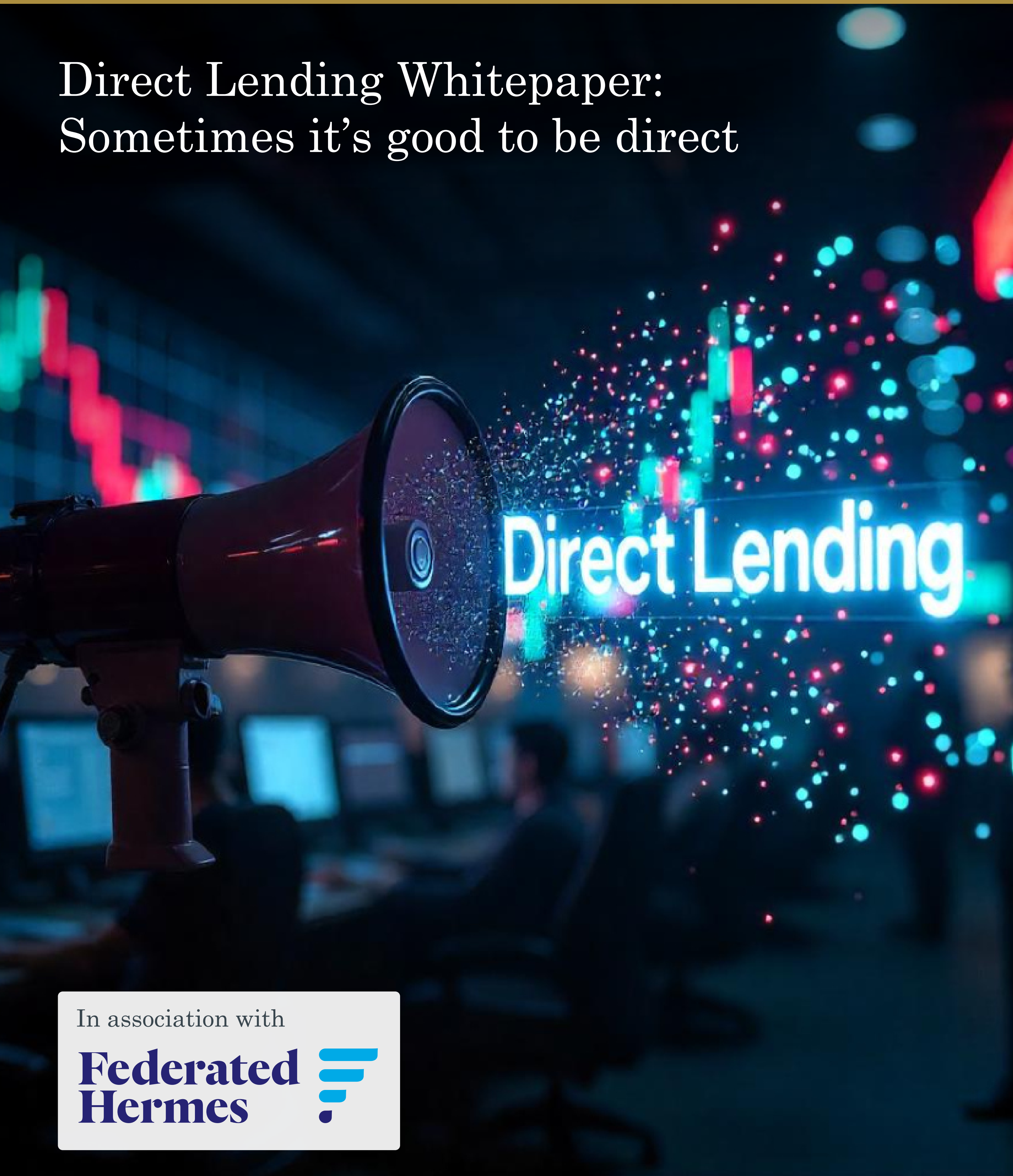
cio investment club

Whitepaper #15 June 2025

Direct Lending Whitepaper: Sometimes it's good to be direct



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Roundtable sponsor

Thank you to our sponsor for this edition of the Direct Lending Roundtable.

Federated Hermes

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Direct Lending Whitepaper: Sometimes it's good to be direct

Pension funds and insurers have been pouring money into private debt in recent years. Moody's predicts the global market will double between 2023 and 2028 from USD1.5trn to USD3trn. The cio investment club gathered chief decision-makers in London to find out more about their appetite and concerns.

