Allison Lam:

PGIM Private Capital is a private credit unit of PGIM. PGIM is the $1.4 trillion global investment management firm backed by Prudential. So we're a large global organization, 200 investment professionals across 15 offices, and we've been investing in the private debt markets for over 75 years, managing third party institutional capital since 1976.

And today we manage about 100 billion in private debt through the full risk spectrum, and that's deployed really across various strategies which span long-term fixed rate debt tranches out to leveraged finance in the form of both senior secured floating rate loans, damaged junior capital, that ranges in the form of mezz, debt, and structured equity.

And so, joining us is Matt Harvey. Matt is a managing director and head of our direct lending business. So Matt's been with PPC for nearly 20 years now. Started as an analyst in our Mezzanine business, moved to London to build out our European mezzanine practice there. And most recently shifted his focus to expand our direct lending efforts at PPC. And so today, we're going to talk to you about PGIM Private Capital's approach to direct lending and the private debt landscape. And so with that, Matt, I'll turn it to you.

Matthew Harvey:

Great. Thank you, Allison, and good morning everyone. It's a pleasure to be here to talk about this asset class. It's an asset class, I think, as most of you all know and appreciate has grown quite a bit over the last 10 years; really was born in the depths of the financial crisis as bank regulation and other market shifts created a demand for an alternative source of leverage capital to middle market companies. And so what we'd like to do today is spend a little bit of time introducing the asset class itself. We'll keep the comments, I think, objective and educational, and then we'll obviously have some time for moderated questions between Allison and myself, and would obviously encourage participation and questions from the audience.

Usually we find those to be frankly the richest source of content discussion. And I notice here, I'm based in Chicago, so this is a picture of the Chicago River looking west down Wacker Drive, so maybe familiar to some of you. But in any event, just to get started here, when we think about direct lending and where this fits in, you have to think about it within the context of the leverage finance landscape. And ultimately what direct lending is, it's senior secured loans to middle market and small cap companies.

Generally $10 to $50 million of EBITDA in issuer size. Of course, you have outliers to that on the upside. And generally financing event driven transactions for leverage buyouts, for acquisition or recapitalizations. It's something more than just a plain vanilla or traditional refinancing in most. And therefore, the need for capital, the depth of capital, the sophistication of capital is a little greater than the average bank refinancing.

When you think about where direct lending on the private side fits within the leverage landscape, start really on the right-hand side. There are larger issuers that access capital markets. And in leveraged finance that’s either broadly syndicated loans that's underwritten by a proportion of banks, sold to investors. And that's what you see on the top right that's generally senior secured, and therefore less risky than unsecured debt or it's close cousin, at the bottom right, high yield bond. Generally unsecured, term debt, fixed rate versus floating rate, which loans are.

But in any event, on this right-hand side, companies of this size are larger. They generally obtain a credit rating from a ratings agency such as S&P or Moody's, and therefore they get syndication depth, their issues trade in the marketplace, and it's generally a very efficient means of financing for large companies. On the other hand, middle-market companies are generally not able to access that level of depth in the capital markets for a number of reasons. A, the transactions are generally kept private. B, they're not rated. C, they don't have the issue size to create liquidity in the marketplace.

And you can see that here. If you look at the middle column where we're talking about true mid-market companies, you have private debt and leverage lending that comes in essentially three forms. Number one is first lien senior secure; the same character of loan as the broadly syndicated market. It comes with an illiquidity and size of company premium in comparison. So, the yields here are 6% to 8%, versus 4% to 6% in the broadly syndicated loan market as a illustrative comparison. And generally where it sits within the value of a company's business is at 50% of less of loaned enterprise value generally somewhere between three to five times debt to EBITDA or debt to cashflow.

