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Monroe Capital
Insights Series – From A To Zia

Lower Middle Market Direct Lending

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Introduction

Over the past decade, private credit has emerged as an established high-growth asset class due to the favorable supply/demand characteristics and attractive fundamentals as nonbank lenders continue to disintermediate traditional lending markets. We believe borrowers prefer the customized funding solutions, certainty of execution and flexibility that private credit offers. For investors, the higher interest rate environment has increased private credit's appeal as floating-rate loans offer higher risk-adjusted returns compared to other asset classes.

Despite the highest interest rates since 2007, the U.S. economy has remained resilient with increasing optimism of a soft landing. The Fed signaling the end of the current rate hike cycle has led to increased M&A activity due to greater certainty of investors' cost of capital. 2024 is off to a strong start with the U.S. sponsored middle market volume experiencing robust growth with volumes 62% higher YoY during the first half.[1]

We believe the secular tailwinds and the maturation of the asset class combined with an increasingly optimistic economic outlook has led to the proliferation of private credit. Nevertheless, not all segments and managers within private credit are the same and extensive diligence is required on where to allocate capital.

In this Insights series, we highlight the lower middle market segment of direct lending known for its higher spreads, lower leverage and tighter covenant packages. We also present the following key characteristics that support investing in Lower Middle Market Direct Lending:

1. Demand for global private credit remains strong
2. Lower middle market direct lending set to outperform
3. Existing portfolios appear well positioned
4. Manager selection matters

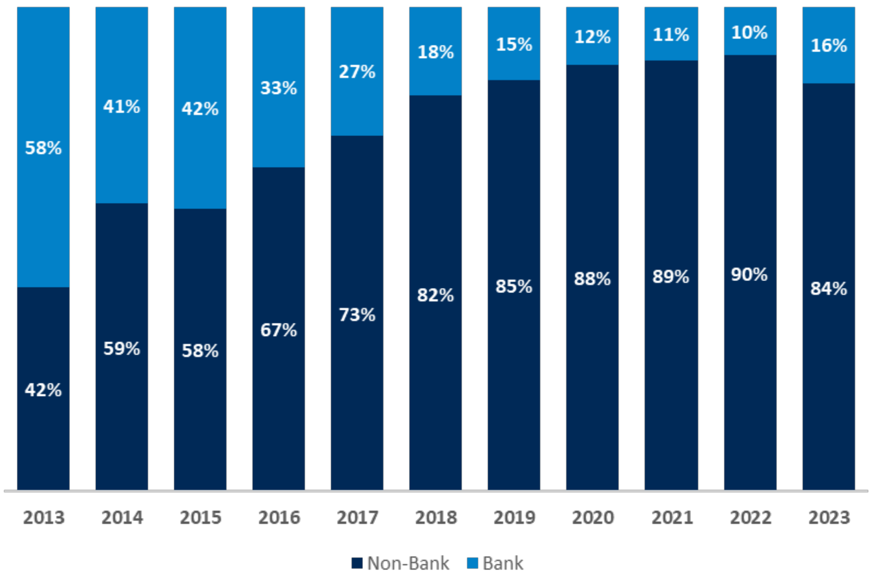
Demand for Global Private Credit Remains Strong

Private credit continues to strengthen its reputation as a resilient and scalable investment choice for a wide range of long-term investors. It is the fastest growing alternative asset class and is expected to grow to $2.8T by 2028 from $1.6T at the end of 2023.[2] This rapid growth is attributed to attractive fundamentals and favorable supply/demand characteristics.

We believe private markets have gained market share due to the availability of larger capital pools and flexible investment structures compared to banks, which are limited by liquidity constraints, regulatory requirements, and high costs. With banks retreating and a clear structural shift underway, private capital has stepped in to provide a stable and long-term source of funding for borrowers. Today, this significant supply/demand imbalance in the market combined with banks restructuring their balance sheets has enabled the rapid growth and rise of the private credit market.

In our view, the ability for borrowers to build long-term relationships with private debt managers is a crucial differentiator. A long-term borrower-lender relationship provides flexibility that not only allows the lender to grow along with the borrower, but also provides customized funding solutions with certainty of execution. Enhanced dialogue enables private lenders to better structure the financing, pick the collateral and craft the appropriate covenants. Post-close, this relationship facilitates the lender's ability to get in front of the borrower promptly to monitor performance, proactively address concerns and mitigate adverse issues collaboratively.

