Future of finance

Private Debt: The Core Middle Market

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A major economic need

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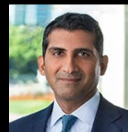

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Key takeaways

- In both the U.S. and Europe, middle market companies represent roughly one third of the workforce and GDP, and these companies continue to scale meaningfully.
- Tighter bank lending standards and a structural shift in public debt markets toward larger deals have created a funding shortfall for many middle market firms.
- Private loans to companies in the core middle market, while often requiring more extensive sourcing and due diligence than loans to larger companies, can offer higher spreads and more protections to investors.
- We see investments with non-sponsored companies – business that don't have backing from private equity – as a significant opportunity in the core middle market.

Introduction

The middle markets in the U.S. and Europe are sometimes overlooked in the context of the broader economy, but they are important segments where we see compelling opportunities in private debt.

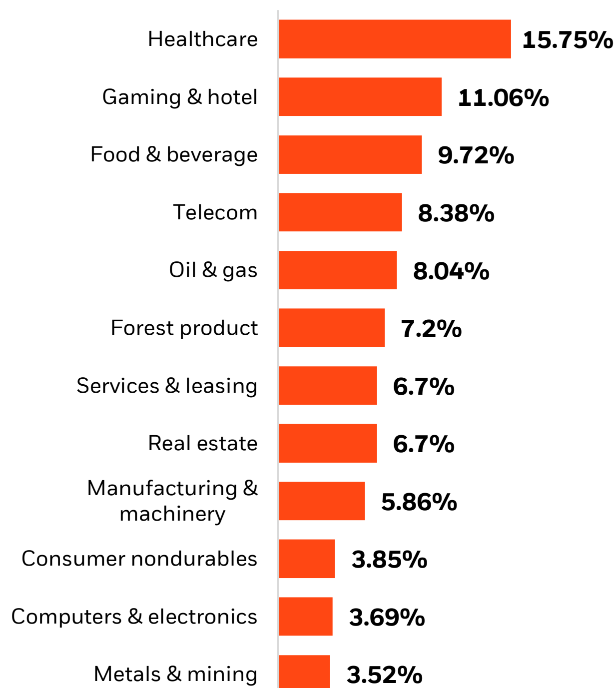
Middle market companies in the U.S. are those with annual revenues between US$10 million and US$1 billion. Definitions vary throughout Europe – in the U.K. and Germany, they are defined as those with annual revenues between €20 million and €1 billion, while in Italy the range is typically from €5 million to €250 million[1].

There are roughly 200,000 such businesses in the EU and an equal number in the U.S. They are responsible for roughly one-third of U.S. employment and GDP. And they drive a similar percentage of Europe's economic activity[1].

The middle market has seen double-digit annual growth in both revenue and employment in 2022 and 2023[1]. Despite its collective size and economic might, the middle market today lacks the capital and financing options it once had.

Sector variety

U.S. middle market loans in 2023 covered a wide range of sectors[2]



Source: 1. The National Center for the Middle Market, 2023; 2. Pitchbook LCD, Q4 2023.

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A need for capital

The past 20 years have seen traditional banks pull back from financing middle market companies. This has opened the door for private lenders to increasingly become the main - and sometimes only - option for middle market borrowers.

While 2022 saw a small uptick in bank lending to the middle market, that was dampened by the 2023 regional banking crisis. As public debt markets continue to focus on bigger companies and larger deals, the middle market continues to be underserved by banks.

At the same time, the preferences of middle market borrowers have shifted meaningfully in favor of private lenders. The reasons are that these lenders can offer unique funding solutions, certainty of execution, and the flexibility that comes from a long-term financing relationship, typically of three or more years to maturity.

For investors, middle market private debt offers exposure to these companies, and to higher spreads and stronger structural protections versus broadly syndicated loans.

Market profile

There's no prototypical middle market company. It is highly diversified across geography and sector, ranging from Dutch medical device companies to trucking fleet operators in the U.S. Midwest and even to local pizzeria chains.

