CAPITAL THINKING: Growth in Middle Market Access to Private Credit

By: Davidson Hall

The explosive growth of private credit funds, also known as private debt funds, by direct lenders has transformed access for middle market firms to debt capital markets.

Between 2014 and 2020, capital raised by private debt funds targeting loans to middle market companies increased by more than sixfold, going from a minority to a substantial majority of all middle market credit product fundraising in those years.[1]

Between 1Q 2014 and 1Q 2021, direct lending sponsored issuance to the middle market went from a small fraction of the size of bank syndicated sponsored issuance to the middle market, to more than twice that of banks.[2] Due to temporary headwinds related to COVID-19, the acceleration of private credit funds did slow down somewhat in the second half of 2020. Direct lending sponsored issuance to the middle market fell markedly between 2Q 2020 and 3Q 2020 before rising slightly in 4Q 2020.[3]

Now that coronavirus infection rates are dropping in the U.S. and the economy appears poised to maintain healthy growth, private credit funds may well regain significant momentum. The portfolio companies of private credit funds are stabilizing, which has allowed funds to focus on new investments and resume fundraising. For the first time ever, in 1Q 2021 the average size of all private debt funds raised in a quarter exceeded $1 billion.[4]

VIABLE ALTERNATIVES

This shift toward private credit funds, which allow investors to hold shares whose underlying assets consist of corporate debt, has been driven by both regulatory issues that banks face and by pure economics. The trend started with tighter controls on banks, due to fallout from the 2007-2008 Great Financial Crisis, and continued during the subsequent economic recovery as institutional investors with excess cash began pursuing a wider range of non-traditional asset classes.

Corporate borrowers in search of leverage exceeding the regulatory constraints imposed upon banks discovered that they could access private credit from direct lenders. However, that private credit came at a higher cost of approximately 10% interest (LIBOR plus 7% to 9% post-crisis) instead of the 4% interest that many banks had charged prior to the crisis. In return, the borrower would enjoy higher leverage and greater operating flexibility.

Since middle market firms of a certain financial condition generally do not issue into the more liquid corporate bond or Term Loan B markets, direct lender private credit has emerged as a viable alternative to bank loans for borrowers across the middle market and increasingly across all market sizes. An experienced investment banking team can guide middle market firms through this process, while explaining what borrowers should expect along the way.

Depending on the private credit fund, borrowers may gain access across the capital structure spanning first and second lien, mezzanine, subordinated or unitranche debt. As a result of this appetite and an influx of direct lenders to meet it, in recent years, private credit funds have been able to offer middle market borrowers rates somewhat more in line with what banks had

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traditionally charged — and with greater flexibility — in the process gaining market share and revenue at the expense of banks.

Institutions such as Oaktree Capital Management, Ares Management Corporation, KKR, Apollo Global Management, the Carlyle Group and the Blackstone Group are among the biggest providers in the space, all operating multiple private credit funds. Indeed, they have expanded beyond private equity to effectively become global asset managers not subject to the same regulatory limits as banks.

DEAL DYNAMICS

Yet middle market firms seeking to access private credit must still discern which direct lenders are the best fit for their needs. This calls for understanding the borrower's own financial condition. Different types of credit may affect its short-term and long-term ability to achieve strategic priorities, given sector-level expertise and broader macroeconomic developments.

Another crucial factor is the priorities of the direct lender. Direct lenders tend to work with borrowers that fall into one or more specific categories. Firms whose size limits their ability to issue debt, firms in struggling sectors or subsectors, as well as firms that may be involved with situations that severely limit their access to bank capital.

And while direct lenders usually hold deals they underwrite to maturity, they sometimes can sell them to other direct lenders. Borrowers that overlook these considerations could enter suboptimal situations which could have been avoided had they sought the advice and guidance of a qualified advisor.

A middle market firm that over time fails to cover substantial private credit obligations might even be at risk for a change of ownership situation. To be sure, the goal of the vast majority of direct lenders is to earn a profit alongside borrowers that remain independent entities and not portfolio companies by way of default. Still, on rare occasions, such takeovers do occur. For many middle market firms, the benefits of private credit far outweigh the risks.

STRATEGIC RATIONALE

The greater challenges for them are obtaining introductions to the proper direct lenders – meaning those with strong reputations and deep expertise in the borrower's sector or subsector – as well as running a competitive process between lenders to obtain the best deal terms. In addition to PE firms of varying size, available pools of capital include private and public business development companies (BDCs), small business investment company (SBIC) funds, hedge funds, family offices, and insurance companies.

The primary concern for most middle market firms is cost. Even with rates lowering over the past several years, private credit deals may cost borrowers anywhere from 6% to 10% per annum for five- to seven-year terms. A strategic rationale exists for incurring higher costs, if the deal enables a firm to accomplish its operational goals within the relevant time period.

When weighing direct lender private credit against traditional bank loans, borrowers must balance the need for a good capital provider with the need for a good capital partner. While the interest cost may be higher from a direct lender, when combined with the required amortization commonly associated with a bank loan, the total cost of the credit facility can actually be lower with a direct lender when their materially lower amortization is factored into the cost.

Direct lenders are known for providing additional capital to existing borrowers intent on opening new factories or pursuing acquisitions. They also can include "builder baskets" that let borrowers carry over unused credit into the next year of a loan, and renegotiate covenants when appropriate for healthy firms. Accessing private credit is not always the best course of action for a middle market firm in need of financing, but that assessment calls for knowing how to navigate the lender landscape.

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[1] Source: Refinitiv LPC
[2] Source: Refinitiv LPC
[3] Source: Refinitiv LPC
[4] https://www.privatedebtinvestor.com/download-average-debt-fund-size-breaches-1bn/