Investing Ideas

Institutional Insights

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Direct lending: Does borrower size matter?

A closer look at risk and returns. The rest of the story...

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KEY TAKEAWAYS

- Defaults are generally viewed as a sign of an imminent loss, but not all defaults are the same.
- Financial covenant defaults protect capital by forcing the borrower back to the negotiating table before a payment is missed.
- Leverage matters. Larger borrowers generally use more debt in their capital structure, increasing the risk profile of the loan.
- Financial covenants, combined with lower capital structure leverage, have produced slightly higher returns and narrower dispersion for direct loans in the lower middle market versus the upper middle market.

Some investors may assume that "bigger is better" when it comes to direct lending: the larger the borrower, the safer the credit. Higher covenant default rates by smaller borrowers are often used to support this argument. However, financial covenant defaults are very different from payment defaults, which occur when a borrower misses a payment on a loan. Financial covenants are an important feature of private loans that protect the lender by forcing the borrower back to the negotiating table when violated, before the enterprise value collateralizing the loan is materially impaired.

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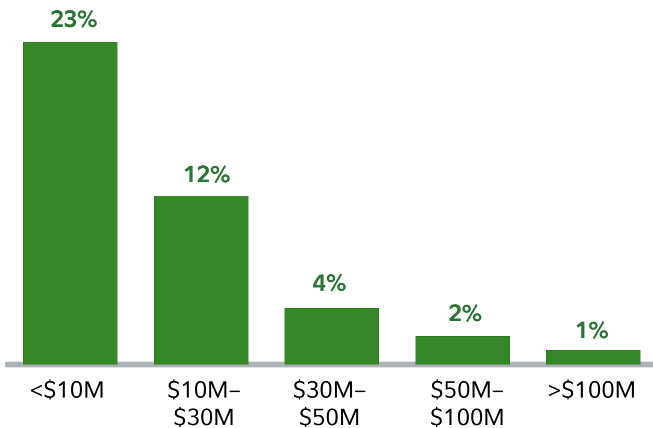
Understanding how financial covenants play a key role in protecting capital for lenders before a payment default, Exhibit 1 suggests that loans to smaller companies generally have stronger covenants. These structures meaningfully mitigate the risk profile of the loan. The early intervention and closer oversight facilitated by financial covenants can serve as an effective defense against a payment default, which could result in realized losses for the lender.

Meaningful financial covenants are quite common in the lower middle market but are relatively rare when lending to larger borrowers. The data depicted in Exhibit 2 illustrates the prevalence of financial covenants by the size of the total senior loan facility, which is closely associated with the size of the borrower. Loans for smaller borrowers are ~9-10X more likely to have a financial covenant than loans for larger borrowers.

EXHIBIT 1: Direct lending financial covenants are generally stronger for lower middle market borrowers.

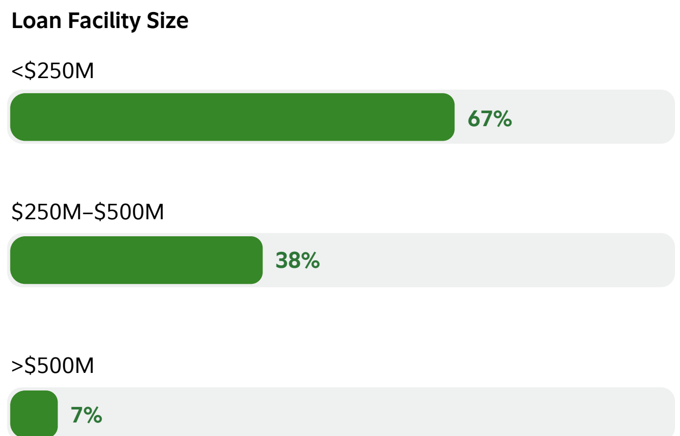
Financial covenant defaults by borrower size



Source: Lincoln International Valuation & Opinions Group. Data represents average for each borrower cohort over the trailing four quarters ending June 30, 2024.

EXHIBIT 2: Financial covenants are more prevalent in lower middle market loans.

Percentage of loans with financial covenants[1]



Source: 1. Moody's Investor Services - Report on Private Credit, October 2023.

