diversified across a higher number of borrowers and sectors;
- focused on lending to larger businesses, which may have a more established track record.

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From direct to syndicated

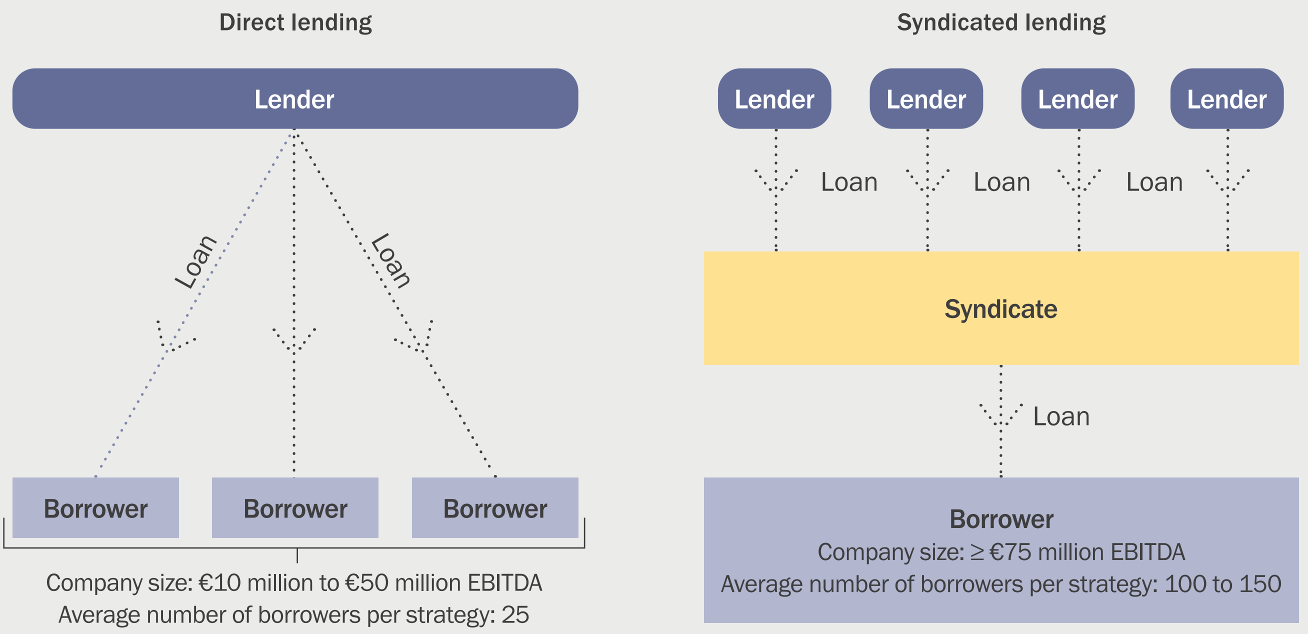
In our interview on managing a direct lending fund, we discussed the history of the French clinical laboratory business Biogroup LCD. Through direct lending, Merchant Banking first lent to Biogroup when it had an EBITDA of around €30 million in 2014. We provided debt financing to support the founder CEO's strategy of consolidation in the French laboratories market via M&A transactions. This, together with robust organic growth, saw Biogroup grow to a run-rate EBITDA of around €200 million. Direct lending allowed Biogroup to grow at a critical stage of its development and ultimately made it eligible to access the syndicated loan market.

[4] €50 million to €500 million market capitalisation.

[5] Earnings before interest, tax, depreciation and amortisation.

[6] €750 million market capitalisation or above.

Figure 2: Direct and syndicated lending



Larger businesses with an annual EBITDA of €75 million or more tend to have a longer trading history from which to assess performance than their smaller counterparts. At Rothschild & Co we tend to limit our position in any given syndicated loan to no more than 10% of the overall loan size. When coupled with the fact that there is an active secondary market for trading, this means we can swap individual loan positions in our funds with relative ease should our view on a company change.

