Business of Private Credit: Sectors and SIC Codes

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We’ve spent the last few weeks covering the businesses of the core middle market. Does that same discipline hold when you move up market?

The way managers organize their underwriting and portfolio management teams is a byproduct of sector focus. Deal selection in the BSL market runs through sector specialists, analysts responsible for specific coverage areas. The core middle market leans towards generalists evaluating businesses on their own merits. The upper middle market uses a generalist model with some industries (e.g. healthcare) deserving more attention.

Given how the UMM competes with the BSL market, it can reflect the same momentum-driven traits. The hottest sectors and themes tend to make up a larger share of the portfolio. Whether that is energy, retail, or transportation when the economy is running hot, or AI and technology in the post-COVID, low-interest rate world.

In the CMM, the borrower comes first. You underwrite a pest control company, an HVAC business, or a wastewater management contractor because of what it does and who it serves. Middle market businesses are too niche and specialized to fit neatly in industry categories. Think SIC codes.

As we noted in our *(Smaller) Size Matters* piece, concentration runs meaningfully higher in the UMM than the CMM, and that gap has only widened. Over the last five years, UMM overlap has climbed sharply, a function of just how competitive and crowded that end of the market has become.

Everyone looks good when the cycle cooperates. But when it turns, or a hot sector starts showing cracks, that concentration compounds fast. Non-accruals in software have been climbing right along with the momentum that drove them.

Core MM lenders typically don’t chase sectors. They favor “LALO” (light-asset, low obsolescence) businesses that have demonstrated steady, non-dramatic growth. Owners and management teams improve revenue and cash flows through customer relationships, disciplined M&A, and operational execution rather than sector tailwinds. Performance can often outpace their larger (or non-sponsored) peers.

And because sector exposure is a secondary sourcing filter, CMM portfolios are spread across industries that aren’t synched to the same economic cycles.

Momentum can be your friend, but sometimes not so much. We think public equities and fixed income are great complements to a private capital allocation because you can have the best of both worlds. Momentum as the accelerator and privates as the brakes are helpful for a safe investing journey.