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Mapping the Lower Mid Market - Dimensions and pitfalls in investment decision-making

HAUCK
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Is there an alpha in the Lower-Mid-Market?

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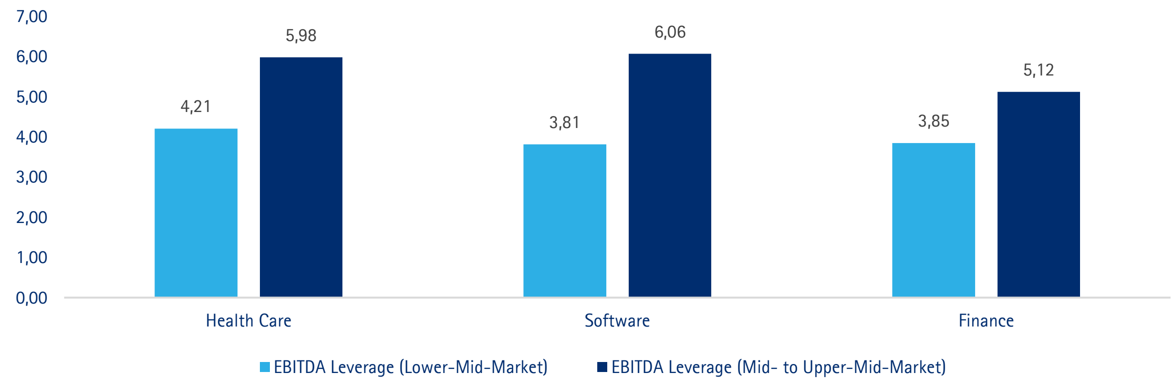
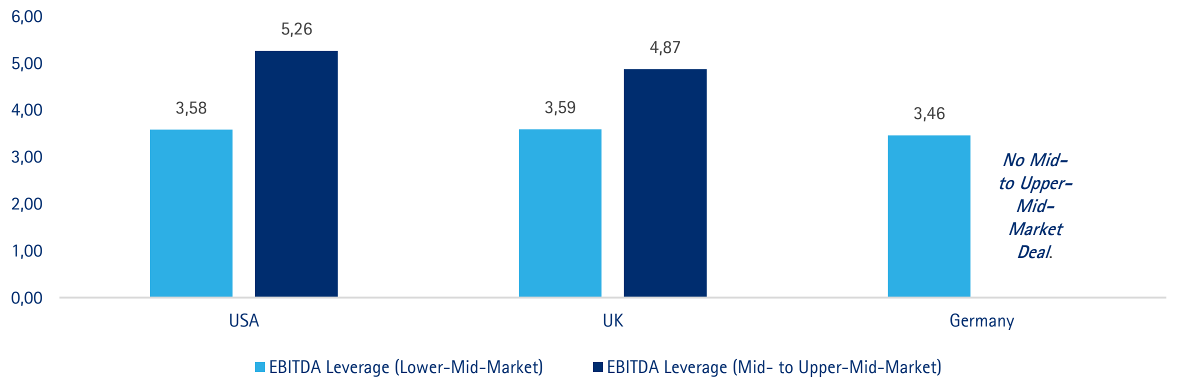
1852 Leverage level analysis per sector & geography (Lower-Mid-Market vs. Mid-Market)[1]