Increasing Demand for Private Credit



Source: LSEG Data & Analytics

An investor survey conducted by Preqin indicates a near-term expected increase in allocation to private credit with the asset class underpenetrated (6.4%) compared to Private Equity (14.8%).[3] The stable current income, high risk-adjusted returns, portfolio diversification, and reduced portfolio volatility have contributed to the growing demand for private credit among institutional and retail investors. Private credit has historically offered incremental yields and lower losses compared to public credit markets.

>50%

of investors surveyed expect to increase allocations long-term to Private Credit[3]

Lower Middle Market Direct Lending Set to Outperform

With the continued strength in demand for private credit and entry of new managers, investors should understand that not all direct lending within private credit is the same. Despite lending to smaller companies, the lower middle market has several distinct virtues. These position the strategy to outperform, generating additional alpha compared to other segments of the direct lending market. We examine four of these qualities below:

Greater Selectivity

The middle market consists of approximately 200,000 companies, 90% of which are in the lower middle market and generate annual revenues between $10 million and $150 million.[4] Since 2021, the lower middle market has reported an average 6,500 transactions valued at over $400 billion, outpacing traditional and upper middle market transaction volume by 7x.[5] In our view, this large annual opportunity set enables lower middle market lenders to be more selective and determine which deals meet their investment criteria rather than being restricted to deals dictated by the market.

Premium Pricing

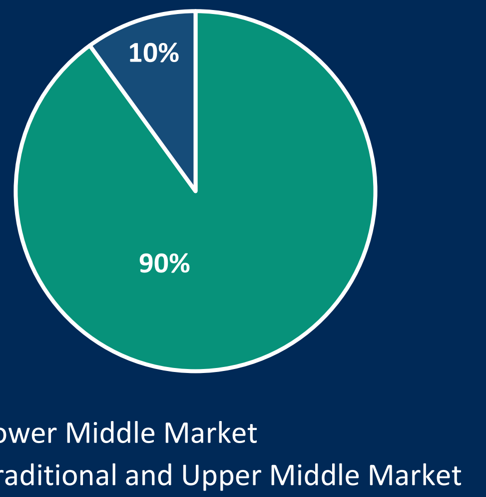
We believe the lower middle market is highly fragmented and endures less competition to win deals due to the fact that the vast majority of middle market transactions (<$500mm) are too small for large lenders. New managers have entered the direct lending market primarily focusing on the traditional and upper middle markets in order to deploy capital into uniform club transactions without requiring significant resources or capabilities. Additionally, existing direct lenders have moved up market to deploy capital at faster rates through fewer transactions; however, this results in less control, lower pricing, and not as many lender protections. This trend to move up market, along with the highly fragmented number of companies seeking financing, has created a capital supply and demand imbalance where existing lower middle market managers can generate a premium through higher spreads.

