SHIFTING GEARS: INVESTORS HEAD TOWARD THE US LOWER MIDDLE MARKET

JUNE 2018

In association with

NXT CAPITAL

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ABOUT

Following Preqin and NXT Capital's report **Growing Interest in the Lower Middle Market in 2017**, this year's report, **Shifting Gears**, revisits attitudes towards, and appetite for, the US lower middle market* among the institutional investor community 12 months on.

The results of the survey conducted in Spring 2018, coupled with Preqin's market-leading data on the private debt industry, show that lower-middle-market direct lending in the US is increasingly at the forefront of investors' minds due to the market's perceived resilience to cycle change and attractive risk/return profile.

Preqin Contributors: Tom Carr | Douglas Paolillo
NXT Capital Contributors: Robert Radway

**The lower middle market is defined by NXT Capital as companies with sub-$50mn in EBITDA and/or typical transaction sizes between $30mn and $150mn.*

ABOUT PREQIN

Preqin is the leading source of information for the alternative assets industry, providing insight and analysis gathered by its global teams of dedicated researchers. Our products and services are utilized by more than 60,000 professionals located in over 90 countries for a range of activities including investor relations, fundraising and marketing, and market research.

Founded in 2003, the company is a frequent source of intelligence used in the global financial press, through its online databases, regular publications and bespoke data requests and operates from offices in New York, London, Singapore, San Francisco, Hong Kong, Manila and Guangzhou.

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ABOUT NXT CAPITAL

NXT Capital is a leading provider of structured financing to the U.S. middle market. Since its formation in 2010, the company has originated approximately $20bn in total financing volume spread over 600+ transactions. With $12bn of committed capital at its disposal, NXT provides a full range of structured financing solutions on a direct basis through its Corporate Finance and Real Estate Finance groups. NXT manages capital for third parties through its asset management platform and offers investors proprietary access to primarily first lien senior secured loans that are not broadly traded or otherwise generally available without a loan origination platform. Investment offerings include levered and unlevered funds, separately managed accounts and CLOs. NXT's investor base includes public and private pension plans, insurance companies, endowments, foundations and other institutional investors. NXT Capital Investment Advisers, LLC, a subsidiary of NXT Capital LLC, is registered with the SEC as an Investment Adviser.

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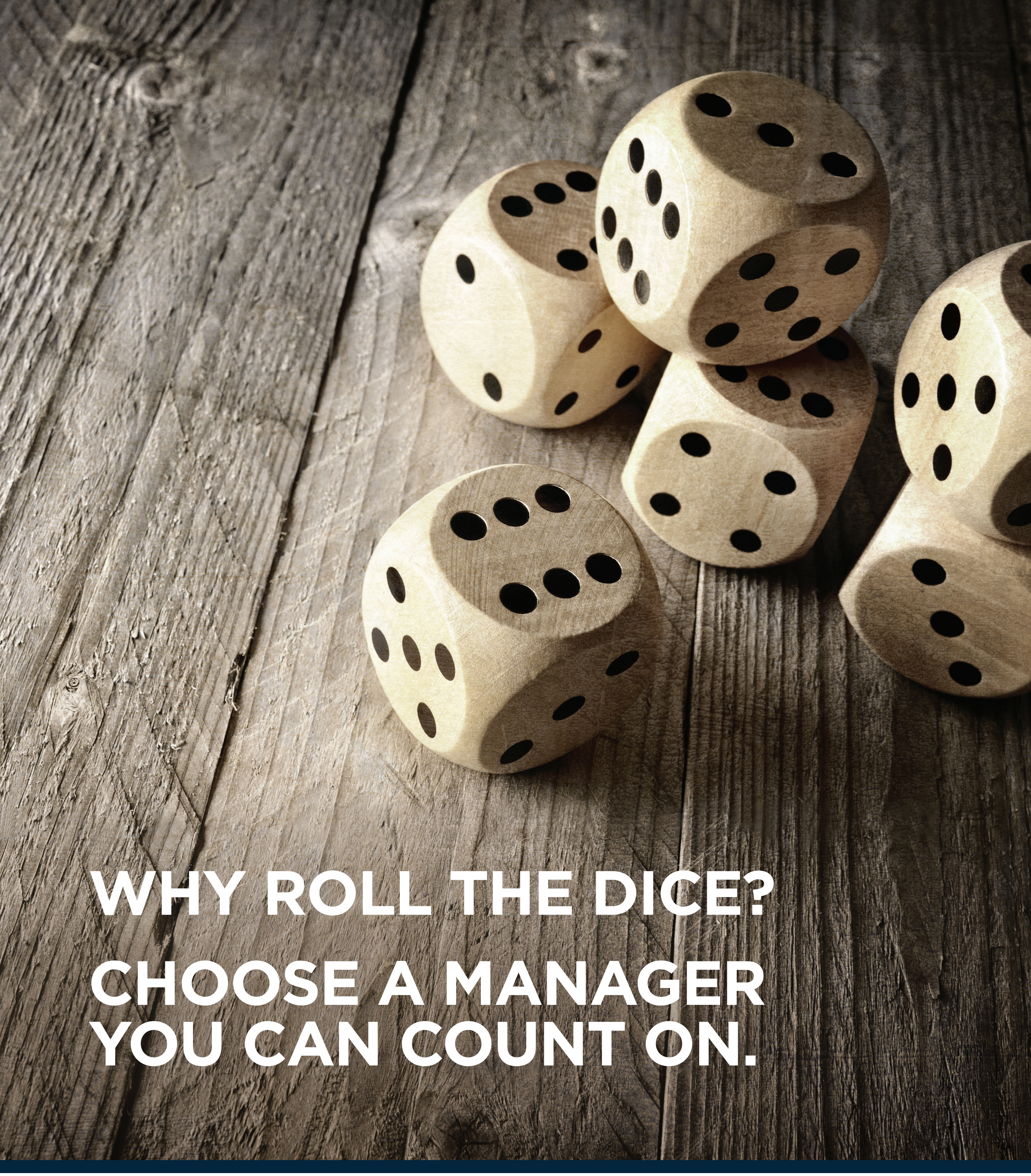
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A CLOSER LOOK AT US LOWER-MIDDLE-MARKET PRIVATE DEBT
- Robert Radway, **NXT Capital**