These companies do share a common approach to how they access financing. As they grow, they tend to take a more strategic view toward debt, with leverage targets and more formalized processes for evaluating debt financing[1]. Many of these companies are run by owner-operators and can be less price-sensitive. More than half (54%) of respondents in a recent survey said that a rise in interest rates would not cause them to change their growth plans[1].

While most businesses in this space still primarily look to banks for financing, their priorities when selecting a lender can align in ways that make private lenders comparatively more attractive.

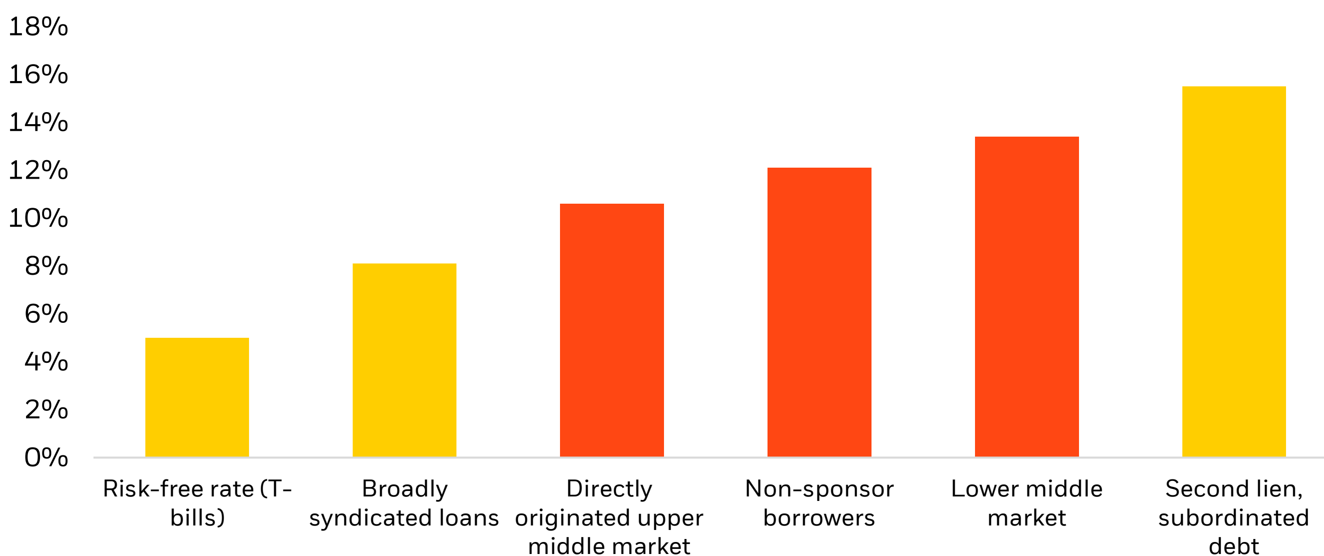
As middle market companies grow, more of them are taking advantage of private debt. For firms with US$50 million to US$100 million in revenue, private debt accounts for an average of 40% of their debt load[1], versus 26% for companies with revenues between US$10 million and US$50 million.

Core opportunities

Amid a favorable environment for private lenders across the middle market, we see particularly compelling opportunities in the core segment, which we define as companies with an annual EBITDA between €10 million and €50 million in Europe, and US$25 million and US$75 million in the U.S. Deals in this space are usually underwritten by either a single lender or a club of no more than five institutional investors.

Premium spreads

Middle market loans can offer attractive risk-adjusted yields[2]



Source: 1. "Access to capital – How small and mid-size companies are funding their futures," the NCMM and the Milken Institute, 2023. 2. Cliffwater; 2023 Q3 Report on U.S. Direct Lending.

This differs from larger borrowers, who tend to rely on financing by banks and dedicated mid-sized lenders. In broad terms, loans to core middle market companies can provide better protections and higher spreads than those to larger borrowers, but they also typically borrow smaller amounts and have smaller networks.

