PCA | PENSION CONSULTING ALLIANCE

VIEWPOINT

MARCH 2018

Middle Market Direct Lending: Overpaying for Stability

Middle market direct lending ("MMDL") investors have been pitched largely the same supply/demand imbalance argument since the Global Financial Crisis ("GFC"). The thesis is compelling in its simplicity: LPs, with their multi-year time horizons, could step in and fill the void left by banks and earn a modest illiquidity premium, be protected by better covenants and experience lower defaults and higher recovery rates relative to the broadly syndicated market. The argument has been so compelling, particularly in a yield-starved environment, that $176 billon in MMDL capital has been raised since 2012 and 158 new vehicles are currently in the market seeking an additional $66 billion in new capital.[1] Investors are starting to ask, however, whether the thesis is still relevant today and whether too much MMDL capital has been raised.

In this Viewpoint PCA argues that the supply/demand question is no longer the right question to ask and that investors are currently overpaying for simplicity and perceived stability. In contrast, specialty lending, a broad group of asset-focused strategies that have not been widely adopted by institutional investors, offers more attractive prospective returns for those willing to embrace additional loan structures.

QUALITY OVER QUANTITY

The post-GFC compound annual growth rate ("CAGR") of private credit fundraising has been an eye-popping 20.5%, and MMDL has been one of the biggest beneficiaries of this growth.[2] MMDL fundraising hit a new record in 2017 with over $54 billion raised and accounted for over half of the total private credit capital raised.[3] While fundraising hit new highs, so did dry powder leading many market participants to ask whether the market can absorb all of these commitments. Preqin, one of the leading private markets research providers, sought to answer this supply/demand question by analyzing dry powder levels both in MMDL and buyout funds (while adjusting the latter to focus on smaller deal sizes).[4] Preqin estimated the addressable buyout universe at $417 billion (demand) and MMDL dry powder at $65 billion (supply), implying significant opportunity for MMDL capital to be

