Direct Loan Origination: A Superior Alternative in Lower Middle Market Credit*

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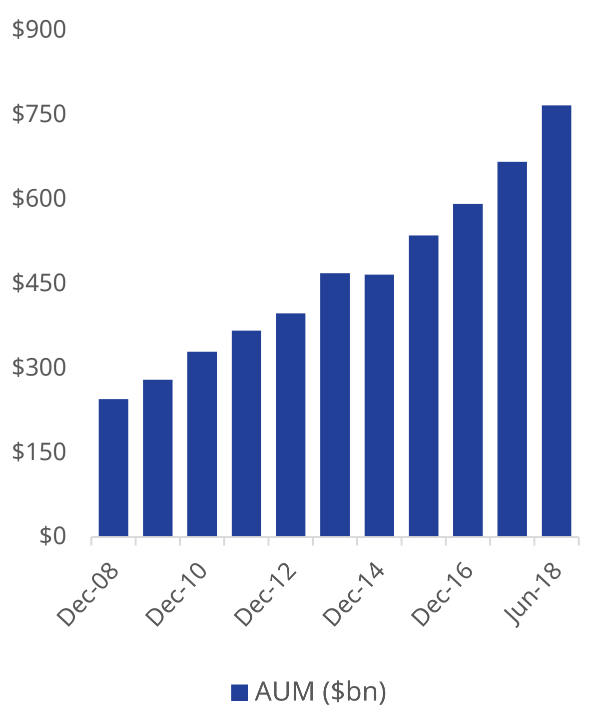
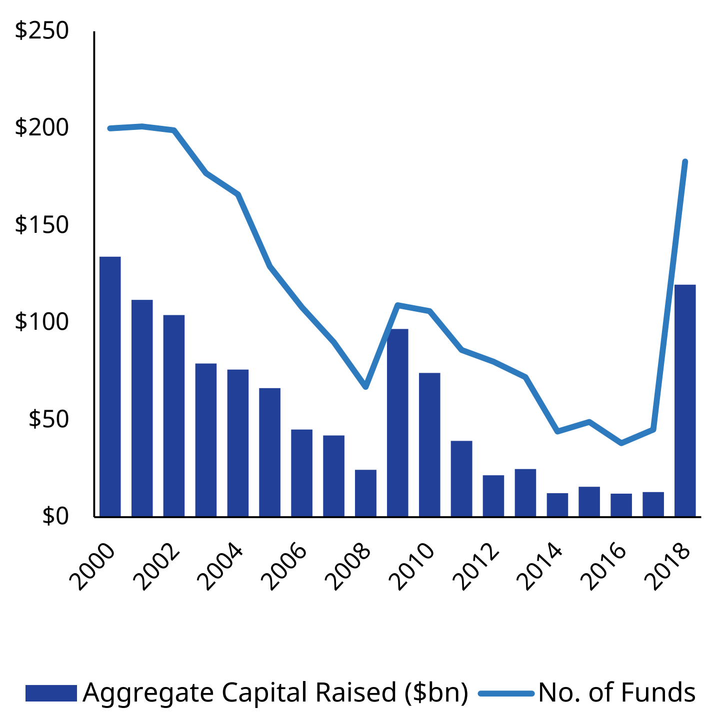
As interest rates fell in the years following the Global Financial Crisis, investors' appetite for risk increased and investors pivoted from seeking safe haven assets to pursuing assets with higher returns in an unabated quest for yield. Sovereign interest rates hit all-time lows and have, until recently, remained there. The corresponding drop in interest rates fundamentally transformed the credit investing landscape as investors sought opportunities in higher yielding assets. As investors pursued yield, asset flows into previously niche lending products soared along with more conventional syndicated products.

Private Debt AUM ($bn)