What are the risk and return expectations of these two strategies?

MR: The combination of larger borrowers and liquidity naturally means that the return clients can expect from a syndicated loan strategy are therefore lower than a direct lending strategy. The secured nature of both syndicated and direct lending loans also means they generally offer lower volatility than other risk assets.

Comparing the two strategies in practice is useful as we can see their different risk–reward profiles. Our syndicated loan strategy, Oberon, targets an average annual gross return of Euribor +4% in Europe and Libor +4% in the US. By way of comparison, a direct lending strategy at Rothschild & Co financing mid-market companies targets a gross annual IRR[7] of around 10%.

Direct lending and syndicated loan strategies are therefore complementary in that they give investors access to different risk and reward exposure within the private debt market.

How do you assess the companies you lend to in a direct lending and syndicated loan context?

MH: In our direct lending strategies, Rothschild & Co generally acts as the sole lender to a business. This means that when assessing the creditworthiness of companies wishing to borrow, the due diligence process can on average take two to three months per loan. As a syndicated lender, by comparison, the due diligence process would more commonly average around two weeks. The difference in this timeframe reflects the different roles and profiles of the two strategies.

In addition, direct lending strategies generally give lenders more control if a business defaults. The lender in this case can take control of the business to ensure repayment, having negotiated bespoke legal documentation with strong rights and controls, on a loan-by-loan basis. By contrast, this process is standardised in the syndicated loan market and reflects the size and role of each lender in the syndicate.

Direct lending and syndicated loan strategies are therefore complementary in that they give investors access to different risk and reward exposure within the private debt market.

Given the differences in the two strategies, what are their mutual benefits?

MH: Both direct lending and syndicated loan strategies offer investors the possibility to lend to high-quality, well-researched businesses paying attractive and stable income at two complementary risk–return levels.

These two strategies also protect real returns should interest rates rise. This is a key attribute of private debt investing and arises from the use of a floating rate when calculating interest payments on loans (see box 'The importance of floating rates' below).

The benefit of floating rates distinguishes private debt investing from, for example, investing in high yield bonds, where bond prices and, hence, returns tend to be negatively impacted when interest rates rise. Lastly, it is worth noting that both private debt strategies provide a regular income, which is usually distributed quarterly.[8]

The importance of floating rates

Interest on private debt loans is calculated using an agreed base rate, currently Libor or Euribor, and then adding a credit margin, or spread, on top.

Interbank rate + credit margin = interest

Should short-term interest rates rise, as happened in the US in 2018, this will be reflected in the interbank rates used to calculate interest payments. Therefore, investors will benefit from any increase in short-term rates, whilst protecting returns from inflation.

[7] Internal rate of return.

[8] In the case of Oberon USA, income is paid out monthly in the distributing share classes.

Turning back to the market, you mentioned earlier that banks are largely absent from the private debt market today. Is this likely to continue?

MR: Since the 2008 Global Financial Crisis, mainstream commercial banks have faced stricter capital ratio requirements and restrictions on lending. We do not see these controls being relaxed any time soon and so would expect banks to remain a smaller player in the private lending market. As private debt becomes a standalone asset class, the more institutional nature of the market means it is becoming less and less practical for banks to return to the commercial lending market.

To conclude then, why should clients be interested in both strategies today?

MH: Private debt markets have grown to the point where 70% of transactions involving non-investment grade businesses in Europe are now financed through private debt. Therefore, the market is not only deep but has potential for further growth. Within this space, both direct lending and syndicated loan strategies offer low-risk, income-generating returns for investors seeking to protect and grow the real value of their wealth in a negative-yielding environment.

By providing a regular and steady source of income, both direct lending and syndicated loan strategies offer complementary entry points to investing in private debt markets today.

How to invest in private debt funds

With our **Investment Solutions** team at Rothschild & Co Wealth Management, we can advise on the most appropriate ways of gaining access to private debt funds.

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