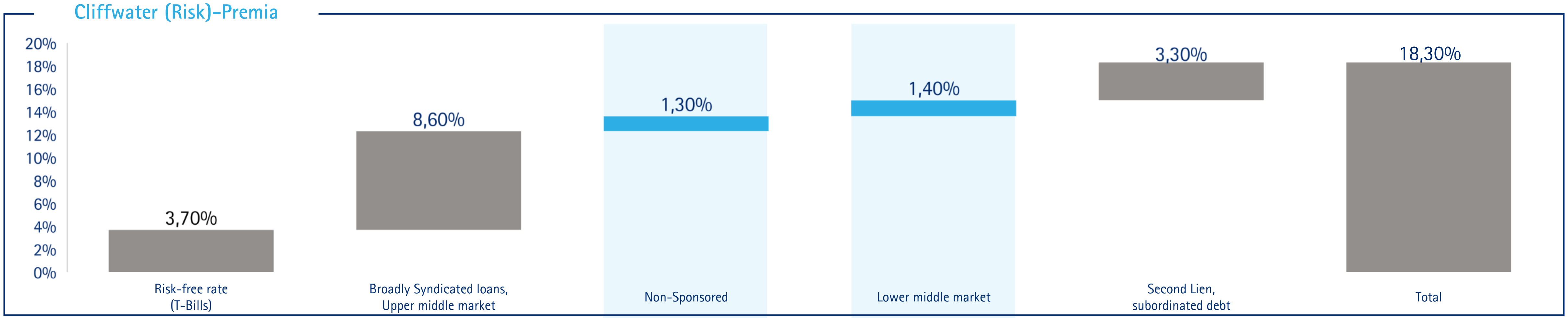
1852 Return analysis per sector & geography[2]

Spread – Lower-Mid-Market

Spread – Mid- to Upper-Mid-Market

1 The results are not representative of the entire market due to the self-selection bias of the portfolio of lower-mid market and mid-market funds. In a similar analysis with upper-mid market funds, the differences in leverage levels were even higher. 2 Total contractual gross credit return excl. base rate

(Risk)-Premia in the Lower-Mid-Market



Reason for premia: Bargaining power
- Non-sponsored deals with 25% more convenants in place
- 14% of non-sponsored deals have warrants in place (vs. 2% of sponsored deals)

Limitation: Organizational requirements
- Organizational capacity for monitoring
- Organizational capacity for the direct relationship to the company
- Capacity for restructuring

Limitation: Scalability
- Potential limitations occur due to unique situations
- Maintaining regional focus
- Maintaining non-sponsored focus

Reason for premia: Bargaining power & selectivity
- Sole lender positions & strong relationships (to the sponsors)
- Higher number of potential companies

Limitation: Dependencies
- Dependence on local sponsor relationships
- Local market conditions

Limitation: Strategic focus
- Maintaining lower-mid-market focus over different fund generations

Source: Cliffwater 2023

Determinants of portfolio diversification: In the LMM, more managers are focused on non-sponsored direct lending