Source: Preqin

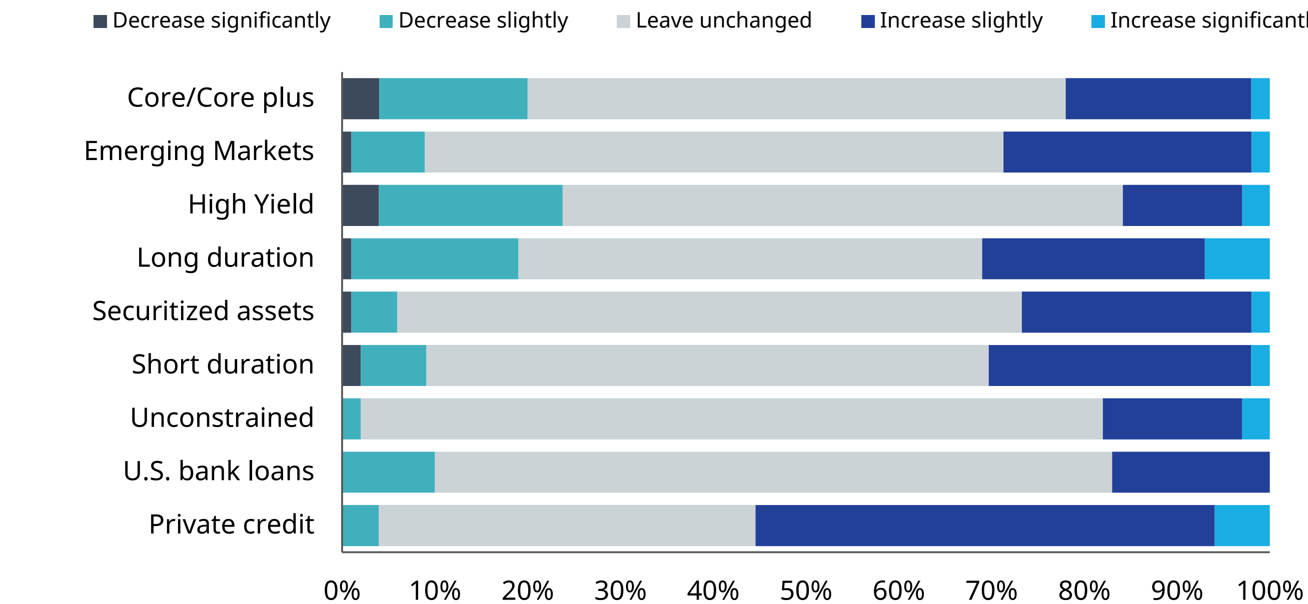
Private Debt Fundraising



Source: Preqin

** Please refer to page 9 for additional important information.*

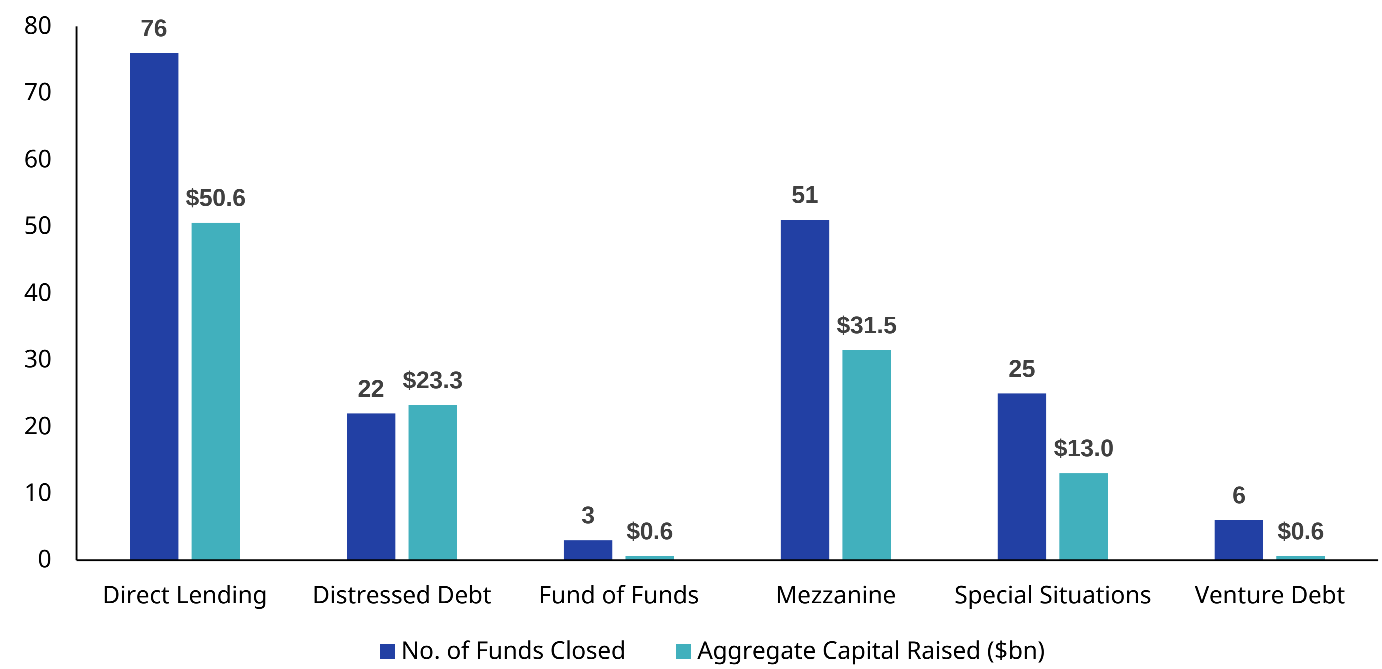
Institutional Clients Fixed-income Allocations (As of December 2018)



Source: Blackrock

New firms and vehicles launched at an unprecedented rate due to strong demand from investors with $50.6 billion of capital committed to direct lending strategies in 2018, according to a recent Preqin report.