April 2025's cio investment club roundtable began with a simple question: what is Direct Lending? Todd Isaac, chief investment and treasury officer of Hiscox, a USD8.5bn property and casualty insurer, answered that directly originated loans are highly bespoke agreements often with covenant protection. "They are not bought off a screen but deeply underwritten," he said. "It is about investing through the life of the loan and therefore understanding what the manager is likely to negotiate and invest in. You are going to have to live with these investments and partnerships." He compared the process to insurance underwriting.

Chris Palmer, senior advisor at AlphaReal and former head of illiquid assets origination at Phoenix, said that because most asset owners remain wary of Direct Lending, that leaves value for those who are prepared to do the extra analysis. While the majority of pension funds and insurers stick to public debt or Broadly Syndicated Loans, relying there on the big credit ratings agencies for guidance, Palmer said that asset managers in Direct Lending "can walk into the shadows" and find incremental value. He emphasised that investor due diligence is therefore on the manager, not the underlying credit: "Your asset manager will get you invested into places where 85% of capital refuses to go. What you as the asset owner gets is priced 50-100 bps wider."

Alastair Whitfield, head of investment & treasury management at IQUW, a speciality insurer and reinsurer, said: "You must be comfortable with a complete lack of liquidity in the underlying exposure in Direct Lending. That is giving you the additional premia."

Laura Vaughan, head of direct lending at Federated Hermes, said that its European strategy concentrates on senior secured lending, which meant secured on all assets of the borrower. Equity tended to be 60-70% of the worth of the company; leverage on loans tended to be 3.5x.

> *"In times of public market volatility, private investments are less reactive to broad-based pricing shocks"*

Who wants liquidity?

David Will, fixed income investment lead in the portfolio management and implementation team at Scottish Widows, said its current allocation to Direct Lending was in With-Profits funds for clients, but there is also a loans team within the shareholder assets team that does direct lending. Allocations to Direct Lending and other types of private credit will change, however, as Scottish Widows populates its Long-Term Asset Fund (LTAF) later this year. That will include a Private Credit sub-fund and use SMAs.

Dean Wetton, founder of Dean Wetton Advisory said that from an overall asset allocation perspective, Direct Lending seems to be the most attractive segment within Private Credit. He added that in UK DC pensions, you want some liquidity for safety. "We can sort of mark-to-market, so that creates relative equity between DC members," he told the cio investment club roundtable.

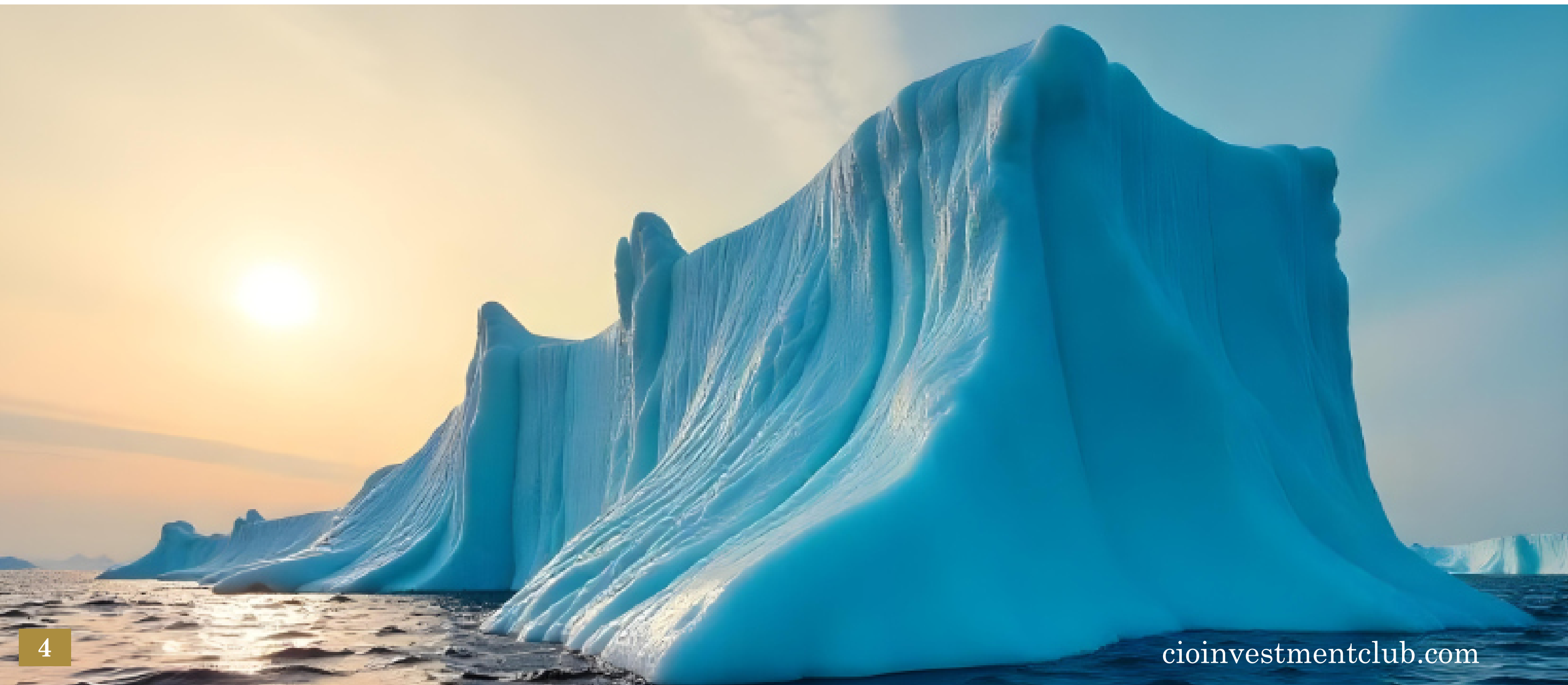
Isaac, on the other hand, saw advantages in lower mark to market volatility. "In times of public market volatility, private investments are less reactive to broad-based pricing shocks," he said. "As long as there isn't a lack of ability to service the debt or danger in the loans, not reacting to market swings has its advantages."