Tom Carr: What is most interesting about this year's survey?
Robert Radway: *Shifting Gears* offers many insights, but one of the top takeaways is the growing investor knowledge about US middle-market private debt and how the asset class is maturing.

It is clear that investors have a greater understanding of US middle-market private debt and its benefits. They are beginning to recognize differences between various lending or product strategies, as well as increasingly distinguish between managers that have proven origination platforms to deploy funds and that demonstrate investment activity that is consistent with their articulated strategy.

As a result, we no longer spend as much time educating investors about middle-market private debt as an asset class. Instead we spend time exploring whether our approach and the investment vehicles we offer can help investors accomplish their objectives. For example, NXT has raised multiple funds and separately managed accounts that offer access to the middle-market loans we originate and manage, which generally involve lower-middle-market companies. We couple that focus with the possibility of investing in both levered and unlevered vehicles to suit specific investor preferences and parameters.

TC: Why is US middle-market private debt appealing to investors?
RR: This year's survey identifies three key reasons why investors that are currently allocating to US lower-middle-market direct lending plan to continue doing so, and why more than half expect to increase their investments to this part of the private debt market.

Investors are looking for higher risk-adjusted returns than other fixed income assets, as well as portfolio diversification. They are also seeking protection from rising interest rates based on the floating rate nature of the underlying loans. A well-constructed lower-middle-market portfolio of senior loans meets these criteria.

Resilience is another aspect of US lower-middle-market private debt portfolios that appeals to investors. According to *Shifting Gears*, investors believe such portfolios offer a greater degree of protection in a downturn compared to both broadly syndicated loans and/or upper-middle-market private debt in general. We believe this speaks to investors' recognition that lower-middle-market corporate loans typically include more conservative structures and covenants.

TC: Given today's investment climate, does lower-middle-market private debt still offer attractive opportunities?
RR: NXT is seeing a strong flow of appealing direct lending opportunities and our origination and deal selection strategies are achieving expected results, so we firmly believe that lower-middle-market private debt continues to meet many investors' needs.

This year's survey confirms that investors agree. Risk-adjusted returns remain compelling and nearly 70% of investors surveyed indicated that returns either exceeded or met their expectations. This helps explain why more than 95% of respondents have an allocation for private debt and 86% have an allocation specifically for US lower-middle-market managers.

Equally important, two-thirds of investors plan to increase the size of their private debt allocation over the next two years, and more than 50% anticipate expanding their allocation to the US lower middle market.

TC: The survey shows growing investor interest in special situations and distressed debt. Does this mean straight senior debt is falling out of favour?
RR: The *Shifting Gears* report reveals ongoing demand for direct lending, which is consistent with our experience and what we are hearing from LPs.

Growing interest in special situations and distressed debt speaks largely to an anticipation of a cycle change. Indeed, many of the new lenders and managers that have entered US middle-market private debt are focused on these strategies.

Based on our discussions, investors view direct lending overall and senior debt in particular as an anchor of their US middle-market private debt portfolios. Once those investments are in place, some investors are diversifying their portfolios with niche or opportunistic strategies in distressed, industry verticals or junior capital strategies involving mezzanine or second lien transactions.

Another interpretation is that investor interest in a range of strategies supports the growing maturity of US middle-market private debt as an asset class. Investors are distinguishing between various opportunities in middle-market private debt and building more complex portfolios.

TC: Are we at the top of the credit cycle? Has NXT changed its investment approach accordingly?
RR: Today's cycle is undoubtedly extended on a historical basis, but market timing is extremely difficult to predict. As a result, NXT uses the same rigorous underwriting standards and credit discipline in every cycle.

Nonetheless, we have expanded our origination efforts to increase deal flow and market coverage. We continue to align with top sponsors that have a proven record of supporting deals. Last, while we may be slightly more aggressive in competing for transactions about which we have conviction, we do not hesitate to walk away from deals that do not fit our parameters.

TC: What is NXT doing to mitigate risk in the face of an inevitable cycle change?
RR: We believe that it is important to build diversified fund portfolios in every market. Each of our loan funds consists of more than 100 positions, so an adverse event in a small number of loans will have a minimal impact on the overall fund performance. In contrast, other middle-market direct loan portfolios typically consist of 20 to 40 larger positions, which creates more concentrated risk.