This is what I would call the core or more conservative end of the direct lending market. It's where frankly the most of the direct lending volume is. And it's the part of the market that's grown the most over the last 10 years. Then you have what we'd call core-plus from a return and risk perspective. These are so-called Unitranche funds or Unitranche issues, second lien, where you're taking a subordinate or deeper secured loan position. As a result of that incremental risk, you're getting paid incremental return, and you can see here, yield targets of 8% to 10% for Unitranche, 9% to 11% for second lien.

These are generally still secured loans, and they generally are still floating rate issues. And so you have the natural inflation hedge of floating rate coupon. And then finally on the more opportunistic into the market going left along the spectrum here, you have lower, middle market and SME issues. There are managers and companies that play in this space, and this is a space that has the same characteristics of direct lending, except applied to smaller companies and riskier credits.

And so you can see the yield premium as a result of moving down the risk spectrum, so to speak. And potentially going into other forms of junior financing such as Mezzanine, where the return expectations are almost private equity alike; low to mid-teens, but again, going deeper into the balance sheet from a risk profile for smaller issuers. This is all illiquid credit. It's privately negotiated. It's unrated. It's originated and executed and held by small groups of investors that typically would either hold the entire issue or will do this on a bilateral club basis without the benefits of syndication.

So if you think about this asset class, we often get the question, well, it's grown dramatically over the last 10 years, is it sustainable, and what is the opportunity set going forward? And I think if you follow this progression, I'd like to sum that up for this audience. Number one, and this is just focused on the US, but you could apply this to the European economy as well now. The US middle market by GDP is the third largest economy in the world; $10 trillion of GDP annually. And these middle market companies generally because of evolving bank regulation and generally because of size, they don't have access to the same depth of capital market solutions as larger companies.

So there is a plentiful issue we're set to begin with. Number two, as we've talked about, post GFC, post Dodd-Frank, and really just based on competitive market evolution, banks are in the business of warehousing risk and moving risk. Investors like us, non-bank investors, institutional investors are in the business of owning assets and creating returns over a long period of time for fundamental risk. And you can see that in this chart in the middle, bank participation in leveraged loans is a sort of a common refrain where 20 years ago, 50% plus the market, today, less than 20% of the market.

And of course, that share's been taken by non-bank lenders that have a longer term, more asset driven approach to underwriting this risk. So, not only do you have the middle market company opportunity set being deep, you have the relative market share for direct lending and non-bank investors increasing over time. And then finally what further enhances the opportunity set is the prevalence of the private equity industry. And outside of certain markets cycles like the availability of SPACs, et cetera, the IPO market over time generally creating a higher sized barrier to list.

And what that does is it keeps more middle market companies private. When private equity companies acquire middle market businesses, they generally look to secure financial leverage for those acquisitions. And in general, rule of thumb would be every dollar of equity that's invested attracts a dollar of debt invested to support the acquisition. And so you can see with the confluence of these trends how although quite a bit of capital has come into the direct lending market, it's enjoyed success as an asset class. We think and the industry generally thinks the trends are sustainable and the market depth is continuing to be very deep.

On the demand side, the investor capital equation supports this progression. You can see on the left hand side here, we have an illustration of direct lending AUM between North America and Europe. Important to note, both markets are growing at virtually the same rate and virtually for the same reasons. Bank retrenchment from the market and asset management firms like ourselves being able to provide more competitive solutions to these borrowers; more flexible solutions than the bank market can provide. Dry powder is more of a leading indicator, of course, of where this market is headed.

And I think what you'll find here is generally speaking the growth rates of dry powder have accelerated the last couple of years, again, both in North America and Europe. And this is reported dry powder and commingled funds. I think it's important to know there's a much larger market and capacity available in the institutional world, which sits in captive insurance companies, captive sovereign wealth funds, other non-reported forms of committed capital that would increase the available dry powder for this industry. So again, think about the supply side, you think about the demand side, there's equilibrium being found and there's continued demand for this type of capital.

And I'll stop sharing the screen there. Hopefully that was a helpful introduction to the asset class and the evolution over the last 10 to 20 years. And Allison, I'll turn it back to you to go through your initial questions.

