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Industry Voices

Commentary: How structural changes have unlocked credit opportunities in the lower middle market

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By Tom Hall and Jens Ernberg

With the Fed once again raising interest rates, institutional investors are ramping up the search for attractive yield opportunities in credit markets. The lower middle market might be one sector worth their attention.

The U.S. middle market, loosely defined as companies with $5 million to $1 billion in revenue, has undergone a rapid transformation as economic and regulatory forces have combined to redefine how smaller companies gain access to capital. Despite new players entering the sector, the market continues to be underserved, offering compelling risk-adjusted returns both for lenders and for investors in private debt funds. The key is to understand how the market has evolved and how to unlock the most attractive opportunities.

Small and medium-sized businesses traditionally were served by U.S.-based commercial banks. But a 30-plus-year trend of bank consolidation has resulted in local and regional lenders exiting middle-market corporate direct lending or refocusing efforts and resources on other opportunities, after being absorbed by larger superregional and national banks. The financial crisis and resulting regulations further motivated national and global commercial banks to look for larger corporate lending opportunities to boost growth and repair their balance sheets.

Despite recent efforts in the U.S. to loosen banking regulations, the outflow of sourcing and underwriting talent and changes to risk tolerances suggest the exit of commercial banks from middle-market corporate lending is structural and permanent.

In recent years alternative lenders have stepped in to fill the void as a supply of debt capital, providing innovative and flexible loan structures that were previously unavailable to middle-market borrowers. According to S&P Global Market Intelligence Institutional, direct lenders now hold more than 90% of all middle market loans as of June 30, a sharp contrast with the 70% market share enjoyed by commercial banks since 1994.

However, much of the capital raised to serve the middle market is still reserved for larger businesses, leaving a gap in the lower middle market. There are two reasons for this gap — first, the direct lenders who have traditionally been major players in the middle market have in many cases raised large amounts of capital that have made it uneconomic to continue pursuing loan opportunities in the lower middle market. Second, recent consolidation among non-bank direct lenders has reduced the number of smaller competitors in the market; at the same time, acquired entities have largely refocused their efforts up-market. Recent examples of large asset managers acquiring lower-middle-market-focused direct lending specialists include Oaktree's acquisition of Fifth Street, Benefit Street Partners' acquisition of Triangle Capital and Business Development Corporation of America, and Apollo's acquisition of Credit Suisse Park View BDC.

As a result of these concurrent trends, fewer players serve the lower middle market than just a few years ago. The lack of competition creates a compelling opportunity for investors, as many of the lenders that continue to serve the lower middle market are able to extract better risk-adjusted returns than those that focus on larger companies.

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There are three primary reasons reduced competition has unlocked attractive credit opportunities in the lower middle market:

1. **Higher contractual returns.** With less competition, those remaining lenders who continue to serve the lower middle market are generally able to negotiate attractive terms and pricing. The higher rates available to lower-middle-market lenders act as both an illiquidity premium and small market premium, compensating investors for the added risk of allocating to a less mature market.

2. **Lower leverage levels and more conservative loan-to-value metrics.** The reduced competition also plays to the lender's advantage when it comes to how much leverage is applied to borrowers' balance sheets. Historically, new-issue middle-market leverage has been almost one multiple of EBITDA lower than that of broadly syndicated loans, with lower-middle-market issuance enjoying even more conservative leverage. This trend is increasingly important as average leverage levels for middle-market syndicated leveraged buyout deals reached a record high of 6.28 times through the first half of 2018, compared with the previous year's record of 5.95 times. These levels reduce borrowers' margin for error and increase the risk of principal loss in the event of default. Furthermore, increased relative valuations — similar to those observed in the larger markets — coupled with higher equity contributions in small-to-medium-sized company LBOs have resulted in more attractive loan-to-value metrics and equity cushions in excess of 50%. These characteristics provide increased downside protection for investors vs. those afforded in comparable loans issued to upper-middle-market LBOs.

3. **Better structural integrity of loan documents.** Covenant-light loans, or loans that exclude financial maintenance covenants, have become the standard for the broadly syndicated loan market and now represent in excess of 80% of outstanding issuance. Financial maintenance covenants are designed to alert lenders to deteriorating financial performance and, if breached by the borrower, provide lenders with the ability to address the situation with the company's management and its financial sponsor, discuss possible remedies and, under certain circumstances, implement measures to protect the lenders' investment. As a result of competition, lenders have been forced to compromise, and this large-market phenomenon is now starting to seep into the upper middle market. Thomson Reuters data show that as many as 26% of syndicated middle-market sponsored loans issued in the first three months of 2018 were covenant-light, a record high. In contrast, with less competition, lower-middle-market lenders have remained disciplined and have maintained the structural integrity of loan documents, marked by virtually no covenant-lite loan issuance. In addition, lenders to middle-market buyouts are typically able to insist on securing other structural protections, such as more frequent and detailed financial reporting; excess cash flow sweeps and contractual amortization; as well as restrictions on the borrower's ability to incur additional indebtedness or distribute cash out of the borrower. In short, lower competition helps to maintain discipline and higher lending standards because there are fewer direct lenders willing to offer looser terms to borrowers to gain market share.

Therefore, lower-middle-market loans offer a more attractive risk-return profile than the broadly syndicated loan market, or even the upper middle market. The premium priced into the market more than compensates investors for the added risk of lending to smaller, potentially more vulnerable companies and the relative illiquidity of participating in smaller loan facilities with fewer market participants.

Institutional investors are understandably wary of the lower middle market, hypothesizing that a credit downtown will make small businesses vulnerable and potentially lead to a spike in defaults. But lower middle market lenders are well-protected — and well-compensated — for this risk because of the stronger covenant structures and lower leverage that have come to define the asset class today.

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