



European
Direct Lending -
Delivering Through
the Crisis

EXPERT INSIGHT

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EUROPEAN DIRECT LENDING - DELIVERING THROUGH THE CRISIS

Summary

Direct lending is currently in uncharted territory. The asset class has grown rapidly in the last decade to establish itself as the largest segment of the private debt market and an important adjunct to the traditional leveraged loan market. Notwithstanding its successful development, associated concerns about an overheated market leading to deteriorating underwriting conditions, and the fact that it had never been tested in a downturn were expressed with increasing frequency. The Covid-19 pandemic is now providing that test.

While it is still too early to understand the true impact of the pandemic on direct lending we believe that its role is of systemic importance in the financing of mid-market companies, and in the provision of stable real returns to global savings pools as an alternative to traditional public debt. Given the private nature of direct lending and the relative lack of publicly available information we therefore want in this paper to offer a view from our 'ground zero' to address some of the key questions on investors' minds – what steps are managers taking to monitor and manage its impact on portfolios? What are they doing differently now? What has been the impact on transaction activity and are there enough deals available in hot sectors? What's the story with valuations? Will defaults and losses be

worse than the Great Financial Crisis ('GFC') of 2008? Will direct lending continue to deliver attractive returns and how can investor confidence be retained?

This is not a normal crisis and how a direct lender adapts and manages its portfolio and engages with its investor base will determine the stability and longevity of its franchise.

We conclude that the answers to many of these questions are quite intuitive, but it is nevertheless important to articulate them. In our view, direct lending will not experience a major paradigm shift and the factors that have made it an attractive asset class during the last ten years will reassert themselves over the next ten.



Key points

- Direct lending is an established, systemically important and complementary asset class
- It has delivered consistent premium returns over liquid debt with modest drawdowns
- The Covid-19 crisis represents its first real test
- Positive and timely government liquidity support, together with alternative lenders' remedial actions, have provided significant mitigation
- Restructuring activity will increase and there is likely to be significant dispersion in returns among managers
- Pre-crisis lending decisions, in terms of pricing and leverage, sector allocations and portfolio diversification will be more important than immediate valuation impacts
- Focus has shifted to borrower fundamentals – business model, liquidity, cash flow and debt service capacity
- Reduced market activity in the near-term won't derail the long-term growth trend of direct lending in Europe
- Competition factors have been magnified by the crisis, favouring local sourcing, incumbent lenders, and those with established origination networks and track records
- Investors will want a clearer road roadmap of the outlook for the asset class and how to identify the best managers

An Asset Class with Solid Foundations

A quick recap on the development of this relatively new asset class may provide a useful context in which to review the road ahead, and it is important to do so from the perspective of the stakeholders that have played (and will continue to play) such an important part in its past and future success.

Direct lending has proven itself as a critical agent in addressing the financing needs of the systemically important mid-market sector

Direct lending has proven itself as a critical agent in addressing the financing needs of the systemically important mid-market sector, generally identified as comprised of ‘in-between’ enterprises spanning the upper end of the SME universe and larger private companies that do not receive the wider coverage of large, usually listed companies. Studies, (such as ‘The Mighty Middle - How Mid-Market Companies are the Growth Engine of Europe’, ESSEC Business School) have illustrated how this sector represents the growth engine of Europe, with around 2% of companies by number generating about a third of revenues, employment and growth on a scale which would qualify it as a global top 10 economy.

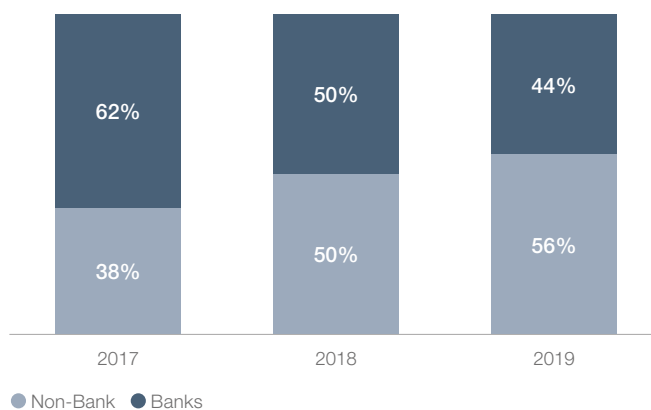
Traditionally served by banks, the credit shock of the GFC created a funding gap as regulatory and capital constraints led banks to retrench from this market, setting in train the progressive disintermediation of the traditional financing source for mid-market companies. Alternative European lenders, funded by long-term institutional capital rather than depositors, provided flexible tailored private debt solutions to mid-market companies and their sponsors, in an accelerated trajectory that replicated the growth of direct lending in the US.

Initial scepticism towards alternative lenders, as reflected in the moniker ‘shadow banking’, has given way to the

recognition by governments and regulators in Europe of the important role that alternative lenders are playing in supporting supranational initiatives (such as the European Commission’s ‘Small Business Act’) to encourage entrepreneurship, innovation, employment growth, and better access to finance (among other things) for small and medium-size companies. This endorsement was highlighted in 2018 when the Financial Stability Board (‘FSB’) replaced the term ‘shadow banking’ with Non-bank Financial Intermediation (‘NBF’), acknowledging that it provides legitimate, regulated and transparent sources of capital.

