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# INVESTING IN THE MIDDLE

## TAPPING INTO OPPORTUNITIES IN MIDDLE MARKET LENDING



**IN THIS PAPER:** Middle market lending is a growing opportunity for investors looking for attractive yields, diversification and downside protection. But a manager with a check-the-box approach to identifying and investing in loan opportunities may leave some of these benefits out of reach.



### THE GROWING NEED FOR DIVERSIFICATION AND YIELD

In the post-beta-trade environment, return expectations for traditional portfolios are lower and volatility is likely to stay higher, as investors face a lower-growth environment and a host of geopolitical risks that seem to keep markets constantly on edge.

In this type of landscape, investors are hungry for sources of extra yield—but they also need to avoid stretching too far and taking on more risk than they bargained for to capture that yield. It's also critical today to incorporate downside protection in case markets take a tumble.

These needs have led many investors to consider incorporating alternative investments into their portfolio design. Alternatives bring the potential for diversification and may offer a cushion that can take some of the pain out of market sell-offs. Investors have turned to private credit as a solution.

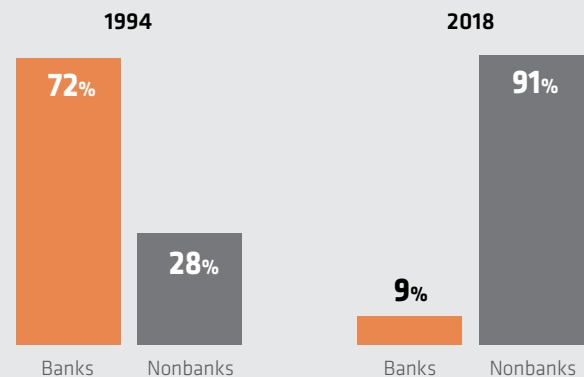
### PRIVATE CREDIT MOVES INTO THE MAINSTREAM

As an asset class, private credit has delivered consistent absolute and risk-adjusted returns, 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 these types of illiquid alternative assets. But times have changed: Technology has emerged that modernizes subscription and reporting processes. Also, investors have become more willing to accept illiquidity in exchange for incremental return. These and other developments have helped alternatives spread further into the portfolios of 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 that will continue to redefine the investment universe available to investors.

### DISPLAY 1: SECULAR DECLINE IN BANK ISSUANCE OF LEVERAGED LOANS



For illustrative purposes only.

2018 issuance represented by primary issuance of leveraged corporate loans  
Source: S&P Global Market Intelligence

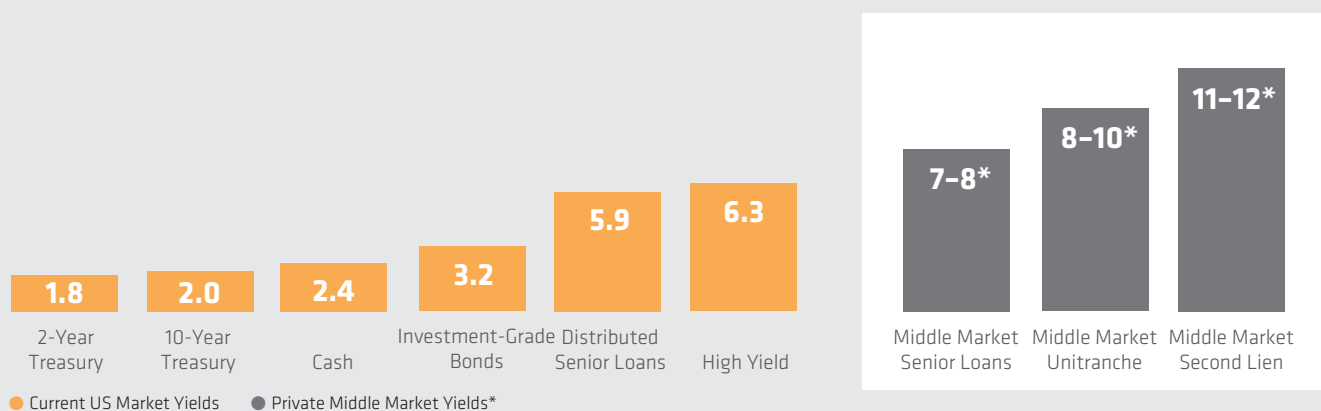
### A FUNDING GAP OPENS THE DOOR TO THE MIDDLE MARKET

This brings us to US middle market lending. The middle market is a vital part of the US economy that includes more than 200,000 businesses and nearly 48 million jobs. That's 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 businesses they were involved in before the crisis, including middle market lending. This accelerated the trend of resources being redeployed away from middle market lending businesses—a trend that had started amid the banking consolidation that emerged in the 1990s.

## DISPLAY 2: ILLIQUIDITY PREMIUM DRIVES STRONG RELATIVE YIELDS

Middle Market Private Credit: Illustrative Yield Profiles (Percent)



### For illustrative purposes only.

As of June 30, 2019.