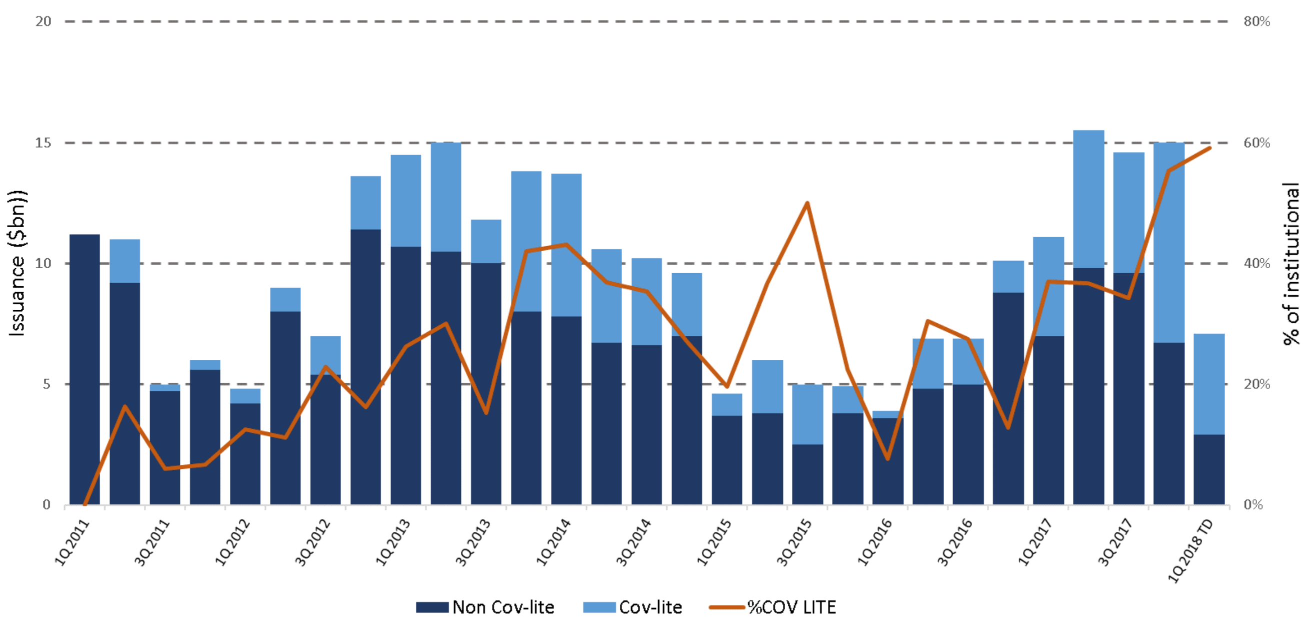
---

[1] Source: Preqin
[2] Source: Pitchbook
[3] Source: Preqin
[4] Preqin adjusted the total buyout dry powder amount ($605B) to reflect that, on average, 46% of buyout deals have a total value of $1billion or less ($278 billion). They further assumed that buyout transactions are financed by 40% equity and 60% debt to arrive at $417B in financing needed.

deployed in the coming years and writing that "any concerns about an overheated lending fund environment appear to be unfounded."[5]

PCA does not question Preqin's analysis and believes the need for MMDL capital will be persistent and served by institutional capital (absent some regulatory change that again reshapes the cost of capital). We are concerned, however, by the quality, not quantity, of the deals executed. MMDL investors were sold that one of the benefits of direct origination was the manager's ability to structure the transaction and draft restrictive covenants (e.g., interest coverage, maintenance, etc). But a manager cannot be significantly off market. Covenant-lite deals, which have dominated the broadly syndicated markets for years, are now meaningfully impacting the middle market and compromising one of the core tenets of the MMDL argument. According to Thomson Reuters, *nearly 60% of the year-to-date new issuance in the middle market has been covenant-lite* (Figure 1).

Figure 1: Middle Market Volume



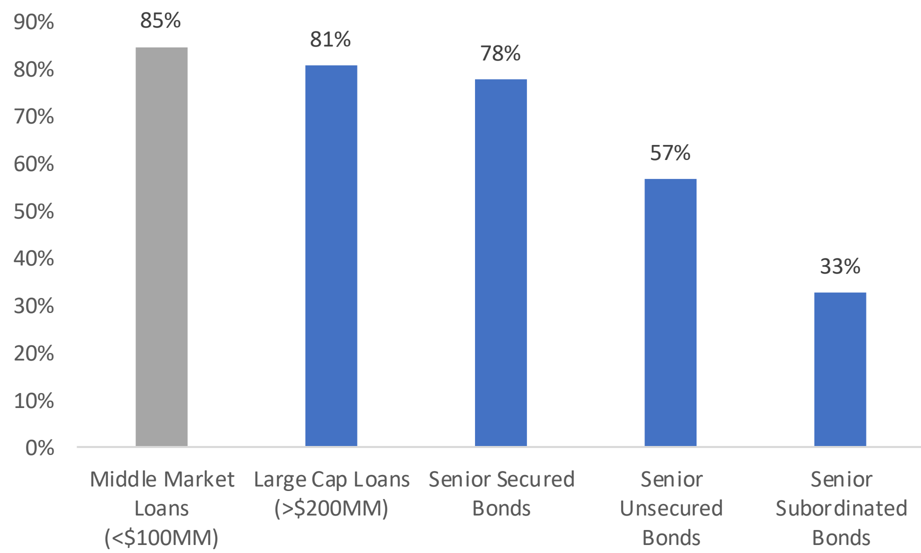
Source: Thomson Reuters LPC

Many managers, however, continue to sell MMDL based on the historical performance of the asset class (Figure 2). We question whether the historical data, particularly about capital impairments, is instructive given the meaningful changes in the asset class. The MMDL universe has expanded significantly since its post-GFC adoption by institutional investors. Once largely constrained to companies with EBITDA less than $50 million, the facility sizes of MMDL deals have expanded on both the lower end and upper end of the middle market to include deals of less than $5 million to multiple hundreds of million. Financings that were formerly served by the broadly syndicated market have now been subsumed into the middle market with certainty of execution being the primary reason given for why companies are willing to pay a meaningful premium. A few of the largest managers are able to serve as the sole agent for these transactions and retain all or the majority of loan; however, as competition has increased, so has the use of club deals where a bank serves as an agent for a transaction and then sells pieces of the loan to small group number of managers. While club deals are