These positive tailwinds have fuelled the rapid rise and establishment of private debt as a major asset class. The disintermediation of mid-market direct lending (the single largest constituent of private debt, accounting for over a third globally) has grown from 38% to 56% in just the last 2 years, tracking the same trajectory of the wider HY and leveraged loan market (c.70%).

Increasing Market Share of Non-Bank Lenders vs Banks



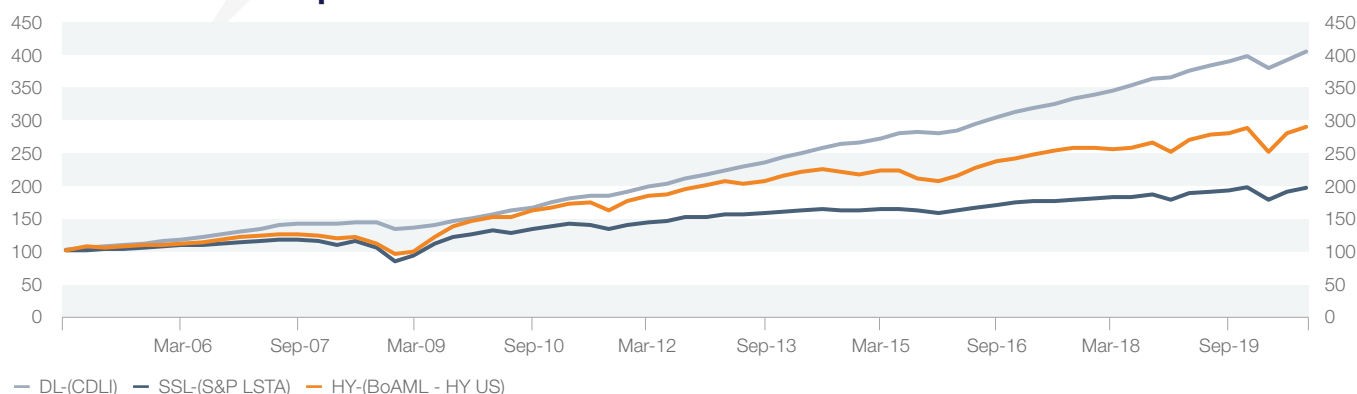
This trend has manifested itself in the rapid growth of global private debt AuM, from around US\$275bn in 2009 to over US\$850bn in 2019, with SME and mid-market activity estimated to represent over a third of this. (Source: European Systemic Risk Board (‘ESRB’) NBF Monitor, October 2020). At the deal level, European mid-market direct lending, as monitored by Deloitte’s Alternative Deal Tracker, has grown over 20% per year since the end of 2012. Over 500 transactions were completed in 2019 with an estimated value of around €50bn to represent a complementary source of financing alongside broadly syndicated lending, where annual deal volumes of about €100bn reflect bigger deal sizes for larger companies.

Demand for direct lending has been driven by institutional demand (predominantly insurance companies and pension funds) for stable and attractive yields, with low volatility, in a low interest rate environment, in order to match long-term liabilities with long-term assets. The attractive characteristics of direct lending have been well-documented - illiquidity premium, regular cash distributions, lender protections in the form of covenants, active asset monitoring and the stability of long-term closed-ended fund structures. The substantial growth in transaction activity to meet the financing needs of the real economy has also enabled astute managers to confer an additional key risk mitigation benefit through substantial diversification across sectors and geographies, as sponsor and borrower demand has grown not only in volume but also in breadth outside of the core markets of the UK, France and Germany, expanding quickly across Benelux, Spain, Italy and the Nordics. The adoption of common Loan Market Association ('LMA') lending documentation provisions and the increasing harmonisation of insolvency regimes has provided further structural attractions.

Alternative direct lending has served its stakeholders well over the past decade since the GFC.

Alternative direct lending has served its stakeholders well over the past decade since the GFC. Sponsors and borrowers have been able to tap into an ever-expanding source of financing that can address all layers of the capital structure in a flexible and non-commoditized manner. Asset managers have been able to scale their activity, build the sponsor and geographical networks that are a key ingredient for successful origination, and demonstrate a track record over multiple vintages. And investors have benefited from attractive returns and outperformance, with lower drawdowns than other private debt and HY segments.