In addition, NXT holds on its own balance sheet a portion of every corporate loan we originate. This reinforces our commitment to rigorous underwriting and credit discipline. Equally important, holding loans for our own account means we are serious about negotiating credit agreements to ensure that we can get the borrower and/or sponsor to the table to address issues in a timely manner.

Last, we provide only straight senior debt. This puts NXT and our investors in the most senior position, which affords greater downside protection.

TC: Has investor due diligence changed as US middle-market private debt has matured as an asset class?
RR: Absolutely, and in a very positive way. Investors are looking for metrics to demonstrate the extent to which a manager's activity is consistent with the strategy it presents. Nearly 50% of survey participants identified this as the first or second most important factor they consider when choosing an asset manager. In the past, investors generally took those statements on faith. Today, they are requesting data to prove it.

Increased due diligence is another reason investors tend to favour experienced asset managers. In addition to having the relationships and origination platforms to ensure a steady stream of high-quality deal opportunities, established managers have a track record that details their activity and systems to respond to due diligence requests and provide market insight.

TC: Is it surprising that investors are so interested in the lower middle market since it is not liquid and smaller companies are often viewed as riskier?
RR: Not at all. As investors learn more about the US lower middle market, they realize financing a company with $10mn of EBITDA is not necessarily riskier than financing a company with $75mn of EBITDA.

For example, NXT's underwriting criteria are consistent regardless of a company's EBITDA. That is, we evaluate a company's strength based on key attributes such as recurring revenue, number of products/SKUs, customer diversification, lack of supplier concentration, overall consistency of historical performance and so on. A company that meets our underwriting criteria is likely to be resilient whether it is small or large.

The smaller size of lower-middle-market transactions also means NXT can finance the entire deal. This provides substantially more control than a larger transaction with multiple lenders. As a sole lender, NXT can set tighter covenants and insist on more conservative structures. For example, senior and total leverage for these deals is typically around 4.0x and 5.5x, respectively, compared to the 5x and 7x we see currently done for larger deals.

Further, we have a team dedicated to monitoring every loan on an ongoing basis. Borrower performance issues are identified early, so we can resolve problems before they escalate. In addition, since nearly all NXT transactions are private equity-sponsored, the sponsor also has substantial incentives to be part of the solution when a deal is off track.

TC: Growing investor interest in US middle-market direct lending has led to corresponding growth in the number of lenders serving the middle market and managers offering these assets. Is the market overcrowded?
RR: On an aggregate level, there are many more managers offering middle-market loan funds today than five years ago. However, the broad scope of US middle-market direct lending can make those numbers deceptive.

New managers may focus on straight senior debt, unitranche, mezzanine, distressed debt, special situations, real estate, infrastructure, various geographies or a combination of strategies. A rush of new managers in specialty segments attracts attention, but it has little or no impact on established managers such as NXT that specialize in senior debt for sponsor-backed lower-middle-market companies.

Questions about a crowded market also revolve around whether there are enough high-quality lending opportunities. Given the tremendous size of the middle market, the answer depends largely on a lender's ability to access quality deal flow based on relationships and a proven origination platform.

NXT has built decades-long relationships with private equity firms that understand our credit parameters, and they consistently show us transactions and rely on NXT for a quick response. We have also built a proven underwriting and transaction funding process that sponsors know will provide a smooth and efficient closing. It takes time to build these relationships and platforms, so newer lenders may find it difficult to access quality deal opportunities.

It may be tempting to view US middle-market private debt through the lens of an extended cycle, large capital inflows and a growing number of asset managers. Yet the *Shifting Gears* report offers a more positive and compelling perspective. Investors recognize that US middle-market private debt offers valuable benefits and resilience, especially when working with proven asset managers that have proprietary origination platforms and access to high quality deals. The next few years may present some challenges in terms of the rate of capital deployment among different managers and the inherent risks of lending at the peak of the economic cycle, but NXT firmly believes that US lower-middle-market debt will continue to mature as an asset class. Over time, it will become a standard component of many investor portfolios.

