Give a Little Credit: Making the Case for the U.S. Lower Middle Market and Addressing Myths of Direct Lending

Viewpoint

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Private Debt Portfolio Managers Eric Green and Jeff Youle reiterate their conviction in the asset class

Over the past decade, Direct Lending[1] has developed into an accepted asset class for institutional investors, and a flexible capital substitute for leveraged loans. In the U.S., alternative lenders seem to have occupied the void left by the retreat of commercial banks,[2] and institutional investors have found the asset class attractive given its: return profile, floating rate protection against rising interest rates and low correlation to traditional risk assets.

U.S. Commercial Banks numbered more than 12,000 in 1990 which has dwindled to fewer than 5,000, as AUM in direct lending strategies has expanded fifteen-fold.[3] Preqin's survey data of institutional allocators indicates 77% of the respondents plan to increase allocations into direct lending over the next 12-24 months.[4]

Notwithstanding growing institutional adoption of direct lending, some investors still have questions about the strategy. We believe many of these questions may be grounded in myths and misperceptions. Within this paper, we intend to provide experienced practitioners' insights to dispel four such myths:

- *Smaller companies are riskier credits*
- *Direct Lending is a "crowded trade"*
- *Direct Lending does not need diversifiers*
- *Direct Lending should underperform in a market downturn*

1. Direct Lending is the segment within Private Debt whereby senior secured floating rate loans are directly originated.
2. According to Federal Reserve Economic Data (FRED), a database maintained by the research division of the Federal Reserve Bank of St. Louis, the number of commercial banks has declined by 60% from 1990 to December 2016.
3. Source: Federal Reserve Bank of St. Louis, FRED Observations through January 1, 2018.
4. Source: 2018 Preqin Global Private Debt Report (2H 2018).

Eric Green

Global Co-Head, Private Markets

Eric joined Muzinich in 2012 from Cyrus Capital Partners, a credit opportunities firm, where he was a Managing Director. Previously, Eric was the Senior Partner and Portfolio Manager of FriedbergMilstein (a direct debt origination firm), a Partner and Managing Director of JP Morgan Partners and a Managing Director of BNP's Merchant Banking group. Eric started his career at GE Company/GE Capital.

Jeff Youle

Head of U.S. Private Debt

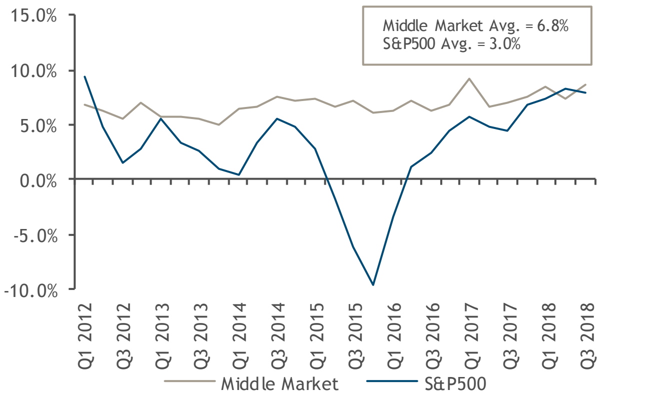
Jeff joined Muzinich in 2017. Prior to joining the firm, he was Founding Partner of GLC, (a direct debt origination investment and distressed advisory firm). Before GLC, Jeff held a number of Senior Leadership positions during his 18 years at BNP Paribas, most recently Head of North American Corporate Investment Banking.

The Myths

1) Smaller companies are riskier credits:

Smaller companies have actually delivered higher and more stable revenue growth than the S&P 500, according to data from the National Center for the Middle Market.