2018 Private Debt Fundraising by Type and Capital Raised



Source: Preqin

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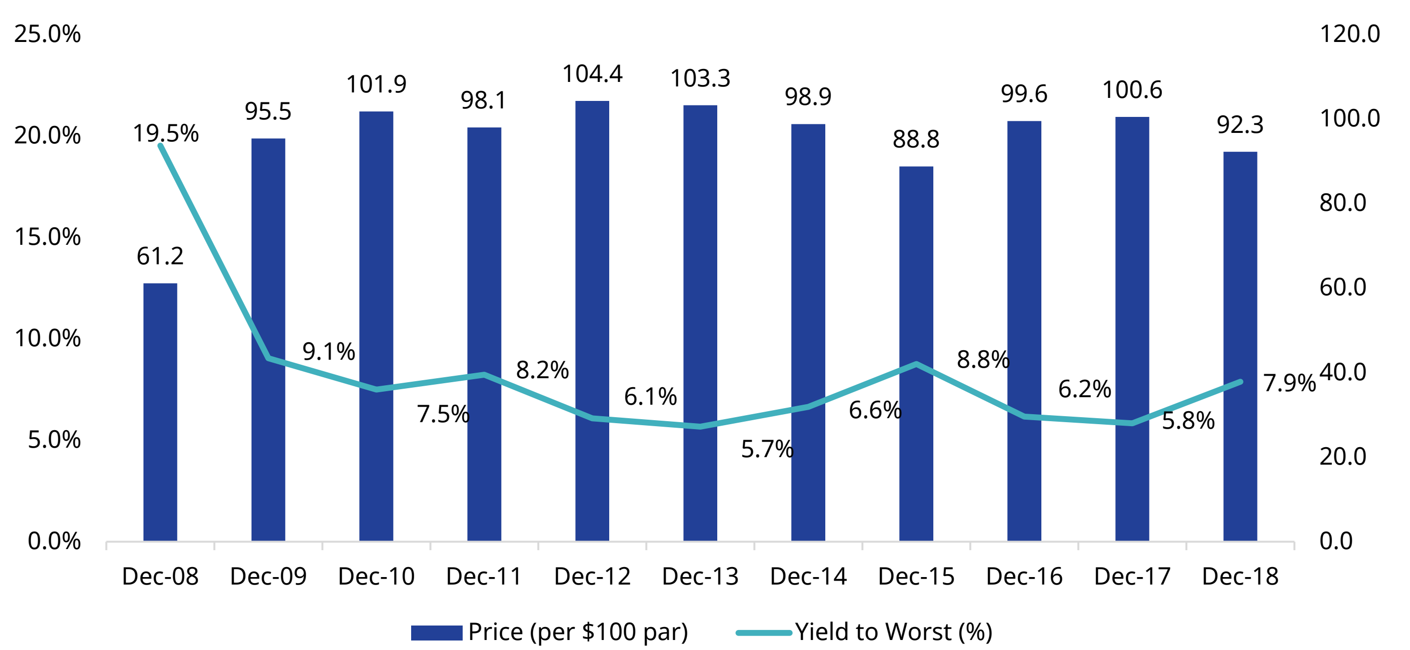
While non-bank lending grabbed headlines, there has also been a proliferation of active syndicated high yield and loan funds, as well as senior loan and high yield ETFs. The most common question we get from investors today is whether direct lending and high yield investments continue to produce attractive risk adjusted returns at this stage of the credit cycle. Given the length of the cycle and the amount of capital invested, selectivity is of the utmost importance. The best opportunities for risk-adjusted yield today likely exist in directly originated private credit opportunities in the lower middle market (*i.e.*, companies with less than $50 million of EBITDA) where lenders can be selective and secure the appropriate covenants and protections in relation to the risk. In addition, middle market loans tend to have floating rates, which helps to mitigate the risk of higher interest rates in the future.