Allison Lam:

Yep. Great, Matt, thanks for giving us that run through. I think that really helps us set the stage, frame the market a little bit before we start our discussion. Clearly it's an area that's front and center what you mentioned about the amount of committed capital, not just what we saw on screen, but on insurance companies and other institutional accounts. But yeah, raising a lot of institutional capital. So we do have a couple of questions that we'd like to dive deeper into. And I think we do have questions more at the end.

So why don't we start with a higher level one, from a macro lens. So, against a backdrop of what we're seeing monetary and fiscal stimulus coupled with inflationary pressures, we've seen a market rallying credit, historic highs in high yield spread. To what extent has that impacted the direct lending market? And do you think that illiquidity premiums going forward will be sustainable?

Matthew Harvey:

Yep. It's a good question. I think as you look at how markets cycle, there's a couple of takeaways from my perspective. Number one, the direct lending and private side market in general, it directionally tracks what's happening in the capital markets, whether that's private equity or private debt. However, there is a lag effect and it tends to be more sticky. So, one of the benefits for investors in this asset class is it's not as volatile as investing in syndicated loans, in part because these loans, again, don't trade. They're invested in smaller companies, the loans themselves have terms and other abilities to arrest and manage credit risk, and therefore the volatility of the loan's value is much tighter and much less than you find in the capital markets.

The idea of spread compression in over a long period of time, I think you have to look at that through cycles. Over many years, I would estimate the direct lending market as an asset class, and again, focused on the core part of the asset class; senior secured lending. Picks up about 200 to 300 basis points over comparably rated broadly syndicated loans. And comparably rated as an indication would be a single B credit quality issuer. If you look at what folks like S&P would publish, and you look at the LSTA index, for example, over that same period of time, total return in the index the last 20 years, let's say, has been 5%.

You can extrapolate that to direct lending as an asset class, achieving a 7% to 8% total return over that period of time. As markets move, what we saw during COVID is a good example of that. Pre COVID, the relative illiquidity pickup on average might've been 100 to 150 basis points to broadly syndicated loans. That gapped out during COVID. The reality is, supply on the issue side was more limited. And so the transaction activity was much lower at that gapped out premium. Post COVID, as the capital markets have recovered, so has direct lending spread premiums.

They've come back to be a little more competitive. And I would say in general, on average, in that 150 to 200 basis points range still today. And so I think over time what you'll see is directional movement similar to how broadly syndicated loans get priced, but hopefully what you'll also see, especially for the more disciplined managers, is the other key benefit of direct lending is retaining terms; maintenance, covenants, underwriting standards that are generally more conservative than what's available in the capital markets. And therefore the risk adjusted yield available to investors, as we think about it, we think offers superior value over a long period of time regardless of the relative spread compression or expansion at any given period.

Allison Lam:

Got it. That's really helpful. So I just want to stay on that topic with respect to performance and during COVID. So, direct lending as an asset class, there's a lot of discussion about how direct lending performs through cycles. And now that we're 16 months into COVID now, how did the market react with respect to defaults or deployment, or as we think about inter-creditor arrangements or relationship? And from your view, who were some of the winners and losers in private credit?

Matthew Harvey:

Yep. Well, you're bringing me back to delicate and fragile periods in March and April of last year. And any credit investor, any investor period, obviously we all went through a period of re-evaluation of risk and speculation as to how our portfolios would perform and behave after the COVID shock. I think in hindsight now 16 months after the fact or thereabouts, the direct lending asset class has performed predictably in a positive way. The idea of the asset class is that you're picking up an illiquidity premium relative build larger capital markets issuers, but you're retaining a risk profile that's top of the company's balance sheet, and therefore the least risky issue within a company. On average, you're lending at a reasonable cashflow multiple in normal times, three to four times debt to EBITDA.

