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Lower middle market could be sweet spot in downturn

US Low leverage and strong covenants likely to protect borrowers against ailing economy

Companies with just a few million US dollars in earnings and little debt may be better suited to brave higher interest rates and rising inflation than their larger counterparts, a characteristic that could buttress lower middle market lending volumes further in a downturn scenario.

In an inflationary environment plagued by recession fears, low leverage and strong covenants are intrinsic characteristics of lower middle market borrowers that are likely to protect them against an ailing economy.

There were 158 lower middle market loans issued in the second quarter of 2022 as opposed to 133 in the same quarter of 2021.

"When we lend money to lower debt-to-Ebitda companies, they have more room to absorb the 'shock' [of higher inflationary costs or a challenging economic environment]. If a business is already leveraged five times or more, it doesn't have much room left to absorb pressure," said Rohit Vohra, head of global wealth alternatives at Principal Global Investors, a multi-investment firm with US$507bn globally as of June 30.

While each firm may have its own definition of lower middle market, Principal Alternative Credit, the direct lending business of Principal Global Investors, defines it as a company with Ebitda between US$5m and US$15m.

Average leverage on deals for middle market borrowers with less than US$20m of Ebitda dropped slightly to 4.14 times for first-lien leverage and 4.31 times for total leverage in the second quarter from 4.33 times for first-lien leverage and 4.63 times for total leverage in the first three months of the year, according to LPC data.

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According to Capital Dynamics, a lender focused on companies with Ebitda between US$7.5m and US$50m, tighter financial terms and less debt make the lower middle market more attractive to lend to than larger companies with more debt.

"Lower leverage allows borrowers to absorb increasing interest rates for longer, as well as reduced margins caused by inflationary pressures," said Thomas Hall, co-head of private credit at Capital Dynamics.

"Inclusion of strict financial maintenance covenants, which will serve as an early warning sign if results start to deteriorate, give lenders the ability to be at the negotiating table."

A strong covenant package allows the lenders to meet the borrower at the negotiating table as soon as an issue arises. In the upper middle market, loans have fewer covenants, giving investors less power to push for immediate changes to the credit.

"In non-sponsored middle market lending opportunities, lenders have much higher covenants and therefore the ability to sit at the table much earlier in the process to renegotiate the loans or set up a path for recovery," said Vohra.

The risk, on the other side, is that these smaller companies can go out of business more easily for poor management, insufficient capital, or lack of planning rather than specific market conditions.

Middle market lenders remain watchful of deteriorating market conditions and are "highly selective", said Carey Davidson, head of capital markets at Monroe Capital, about picking the right sector and company.

Monroe Capital typically lends to companies with Ebitda between US$3m and US$35m that are backed by sponsors and privately held.

Monroe has not seen "significant liquidity issues in [the firm's] companies with the rate increase to-date", but "is watching closely", she said. "We are not naïve, we acknowledge there will be a pressure point."

Despite rising rates and economic woes, demand for middle market lending – and specifically, lower middle market lending – is expected to endure.

"The private equity community has substantial dry powder and the number of private equity-owned businesses is at record highs," said Reed Van Gorden, head of origination at Deerpath Capital Management, a direct lender specialised in senior debt investment to lower middle market companies.

"These companies will need growth, acquisition or refinancing capital."

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