DIRECT LENDING IN CONTEXT

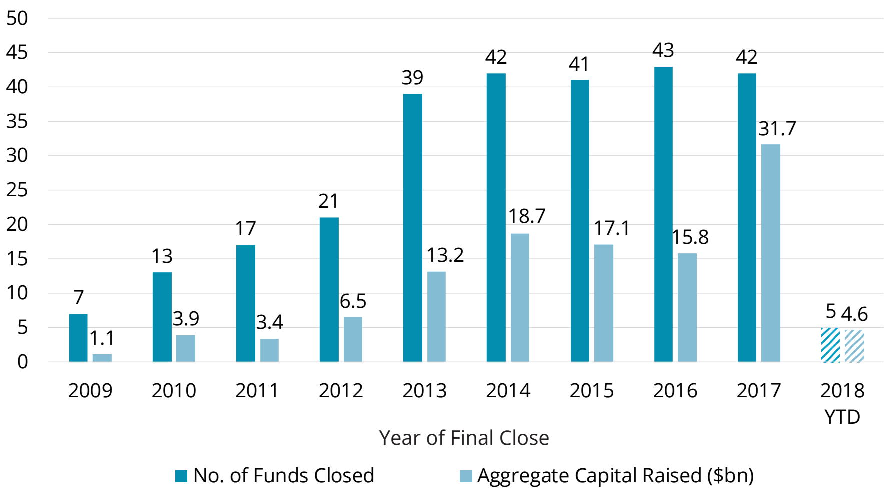
With capital continuing to flow into middle-market private lending platforms in the US at unprecedented levels, it is evident that institutional investors are attracted to the risk/return proposition and other benefits that exposure to private debt offers their portfolios. This industry growth and heightened liquidity across the sector has sparked many institutional investors to search for less saturated opportunities. One sector that is drawing their focus is the US lower middle market, defined as companies with sub-$50mn in EBITDA and typical transaction sizes between $30mn and $300mn. In addition to more favourable liquidity dynamics, investors also believe that the US lower middle market provides greater levels of protection relative to credit markets in general in uncertain economic times.

Since 2008, private equity sponsors in the US lower middle market have been inclined to work more frequently with finance companies rather than banks, as those firms operate platforms tailored to the intricacies of transaction types and have the flexibility needed to successfully deal in the lower middle market. Furthermore, due largely to regulatory shifts, banks have continued to display a reduced tolerance for risk and provide less flexible loan structures than many sponsors need.

Institutional investors find that traditional fixed income does not always provide the level of returns they seek. The emergence of direct lending as a preferred asset class has been in large part driven by that search for yield.

Investors have expressed a clear preference for direct lenders in the US lower middle market that have a track record of generating target returns while maintaining strict credit standards. With an ever-increasing number of managers fundraising, investors looking to put capital to work are gravitating towards specialized asset managers with proprietary transaction flow and a consistent track record of generating strong risk-adjusted returns through cycles, especially in light of the potential for an impending change in the credit cycle.

Fig. 1: Annual North America-Focused Direct Lending Fundraising, 2009 - 2018 YTD (As at April 2018)



Source: Preqin

NORTH AMERICAN DIRECT LENDING FUNDRAISING SURGES IN 2017

Fundraising in 2017 reflects the expectations of last year's report (**Growing Interest in the Lower Middle Market, May 2017**), which indicated that the strategy's growth in North America would be fuelled by the combination of strong investor appetite for exposure across the capital stack and managers' ability to meet this new level of demand from the institutional marketplace.

North America-focused direct lending fund managers that closed vehicles in 2017 secured a record $32bn in capital, double the $16bn secured by funds closed in the prior year (Fig. 1). This unprecedented figure was achieved by 42 funds, including 11 $1bn+ funds that buoyed the year's fundraising totals compared to four funds over the same mark in 2016. These 11 funds accounted for 68% of direct lending capital secured for the region in 2017, which signals a preference for select managers that are now able to attract the majority of new investor capital.

Fundraising tailwinds for managers with expertise in the US lower middle market have been substantial for several years, and will likely continue throughout 2018 given the current positive investor sentiment. In the first quarter of 2018, five North America-focused direct lending funds reached a final close, securing an aggregate $4.6bn, on pace with the $4.2bn closed by six funds in Q1 2017. As at April 2018, there were 82 North America-focused direct lending funds in market, targeting nearly $38bn; half of these funds have achieved interim closures and begun putting capital to work.

RECORD LEVEL OF ASSETS UNDER MANAGEMENT

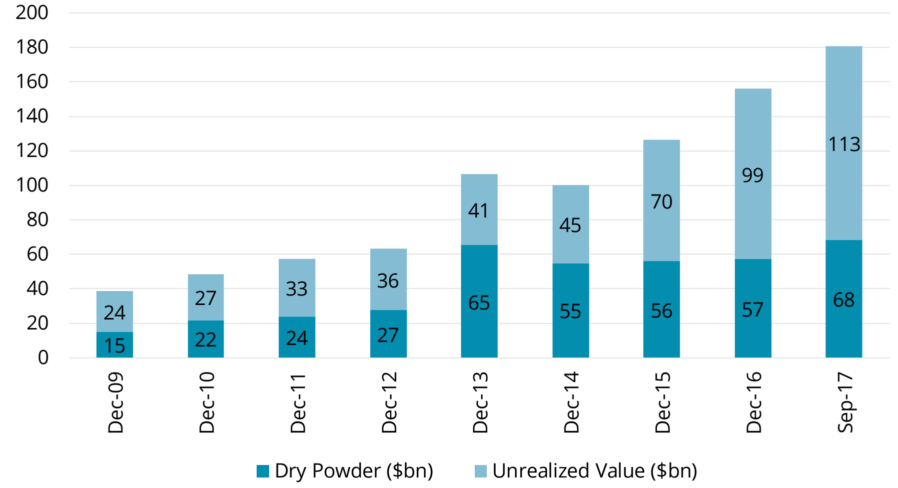
Many factors account for record levels of growth in assets under management. For example, the vast majority (94%) of private debt investors surveyed in April 2018 expect to maintain (37%) or increase (57%) the size of their allocations to US lower-middle-market direct lending over the next 12-24 months. Many also believe that the lower middle market will provide better protection in a downturn when compared to direct lending in general.