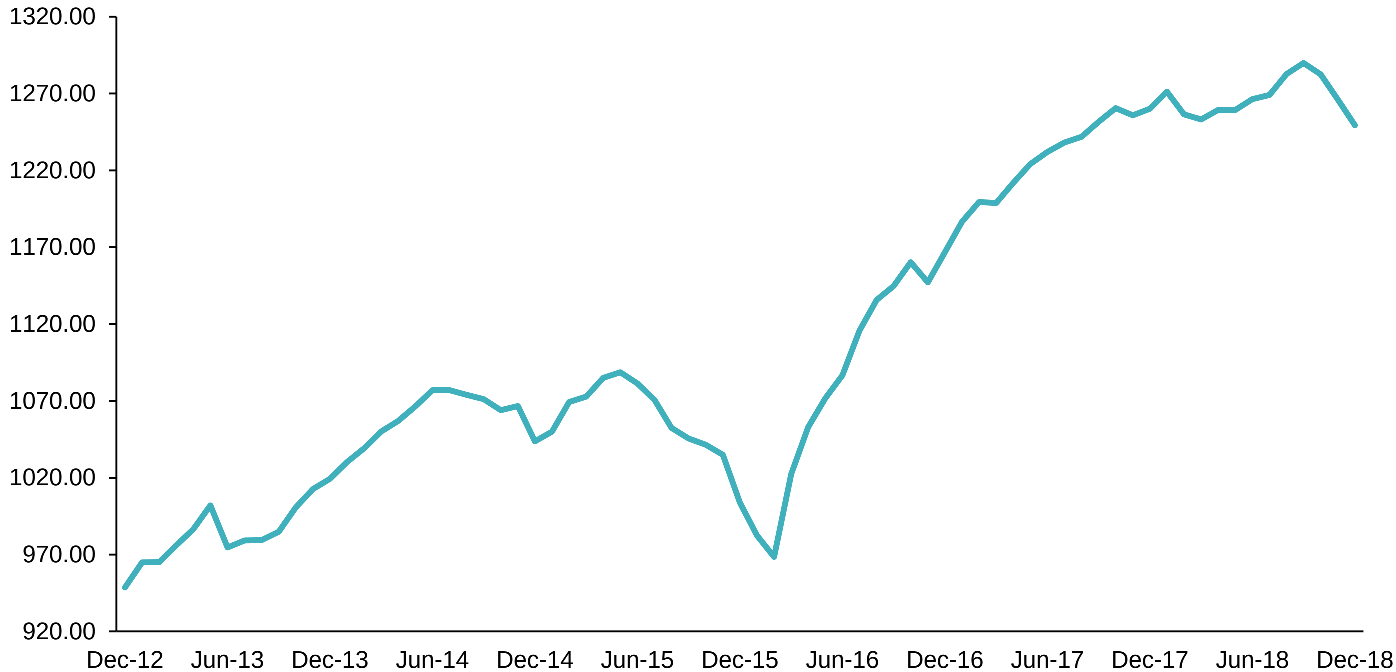
While pension funds and income investors lament the drop in absolute yields, lower risk free rates have led to over $1.6 trillion of both investment grade and non-investment grade debt issuances by U.S. institutions in 2017, according to SIFMA[1]. These debt offerings have found their way into institutional portfolios, such as CLOs, ETFs, and mutual funds. While many investors have witnessed the success of passive equity investing, the performance of credit-focused passive strategies and high yield ETFs has been relatively poor when compared to the BAML U.S. High Yield Master II Total Return Index[2], and has underperformed nearly 70% of managers on a long-term basis. Because ETFs generally allocate their investable assets to the largest borrowers by design, investors can have significant exposure to challenging sectors such as retail, cyclicals, and energy versus the selectivity they could achieve in a more actively managed portfolio. Although we believe there is a substantial liquidity benefit from investing in traded credit strategies, it comes with a major return tradeoff, with high yield benchmarks returning approximately 5% or lower in 2018 and well below 4.5% annualized over the last five years[3].

Bank of America Merrill Lynch U.S. High Yield Index Price & Yield To Worst



Source: Bank of America Merrill Lynch.

