

DIMENSIONING TODAY'S MIDDLE MARKET LENDING OPPORTUNITY

Middle market private credit offers attractive characteristics and historically strong returns. But not every manager is alike; investors need to take a careful look at a manager's approach, process and track record before tapping this segment.

BROADER ADOPTION OF ALTERNATIVES

As an asset class, middle market private credit has delivered consistently attractive investment characteristics, helping many investors diversify their public market exposure while adding higher yields in a low-return environment.

Historically, only institutions and certain investors could access illiquid alternative assets such as private credit. But new factors, including the advent of technology that modernizes subscription and reporting processes, as well as the greater willingness of investors to withstand illiquidity in exchange for incremental return, have led to the broader adoption of alternatives among individual investors.

New vehicle structures are being launched to serve this segment from a regulatory perspective, and financial technology firms are streamlining back-end operations. We believe that this is a paradigm shift that's here to stay and continue to redefine the universe of investors.

To fully understand the middle market opportunity, we need to start with a brief history.

A FUNDING GAP OPENS THE DOOR TO THE MIDDLE MARKET

The middle market is a vital part of the US economy, with more than 200,000 businesses and nearly 50 million jobs—about one third of the private sector jobs in the country. In the wake of the global financial crisis, new regulations mandated that banks increase their capital levels and tighten underwriting standards.

As a result, they pulled back from a variety of precrisis businesses, including middle market lending. This accelerated the trend of reallocating resources away from middle market lending businesses, which had started amid the consolidation in the banking sector that emerged in the 1990s. The ensuing shortfall of available credit for businesses hungry to expand created a gap that opened the door for nonbank lenders to step in, bringing alternative lenders much closer to middle market borrowers.

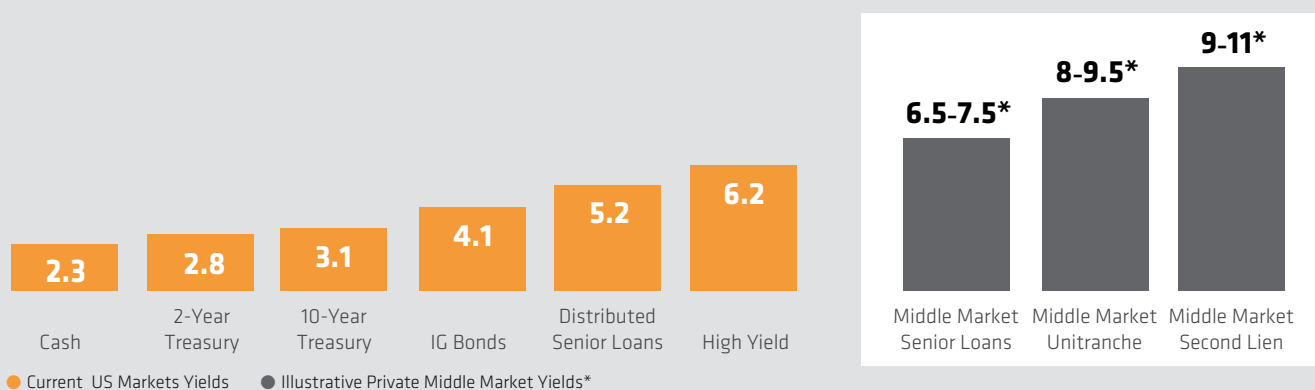
WHAT MAKES MIDDLE MARKET LOANS SO COMPELLING?

Attractive Income: Middle market loans are less liquid than public fixed-income instruments, so they carry a significant yield premium. As of September 30, 2018, high-yield bonds yielded 6.2%. By comparison, middle market senior loan yields ranged from 6.5% to 7.5%, while yields on middle market second lien loans ranged from 9% to 11%. (*Display 1, next page*).



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DISPLAY 1: MIDDLE MARKET PRIVATE CREDIT HAS HISTORICALLY GENERATED STRONG YIELDS RELATIVE TO OTHER FIXED-INCOME ASSET CLASSES DUE TO A SIGNIFICANT ILLIQUIDITY PREMIUM (PERCENT)



As of September 30, 2018. For illustrative purposes only. Cash is represented by 1-Mo. USD LIBOR, 2-Yr. Treasury by Bloomberg US Generic Government 2-Yr. Yield, 10-Yr. Treasury by Bloomberg US Generic Government 10-Yr. Yield, investment-grade (IG) bonds by Bloomberg Barclays US Corporate Investment Grade, distributed senior loans by S&P/LSTA US Leveraged Loan 100 and high yield by the Bloomberg Barclays US Corporate HY 2% Issuer Cap. 2-Yr. Treasury, 10-Yr. Treasury and distributed senior loans yields represented by yield to maturity. IG bonds and high yield yields represented by yield to worst. An investor cannot invest directly in an index or directly in these types of underlying corporate loans.

* Yields are hypothetical and based upon historical data and forecasts. There can be no assurances that any target return objectives will be met. Assumes pricing of LIBOR +400–450, 2.0% 1-Mo. LIBOR, 98–99 OID for middle market (MM) senior loans; LIBOR +500–700, 2.0% 1 Mo. LIBOR, 98–99 OID (original issue discount) for MM unitranche and LIBOR +650–800, 2.0% 1-Mo. LIBOR, 98–99 OID for MM second lien. Assumes a 3-year average life
Source: Bloomberg, Bloomberg Barclays, St. Louis Federal Reserve, S&P/Loan Syndication & Trading Association (LSTA), Thomson Reuters LPC and AllianceBernstein (AB)

The benefit of this yield premium is amplified by middle market loans' floating-rate structures: In public markets, investors who want to reduce interest-rate risk have to reduce duration, typically giving up yield in the process. Likewise, investors who want more yield must add duration—and interest-rate risk. Middle market loans are floating rate and higher yielding, so investors can boost yields without increasing duration.

