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Why Sponsored Deals?

Prospective investors often ask, “Why does NXT Capital focus on the sponsored market? Why not source opportunities directly?” These are good questions. Their answers reveal a fundamental difference in a manager’s strategy that has far-reaching impact on investors.

For NXT Capital, the answer is clear: In the lower-middle market, we believe that a private equity-sponsored strategy provides stronger, more stable risk-adjusted returns over the long term. This is the result of more effective deal sourcing and due diligence, availability of growth capital and management expertise, and support throughout the life of a loan.

In our opinion, the slightly higher upfront yield that a direct strategy may offer today creates additional risk.

More Competitive Deal Sourcing

The advantages of a sponsored strategy start at the beginning of the deal process or “sourcing.”

Managers that use a direct strategy must constantly find deal opportunities. This requires building relationships with bankers, accountants, attorneys and trade organizations, while also cold-calling potential deal sources. The process is time-consuming, and we feel may result in a limited number of deals from which to choose.

In our experience, sourcing through private equity sponsors gives managers consistent access to a high volume of investment opportunities. In addition to more predictable capital deployment, the larger pool of opportunities also may allow managers to be more selective.

A few direct lenders, including NXT Capital, have long-term relationships with sponsors and are viewed as preferred financing sources. We believe this provides a competitive advantage in sourcing.

Stronger Due Diligence

The standard for private equity due diligence is very high, resulting in much more robust information than that provided to lenders in non-sponsored investments.

A typical private equity transaction will include accounting diligence performed by a nationally recognized firm to validate the integrity of the numbers,

and in-depth industry analysis including the competitive landscape, customer relationships and more.

In our lead role in loans, NXT Capital works closely with our sponsor partners to conduct deep due diligence on potential investments. We also maintain relationships with sponsors who have substantial investment and operating experience in a particular industry, and can offer additional insight or access to experts.

Support from Start to Finish

NXT Capital underwrites not only the borrower, but also the sponsor’s investment thesis. Sponsors often work with company management to grow the business and add enterprise value. This improves loan-to-value and can potentially de-risk the investment more quickly than non-sponsored companies that do not have access to this support.

Sponsors’ industry networks and operating expertise can be instrumental in helping portfolio companies succeed. This includes cost savings and diversity through access to new suppliers, building revenue and reliability with new customers, as well as helping identify new acquisition targets and executing those transactions. Sponsors also help management improve financial analysis and reporting.

NXT Capital’s investment horizon and that of a private equity sponsor generally match, which may facilitate faster realization when investments perform as planned. But if companies encounter stress, sponsors are an

important source of additional liquidity and financial support, as well as operating experience and deal-making networks. With purchase price multiples high today, sponsors are making large investments that create substantial equity cushions for our senior loans, and provide strong incentives for sponsors to support investments through the life of the loan. These important tools for preserving a senior loan's value are not available to borrowers that are not private equity-owned.

Beyond financial support, sponsors can provide critical benefits if a company's issues escalate to a workout situation. Sponsors have workout experience. They are also more efficient and effective in reaching a positive outcome for all parties. In contrast, when directly sourced deals escalate to a workout, managers may lack capital to support the company and have little or no experience working through such difficult situations.

Changing Market Dynamics

These are all good reasons why NXT Capital focuses on the sponsored market. However, another important reason may be on the horizon. Yield premiums are likely to compress and losses are expected to expand, which may create greater risk for managers using a direct strategy.

Rising asset prices are leading more private equity firms to move down market to find buy-and-build targets, which leads to additional acquisitions of smaller companies. The result? When sponsors absorb most of the desirable lower-middle market assets, there are significantly fewer high-quality opportunities available for direct managers to source. As this trend continues, non-sponsored managers may face difficulty deploying capital and possibly in recoveries.

In our experience, most investors are focused on risk-adjusted returns. While a direct strategy may provide slightly higher upfront yield today, the risks associated with a direct strategy are, in our opinion, likely to drive higher losses, reducing return. Over the years, we have found that maintaining strong relationships with private equity sponsors is key to developing a well-diversified, consistently performing middle market portfolio. Sponsors provide the consistent, credible deal flow, thorough due diligence and significant company support that NXT Capital seeks for our investments and our investors.

About NXT Capital

NXT Capital, based in Chicago with over 100 professionals, is a leading provider of senior structured financing solutions to the U.S. middle market. Since inception to 12/31/2021, the company has originated approximately \$25.4 billion in total direct lending financing volume spread over 1,021 transactions. NXT Capital also manages capital for third parties through its broad platform with multiple funds and separate accounts. Investment programs are managed by NXT Capital Investment Advisers, LLC, which is registered with the SEC as an investment adviser. Registration with the SEC does not imply a certain level of skill or training.



Ted Denniston Head of Originations

Ted leads NXT Capital's origination efforts. His team is responsible for originating and closing new transactions, as well as maintaining relationships with private equity clients in the U.S. In addition, Ted is involved in

the group's strategic planning and broader marketing efforts. Ted is a member of NXT's Credit and Investment Committees.

Ted brings over 25 years of experience in credit, originations and portfolio management to NXT. Previously, Ted was a Director at Merrill Lynch Capital, where he was responsible for sourcing, closing and managing transactions with private equity firms in the Northeast. Ted also spent nine years in a variety of roles at Transamerica Commercial Finance.

Ted majored in Business Administration at Emporia State University.

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