Global direct lending dry powder (uncalled capital commitments) and portfolio assets both continued to grow throughout 2017, and total assets under management (AUM) reached a record $181bn as at September 2017 (Fig. 2). As portfolio assets surpassed $100bn for the first time, fund managers have continued to demonstrate their ability to deploy unprecedented levels of capital over the past five years (direct lending includes funds that may partially operate in other areas of private debt). With the influx of fundraising, dry powder among direct lending mangers has also climbed to a record high of more than $68bn. As a result, lenders have ample capital to allocate.

PRIVATE DEBT RISK/RETURN

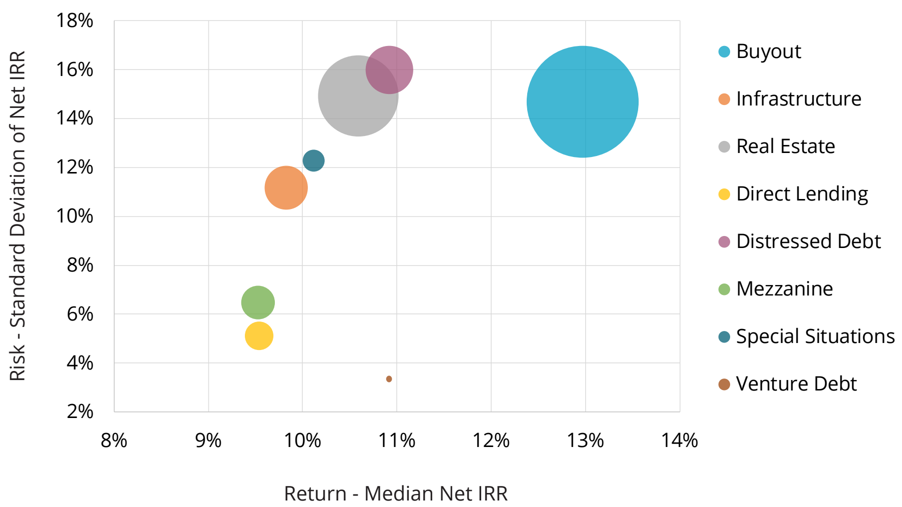
Direct lending has provided attractive risk-adjusted returns to investors in recent years, with the strategy delivering a median net IRR of 9.5% for vintage 2005-2015 funds (Fig. 3). Despite concerns around the availability of high-quality investment opportunities and increasing competition among managers after several record-breaking years for both fundraising and dry powder, more recent direct lending fund vintages have generated attractive returns on a risk-adjusted basis according to Preqin performance data.

Fig. 2: Global Direct Lending Assets under Management, 2009 - 2017



Source: Preqin

Fig. 3: Risk/Return by Strategy (Vintage 2005-2015)



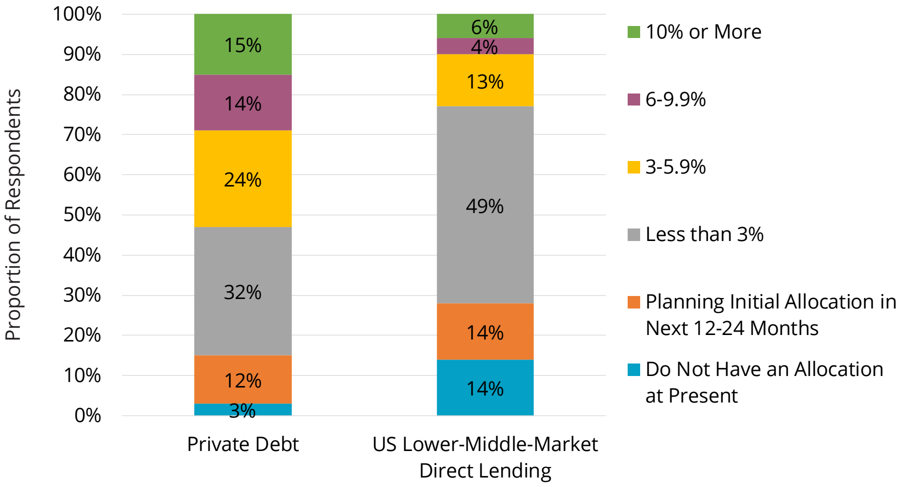
Source: Preqin

INVESTOR ATTITUDES

INSTITUTIONAL INVESTOR PLANS

In April 2018, Preqin surveyed the institutional private debt investor community, including those that are actively investing in private debt funds targeting the US, those that have made previous investments and those that are planning to in the next 12-24 months. As seen in Fig. 4, 97% of investors have a dedicated current or target allocation to private debt (up from 91% in 2017), with 15% of respondents reporting a current allocation of 10% or more. A larger proportion (86%) of respondents in 2018 have current or target allocations to US lower-middle-market direct lending specifically, compared to 82% in 2017, illustrating the growing interest in the space.