Cumulative Outperformance



Resilience in a Crisis

	Cliffwater Direct Lending Index	Bloomberg - Barclays HY Bond Index	S&P/LSTA Leveraged Loan Index
2005	10.10%	2.74%	5.06%
2006	13.70%	11.87%	6.74%
2007	10.23%	1.88%	2.08%
2008	-6.50%	-26.15%	-29.10%
2009	13.18%	58.21%	51.62%
2010	15.79%	15.11%	10.13%
2011	9.75%	4.98%	1.51%
2012	14.03%	15.81%	9.67%
2013	12.68%	7.46%	5.29%
2014	9.57%	2.46%	1.59%
2015	5.54%	-4.46%	-0.70%
2016	11.24%	17.14%	10.11%
2017	8.62%	7.50%	4.14%
2018	8.07%	-2.08%	0.46%
2019	9.00%	14.20%	8.65%
Q1 2020	-4.84%	-12.68%	-13.05%

Source: Cliffwater, Bloomberg Barclays, S&P Capital IQ *Orange colouring indicates lower drawdowns of direct lending relative to high yield and leveraged loans



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The Outlook for Fund Returns

It is important to look beyond the short-term impact of reduced valuations. Direct lending by construction is a long-term enterprise, and the investment thesis is founded on the realization of a stream of contractual returns. In the short term, and on an individual asset basis, write-downs driven by a waterfall approach (for the most impacted names) may have been significant, from 10% - 20%. The impact on fund portfolio returns will depend on a number of factors:

- **Extent of absolute diversification within a fund:** while single obligor limits are standard, (7% in the case of Tikehau funds), a high level of diversification can represent a significant mitigant as long as it is not comprised by excessive sector concentration, reducing the average invested amount to 2%-3%, based on around 40 transactions in a portfolio. Diversification does pose challenges – primarily the ability to sustain a strong pipeline of transactions across a range of attractive sectors and geographies and a critical mass of AuM into which they can be deployed based on the size of a typical mid-market financing and, ideally, the manager's capacity to act as sole arranger to maintain lender control.
- **Concentration of exposure to the most affected sectors:** while this may seem obvious it is important to look beyond the narrower segmentation of sector and industry indices. Significant dispersion within the definition of, for example, consumer discretionary in terms of products and services, warrants more granular analysis of related portfolio exposures. On the one hand leisure travel and health and fitness clubs have been severely impacted, but home entertainment such as gaming and media, and home improvement services, have seen rises in demand. It has been an axiom of the direct lending market that the strategy generally seeks to avoid cyclically exposed sectors that also include energy and commodities. This should bode well for eventual return outcomes, and is also a reason why cross-readings of historical returns from liquid credit markets in previous crises may not be a reliable indicator of outcomes in the direct lending market. To the extent that managers will have exposures to affected sectors, other factors that should be assessed are the quality and experience of the sponsor in the particular sector, the terms and conditions associated with the original transactions and the timing of the investment.
- **Maturity of the fund:** earlier vintages which are at or near to the end of their investment period may have seen less of an impact on IRRs and multiples for two reasons.

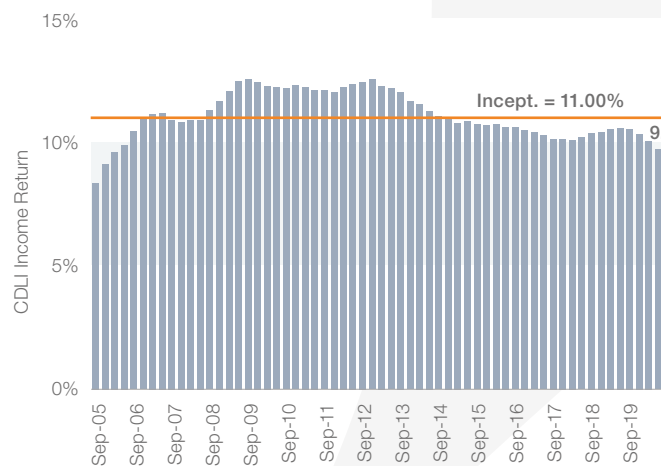
First, realized distributions over time can represent a significant buffer in relation to the impact on IRR and multiples from valuation write-downs. Modelling the impact of loss assumptions has pleasantly surprised investors in illustrating the resilience of direct lending in being able to generate positive returns even under quite extreme scenarios. For recent vintages or more recent investments valuation write-downs can have a disproportionately large impact in the short term, given the weighting of the NAV as a determinant of returns, but as a counterweight one should bear in mind that recent vintages in the early stages of their deployment phase will be able to adapt investment strategy to a post-crisis environment. Second, exposed names which have been in portfolios for some time are likely to have seen material growth with a corresponding reduction in leverage which should provide a measure of resilience in weathering the downturn.

In the longer term the major threat to returns will be the absolute level of losses sustained by a fund portfolio as a result of fundamental factors. Time to recovery, consumer behaviour and capacity may be considered important elements that can shape debt sustainable debt quantum and service capacity over the longer-term. Without a recovery in demand the regular interest distributions that underpin returns, and refinancing risk, may crystallise losses without a fundamental restructuring of the business model and capital structure. Fund level losses will in turn be impacted by factors in portfolio construction referred to above.