The loans also require more extensive due diligence, and this can make sourcing deals more challenging at scale. Smaller companies can also bring higher business and operational risks. And loans to them may require more protections in the form of covenants and deal structuring to deliver a compelling risk-adjusted return.

But we believe that core middle market businesses provide many of the same benefits as their larger counterparts, such as more developed infrastructure and governance processes, which can help to minimize risks created by unexpected events.

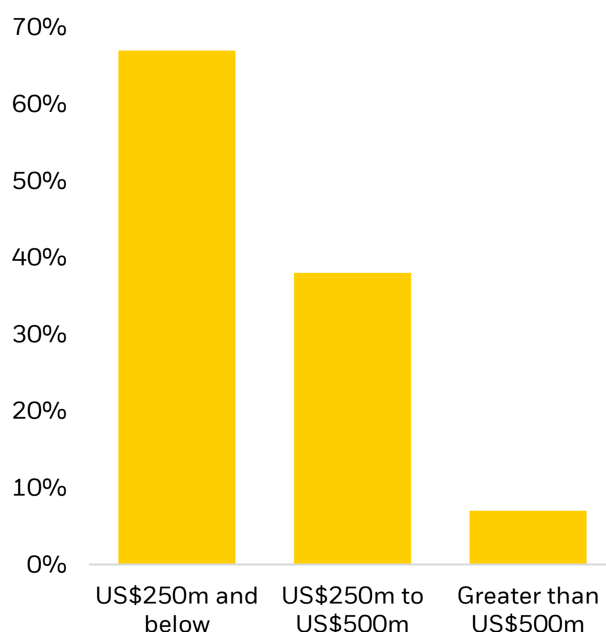
In addition, we see significant upside in the core middle market compared with the upper middle market, where there are more lenders competing for deals. Reduced competition in the core middle market offers wider spreads to lenders, providing greater agency over pricing and better opportunities for outperformance.

Investor protections are one major reason we like the core segment. Because of the bespoke nature of private credit deals, the terms are directly negotiated between borrowers and lenders. Smaller borrowers are thus typically more amenable to providing lenders with covenants and other protections.

Most core middle market companies are also willing to work with lenders to optimize the structure of the loans with lower loan-to-value ratios and larger equity cushions.

More covenants

The percent of middle market deals with maintenance covenants by deal size



Source: Moody's Investors Services, September 30, 2023.

Lenders can also often negotiate prepayment protection and the ability to customize reporting to ensure greater transparency and visibility into operations and performance.

And even as maintenance covenants have become less commonplace in the upper middle market, they remain accessible within the core middle market.

