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7 Things You Didn't Know About Direct Lending Funds

Editor's note: Direct Lending has become one of the hottest areas of alternative finance as investors become better acquainted with the asset class and its potential to generate attractive risk-adjusted returns. That said, there are a few unique aspects to direct lending funds that should be kept in mind, writes SS&C GlobeOp's Joe Patellaro in this contributed article.

7 Things You Didn't Know About Direct Lending Funds

By Joe Patellaro, Managing Director, SS&C GlobeOp Global Private Equity Services

As markets around the globe have forced investors to look at new avenues of investment, alternative asset classes continue to gain market share and overall acceptance by the investment community at-large. Direct lending funds in particular have gained a great deal of momentum and media attention in recent years, especially after banks curtailed their lending activities in the wake of the financial crisis and investors searched for yields higher than traditional government or corporate debt.

Investors typically expect direct lending funds to provide higher yields, frequent cash distributions and relatively low volatility compared to some traditional investment instruments. Nonetheless, there are many things investors don't know about direct lending funds, so consider the following facts about direct lending if you are thinking about investing.

1. Direct lending funds fill a need in the market: Before investing in a direct lending fund, it is important to understand the characteristics of the borrowers. The vast majority of direct loans are given to small and medium-sized enterprises that are unable to easily leverage banks for large-scale capital needs. Direct lending funds cover this void in the market by acting as a liaison between non-bank entities that have the funds to provide loans, and entities that need said loans.

2. Collaboration between hedge funds and private equity firms has led to new opportunities for borrowers: The direct lending market is highly opportunistic now that hedge funds and PE firms are beginning to team up in order to directly compete with banks. Investors should be prepared to see direct lending funds provide borrowers with flexible financing terms, time horizons, incentives and other options.

3. Fund structures are complex: Investing in securities such as stocks and bonds is generally not considered to be the conduct of a U.S. business; however, activities such as loans by partnerships that could constitute lending may have the consequence of classifying the partnership activities as U.S. Trade or Business. If this happens, then the partnership can be subject to various tax obligations on the income received from these activities as well as potentially expose themselves to state and local jurisdictions where they otherwise may not have had responsibilities. Fund managers will address these concerns usually by creating several separate investment vehicles within the fund as well as specific

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actions with regard to the loans themselves.

4. Compliance and governance management of direct lending funds is crucial: Loans are much less straightforward compared to other financial instruments. Due to the unique structure of these kinds of funds, investment firms must be able to accurately reflect when payments are due, as well be able to pinpoint when borrowers have to submit financial information to lenders. This constant stream of activity inherent to the lending process means that lenders and fund managers must be constantly vigilant to ensure that compliance is managed properly.

5. Direct lending funds require dedicated fund administration services: The complexity of a diverse loan portfolio requires diligent oversight since every loan can have unique terms. It also provides fund administrators with fresh incentives to build dedicated direct lending platforms given that the market's growth opportunities. Depending on where a fund administrator has focused historically, its systems might not be able to handle the characteristics of the direct lending asset class as well as the complexities of the investor allocation waterfall at the same time. This means a dedicated direct lending solution is imperative for proper fund performance, as the structures required to make a direct lending fund tick must be built from the ground up.

6. Direct lending funds have lengthy investment horizons: Investors need to understand that direct lending funds are usually more liquid than traditional private equity but less liquid than traditional hedge funds. One of the reasons why the funds have such high yields is due to their lock-up periods, which prevent investors from touching their principal for years at a time.

7. Regulatory change continues to benefit direct lending platforms: As is often mentioned with direct lending, the asset class experienced its highest growth in the wake of the 2007 financial crisis that led to a purse-tightening of banks around the world. Since then, ongoing regulatory changes have continually put a lid on lending activity for banks. For context, the 2011 Basel III regulatory framework led to a requirement for banks to hang on to more capital against riskier loans, which has ultimately reduced lending activity even further for banks. As these changes continue to affect banks, direct lending funds should only continue to grow in volume.

As banks continue to tighten their lending operations, the market for direct loans will only continue to expand, and with more platforms available than ever before, investors can enter the space with ease and efficiency. Indeed, with high growth, high yields and increasing scale, such recent industry trends will necessitate savvy investors to keep their eyes on the direct lending space for years to come. ■

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