Direct Lending (Private Credit)

Interview preparation summary · PC track

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INT.CT.1.a · The market and origination

Explain what direct lending is and why it grew, how it differs from bank lending and the broadly syndicated loan market for a borrower and a lender, and how the main fund vehicles work.

Direct lending means non-bank lenders, such as private credit funds, business development companies and insurers, originating senior secured loans to middle-market companies and holding them rather than selling them on. It grew as banks, facing higher capital charges after the financial crisis, pulled back from lending to mid-sized, more leveraged borrowers, and as borrowers and sponsors came to value speed, certainty of terms and confidentiality. Set against the broadly syndicated loan market, where an arranger places a rated, tradable loan with many investors and prices it through market flex, a direct loan is negotiated with one lender or a small club that expects to hold it to maturity. The borrower usually pays a wider margin and a higher upfront fee for that certainty, and the lender earns a premium for illiquidity, structuring and monitoring. Banks still offer the cheapest senior debt, revolvers and ancillary services, so they often sit alongside direct lenders rather than against them. Drawdown funds call commitments as loans are made, have a finite life and charge fees on invested capital or on commitments; evergreen and open-ended vehicles take in and return capital continuously; business development companies are regulated, often listed vehicles that pay out most of their income. Counsel and advisers handle regulation and tax. A strong answer gives the borrower's reason and the lender's reason, not slogans.

WORKED EXAMPLE: WHAT CERTAINTY COSTS A BORROWER

Hollin Foods, an invented company, needs a 180m term loan. An arranger offers a syndicated loan at a margin of 4.25% over the base rate, issued at 99.0 with a 2.0% arrangement fee. A direct lender offers a unitranche at a margin of 5.50% with a 2.5% upfront fee, committed and closing in six weeks. Use the four-year convention for fees. What does the borrower pay for the direct loan, and how much more a year?

Answer: The direct loan costs about 6.125% a year all-in against 5.00%, roughly 2.0m a year more on 180m, in return for certainty, speed and a single counterparty.

> **Interview tip:** Give the cost gap in points and in money, then name what the borrower buys with it; say the premium is also the lender's pay for illiquidity, not a free gain.

INT.CT.1.b · The market and origination

Describe how a direct lender sources and converts deals: the origination channels, the funnel from screened to closed, why selectivity matters and what an origination platform costs.

A direct lender needs a steady flow of loans that it would be glad to hold, so origination is both a sales activity and a filter. The main channels are private equity sponsors, who give repeat business but run competitive processes; advisers and investment banks that run sale and refinancing processes; banks that refer borrowers they cannot or will not serve; and direct relationships with owner-managed businesses, which are less contested but need more diligence and negotiation. Track the funnel: deals screened, deals where the lender gives an indicative quote, deals mandated, and deals closed. A low conversion rate is normal and healthy; a fund that closes most of what it sees is probably not being selective. Dividing the loans the fund needs to close by the product of the conversion rates gives the number of deals the team must screen, and a fall in any rate raises it. Origination platforms are costly: team, travel, legal and diligence on dead deals. Expressed as a share of the capital deployed, that cost is part of the economics and must be covered by upfront fees and margin. Beware winning every contest: if the fund is always the highest bidder on terms, it may be mispricing risk or seeing the deals others declined. Saying no early, and saying why, protects both the fund and the relationship.

WORKED EXAMPLE: HOW MANY DEALS MUST THE TEAM SCREEN?

A fund wants to deploy 1,000m this year at an average ticket of 40m. Of the deals it screens, 20% reach an indicative quote, 50% of quotes are mandated and 50% of mandates close. How many deals must it screen? If competitive pressure cuts the closing rate from 50% to 40%, how many?

Answer: The team must screen 500 deals; if the closing rate falls to 40% it must screen 625.

> **Interview tip:** Show the funnel as a product of rates and say that the answer to a lower hit rate is more sourcing or a bigger ticket, never weaker underwriting.

INT.CT.2.a · Instruments, underwriting and pricing

Compare the main direct lending instruments, including senior term loans, unitranche, first-out and last-out splits, delayed-draw and revolving facilities and club deals, and say how a lender sizes and tests the loan it will hold.

