

The Cargo Pants Strategy

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How much direct lending capacity is in the middle market? Welcome to one of the most frequently asked (and most challenging) questions in the world of leveraged lending.

Several factors make this question topical. First, banks are being forced to scale back their ambitions in “risky loans” as regulators bury them with restrictions. Non-regulated entities – BDCs, insurance companies, hedge funds, finance companies and pension funds – see the exit of banks as a vacuum to be filled. This trend is compounded by investors’ belief that the middle market offers benefits other asset classes do not: better yield, conservative structures and lower volatility.

Middle market firms such as GE, Ares, Golub and Madison – leaders in the space for over a decade – have been joined by other entrants, including Monroe, NXT, Fifth Street and Prospect. These companies began with one or two funds, often backed by LP investors. To enhance capacity they launched structured vehicles, such as CLOs and public BDCs, all dedicated to providing private credit to medium-sized entities.

These strategies required considerable equity investments over time, so lower-cost alternatives emerged. Separate managed accounts became increasingly popular. Insurance companies, for example, gave firms capital to invest in subsidiaries of the management companies.

Creating multiple funding pockets – we’ve dubbed it the cargo pants strategy – allowed middle market arrangers to compete effectively against banks (see [Chart of the Week](#)).

Two types of players are now in a battle to add capacity: loan arrangers (originators of leveraged loans who underwrite and distribute the paper) and loan buyers (asset managers who control buckets).

For arrangers, the name of the game is creating one-stop debt solutions for clients, particularly private equity sponsors. Historically, underwriting roles went to banks. But even the larger agents had hold limits. Non-banks with cargo pants can write big checks and hold them in various pockets.

Take Golub Capital. Once primarily a provider of mezzanine capital, Golub has become a leading arranger and asset manager of middle market senior debt. The firm has established over a dozen separate vehicles – including leveraged private funds that use CLO technology to borrow at low rates, a BDC and separately managed accounts. This diversity allows Golub to underwrite big deals for sponsor clients, then distribute the loan among its internal funds.

While arrangers can sell strips across multiple (or within single) tranches, holding the entire loan removes syndication risk, satisfies asset appetite for investors and co-investors and limits each pocket’s concentration risk with borrowers.

For loan buyers, more capacity means higher hold levels. The difference between a \$10 million and a \$75 million ticket is significant in a \$200 million term loan. Larger buy-side shops receive favorable allocations, translating to faster AUM growth, greater fees and income.

It's hard to know how this arms race will end. But as more players wear cargo pants, it is tough to track how much lending capacity is being built by nimble firms who find innovative ways to grow.

So what happens in a downturn? As in 2009, the middle market will be ripe for consolidation, with access to capital limited to the fittest. To paraphrase Warren Buffett, when the tide goes out, we'll see who's really wearing cargo pants.

This column first appeared in the weekly newsletter of [Creditflux](#), a leading global information source for the credit trading and investment market.