Fig. 4: Investors' Current Allocation to Private Debt (As a % of Total Assets)



Source: Preqin Investor Interviews, April 2018

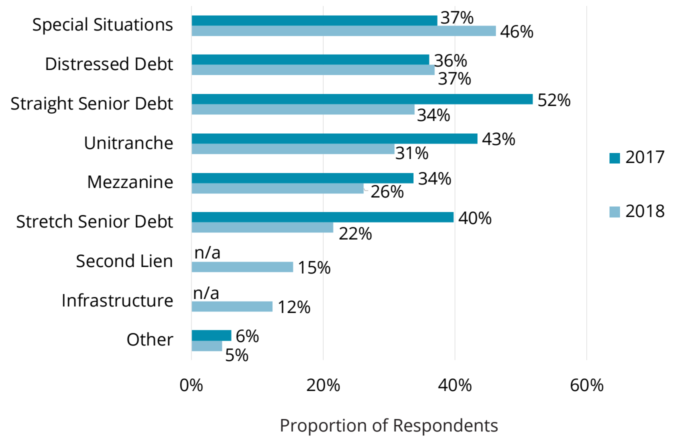
Over the next 12-24 months, a majority of investors plan to increase the size of their allocations to both the US lower middle market (56%) and the private debt asset class as a whole (66%). Commenting on the decision to increase the size of their US-focused lower-middle-market allocations, one US-based private sector pension fund stated: "We think the middle market in general has better risk-adjusted returns and less volatility," while another mentioned the lower middle market's ability to fulfil "a need for yield and low volatility." Importantly, investors appear to understand the various nuances and differing risk/return profiles of investing in the lower middle market compared to the broader middle market in the US.

Among respondents with exposure to the US lower middle market, the main driver of sustained allocation is unsurprisingly higher relative returns than other credit alternatives, as cited by 57% of respondents, followed closely by portfolio diversification (55%) and access to floating rate assets as a hedge against rising rates (50%). A US-based single-family office went on to comment: "The (lower) middle market still has supply/demand inefficiencies created by regulation (post financial crisis). Furthermore, lending in this market is linked to LIBOR, and as LIBOR goes, so will cash yield on lending... and in the case of default, recovery rates are strong."

STRATEGY PREFERENCES

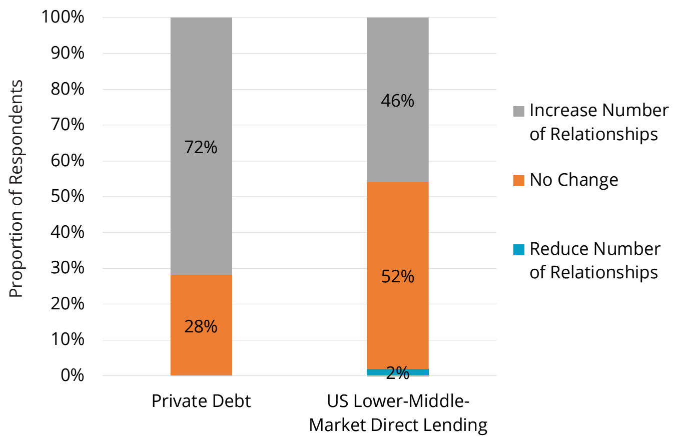
Investor opinion varies when asked which private debt strategies will present the best opportunities in the next two years. While straight senior debt is seen as an attractive option by just over a third (34%) of respondents in 2018, larger proportions expect to see the best prospects in special situations (46%) and distressed debt (37%,

Fig. 5: Investor Views on the Private Debt Strategies that Will Present the Best Opportunities in the Next 12-24 Months, 2017 vs. 2018



Source: Preqin Investor Interviews, January 2017 - April 2018

Fig. 6: Investors' Plans for Adding New Portfolio Managers in the Next 12-24 Months



Source: Preqin Investor Interviews, April 2018

Fig. 5). This may be attributed to investors' views on where we are in the credit cycle, and given the substantial amount of debt issued since 2009 coming due for refinancing, along with a potential uptick in corporate bankruptcies on the horizon, that these strategies will become more sizeable and compelling.

As seen in Fig. 6, 46% of respondents intend to increase the number of manager relationships they maintain in the US lower-middle-market private debt space in the next 12-24 months, while 72% will look to add more connections within the more general private debt market. Only 2% of investors surveyed plan to reduce manager relationships in the US over this period. Given the potential for a market correction in the domestic economy, this suggests that many investors are satisfied with their current manager relationships in the US lower-middle-market private debt space and are likely to increase allocations to these firms, which will make it more difficult for other managers to attract new capital.

