DLD chats with Art Penn of PennantPark about direct lending: *It’s not some exotic ‘alternative asset class.'*

Art Penn, a 34-year credit veteran and founder of PennantPark Investment Advisers, took some time for a quick chat with Direct Lending Deals this week to discuss sizing and defining the market, and the fallout from coronavirus fears.

DLD: You've been doing this awhile, Art. Is direct lending really anything new? How do you define direct lending?

AP: *It’s not some exotic ‘alternative asset class.’ It’s classic bank lending. One of the oldest forms of commerce. Only banks aren’t the ones doing it anymore.*

It’s actually safer and more boring than before. Finance companies or credit funds are typically leveraged at two, maybe three times. Compare that to banks before the credit storm. They were eight to one; 10 to one leveraged, in most cases. CLOs were at least 4x or 5x and performed well during the downturn.

DLD: What size do you put on the direct lending market? We think it's about $1 trillion.

AP: *It's really tough to track. We think that sounds about right. Nobody is really sure. Preqin came out with a $1.5 trillion estimate of PE dry powder. We like to think that sponsors will then need at least $1.5 trillion of debt to match, assuming a 50/50 capital structure.*

DLD: Most of direct lending is to middle and lower middle market borrowers, with varying definitions for each of those categories, depending who you ask. How does PennantPark define middle market?

AP: *For us, it's $10 to $50 million of EBITDA or what we call "classic middle market." When you go larger than that, companies can go to the BSL market and get covenant-lite, lots of leverage and aggressive docs.*

When you stick to classic middle market, you're still important to the borrower, you still underwrite to hold, you have time for your own due diligence, you receive monthly financial statements. If things go south, you can be at the table quickly with the borrower to work out issues and revisit terms. In a BSL deal, there will be 100 people at the table.

DLD: Like 'middle market,' there are differing opinions about what defines a loan as 'unitranche' these days. What's your call?

AP: *That's another one that's tough to answer. You can ask three people and get six different answers. As of today, we generally consider unitranche anything that stretches beyond 5x first-lien leverage. Back in 2009, we would have said 2 or 3x. Certain industries can take on more leverage, software for example.*

Coronavirus

DLD: Any effect on originations yet? Are sponsors cancelling or delaying M&A because of it?

AP: *In the direct lending market, most deals take awhile. It can be six, eight, or 12 weeks before a deal is signed, so it's too early to tell what kind of impact this will have on originations.*

What is happening right now is we're figuring out how this affects the existing portfolio. We're piecing together information and feedback from companies to try to synthesize the effects. So far it hasn't had a big impact.

DLD: Yet…

AP: *Obviously, if this continues to escalate, then everybody is going to press pause for awhile. Up until last week, deal activity had been slow for seasonal reasons — the first quarter tends to run slower following the fourth quarter rush to close year end business. The view had been that sponsor activity would ramp up in the next few weeks to close exits by the end of the third quarter ahead of the election.*

DLD: And now?

AP: *Every day this thing moves in a new direction. There is not a ton of clarity out of China, because it's China, and there's never much clarity out of China. The stock market has taken a beating all week. Everybody will be watching the BSL market in the coming weeks to see how deals fare. Will they have wider pricing? Will there actually be covenants added to deals? Nobody has any idea how this will play out. We just have to wait and see.*

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