A look at the return history for direct lending disaggregated by borrower size provides further empirical support for the efficacy of financial covenants (Exhibit 3). Borrowers in the lower middle market have produced slightly higher median returns – *net of any losses*. In addition, the dispersion of returns around the median has been narrower in the lower middle market compared to the upper middle market, suggesting an even more attractive return profile on a risk-adjusted basis. Considering the incidence of financial covenant defaults illustrated in Exhibit 1, the results illustrated net of any incurred losses from the lower to upper middle market may come as a surprise to some. Financial covenants are a material risk mitigant generally in favor of lower middle market lenders. There are however, other structural features that contribute to the risk-adjusted return advantage of lower middle market direct lending illustrated in Exhibit 3.

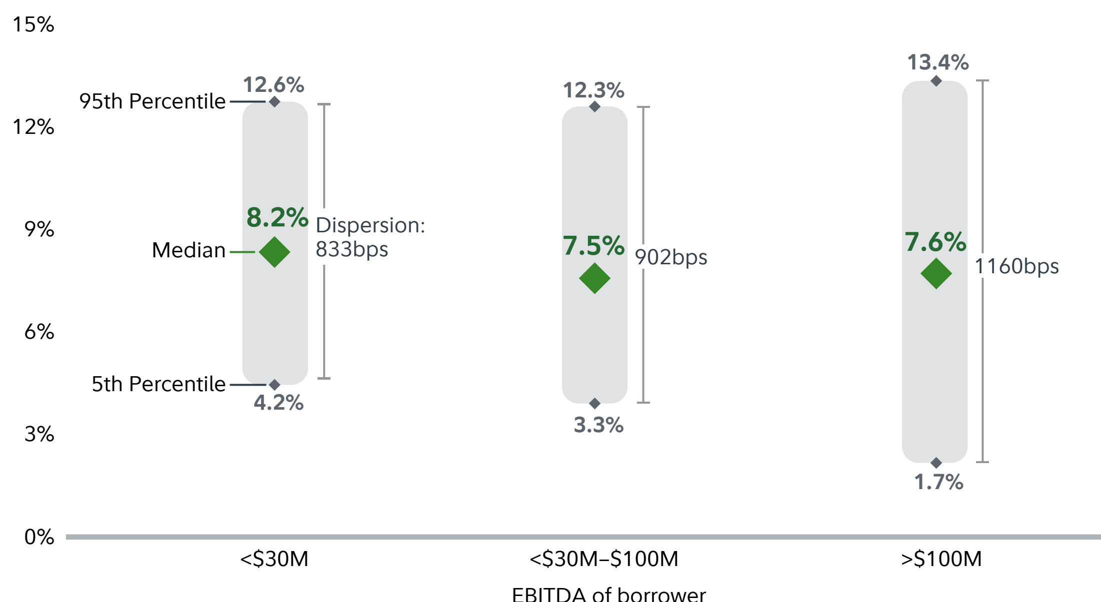
Financial covenants at a glance

Financial covenants are structural loan features designed to help protect capital in the event a borrower experiences deteriorating financial performance. Below are two common financial covenants.

- Total net leverage ratio – compares a firm's net debt to its EBITDA.
- Fixed-charge coverage ratio – measures a firm's available cash flow to cover its current service payments and capital expenditure needs.

EXHIBIT 3: Lower middle market loans have generated higher returns on an absolute and risk-adjusted basis.

Senior direct lending by borrower size, rolling 1-year returns



Past performance is no guarantee of future results. Source: Lincoln International Valuations & Opinions Group. October 2014 through June 2024.

Capital structure leverage

Beyond financial covenants, another key factor contributing to the return advantage of lower middle market loans is lower capital structure leverage – transactions that are financed with larger equity contributions and less debt. Examining the capital structure of middle market transactions reveals that generally the larger the operating company, the more debt is used in the capital structure. This can serve to enhance returns to the equity holders but at the cost of increased risk to the lenders.

