PennantPark

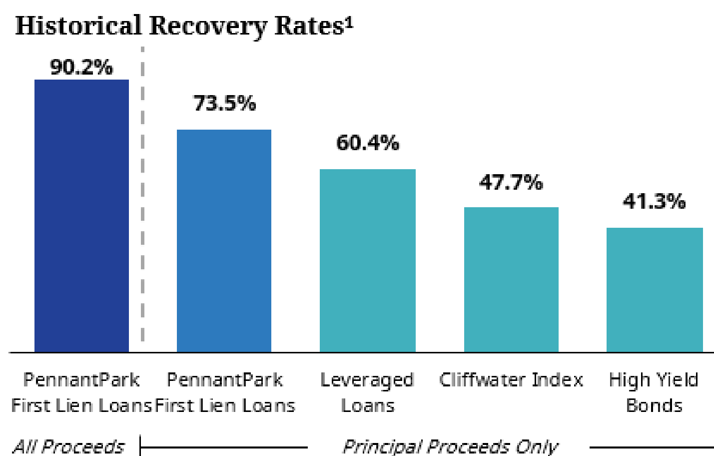
Is Bigger Better?

February 2024

Perception Versus Reality: Despite the claim that bigger companies are safer investments than smaller ones, the data tells us otherwise.

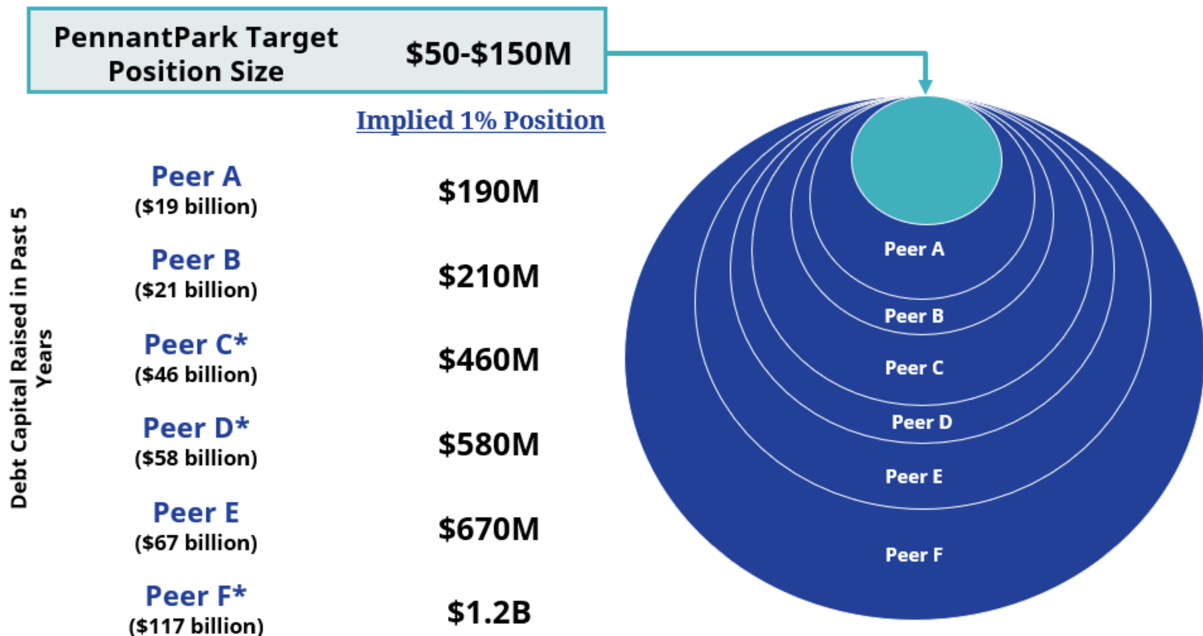
There is a widely-held misconception that bigger companies are safer investments than smaller ones. Mega Fund managers are happy to perpetuate this claim to further their fundraising agendas. These managers claim big companies have more established operations, larger market shares, and better access to capital markets. They're simply too big to fail! Where have we heard that before?

Despite this claim, the data tells us otherwise. While big companies may benefit from economies of scale, they do not necessarily make for safer credit investments. In reality, large corporations tend to have much riskier, highly leveraged capital structures that can put them at increased risk of payment default, especially in today's high-interest rate environment. As shown below, the core-middle market (PennantPark First Lien Loans) has a higher recovery rate compared to the other market segments. Additionally, these companies tend to not have the protective covenants of medium-sized companies.