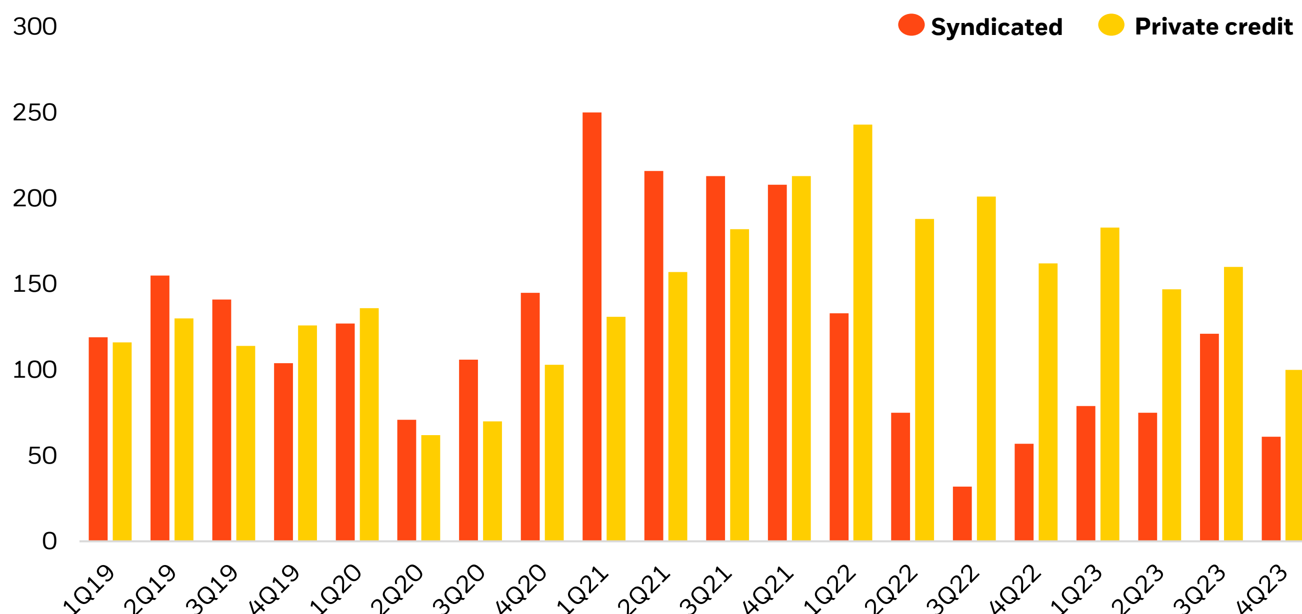
Challenges and opportunities

As the middle market grows, its financing needs continue to increase. Loans to middle market companies can provide attractive risk-adjusted returns, with higher spreads and more contractual protections, but investors need to exercise diligence to be successful.

	Lower middle market	Core middle market	Upper middle market
Company size EBITDA ($ and €)	Up to US$25m	US$25m- US$75m	US$75m and US$150m
	Up to €10m	€10m - €50m	€50m and €100m
Typical lender	Commercial banks, sole lenders, small clubs	Commercial banks, sole lenders, or clubs of 1-5 lenders	Investment banks, dedicated middle market lenders, clubs, or syndicates

Going private

Middle market private deals are increasing relative to broadly syndicated loans



Source: Pitchbook LCD, Nov. 30, 2023. Chart is composite of data for LBO and non-LBO deals. Private credit count based on transactions covered by LCD News.

The market for middle market loans is spread out geographically and across industries. Sourcing the right opportunities can be challenging, given the breadth of companies and the limited information available to lenders. Venture capital and private equity firms can be a reliable pipeline for private lenders, and these relationships are essential in this space. Loans to companies backed by these investors are referred to as sponsored financings, with the sponsor often playing a big role in soliciting and negotiating the loan.

Non-sponsored loans are those made to companies that lack the backing of a venture-capital or private-equity investor. Rather, the lender works directly with the company, often without a bank or other intermediary.

Historically, many private debt investors have favored sponsored over non-sponsored borrowers, as sponsors can provide valuable guidance and insight, as well as additional equity capital during periods of distress.

In addition, borrowers can often rely on the sponsor to provide useful information to potential lenders and help to expedite financing and diligence processes.

Lending to non-sponsored companies typically requires an experienced lender with the resources and expertise to complete a more hands-on due diligence and credit analysis.

On occasion, this can create additional challenges, though opportunities in the non-sponsored space often provide meaningful upside to compensate for this perceived risk.

There are a limited number of private credit lenders capable of this level of work, and non-sponsored companies lack the venture capital or private equity partners to facilitate borrowing opportunities. As a result, these companies typically don’t have as many bidders for their loans. And lenders have more bargaining power to negotiate better pricing and stronger downside protections, which can result in a better risk-return balance.

It’s important for lenders to access different sourcing channels in response to market events, so if sponsor-backed M&A activity slows down, investors can still access non-sponsored deployment opportunities without sacrificing on key terms.

The importance of middle market companies to the global economy makes it essential for them to access capital when they need it. And we believe that this segment offers unique opportunities to the lenders who provide the requisite capital to these companies as they continue to expand their operations.

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