The core instrument is the first-lien senior secured term loan. A unitranche combines what used to be senior and junior debt into one loan at one blended margin, with one set of documents and one lender or club. Where several lenders share it, an agreement among lenders usually splits it into a first-out piece, which is repaid first from enforcement proceeds and earns a lower margin, and a last-out piece, which earns a higher margin and takes losses first. The borrower sees only the blended margin; the lenders see two different risks, and the blend is the weighted average of the two margins. A delayed-draw term loan lets the borrower draw later, for example for acquisitions, and the lender earns a commitment fee on the undrawn amount; a revolver is a drawable and repayable line, often provided by a bank and ranked ahead of the term loan. In a club deal a few lenders each hold a share, which spreads hold size and lets one fund take a position it could not take alone. The lender underwriting its own hold asks whether the amount fits its limits, tests leverage, interest and fixed charge cover, and liquidity against a downside case, checks that guarantors cover most of the group's earnings and assets, and reads the covenants for what they actually protect. A smaller borrower, or one late in its cycle, deserves lower leverage and tighter protection than a larger, steadier one. Core credit analysis has its own topic; here the point is which instrument and which slice you are buying.

WORKED EXAMPLE: SPLITTING A UNITRANCHE INTO FIRST-OUT AND LAST-OUT

Brandt Fabrication, an invented company with EBITDA of 30m, takes a 150m unitranche at a blended margin of 6.00%. Lenders agree a first-out piece of 90m at a margin of 4.25% and a last-out piece of 60m. What margin does the last-out piece earn? If the business is worth 105m after costs in a default, what does each piece recover?

Answer: The last-out piece earns 8.625%; in the 105m default case first-out recovers 100% and last-out 25%, against 70% for the whole loan.

> **Interview tip:** Say that the borrower sees one price while the lenders hold two risks, then give the last-out margin and recovery to show you can price the slice you would actually buy.

INT.CT.2.b · Instruments, underwriting and pricing

Price a direct loan and work out a fund's return: margin over a floating base rate, floors, upfront fees and discount, call protection, the return after losses and fees, the effect of a base rate move and the effect of fund leverage and a subscription line.

A direct loan pays a floating base rate plus a fixed margin, so the lender's income rises and falls with the base rate. A floor sets a minimum for the base rate in the coupon, so if the base rate falls below the floor the borrower still pays as if it were at the floor. Upfront fees and any discount to par are earned at closing; to compare loans, spread them over an assumed life, often four years, and add them to the margin. Call protection, such as a premium for early repayment in the first years, protects that yield if the borrower refinances. A fund's net return starts with the loan yield, subtracts expected credit losses, then management fees and expenses, and then any incentive fee above a hurdle. Fund leverage multiplies the return on equity when the assets earn more than the debt costs, and it multiplies losses too. Because both the loans and the borrowing usually float, a fall in the base rate lowers the equity return by roughly the full change, not just the asset yield change, and a floor on the loans limits the damage only below the floor. A subscription line lets a fund draw on investors' commitments late: it raises the reported IRR because investor cash goes in later, but it lowers the money multiple because interest on the line is paid, and it adds the risk of a call that investors fail to meet. Fund regulation and tax are for counsel. A good answer states the return as a stack of steps and gives each number.

WORKED EXAMPLE: RETURN ON EQUITY WITH AND WITHOUT LEVERAGE, AND WHEN THE BASE RATE FALLS

A fund holds 1,000m of loans at a base rate of 4.0% plus a margin of 6.0%, with a 2.0% upfront fee earned over four years. Expected credit losses are 1.0% a year of the loans. It borrows 500m at the base rate plus 3.0% and has 500m of equity. Ignoring fund fees, what is the return on equity, and what is it if the base rate falls by 1.5 points (no floor binds)?

Answer: Return on equity is 12.0% levered against 9.5% unlevered, and 10.5% after a 1.5 point fall in the base rate.

> **Interview tip:** Show the equity return as assets income less interest over equity, and note that a falling base rate cuts the levered return by about the same number of points.

