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FEATURE DIRECT LENDING

READY, WILLING AND ABL

The financial crisis was tough on asset-backed lending funds, and a spate of redemptions saw the space shrink considerably. But the launch this year of a new $1bn fund from FrontPoint Partners suggests that direct lending and ABL is making a comeback, and, due to the restrictions of Dodd-Frank, the space offers a wealth of opportunity for smaller niche players BY TONY GRIFFITHS

When FrontPoint Partners unveiled its new direct lending hedge fund in January, most of the headlines concentrated on its size. This was, after all, one of the industry's first $1bn launches in almost a year. It was also FrontPoint's biggest to date. Six months and several more direct lending funds down the line and it's clear the launch was significant for a second reason – it marked the mainstream return of the direct lending strategy itself.

Big in the mid 2000s – largely in the form of close cousin, the asset-backed lending (ABL) fund – direct lending hedge funds endured a particularly tough crisis. Squeezed by redemptions from their traditional investors – mainly high-net-worth (HNW) individuals, family offices and a specific group of large funds of hedge funds (FoHF) – they also suffered from a dramatic reduction in the profitability of loans themselves. Liquidity mismatches spread like wildfire. Investors got burned, money came out, gates went up and the majority of participants exited the space.

"At the height of the market, in 2008, there were probably about 150 ABL hedge funds, the vast majority of which were forced to gate, suspend or restructure" says Jonathan Kanterman of Institutional Asset Advisors. "The space has been stagnant for the last couple of years or so, yet now, since the start of 2011, we're starting to see them pop up again. I believe this is just the beginning."

Kanterman, a veteran of the direct ABL space, estimates there to be about 40 direct lending hedge funds currently operating, a significant proportion of which have launched since the turn of the year.

A CLOSED-END VEHICLE WITH $1bn in committed capital, the FrontPoint-SJC Direct Lending Fund is not only one of the newest funds in the space but one of the very largest. SJC offers tickets between $7.5m and $100m, and for Steve Czech, the fund's portfolio manager, this range places it at a distinct advantage.

"The biggest opportunity exists for companies that generate less than $50m of annual Ebitda [earnings before interest, taxes, depreciation and amortisation] and who cannot issue in minimum tranches of $100m-$200m," he says. "These borrowers rely on commercial banks, commercial finance companies, BDCs [business development companies]and direct lending funds like SJC for their capital. Banks and commercial finance companies in this sector are very risk averse at the moment and there simply aren't enough direct lending funds or BDCs to fill the void."

FrontPoint's investors – a diverse set of institutional investors including domestic and international pension funds, endowments, foundations, family offices and HNWs – clearly appreciate the opportunity set for a fund of SJC's size and focus. Having made headlines for the wrong reasons of late, Greenwich, CT-based FrontPoint has ring-fenced SJC (along with three other hedge funds), as it looks to reduce its roster following recent redemptions at its other funds, prompted by an unrelated insider trading probe. For FrontPoint, direct lending is here to stay.

"We have yet to see the same competitor twice," Czech adds. "We encounter other funds and, in some cases, BDCs. I don't expect the pool to grow quickly because the supply of lending expertise required to effectively run these funds is very small relative to the demand for credit and investors have learned through the crisis that there is a material difference between 'credit trader' fund managers and 'credit lender' fund managers. We are 'credit lenders'."

In terms of size, FrontPoint SJC is at one extreme of the direct lending spectrum. Direct lending hedge funds are among the industry's smaller strategies. A fund with $100m AuM is considered a sizeable product and the majority of players offer loans in the $5m-10m bracket. At the modest end of the AuM spectrum, operators are focused less on occupying a price pay bracket and more on niche markets. There are direct lending hedge funds in the worlds of mortgage, sport, media and even divorce. The BBL Churchill Group – due for launch later this month – will extend bridge loans to divorcees. Managed by lending stalwart Brendan Lyle, the fund is an extension of a strategy Lyle ran successfully in Australia.

NEW FUNDS ARE COMING FROM both fresh entrants – FrontPoint hired an entire team in preparation for its own foray – and veterans returning to the space. However, while those heading direct lending version 2.0 could not be considered en masse a new generation, today's space is regarded as an improvement.

"The funds now are going to be better structured, because the investors themselves are more knowledgeable of the strategy and have learned from the past," says Kanterman. "Illiquidity was at the heart of many of the problems – many funds would be dealing with, in essence, level-three assets. People learned to create better structures and investors demanded better reporting, oversight and transparency."

According to Kanterman, liquidity expectations have realistically changed from quarterly to annual or two-yearly. The price range of the loans that funds are charging, however, has remained relatively steady – between 15% and 20% APR. By and large, this was, and is, the minimum range necessary to create the monthly returns of 10-14% that investors target, without using leverage.