In terms of direct lending as an asset class, investors may be reassured by US data derived from the Cliffwater Direct Lending Index ('CDLI'), which illustrates well how income returns represent a powerful off-set to shorter term valuation impacts. Total returns have historically been driven by consistent double-digit gross income returns, averaging 11% over the lifetime of the CDLI, and with a historical range between 10% and 12%. Higher yields have been associated with economic distress and lower yields associated with economic growth. The chart on the left shows historical trailing four quarter income returns for the CDLI, starting at its September 2004 inception. The lower CDLI yields in recent years are the result of (1) a decline in Libor, (2) yield spread compression, and (3) the growth of senior loans within CDLI, which increased from 38% at the end of 2009 to 71% at the end of June, 2020. The chart on the right reports trailing four quarter CDLI total return, combining income return, net realized gain(loss), and net unrealized gain(loss) components.

CDLI Income Return

Trailing four quarters ending June 2020

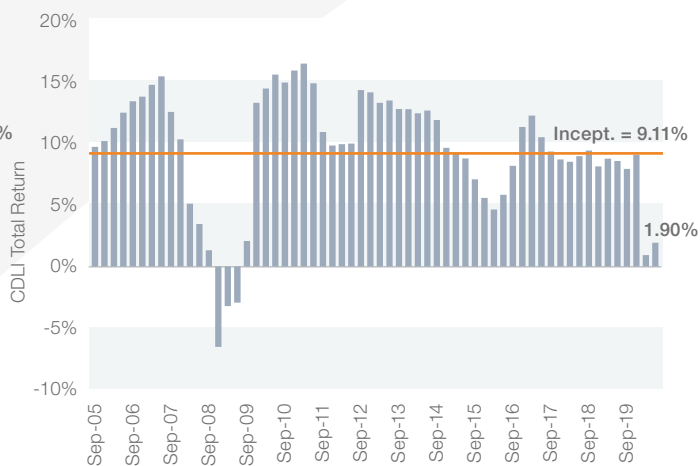


● Trailing 4 Quarters Income Return — Annualized Income Return

Source: Cliffwater Direct Lending Index Q2 2020

CDLI Total Return

Trailing four quarters. Sept 2004–June 2020

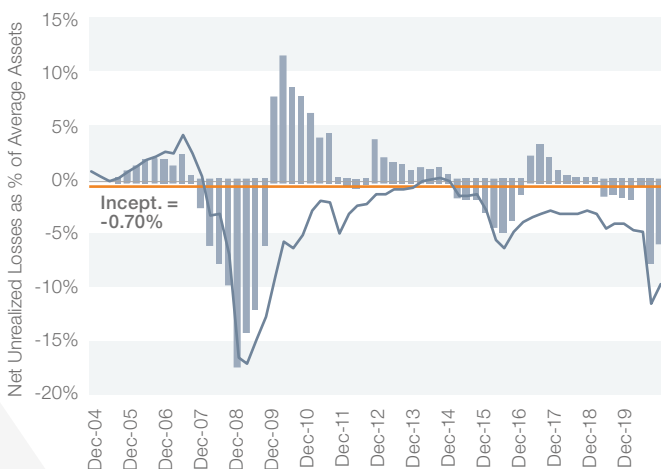


● Trailing 4 Quarters Total Return — Annualized Total Return

Loss Expectations in Direct Lending

Further reassurance may be provided by looking at trends in unrealized and realized losses in the CDLI over time. Unrealized gains or losses will reflect changes in overall market credit spreads or will harbingers expected but uncertain future credit losses in the same way that banks book reserves against future realized losses. CDLI unrealized gains or losses come from quarter to quarter changes in valuations of existing loans. The CDLI experienced significant -6.80% net unrealized losses during the first quarter, the largest since the fourth quarter of 2008 when net unrealized losses totalled -9.71%. Those unrealized losses were partially reversed in the second quarter by unrealized gains.

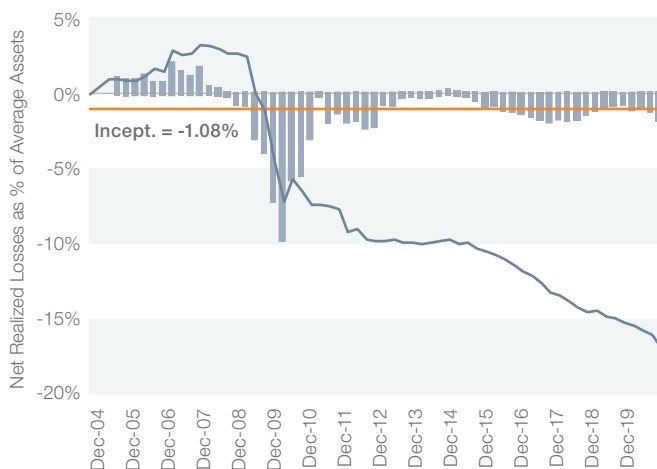
CDLI Unrealized Gains/Losses



● Trailing 4 Quarters Unrealized Net Gains/Losses — Annualized Unrealized Net Gains/Losses — Cumulative Unrealized Net Gains/Losses