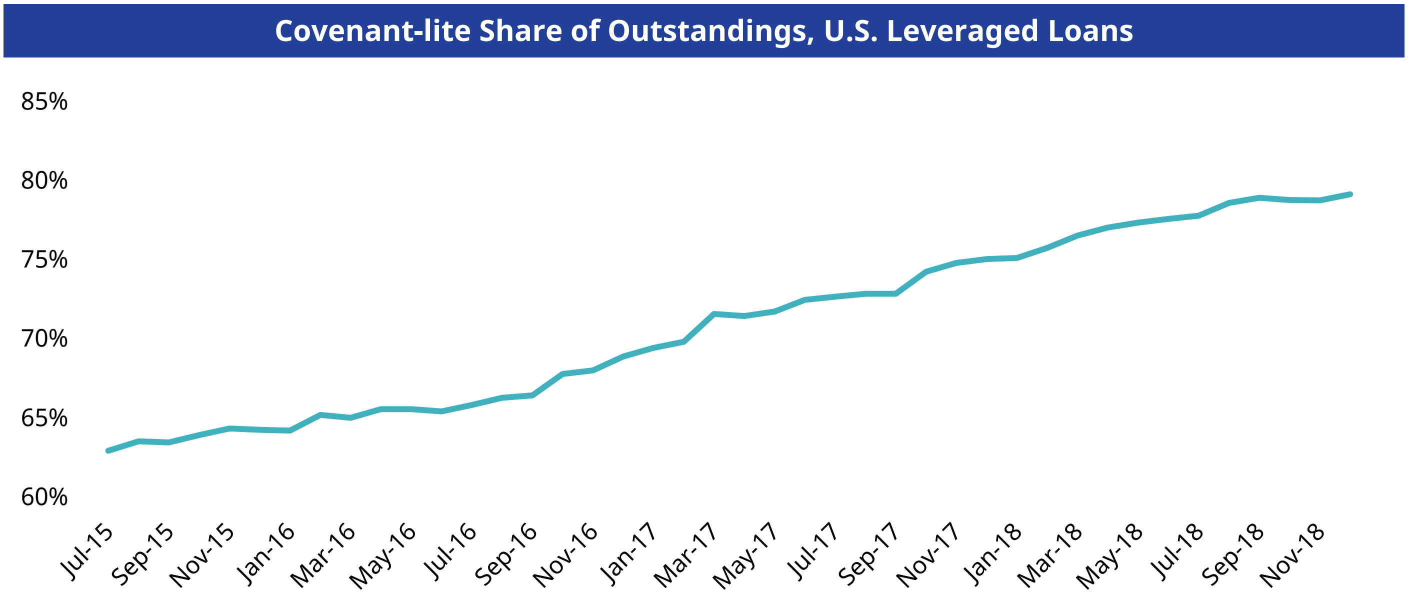
U.S. High Yield Total Return Index Levels



Source: Bank of America Merrill Lynch.

While offering more than double the risk free rate, fixed rate high yield bonds generally lack protection from inflation and duration, as well as other structural creditor protections, such as covenants, commonly found in professionally managed loan products. The proliferation of fixed rate securities is a notable risk in a market where the Federal Reserve has recently telegraphed its intention to consistently raise rates.

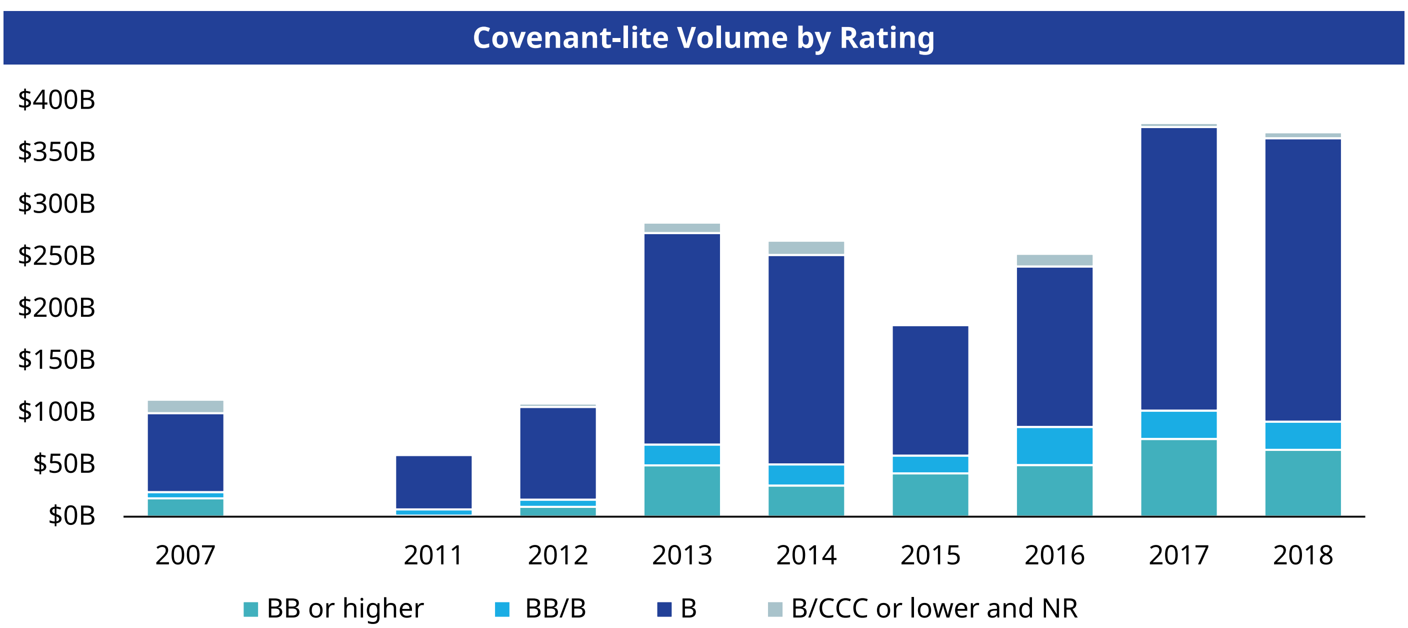
Concerns regarding an eventual rise in rates have served as a catalyst for the loan market for the past several years. During this time, investors have gravitated towards the asset class with the view that floating rate characteristics combined with strong covenants provide more protection in an ageing bull market. Additionally, investors are now seeking vehicles that are structured with relatively generous liquidity features. Memories of the recent credit crisis die hard, and nobody wants to be a casualty of the next liquidity crisis. Unfortunately, while the interest rate protections are real, the syndicated loans typically held in the most liquid vehicles often lack the covenants that are found in middle market loans. S&P noted that 79% of leveraged loans outstanding at the end of 2018 qualified as covenant-lite, meaning their protections are more akin to high yield bonds and lack the maintenance covenants that traditional loans have. The amount of covenant-lite loans outstanding during the last credit crisis was merely a fraction of today's covenant-lite issuances outstanding. Additionally, promises of liquidity in the broadly syndicated loan and high yield markets have historically not proven themselves when there is market disruption.



