EXPERT Q&A

The lower mid-market offers distinct advantages in all kinds of macroeconomic weather, say NXT Capital co-heads Ted Denniston and Joe Lazewski

Bigger is not always better

The private credit industry has enjoyed massive growth over the last few years, and most managers will admit that boom was fed by factors well outside their control, including accelerated recognition by both institutional and retail investor channels to the attractiveness of the space. This increased capital base had the incremental benefit of the syndicated markets seizing up for a spell. Now that the broadly syndicated market is showing signs of life, there are questions about what this means for private credit going forward.

Ted Denniston and Joe Lazewski, the co-heads of NXT Capital, a subsidiary of ORIX USA, argue that the lower mid-market can be far less susceptible to the slings and arrows of the macroeconomic environment, and offers more opportunities and protections than larger transactions.

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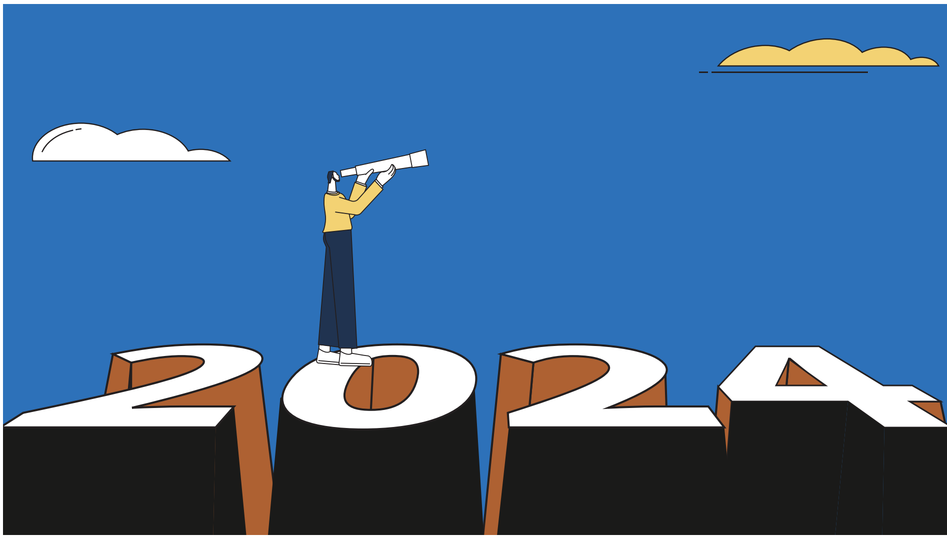
Q How do you view the market at the moment?

Ted Denniston: We see the opportunity set recovering nicely from a year ago with a 25-35 percent increase in dealflow coming into our shop. So, we feel encouraged by that. Our focus is on the lower mid-market, which for us are companies with less than $35 million EBITDA. We do exclusively sponsor-backed, first lien transactions, require 100 percent cash pay interest, and every transaction we do has a financial covenant.

We find that the lower mid-market has remained fairly disciplined and with somewhat limited competition. Our part of the market tends to have the same focused players and it has been that way for many years. This stands in contrast to all the new entrants and massive amounts of money being raised in the core and upper mid-markets, potentially impacting the terms at that end of the market.

A year ago, money was pouring into the upper market because as rates moved and the broadly syndicated market stalled, upper mid-market lenders were able to increase pricing dramatically. Fast forward to now, and we're seeing those spreads compressed by 100 to 200 basis points on the yield side, and their documentation terms are eroding rather quickly. The lower mid-market has seen far less erosion around terms and greater discipline around financial covenants and price.

> *"There are simply fewer established, tenured managers that have remained committed to these smaller transactions, and astute investors are recognising this"*
>
> **JOE LAZEWSKI**



Joe Lazewski: I'd add that our universe of established competitors has shrunk over this time as well. Many firms we competed with five to 10 years ago decided to move up market. There are simply fewer established, tenured managers that have remained committed to these smaller transactions, and astute investors are recognising this.

Q Many historical lower mid-market firms have moved to the upper mid-market, especially with the syndicated market slowing down as dramatically as it did. But now that the syndicated market is starting back up, what does that mean for managers?

TD: As some of our competitors raised significant levels of third-party capital, they made a conscious decision to move away from the lower mid-market, focusing on the kind of larger deals that were once served by the BSL market.

The upper market allows managers to deploy larger pools of capital more expeditiously. It takes a long time to deploy $5 billion, $100 million at a time, and the large market managers may deploy $1 billion or more into a single transaction. The return of the BSL market has reintroduced competing capital and has put pressure on terms.