Source: Cliffwater Direct Lending Index Q2 2020

CDLI Realized Gains/Losses



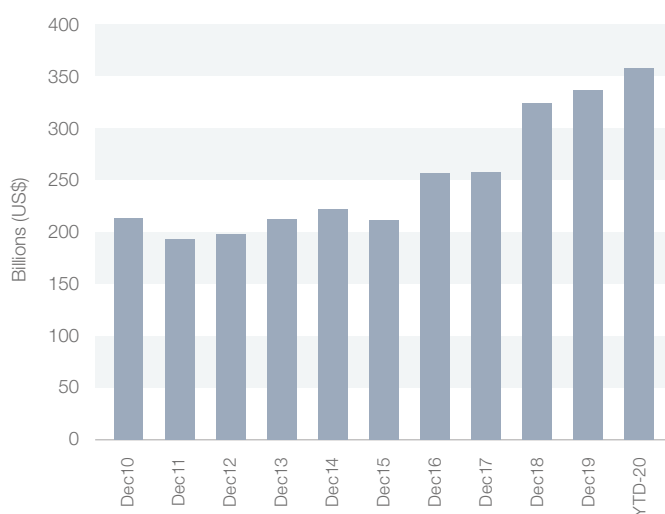
● Trailing 4 Quarters Realized Net Gains/Losses — Annualized Realized Net Gains/Losses — Cumulative Realized Net Gains/Losses

While loss figures are difficult to come by for the European direct lending market anecdotal evidence suggests similar patterns of write-downs while realized losses still remain low, which may not be surprising given that the effects of the crisis are unlikely to become known for some time yet.

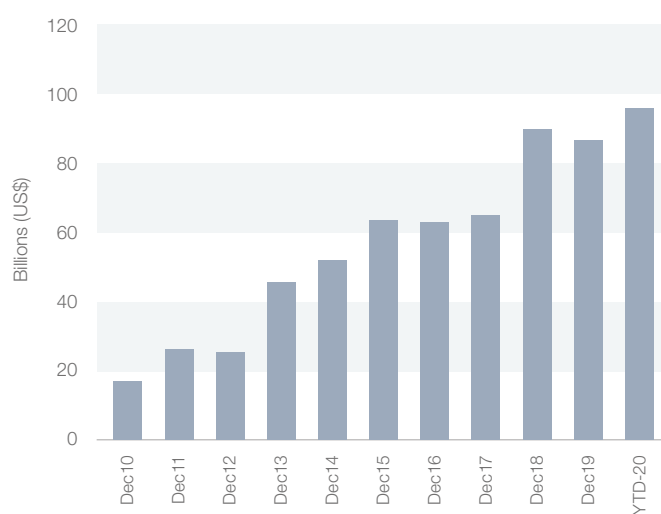
Deal Activity and Lending Terms

The sharp fall in deal activity early after the onset of the crisis, in both private equity and mid-market lending, has given way to a relatively quick and substantial resumption of deal flow. This is not surprising given the substantial levels of dry powder in the private equity market in particular.

European Private Equity Dry Powder



European Private Debt Dry Powder



Source: Preqin Alternative Assets in Europe, September 2020

The pick-up in deal flow has also been helped by reduced levels of activity in the European leveraged loan market. According to LCD, issuance in September 2020 of €4bn was down over 75% compared to the €18.8bn issued in September 2019, with new issue yields widening from 369bps to 489bps and lower leverage multiples (4.1x vs 4.8x) a reflection of reduced demand. Another factor has been that the first point of focus for banks has been to manage their current books, highlighting potential stress and taking appropriate action, such as setting aside large sums to cover projected losses and supporting companies with whom they have strong relationships to last the course. Banks may also be concerned over increased regulatory burdens which can often be a side effect of a recession, regardless of cause. This internal focus has also been driven by a lack of desire to lend to a market which is dominated by concerns over a rising default rate, especially for mid-market companies.