Isaac added that another change in the market is how these loans are being sold to asset owners. "It used to be exposure via hedge funds; now there is more choice via Separately Managed Accounts (SMAs). Evergreen and open/closed-ended fund structures are all on the rise. Direct Lending is also being marketed to High-Net-Worth individuals and Family Offices. As an insurer, I am not a fan of so-called fast money interest as I don't think fundamentals are necessarily aligned. Thus, how and why one invests in private assets are equally important. I like to see exits controlled via a liquidation share class or closed-ended structures to align investor to the underlying liquidity of the strategies. As insurers, we are long-term partners and owners."

Vaughan agreed. "I am rather cynical about evergreen vehicles," she said. "To facilitate the liquidity, you are not getting as much yield. So, do I balance that with a sleeve of riskier assets? Liquidity we all know is never there when you need it. Is a 5% gate in a Direct Lending fund enough when everyone is heading for the door?"

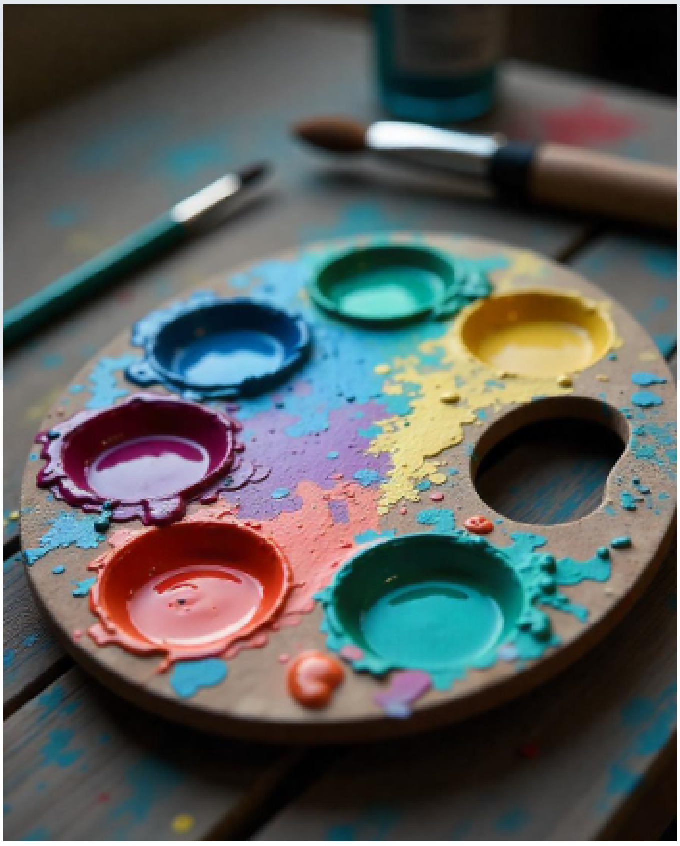
Vaughan recommended a more effective course of action: just obtain your need for liquidity in a separate pot.

