EXPERT Q&A

Lending to non-sponsored businesses or underbanked industries requires greater resources but can generate higher returns, say Robert O'Sullivan, Greg Reynolds and Jason Gelberd of Comvest Partners

Why complexity pays in the mid-market

Comvest Partners is a US middle market private equity and credit firm with $3.3 billion in assets under management. Robert O'Sullivan, managing partner, and Greg Reynolds and Jason Gelberd, partners and co-heads of direct lending, talk about the complexity premium that can be found in less competitive lending sectors such as non-sponsored borrowers or underbanked industries, including specialty finance (eg, leasing companies). They also discuss their approach to lending to non-sponsored and non-traditionally sponsored (eg, family office owned) businesses. Other topics include the importance of having access to industry operating expertise, the resource intensive nature of non-sponsored lending, and the need for disciplined loan structures – including maintaining comprehensive and stringent covenant protections.

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Q Has the middle market become very competitive?

Robert O'Sullivan: Sponsored lending has grown significantly, with more competition in the market – and particularly, the larger part of the middle market. Lending has become somewhat commoditised, resulting in pressure on pricing and structure.

Q How can lenders respond to this increased competition?

RO: We focus on segments of the mid-market that are generally less trafficked by other lenders. Consequently we think we can get a good risk-adjusted return, with premium yields and better structures. These less competitive areas include non-sponsored and non-traditionally sponsored borrowers. We also finance sponsor-owned businesses in situations that are typically more complex or where we think we have an information edge through Comvest's private equity industry operating resources available to us. We focus on sectors where we have significant investing experience and access to operating expertise, such as healthcare, and industries we consider to be underbanked, such as financial services companies.

Greg Reynolds: The common characteristic of our deals is complexity because it reduces competition. This is sometimes referred to as the 'complexity premium'. If you are willing to take on the complexity and have the necessary resources, you achieve negotiating leverage to position yourself to be able to achieve conservative loan structures – lower leverage, lower loan-to-value ratios – with comprehensive controls, while receiving a material pricing premium.

Q How would you characterise a non-traditional sponsor?

RO: A non-traditional sponsor is either a small or first-time sponsor, or a manager without third-party capital.

For example, a family office or fundless sponsor seeking to buy a business with a combination of debt and equity that is not a regular borrower like a seasoned PE firm.

Q Is it hard to find non-sponsored firms?

Jason Gelberd: Yes, and this is precisely what makes it less competitive. Non-sponsored lending requires more work and resources than sponsored lending, starting with a more elaborate origination infrastructure.

RO: While everyone at Comvest has some origination responsibilities, 11 people out of about 100 work full-time on private debt and private equity origination at our New York, Los Angeles, Chicago and West Palm Beach offices. As originators, we target about 2,000 intermediaries ranging from one-person boutiques to middle market investment banks that we have established relationships with over the past 20 years.

Q But once you have a potentially suitable non-sponsored company, it can still be hard work?

GR: Yes, origination is just one component. We feel proper non-sponsored company diligence requires private equity-type due diligence. An important factor is being part of a broader platform with a long history of private equity investing. We can utilise the firm's industry operating resources to help us make well-informed decisions. In general, the underwriting process is lengthy and labour-intensive, which usually reduces competition from more volume-oriented lenders.

RO: I absolutely think completing non-sponsored deals would be harder without our private equity division's experience, knowledge and capabilities.

Q Which lending metrics make the most sense?

JG: For cashflow-based loans, many lenders focus on leverage, and our average leverage historically has been about 3.8x. However, we focus most on the loan-to-value ratio, which averages slightly under 50 percent in our cashflow-based loans.

Q What about specialty finance structures?

JG: Historically, about one-third of our portfolio has been borrowing base-governed, asset-based transactions, which are typically loans to financial services businesses. Within this focus, we lend to finance companies, including various consumer and commercial specialists. This is a market I've been active in for more than 10 years, beginning with overseeing the development of Goldman Sachs' lender finance group. While there, I saw how loans performed in different economic cycles, learned a lot about structuring and risk mitigation, and saw how predictive models informing our lending held up during a recession.

This sector is attractive to Comvest because we believe it is a proven strategy that requires expertise, thus reducing competition. You need deep knowledge of differentiated sector sub-segments, and generally companies are non-sponsored, which we like. Some of the key origination focus areas are companies doing small business finance, consumer point-of-sale transactions, healthcare, and auto and motorcycle finance. Conversely, we avoid some sectors, including real estate finance, because of performance during the last cycle.

Q What sectors are interesting right now?

JG: Comvest has significant healthcare investing experience and access to subsector industry expertise through our operating partner network. We recently lent to a chain of paediatric urgent care clinics where we had experience and knowledge of consumer habits and spending due to a prior private equity urgent care investment in Fastmed. Accessing our existing relationships enabled us to have a greater understanding of the industry drivers and the competitive environment, which gave us the confidence to underwrite a growing niche player in the healthcare sector.

Similarly, in financial services, we take advantage of our expertise and acquire significant data by completing multiple transactions in the same sub-segment. We've completed numerous transactions with companies that lease used motorcycles, primarily Harley-Davidsons, to consumers. Used motorcycles generally have a very predictable and flat depreciation curve after a few years, which makes them attractive assets to lease.

Q What is the best way of approaching covenants?

GR: We have on average four financial performance covenants per transaction. While this metric is important, we find it more important to understand the type of covenants, how tightly the covenants are set, and whether borrowers have the flexibility to make significant adjustments to measurements such as pro-forma EBITDA. Because we compete in niche middle-market segments, we normally have negotiating leverage with covenant protections. We focus covenants on key performance indicators, such as recurring revenue when lending to a software company.

Additionally, we target relatively tight covenant tolerances compared with the borrower's projections – typically around a 20 percent cushion. Finally, we strive to maintain simple and well-defined definitions within our credit facilities on all terms, including those that are fundamental to covenant calculations.

Q Is there more competition than there was a few years ago?

RO: Compared with two or three years ago there is more competition broadly in middle market direct lending, but we've seen significantly less in the complex pockets of the middle market where we operate.

Although there are always new middle-market lenders, many existing firms have left due to poor performance or have been acquired by larger platforms. Other former competitors for loans of between \$50 million and \$100 million – our sweet spot – are concentrating on larger deals because they have grown their assets significantly or returned to traditional sponsor lending.

Q Where are we in the cycle, and how does that affect your attitude to lending?

GR: We assume that we are at the peak of the economic and credit cycles, which strongly influences our market participation and loan structuring. We are cautious about heavily cyclical industries, such as consumer durables, and we concentrate on less cyclical industries like healthcare. Having said that, we track and analyse our existing portfolio closely, and do not see signs within these companies that a slowdown has begun.

JG: We also focus on senior-secured debt these days. Having to trade some return for a maintaining disciplined structure has always been our mantra. The team has worked together through multiple cycles and has deep experience to respond to whatever dislocation may be awaiting us. ■