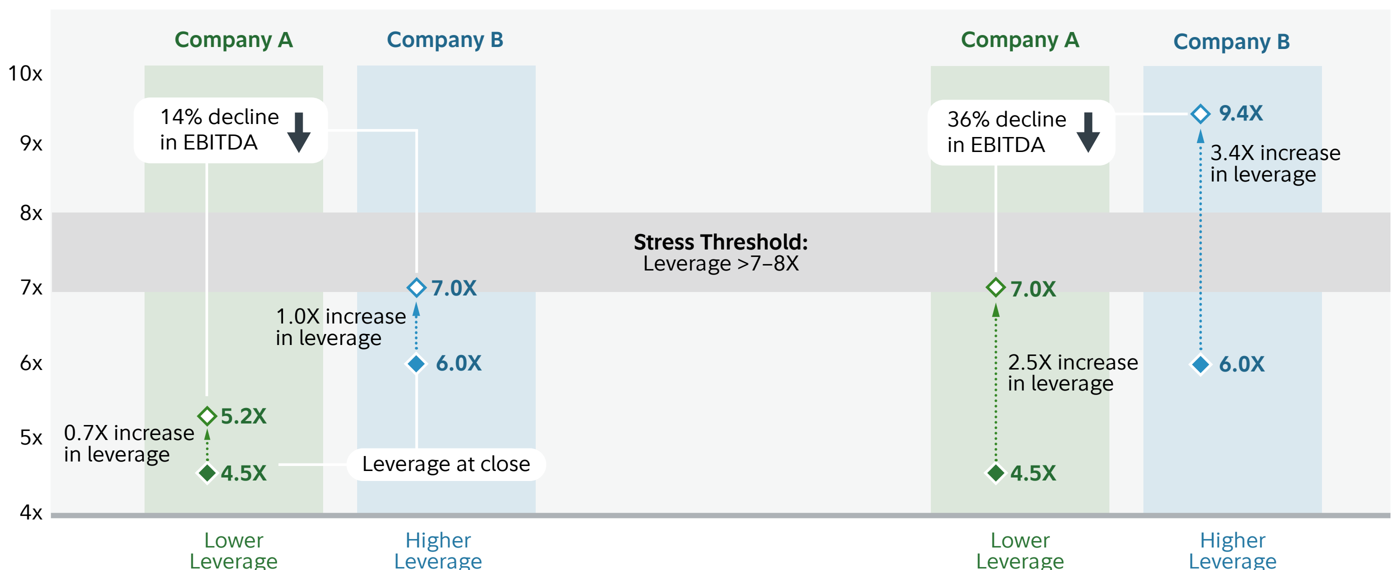
In Exhibit 4, we illustrate the effects of leverage by depicting the amount of debt extended to two hypothetical borrowers based on multiples of earnings (EBITDA). Company A represents a lower middle market borrower, with capital structure leverage of 4.5X earnings. Company B represents an upper middle market borrower, where higher leverage at 6X earnings is common.

While there is no hard line in terms of the amount of debt a borrower can support, historical data on the typical capital structure of sponsor-backed buyout transactions suggests that 7X earnings is a fair threshold to consider a borrower to likely be under some level of stress to service their debt and other business needs (e.g., capital expenditures and growth initiatives).

Using our hypothetical example in Exhibit 4, we can see that a decline in operating performance of only 14% raises the leverage to the 7X threshold for a loan that was initiated at 6X leverage. A similar decline for the lower-leverage borrower increases leverage to ~5.2X leverage. Said another way, the margin for underwriting error (or protective cushion) is meaningfully smaller for the higher-leverage transaction and there are often no financial covenants in the loan document to protect the lender until the borrower has actually missed a payment.

In contrast, the lower-leverage transaction has a much greater margin for error as it would require a decline of 36% to reach leverage of 7X earnings – more than double the protective cushion of the upper middle market borrower with initial leverage of 6X earnings.

EXHIBIT 4: Leverage increases exponentially as earnings decline, increasing the probability of losses for lenders.



For illustrative purposes only. Source: Fidelity Investments.