Source: LCD, an offering of S&P Global Market Intelligence

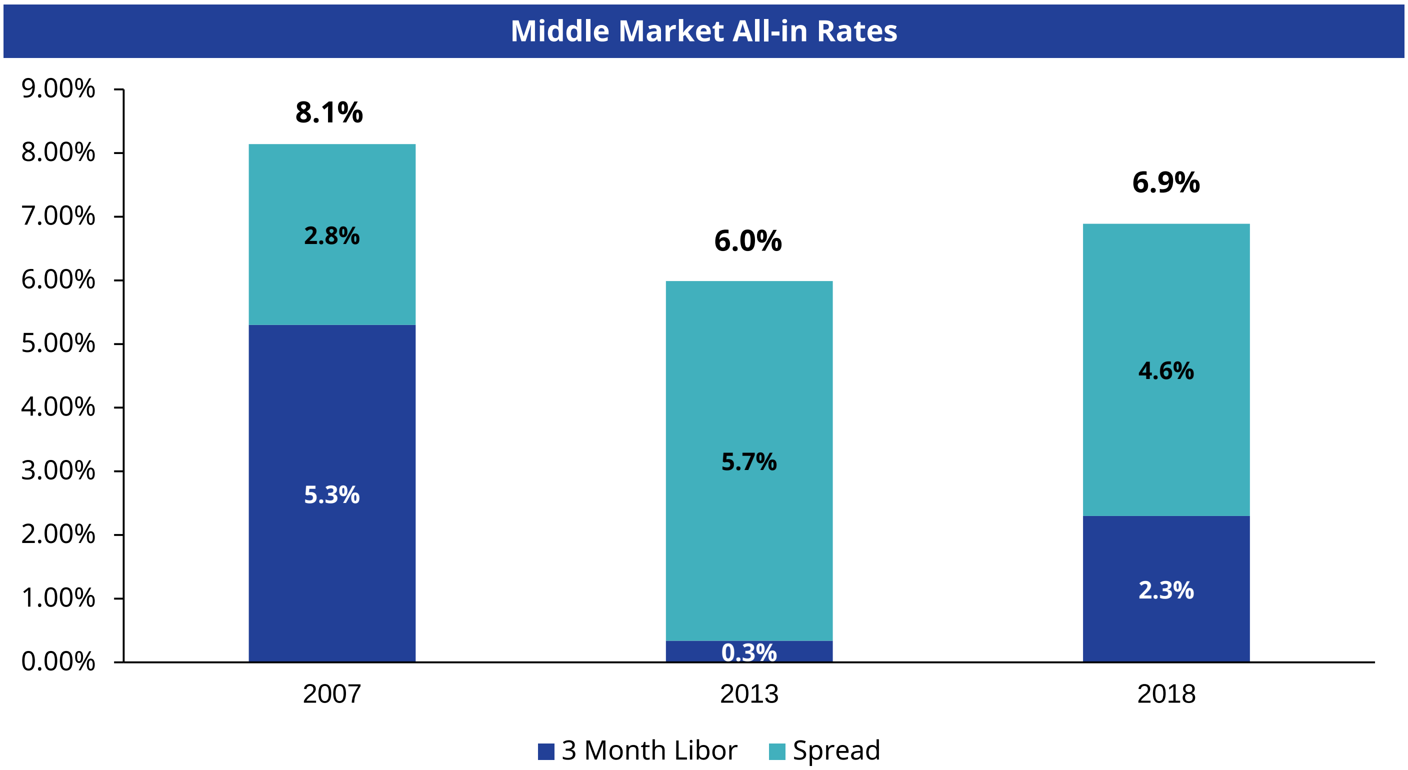
Presented with declining investor protections in the more broadly syndicated loan universe, investors seem to be increasingly concerned about the opportunities available in direct lending as well.

