And Such Small Portions (First of a Series)

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Last fall we ran a special series on the size of the middle middle for loans (*"How Big is the Middle Market")*. This week we re-examine that question with Kelly Thompson, the middle market analyst for LevFin Insights.

In a recent report, Kelly discussed both the volume of middle market loan activity in 2017 as well as the supply/demand dynamics generating that activity. We caught up with Kelly this week to compare notes on these two important issues for lenders and investors.

"We measured $29 billion in sponsored loan volume in the middle market last year," Kelly told us. "That's not a bad number for any vintage. But middle market loans have become an institutional asset class in their own right. It's becoming more difficult to sop up all that supply given the cash flowing into the market."

How much are those in-flows? "Well, compare that $29 billion to the $43.2 billion in visible funds we (with our friends at Wells and Fitch) tracked last year across new-issue MM CLOs, credit funds and BDC equity raises. That's a big gap of $14 billion."

Ok, but as we covered in our series, there's guesswork in both sets of numbers. "You're right," she said. "But first let's talk about the definition of middle market. LevFin's metric is Ebitda of $50 million or less. Of course you need a Ouija board to call up the right definition of Ebitda today, what with add-backs and adjustments. But our sample is pretty clear cut."

So you don't sort by facility size? "No, that would allow add-ons for larger issuers to slip into the sample. It can also be muddied by companies with term loans of a certain size, but also outstanding bonds. If you're a high-yield issuer, you're not a middle market company."

Kelly continued. "Our $29 billion tracks a very specific tier of the middle market —sponsored loans. That's where the action is. Traditional middle market players like you guys, Antares, Golub and new entrants play here because fees and yields are better. Sponsored deals are mostly funded, so investors benefit more than from unfunded corporate pro rata deals. And experienced PE shops can shield senior lenders with significant equity cushions."

We wondered, do you consider this the "club" market? "It's certainly not broadly syndicated," Kelly said. "It's distributed to an average group of 8 to 10 lenders. Clubs of two or three aren't in the report. Neither are lower middle market credits. Of course the less visible or efficient the distribution process, the better for investors. The tough part is digging out those deals."

On the demand side, we talked to Kelly about the $43.2 billion of fundraising (see our *Chart of the Week*). How much of this captures market appetite for middle market sponsor credits?

"That includes direct lending funds, middle market CLOs and listed BDC equity raises," she replied. "We know direct lending earmarked for middle market loans was $27.5 billion, or about two-thirds of the total. That jives with Preqin's $29.2 billion for midcap-specific funds.

New CLO activity was pretty strong last year. “Yup. A post-crisis record of $14.5 billion, second only to 2006’s $20.3 billion (per Wells Fargo).”

But there’s stuff you’re not capturing. “The $43.2 billion doesn’t include SMAs, co-mingled funds and pension and endowment allocations,” Kelly said. “SMAs and co-mingled funds are tough to track because they’re not publicized. Pension fund allocators are relatively new to the middle market asset class. It’s not yet tracked separately among allocations.

“But most investors tell us these numbers are directionally right. The fact that terms are so issuer-friendly today bears that out.”