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Mid-market lending: Five things every investor should know

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The mid-market is an ever-more attractive place to be, but it is also a sector evolving at pace. We look at the key trends that limited partners need to be aware of.

Funds focusing on mid-market credit have mushroomed around the world in recent years as investors try to tap into the opportunity.

While the definition of mid-market is not always uniform between managers, most LPs will want a slice of the top end of the market, but where the competition for private debt deals is fiercest.

David Waxman, managing director of Azla Advisers, says: “The mid-market has always been, and continues to be, a favoured area for the LP community. The larger mega private equity deals requiring debt are covered by the larger private debt funds, but there’s always been a strong appetite among the LP community for mid-market in the context of a portfolio approach.”

But with so many managers offering mid-market opportunities, what should LPs think about before they move into the space? Here’s PDI’s guide to the five things every investor should know.

1 A clear investing strategy is vital

There are a lot of things to bear in mind before putting money to work in the mid-market private debt arena and investors cannot afford to be ill-prepared. Justin Mallis is a principal at First Avenue, the global advisor and placement agent, with a focus on private credit. He says investors need to be thoughtful in their approach and planning when it comes to choosing private credit managers.

“It can’t just be about getting exposure to yield,” he says. “The growth of the number of product offerings and variety they offer can be challenging otherwise. For instance, investors have to choose between asset class – corporate, real estate, infrastructure, sponsor and non-sponsored, senior only, senior and subordinated, or subordinated debt; sector – diversified, or technology, healthcare, or other; cashflow or asset-backed lending; and loan tenor, to name a few. If an investor does not have a multi-year plan it will be very difficult to manage its portfolio build-out or complement its existing exposures. Getting exposure to the mid-market is relatively easy, you just have to understand where in the mid-market you want to have that exposure. You really have to have a game plan, and then build your portfolio.”

2 Key geographies remain the US and Europe

While mid-market private debt funds may be springing up all over the world, the best opportunities remain in the US and Europe, and, within Europe, the UK, France and Germany, in particular.

Damien Webb is head of income and real assets at First State Super, one of Australia’s largest profit-for-member super funds, with more than $75 billion under management. He says: “The key middle-market opportunities are in the US and Europe. Australia is still a developing market, with the banks still quite robust and continuing to lend, so the opportunity here is more around the property side of lending. In corporate lending there are opportunities, but not the volume. In the US and Europe, it’s a fairly constant flow and with good partners you can have a relatively steady allocation.”

3 Sponsorless deals present a huge opportunity

While there is little data to compare the returns on non-sponsored versus sponsored deals in the private debt market, advisors say the sponsorless market – where private equity firms are not involved – offers much better results. “When an investor asks if non-sponsored is more attractive, we have to ask what they are trying to accomplish,” says Mallis.

“Non-sponsored might be the better alternative for a private equity investor looking to decrease volatility and gain income, or for an investor whose portfolio is mature, while sponsored lending is probably the right choice in the early stages of building a programme out or for conservative investors that are open to utilising fund level leverage to increase returns. Overall, there are high-quality managers that invest in non-sponsored and other managers that are excellent at sponsor-backed lending.”

Certainly, the opportunity is greater for non-sponsored deals. James Newsome, managing partner at Arbour

Partners, says his research indicates that in the top half of the mid-market (where EBITDA is €50 million-€100 million), there are currently five funds raising and there are between five and 15 private equity LBO deals annually, as compared to between 50 and 100 corporate deals.

“If you’re relying on the private equity market,” he says, “you have a narrow spectrum of deals to go in to, pricing is being eroded, and it is cyclical. When you look at the number of corporate deals looking for new financing solutions, there’s a huge opportunity. A lot of managers are trying to break into that, but you have to have the origination capabilities...

“It’s looking like only a few big beasts are feasting at the waterhole of private equity deals, and LPs have to invest elsewhere. If managers can source corporate deals through banking relationships, there are many more transactions on offer.”

In the US, Mallis says there are only about a dozen high-quality managers in the non-sponsored space, while in Europe it has developed into a much more prevalent strategy, particularly in Germany, France and the UK.

4 A lot of manager due diligence is required

With so many mid-market fund managers to choose from investors can no longer avoid spending a lot of time on due diligence.

Waxman says: “LPs need to be very busy seeing a lot of people to ensure they are really choosing the best. There are a lot of groups to see and they should be seeing a fair number of them if they are to be executing on their fiduciary duties.”

As a result, there is a growing role for advisors, placement agents and gatekeepers, who can support LPs in the process.

Waxman adds: “Proper due diligence means getting to know people, getting comfortable, looking at the deals, the credit ratings, and how they do their work, and looking at the investment picks and really understanding how the GP thinks. There’s no avoiding that real hard work.”

Mallis says: “It’s imperative for investors to ask the right questions, know who is leading on deals, and why one manager is passing up an opportunity and another isn’t.”

5 Manager track record is key

Finally, if there is one thing that investors need to focus on before backing a mid-market credit fund manager it is track record. That means not only finding a manager that can originate the opportunities, be they sponsored or non-sponsored, but also one with experience of working through a downturn, and supporting companies through difficult times.

Webb says: “One thing we look for is a good and very, very solid track record. Credit is an asymmetric asset class, so it is not so much about the upside but protecting the downside. We look for a good recovery track record and the ability, resources and depth to be involved in credit committees and workouts if the issues arise.”

Waxman says that glossing over a patchy track record and getting away with it is now well and truly a thing of the past: “Maybe three or four years ago LPs recognised that GPs didn’t necessarily have track records in the niche of private debt. Now they are a bit more discriminating and not much allowance is given for track record variability. LPs are going to be looking less at newer teams, except in new markets.”

With the mid-market space now crowded with funds, it can be harder than ever to separate one manager from another, but track record, origination capabilities and a proven strategy remain the things investors should prioritise.