E X P E R T Q & A

Maintaining a consistent approach to terms and deployment is something LPs value in the mid-market lending space, say Ted Denniston and Joe Lazewski, co-heads of NXT Capital

Standing out in the lower mid-market

Q What are the biggest lessons you have learned about underwriting and evaluating downside risk in the lower mid-market over your 25-plus years in the space?

Joe Lazewski: There is a lot of uncertainty in the market at the moment, given the geopolitical backdrop, and that has given rise to many questions from investors about the resilience of different parts of the market and different investment strategies. What we have learned through the various cycles is that our job is not to predict the next crisis, but to build a portfolio designed to remain resilient in challenging environments.

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We play in the lower mid-market space, all of our deals are private equity-backed and have financial maintenance covenants. When you combine the financial support and the wherewithal of top-tier financial sponsors with the protections of maintenance covenants, it results in us having an enhanced credit position for deals.

What we have learned is that you are likely to have economic shocks in a fund's lifetime, and you are going to have deals that do not go as planned. That is just reality, so the diversity of the portfolio, the sectors in which you choose to be active, the financial sponsors with which you work and the covenants that you secure are what provides for better outcomes.

We avoid investing in sectors that have historically had the highest default rates due to their dependence on the overall economy. We do not invest in travel and leisure, restaurants, hotels or gaming, nor do we invest in oil and gas or energy. We believe this gives us that additional layer of protection upfront by avoiding those volatile sectors in the composition of our portfolio at the front end.

Ted Denniston: The other important thing is to play to your strengths. When uncertain economic situations arise, you want to know what you are dealing

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with – you do not want to find yourself working in a portfolio or an industry where you have limited experience.

Avoid the temptation to chase opportunities that merely look attractive on entry – whether it's an oil and gas deal or a non sponsored loan – if you lack a long track record and the experience to manage problems that may arise. One thing that our investors really appreciate is that we have avoided strategy drift and stayed true to our targeted approach.

Q The lower mid-market has gained significant traction with investors. What makes this part of the market so appealing?

TD: One of the attributes that is really appealing about the lower mid-market is that the data is starting to prove one of our long-held philosophies – it is a safer place to put your money if you want to achieve consistent returns. When private credit first developed, the assumption among investors was that bigger was better, and that smaller companies would be the most challenged in the event of rising interest rates or other economic headwinds.

What people have learned since is that, when done right, the lower mid-market offers stronger financial covenants, stronger financial reporting, and direct dialogue with both chief financial officers and private equity sponsors.

All of this is borne out in recovery rates. In the broadly syndicated loan market, you are seeing recoveries of 50 percent or lower, whereas we are still running above 80 percent. Our recovery rates have been higher than the upper end of the market since our inception, and that is largely due to the underwriting and the controls we have in place.

At the same time, the upper mid-market space is becoming much more crowded. If you are going to compete with the broadly syndicated loan market, you have to accept the terms that are typical in that market. The cash return for investors is also undermined in that market by the prevalence of payment-in-kind structures, whereas our loans are cash-paying from day one.

JL: Structural provisions in lower mid-market documentation are also compelling. We aren't seeing the kind of liability management exercises that are damaging recoveries at the upper end of the market. We have controls in our documentation that help us to avoid those situations, as well as the fact that most of our deals involve sole

Q Deployment speed is another critical factor for LPs. How can managers balance the challenges associated with timely capital deployment while maintaining discipline?

TD: Deployment is one of the biggest challenges that most of our competitors are facing because private credit funds have seen record inflows and there are not enough deals out there for us all to put capital to work.

For us, this is all about discipline. We are not growing for the sake of growth; we will continue to raise capital that we know we can confidently deploy without drifting from our strategy. This is the fundamental question LPs should be focusing on when assessing managers, because deployment for the sake of deployment can really impact loss rates.

The other piece to this discussion is that we are investing our own capital right alongside our investors. So, unlike with carried interest programmes, where a manager is participating in the upside, we are also participating in the downside. If a loan goes wrong, we lose money on our balance sheet.

JL: Our goal is to be consistent in our approach, our strategy and our investment activity. That is why we favour working with market-leading private equity sponsors, because they are not chasing growth either and are less vulnerable to strategy drift or adverse selection in the assets that they are able to win.

The sponsors that we work with get early looks at transactions and they win the top-quality transactions. We are building a portfolio with experienced sponsors, and that experience really pays off in adverse economic situations.

lenders or small clubs versus much larger lender groups.

Q Investors are concerned about macroeconomic headwinds like tariffs, interest rates and economic downturns. How have lower mid-market strategies performed when tested through past cycles?

TD: The fact we are a 100 percent sponsor-backed lender is an important differentiator. It has helped us to navigate through some of those economic cycles because we only work with sponsors that stand behind their investments. Since inception, we've deployed $32.1 billion, and during market stress, our private equity sponsors have injected more than $1.8 billion of defensive capital into our portfolio companies – a level of sponsor backing few platforms our size can match.

JL: Financial covenants also make a real difference. In the mid-market, our discussions with private equity groups in the event of challenges happens much earlier than it would in a covenant-lite transaction – in that instance, you would need to wait for companies to run out of money. We are able to begin that dialogue much sooner in an economic shock environment.

In terms of our strategies, we look to work with companies that have high organic growth rates in industries that also have high growth rates. Therefore, if an industry is expecting 10 percent growth and that projection is suddenly halved, you are still working within a relatively high-growth industry.

We work with businesses that are providing services or products that are purchased frequently and at a low cost, and that are backed by large, experienced private equity groups, most of which are managing more than $1 billion in capital. We find that this strategy tends to perform well when tested through cycles.

Q What should LPs consider when assessing managers in the lower mid-market? Has the market become much more competitive?

JL: From our perspective, the landscape of scaled direct competitors in the lower mid-market has not really changed over the last five years. Some very large managers have emerged in the upper mid-market, but our competitive set has arguably fewer names now than it did in the past as so many of our peers have migrated towards those bigger deals.

We do see larger players dropping down into the lower mid-market on occasion, typically based on long-standing sponsor relationships. But our average EBITDA was $25 million last year, so those managers with multibillion-dollar funds are going to take a very long time to deploy their funds if they are doing deals at that size.

TD: We believe the way to differentiate yourself as a manager in this space is with a dependable sourcing model that is based on strong relationships with private equity sponsors and access to high-quality dealflow. This allows you to be selective in your dealmaking and maintain consistency in your deployment and underwriting discipline.

The main thing that private equity sponsors are looking for is certainty. When larger firms dip down into the lower mid-market, private equity firms understand that they cannot count on them to stick around once the billion-dollar deals open up again.

We do see tourists in our market, but that is not as prevalent a trend as it used to be. Even so, LPs really need to look for that consistent strategy and commitment when they assess managers in this part of the market. ■