FACTORS FOR INVESTMENT DECISIONS

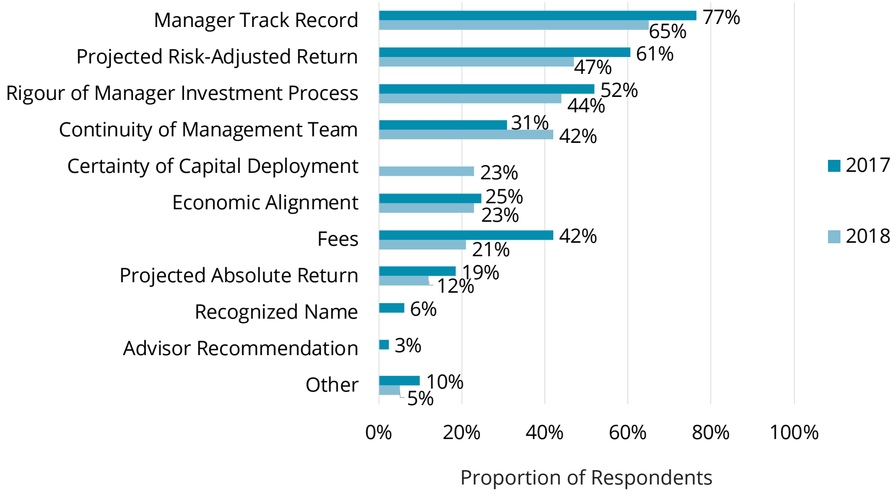
When looking at the key factors investors consider when allocating capital to lower-middle-market debt managers, it is vital to understand the drivers and nuances behind the market, especially with regards to the differences between the lower middle market and the more general private debt space.

Primarily, investor attitudes towards the US lower middle market differ from that of private debt in general in terms of the risks associated with the underlying loans within funds, most notably in the case of the impact of economic cycles. Significantly fewer respondents (a difference of 10 percentage points) believe the US lower middle market will be adversely affected by a cycle change as compared to the whole of private debt. The case could be made that the lower middle market, where loans are made at lower leverage multiples and protected by covenants, is somewhat less exposed to market-wide economic shifts and the reduced liquidity that is typical during an economic downturn.

This marketplace insulation could help shield the US lower middle market from other macroeconomic trends as well. Forty-three percent of investors believe this area of the market will be affected, while 86% foresee potential disruptions in the wider private debt space. This factor is key to the benefits of investing in the US lower middle market, and having dedicated allocations in place could help investors achieve more stable returns during a downturn.

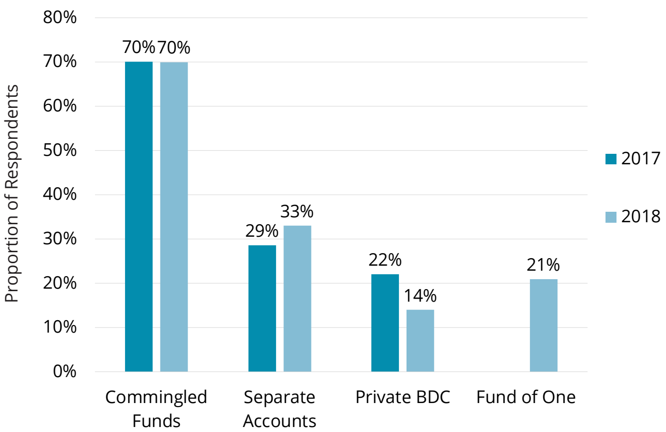
For 65% of respondents, a manager's track record remains the most important factor to consider when allocating capital to the asset class (Fig. 7). Projected risk-adjusted return also ranks among the most crucial factors considered (47%). The factor that has most gained in prominence over the past year is the continuity of the management team: 42% of respondents cited this as one of the most important factors they consider when deciding whether to commit to a fund, compared to 31% in 2017. The role of fees in investment decisions declined significantly between 2017 and 2018. Fifty percent fewer respondents identified fees as an important

Fig. 7: Investor Views on the Most Important Factors when Assessing US Lower-Middle-Market Direct Lending Fund Managers, 2017 vs. 2018



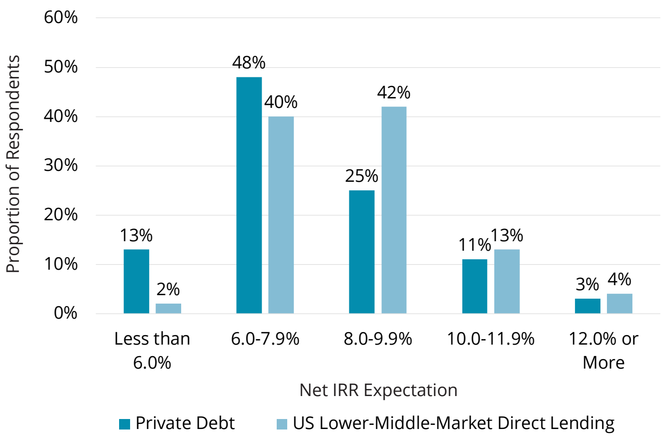
Source: Preqin Investor Interviews, January 2017 - April 2018

Fig. 8: Investors' Preferred Investment Structures for US Lower-Middle-Market Direct Lending Funds, 2017 vs. 2018



Source: Preqin Investor Interviews, January 2017 - April 2018

Fig. 9: Investors' Net Return Expectations for Non-Leveraged Private Debt



Source: Preqin Investor Interviews, April 2018 factor in choosing a US lower-middle-market direct lending manager in 2018 (42% vs. 21%).

Evidenced by fundraising trends in 2017 and the first quarter of 2018, institutional investors have a strong preference for lenders with a proven history of attaining target returns while maintaining transparent and tested investment standards. Established lower-middle-market private debt firms have seen greater success in securing capital than less experienced peers, as investors are typically more confident in veteran managers' ability to deploy capital efficiently than many of the newcomers to the space. Furthermore, experienced managers have the relationships in place to originate and maintain a high-quality deal pipeline, which allows them to be more selective while still deploying capital and to partner with equity sponsors that are similarly experienced in managing through credit cycles.

