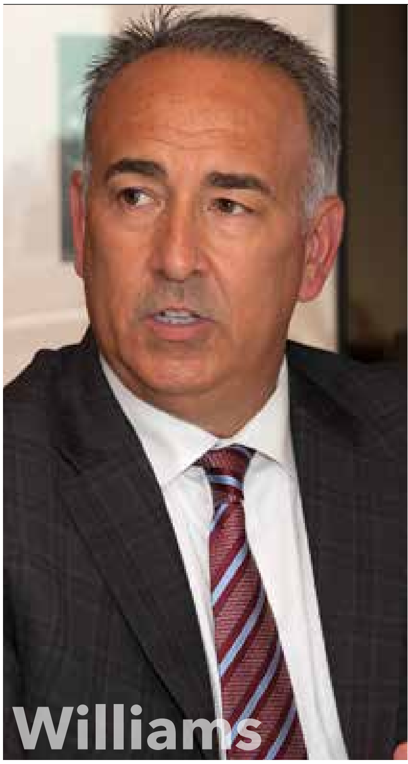
US MID-MARKET



Drumming for dollars

As the private mid-market debt asset class grows, choosing the right lending partnerships and financing diversification are uppermost in the minds of some of the market's leading operators. **Andrew Hedlund** sat down with seven US private debt experts to find out more

"THE MOST IMPORTANT PART OF THAT IS TO BE PROACTIVE, FROM A LEGAL AND A BUSINESS PERSPECTIVE – TO BE PROACTIVE, NOT REACTIVE"

Bill Brady

Fundraising may be slowing but you wouldn't know it talking to a group of mid-market lenders. Around $46 billion was raised in the first half of 2016, according to PDI Research & Analytics, a 22 percent drop on the same period last year. But those sat around the *PDI* roundtable rebutted the idea that investor interest in the private debt asset class has cooled this year.

The trendiness of mid-market lending has propelled a lot of capital into the space lately, they claim, giving rise to the notion that firms of all sizes might see some fundraising success rather than just those doing large-cap deals.

Alongside the growing interest in private credit, some participants said that global volatility could drive further interest in the asset class because of its ability to return higher yields for a reasonable amount of risk. However, none were ready to predict a downturn just yet, even though many have shifted their investment focus to debt higher in a company's capital structure, partly to mitigate any downside risk.

Q How has the fundraising market been this year?

Ted Koenig: Last year was probably our biggest fund-raise year ever. We raised a little over $1 billion in new capital for the Monroe platform, and this year we're on pace to exceed that amount. I think a big reason for that is there is a worldwide investor search for yield.

Kelli O'Connell: A lot of investors now recognise the many attractive attributes of middle-market private debt. Markets being what they are, we have also seen a lot of managers chasing these inflows of capital. But here's an important difference from three to five years ago. Then, we were educating investors about middle-market private debt as an asset class. Today, the bigger challenge as a manager is differentiating who you are and what products you provide.

Chris Williams: I will say that differentiation [between your firm and others] is the hardest, to the point that was just made. These people are seeing so many firms roll through their office and the middle-market, direct-lending term has been bastardised. Everyone wants to categorise themselves as a "middle-market direct lender" because it's a hot space to raise money right now.

Bill Brady: There is a lot of dry powder out there, and it seems to be not only growing, but growing in a way where every day or two there seems to be another entrant into the market who is successfully raising significant capital.

Brent Humphries: There has been significant capital formation by alternative credit investors but it's hard to get good data on the other side of the equation. So it's hard to really get your hand on whether there been a substantial increase in capital flow to the market, or are we just seeing capital exiting the sector being replaced structurally by non-bank lenders?

Rich Randall: We've had terrific success lately, and I think part of that is it's a defensive asset class whether we are talking about equity or infrastructure debt. I think it's become a bit en vogue to invest in infrastructure. Equity has been very successful in the past seven, eight years for us and now infrastructure debt.

Q What's your approach to risk management? How do you avoid defaults? And if – heaven forbid – somebody can't pay their debts, what do you do in the event of a restructuring?