1. *Source: Cliffwater 2023 Q3 Report on U.S. Direct Lending. Benchmark recovery rates are estimated based on the market price of defaulted loans at the time of default over par value. Benchmark recovery rates are calculated as an average of monthly LTM recovery rates since the inception of PennantPark managed vehicles in 2007. PennantPark's recovery rate on first lien loans is calculated by dividing the sum of principal proceeds and market value of defaulted first lien investments by the total capital invested in such defaulted first lien investments. "Leveraged Loans" and "High Yield Bonds" are represented by JPMorgan Markets, Bloomberg US High Yield Index, Morningstar LSTA Leveraged Loan Index.*

Why do Mega Fund managers tout this false narrative? Many are forced to move up-market to invest in the big companies with larger capital structures due to their need to deploy billions of assets. Smaller investments in core middle market companies simply do not "move the needle" for these managers.

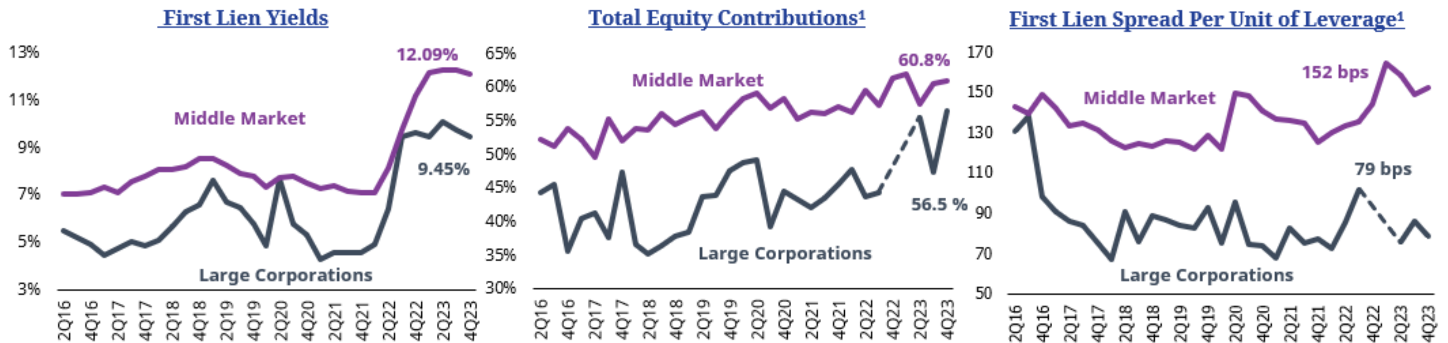


Source: Private Debt Investor PDI 100 rankings December 2023. Peers include Golub Capital, Crescent Capital, Oaktree Capital Management, Blackstone, HPS Investment Partners, and Ares Management. Capital amounts are based on the amount of private debt investment capital raised by firms over the past five years. Area of circles is roughly proportional to the size of the implied 1% position.
** Signifies publicly traded asset management company*

As a result, these managers are often targeting investments in direct competition with the broadly syndicated loan market from banks. This competition compresses the illiquidity premium paid and results in covenant-lite structures.

With this in mind, at PennantPark, we invest in the core-middle market, where there is less competition and target loans with persistently lower leverage multiples, more conservative loan-to-value ratios, and higher interest coverage ratios. Middle-market companies are generally considered underbanked and historically have less access to typical financing. This deficiency of bank capital can give middle market managers, such as PennantPark, the potential to secure favorable terms with tighter financial covenants and additional protections, even as the broadly syndicated loan market has migrated almost entirely to covenant-lite loans.

Below, Refinitiv provides some excellent data showing how middle market first lien loans have historically generated higher yields, compared to large corporations, and with lower risk in today's environment.



1. *Source: LSEG LPC's Middle Market Connect The Middle Market Opportunity, 4Q2023. LSEG does not have sufficient observations at this time to provide Q1-23 data for the syndicated market.*

PennantPark remains disciplined in our approach to lending to core-middle market companies that benefit from underlying solid growth fundamentals. We focus on first-lien loans to cash-flowing companies, where we aim to leverage our flexible financing to secure lower leverage and higher yields in combination with strong covenant packages. We have been investing in the middle market for 17 years through various economic cycles and remain committed to our approach.

Ultimately, we urge investors to do their homework and refrain from following industry tropes that don't hold up under scrutiny. Thorough due diligence should always include an in-depth analysis of a manager's default, recovery, and loss history – with skepticism toward those managers who have never invested through a full economic cycle.

We welcome a conversation; please contact invest@pennantpark.com or the professionals listed on the next page.

Contact Us

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About PennantPark:

PennantPark is an independent middle market credit platform with $6.8 billion of assets under management. The firm is headquartered in Miami with additional offices in New York, Chicago, Houston, Los Angeles, and Amsterdam. PennantPark primarily invests in the core middle market, defined as companies with earnings of $10 million to $50 million. Our industries of focus include business services, government services, healthcare, consumer, and software/technology. In addition to middle market CLOs, the firm offers its investment strategies through a range of public and private fund structures.

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