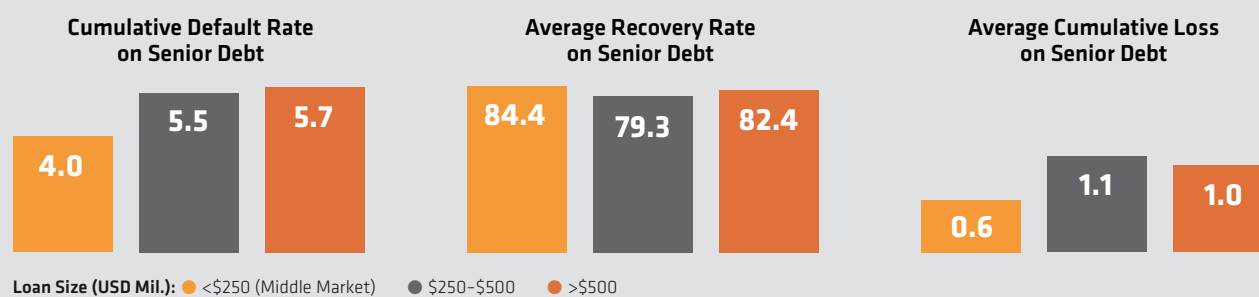
Downside Protection: Middle market senior loans have structural advantages over traditional high yield and broadly syndicated loans. First, they feature strong loan collateral and reasonable leverage, and they're typically originated directly, so lenders can negotiate loan protections and deal terms tailored to borrowers' specific business risks. This stands in stark contrast to the public broadly syndicated loan market, which has seen record covenant-lite issuance lately. Second, middle market lenders have direct access to company management teams and financial sponsors, which facilitates thorough primary due diligence before an investment is made and proactive portfolio management afterward. This information is critical to identifying issues early and managing risk more effectively.

These characteristics have created a favorable downside profile for middle market senior loans. They have lower cumulative default rates and higher average recovery rates if they do default (almost 85% over the past 20 years or so), driving consistently lower loss rates than the large-cap loan market (*Display 2*). This downside protection can be extremely valuable in a diversified portfolio.

Portfolio Diversification: Middle market loans aren't highly correlated to traditional equity and fixed-income markets. Since 2000, their correlation to US stocks, as represented by the S&P 500 Index, has been 0.34. And their correlation to US bonds, as defined by the Bloomberg Barclays US Corporate Investment Grade Bond Index, has been 0.20.

This low correlation to traditional fixed income stems mainly from middle market loans' floating-rate nature, which creates a natural hedge against rising rates, as well as the illiquid nature of the investments. Conversely, fixed-rate fixed-income portfolios are much more sensitive to rate changes. As the US Federal Reserve raises short-term interest rates from historical lows, interest-rate-risk hedging is essential.

DISPLAY 2: MIDDLE MARKET SENIOR LOANS HAVE HISTORICALLY PRODUCED LOWER LOSS RATES THAN THE LARGE-CAP LOAN MARKET (PERCENT)



As of December 31, 2017; represents data from 1995 to 2017. For illustrative purposes only.
Past performance is not necessarily indicative of future results.
 Source: S&P and AllianceBernstein (AB)

KICKING THE TIRES ON MIDDLE MARKET LENDERS

Growing demand for private credit has led to a rapid growth in the number of direct lenders. Preqin, the industry’s leading source of data, cites 113 direct managers with \$88 billion in dry powder waiting to be put to work, and financial publications regularly comment on the increasingly crowded market.

But not all lenders are created equal. Those with differentiated sourcing capabilities that conduct sound due diligence are better equipped to generate strong risk-adjusted returns across market cycles. Here are a few areas investors should examine when evaluating managers:

Experience, Expertise, Access: It takes time to develop the right mix of credit and sector expertise to invest effectively across the capital structure and maximize the recovery of troubled credits during downturns. Deal-flow access is critical for generating differentiated opportunities. That means developing and maintaining a strong direct-sourcing network across channels, including middle market private equity sponsors, intermediaries, co-investors and corporate issuers. Managers must focus on industries aligned with their philosophy—and maximize their sourcing edge in those channels. These networks can’t be built overnight.

Investment Approach and Philosophy: Lenders use a variety of approaches and processes. From our perspective, a traditional “check-the-box” approach to middle market credit underwriting isn’t best—there are too many firm-specific variables across transactions.

Customization and structuring expertise are key elements in generating attractive risk-adjusted return opportunities not available to traditional lenders.

A disciplined process should support this approach. Investors should examine how managers source and select loan opportunities, how much they influence deal structuring and the negotiation of creditor documents, and their portfolio-management approach: Does a manager value the volume of transactions over credit selection? Is there a “cradle-to-grave” approach that creates accountability for loan performance from origination through repayment? How is risk managed through governance structures and controls?

Performance History and Characteristics: Managers ultimately must be able to properly apply their infrastructure, resources and talent to deliver differentiated performance. We’ve already seen that middle market loans have the ability to deliver strong risk-adjusted returns over time. For investors to reap the full benefit, the middle market lenders they choose must do the same, consistently and across market cycles.

Alternative lenders seem likely to continue providing attractive opportunities, and fixed-income strategies currently viewed as opportunistic—including middle market lending—may increasingly be seen as core portfolio components. But for middle market loans to deliver on their value proposition, investors must be as selective in choosing managers as they expect managers to be in choosing loans.

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