Illustrative Loan Comparison

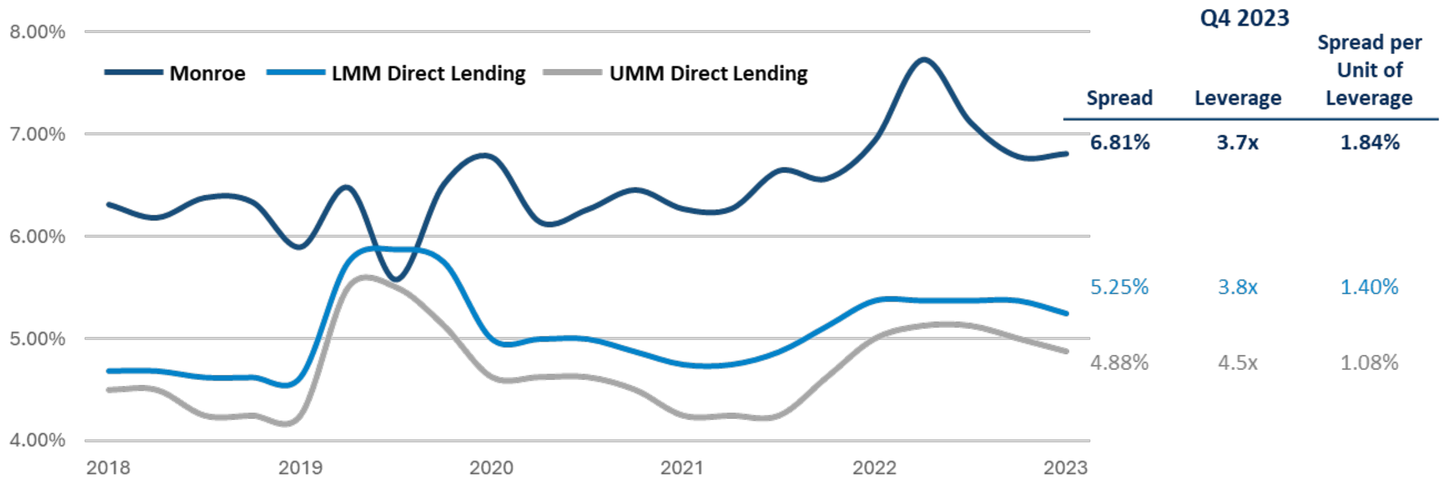
	Lower Middle Market	Upper Middle Market
Enhanced Pricing	X	
Covenants	X	
Lower Leverage	X	
Lower LTV %	X	
Agenting	X	
Company Size (>$50mm EBITDA)		X
Company History (>20 years old)	X	X

Middle Market - Potential Sourcing Opportunities

(based on number of companies in the middle market)



Middle Market First Lien Spreads (%)



Source: Lincoln International. Monroe data includes enterprise value loans, recurring revenue loans and opportunistic loans.

Lower Use of Leverage

As interest rates increased during 2023, new deals were completed at a lower leverage standpoint compared to previous years to ensure companies can cover their debt burden. Upper middle market borrowers have more capital demand and financing often coming from numerous lenders, meaning that those companies can borrow more total leverage adding incremental risk compared to the lower middle market. In 2023, Monroe's deals executed in the lower middle market were done at an average 3.7x leverage multiple, compared to 4.5x in the upper middle market.[6] Due to conservative structuring, the lower middle market is able to generate higher returns with lower risk.

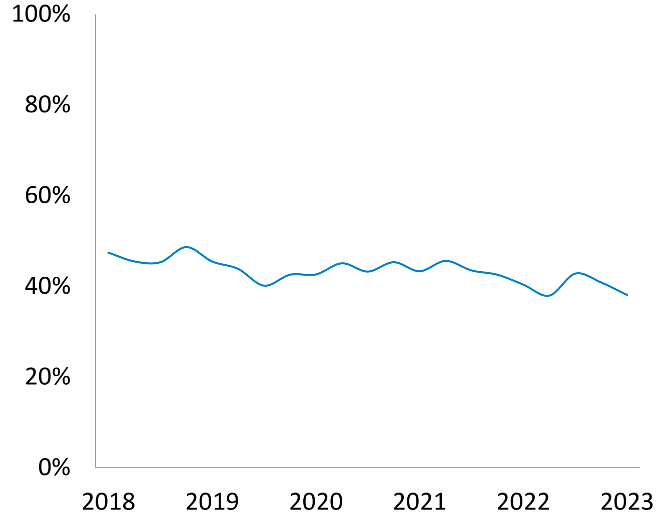
Enhanced Lender Protection

In our experience, the lower middle market direct lenders are positioned to negotiate better documentation and information rights on their loans due to the aforementioned capital supply/demand imbalance and nature of the lower middle market. While exercising their greater agency rights, lenders in the lower middle market often structure two or more covenants compared to that of the traditional middle market and syndicated market, which are often covenant-lite deals. Increased transparency through more frequent and detailed reporting allows lenders to identify issues in company performance early and gives the ability to intervene and create an action plan to prevent defaults and protect their investment. At the end of 2023, Monroe's annualized lower middle market default rate was 1.5% compared to 2.6% for both the traditional middle market and broadly syndicated market.[7] Additionally, with increased information rights and a better negotiating standpoint, lower middle market lenders are less accepting of EBITDA adjustments and PIK payments, creating a better underlying definition of EBITDA and generating real earnings.