> *In times of public market volatility, private investments are less reactive to broad-based pricing shocks*



Preferred sectors

The cio investment club roundtable then heard more about the Federated Hermes strategy from Vaughan. It lends to European businesses with EUR5-35m in EBITDA. Leverage is approximately 3-3.5x. Whitfield asked if there were areas of the market where Federated Hermes doesn't look.



Vaughan's answer was consumer discretionary and anything cyclical.

"We don't do cyclicals sectors such as consumer or energy. Most of the loans are backed by private equity sponsors," said Vaughan. "We prefer lending to tech businesses, for example, because you can get those sticky cashflow profiles."

The strategy was born over ten years ago by the desire of Hermes' then-owner, the BT Pension Scheme, to loan to smaller businesses in the UK. But in a sector dominated by bank lending, any successful alternative needed strong sourcing.

That was achieved by a legally binding and exclusive origination model with NatWest. Within the parameters of the agreement, NatWest is legally obliged to show all middle-market sourced opportunities in the UK to Vaughan's team before anyone else. "We then do our own analysis. If we like the transaction, then it's a joint term-sheet," explained Vaughan. "We are lender of record, putting in £25-40m. What's in it for the bank? They have had limits since 2009 on how much they can lend so with Federated Hermes on board, our combined hold levels mean we are more competitive to win deals and negotiate better loan terms. But the bank owns the relationship and maintains the ancillary income such as bank accounts and hedging services."

Federated Hermes has replicated the arrangement with three other banks: DZ Bank in Germany, Danske Bank in the Nordics and KBC in the Benelux. It sees 200-300 loans from the quartet a year; and proceeds with about 5%.

"Our originating model is unique: 30-35 positions, including a large amount of off-market loans via the banks' existing loan books which won't be seen outside the portfolio," said Vaughan.

Palmer approved of the approach of the more successful asset managers to take a joint venture with commercial banks rather than competing against them. "If a bank wants to manage away a dodgy client, then they actively work to move them away to a mid-sized European fund manager. That manager thinks it has outwitted the bank, but it hasn't. The bank has the relationships; it knows its clients. Incomers cannot hope to outcompete these local strengths."

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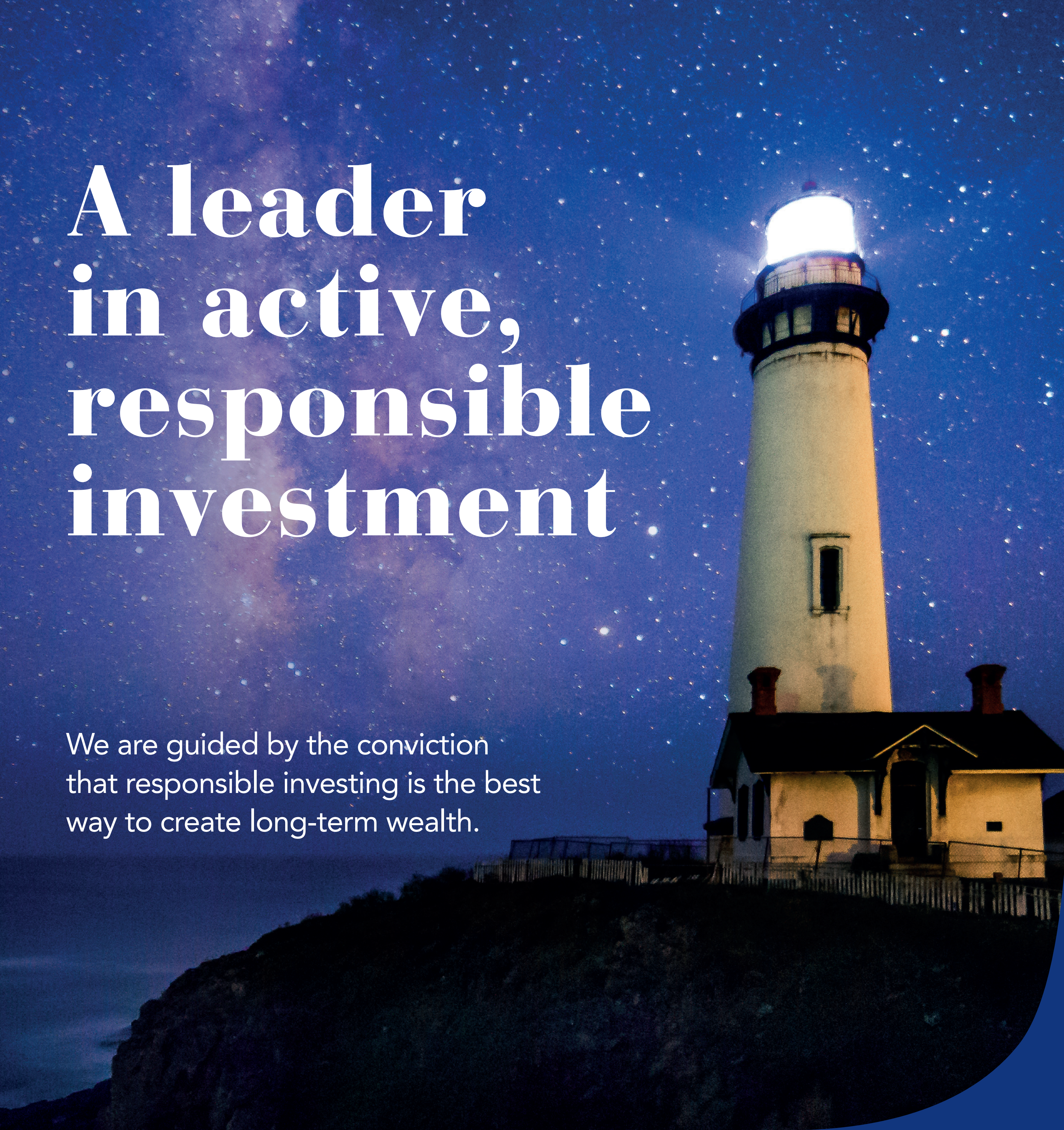
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We are guided by the conviction that responsible investing is the best way to create long-term wealth.