[5] Source: Preqin, Private Debt Spotlight, September 2017

not inherently more or less risky than other loans, they further blur the line between MMDL and the broadly syndicated market and compromise the investment thesis presented by the MMDL industry of direct origination. Covenant-lite deals, which can be more risky, were not prevalent in the middle market before the GFC. Other meaningful industry-level changes include the rise of unitranche structures (which collapses the senior and subordinated debt into one) as well as the wide-spread use of fund level leverage and subscription lines. Collectively, these changes cause PCA to believe that historical performance, particularly for default and recovery rates, is not likely indicative of future MMDL results.

Figure 2: Historical Average Recovery Rate



Source: S&P CreditPro

We recognize that these comments are painted with a broad brush and do not differentiate between approaches utilized by managers – namely, strategies differentiated by their focus on sourcing and use of proceeds (sponsored vs. non-sponsored), capital structure, leverage and facility size. We believe that manager dispersion will likely be greater in the coming years, making manager selection of greater importance. Returns will likely be driven more by manager skill rather than risk taking. Moreover, we are confident that select well-resourced managers, particularly those with a focus on the top of the capital structure, will continue to offer strong risk-adjusted returns. However, given the fierce competition for capital we believe investors are better served by focusing on less widely trafficked opportunities – namely, specialty lending.

LESS TRAFFICKED

Like MMDL, specialty lending, which can be broadly defined as any financing activity outside of the traditional banking system, also pre-dates the GFC. Also like MMDL, specialty lending capitalizes on funding gaps created by a myriad of post-GFC regulations which caused banks to further pull back in lending to both consumers and small businesses.[6] Unlike MMDL, specialty lending has not been widely embraced by the institutional investor community. Based on one market participant's estimate,

[6] For reference, consumer loans as a percentage of the total loans made by banks, fell from 27% in 1995 to 18% in 2006, while the decline in small business lending (to fund opportunities in equipment leasing and merchant cash advances, for example) was greater, falling from 40% to 20% over the same time period. Source: Federal Reserve Economic Data (January 2018).

between \$3 to \$5 billion in dedicated specialty lending assets were raised last year, a fraction of the \$54 billion in MMDL.

Part of this lack of institutional sponsorship is likely because specialty lending is not simple to explain. The strategy does not tie to a single collateral type or implementation approach – or even a single name. Some market participants refer to it as "asset-backed lending" or "private ABS." Implementation strategies also differ. What ties the strategy together is focus on asset-based collateral (including credit card receivables, equipment leases, aircraft, merchant cash advances, consumer installment loans, etc.) and structure.

Structure is a key part of the risk control and value proposition in specialty lending. During transactions, which are bespoke, these assets are typically segregated into a bankruptcy-remote special purpose vehicle. This arrangement isolates the performance of these assets (which are the collateral for the loan) from the performance of the operating company and gives control of the cash collection to the manager. Moreover, the loan is typically structured as self-amortizing, meaning both interest and principal are paid back throughout the life of the investment. This cash flow profile materially reduces the risk of investment as there is no need for refinancing or a capital markets exit unlike in a bullet cash flow (which is the primary structure for MMDL transactions).

With limited institutional capital, specialty lending strategies currently allow for gross unlevered returns of 11% to 15% -- or a premium of 6% to 7% relative to public ABS where the securitization market remains moribund.[7]

CONCLUSION

The MMDL pitch is straightforward and one that many institutional investors have embraced. We are concerned, however, that investors are currently overpaying for stable cash flows while the stability of the cash flows on a go-forward basis may be less certain. We believe that diversifying into specialty lending offers more compelling returns for those willing to embrace moderately more complex structures and welcome the opportunity to further discuss this broad opportunity set with interested investors.

[7] The annual securitization market for structured credit (defined as public ABS, private/144! ABS, MBS, CDO and non-U.S. ABS/MBS) was at the same level in 2016 as in 2008 at \$469 billion. In 2006 the aggregate securitization was \$2.6 trillion. Source: Asset-Backed Alert (as of September 2017).

