EXPERT Q&A

The core mid-market offers a wealth of opportunities for lenders able to provide creative financing solutions rooted in deep due diligence, say Michelle Handy and Garrett Stephen of First Eagle Alternative Credit

Private debt's sweet spot

Q What does private credit in the core mid-market space look like right now?

Garrett Stephen: So far, 2023 has been a lot like 2022. The high inflation, rising interest rates and fears of recession that have contributed to volatility in the public markets also have continued to weigh on the M&A activity that serves as a key source of demand for direct lenders. More recent signs of strain among regional banks have further heightened the uncertainty among borrowers and their private equity sponsors. Some who have leaned heavily on the likes of Silicon Valley Bank are reconsidering the value proposition offered by these low-cost funding solutions.

Overall, there have been fewer new underwriting opportunities for cashflow loans. We have seen, for example, recent volume dominated by add-on activities by our existing borrowers.

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However, uncertain conditions tend to favour private credit over other forms of leveraged finance, as the lower cost that may be available through a regional lender, bond issuance or a syndicated loan may take a backseat to direct lenders' ability to close deals more quickly and with greater certainty of terms.

Michelle Handy: While we are sensitive to market trends and the macroeconomic backdrop, our focus is on building all-weather loan portfolios that we expect will perform across market cycles. We seek to accomplish this through the specific borrowers we target within the core mid-market – which we define as $5 million to $50 million EBITDA companies – the structure of our loans and the rigour of our underwriting and portfolio construction.

Q What makes the core mid-market all-weather?

MH: While we believe the core mid-market has inherent advantages, we view our strategy as more important than the market segment. For us, this means targeting borrowers with stable historical earnings, strong cashflows and private equity sponsors.

We focus our origination efforts on select industry verticals where we have specific expertise, including business services, consumer, financial services, healthcare and technology within the cashflow segment, as well as asset-based lending, and further sharpen our attention within those verticals on a subset of industries that are less cyclically exposed.

"While the rates on some unsponsored deals may look more attractive, history suggests they also will involve more losses"

MICHELLE HANDY

"Smaller sponsor-backed deals in which only one or two lenders are involved can be more nimble"

GARRETT STEPHEN

We look to be first lien in the borrower's capital structure and incorporate at least one financial covenant and/or liquidity test in all our directly originated cashflow loans. And upfront portfolio diversification is vital, given the illiquidity of these assets; by funding a larger number of smaller loans, we avoid any outsized positions that could materially influence the performance of the portfolio.

Looking at the core mid-market space more broadly, there are a few primary characteristics that we believe make it particularly attractive. Dealflow in the sponsored mid-market space has increased significantly over the past 10 years, as an increasing number of sponsors have looked at the lower end of the mid-market to establish a platform they can build over time through add-on acquisitions. Strong relationships with sponsors can help support consistent dealflow over time, even when markets in general appear unstable.

Moreover, we've found that lenders can be more thoughtful about structure in this segment of the market, compared with mega-deals that often require a relaxation of contractual provisions.

As a result, we can write what we consider to be well-collateralised loans with less leverage, lower loan-to-value and more financial covenants, which ultimately helps mitigate downside risk. Similarly, the size of these loans enables us to sit at the top of the borrower's capital structure and gives us a decided advantage in workouts and recoveries.

GS: I'd add that the one factor feeding into the volume of deals here is that often these smaller companies are led by their founder or founders, and the transaction is driven by their desire for a liquidity event, which often comes from the sale to a private equity firm. Given the number of small businesses in the country and the giant mound of private equity dry powder, there are plenty of these situations to choose from. We can be selective.

Q Increased volume is also turning the core mid-market into a haystack. How does the firm find a needle?

GS: When we're looking at a specific core mid-market business, we look at the sponsor, the underlying management team and, of course, cashflow and other financial metrics. Notwithstanding the foregoing, industry fundamentals also deserve close consideration, and we believe the structure of our organisation provides us with an advantage here. By focusing on our key industry verticals rather than the entire opportunity set, we have been able to develop a deep expertise that helps us interpret broader trends and their potential impact on companies in the space.

We examine the industry curve. Is it early stage or growth? Is it mature or in decline?

There are plenty of small businesses in growing industries that have real resiliency in their revenue, and we can put the right structure in place to make the most of that transaction. In contrast, we want to avoid small businesses operating in mature or declining industries.

Industry specialisation is extremely important for us because there's a wealth of untapped niche subsectors with a lot of green shoots of promising growth. We believe a deep understanding of those industries is necessary to discover the green shoots and capitalise on them.

We want to tap those niche subsectors early, when they're still fragmented, so we have the chance to buy, build and grow that business as a platform. In our view, the organic growth rates that we see in many of these core mid-market companies are pretty strong. M&A is not always a necessity.

Q Why avoid non-sponsored lending, which has exploded in recent years?

MH: There are a few reasons, but risk mitigation may be the most important.

Q What do you expect for mid-market direct lending going forward?

MH: As long as the market and macro environments remain somewhat volatile, it's hard to see a significant rebound in M&A activity or new-loan volume. That said, lower volumes aren't necessarily the end of the world. A well-underwritten portfolio in the low volume years following the global financial crisis, for example, still had the ability to generate strong returns.

While pinpointing a specific catalyst to get the market back to 'normal' may be a challenge, I'm confident the market at some point will find the level at which the deal economics work for borrowers, lenders and sponsors, and we'll be back off to the races.

Either way, we intend to maintain our stringent underwriting standards, leaning on our decades of experience providing capital in the mid-market space. Good markets or bad, we are not going to lend money just for the sake of it.

Companies at this end of the mid-market don't necessarily have lower default rates than larger companies, but those with private equity sponsors do. Private equity sponsors provide more governance and professional, experienced management oversight, which leads to greater stability than is likely from a company being led by the entrepreneur who founded the enterprise.

Private equity firms also have the resources, either in talent or capital, to address problems as they arise. They can anticipate liquidity issues heading their way and do something about them before it becomes a genuine threat to cashflows and debt service. All of that contributes to a lower default rate among sponsor-backed companies in this space.

GS: I'd also argue that smaller sponsor-backed deals in which only one or two lenders are involved can be more nimble. It's easier to build a consensus around a particular direction. If a sponsor needs additional funding, we make one or two calls and can quickly make a decision.

In contrast, larger transactions might have more capital to tap, but complex capital structures make those negotiations much harder to manage. In a club deal, there might be competing priorities. The sponsor may need to compile a stack of six to 10 lenders, and that starts to feel like a market onto itself. Our world is rooted in close relationships with certain sponsors because we're often the only lender.

Further, pricing is a relationship game in this space, and many sponsors place a premium on working with a lender they know. Someone who has been in the trenches with them on previous deals and has proved their value as a partner is likely to have an edge over an unknown provider who is simply offering a lower rate.

The relationship factor is how we believe we can win the day, even at a higher price. Often, we look to deepen our relationships with sponsors by looking at other ways we can work with them or by lending guidance on portfolio companies we're not involved with.

MH: We all have experience in our careers underwriting unsponsored cashflow loans, and we know how volatile they can be. Our goal is to deliver favourable risk-adjusted returns on cashflow loans to our investor base by focusing on sponsored transactions.

While the rates on some unsponsored deals may look more attractive, history suggests they also will involve more losses and require more internal resources to ultimately get repaid. All in, we think the sponsored core mid-market is the sweet spot for us and our investors. ■

Michelle Handy is direct lending deputy CIO and Garrett Stephen is co-head of origination and structuring at First Eagle Alternative Credit

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