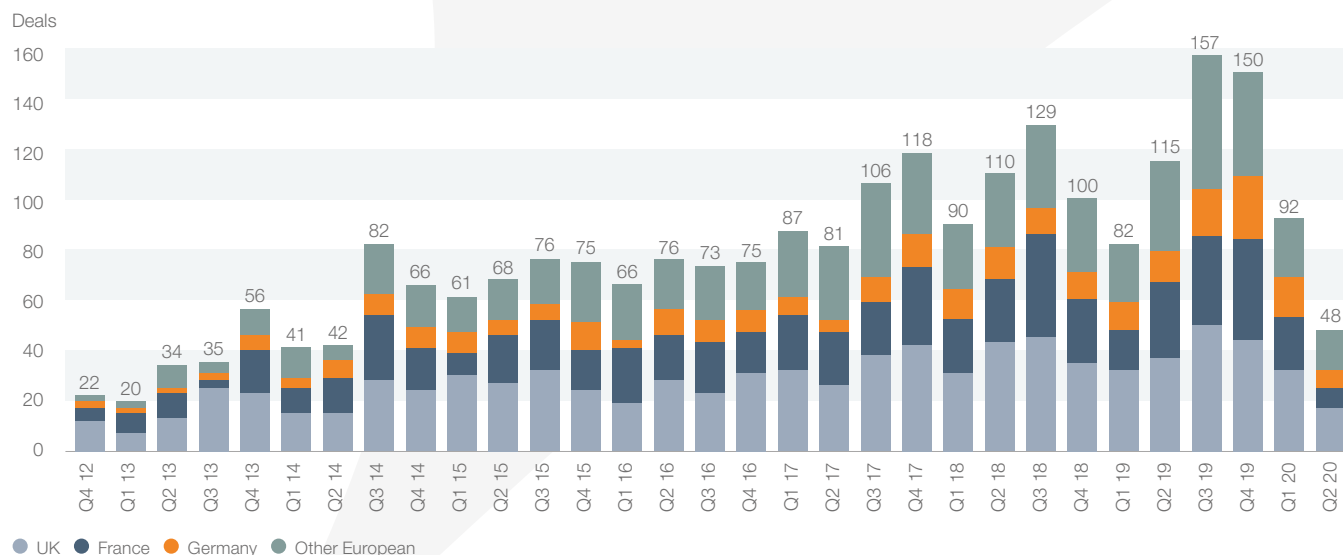
As interest rates push towards negative and banks margins tighten even more, they have moved to survival mode, avoiding unnecessary lending and focusing on more socially focussed schemes such as state-backed loans.

According to Deloitte's Alternative Deal Tracker, there were 140 deals in H1 2020 in Europe, 29% fewer than the 197 in the first half of 2019, highlighting the underlying strength of demand for mid-market financing. This deal flow taps into a larger trend, as in 2013 there were approximately 145 alternative lending deals in Europe whilst in 2019 there were 504. Since Q4 2012, there have been 2,433 transactions, representing a 22% CAGR, with increasing geographic diversification.



The sharp fall in deal activity early after the onset of the crisis, in both PE and mid-market lending, has given way to a relatively quick and substantial resumption of deal flow.

Deloitte's Alternative Deal Tracker



Source: Deloitte Alternative Lender Deal Tracker, Autumn 2020

Sector appetite has become bifurcated: impacted sectors, such as restaurants, travel, and certain businesses impacted by supply chain disruptions are out of favor, while preferred sectors such as IT, healthcare and financial and business services are seeing significant demand. Lending terms and conditions have been reflecting this. Expectations of significant increases in lending margins and reduced leverage, and better documentation terms have not materialized across the board. Due to dry powder, and greater competition than before for a limited number of high quality deals in preferred sectors, terms and conditions have undergone a V-shaped reversion to pre-Covid conditions, buoyed also by the prospective roll-out of a series of vaccines which have provided tangibility to the recovery outlook, if not timing. A flight to quality has favoured safe credits which performed well through the pandemic, even at tight pricing and higher leverage, over more speculative transactions on richer terms and conditions.

Nevertheless, documentation terms that had been trending unfavourably towards those of large cap transactions have been successfully recalibrated towards a better balance for lenders. Covid-specific add-backs to adjusted EBITDA that were being tabled between March and June 2020 have been resisted by lenders. The existing exceptional items regime for extraordinary, non-recurring and unusual costs and expenses has been challenged more successfully, including adjustments for 'lost revenues'. Indeed lost revenue cannot be considered a 'loss' under the accounting principles used to calculate EBITDA. There has also been successful push-back to 'shock event' provisions to use last year's numbers, a

common feature in large-cap transactions, as well as Covid-related amendments to 'material adverse change' and 'event of default' clauses.

Other documentation improvements include 'most favoured nation' (MFN) protection with longer 'sunset' periods. Add-back aggregate caps have been challenged less and are more lender friendly now, possibly because of the greater attention that lenders as a whole are giving to these adjustments, and demands for incremental debt baskets have been more reasonable. Rendezvous clauses to address side-car debt once earnings visibility is clearer, are also being included.

An Investor Map for the Road Ahead

Direct lending commitments are illiquid and long-term in nature and, given that the crisis is less than a year old and visibility as to the timing and trajectory of recovery is uncertain, allocation decisions must address a number of issues raised by the crisis. We would like to conclude by a review of the questions most frequently raised by investors in recent months and our current take on them.

The impact of lower market activity and changes in sector focus on competition and deployment

In our view the competition factors that were in play to succeed in direct lending have become more pronounced in the context of the pandemic.

It has been axiomatic that a **local presence** in core target markets has been key to the origination of the most attractive transactions. In the context of the pandemic and local lockdowns such presence has enabled managers to overcome basic physical impediments in the form of travel restrictions, reduced opportunity for direct engagement with clients, and increased complexity in transaction execution. Notwithstanding the sophistication of modern communications channels and digital business services, a full local presence that spans all aspects of the sourcing process from origination to transaction execution and portfolio management (especially important given the context) is a major differentiating factor.

