Private Debt - Opportunities in the Lower Middle Market

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Ongoing bank disintermediation and tighter regulations have resulted in private lenders becoming a fixed part of the lending landscape. The US market is the most established, followed by Europe with the Asia Pacific catching up fast.

As well as by region the asset class is also split by EBITDA. Taking Europe as an example, it is divided into the lower middle market (€5mn-€25mn), upper middle (€25mn-€75mn) and large cap (>€75mn). In our view, the landscape appears to be dominated by lenders in the upper middle and large cap parts of the market which provides lenders focused on underserved lower middle market with a larger pool of investment opportunities.

Performance Drivers

Are there increasing risks associated with lending to smaller firms and is company size a key driver of poor performance and/or defaults?

We do not believe this is the case. According to a study performed by Moody’s in 2012, it was suggested that leverage, rather than company size, is a key driver of default. Moody’s conducted its study of default history across a large data set of borrowers over a 16-year period (1994-2010), which included the financial crisis, and encompassed 133,000 individual borrowers with over 9,000 defaults.

The study included borrowers of all sizes, including lower middle market through large corporates, from data provided by large national banks (e.g., Bank of America, Wells Fargo), and regional banks (US Bank, Fifth Third Bank, Regions Bank, Zion’s Bank, M&T Bank, Citizen’s Bank, Huntington Bank, First Horizon).

As Fig. 1 illustrates, structural considerations, like leverage, liquidity, and debt coverage, were much larger contributing factors to loan defaults than company size. We believe this study remains relevant today and can alleviate concerns that lending to smaller businesses will automatically lead to higher default rates.

![Fig. 1 - Default History in Private Debt Market](image)

Source: Campbell Lutyens, Moody’s Analytics RiskCalc 4.0 US, as of 30th April 2012. Most recent available data used. For illustrative purposes only. Not to be construed as investment advice.

Capital at risk. The value of investments and the income from them may fall as well as rise and is not guaranteed. Investors may not get back the full amount invested.
The more-established US direct lending market offers better empirical data than other regions on trends within the sub-asset class. Recent research suggests lending to companies in the lower middle market offers better risk return metrics than other segments. According to alternatives consultant adviser and fund manager Cliffwater, they “found a 1.3% yield premium for lending to lower middle market borrowers (companies with <US$10 million EBITDA) compared to upper middle market borrowers with EBITDA over US$100 million. This could be the ‘size premium’ often found in other asset classes.”

In addition, based on our own experience over the turbulent months of the second half of 2022, deal volumes - specifically regarding private equity sponsored deals - tended to follow a steadier pattern for smaller firms. However, for larger deals, the absence of an open-ended liquid primary market may have led to the collapse of transactions.

Many companies in the lower middle market are family and founder-owned businesses where the key stakeholders have a deep rooted and personal interest in ensuring the company is a success. They are often seeking funding for expansion or acquisition opportunities, not because they are distressed, meaning they have solid balance sheets. We believe, alternative lenders are well placed to provide flexible financing solutions to support these ‘buy and build’ and organic growth strategies.

**Risk Mitigators**

Company size can also be seen as a benefit in terms of risk mitigation. In Europe, the direct lending market is divided into the lower and upper middle market, with ticket sizes indicatively above and below €100mn.

The main competitors for lenders in the lower middle market segment are banks whereas the upper middle market funds might compete against syndicated loans and bonds. As a result, lower middle market deals are often structured with more conservative leverage levels, stronger equity cushions and better covenant protection as they only need to differentiate themselves against conservatively structured bank loans. In addition, work out situations are typically in a single jurisdiction, therefore more streamlined processes focused on preserving value. It is therefore not surprising that the expected recovery rates in the smaller segment are observed to be significantly higher.

For the deals in the upper segment the differentiation factors are based on the size and the absence of “market flex” requirements (i.e., the ability to underwrite to flex terms in case the transaction struggles in syndication). The structures here are like those of syndicated loans and include factors such as high leverage levels and loose, covenant light structures.

**Conclusion**

We believe direct lending is appealing for investors given the asset class’s ability to provide potentially higher yields, lower volatility and less correlation to public market debt. A more cautious lending environment for banks on the back of recessionary fears, alongside the long-term retrenchment trend, continues to increase lending opportunities for private lenders in the lower middle market. In addition, the lack of competition in the lower middle market means lenders can be increasingly selective and push through more conservative structures and better deal terms with regards to pricing. As outlined above, we don’t see evidence that lower middle market direct lending transactions bear higher risks. On the contrary, in our opinion they appear to offer more appealing risk return metrics.

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1 Cliffwater Q1 report on US Direct Lending, 2023.
2 Anlageklasse Private Debt, Sammelband 2023, SECA Booklet no. 18.
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