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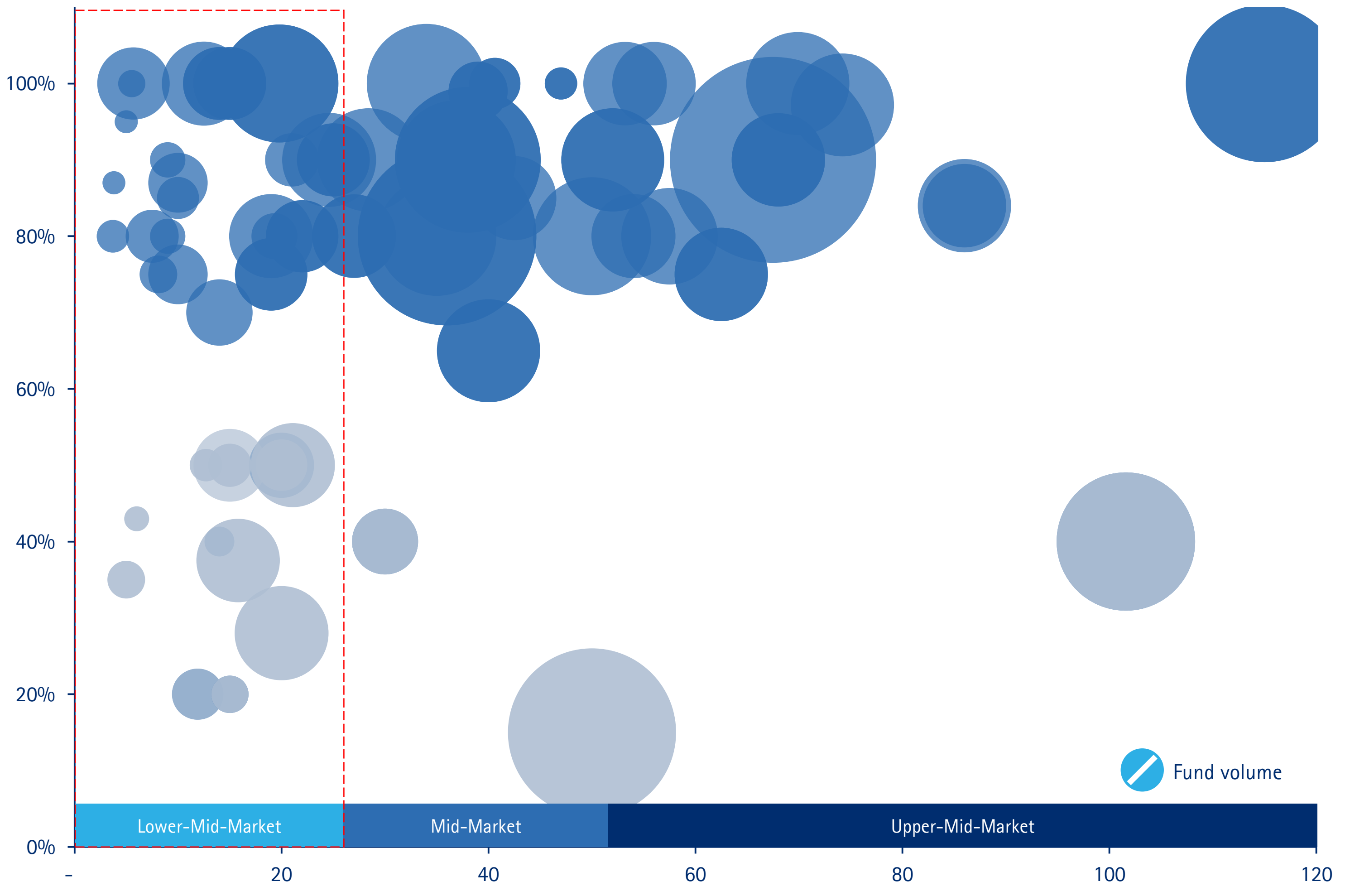
PE-Sponsored Transactions



Summary of the data & results of the regression

Average PE-Sponsored

Lower-Mid-Market	*71,06%*
Mid-Market	*80,75%*
Upper-Mid-Market	*78,33%*

Fund volume & EBITDA effect

- *No linear statistical effect can be observed. However, a significantly different variance of the access routes between the groups can be demonstrated using non-parametric tests*

Central observations & considerations from the perspective of an LP

1. The implementation of non-sponsored strategies is strongly dependent on the personnel capacities of the organisations
2. Managers must be able to source, execute, monitor and, if necessary, restructure non-sponsored transactions, especially during economic downturns.

Does the size really matter for the probability of defaults?