But again, you're protected by built-in equity cushion and the underlying issuer, that leaves 50%. And so what we saw during COVID, and of course there are exceptions to the role based on the industry that we're talking about; aviation, retail, restaurants, et cetera, of course, had significantly more stress and challenge than business services, technology, healthcare companies, for example. But the asset class generally produced default rates that were better than what was seen during the financial crisis generally because of the liquidity available in the marketplace as the Fed intervened and the markets reopened later in the year, as well as the equity support that was provided by both financial sponsors and family owners of companies.

It avoided any significant loss and significant default circumstances that would imply more long-term credits for us. And so as we sit here today and we look back, portfolios have performed quite well... the relative value of the asset class, I think, has held intact through that cycle, that the capital markets and spreads, as we talked about in the prior question, recovered much quicker than the direct lending spreads did, and that was to the benefit of direct lending investors.

And as we sit here today, default rates just like seen in the syndicated loan market, have recovered to historical medians. And for the most part, healthy companies have access to capital and have performed through the cycle. The cautionary note on all of that would be as for the rest of the capital markets, there was significant intervention. Monetary and fiscal stimulus of course supported that narrative, but even so, I think the idea of investing in established middle market companies at lower entry leverage, having motivated owners to protect those investments and therefore support the debt and having the maintenance covenants and terms as a credit investor to ensure all of that capital stays in the issuer and supports the loan.

And therefore we prevent the companies from doing riskier things than otherwise what we think is appropriate. I think that's a result that is vindicating of the asset class. It's something that we expect to continue to protect it during future cycles.

Allison Lam:

Yeah. And as we're talking about risk, are there any types of stories or deals that you were surprised to see get done in the market?

Matthew Harvey:

Yeah, I think generally, and I'll avoid talking about of course specific names or specific circumstances, but I think generally what's been interesting to observe this year is it's how quickly the rotation to value, so to speak, or the willingness to underwrite post COVID normalized businesses, earnings, cashflows has been even in the more cyclical sectors. And like any economic model where you have supply and demand, the yield opportunities to advance recovering industries has been attractive, so many investors have supported that.

So we've seen restaurant deals get done again at maybe not pre COVID levels, but not too far off from pre COVID levels. And those are situations that require a normalized and pro forma of view of the world, right? You're not underwriting LTM earnings, you're underwriting forward earnings, which is quite rare for lenders. And so we've seen some of these sectors that are bouncing back, aviation and travel, of course is another one. The LTM and 2020 results are not really indicative or proxy for where those companies will be, the companies that have survived this and have improved their models throughout this will be in the future, and that's attracting capital.

I think, and maybe we'll get into it in additional questions on this panel. I think what has surprised me a little bit is how quick capital markets recovered. And again, that's really driven by, I think monetary easing. That market and the pricing of that market snapped back and got tighter much quicker. The private side has been important for the recovery and evolution out of COVID last year.

Allison Lam:

So it sounds like there's a bit of market retracement with respect to terms in pricing with where we are now.

Matthew Harvey:

That's right.

Allison Lam:

Well, so let's move to a separate topic. In talking about lending protections in this market, I'd say for most of 2020, what we saw really was credit standards and covenant protections deteriorate in the liquid leverage loan markets. Have you seen that also bleed into the direct lending market and what shifts have you seen in lending terms?

Matthew Harvey:

Yes and no. I think if you look at the syndicated loan market as many are familiar with over a long period of time, what was once a maintenance covenanted market. So lenders had a financial covenant ratio that risk in the underlying issue were increased and the performance deteriorated brought the lenders to the table to demand concessions, demand additional collateral, demand additional interest rate to compensate for the risk, demand other things that help support the credit story. Pre financial crisis, 85% to 90% of the syndicated loan market came with governance. Today it's less than 15% and COVID frankly did very little to dissuade that long-term trend. That's just simply a feature, so-called covenant light bills is a feature of the broadly syndicated loan market these days. That seems unlikely to reverse anytime soon. In contrast, the direct lending market has been much, much more disciplined about retaining terms.