INT.CT.3.a · Portfolio, monitoring and funds

Construct and police a direct lending portfolio: position, sector and sponsor limits, deployment pace, the loss budget and the break-even default rate, concentration risk and the early warning of non-accruals and payment-in-kind elections.

Diversification is the lender's main protection because its upside is capped. A fund sets limits, for example a maximum share of the fund in any one borrower, in one sector and in loans to one sponsor, and checks every new loan against what is already held, so the headroom under the tightest limit sets the hold size. Deployment pace matters: investing too quickly in one year can concentrate a vintage in one part of the cycle, while investing too slowly drags returns. A loss budget turns the target into a number: start from the portfolio yield, subtract fees and the return the fund wants to deliver, and what is left is what credit losses can consume. Expected annual loss is the default rate times loss given default, which is one minus the recovery rate. Dividing the loss budget by loss given default gives the break-even default rate. Losses arrive in clusters, because defaults are correlated by sector, sponsor and cycle, so the year's actual loss can exceed the expected loss many times over, and the limits exist for that reason. Early warnings include loans moved to non-accrual, where interest is no longer recognised, and borrowers that elect to pay interest in kind, because the balance then grows while the business shows no extra cash. A sound answer talks about the portfolio, not the loan.

WORKED EXAMPLE: THE BREAK-EVEN DEFAULT RATE

A fund earns a loan yield of 10.5% on its invested assets. Management fees and expenses take 1.5% and the fund wants to deliver 7.0% before any incentive fee. Recoveries on defaulted loans have averaged 60%. What is the loss budget, and what annual default rate would use it all?

Answer: The loss budget is 2.0% a year, which is a 5.0% break-even default rate at 60% recovery, falling to 3.6% if recovery is 45%.

> **Interview tip:** Walk the arithmetic in order, from yield to budget to default rate, and always give the break-even under a weaker recovery.

INT.CT.3.b · Portfolio, monitoring and funds

Describe how a direct lender monitors loans and manages problems: reporting and covenant tests, internal ratings and watch lists, waivers, resets and amend-and-extend, equity cures, and the lender's control in a restructuring.

Because the lender holds the loan, monitoring is its job and not an afterthought. It receives monthly or quarterly management accounts, a compliance certificate showing the covenant calculations, budgets, and often a lender call. It tests covenant headroom, which is how far earnings can fall before a test is failed, and gives each loan an internal rating that moves with performance, with weaker loans placed on a watch list that triggers more frequent reporting and senior attention. When performance weakens before a breach, the usual tools are a waiver, a covenant reset, often with a fee and a margin uplift, or an amend-and-extend, which lengthens maturity in exchange for terms. An equity cure lets the sponsor or owner inject money to restore a covenant. These choices are weighed against enforcing: acting early can protect value, but a lender that always agrees to terms it does not believe in only delays a loss. In a workout the direct lender usually has more control than a lender in a large syndicate, because it is one of very few decision-makers and can move quickly, and the choice is between a consensual restructuring, new money, a change of ownership and enforcement. Compare the expected recovery of each route, discounted for time. Legal enforcement detail is for counsel. A strong answer is calm, quantitative and clear about what would make the lender change its mind.

WORKED EXAMPLE: A RESET THAT COSTS THE BORROWER SOMETHING

Cordell Print Group, invented, has net debt of 150m and a maximum net leverage covenant of 5.50x. EBITDA was 30.0m and has fallen to 28.0m, and the budget points lower. What is the headroom now? If the lender agrees to reset the covenant to 6.25x for a 0.50% fee on 150m and a margin increase of 0.50%, what does it cost the borrower in the first year?

Answer: Headroom has shrunk to 2.6%; a reset to 6.25x costs the borrower about 1.5m in year one, and should come with reporting and recovery conditions.

> **Interview tip:** Give the headroom in per cent of EBITDA, price the amendment in money, and say what you would ask for in return.

Summary of the Charta interview-preparation topic. Companies and figures in the examples are invented. Draft content, not yet expert reviewed.