E X P E R T Q & A

Jens Ernberg and Thomas Hall, co-heads of private credit at Capital Dynamics, discuss opportunities in the often overlooked lower mid-market

The road less travelled

Q How have direct lending portfolios fared through the pandemic?

Jens Ernberg: Portfolios have performed remarkably well overall, given the magnitude of the economic shock they have had to absorb. A lot of that has had to do with the massive amounts of fiscal and monetary stimulus that has been injected into the market, supporting businesses and consumers and propping up the economy.

Of course, sectors that rely on bringing people together, such as travel, leisure and hospitality, have been hit especially hard. Shutdowns have resulted in these industries being unable to generate revenues in the traditional way.

But elsewhere, businesses that have managed to come through the past 12 months relatively unscathed should be well positioned going forward. Certainly, a key lesson here from a portfolio management point of view is the importance of diversification.

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Q How has the relationship between direct lenders and sponsors been impacted?

Thomas Hall: We have seen strong support for our portfolio companies from our sponsor partners. Early on, that support came in the form of liquidity, if and when it was needed. Just as important, sponsors stepped in to provide oversight to management teams and apply lessons learned across their entire portfolio. The pandemic has had real, operational consequences on all businesses.

Whether that has meant transitioning to a work-from-home environment or reconfiguring manufacturing processes to ensure worker safety, these are transformations that would normally take years but have had to take place in a matter of months, if not weeks. Having a sponsor there to help in that decision-making, planning and prioritisation has been incredibly helpful.

Q What role have covenants played in supporting outcomes?

JE: We are very focused on having financial maintenance covenants in our loans. We target the lower end of the mid-market in North America, lending to sponsored-backed companies with EBITDA between $5 million and $25 million, with a sweet spot of $10 million to $15 million. That space is less efficient and less competitive, which gives us greater freedom to dictate terms and structures.

We are able to insist on having maintenance covenants and, philosophically, we think that's important for a number of reasons.

First, it provides an early-warning signal if the business starts underperforming. It means we can come to the table early with the sponsor and management team to address issues while adequate liquidity remains and the company has more strategic optionality, which we believe contributes to better recoveries.

Just as importantly, however, covenants may allow lenders to reprice the loan. We have had a couple of businesses trip their maintenance covenants during the pandemic and that has enabled us to reprice the loans to reflect the changed circumstances.

In the absence of those covenants, the loan would have been underpriced relative to current market expectations, in which case we would have had to mark it down in our book.

Q What other advantages do you see in focusing on the lower mid-market?

TH: In addition to the ability to dictate terms, there is also lower leverage and larger equity contributions. These are smaller businesses, so you could argue that they should be more conservatively structured in any case. But, from a relative perspective, we think this part of the market is disproportionately conservative when compared with private equity-backed loans in the upper mid- and broadly syndicated markets.

That conservatism is particularly helpful in a crisis. Not being leveraged to the hilt gives a business the flexibility to weather both transient and longer-term issues. Lower debt levels mean less debt servicing and a greater ability to absorb shocks.

Yields are also more attractive in this part of the market because it is less efficient and less competitive. For example, our current portfolio has a weighted average spread of above seven percent, and each deal has a LIBOR floor. Whereas spreads in the broadly syndicated market are between the 350-400bps range. All told, the lower mid-market offers a compelling relative risk-adjusted return profile.

Q Where are the best lower mid-market opportunities as a result of the pandemic?

JE: Volumes in the second quarter and most of the third quarter last year were very low. The sponsor and lending communities were busy assessing what the impact of the pandemic was going to be on their portfolios and the economy. But by the fourth quarter, activity had picked up again. There were the obvious areas that had benefited from covid-19, such as software, services and/or products that enabled or enhanced the work-from-home experience. Those opportunities were very well banked. But there were also opportunities away from those crowded trades – consumer products businesses sold through essential retail, for instance – that had performed solidly. We would argue those investments offered more attractive risk-adjusted returns than those hyped sectors where everyone was piling in.

Meanwhile, opportunities were also presented by companies experiencing short-term liquidity needs in order to deal with transient challenges related to the pandemic. The urgency of those capital requirements meant lower sensitivity to structuring and price.

Q Where do you see the most interesting opportunities in 2021?

TH: If early signs are any indication, we think the scale of opportunity we are going to see in the lower mid-market will be immense. Banks continue to exit the leveraged lending markets due to a combination of regulatory pressures, including higher required capital reserves, and continued consolidation in the industry. Smaller businesses in the US have been particularly dependent on those commercial banks and so their exit has created a void. Meanwhile, private credit fundraising has been heavily concentrated on those managers with large AUM bases – which, by definition, are focused on the upper mid-market or broadly syndicated market, in terms of the scale of businesses being backed. But the funding needs of those lower mid-market companies, post-pandemic, will be enormous. That has created a perfect storm which should produce a rich stream of opportunities for several years to come.

Q How is the role of ESG evolving in private credit?

JE: We are encouraged by the scrutiny and accountability our LPs are demanding with regards to ESG issues. Clearly, a business that is operating with little regard for its environment, governance structure or social responsibilities is creating additional risks in the form of both financial and reputational liabilities, which could prove detrimental to our investment. Historically, lenders have primarily approached these types of issues with a negative screen. What is changing however, is that ESG is starting to be viewed on a more holistic basis and we are recognising the importance of each element in driving sustained performance over time.

TH: Our credit business operates with this holistic approach in mind, incorporating ESG into all aspects of our diligence process as well as ongoing portfolio management. All investments are rated for sustainability along the three ESG dimensions using our team's proprietary framework, and then reassessed on an ongoing basis. Our ESG process is further supported by the diverse perspectives of our responsible investment committee, which advises investment teams on best practices, evaluates potential ESG-related risks and helps advance the firm's ESG priorities. ESG will continue to receive more attention in the upcoming years and we believe that embracing it will lead to more sustainable performance over time. ■