Cash flow and coverage ratios

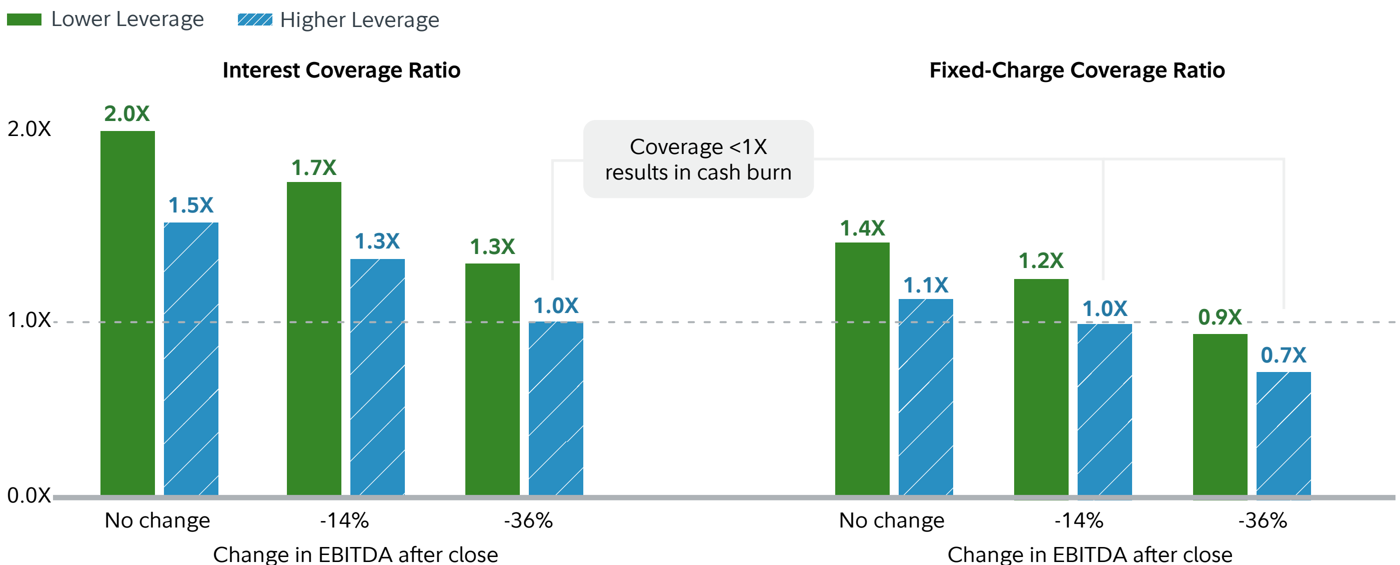
To better understand the magnitude of the stress resulting from operating performance declines of this magnitude, two key credit metrics lenders often consider in their underwriting efforts are **interest** and **fixed-charge coverage**. These metrics express earnings (EBITDA) as a multiple of debt service cost and total fixed charges, respectively.
When company earnings are less than fixed charges (coverage ratio of <1X), the company may be spending more than they are earning, or "burning cash." Cash reserves must be used to fund operations as earnings are insufficient to support normal business activities.

Compared to interest coverage, fixed-charge coverage also includes capital expenditures necessary to maintain and/or grow the business as well as taxes for a more fulsome look at the cash flow needs of the borrower. As outlined in Exhibit 5, higher-leverage borrowers are likely to experience greater stress in the form of cash burn at more modest levels of operating performance declines. Again, the margin for underwriting error is much smaller when there is more leverage in the capital structure.

The combination of financial covenants, lower leverage, and stronger coverage ratios can materially offset the perceived safety of larger borrowers. In fact, we believe the higher covenant defaults depicted in Exhibit 1 among cohorts of smaller borrowers is prima facie evidence of stronger lender protections, which may lead to better investment outcomes.

Finishing this point where we started, some investors may assume the larger the borrower, the safer the credit. However, other material factors, such as leverage levels and structural protections in the form of financial covenants (or lack thereof), may serve to offset that perceived advantage.

EXHIBIT 5: Declines in coverage ratios increases stress on borrowers.



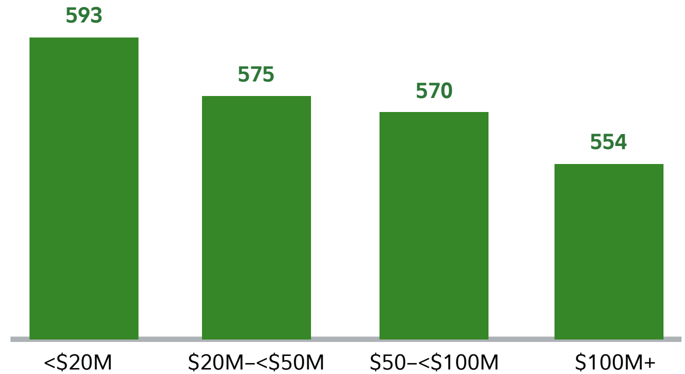
Source: Fidelity Investments.

