NXT CAPITAL

# Exploiting opportunities in the US mid-market

Market shifts require an experienced hand on the tiller when seeking the best of US mid-market debt in 2016, write NXT Capital's **John Finnerty** and **Neil Rudd**

In 2016, the US middle-market will offer compelling investment opportunities to astute sponsors and investors. Broader market volatility will make the year more complex to navigate, but experienced, patient participants in the US middle-market will find opportunities to achieve attractive risk-adjusted returns.

On the positive side, transaction levels should generally be in line with 2015. Ample liquidity will be available, especially from non-bank capital providers. Most companies are expected to grow, particularly those in high-demand sectors such as healthcare and technology.

Yet 2016 will present challenges, including an economy in its seventh year of expansion and the ripple effects of a strong US dollar, volatile energy and commodity markets and slower Asian growth.

During these times, sponsors will turn to experienced, relationship-driven lenders that have been active through economic cycles and behaved rationally when a company had a setback. Investors will favour managers that focus on senior debt, have direct origination expertise and strong alignment with investors' interests. A manager's ability to mitigate risk by constructing highly diversified portfolios will be important, as will its proven experience managing through cycles.

## LIQUIDITY

Middle-market lending will be led by finance companies and other non-bank lenders that can provide flexible capital to meet the needs of many sponsors and deals.

John Finnerty

Banks will continue to be less active in financing traditional loans for more highly leveraged transactions, as the regulatory focus on these loans has reduced their risk appetite. Due to regulations, many sponsors are finding the structures proposed by banks are less flexible, with increased amortisation requirements and very little room for manoeuvre in adding acquisition lines for growth strategies.

Not all mid-market lenders will prosper in 2016.

"INVESTORS WILL FAVOUR MANAGERS THAT FOCUS ON SENIOR DEBT, HAVE DIRECT ORIGINATION EXPERTISE AND STRONG ALIGNMENT WITH INVESTORS' INTERESTS."

The most successful will be those with defined, proven investment standards; robust direct sourcing capabilities; deep-rooted investor and sponsor relationships; and the ability to consistently raise long-term flexible capital to fund future growth.

Newer, unproven platforms with limited access to capital and fewer relationships will struggle with market share, as will lenders grappling with investments in sectors such as oil, gas, commodities and mining. Lenders that depend heavily on access to the public debt and equity markets will face similar hurdles.

## SHIFTING TERMS

As the economy brought more liquidity to the middle-market in recent years, there was a steady shift toward more favorable terms for borrowers. This has been particularly evident in the high-yield and broadly syndicated loan markets, but it is also true of the mid-market.

Today, experienced lenders who have managed through multiple cycles are beginning to recalibrate terms to reflect prevailing conditions and the possibility of an economic downturn in the next few years.

In some cases, the pendulum is swinging towards more conservative terms, including tightened covenant packages, reduced "large market terms" and a dramatic drop in middle-market covenant-lite issuance. This discipline is critical for the long-term health of middle-market lending, but may temporarily impact activity as the market adjusts.

Although early, pricing for new middle-market deals has started to trend slowly upwards.

The recent actions of the Federal Reserve Bank, coupled with tightening institutional CLO markets and the pressure on public BDC valuations, are expected to lead to continued, gradual pricing upticks in the near-term. This will begin to reverse a fairly long period of contracted pricing that reflected the growing supply of low-cost middle-market capital.

However, by historical standards, interest rates remain comparatively low and are certainly attractive enough to transact deals.

### SPONSORS IN 2016

We anticipate that US middle-market transaction volume will stabilise after a 30 percent decline in 2015.

Equity sponsors still have significant dry powder to invest and, in addition to change-of-control transactions, sponsors are aggressively pursuing add-ons to support portfolio company growth. Ample liquidity will be available to support these transactions, especially from non-bank capital providers.

There is widespread concern about market dynamics so far into the credit cycle, yet we believe US companies generally will be stable and that most industries will experience modest growth. Several sectors including healthcare, technology and businesses providing goods and services at moderate price points are expected to be particularly appealing opportunities.

Indeed, a number of sources, not to mention the timing of the Fed's long-awaited rate increase, suggest that the economy still has room to expand.

Yet 2016 does not look entirely rosy for sponsors.

Competition for the best acquisition targets will keep valuations high. If the economy softens, it may create a disconnect between seller and buyer valuation expectations that could make deals more difficult to complete. As discussed, terms are shifting and pricing for new deals may rise.


Neil Rudd

Sponsors will respond to these challenges by consistently choosing experienced, relationship-driven non-bank lenders that have proven their ability to offer flexible terms to address complex deals and maximise enterprise value. Sponsors will also seek lenders that have a track record through numerous cycles and a collaborative approach to resolving issues.

### INVESTOR APPETITE

Investors increasingly recognise the benefits of middle-market loans, in particular their compelling yield and performance attributes relative to broadly syndicated loans. In recent years, we've seen many investors define US private debt as a distinct asset class, rather than part of fixed-income or alternatives, and make meaningful commitments to funds investing in middle-market loans. We expect this trend to continue in 2016.

As the US economy continues to perform better than most developed countries, US middle-market loans will remain a desirable asset class for domestic and foreign investors this year.

Funds comprised of a diversified portfolio of first-lien, senior-secured loans will be especially appealing, offering stability, current income, asset diversification and downside capital preservation.

Yet it is important to recognise that most current investors have not seen the asset class through a credit cycle.

If investors anticipate a slower economy, we expect to see priorities shift to favour risk-adjusted returns over absolute returns on underlying loans. In addition, investors will become more selective in choosing managers and place greater importance on their track records in managing mid-market loan portfolios through interest rate and credit cycles.

Better intelligence will facilitate that choice. Investors who have made multiple middle-market loan investments and their advisors can now review actual track records to evaluate performance versus expectations. Those considering follow-on investments will make additional commitments to managers that have proven their ability to deliver compelling results.

Savvy investors are also expanding their evaluation criteria to consider the alignment between their interests and those of potential managers. This trend will intensify in 2016, with investors preferring managers that put their own capital at risk – and whose earnings are highly correlated to the performance of the underlying assets – rather than giving so much weight to the magnitude of a manager's assets under management.

Between active transaction volume, growing companies and ample liquidity, the 2016 outlook is generally positive. Although some clouds linger, prudent, disciplined sponsors and investors will find compelling opportunities in the US middle-market. ■

## PROFILE

**John Finnerty** leads NXT Capital's corporate finance group and **Neil Rudd** is NXT's chief financial officer. A leading provider of structured financing to the middle-market, NXT Capital's asset management platform offers proprietary access to floating-rate middle-market loans sourced nationally through NXT's direct origination network.