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Why Sponsors Matter (First of a Series)

THE LEAD | September 14, 2016

Our discussion last week of the Fed's confusing position on interest rates drew a number of favorable comments. "This is precisely right," one reader wrote us. "They should just go ahead and raise rates. The more they delay, the tougher it'll get."

But our reference to the economy as a "Goldilocks environment" left at least one reader puzzled. "Loved your article," this young banker tweeted us, "but was wondering what the state of the US economy has to do with the Three Little Pigs?"

Nursery rhyme confusion seems to be just one of the many symptoms afflicting investors today. Amid numerous cross-signals from both the Fed and the economy, it's a wonder anyone retains a clear sense of direction.

Bullish signals from governors following their August meeting resulted in the "Jackson Hole rally" in which markets headed higher. But worries about interest rates, oil prices, and corporate earnings have caused the Dow to sink 500 points in the past week.

This bewildering state of affairs reminded us that investors now put a premium on non-correlated assets. They also crave access to leadership that understands how to operate in an environment in which market volatility will be a long-term factor.

That view has inspired us to address a topic that seems to be much on the minds of institutional investors; namely, what are the benefits of investing in private equity owned middle market companies, compared with non-sponsored, mid-corporates?

Over the next several weeks, we'll examine the features of both types of lending, with particular attention to the role private equity sponsors play in the management and governance of their investments. We'll also take a look at the non-sponsored lending landscape – who are the players, what are the upsides, and what are the risks?

To begin, let's state the obvious: private equity sponsors are professional investors/managers whose job it is to invest their capital (and that of LPs) to produce the consistently highest returns at the lowest risk. As we've often highlighted in this space, PE-backed companies are chosen because they represent the best opportunities for revenues and earnings growth, as well as enhancement of enterprise value.

Middle market companies are often begun by entrepreneurs with visions of fulfilling a consumer or corporate need. These founders can be long on creativity and short on management skills. Their businesses display early growth, then plateau unless more experienced executives are recruited to help guide corporate development.

It's for precisely that reason that lending to mid-corporates is tricky. Without better managers, these companies find it difficult to "get to the next level," and may run into trouble in challenging economic or industry climates. Ironically, these are the very companies sponsors look to invest in. And they bring unique tools to the table.

Next week, we take a look at what those tools are, and how private equity and lenders work together to create successful middle market investments.