The potential income advantage

A key attribute that has led to increasing investor interest in direct lending is the regular income distributions associated with the contractual nature of the returns on direct loans. The yield on lower middle market loans is generally higher than that for larger borrowers (Exhibit 6). Based on 3rd-party data and Fidelity market observations, lower middle market loans may earn a 0.50% spread premium compared to upper middle market borrowers. The yield advantage varies over credit cycles, but even at modest levels, can have a material effect not only on returns but also the portfolio risk profile. Portfolio leverage is often used to further enhance income – but at the cost of higher investment risk. Given the higher organic income associated direct lending strategies focused on the lower middle market, upper middle market direct lending strategies must utilize more portfolio leverage to produce expected income on par with lower middle market strategies. For upper middle market lending strategies, the combination of higher capital structure leverage at the borrower level and higher portfolio leverage may result in a materially higher overall risk level for the investor.

EXHIBIT 6: Lower middle market loans generally benefit from higher spreads.

Average direct loan spreads by EBITDA cohort



Sources: KBRA/DLD, Fidelity Investments. Trailing 12 months ended Sept. 30, 2024.

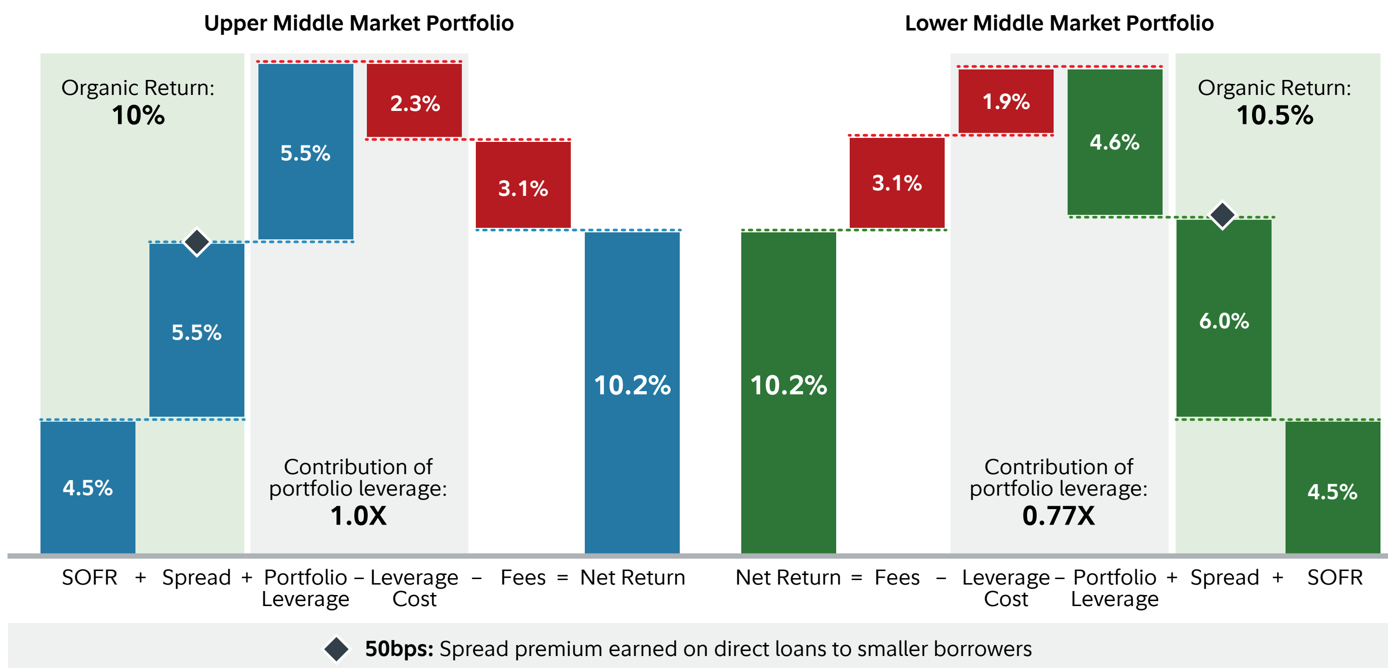
For many investors, a prevalent delivery vehicle is a business development corporation (BDC). Generally, BDCs target portfolio leverage of approximately 1X to enhance returns. In other words, the manager borrows a dollar for every dollar contributed by investors with the objective of capturing the extra income generated by the direct loans over the interest expense associated with borrowing the capital. These vehicles have a regulatory cap of 2X leverage. The leverage target of 1X that is prevalent is intended to provide sufficient "cushion" in periods of stress when loan portfolios are vulnerable to markdowns. A sufficient cushion is critical when employing leverage since leverage increases on an accelerating basis as the loans that serve as collateral experience markdowns. Said another way, for each incremental unit of decline in value of the portfolio (collateral), portfolio leverage increases by a greater amount.