Existing Portfolios Appear Well-Positioned

Existing lower middle market portfolios exhibit strong underlying credit metrics that have proven resilient during times of rising interest rates and market volatility. With an average LTV of 38%, portfolio companies have shown strength with current middle market interest coverage ratios averaging 1.4x at year end 2023. This demonstrates the ability to cover increased interest burden despite interest rates at 20-year highs. In fact, underlying middle market companies have illustrated growth during the volatile 2023 with revenue and EBITDA increasing 3.1% and 6.7%, respectively, compared to the previous year.[6]

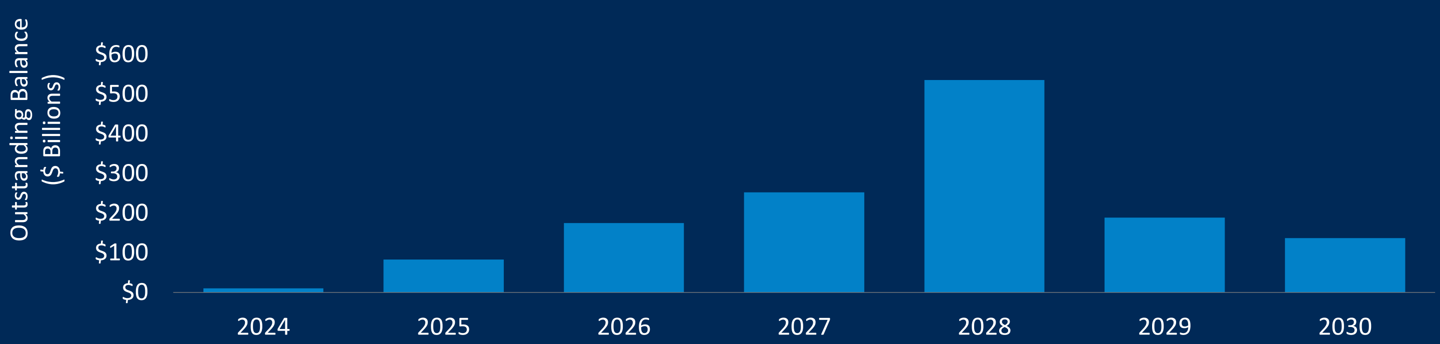
LTV in the Middle Market



Source: LSEG LPC 4Q'23 Private Deal Analysis

Current outstanding loans indicate that refinancing risk is well contained, and near-term maturities are low with only 1% of outstanding loans due in 2024.[8] Sponsors and lenders are proactively working in partnership to extend nearing maturity dates to later years. Monroe believes that these parties will continue this behavior and see borrowers drift from traditional financing options to private credit direct lending to meet their specific needs.

Maturity Breakdown of Performing Loans

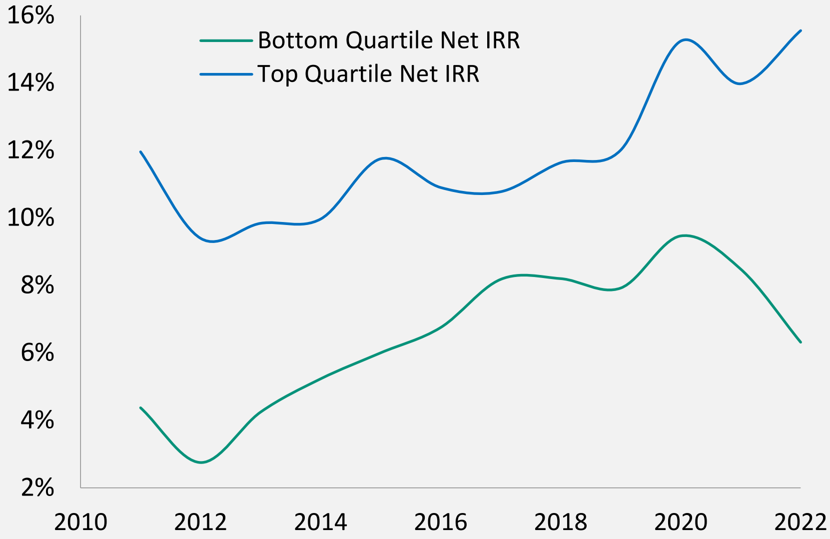


Source: PitchBook LCD

Deal sponsor support is another reason why existing private credit portfolios are well positioned going forward. Over the last few years, private equity fundraising has grown to new heights providing an outsized amount of capital sponsors must deploy. The growing dry powder availability allows deal sponsors to set up their portfolio companies at acquisition with sufficient equity as well as to fund M&A and organic growth opportunities in existing assets. Their support further aligns incentives with company performance and reduces risk of default.