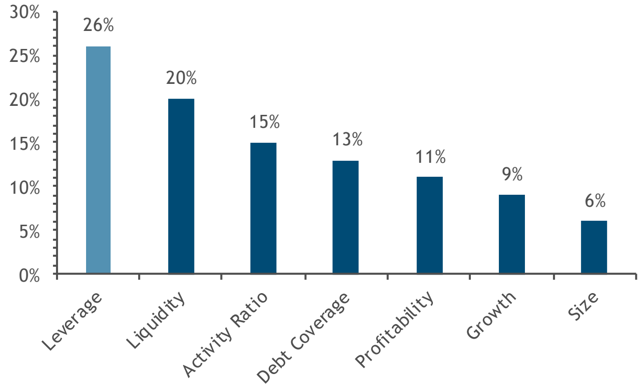
Fig. 1 – Revenue Growth – Past 12 Months



Source: National Center for the Middle Market – "Current Middle Market Trends". Data as of September 30, 2018. The National Center for the Middle Market's definition of the middle market is any company between $10mm-$1bn in annual revenues. Survey is completed quarterly.

Further, an often-cited study from Moody's "RiskCalc" observes a limited relationship between size of a borrower and its likelihood of default. This study, summarized in Figure 2, notes that the single most important predictor of default is the financial leverage of a company's balance sheet – not the size of the company.

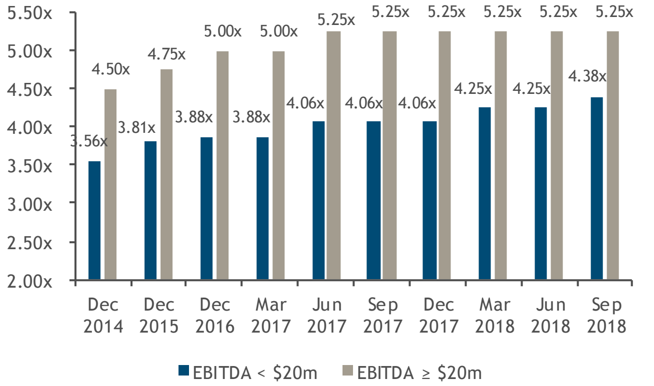
Fig. 2 – Relationship: Factors Relating to Risk of Default



Source: Moody's Analytics "RiskCalc" 4.0 US, April 30, 2012. Based on 25 years of private firm data including 110,000 financial statements, 25,000 firms, and 1,600 defaults. Size of company is measured in total assets.

Supporting the above, SPP, a middle market corporate finance firm, provides market data (see Figure 3) which evidences that smaller sized companies have historically employed materially lower levels of leverage than larger companies. In fact, debt to EBITDA levels between December 2014 and September 2018 show on average 1.0x lower for companies generating EBITDA less than $20M. Our Private Debt team has observed a similar pattern, with leverage levels of 4.0x and below within our lower middle market segment.

Fig. 3 – Historical Total Leverage



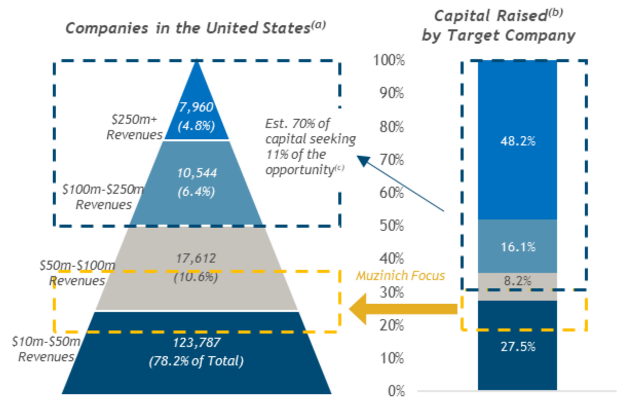
Source: SPP's "Middle Market Leverage Cash Flow Market at a Glance 2018". Data as of September 30, 2018. Most recent data available.

2) Direct Lending is a "crowded trade":

Similar to private equity, private debt can be broken into three distinct segments: Upper Middle Market, Middle Market, and Lower Middle Market.[5] We believe it is paramount to appreciate the differences across these market segments. As institutional allocations to direct lending continue to grow, investors appear to be taking note of the increasing amount of dry powder raised.