The organic return advantage generally associated with smaller borrowers is seemingly modest in the context of a high reference rate environment (SOFR) for these floating rate loans. That said, the additional return expected from each incremental unit of portfolio leverage is greater for lower middle market strategies. The result is that in order to make up for the lower organic returns generated by an upper middle market portfolio of higher-leverage borrowers and generate a similar level of portfolio level income, the manager must use higher levels of portfolio leverage, increasing the risk profile of the strategy. Exhibit 7 depicts the approximate net return for a portfolio of higher-leverage borrowers utilizing portfolio leverage of 1X. On the right half of the chart, we solved for the portfolio leverage required to produce the same net return on a portfolio of lower-leverage loans with a 0.50% higher organic yield.

The higher organic returns generated by the lower-leverage portfolio allow the manager to produce a similar total return to the client with less portfolio leverage – $0.77 per $1 of contributed capital versus $1 for $1. While this may at first appear modest, the risk profile of a portfolio structured with 1X leverage is materially different than if managed at 0.77X leverage.

Consider the impact that markdowns in the valuation of the portfolio have on portfolio leverage and risk. While valuation data on private market investments such as direct loans is limited, broadly syndicated loans (BSLs) may serve as a reasonable proxy for valuations – particularly at the upper end of the middle market, where lenders compete directly with the syndicated loan market, resulting in structures and borrower profiles that are increasingly similar. The emergence of the $1B+ unitranche direct lending market segment has increased the overlap of these two financing options possibly

EXHIBIT 7: Higher organic returns in the lower middle market produce comparable returns with less portfolio leverage.

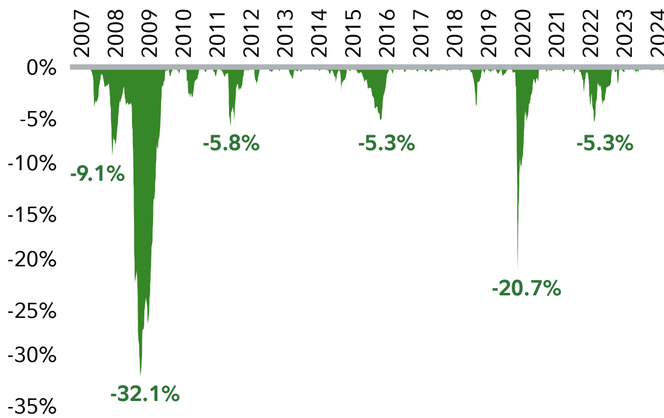


For illustrative purposes only. Source: Fidelity Investments. Fee structure assumed to be 1.25% and 12.5% over 5%. Cost of leverage for upper middle market portfolio assumed to be priced at a discount of 20 bps to lower middle market portfolio. On these assumptions, the lower middle market portfolio produces the same net return to investors with less portfolio leverage (0.77X vs. 1.0X).

portending further convergence of pricing and terms as direct lenders in these transactions face heightened pressure to compete with the lower pricing and more borrower-friendly terms that are standard in the syndicated loan market.

EXHIBIT 8: Markdowns of loan portfolios can be swift and deep.