Raise the red flag

On coping in tougher times, Issac remarked: "Every Private Credit manager will say that they had just 3 bps of losses in the last ten years. Some will say: 'We don't have a work-out team but we know all the lawyers.' That is a red flag for Hiscox."

"It's a red flag for Scottish Widows too," said Will. "If a manager has not been through a crisis and has their own workout team, we worry about how they will cope when the next one arrives."

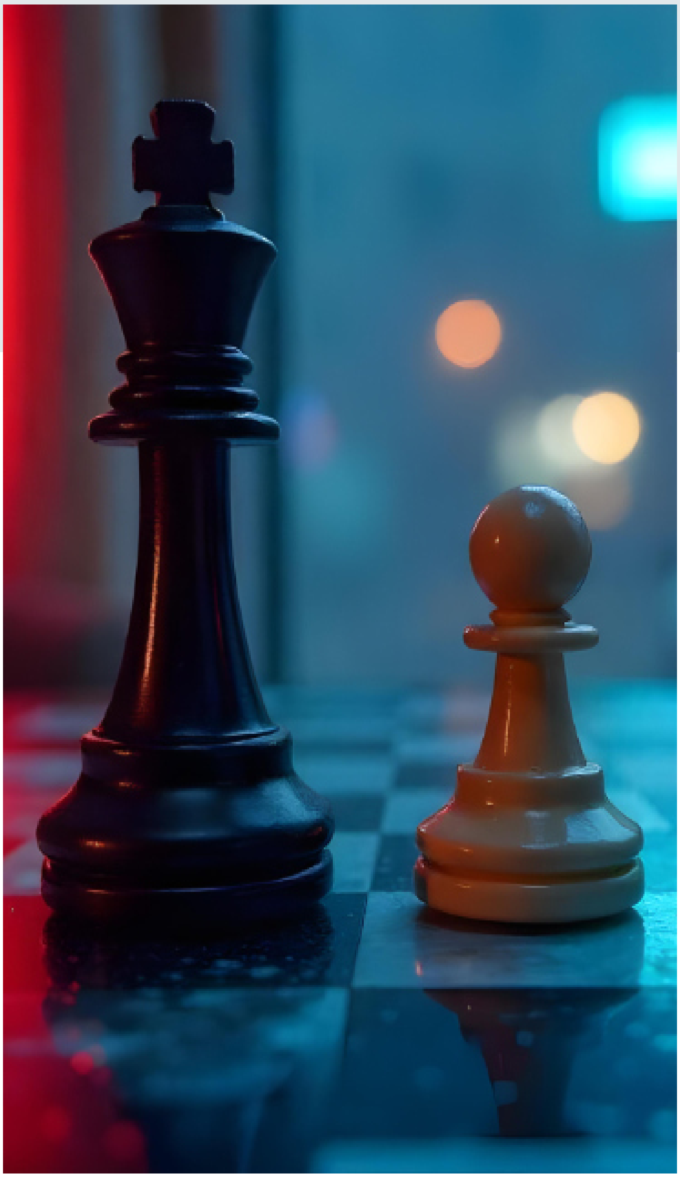
Federated Hermes has never suffered a loss in this European strategy but Vaughan described one loan that wobbled. That was to a fundamentally strong business whose orders had been impacted by the Russian invasion of Ukraine. Initially, there was a bump in orders as clients bought extra. But then orders fell away. "Everyone was round the table: management, sponsor and lenders," recalls Vaughan. "The business was sound. The sponsor put in some more capital."