And I do not see any wholesale or radical deviation from that historical standard in concept. Maintenance financial covenants are still demanded for direct lending private side deals. And the reason is we don't have liquidity to trade out of problems. They're illiquid by nature, they're buy and hold investments and you have to have the ability to actively manage the risk of your portfolio within reasonable tolerances. What I will say is that there was hope among credit investors that the long trend of issuer side expansion and friendliness of terms and therefore at the detriment of lenders would stop and reverse post COVID. I think that that trend was more of a stabilization than a reversal.

And so what I mean by that is more broadly marketed direct lending deals, there has been I would say a little bit of a loosening of credit terms within some of the definitional nuances of that and covenant cushions is a great example. But again, overall, the packages are still attractive and I think individual managers that have their own ability to originate and ability to influence the outcomes of those deals can still find very attractive terms in particular, in comparison to the syndicated loan market.

Allison Lam:

Okay. Well, maybe you can speak a bit to maybe the type of typical protections that we can expect in the asset class and the deals that we're looking to underwrite.

Matthew Harvey:

Yep. I think on average, if you look at the asset class you have oftentimes two, and if not two, one maintenance financial covenant, a net leverage or gross leverage test is probably the key covenant. If you have a second covenant, oftentimes you'll target a fixed charge cover or debt service cover test, which is a better short term assessment of the ability for the company's cash flows to cover its current obligations. Those are two very important maintenance financial covenants. A lot of the value beyond that though is in the other negative covenants of the credit agreement. These are things like the ability for a company to make dividends to the equity, the ability for the company to issue more debt, including priming debt or priority debt, which is obviously an element of risk for an existing debt investor and the business's balance sheet.

The ability for the company to make acquisitions, joint ventures, investments, bring in or move assets from guarantor subsidiaries to non-guarantor subsidiaries. There are many things that you see in these credit agreements where it's important to focus on the sanctity of the issue where we're underwriting at closing and ensure the assets and the cash flow and the earnings ability of that issue where it stays within our lending package. And again, I think in general, the direct lending market does a very good job of having discipline over terms, perhaps more so than capital markets and broadly syndicated loan market. And I don't see those headline terms really changing.

I think if those headline terms start to change materially, then what will happen, the supply demand will take over. There'll be less demand for these loans, and naturally, the equilibrium will be found again, because again, you simply have to have these covenant protections to protect the portfolio. You can't trade out of problems with middle market issuers, you have to work out those problems directly with the company and the owners of those companies.

Allison Lam:

And how might that change with respect to a more syndicated or going direct deal?

Matthew Harvey:

Well, I think generally what's happened in the last few years is more capitalists come into the direct lending asset class. There's been an elevation of the issue and issuer size that can stay private, and really in concept very similar to what's happened in private equity. Previously, companies north of $50 million of EBITDA had to go to the broadly syndicated or high yield markets to secure leveraged finance. They had to hire a bank and they had to run a syndication. They had to get a credit agency to rate their issue, and they had to go through that process. Now, I would say the average ceiling of issuer size in the direct lending market is closer to $100 million of EBITDA. And so you see significant transaction activity up to that size range, and you even see some deals getting done with issuers well above that. There's been several bellwether direct lending transactions done on a club basis among a handful of large lenders, anywhere from a billion up to $2 billion of financing size.

And so the market has expanded considerably. What you see in the upper end of the direct lending market and what you see in the lower end of the syndicated market and the capital markets starts to show convergence naturally. Because the owners of those companies then have options, they can decide that they want to do a syndicated deal and perhaps achieve a lower interest rate and better terms, but take more market risk. Their loans are trading funds and primary and secondary buyers can freely trade the credit. And that could create adverse consequences in a down cycle. They could time the market's indication poorly like March and April of last year, if you're issuing in the syndicated loan market, that market window shut down in a hurry, and, or flexed out significantly in the cost of doing that deal. On the other hand, the private side, private lenders for larger deals will have to compete with a syndicated option, but you don't require ratings agency.