ABOUT THE AUTHOR

MARY BATES is a Principal in the Private Markets group at PCA. Prior to joining PCA, Mary was the Director of Credit Strategies at Silver Creek where her responsibilities included leading the firm's consultant relations effort, serving as a product specialist and underwriting private credit managers. Prior to joining Silver Creek, Mary spent over eleven years at Hewitt EnnisKnupp where she most recently served as a Senior Research Consultant on the Liquid Alternatives team, focused on credit-related hedge funds. While at HEK, Mary worked with some of the largest institutional plan sponsors in the industry on their hedge fund programs, advising on portfolio construction, manager selection and program design. She also was a key team member of the manager selection phase of the Public-Private Investment Program (PPIP) of Troubled Asset Relief Program (TARP). Prior to joining Hewitt EnnisKnupp, Mary began her career at Lehman Brothers where she was an analyst on the emerging market debt desk. Mary holds a B.S. in Business Administration with a concentration in finance from Indiana University.

ABOUT PCA

Pension Consulting Alliance, LLC (PCA) is a national full-service consulting firm that provides a comprehensive range of services to clients across all major asset classes. Our clients include several of the largest plan sponsors in the United States. In total, our 33 clients represent approximately $1.35 trillion in plan sponsor investment assets.

CONTACT US

Office: 411 NW Park Avenue, Suite 401
Portland, OR 97209
Phone: (503) 226-1050
Website: www.pensionconsulting.com

Mary Bates, Principal
Direct: (971) 808-5394
Email: marybates@pensionconsulting.com

Notes and Disclosures

This edition of Viewpoints is being provided by Pension Consulting Alliance, LLC ("PCA"). The information contained in this document (the "PCA Information") is general in nature, is provided for informational purposes only, and does not take into account any investor's particular circumstances. This report does not constitute an offer of securities of any of the issuers that may be described herein. Information contained herein may have been provided by third parties, including investment firms providing information on returns and assets under management, and may not have been independently verified. The past performance information contained in this report is not necessarily indicative of future results and there is no assurance that any investment in question will achieve comparable results or investment objectives.

Neither PCA nor PCA's officers, employees or agents, make any representation or warranty, express or implied, in relation to the accuracy or completeness of the information contained in this document or any oral information provided in connection herewith, or any data subsequently generated herefrom, and accept no responsibility, obligation or liability (whether direct or indirect, in contract, tort or otherwise) in relation to any of such information. PCA and PCA's officers, employees and agents expressly disclaim any and all liability that may be based on this document and any errors therein or omissions therefrom. Neither PCA nor any of PCA's officers, employees or agents, make any representation of warranty, express or implied, that any transaction has been or may be effected on the terms or in the manner stated in this document, or as to the achievement or reasonableness of future projections, management targets, estimates, prospects or returns, if any. The views or terms contained herein are preliminary only, and are based on financial, economic, market and other conditions prevailing as of the date of this document and are therefore subject to change.

The information contained in this report may include forward-looking statements. Forward-looking statements include a number of risks, uncertainties and other factors beyond the control of PCA, which may result in material differences in actual results, performance or other expectations. The opinions, estimates and analyses reflect PCA's current judgment, which may change in the future.

PAST PERFORMANCE IS NOT NECESSARILY INDICATIVE OF FUTURE RESULTS, AND THE PERFORMANCE OF EACH INVESTMENT PRODUCT COULD BE VOLATILE. AN INVESTMENT IN AN INVESTMENT PRODUCT IS SPECULATIVE AND INVOLVES SUBSTANTIAL RISK (INCLUDING THE POSSIBLE LOSS OF THE ENTIRE INVESTMENT). NO ASSURANCE CAN BE GIVEN THAT ANY INVESTMENT PRODUCT WILL ACHIEVE ITS OBJECTIVES OR AVOID SIGNIFICANT LOSSES.

Any tables, graphs or charts relating to past performance included in this report are intended only to illustrate investment performance for the historical periods shown. Such tables, graphs and charts are not intended to predict future performance and should not be used as the basis for an investment decision.