Peak-to-trough drawdown history of broadly syndicated loans



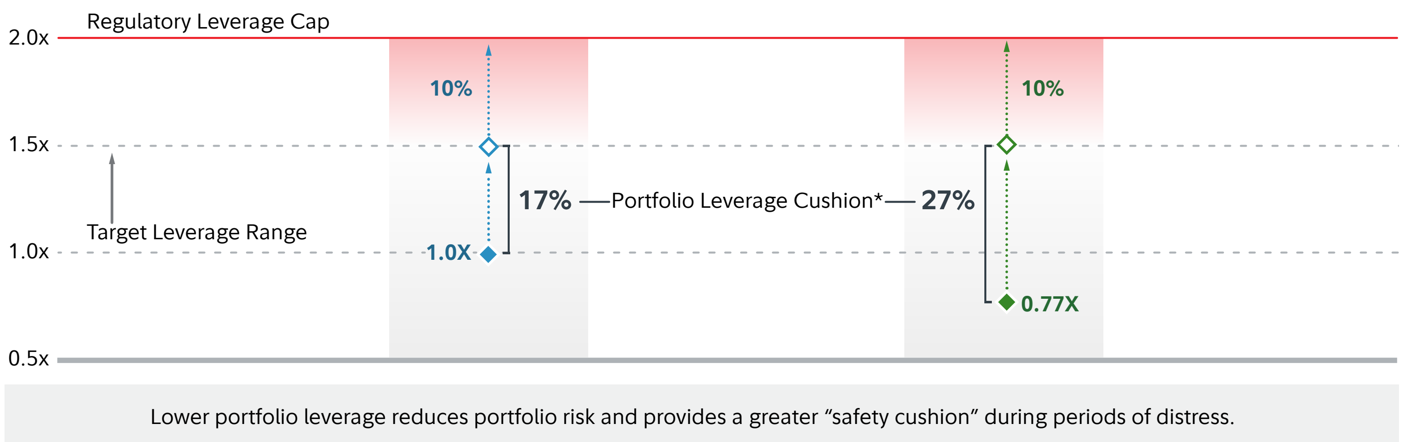
Source: Morningstar LSTA US Leverage Loan Index 2007–2024. As of June 2024.

Exhibit 8 depicts the peak-to-trough declines of the BSL market on an unlevered basis – certainly a directional guide to the frequency and magnitude of portfolio markdowns in the upper middle market.

While rare, history tells us that in periods of market stress, drawdowns in valuation of collateral can be deep and occur quite quickly. Further, as portfolio valuations decline, leverage is amplified at an increasing rate. In this context, it becomes more clear to what degree overall portfolio risk is affected by use of higher levels of portfolio leverage.

As illustrated in Exhibit 9, if the upper limit of the target range for portfolio leverage is 1.5X, the portfolio leverage cushion is 17% for a portfolio of higher-leverage loans opening with 1X portfolio leverage. For a portfolio operating at 0.77X in portfolio leverage, the portfolio markdown required to reach 1.5X of leverage is meaningfully higher – about 27%. At 1.5X leverage, the portfolio could only tolerate a further decline in value of 10% before it would reach the 2X regulatory cap, which could force the manager to be a seller at distressed prices.

EXHIBIT 9: Portfolio leverage increases at an accelerating rate as the portfolio suffers declines in valuation.



Lower portfolio leverage reduces portfolio risk and provides a greater "safety cushion" during periods of distress.

For illustrative purposes only. Source: Fidelity Investments. *Portfolio leverage cushion represents the decline in portfolio valuation that can be experienced without exceeding 1.5X of portfolio leverage from a starting leverage level as indicated above at 1.0X and 0.77X, respectively.

Investment implications

The growth of direct lending, despite a large and diverse investment opportunity set, has led to a narrative that centers around larger borrowers. We believe strategies across the size spectrum have their merits and in fact may be complementary, serving to further enhance diversification and more fully capture the opportunity across the spectrum in the asset class. The amount of leverage in the capital structure as well as the presence of financial covenants (or lack thereof) are critical factors to consider for a more fulsome perspective on the risk profile of direct lending strategies. Further, the higher organic returns associated with lower middle market loans may also reduce the reliance on portfolio leverage resulting in more attractive risk-adjusted returns to investors. So while the size of the borrower may be a factor to consider, there is much more to the story…

For more information on direct lending, please contact your Fidelity representative.

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David Gaito is head of direct lending in the High Income and Alternatives division at Fidelity Investments. In this role, Mr. Gaito leads Fidelity's direct lending business, which focuses on making credit investments to middle market companies predominately owned by private equity firms. He also co-manages private credit strategies.

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Thought Leadership Vice President Martine Costello Duffy provided editorial direction for this article.

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