While the middle market asset class continues to present a favorable landscape for investors, the movement in the broadly syndicated markets has transformed the type of protections most lenders are able to negotiate. For example, according to S&P the volume of outstanding of single B covenant-lite loans has surged six-fold from 2011 to 2018.



Source: LCD, an offering of S&P Global Market Intelligence

Without reading too much into the data, it may be logical to conclude that lending standards have eased materially. Our own experience suggests that there is less ability to negotiate terms, including covenants, than a few years ago for companies with more than $50 million of EBITDA. However, companies with EBITDA below $50 million continue to offer attractive opportunities to invest in first lien senior secured floating rate loans with covenants and attractive yields averaging 6.9% as of 2018.



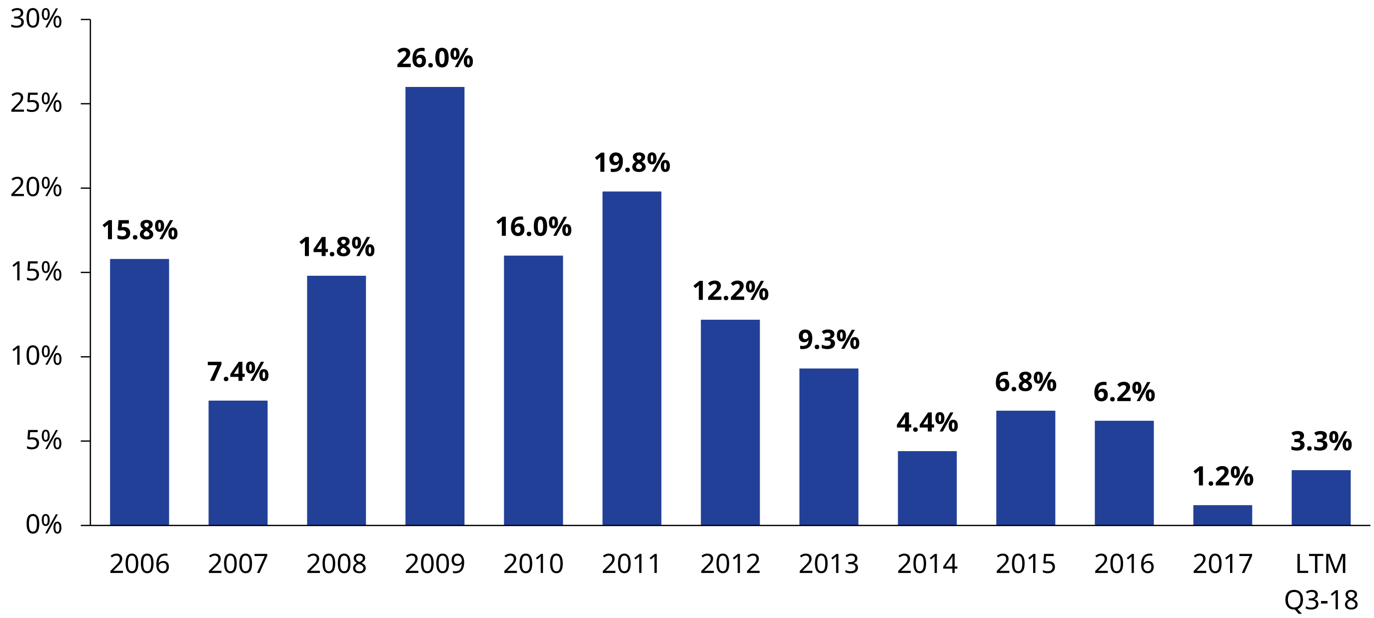
Source: S&P Capital IQ

Covenants play an especially important role in middle market lending as they provide an early warning sign of potential troubles down the road and, thus, bring stakeholders to the table sooner rather than later. The lower middle market typically affords lenders these protections and offers more attractive structures. For example, we generally feel more comfortable that we have greater downside protection through the cycle because companies in the middle market often have leverage levels of 10-20% below those of their large market peers. In addition, equity contributions for this segment are often 20% higher than those of the large, broadly syndicated market. Although middle market companies are smaller and may appear to have more risk on the surface, the combination of meaningfully less leverage and a higher proportion of equity supporting the transaction gives us comfort. This is true at any time, but is of particular importance at this stage of the economic cycle.