> *Everyone was round the table: management, sponsor and lenders*

Regarding defaults, Vaughan said her team was not naïve enough to think it won't happen at some stage but is confident that the team has the required loan restructuring and work-out experience and skillsets available inhouse. Notably, before joining Federated Hermes, Vaughan's colleague, Patrick Marshall (head of private credit) led the restructuring team in Europe and Asia for Lehman Brothers prior to its bankruptcy and subsequently oversaw the work-out of the Lehman Brothers European corporate and real estate loan portfolios.

Big is not always better

Palmer reckoned that Broadly-Syndicated Loans have among the lowest standards of underwriting. He warned that people conflate the size of deals with greater security.



Wetton said the difficulty when assessing managers' competence is that the last 15 years have been so benign. Vaughan responded that benign conditions do not mean the manager is merely investing as if nothing can happen: "We model scenarios of interest rates at 12%. We ask ourselves what can go wrong."

Wetton asked about conflict of interests. "Are you completely aligned with the sponsor? Will they give you access to the next deal?"

Whitfield asked Vaughan: "You prescribe the level of the loan you require. Does the bank always accept?" Vaughan replied that the four banking partners know Federated Hermes well enough by now to understand where its appetite sits. In contrast to a syndication, both the Bank and Federated Hermes structure the loan and put forward their combined appetite for that borrower and structure. She added that by deliberately capping its fund sizes, her team maintains its own discipline to remain a true lower mid-market lender.

On the wider picture in Europe, however, she remarked on a couple of trends. The first was that banks are retrenching from their non-domestic markets. The second was that national governments are encouraging the banks to loan to SMEs. The third is that direct lenders have raised a lot of capital and are under pressure to deploy into a market with a finite supply of quality assets.

"Banks [in the UK] are currently lending at 5% over base rates; unitranche lenders at 5.25% over," said Vaughan. "Further, it doesn't make sense to have super senior priced at 350bps at one turn of leverage."

> *Tariffs are a huge unknown. Borrowers are susceptible to big macro moves.*

In Europe, the gap was wider. Vaughan suggested unitranche funds were lending at 550-600 bps; banks at 425-475 bps.

Vaughan warned that the knock-on of spreads compression is that you will see a re-sizing of the field of players in Private Markets as managers fail to deliver on their yield target, which will impact subsequent fund raises. "There is currently a race to the bottom in some segments of the direct lending market." But she warned that Private Equity sponsors don't want to borrow from someone without a track record to demonstrate how a fund will behave when things get tricky: "New entrants have it all against them."

Palmer completely agreed. "Tariffs are a huge unknown. Borrowers are susceptible to big macro moves." Meanwhile, he saw spreads narrowing in part because lenders were becoming too relaxed about terms such as leverage.

> *Without being the loan originator, we really try and take into consideration everything we can when evaluating managers and strategies*

"The total return discount is finished," said Palmer, before adding that euro and dollar-based investors could still take advantage of cross-currency effects to lend in sterling transactions.

Following Vaughan's points about competition in the market, Isaac added that private market Secondaries were "going through the roof" both in popularity and availability.

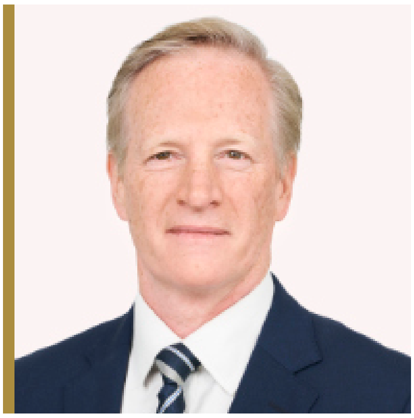
Palmer said that Secondaries tended to be attractive when there was a forced seller. "The owner wants to get out and you can get into a new underlying business. If I played devil's advocate, on the other hand, you are another step away from the manager and the business. Of course, if the offer is a 10% discount, then it's all about the pricing upside."