Manager Selection Matters

The secular tailwinds in the asset class, higher base rates, portfolio resiliency and an increasingly optimistic economic outlook has led to the proliferation of private credit. However, not all segments and managers within private credit are the same, and extensive diligence is required on where to allocate capital within the asset class. In our view, there will likely be a wider dispersion of returns between those managers who have an extensive track record, differentiated origination, selective underwriting, and robust portfolio monitoring capabilities, and those managers who do not.



Source: Preqin benchmarking analysis for North American Direct Lending, excluding Opportunistic strategies.

	Average Net IRR	Average Net TVPI
Top Quartile	12.4%	1.3x
Bottom Quartile	6.8%	1.1x
Δ top and bottom quartile manager	**5.6%**	**0.2x**

We believe the following factors are critical to keep in mind when selecting a private credit manager:

1 Strong Track Record and Tenure

With many new entrants into the direct lending space, it is important to vet that a manger has a strong track record across multiple economic cycles. This will demonstrate that a manager is able to consistently apply a disciplined credit philosophy across vintages and not just during bull markets. According to Preqin, experience is rewarded by the market when fundraising.[9] New managers have flatlined in terms of average fund size, while experienced managers have grown rapidly (experience is defined as four or more funds).

A strong track record of deals can also generate incumbency lending opportunities. The ability to deploy capital via add-ons is an important tool for managers to grow their portfolio as M&A levels have declined from 2022 peaks. In 2023, add-on acquisitions represented 35% of all transactions versus 21% at the end of 2021.[10] Along with generating deal flow, incumbency lending provides significant history and information on a borrower resulting in materially lower risk of loss.

2 Large Dedicated Originations Team

A large origination team allows a manager to generate diverse deal flow enabling a manager to be highly selective and allocate towards high-quality borrowers. Having a dedicated originations platform also benefits the underwriting and workout processes as seen below:

Benefits of Having Separate, Dedicated Teams

Originations	Underwriting	Workout
Not distracted by underwriting or deals that require additional resources and time	Does not exhibit bias when underwriting deals, since not involved in originations	Sole focus is on deals that need early intervention that require significant resources

3 Focus on Capital Preservation

With rates being higher for longer, it is critical to pick a manager that is focused on capital preservation rather than reaching for incremental yield that may lead to losses down the road.

Emphasis on Defensive, Recession Resilient Sectors

Managers should focus on industries that have products and services that can generate sales no matter what stage the economic cycle is in. Portfolio mixes that prioritize industries including healthcare, business services and technology, are often more recession-resilient and defensive, than investments that focus on retail and consumer companies.

Bottoms-up Underwriting Approach

Deal fundamentals must be underwritten from the bottom up rather than relying on the caliber and reputation of a sponsor. Managers who work with a wide array of sponsors are not beholden to a few sponsors for deal flow and are more able to have constructive conversations if a deal is underperforming.

Dedicated Workout Capabilities

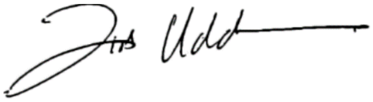
In-house workout experience can be a key differentiator when evaluating GPs. Dedicated workout teams can focus on early intervention which allows a lender and borrower to have flexibility to discuss potential solutions before a borrower breaches a covenant or defaults on payment. The enhanced and more frequent oversight of underperforming deals can lead to fewer defaults and higher recoveries than the market.

Our Conclusion

While the fundamentals for private credit remain attractive, the lower middle market continues to offer higher risk-adjusted returns within the asset class due to its inefficiency and high degree of fragmentation. Existing portfolios have proven resilient and well positioned to handle the elevated interest rate environment. However, to benefit from the higher current yield, prudent manager selection is required to avoid losses. Monroe is confident in its ability to deliver differentiated returns to its investors through its strong track record, vast origination footprint and 'Credit First, Zero Loss' philosophy of investing.

Zia Uddin

President



Endnotes

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