"One of the problems before was that as capital came into the space people still needed to lend at that 15-20% range, but as more money flowed in, the funds had to go from A-list deals to B-list deals to C-list deals in order to put the capital to work. Now managers are seeing much less compe- tition, better deal flow and lending opportunities, and better collateral. In essence, there is a lot more cherry-picking for the time being."

"BASEL III AND DODD-FRANK ARE CREATING A BARBELL BANKING SYSTEM – A FEW HUGE BANKS AND THOUSANDS OF SMALLER BANKS THOSE WHO ARE SHRINKING TO AVOID BEING SUBJECT TO DODD-FRANK" STEVE CZECH, FRONTPOINT PARTNERS

For those funds that survived the downturn, striking the A-list deal is vital. "Finding capital is never the issue – finding the right loan opportunities is always hard," says Gregg Winter, CEO of the $50m W Financial Fund, a hedge fund that sources and originates first mortgage loans between $2m and $8m on commercial real estate, mainly in the New York Metro area. "We maintained our discipline before the downturn, and today we still do," he says.

Currently with over $100m in AuM, New York-based Trafalgar Capital Advisors' (TCA) Global Credit Master Fund, up 7.11% YTD, is among the sector's more successful veterans. TCA, however, operates at the low end of the direct lending hedge fund market; profits are generated by extending loans of $1m-2m to micro and small cap firms. The firm currently has 60 positions via around 50 firms and is sector agnostic.

"There's always been competition but, coming out of the global financial crisis, competition from funds has lessened dramatically," admits TCA founder Bob Press, adding that he expects this to be a temporary phenomenon. The biggest threat to business TCA has encountered in its history was what Press calls the competition of inertia; during the immediate post-crisis period, when companies concentrated on staying alive, rather than growing.

Press highlights family offices as current, if untraditional, competitors to TCA. "We're actually talking to a few family office lenders right now about doing a joint venture, where they put up a larger ticket and we put up some of our capital and we do the vehicle almost like a managed account but in more traditional sense. This is brand new." Such talks are at a very early stage, he adds.

Any concerns that increased competition from the recent jolt in the direct lending hedge fund space could lead to opportunity saturation appear moot. A growing number of hedge funds may be entering and re-entering the space but few are doing so in the same vein, be that via sector niche or loan bracket. As a result, talk is both of an increasing number of entrants and diminished competition – potentially paradoxical but seemingly accurate.

And what of the prospective return of the banks themselves as competition for the larger players? FrontPoint's Czech is not overly concerned. "Even if the banks re-enter this space, and I don't believe they will, they will not be a major factor. Why? Because Basel III and Dodd-Frank – in addition to increased capital requirements, restricted business lines and an increase in the type and frequency of regulatory oversight – are creating a barbell banking system – a few huge banks and thousands of smaller banks, those who are shrinking to avoid being subject to Dodd-Frank," he explains.

"Hence, for the companies we lend money to – annual revenue of $75m-500m – their borrowing needs are either too large for the small banks or too small for the big banks. The opportunity for nimble providers like SJC is significant and, I believe, long lasting. As a result of Basel III and Dodd-Frank, credit will likely become more expensive, less flexible and scarcer than during any time in my 23-year career." ■

LEND ME YOUR EARS

Three examples of Trafalgar Capital Advisors' direct lending scenarios.

Sector-agnostic Trafalgar Capital Advisors (TCA) holds positions across a range of firms. The collateral box – perhaps the vital consideration for direct lending funds – however, is narrow. Founder Bob Press explains: "The best example we have is: if you're an oil producer and you want capital to drill 50 holes in the ground, we're not the right lender. If you want to build out the existing interest on lease holes that you're already producing on, we may be." Below are three examples of transactions in which TCA is involved

CASE STUDY 1

$1m asset-based line of credit to US-based consumer services company

The company is a US-based consumer service company with over 20 years of history. It specializes in a range of services including maintenance, repair and new product sales. Due to the seasonality of the industry, the company experiences difficulties with cash flow management. Additionally, its customer base numbers are in the thousands with small ticket sales making any traditional financing route very difficult to obtain.

CASE STUDY 2

UK-based company that hosts global golf tournaments

TCA has been financing the UK-based company for several years. The firm puts on golf tournaments in the likes of Hong Kong and South Korea. Getting 90% of its revenues from the events, the firm is still required to keep offices open in Seoul and in Hong Kong for 12 months a year. TCA has been issuing an annual loan to smooth the process over.

CASE STUDY 3

UK-based motion picture production and distribution company.

This publicly listed company's subsidiaries engage in the development, financing, production, and licensing of theatrical motion pictures with budgets in the range of $2m to $15m in the UK, Europe, Canada and the US. TCA provided the Term Note facility, access to a Committed Equity Facility as well as engaging in an investment banking agreement to assist the company in raising equity capital in the UK.