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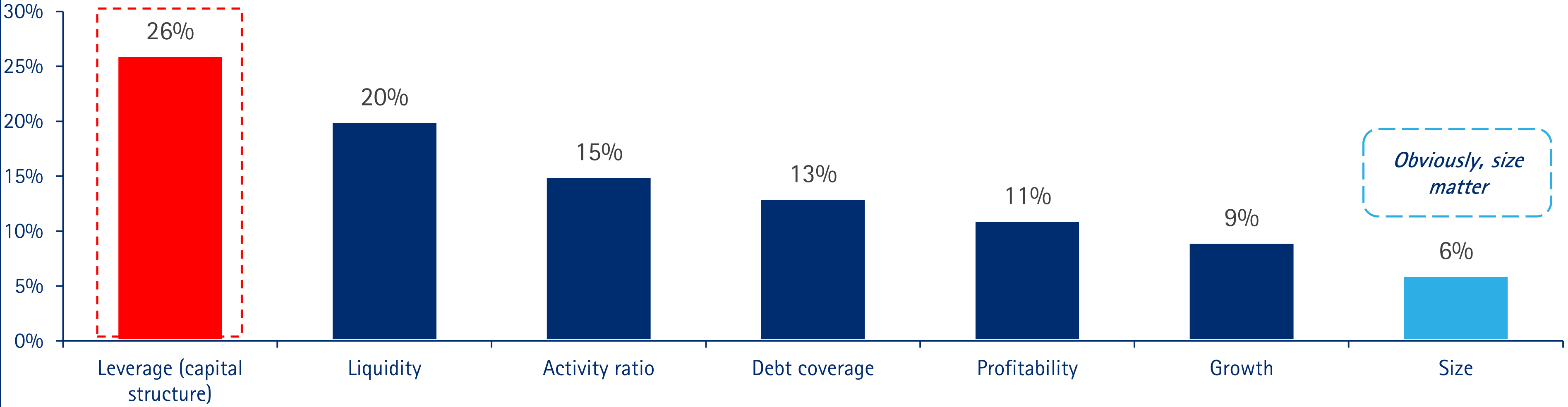
Factors which can explain defaults



Size is **one of the seven factors**, but ranks as the **least significant** factor, with a weight of only 6% out of 100%

Loans to smaller businesses tend to have lower default rate incidence than those to larger businesses

- Lower-mid-market loans tend to have **lower leverage levels**, **lower loan-to-value ratios**, and **stronger covenant packages**
- Smaller loans tend to have **more simple capital structures**, with **only one lender** who can control negotiations with the borrower
- Deals in the **mid-market and upper-mid-market have been shown to default at a higher rate**, based on Moody´s research

Source: Moody's Analytics RiskCalc 4.0 U.S., April 30, 2012

The lower-mid market has significantly lower EBITDA leverage than the upper-mid market

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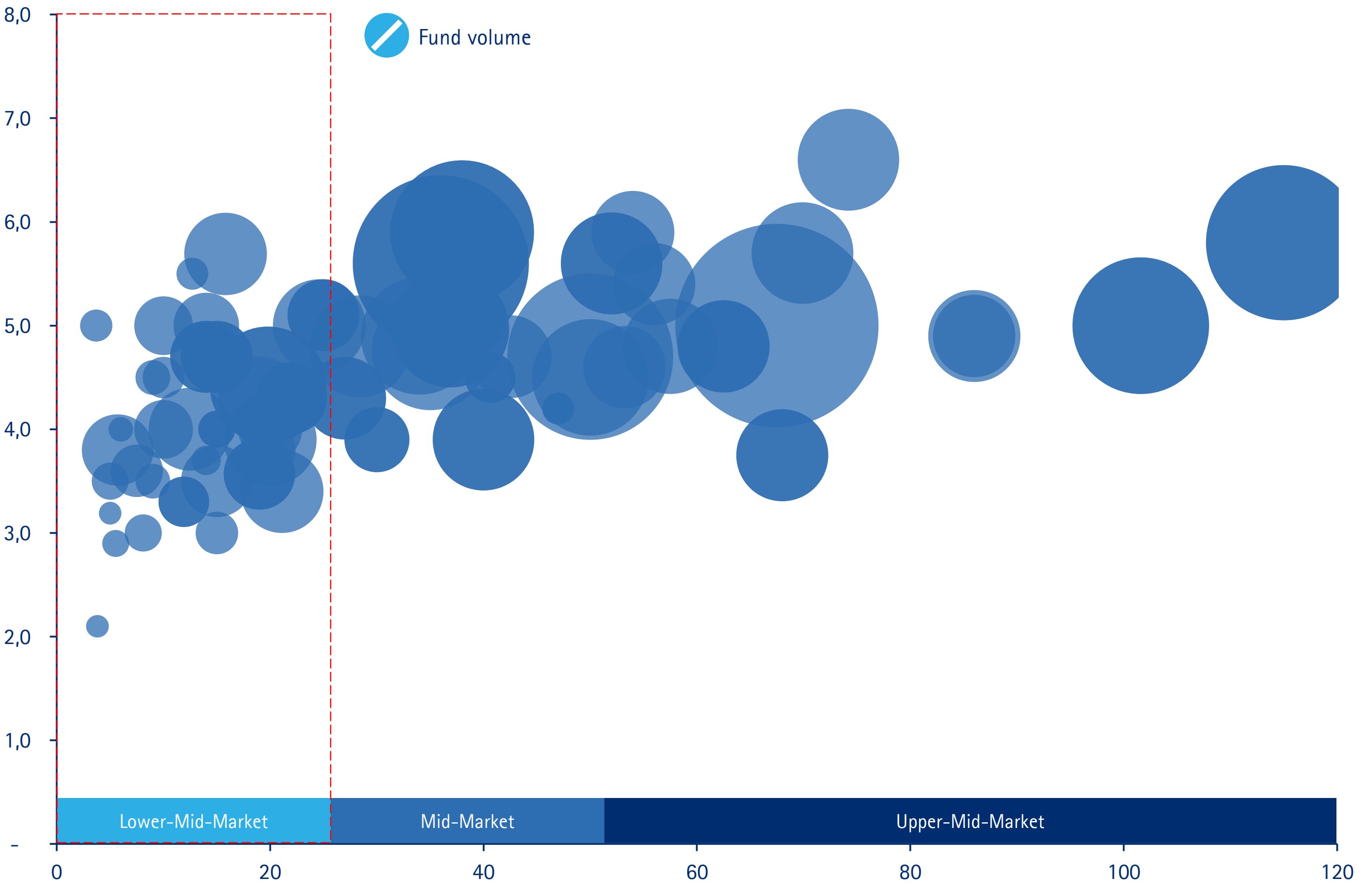
EBITDA-Leverage (EUR m)