You get more execution certainty of that deal completing, because you don't have to test a broader market of many, many lenders. You're doing a bilateral deal to a handful of influential lenders. And therefore as a lender, you get a little bit of pricing premium, a little bit of terms premium, as an issuer you get more execution certainty, which is really important and especially if you're financing an M&A deal, a leverage buyout deal, something that has a milestone at a timeline, where execution certainty is paramount. So in summary, you see more convergence over time as the market's grown, but I think still very distinct differences between private side direct lending and capital markets, syndicated loans.

Allison Lam:

That's helpful. So let me hit on a question that we actually invariably always get asked in this market. So when considering sponsored versus non-sponsored strategy, what are some of the merits or risks of investing in different types of these ownership structures and, is one fundamentally positioned to outperform the other in the current environment, or do they perform differently in different parts of the cycle? What's your view on that?

Matthew Harvey:

Great question. And really one that you can dedicate days to explore in any number of examples and circumstances. To take it to a high level sponsored versus non-sponsored is simply the profile of ownership. Is it a financial investor, commonly a private equity fund, or is it a family owner or management team, even a publicly listed company that has more permanent ownership? And generally the agenda of the company, the strategy, the timeline it wants to achieve that strategy and the financial leverage to help achieve it is driven by of course, the ownership circumstances and what the expectations are with sponsored private equity funds having a more finite horizon needing to make a return over a three to five-year period.

And therefore financial leverage is very important to generating the return expectations over that period versus non-sponsored deals and non-sponsored owned companies that generally have a more permanent or longer term horizon, and there are other considerations than just the price in terms of the debt and helping to achieve those objectives.

And there are pros and cons to lending in both markets. On the one hand, sponsored deals you have sophisticated owners with deep pockets of capital. In a committed way they're financial investors, and they're motivated to buy attractive companies, diligence those companies, improve those companies and generate higher returns for the equity. And of course the equity is behind the debt in the capital stack. And so if all that goes to plan, that's a good outcome for lenders, it's a good outcome for private equity funds. And the vast majority of the direct lending market exists to finance leveraged buyouts, acquisitions, et cetera, many times involving sponsors that are transacting in that market, and we do as well, it's a very healthy part of the market. On the non-sponsored side though, you have a very big middle market. We talked about that earlier today.

The majority of the middle markets still, despite private equities growth, is not owned by private equity. And those companies equally are looking for access to financing that's non-bank, more flexibility, longer term, deeper hold sizes, the ability to do things that perhaps banks won't entertain. That's a market that we like to access as well. It's usually a market that comes with a little more patience than a longer-term horizon in terms of the ownership agenda. It's usually an issuer that as a result, entertains slightly lower financial leverage. And so you can offset in theory, the idea that you don't have a new deep pocketed committed capital financial investor with the theory that you have a stable long-term owner, that's perhaps not as focused on maximizing leverage. And from our perspective, what it does as a lender is it gives you selectivity.

You want to be able to originate from both markets because in the private side, origination is ultimately the most scarce advantage any lender has. Of course you have rigor of portfolio management, underwriting processes, selectivity processes, but we can't go out onto the market and buy loans off an exchange. We have to go find relationships with companies, financial sponsors and pick the best deals out of what we can originate and what's available. And so I think both markets are large, both markets are healthy, they cycle at different times. And as a lender, what you want to be able to do is to find the best value and construct a diverse portfolio from accessing both markets.

Allison Lam:

That's helpful. It sounds like diversification is important. How does the borrower's size, being either of those two markets, affect the way that you're thinking about calibrating?

Matthew Harvey:

Sure. Yeah. Great question. So, clearly there's a size premium for larger issuers. And we've talked about where that starts and stops from a private market standpoint to a public market issuer. Generally all things equal, a comparably sized company will be less risky if there's a new financial owner of the business with new equity capital behind it, all things equal. Having said that, larger companies that are sponsored and have financial owners oftentimes have the ability in contrast to issue at terms and pricing that's more akin to the syndicated loan markets, as we were talking about earlier, the convergence of those markets. And so as a lender, balancing middle market size and small company credit risk versus the terms of pricing and underwriting leverage that you're willing to tolerate is a tricky balance.

