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Private Credit: How Supply/ Demand Dynamics are Shaping the Landscape



BARINGS CONVERSATIONS

This piece was adapted from an interview with Ian Fowler. The full audio podcast can be found [here](#).*

In this Q&A, Ian Fowler, Barings' Co-Head of the North American Private Finance Group, discusses the dynamics of each middle market segment—including the style shift that is resulting from competitive pressures in the space—and why he believes the traditional middle is the sweet spot.

*Full podcast URL: <https://www.barings.com/us/institutional/viewpoints/is-there-style-drift-in-middle-market-lending>

Can you start by defining the middle market for us?

The middle market in the U.S. represents over 200,000 companies that employ over 50 million Americans. As an investible asset class, S&P defines it as companies with less than \$50 million of EBITDA, whereas Reuters calls it those with revenues or a loan facility size under \$500 million. From a GDP perspective, the U.S. middle market would be the third largest economy in the world. So, as a whole, the middle market represents a significant growth engine for the U.S. economy. It also poses a particularly attractive opportunity for our clients, because these companies often cannot directly access liquid capital markets, and therefore they need private lending to raise capital for investments.

Can you describe the different segments of the middle market issuer universe? And where do you see the most value?

You can break it into three market sub-segments—the first being the lower end of the middle market, which we think of as companies with \$15 million or less of EBITDA. This equates to a loan facility size of \$5–25 million. The traditional middle market would be companies with EBITDA between \$15 and \$40 million, which would mean loan facilities of under \$100 million in size. On the upper end, we’re talking about companies with EBITDA north of \$40 million, probably up to about \$75–100, with loan facilities over \$100 million.

On the upper end of the market, we’ve seen a continued strong fundraising environment that has encouraged managers to raise bigger and bigger funds. As these managers still need to deploy capital over a specific period of time—often two or three years—there is a trend toward doing fewer deals of larger size, as opposed to more deals of smaller size. While that may make some sense in terms of efficiency, it also introduces potential style drift into the equation. In fact, the willingness to

invest into larger and larger deals is actually graying the lines with the broadly syndicated loan market—resulting in some transactions that have loose covenants and weaker structural protection for investors. In the broadly syndicated market, that’s not necessarily a bad thing, as investors have liquidity—meaning they have the option to sell. But it is more troubling in the private lending space, where those covenants are extremely valuable, as they effectively give lenders a seat at the negotiating table if a company runs into trouble. Given the style drift and weakening structural protection in the upper part of the middle market, we’re not seeing tremendous value there today.

On the lower end, enterprise value risk is the main concern—because in the event of a default, the loss potential is greater simply due to the lesser value of the companies in this space. They have fewer levers to pull from a strategic standpoint—and while they do have the structural protection that is lacking on the upper end, it doesn’t do much good if the enterprise value is compromised. The lower part of the middle market has also experienced increased competition, as new entrants and/or managers that can’t hold positions over \$100 million are pushed into the space and often compete for deals there. This has resulted in spread compression and increased leverage levels, as too much money is chasing too few deals. In fact, spreads on transactions in the lower end of the middle market are only marginally wider than those in the traditional middle market—for what we perceive to be materially greater risk. So, if you’re an investor on the lower end, you want to get appropriately compensated for the risk. For us, that has generally meant focusing on the mezzanine part of the capital structure for these smaller companies, which is a strategy we’ve been active in for multiple decades.

Between spread compression and increased leverage on the lower end, and volatility on the upper end, we’re finding that stability is in the middle. Spreads in the middle market have remained broadly stable in recent years, and leverage has been up slightly but not materially, on average. So, for us, the middle is really the sweet spot.

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From a sector perspective, are there areas of the middle market that you avoid?

Simply put, we tend to favor boring and defensive. 80% of defaults in the leveraged loan index are in sectors where we don’t invest.¹ We don’t invest in cyclical businesses like oil and gas, or mining. We don’t like restaurants or retail. Essentially, anywhere that there’s fad risk, we avoid—because when we think about middle market deals and the illiquidity that comes along with them, we need to assume that we are holding an investment until maturity. And we don’t want that to be mismatched with a cycle.

