EXPERT Q&A

Global trends are less of an issue in the traditional mid-market, say Churchill Asset Management's Randy Schwimmer and Derek Fricke

Direct lending: Where LPs should be focused

Q As interest rate expectations shift and the broadly syndicated loan market has reopened, how can investors evaluate the private debt opportunity today between the lower, traditional and upper-mid market?

Randy Schwimmer: As market observers look at what is going on in public and private credit, what often gets overlooked is the traditional mid-market. Headlines tend to focus on large sponsors and the global M&A dynamics, losing sight of many great companies that are not traded and may fly under the radar.

People may not know the names of the companies in our portfolio as well, but over time, traditional mid-market private equity has been able to build value in these small and mid-sized businesses. They have grown these companies organically with sophisticated management tools, capital and resources to help take them to the next level. Traditional mid-market companies, with EBITDAs between $15 million and $75 million, generally tend to be more growth-orientated, less cyclical and more service-focused, so with sponsor support, there are natural tailwinds that allow them to generate good value for LPs.

We believe financing these companies is attractive because they typically come with covenants, more conservative lending structures and slightly better pricing than the liquid markets.

Derek Fricke: In our private equity and junior capital business, we have focused on the traditional mid-market because of the embedded growth opportunity that sponsors with a demonstrated track record can bring to the table.

Additionally, as an LP in more than 300 private equity funds, we can actually access that track record data and use it to our advantage. The fundamental question is always "why should this sponsor own this platform, and why are they the right buyer to execute the value creation strategy?" We look at prior outcomes to truly understand if they are the right buyer and the ability to

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underwrite both the company and the sponsor really differentiates our investment approach.

In larger upper mid-market transactions, however, you often get limited access to information and have limited time to complete your underwriting, which is why our model works best in the traditional mid-market, where deals are often directly negotiated.

We also believe traditional mid-market companies offer multiple ways to win. They don't have to maximise leverage to hit the base case, and can carry a more conservative capital structure that aligns to their growth initiatives with a built-in cushion so they can service their debt even while re-investing in the platform.

Q How do deal sourcing strategies differ and, in a more competitive market, which managers are accessing the top deals?

DF: Scale matters, as does having a true partnership approach. Can the lender construct a comprehensive and creative capital solution that aligns with the sponsor's goals? Having a strong balance sheet and capabilities spanning senior and junior debt to equity co-investments and secondaries helps.

We have hundreds of long-standing private equity relationships, many of whom we are an LP in, and importantly, we have proven to be a good partner over time – in the good times and the bad. That differentiates us from competitors that just want to compete on price and allows us to consistently

Q When looking under the hood of a manager's track record, which key metrics are really most important?

DF: It is all about providing investors an in-depth understanding of where they sit on the balance sheet and how you are delivering an appropriate risk-return profile. Some of the key metrics that investors hone in on are absolute leverage, LTV, fixed vs floating and all-in coupons, total returns, and what your historical loss ratios are.

Collectively, these metrics give an investor a picture of the risk-return they can likely expect through an investment. Over the last 12 years, our junior capital detachment point has been approximately 5.5x, our LTV is roughly 50 percent, and our all-in total yield is in the double digits. Over the same period, our loss ratio is less than 2.5 percent across $7.5 billion of invested capital.

RS: Track record is a bit like sourcing: the reality is that having low losses in a benign environment is wholly different to having low losses in a high interest rate environment and being able to continue to grow the portfolio when global M&A is down.

Being able to work with private equity clients to continue to source quality transactions, and knowing they will be there to support the businesses through difficult times, is just as important as track record.

source attractive dealflow through market cycles from top firms.

RS: As companies get to a scale that qualifies for high yield bonds or broadly syndicated loans, the nuances of structuring tend to fall away. The discussion is more about higher leverage, lower pricing and weaker structures. In direct lending, there is more focus on flexibility and having a quicker and more efficient financing process with a lender that can be trusted.

In 2022 and 2023, broadly syndicated loan activity was muted and borrowers had to come to us. Today, if you are a credit manager in the large cap space, you are competing with the banks. We don't do that: the private equity clients we are partnering with are looking for structures for growth and flexibility, and for lenders that can speak for entire deals rather than syndicating to 50 different lenders they don't know.

Investing within the traditional mid-market allows for much more consistency in the way we source deals ,because whether there is a broadly syndicated loan market or not doesn't affect our strategy. Our dealflow has actually increased with more liquid credit available because our market segment isn't going for that liquid credit.

DF: Our dealflow quarter-over-quarter has remained strong over the last 18 months relative to the overall market backdrop being down 20-30 percent. We think that is because sponsors are calling a smaller group of core lenders that they know have the capital and creativity to construct capital structures that will work in a higher rate environment.

Q In light of today's lower new deal environment, which managers are best positioned to consistently put investor capital to work in attractive opportunities?

RS: The sponsors we target have been working with mid-market companies and industries for decades, with operating partners and senior leaders that can identify attractive opportunities for growth. They seemingly know all the competitors and vendors in their respective sectors, and develop M&A strategies that don't necessarily depend on what buyers and sellers are willing to pay in auctions. As a result, even in today's slower LBO environment, add-on acquisitions and refinancings from our existing portfolio of more than 450 companies has kept us quite busy.

DF: Being the incumbent lender to hundreds of portfolio companies is an enormous advantage when it comes to sourcing deals. Sellers, management teams and founders want to work with a sponsor that is already educated on their space, just as sponsors want to work with lenders that are educated in their space. They don't want to be bringing lenders up to speed on business models and industry verticals.

A sponsor that we know well is buying a food business right now and we have lent to two of their prior food companies in a junior capital position. They have put the same senior lender group together as they had on the previous deals, and came to us as sole junior capital provider. They know we know how to construct an attractive junior capital facility to fit the business model and complement their thesis.

Q Randy, you serve on Churchill's senior lending investment committee, and Derek, you on junior capital. What are some key questions LPs should ask during due diligence when evaluating a manager's underwriting approach and risk management?

RS: It's important to hone in on how a manager thinks about selectivity and diversification, which we believe are cornerstones to building a solid private debt portfolio.

We bring in about 1,000 deals a year and only close on 6 percent, so we have a long list of requirements that companies need to fulfil. We draw on our 18-year track record of seeing which businesses do well despite economic slowdowns. And that selectivity continues into how we construct our portfolio, because we might really like a business but still look at the overall portfolio construction and conclude we don't need another healthcare company, for example.

LPs are laser focused on how we select deals, how we monitor them once they are in the portfolio, and importantly, what we do if there is a problem. Historical data, numerous case studies and detailed examples of outcomes are paramount here. It is all about protecting the downside.

DF: We have a similar investment philosophy across senior debt and junior capital. We get a lot of the same questions about why sponsors ultimately choose us as a partner and what's different about our sourcing model.

They want to know what types of assets we are targeting, and whether they are in defensive growth industries or with service-orientated business models that create recurring revenues, with high free cashflows. They ask if we are conservative with our capital structures, how we think about leverage and how we align a sponsors' interests with our own.

It's a trust but verify model. We benefit from the fact that if you look back over the 12 years since we began our junior capital programme, the annual metrics are consistent, the leverage profile is consistent, the loan-to-value ratios are consistent and the EBITDA profile, size and margins are all consistent. That gives investors comfort that we execute on the strategy that we say we do, and it's proven successful. ■

Randy Schwimmer is vice-chairman for investor solutions and Derek Fricke is senior managing director in the junior capital and private equity solutions team at Churchill Asset Management