And you have to get that right. And where I'm going with that is you might be willing to take a little more smaller company risk if there are good private equity sponsors that are investing new capital and owning that business, improving that business, growing that business, than a non-sponsored deal where perhaps a small company comes with a little more of a risk profile. But equally, a middle market and more established company has a longer track record, has more stable ownership, like I said, is not seeking as much leverage to accomplish its goals in the short term. And therefore you can calibrate that risk profile in a portfolio, if that makes sense. And again, we're talking about businesses broadly speaking, anywhere from $10 to $20 million of EBITDA on the small end, up to $75 to $100 million of EBITDA on the high end, that's really the market that we're discussing.

SME risk is lower companies, smaller companies than that. And that's a different profile, but within that middle market size range, I think the smaller the company, the more likely you are to be comforted by private equity ownership, the larger the company, the more likely you are to be finding value perhaps in a non-sponsored deal, simply because of the establishment of the company offset by the fact that you might be able to attract better terms and better pricing from a lending perspective.

Allison Lam:

And I guess lastly, for investors who either have already made active, direct lending commitments, or maybe even assessing it for the first time, really the benefits of direct lending as an asset class is to potentially generate higher returns than their public counterparts, in this case broadly syndicated loans. But doing so with less risk, right? So what are some of the key fundamental drivers of that outperformance and maybe some potentially overlooked, but important consideration that investors should be aware of?

Matthew Harvey:

Well, I think first and foremost, you have to separate front-end underwriting and the primary benefits or advantages of buying illiquidity at its simplest form, versus backend portfolio management and how lenders avoid losses and generate returns as market cycle. On the front end standpoint, I think we established earlier on anywhere from a 200 to 300 basis points, gross spread premium or return premium over a long period of time to syndicated loans is something that we observe. S&P and others report on that premium and so that's information that you can find and you can contrast to the broadly syndicated loan market. That's the underwritten return. So how do credits perform, how do they cycle and how do you manage risk? The key then is comparing risk metrics. Default rates, post default recovery rates and net loss ratios are three very important metrics that you have to be focused on as an institutional investor in this asset class.

And I think in general, just as underwriting premiums are wider and therefore higher to the investor for illiquidity, the ability to generate outperformance in active portfolio management is greater among direct lenders as well because you have terms. And there is a wide spread of how much greater or how much value managers can add. One is having origination selectivity. So the broader, more diverse your origination is I think the more logically you can defend your selecting the best relative value of a much broader opportunity set than taking the best of a small opportunity set with predictable consequences, having the discipline to keep terms, but then what do you do about terms that you have? How do you enforce covenant defaults? How do you enforce payment defaults? There's a balance, you don't want to be irrational or overly aggressive and be reviewed as an irresponsible lender.

But on the other hand, you have to protect your investment capital and you have to arrest risk as it develops in the portfolio. And so you go through a spectrum of getting paid for risks, coupon bumps, fees, et cetera, as covenants are breached and restructured to potentially the worst case scenarios where you have payment defaults and you have necessary restructurings of portfolio companies, and then having capabilities as a manager with the experience of the captive workouts team, with the experience of a long track record, et cetera, to go through that and protect investor risk and be prepared to go through that ultimate outcome, is obviously very important.

So I would caution that investors, if they're considering the asset class or evaluating their portfolio, look deeper into the risk metrics of the underlying track record and manager, and also the capabilities they have to manage those risks metrics. Because while COVID has been a very good litmus test for the asset class and the asset class has performed well, as we all appreciate it has been from a capital market standpoint, a relatively short cycle. And I think that you have to continue to vigilantly monitor how deals are getting put in these portfolios, the terms that are there and the capabilities that managers have to manage risk and what in the future could be a more elongated cycle.