Turning the discussion toward the current market, can you talk about the supply of deals that you’re seeing?

Over the last two years, the supply of deals has been really attractive. In fact, if you look at 2017 in terms of new issuance, it was a record year going back to 2007. What’s especially interesting is that 74% of the transactions were new buyouts—as opposed to re-financings, which is positive because the terms on buyout transactions tend to be more favorable for investors. Similarly, in 2018, new issuance set a record again, at 3% over the prior year.² So, the point is that we’re continuing to see a robust pipeline of potential investments.

From a quality standpoint, we look at over 1,300 transactions a year, coming from deals we see with over 350 private equity firms—and we only close about 4–6% of them. Using that metric, in the last three years, we’ve closed deals with over 140 different private equity firms. When you think about supply, you want to see the largest possible opportunity set, but you also want to avoid adverse deal selection. It’s all about being in front of the line, in terms of seeing the deals and having varied diversification in your origination sources.

What about the supply of capital? Have you seen any trends?

Over the last two years, over \$350 billion of dry powder has been raised in North America, focused on buyout funds—which means there’s about \$800 billion of dry powder available today overall.³ That is a lot of capital searching for a home, and naturally when you have more capital chasing the same deals, you’re going to see some spread compression and loosening of investor protection, as we discussed earlier, with respect to the upper and lower parts of the middle market. But the supply of deals is not staying static either. We expect somewhere around \$550 billion of loans that will mature in 2023 and 2024.² Overall, we feel pretty good about the supply/demand dynamics in the space, but as we discussed earlier, it’s hard to make broad generalizations across the entire middle market, as the competitive dynamics differ so much across the size spectrum.

1. Source: S&P. As of December 31, 2018.
2. Source: Refinitiv. As of December 31, 2018.
3. Source: Preqin. As of December 31, 2018.

Finally, how should investors consider this asset class in the late stages of a credit cycle?

As we get closer to the next credit cycle, we'd encourage investors to do their homework on the space. Underwrite a manager's investment style—and make sure they are delivering what they say they are. Make sure you understand where the risk (and returns) are coming from. If a manager is promising a 10% return on senior debt—take a closer look at the risk they are taking to actually achieve that number. Make sure you're not overpaying for beta—especially when it comes to senior debt. And underwrite the manager's platform itself: Do they have the ability to write a big check? Can they invest up and down the capital structure? How competitive are they in the marketplace? Is there an alignment of financial interests? Do they have diversified sources of funding to help withstand a cycle? And have they been through economic downturns and credit cycles before?

The opportunity in middle market lending remains an attractive one, in our opinion. But selectivity—at the investment level, and also the manager level—will become even more critical for investors in the years ahead.



Ian Fowler, CFA

Co-Head of North American Private Finance Group

Ian Fowler is Co-Head of Barings' North American Private Finance Group, a member of the group's North American Private Finance Investment Committee and President of Barings BDC, Inc. (NYSE: BBDC). He is responsible for leading a team that originates, underwrites and manages North American private finance investments. Ian has worked in the industry since 1988 and his experience has encompassed middle market commercial finance, including originating, underwriting and managing senior secured loans, mezzanine and co-investment transactions. Prior to joining the firm in 2012, he was a Senior Managing Director with Harbour Group and co-founded Freeport Financial LLC where he was a member of the Executive Credit Committee and responsible for all business development and capital market initiatives. While at Freeport, he helped build the company into one of the top 5 non-bank affiliated middle market Sponsor finance companies in the U.S. Before Freeport, Ian was Managing Director and Global Group Leader for GE Capital's Global Sponsor Finance Group. Prior to GE Capital, Ian held various leveraged finance and investment positions with NationsBank and Mellon Bank. Ian holds a B.A. (Honors) from the University of Western Ontario and is a member of the CFA Institute.

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