How US managers choose the right tactic

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A sharp increase in market participants in the mid-market is pressuring loan pricing and covenants, so where does value sit in the sector?

The US mid-market has seen an inflow of both capital and new players in the last two to three years and, according to Theodore Koenig, CEO of sector specialists Monroe Capital, the result is a much busier sector.

"The US mid-market is crowded and active, those are the two key words," he says down the phone line from his Chicago office. "There are lots of private equity firms vying for transactions in a competitive landscape. There have been a lot of new players coming into the market recently which are putting money to work, and to a certain extent, driving heat in the market."

It is easy to see why Koenig views the market as hot. Debt/EBITDA ratios and leverage multiples on the underlying private equity transactions have been creeping upwards of late. Figures from market information provider Leverage Commentary & Data show that the former are roughly 20 percent higher than in 2015.

On the loan side of the equation, covenants have been disappearing and add-backs are also on the rise. Another mid-market fund manager notes that, rather than being a cause for concern, these developments are the invisible growing pains of an asset class than has moved further into the mainstream.

"Low yields drive alternative investment and what you are seeing right now in the US private debt mid-market is in line with this theme," he says. "Rock-bottom rates have driven capital formation which has in turn led to weaker terms and more opportunities, and options, for borrowers."

Weaker terms mean sharper pricing. Koenig says deals that were pricing at LIBOR plus 600-650 basis points 12 months ago, are now coming to the market at LIBOR plus 525bps. This means tighter pricing has absorbed the impact of the US rate rise that occurred in the interim.

"It is important to generate yield and create alpha, as opposed to being a beta player, in the market these days"- Ted Koenig

Declining prices and weakening covenants have led to a significant repricing of the risk premium within the asset class. This makes it hard to find value but not impossible, says Koenig. The chief executive says his shop has been seeking above market returns in the non-sponsored segment.

"We have been able to create alpha in the non-financial sponsored transactions. It is important to generate yield and create alpha, as opposed to being a beta player, in the market these days. We arrange financing for management teams who buy companies all the time, as well as deals driven by a private equity sponsor."

Koenig says Monroe has invested over a billion dollars in 2018, a third going to non-sponsored deals. He says in these types of deals his firm's extensive existing network gives the firm an advantage over new entrants to the market.

“Our edge comes in sourcing the underlying assets which we do on a proprietary basis. We have been doing this for 17 years, unlike firms which have come-and-gone from the market.”

As well as a source of alpha, Koenig says this approach also means Monroe isn’t forced to search for new opportunities among firms with weaker credit. “Firms get problems when they go down the credit quality curve. It’s possible to make exceptions to pricing, but when you start doing the same for leverage and credit quality, then that’s not a sustainable, long-term strategy.”

Traditional approach

The direct sourcing approach may appeal to Monroe, but according to John Martin, co-chief executive of Chicago-based **Antares Capital**, there is still value in sticking to the tried-and-tested strategies despite new entrants.

“Our traditional approach of providing senior secured loans to private equity sponsors is one that we have followed for the last 25 years, and has worked very well for us, we just continue to expand the private equity sponsored universe that we actively call upon and that is where we get effectively all of our business opportunities.”

“Antares has longstanding relationships with private equity sponsors with whom we have done multiple transactions with. When these sponsors are looking to finance their acquisitions generally they would prefer this to be led by a firm that they have done a lot of business with over the years.”

Martin recognises the challenge from the number of new entrants and the increased flow of capital into the sector, particularly from large institutional investors. On the other hand, he notes that while it is “more crowded than it was”, the US mid-market private debt market is far from overcrowded.

Indeed, Martin welcomes new players, pointing out that the commercial banks have largely withdrawn from the sector. Meanwhile, global investors are waking up to the potential of the asset class.

“Investors around the world have realised that the private debt sector is somewhere they need and want to allocate more of their capital. So, we have seen tremendous flows from pension funds, insurance companies, and sovereign wealth funds, into this area and it is definitely more crowded as new managers have opened-up shop.”

Covenant mystery

Another recent trend is the spread of the covenant-lite structures that were previously the preserve of the syndicated loan market which caters to larger firms. But according to Ruth Yang, managing director at LCP, the sheer opacity of mid-market deals makes establishing meaningful data on loan covenants in the sector very difficult.

Drawing on anecdotal experience, New York-based Yang says managers in the sector appear to be relatively sanguine on the issue of covenants.

“I have had a number of recent conversations with direct lenders and they maintain that in the core mid-market covenant lite is not as prevalent as has been suggested. What concerns them instead is the issue of add-backs: costs, or future earnings which are “added back” into the EBITDA to make an acquisition more attractive on an earnings basis.

Yang notes that while data from LCD is more granular in the broadly syndicated market, the mid-market does tend to broadly follow its larger loan peer, and the trend is concerning. LCD has analysed data around synergy-related add-backs – the amount of savings a sponsor expects to make from the deal and the percentage of deals with synergy-related add-backs in the EBITDA.

Figures for the latter have shot-up markedly hitting 54 percent for the first half of 2018 – way ahead of the post-GFC low of 13 percent in 2009, and more than the double the 24 percent of transactions in 2006, a year ahead of the crisis. The result, Yang says, is confusion for investors.

"We are hearing of cases where that the multiples the company is projecting might sound reasonable – it could be less than six times EBITDA which appears to be the fine line that everyone worries about it – but with the add-backs, the final multiple is much higher. And that's where the concern is. Once you strip away all those adjustments the underlying numbers may not be great."

Add-backs add up

This concern is shared by our unnamed mid-market fund manager. He says the increase in add-backs makes it difficult for investors to compare firms on a borrower-by-borrower basis.

"EBITDA is the basis for purchase price multiples and leverage and if you misconstrue that the whole transaction is kind of up in the air," he says. "If half of a company's EBITDA is add-backs, and they are wrong, then you could have material problems in the recovery rate."

The potential for the mid-market sector to have a serious issue with recovery rates following the peak of the next cycle is clearly of concern, but according to Yang, this is where the good news starts. Her team has done an analysis of recovery of rates for mid-market loans, with the data skewed towards firms with an EBITDA of $30 million-$50 million and she says this cohort typically outperforms larger corporates.

According to Yang, the simpler capital structures among the mid-market makes recovery much more straightforward and should provide the sector with some additional protection during the next downturn in the credit cycle.

"We believe the middle market outperforms broadly syndicated on a recovery basis, because the middle market capital structures have far fewer layers to it than compared with larger corporates in other credit classes. Middle market lenders have few capital classes and tend to be better aligned in their goals, and this goal will be to get the company out of bankruptcy as quickly as possible."

Lenders to the mid-market can draw some comfort from this but according to Koenig one thing is clear – the juxtaposition of investor interest in alternative assets classes and cheap capital means now is a good time to be a borrower.

"The scales have been tipped in favour of the borrower as opposed to the lenders in terms of the sheer capital, as well as the downward pressure from the covenant-lite, fixed income sector."