Some of the firms that elected to move up market have chased a few deals in in the lower mid-market space, but there is no mass gravitation towards our niche. Relatively speaking we have been insulated from those pressures because we have never drifted from our strategy, and the private equity groups we work with recognise that.

Q What exactly are those weatherproof advantages to focusing on smaller deals?

TD: We work with very large sponsors buying small businesses. When some people think of the lower mid-market, they think of small, debut or second-time private equity funds with limited experience. We focus on seventh, eighth, ninth, tenth time funds that manage $2 billion to $4 billion funds. The intrinsic strength that we see is due to the private equity firms' ability to fund growth or liquidity, depending on whether we're in a good or challenging macroeconomic environment.

We have consistently seen these experienced sponsors support their companies in strong environments and when they need help. They acquire companies with a three-to-five-year growth plan, prepared to fuel growth with their significant capital resources. They have also been there when an investment hits a speed bump or interest rates go up by 400 basis points.

These larger funds are not stretching themselves to buy lower mid-market companies. They enter investments planning to provide incremental capital and they support these companies very well.

In terms of protections, having a financial covenant is gospel for many of us who have spent 25-plus years in the industry. People in this market may ask, "What's so necessary about a covenant? If a company is a good company, you don't need a covenant." We have been doing this long enough to know that despite the best underwriting, some deals are going to go off-track.

Financial covenants establish a guard rail when deals vary too far from

Q Let's take a look ahead. What do you expect from the lower mid-market in the next one to three years?

JL: We don't view this time in the market as the 'golden age of credit'. The reason for that is we fundamentally believe this part of the market, and the opportunities here, have been here for decades and will be here for decades to come. Twenty-five years ago, we were financing companies of this size, and there are still thousands of attractive lower middle companies in this market. Entrepreneurs are constantly founding companies, growing them, and looking for exits or growth partners. There are new businesses started every day, and they are the pipeline of lower mid-market companies for tomorrow.

I do think the lower mid-market direct lending channel has some barriers to entry for those looking to enter. Managers will need the expertise that only comes with time. Those who moved up market over the last few years may struggle to come back to this stable, growing category. This is a specialised area where experience, expertise and relationships count. With these advantages, and by utilising our own model, we have achieved strong returns for our investor partners, and we do not intend on changing anytime soon.

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>
> **TED DENNISTON**

expectations. We set covenants at a level where our private equity sponsors still see significant value in their investment. When the covenant is approached or tripped, these larger sponsors are well equipped to provide capital to support their initial investment.

It's a fundamental strength when investing in these kinds of deals and has been part of our investment philosophy since the inception of our firm in 2010.

We also have direct access to the executive suite at the borrower and to the private equity sponsor deal leads. This type of access gets diluted as you go up towards the larger end of the market. Another important factor is that we manage the revolvers on every one of our borrowers. We don't outsource or offload that to anyone else. As revolver utilisation increases, we are able to observe this leading indicator of potential financial problems. Our team uses this indicator as a catalyst to reach out and talk to the company and sponsor to socialise the issue.

Q Even given those intrinsic advantages, eventually a decision must be made about a particular opportunity. So, what do you look for?

JL: In our view, scale does not make a company better, or stronger, or more financeable. What we look for are businesses that are at low average sales points, with high recurring purchases, very stable cashflows, and organic industry growth expectations in excess of GDP growth rates.

We also look at the breadth of their customer base, and in an inflationary environment, see if their sales prices/cost of service relatively insignificant to their customers compared with the value they provide. We want them to be able to pass through price increases with limited friction because it is relatively insignificant in the grand scheme of the customers enterprise.

In our experience, we've seen many large companies fail and smaller, lower mid-market companies be successful. In our view, the critical attribute to understand is the value and necessity of what they provide to their customers.

There is no substitute for experience, and we've been focused at this end of the market, for a very long time. We've spent 25-plus years in the lower mid-market and our investment professionals have an average of 10 years' experience. That's a significant amount of time looking at and understanding these types of companies and building close relationships with sponsors.

Q Your sponsor relationships appear integral to your investment model. How do you maintain them when you have to pass on any number of transactions?

TD: While we have strong relationships with the sponsors, we underwrite the company, not the sponsor. There is a sponsor we've closed 20 transactions with over many years but have turned them down multiple times on companies that they went on and bought. Transparency and communication are the important parts of the relationship.

When we see a deal that doesn't meet our criteria, we quickly say it's not a fit for us. Consistency is also important. If we're holding every company to the same standard, then a sponsor is far less likely to take a decision personally. If we set some metric aside for a 'special opportunity' then other sponsors will be looking for us to set metrics aside for their own 'special opportunity'. ■