Randy Schwimmer: One of the first questions we ask when we're considering a deal is, who else is in it? We are

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BILL BRADY, PARTNER AND HEAD OF ALTERNATIVE LENDER AND PRIVATE CREDIT PRACTICE, PAUL HASTINGS

- Paul Hastings' clients involved in both mid-market and large-cap deals
- Structures and negotiates deals that include unitranche, first lien, second lien, mezzanine and holdco loans
- Particularly active in private equity-backed deals
- Works on transactions in the US and Europe

all buy-and-hold investors who will stick together through difficult times. If you can support the borrower through the downturn, through the tough times, it will enhance the value for the owners and lenders as well. Knowing who your lenders are is as important as which sponsors you're investing alongside.

BH: The easiest way to make money in this industry is not to lose it in the first instance and to pick really good credits. We also focus on trying to build a thoughtfully constructed portfolio. Recurring revenue is a big theme of ours and 50 percent to 70 percent of our portfolio at any point in time will involve companies with a contractual or transactional recurring business model.

CW: [TwinBrook] typically [spends] 60 to 90 days on average getting to know these businesses before they become an asset in our portfolio. We like the detailed and consistent approach that PE firms bring to this aspect of the process. We also think where you invest in the capital stack and how you structure a transaction is equally important.

BB: From a legal perspective, there's really two primary pieces to this. The first is the front end – legal diligence and legal documentation. You want documentation to be tight. Documentation alone is clearly not going to get the lender repaid, but it gets you a seat at the table, hopefully sooner rather than later – which I think translates into the second phase, which is the restructuring itself. On the restructuring side, we typically stay with the credit when a deal goes into a workout or restructuring. The most important part of that is to be proactive, from a legal and a business perspective – to be proactive, not reactive.

TK: We focus strongly on credit as part of the underwriting process for an investment transaction and we are a proactive asset manager. We think we can catch a lot of performance issues early and that's the key to our business; being an agent, being able to control loan covenants, waivers and defaults and bring to bear whatever resources we need in the lower middle market to repair credit prior to defaults.

Q We've been in an era of growth – albeit tepid – for years now. Where does that put us in the credit cycle?

KO: It's difficult to paint the economy with a broad brush. Clearly, some segments are experiencing distress, particularly those that have significant direct commodity exposure. The good news for NXT and the economy generally is that the financial profiles of most portfolio companies are healthy. Of course, nothing lasts forever. As we consider a possible downturn in the credit cycle, NXT has shifted even more of its portfolio over the last 12 to 18 months to the most senior tranche of the capital stack. We expect that this will help minimise potential credit losses in a downturn.

RR: We look at the variables, the exogenous shocks that could hit our markets. We've never seen so many. We get these shocks and they go haywire for a couple of months. We saw that in January and February – they become great buying opportunities for us. But I think given all the liquidity sitting on the sidelines, it quickly rushes in and [the market] rights itself.

RS: We've learned over the last 20 years that it's impossible to predict when a cycle is going to begin or end. So we always forecast a recession by including in our models a downside case off the sponsor's

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Brent Humphries

"I DON'T SEE ANY TROUBLING SIGNS ON THE HORIZON, NOTWITHSTANDING THE FACT THAT WE MAY BE IN THE LATER INNINGS OF A CREDIT CYCLE"
Ted Koenig

case. That case is built off the company's historic performance and projected over the next several years. Every industry behaves differently in a downturn, so we sensitise the numbers differently for each business.

BB: I can tell you anecdotally what I see. Paul Hastings does a ton of deals each quarter. So anecdotally, based on the deals that we've been a part of, the second quarter [of 2016] is a bit of an aberration in that typically you see originations go up and restructurings go down or you see restructurings go up and originations go down. I'm scratching my head, to be honest with you, because in Q2 both went up based on the deals we see.

TK: I think it's about jobs. It's always been about jobs. It's hard to look at other things because the Western governments have gotten much more involved with stimulating their own economies. Complacency tends to happen when the stock markets are strong and it tends to mask other things. I don't see any troubling signs on the horizon, notwithstanding the fact that we may be in the later innings of a credit cycle.

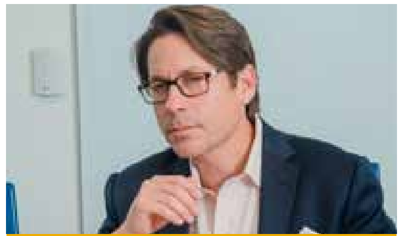
CW: We stress-test all businesses and run pretty severe downside scenarios. I think the benefit of today's market versus the last cycle is that you can see how most of these companies performed during the last significant recession (2008 to 2010). Prior to that, people were running downsides that weren't severe enough as I don't think anyone predicted the downside could go as far, for example in the housing market, as it did in 2008 and 2009.

