Market Commentary

Recent Trends and Cautionary Signals in Direct Lending

Over the past few weeks, three noteworthy events (below) took place that indicate a level of froth building in the direct lending markets. It's a reminder that higher yields do not guarantee higher returns and not all strategies are created equal. We're bullish on the opportunity set within private debt but avoiding 'hot' areas of the market plays a large role in our ongoing allocation decisions.

- **Synthetic Payment in Kind** (PIK) – Direct lenders have recently pitched deals that include a 'synthetic PIK' option. In these transactions, lenders provide a borrower with two tranches of pari-passu debt: a traditional loan bundled with a smaller delayed-draw term loan (allows funds to be accessed over time). The borrower pays the interest due on the first loan with borrowings from the delayed draw term loan. Because these deals are not technically classified as PIK, it makes it more palatable for banks / other lenders to participate and improves access to capital for private borrowers.

- **Vista Equity Partners** – In 2021, Vista financed the purchase of Pluralsight, a tech workforce development company, with a $1.5 billion private loan from a handful of blue-chip direct lenders. Pluralsight has underperformed and Vista marked the equity to zero. In light of their financial struggles, Pluralsight struggled to meet its most recent interest payment. The company decided to move certain intellectual property assets to a new subsidiary (similar to the J Crew 'trap door' event in 2016) and used the revised structure to obtain fresh financing from Vista. The new loan weakened the existing lenders' position and surprised the private credit market which is known for tighter documentation and relationship-based lending.

- **Credit Spreads** – Direct lenders have closed first lien deals in the S+475-550 range over the past few weeks, which is roughly 100 basis points tighter than this time last year. The yield compression has led some managers to target second-lien positions and/or actively reduce their financing costs, which heavily impacts margins.

In conclusion, we continue to monitor the direct lending space for areas of opportunity but remain cautious, as heavy competition and inflows have the potential to reduce risk-adjusted returns going forward.

This week's contributor is Nora Pickens, CAIA.

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