2-Year Treasury is represented by Bloomberg US Generic Government 2-Year Yield; 10-Year Treasury by Bloomberg US Generic Government 10-Year Yield; Cash by 1-Month USD LIBOR; Investment-Grade Bonds by Bloomberg Barclays US Corporate Investment-Grade; Distributed Senior Loans by S&P/LSTA US Leveraged Loan 100; and High Yield by Bloomberg Barclays US Corporate High Yield 2% Issuer Capped. 2-year Treasury, 10-year Treasury and distributed senior loans yields represented by yield to maturity. Investment-grade 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. Assumes pricing of L+450–500, 2.4% 1M LIBOR, 98–99 OID for MM senior loans; L+500–700, 2.4% 1M LIBOR, 98–99 OID for MM unitranche; and L+825–875, 2.4% 1M LIBOR, 98–99 OID for MM second lien. Assumes a 3-year average life.

Source: Bloomberg, Bloomberg Barclays, Federal Reserve Bank of St. Louis, S&P/Loan Syndications & Trading Association (LSTA), Thomson Reuters LPC and AllianceBernstein (AB)

What resulted was a shortfall in the amount of credit available for businesses hungry to expand. This gap opened the door for nonbank lenders to step in (*Display 1, page 1*), bringing alternative lenders much closer to middle market borrowers. This has presented investors with an opportunity to access a sector that has historically been rewarding.

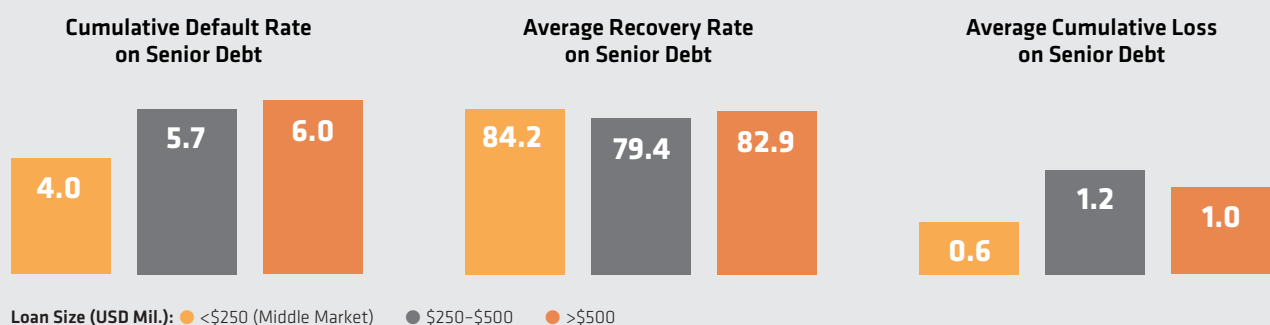
### WHAT MAKES MIDDLE MARKET LOANS SO COMPELLING?

**Attractive Income:** Middle market loans are less liquid than public fixed-income instruments, so they carry a significant yield premium. As of June 30, 2019, high-yield bonds yielded 6.3%. By comparison, middle market senior loan yields ranged from 7.0% to 8.0%, while yields on middle market second-lien loans ranged from 11% to 12%. (*Display 2*).

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 syndicated loan market, which has seen record covenant-lite issuance lately.

### DISPLAY 3: MIDDLE MARKET SENIOR LOANS HAVE PRODUCED LOWER LOSS RATES THAN LARGE-CAP LOANS (PERCENT)



Past performance is not necessarily indicative of future results.  
For illustrative purposes only.  
As of December 31, 2018; represents data from 1995 to 2018.  
Source: S&P and AB

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 3*). This downside protection can be extremely valuable.

**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 0.19.

This low correlation to traditional fixed income stems mainly from middle market loans' floating-rate nature, which creates a natural hedge against rising rates. In contrast, fixed-rate fixed-income portfolios are much more sensitive to rate changes.

### 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 284 direct managers with \$113 billion in dry powder waiting to be put to work in 2019, 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 look at closely when evaluating managers:

**Experience, Expertise and 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.

# Customization and structuring expertise are key to generating attractive risk-adjusted returns.

**Investment Approach and Philosophy:** Lenders use a variety of approaches and processes. From our perspective, it's best to avoid managers who advocate a "check the box" approach to middle market credit underwriting—there are too many firm-specific variables across transactions. Customization and structuring expertise are key to 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, though, 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.

# AN INVESTOR'S CHECKLIST: WHAT TO LOOK FOR IN A PRIVATE-CREDIT MANAGER

We've described some of the attributes that are required for middle market lenders to be successful—and why these traits are important. Here's a simple checklist that can help investors kick the tires on middle market lending managers.



□ **Demonstrated track record:** A good approach only matters if it ultimately allows a manager to deliver better outcomes for investors over time.



□ **Deep industry experience:** The more experienced a team is, the more likely it has navigated different types of market environments and understands how to adapt.



□ **Cohesive team:** This is true for all investment managers—keeping a group of portfolio managers and analysts together over the long run can help a team collaborate and run the strategy smoothly.



□ **Differentiated investment approach:** If everyone is doing the same thing, it's harder to stand out. A traditional "check the box" approach to middle market credit underwriting isn't necessarily best.



□ **Established sourcing networks:** Deal-flow access is critical to generating differentiated opportunities. That means developing and maintaining a strong direct-sourcing network across channels.



□ **Platform scale and stability:** A manager's offering should be big enough to be competitive in providing liquidity but not so big that it's compelled to make deals in order to put money to work.



□ **Flexibility to invest across the capital structure:** It takes time to develop the mix of credit and sector expertise that enables a manager to invest effectively across the capital structure.



□ **Strong governance and controls:** As with any investment strategy, risk management and operational controls can make or break success. Look for a strong foundation and infrastructure.



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