Q When you're looking at partners, how do you pick that partner and look at what they might do or how they might perform in a downturn?

BH: It's really important that your partners are firms and people that you trust, that you have a historical relationship with and also have similar investment horizons and similar fund features. So picking your partners and making sure they have the flexibility in their fund structures to take the long view and are also investor return oriented, and are going to do what is reasonable to protect capital – these are all important considerations.

Q Are you planning on adding any new products – say BDCs or CLOs, investing in a new part of the capital stack – to your portfolios, or is the plan to stay the course?

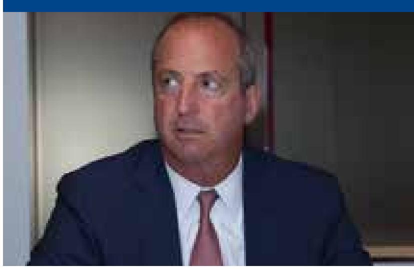
RR: Our business over the past 15, 16 years has been a managed accounts business. Then we found a good deal of appetite for our product, but a lot of investors can't meet our minimums for managed accounts, so we are looking at putting together a



BRENT HUMPHRIES
GROUP HEAD, AB – PRIVATE CREDIT INVESTORS

- AB - PCI is AllianceBernstein's mid-market lending platform
- Invests with emphasis on senior secured, unitranche loans, also does second lien and mezzanine loans
- Companies invested in typically have EBITDA of $10 million-$40 million when financing markets are liquid, will invest in larger companies in more volatile markets
- Focuses on US credits

TED KOENIG, PRESIDENT AND CHIEF EXECUTIVE OFFICER, MONROE CAPITAL



- Monroe targets lower mid-market companies with $3 million-$30 million in EBITDA
- Firm also operates a BDC, Monroe Capital Corporation
- Verticals include healthcare, media, technology, specialty finance and retail ABL
- Does mainly senior secured and unitranche loans

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KELLI O'CONNELL
MANAGING DIRECTOR AND HEAD OF ASSET MANAGEMENT, NXT CAPITAL

- NXT directly originates mid-market loans, particularly first lien, senior secured loans
- Mainly in private equity-sponsored deals
- Firm invests both its own capital as well as capital from the funds it manages
- Largely generalist firm though does have a specialised healthcare team

"AS WE CONSIDER A POSSIBLE DOWNTURN IN THE CREDIT CYCLE, NXT HAS SHIFTED EVEN MORE OF ITS PORTFOLIO … TO THE MOST SENIOR TRANCHE OF THE CAPITAL STACK"
Kelli O'Connell

pooled vehicle to go attract some of the smaller pension fund-type investors.

RS: Another important lesson from the [2008] credit crisis is how important diversification of funding sources is whether it's a CLO, a BDC, a credit fund, or a managed account. A CLO is not a strategy. A BDC is not a strategy. These are financing tools to help execute your strategy.

[Churchhill Asset Management] will employ that same strategy of building out multiple types of vehicles. TIAA is an amazing partner to have because of their own scope of investing activities. That's particularly the case with such things as CLO formation, where risk retention rules require asset managers to provide significant capital to their vehicles. You can't do this as a hobby. It's not something you can do in your living room.

BB: If you would have asked me 15 years ago what I did for work, I would have said I represent mezzanine lenders. That just happened to be the vast majority of the alternative lender deals. What I see among our clients is now, it's everything in the capital stack from senior secured to holdco and everything in between, whether its straight unitranche, bifurcated unitranche, first lien, second lien, or mezzanine.

CW: You've certainly got to diversify your funding sources over time to sustain long-term success. It is great to be able to provide investors with multiple investment vehicles (fund, CLO, BDC, etc). However, at the end of the day you have to have a really successful platform with an experienced team to be able to execute successfully.

KO: NXT relies on a proven strategy that has been successful over the past few decades. We fund our balance sheet through diversified sources that include CLOs. We don't play in the BDC arena and have no plans to enter it. NXT will continue to be a highly selective lender that focuses largely on sponsored transactions with an emphasis on more senior transactions.