Isaac said being very selective in who one partners with is key, as aligning cultural and strategic goals with managers is even more important in illiquid or less liquid structures. I like to see what managers are investing in both in prior vintages and current structures to make sure we are truly aligned."

Isaac said that Secondaries can also help investors build a diversified portfolio, not just invest in a current year's vintage.

Isaac concluded that it all goes back to what you are comfortable with. "We don't invest in private loans directly, but we wanted a diversified portfolio, not just a single vintage with a single manager accessing one sector of the market. To achieve these goals, we review the use of leverage; investment and geographic concentration; diversification between funds and strategies to name a few things. "Without being the loan originator, we really try and take into consideration everything we can when evaluating managers and strategies," he said.

Participants



Todd Isaac

Chief Investment & Treasury Officer, Hiscox

Todd is an investment, treasury, and accounting professional with over 30 years' experience in the Insurance industry.

He has worked in a range of markets including North America, Europe, the UK, and Bermuda and is currently the CITO of Hiscox. His experience covers investing in public and private markets, financial systems debt capital markets and joined Hiscox from Monument Re, where he was Deputy Chief Investment Officer for Europe and oversaw portfolio construction, manager selection and Committee and Board contributions for the reinsurer's European subsidiaries.

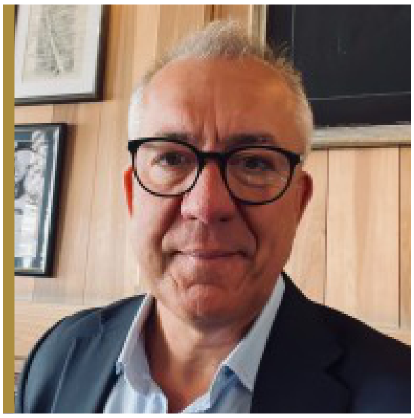
Prior to Monument Re, Todd spent time at Blackrock, where he focused on business development for the Bermuda and UK P&C sector; Hyperion, where he served as Global Treasurer; Endurance, where he was Treasurer and VP Investments, Zurich as VP of Investments and Ernst and Young.

David Will

Senior Manager, Portfolio Management, Scottish Widows

David is a Senior Manager in the Investment Office at Scottish Widows. His responsibilities include investment governance, fund manager oversight, search and selection as well as acting as the fixed income investment lead. Prior to joining Lloyds Banking Group, he worked as an investment consultant where he had responsibility for advising clients on asset allocation, manager selection, liability hedging, strategy implementation and investment governance.

David has over 30 years' industry experience and extensive knowledge of fund manager research across a variety of asset classes. One of his previous roles was that of Head of Manager Research at JLT, now part of Mercer. In addition to his role at Scottish Widows, David is a regular speaker at industry events.

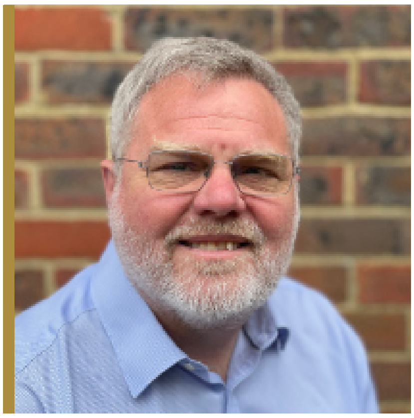


Chris Palmer

Investment Consultant and Senior Advisor

Chris is a senior advisor to Alpha Real Capital, the secure income asset manager and also a consultant to a number of UK infrastructure and social housing investors. He was previously Head of Illiquid Assets Origination at Phoenix Group plc, before that Head of Market Risk, and Credit at Swiss Reinsurance and a credit portfolio manager at Legal & General, Old Mutual Asset Managers and Allied Irish Banks.

Chris is a graduate of the University of Cambridge and a fellow of the London Institute of Banking & Finance. He is Chair of Sporting Wellness, a charity that supports young sportsmen and sportswomen across the UK.



Dean Wetton Advisory

Dean Wetton

Managing Director, Dean Wetton Advisory

Dean Wetton, BComm (Hons), MBA, CFA, Managing Director, founded Dean Wetton Advisory in 2009, recognising the need for a fresh approach to providing investment advice to clients: an approach that delivered straightforward, clear advice in a cost-effective way.