Originators need to have the expertise in structuring and documenting loans in-house to protect their rights if borrowers find themselves missing financial performance targets or struggling to meet agreed-upon terms.

Our research and experience has taught us that the lower middle market direct lending segment continues to present a compelling risk-reward to investors. Unlike other passive debt-focused strategies, one can take a deliberate approach to overweighting or underweighting specific sectors of the economy based on both macro and company-specific issues. While the flow of syndicated deals is based on what larger lenders and banks originate, middle market lenders are typically able to be more selective when assessing the appropriate level of portfolio risk by working with a more diverse group of sponsors that may not be as relevant to large banks. While lending has become more commoditized transaction for many larger companies, the relationship lending business has substantially migrated from banks to direct lenders, which is illustrated clearly by the drop in bank market share in the middle market space over the past eight years.

US Bank Share of Middle Market Leveraged Loan Issuance[1]



1. Middle market loans defined as loans to borrowers with EBITDA < $50 million. Source: S&P Capital IQ.

The emergence of a true partnership between middle market sponsors and lenders provides the lender with greater transparency and a better understanding of risk, the benefits of which we believe accrue to direct lending vehicle investors.

Many lenders today lack sufficient opportunities to deploy capital. In reality, this challenge is often times a function of having a sub-scale origination effort. Given the unique attributes of each middle market company, lenders usually need to look at hundreds of transactions annually to build a defensible, diversified portfolio. In order to gain the broadest exposure to this market, lenders need to have relationships with hundreds of sponsors that are diverse both in terms of geography and sector focus. We believe there are as many as 2,000 middle market financial sponsors in the U.S., and we think it is important to develop and maintain relationships with many in order to maximize selectivity when making investments. It is our view that these market exposure attributes are essential components of the overall risk management process.

Given the volume of credit that has been extended to U.S. companies over the last several years, lenders often chase deals, abandoning the following key tenets which we continue to believe are essential in protecting capital. Central to our middle market lending discipline is a commitment to lend to firms with strong cash flow that can service their debt. It is advisable to verify that there are multiple avenues through which to exit the position, either by cash flow, an acquisition, refinancing, sale, or IPO. We believe that lenders should make this a component of their underwriting process, as well as part of their management and oversight of any given credit portfolio. In addition, meaningful equity contributions from sponsors are viewed favorably by lenders. Equally, lenders focus on sponsors that have a strong track record of honoring their commitments and supporting their portfolio companies. Lastly, while it may seem obvious, rate and terms are not enough if a business does not have a viable reason to exist.

Although most market participants are reticent to acknowledge their lending mistakes, they can and sometimes do happen. Therefore, minimizing defaults and maximizing recoveries is a crucial part of the investment management process. As mentioned above, the middle market segment affords protections that both protect capital and give the prudent lender a seat at the table at a much earlier stage than in larger private and syndicated deals. One benefit that is often overlooked is the periodic reporting middle market borrowers typically are required to provide. Monthly financials provided by borrowers coupled with covenants not only provide an early warning sign for current investments, but also a snapshot on various sectors of the economy that can serve to direct one's investment approach towards or, perhaps more importantly, away from new opportunities. Although larger deals and the syndicated market provide turn-key access to yield, these products often lack the protections one finds in the lower middle market. During the Global Financial Crisis, EBITDA for companies involved in these larger transactions declined more than 40%, as represented by the Bloomberg North America High Yield Index, whereas portfolios of middle market loans often only saw EBITDA declines in the high single digits.

In conclusion, being active, rather than passive, is a crucial component of building a successful selective portfolio of middle market loans. We recognize that this stage of a cycle presents unique risks and challenges. Nevertheless, based on our analysis of and experience through and following the Great Financial Crisis, we continue to believe that a targeted approach to the lower middle market can still deliver attractive risk adjusted returns.

Footnotes:

1. *Source: SIFMA website (https://www.sifma.org/resources/research/bond-chart/).*
2. *The Merrill Lynch US High Yield Master II Index (H0A0) is a commonly used benchmark index for high-yield corporate bonds. It is administered by Merrill Lynch. The Master II is a measure of the broad high yield market.*
3. *Source: Bloomberg Barclays US Corporate High Yield Index as of December 2018.*

Important Notices

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