Q How do you attract new investors?

KO: Middle-market senior lending can mean very different things, so we want to be sure investors understand where NXT should fit in [investors'] overall strategy. We are also spending additional time with existing investors, who are terrific sources of follow-on investments and referrals. One promising development is that as the asset class has grown up, many investors have created allocations specifically for private debt, so managers seeking allocations are not shuffled between departments.

RR: Our offering is relatively new to the US market. A lot of where we are is educating pension fund investors on our asset class.

RICH RANDALL, GLOBAL HEAD OF DEBT INVESTMENTS, IFM INVESTORS

- IFM Investors manages both debt and equity
- Larger number of investors are pension plans and insurance companies
- Investments in North America, Australia and Europe
- Investing in infrastructure for two decades

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When we do have success, we tend to attract very large tickets. We have a long road ahead of us in terms of educating the investor base.

Q One of the things some of you mentioned was diversification. Are there certain approaches you take to diversification?

CW: Our investment model and belief in how you effectively manage risk in this business is through effective diversification. We source from a group of over 300 PE firms and have closed deals with 215 different middle-market PE firms. We are also hyper-sensitive to limiting industry concentrations and position sizes. We feel strongly that the best way to limit volatility in our market is through effective diversification across all parts of the business.

RR: In infrastructure, obviously we have a lot of industry-type focus and sovereign focus. We are a global platform so we tend to offer diversity in terms of the globe, between the US, Europe, UK and Australia. We try to allocate our clients accordingly across those geographies to get diversity in our investments.

Q Brexit is all anyone ever wants to talk about lately. Obviously many of you are in the mid-market. Does Brexit come into play?

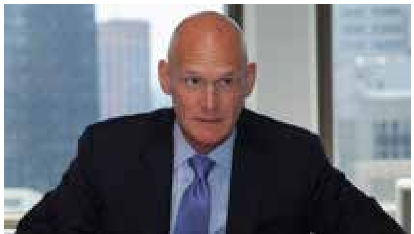
TK: I don't think it's going to be a big factor for middle-market lenders in the US. First, our market isn't affected as drastically by it, if at all. Our borrowers' revenues, customers and suppliers are not in Europe. Second, I don't think the final chapter on Brexit has been written. All that happened was it was an advisory vote. I think if they had the vote again today, they would vote a different way knowing what they now know.

BH: [Brexit] may make the private credit asset class look even better, in terms of the returns we are able to deliver at a lower level of volatility. So it could drive more interest in the asset class.

KO: Brexit shouldn't affect NXT directly because we don't originate loans in the UK or Europe and the exposure of our US borrowers to these markets is generally modest. But Brexit is clearly creating uncertainty in the UK and Europe. That could be positive for US middle-market private debt because the US should offer investors a more stable, attractive market in which to deploy capital.

RS: Brexit was just another chapter in the Euro/Asian volatility story that's played out across markets over the last several years, whether it's the panic last August about growth in China and energy prices or this summer with Brexit, which is why we believe one answer to that uncertainty is to have more of a domestic focus for our investors. The majority of revenues for middle-market companies are US-driven, from US customers, with US dollars. So that has been a helpful story to tell today.

BB: I think many people were surprised by the vote, some weren't – and uncertainty impacts the markets. You throw it in a bucket with the other 92,000 things in the world that are scaring people. Is it going to move the needle? Probably. Will it be a long term game-changer? I don't think so. ■



RANDY SCHWIMMER, SENIOR MANAGING DIRECTOR AND HEAD OF ORIGINATION AND CAPITAL MARKETS, CHURCHILL ASSET MANAGEMENT

- Churchill is a majority-owned TIAA affiliate originating senior debt in mid-market
- Types of debt include senior-stretch, first lien and unitranche
- Companies invested in typically have $15 million-$50 million in EBITDA
- Participates in mainly private equity-sponsored transactions

CHRIS WILLIAMS, PARTNER AND MID-MARKET DIRECT LENDING BUSINESS FOUNDER, TWINBROOK CAPITAL

- TwinBrook works with mid-market private equity firms
- Companies backed typically have EBITDA of $3 million-$50 million
- Largely generalist firm with verticals in aerospace and defense, healthcare and insurance, and financial services
- Has financed leveraged buyouts, recapitalisations and add-on acquisitions