Similar to 2017, 70% of investors in US lower-middle-market direct lending funds prefer a commingled structure, while 33% are interested in separate accounts (Fig. 8). The proportion of respondents interested in a private BDC structure declined by eight percentage points to 14%, and 21% of respondents see a 'fund of one' as a preferable US lower-middle-market vehicle.

LEVERAGE AND RETURN EXPECTATIONS

Figs. 9-11 illustrate institutional investor expectations when assessing returns for levered versus unlevered US lower-middle-market direct lending funds as well as private debt funds. Almost half (48%) of investors expect a return of 6-7.9% for private debt funds on the whole, while 40% expect this return specifically for US lower-middle-market vehicles.

However, the gap between the expectation of an 8-9.9% return is 17 percentage points higher for the US lower middle market, potentially reflecting higher expectations based on an understanding of the different risk/return profile for this sector due to the more favourable competitive dynamics for lenders and the higher targeted and actual returns investors have seen relative to private debt in general.

For leveraged US lower-middle-market funds, 96% of investors expect to see net IRRs above 8%, including 79% that seek returns in excess of 10%. Ninety-three percent of investors expect leveraged general private debt funds to produce net IRRs above 8%. It is evident in these results that regardless of leverage, investors insist on stronger returns from exposure to the US lower middle market than from the wider private debt asset class.

The proportion of respondents that prefer unlevered versus levered vehicles has increased by 10 percentage points compared to last year. Overall, decreasing leverage appears as a trend toward reducing risk at this point in the credit cycle, with the potential for a downturn on investors' minds.

When assessing the performance of US lower-middle-market direct lending managers in their portfolio, investors stated net IRR, net cash-on-cash returns and variability of returns as the most significant factors. Management fees, deployment rate and the quality and frequency of reporting were of less importance, which indicates that higher and more consistent returns can alleviate other investor concerns.

OUTLOOK

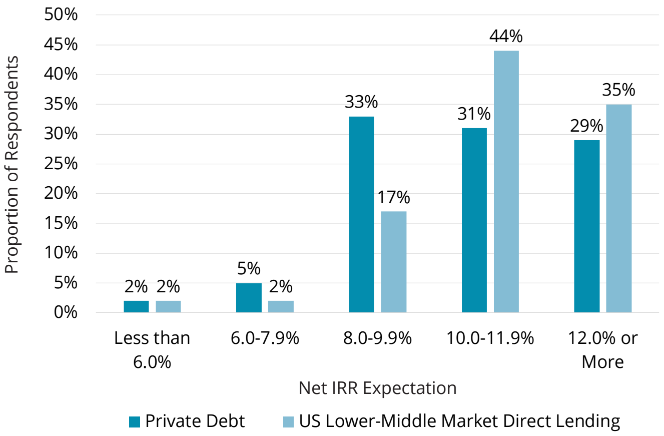
As evidenced by the significant growth in fundraising over recent years, direct lending has been at the forefront of investors' minds when considering asset allocation. More institutions are looking to the attractive risk/return profile and floating rate that private debt provides, especially in light of the low yields associated with fixed income investments.

As the largest and most mature private debt market with a strong history of operating through market cycles, the US continues to attract significant attention. Investors' ongoing search for the best private debt opportunities is creating a shift in focus to the lower middle market.

In addition to looking to higher returns from the US lower middle market and maintaining diversified exposure to credit, concerns about a shift in the credit cycle are fundamentally responsible for the increasing interest in the US lower middle market. With investors looking to protect their portfolios from a potential cycle change, far fewer investors thought the lower middle market would be affected compared to the wider private debt space.

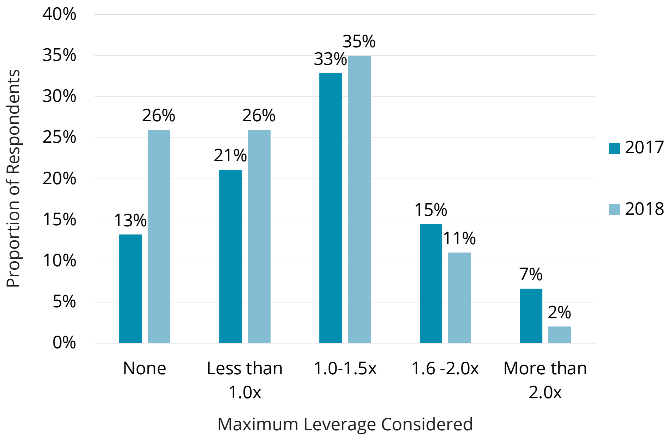
As investors continue to search for attractive risk-adjusted returns and look to hedge against an uncertain future macro environment, it seems likely that US lower-middle-market direct lending will attract further inflows in the years to come.

Fig. 10: Investors' Net Return Expectations for Leveraged Private Debt



Source: Preqin Investor Interviews, April 2018

Fig. 11: Maximum Fund Leverage Considered by Investors for US Lower-Middle-Market Direct Lending Funds, 2017 vs. 2018



Source: Preqin Investor Interviews, January 2017 - April 2018

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JUNE 2018

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