Sector expertise will assume particular relevance given sharply reduced appetite for a range of the most impacted sectors and the tilt towards favoured business such as healthcare, technology, communications and selected business services. Pivoting to such 'hot' sectors will not be easy to accomplish for sponsors or managers that have not already established a track record in them. Sector expertise, not only in itself but also across different geographies confers greater relevance to sponsors seeking to scale businesses globally.


'Portfolio effect' – the ability of established managers to harvest new transactions from a long history of successful transactions sourced from numerous channels should provide a strong competitive edge. This portfolio effect can be derived from a number of sources:

- **A private debt platform** spanning corporate direct lending, mid-market acquisition financing (the mainstay of direct lending) and the leveraged loan market enables a manager to cross-source transactions across the different verticals. We should mention that this does not necessarily follow a linear progression from traditional corporate lending, through mid-market direct lending, to graduation to the liquid leveraged loan market. We have numerous examples of companies that have turned to the direct lending market for its greater flexibility to refinance a leveraged loan.
- **Sponsor network** - a long history of transactions undertaken for a wide range of sponsors, which has established the credentials of both parties and a common understanding and modus operandi for the efficient execution of new transactions.

- **Incumbent lender position** – this represents another source of origination opportunity, whether it be an add-on or refinancing, a new participation in a different part of the capital structure or through the portability of an existing financing in case the borrower is acquired by another sponsor, a feature that is becoming more common.

Given the importance of such factors it is perhaps not surprising that, according to institutions which survey the market, leading alternative lenders have continued to expand market share despite a long tail of new entrants into the market.

Other factors have also assumed greater importance in the challenging conditions. Team stability and experience in the monitoring and management of defaults, even if technical, and the ability to assess and negotiate appropriate remedies which balance the interests of all stakeholders needs to be of sufficient depth not to impede continuity of origination and deployment. Such resources should go beyond portfolio management to include in-house legal capacity, with in-depth knowledge of market norms and best practices, and experience across different legal regimes. Taken together, a strong capital base and robust infrastructure will be needed to navigate the crisis successfully.



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How to identify prospective winners and losers from the crisis

There is a general perception, supported by experience, that post-crisis vintages for private market strategies represent a good opportunity to generate above average returns. But that still leaves allocators with the challenge of identifying which horses to back in circumstance where the caveat 'past performance should not be taken as a guarantee of future returns' is particularly important. Broad views on default and recovery rates, sector impacts and return prospects may be too generic, and we would anticipate that there will be significant dispersion in performance among alternative lenders in the years ahead. We therefore propose some indicators which may act as a guide to future outcomes.

Pre-crisis lending decisions matter more than recent returns. All managers can claim to start with a clean sheet to capture post crisis opportunities, but legacy decisions can say much about ex ante views of the market and attitude to risk. For example, to what extent were investment base (not stress) cases prior to the crisis factoring in late cycle conditions and a prospective economic downturn? How did those assumptions inform decisions on acceptable margins and leverage? And what ancillary lender protections were applied in areas such as financial maintenance covenants and acceptable EBITDA adjustments, at a time when competition and trends in the broader credit market were beginning to seep into the direct lending market? A single turn of leverage can make all the difference between debt sustainability for a given decline in profitability and the need for debt restructuring.

Portfolio construction is critical but difficult to optimise. We suggest that diversification and sector allocation will prove to be the major determinants of long-term potential portfolio returns. Reduction of risk through low average individual exposures, allocated across a range of sectors and geographies, and the avoidance of highly cyclical sectors will be the strongest mitigants in a downturn. Yet achieving this is no easy task. It requires a critical mass of AuM, spread among a number of investment vehicles and managed accounts, to be able to act as sole or majority lender to retain control rights. An established origination network must generate a very significant pipeline of transactions to achieve the diversification targeted. And a high degree of discipline is required to avoid excessive sector concentration, given that specific sector experience naturally attracts additional opportunity.

Strategy creep may become a factor in an asset class which has been expanding very rapidly in Europe over the last decade and where the boundaries between direct lending as loosely defined – companies with an EBITDA of €7-€75m and transaction sizes up to €200-€300m - and the broadly syndicated loan market are becoming blurred. The emergence of 'jumbo' direct lending funds of €5bn or more and €1bn transactions testifies to the attractiveness of the flexibility and capacity of direct lending to accommodate a wider issuer base, but it also means that allocators need to take time to understand the precise nature of the investment strategy being proposed and a manager's specific experience in relation to that strategy, whether in relation to geography, sector, deal structure or size. In origination, a key success factor in our view is the correct matching of the sponsor with the proposed financing target. And in asset allocation it is important that yield enhancement through subordinated exposures is derived from compelling risk-adjusted value propositions.