Summary of the data & results of the regression

Average EBITDA leverage

Lower-Mid-Market	*4,08x*
Mid-Market	*4,70x*
Upper-Mid-Market	*5,12x*

Fund volume & EBITDA effect

- *Fund size has a significant positive effect on EBITDA leverage at significance level <1% c.p*
- *The absolute EBITDA level has a significantly positive effect on the EBITDA leverage to significance level <1% c.p.*

Central observations & considerations from the perspective of an LP

1. The lower-mid market is characterised by small regional specialists that occupy different niches and often have proprietary sourcing
2. The larger the fund vehicles become over time, the more difficult it is to keep the focus on the respective sweet spot

Variance of manager quality is significantly higher in the lower-mid-market – manager selection is crucial

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Major differences in key characteristics of lower-mid-market managers and higher variance in manager quality outlines the need for cautios manager selection

Organisation	Investment process	Fund	Track record	Reporting & ESG etc.
Platform	*Investment strategy*	*Set-up*	*Historical performance*	*ESG*
Investment team	*Origination*	*Investment strategy & fund allocation*	*Historical credit risk*	*Investor communication*
	Underwriting	*Expected return*		*Investors*
	Loan construction & monitoring	*Fees & expenses*		*Reference checks*
	Recovery management			

Due Diligence pitfalls in the lower-mid-market

Organisation	Investment process	Fund	Track record	Reporting & ESG etc.
Personnel capacity	*Strategy persistency*	*Cost base (e.g. higher mgmt. fee on committed capital)*	*Strategy shift with fund growth*	*Reporting quality*
Team quality, competition & capacity	*Tradeoff deployment & pricing*	*Funding risk*	*Consistency of individual transactions*	*Data deliveries (Solvency II / CRR II / ESG / risk management)*
Infrastructure (processes/tools/IT)	*Underwriting & documentation*	*Deployment preassure due to vehicle size*		*ESG quality*
Ownership continuity	*Capacity recovery management*			*Communication*

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