Dean has wide experience of advising clients on a range of investment issues, having previously been Head of the Manager Evaluation Function at P-Solve Asset Solutions and a senior member of Hewitt's Manager Research Team.

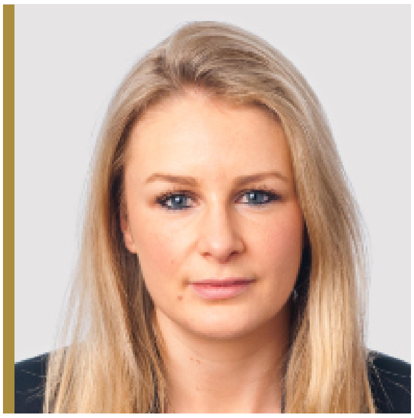
Alastair Whitfield

Head of Investment & Treasury Management, IQUW

Alastair Whitfield is the Head of Investment & Treasury Management at IQUW, a property and speciality insurer and reinsurer.

With a career spanning over 20 years, he started his career on the sell side as a bank credit analyst prior to and through the global financial crisis. Since then, he has held a broad variety of positions responsible for the investment management of P&C and captive insurers since 2011. He joined IQUW in 2023 to lead the build-out of the company's investment function.

IQUW GROUP



Laura Vaughan

Head of Direct Lending and Member of Private Debt Investment Committee, Federated Hermes Limited

Laura joined Federated Hermes in November 2015 when the private credit platform was being established. Laura is the portfolio manager of the third vintage of Federated Hermes' European Direct Lending franchise, as well as Junior Portfolio Manager of the second vintage. Laura is also responsible for managing the team of direct lending analysts. Laura sits on the Private Debt Investment Committee which considers investments across all direct lending strategies at Federated Hermes Limited.

Laura joined from GE Capital, where she was an associate in its mid-market leveraged finance execution team. At GE, Laura focused on arranging financings for European private equity-backed acquisitions funded through senior, second lien, mezzanine and unitranche facilities. Prior to this, Laura worked for three years at Bank of Tokyo-Mitsubishi in its acquisition finance team in London, focusing on opportunities in European large-cap leveraged finance transactions and on portfolio management. Her previous role was at Allied Irish Bank in Dublin in its Corporate Banking North America division, in which she analysed US large-cap and middle-market leveraged finance transactions, and performed portfolio management functions.

She has an Economics degree from University College Dublin and is a CFA charterholder.

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In attendance

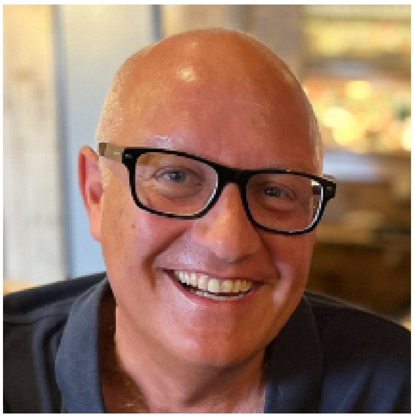
Jaeger Scott, Associate Director

Insurance Relationships, Federated Hermes Limited

Jaeger joined in January 2023 and is responsible for establishing new relationships with insurance clients across the UK and Ireland. She works in partnership with both life and general (re)insurers delivering outcome-orientated solutions through a deep understanding of the client's objectives, constraints and risk tolerances.

She joined from Aviva Investors where she was most recently a Client Solutions Manager (Insurance Relations), proactively targeting well-researched prospective clients and working across Client Servicing, Marketing, Solutions, and all CIOs to accelerate the growth of the Global Insurance business. She began her career as a graduate on the Aviva Insurance Global Leadership Program.

Jaeger has a bachelor's degree in Arabic and Mandarin.



Sean Thompson

Founder & Director, cio investment club

Sean has nearly 40 years of experience working in London's financial services sector and the insurance market. After 10 years as Managing Director of CAMRADATA, Sean launched the cio investment club on 1st January 2024.

The cio investment club's mission is to become the voice of chief investment officers and investment professionals at institutional firms. To help achieve this the club hosts events throughout the year that educate and inform, whilst providing thought-provoking content to its members.

Brendan Maton (Moderator)

Director, Crayford Ash

Brendan Maton has been covering pensions and investments as a journalist for almost thirty years. He began his career at FT Business before going independent in 2003. Since then, he has chaired roundtables, moderated investor conferences and hosted the IPE channel of sponsored webcasts. He still writes on pensions and investments for IPE as well as freelancing for a host of organisations.