Our analysis, shown below in Figure 4, illustrates that more than 70% of the capital raised over the last five years is set to be deployed in lending to the U.S. Upper/Middle Market. However, these two segments represent only 11% of the total direct lending market, comprised of more than 200,000 businesses. This concentration in the Upper/Middle Market is even more pronounced when one considers that a substantive majority of this capital is dedicated to financing private equity transactions.[6] This has resulted in competitive pressures on leverage, pricing, and deal terms, which have been broadly reported by the financial press.

Fig. 4 – Middle Market Opportunity



Source: (a) SOI Tax Statistics 2013 IRS Corporate Complete Report (Table 5). (b) Preqin Private Debt data for Direct Lending and Mezzanine funds between 2013-2017. Updated annually. Most recent data available used. (c) Based on Muzinich estimates; funds targeting companies with EBITDA > $25+ Million. Please see Important Information at the end of this document regarding forward looking statements.

5. The Upper Middle Market includes firms that earn gross revenues of $500mm to $1bn. The Lower Middle Market consists of firms with an annual gross revenue of $5mm to $50mm, and the Middle Market holds the firms in the middle of these two segments.
6. Source: Wells Fargo, Preqin and Muzinich analysis.

However, we believe the Lower Middle Market offers a diverse set of opportunities less served from a lending perspective, and therefore more insulated from many of the challenges impacting the Upper/Middle Market. Further reducing competitive pressures, we have observed a greater percentage of these companies are family- and founder-owned. In our view, accessing this fragmented market requires industry experience, sourcing relationships and a strong reputation for successfully executing transactions. We believe specialization is the key to a successful direct lending business and we remain squarely focused on serving the Lower Middle Market.

3) Direct Lending does not need diversifiers:

Modern Portfolio Theory has demonstrated that an investment portfolio's risk adjusted returns may be improved by diversifying amongst (positive expected return) assets and strategies that are not perfectly correlated.[7] This has laid the groundwork for a constantly expanding quest for diversification on the part of most asset owners globally. Diversification objectives are pursued within private markets as well, where a typical private equity portfolio might be sub-allocated amongst: venture, growth, buyout, or distressed, and diversification extended further across vintage, geographic and sector focus, and manager.

As one would expect, the direct lending asset class offers its own continuum of specialist approaches with similar opportunities for diversifying returns. If we consider the discussion regarding market segmentation highlighted in the aforementioned Myth #2, the Lower Middle Market in particular might represent dollar for dollar the most diversifying source of incremental returns for an existing or prospective investor in the asset class.

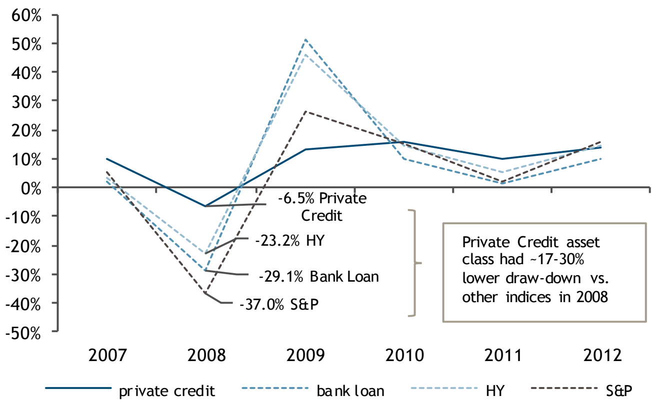
However, accessing the Lower Middle Market may be difficult for institutional investors due to a trade-off between institutional quality and style purity. In our view, many Lower Middle Market specialists are smaller-sized and regionally focused, lacking the infrastructure and credit underwriting capabilities required to meet institutional due diligence standards. On the other hand, for those managers who have achieved scale and developed an institutional quality platform, their success and asset growth may often necessitate a style drift towards larger funds and loan sizes (as they seek to raise even larger funds).