Restructuring experience is now naturally top of mind. One of the differentiating features of some managers, including Tikehau, is that unlike traditional bank lending where origination, portfolio management and restructuring are undertaken by different teams, the investment team that originated the deal is also responsible for monitoring the investment and addressing any credit issues that emerge, including restructuring if required. It should be a given that such experience is embedded within investment teams, ideally from a mix of backgrounds which may include consulting, debt advisory, M&A and private equity, and supported by an in-house legal team with the same experience, knowledge of insolvency regimes and access to the best specialist counsels across the jurisdictions in which the manager operates. Yet, in practice, the process of managing problem credits is much more nuanced than simple recourse to enforcement, and **patience**, afforded by a deep understanding of the underlying business and sponsor, and allied to a substantial toolbox of remedies with reciprocal lender mitigations, is a major factor in delivering low loss rates for the best managers.

Operational resilience will be a key differentiator, and not only in the context of challenging market conditions. Capital, to support the maintenance and development of in-house rather than outsourced operational infrastructure across critical functions such as fund operations, legal (at both fund and transaction level) and technology, and demonstrate a strong alignment of interests with investors through having 'skin in the game', will also enable managers to be agile in capturing new opportunities. At individual

business level, the resources required to manage portfolios under stressed market conditions should not detract from expansion of a strong origination pipeline to maintain efficient deployment pace in times of lower activity and increased competition. Given the rapid expansion of the market and exponential rise in the amount of data generated by what is still considered by many to be a rather opaque asset class, **digital transformation** is a 'must have', not a 'nice to have'. Allocator demands for increased transparency in reporting at borrower, asset and fund level, and more sophisticated KPIs that emphasize meaning over numbers, and substance over sound bites, requires robust systems and transversal integration that allows business intelligence engines to generate customized and automated reporting in a timely and flexible manner.

The Importance of ESG

The pandemic crisis has brought ESG considerations very much into the spotlight. Emerging interest in what may have been considered a rather philanthropic adjunct to the main asset management activity has now acquired an urgency and tangible relevance to the investment management process. Pre-crisis, highly efficient supply chains, delocalized production and cheap labour generated cost competitiveness, productivity gains and expanding margins and profits, and may not have put climate considerations high up on management agendas. Post-crisis, the disruption wrought on supply chains through lockdowns and reduced mobility, aggravated by trade tensions and protectionist tendencies, has set in motion a re-localisation trend where a significant mitigation to higher cost structures will have to come from energy efficiency to maintain competitiveness.

It is now accepted that environmental, (climate concern, efficient use of scarce resources), social (job creation, diversity and talent retention and training), and governance considerations (impeccable business ethics, independent oversight and CSR commitments) can have a positive economic impact on the reduction of risk and the improvement of potential investment returns.

However, in an evolving landscape of multiple ESG labels and 'best practice' standards, managers will need to engage actively with investors to provide evidential assurance that positive noises made about ESG commitments represent more than 'greenwashing'. Allocators will rightly wish to see both a robust framework (top leadership engagement, dedicated ESG managers and governance processes) and understand how policies and guidelines are practically applied in the investment process at individual investee company level.



A 'quid pro quo' in this process will be the adoption of incentives for borrowers, for example in the form of a downward margin ratchet, a feature already being pioneered, as reward for a lower risk profile achieved through meeting ESG objectives.

This will require managers to communicate in a granular way on issues such as exclusions, criteria applied in ESG risk screening and management, its role and weight in the investment committee process, and the extent and manner in which the adoption of ESG commitments and goals may be enshrined in investment contracts. While certain ESG and CSR factors will have a wide commonality across all types of business, the most advanced managers will be mapping specific prospects to those Sustainable Development Goals ('SDGs') which are most relevant, and working constructively with companies in setting and monitoring realistic and meaningful targets. A 'quid pro quo' in this process will be the adoption of incentives for borrowers, for example in the form of a downward margin ratchet, a feature already being pioneered by Tikehau, as reward for a lower risk profile achieved through meeting ESG objectives.

As an example, in order to support the acquisition of Talan, a French IT services company founded in 2002 employing over 2200 FTEs, by Towerbrook and management, Tikehau Capital arranged a €183.5m financing, including a €123.5m Unitranché and a €60.0m Acquisition Facility. Pricing includes an ESG-linked downward ratchet mechanism as an incentive for Talan to further improve its ESG score during the life of the financing. As a digital company, human capital is considered an important driver of value creation and targets were agreed across four criteria covering two SDGs (Quality Education and Gender Equality), as well as a 'Great Place to Work' rating and ESG certification.

A Final Word

Direct lending has firmly established itself as an asset class offering a wide opportunity set and diversification, a stable income stream and premium returns with modest drawdowns over the long term, and as a systemically important contributor to economic growth through its support of the mid-market. Yet its private nature and the massive amount of data that is generated by the activity has raised calls for the establishment of industry benchmarks and standards, and key performance indicators.

We support such initiatives as having a role to play in expanding the availability of capital. But we would caution that the breadth, diversity and flexibility of direct lending, which is the source of its attractiveness to sponsors and managements, does not lend itself naturally to commoditisation.

Instead, investors who take the time to look further into the idiosyncratic drivers of performance, beyond the homogeneous, and those managers who are able and willing to provide the most transparent insights into their investment processes and portfolios, will in our view be well-rewarded through greater understanding and better returns.

About Tikehau Capital

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