4) Direct Lending underperforms in market downturns:

Most every investment strategy has an explicit or implicit linkage to the global economic cycle. Direct Lending is no different but, in our experience, represents an asset class that, if managed skillfully, is an all-weather strategy. In fact, the Cliffwater Direct Lending index demonstrates a more stable, lower volatility pattern of returns during the Global Financial Crisis of 2007-2008 and just after (per Figure 5), relative to traditional asset classes.

7. Modern Portfolio Theory is a theory constructed by Harry Markowitz. He discusses his hypothesis in "Portfolio Selection," published in the *Journal of Finance* in 1952.
8. S&P/LSTA Leveraged Loan Index – The S&P/LSTA Leveraged Loan Index is a market value-weighted index designed to measure the performance of the US leveraged loan market based upon market weightings, spreads and interest payments. JUC4 - The ICE BofA ML BB-B US Cash Pay High Yield Constrained Index contains all securities in the ICE BofA ML US Cash Pay High Yield Index (J0A0) rated BB1 through B3, based on an average of Moody's, S&P and Fitch, but caps issuer exposure at 2%. S&P 500 - The Standard & Poor's 500 Index is an index of 500 stocks seen as a leading indicator of U.S. equities and a reflection of the performance of the large cap universe, made up of companies selected by economists.
9. All information as of November 30, 2018.
10. Source: Muzinich & Co. Views and opinions are for information purposes only, not to be construed as investment advice.

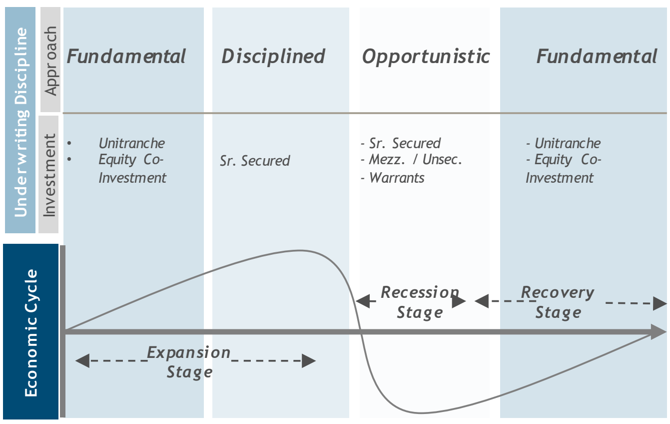
Fig. 5 – Drawdown Percentage: Cliffwater Private Debt Index versus Bank Loans, High Yield & S&P500



Source: Cliffwater Private Debt Index. Data is from 2007-2012. Past performance is not indicative of future results. Please refer to footnote 8 for Index Definitions.

Our team members have been lending across multiple cycles dating back to the 1980's enabling a comprehensive understanding of the expected returns relative to a fundamental analysis of the key risk metrics for a given loan (leverage, security, covenants, priority, etc.).

Fig. 6 – Discipline Across the Cycle



Source: Muzinich opinion.

In summary, we believe the niche of direct lending to U.S. Lower Middle Market companies may offer investors a particularly attractive risk / return profile in a market with a broad opportunity set, high barriers to entry and therefore less competition and pricing pressure, strong lender covenants, and a greater opportunity to offer value-added by structuring non-standard deals.

Muzinich & Co. is a $32 billion global investment manager, specializing in public and private corporate credit. Established in 1988 and headquartered in New York City, our firm has 9 additional offices throughout Europe and Asia.

Our Global Private Debt platform consists of 27 people and $1.6 billion of committed capital.[9] We have five existing strategies covering Pan-Europe, 4 individual European countries and we plan to expand into the US during the first part of 2019. Our dedicated team of investment professionals is tasked with origination and underwriting. We remain tightly tied to our investments throughout their lifecycles. Because we value deep specialization, we focus on leveraging our global scale horizontally across geographies rather than vertically with different market targets and loan sizes. Our team members are experts on investing in the lower middle market, where there are less competitive dynamics and a larger selection of opportunities.[10]

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