INVESTMENT
PERSPECTIVES

Capital Dynamics
TRULY INVESTED.

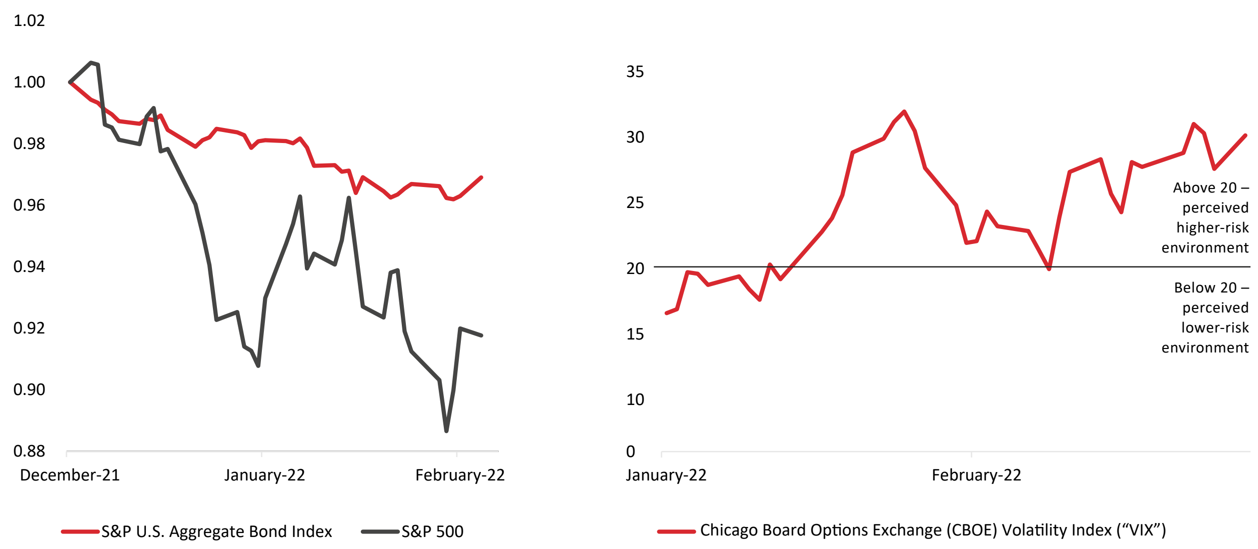
MARCH 2022

U.S. LOWER MIDDLE-MARKET DIRECT LENDING: A SAFE HARBOR IN TIMES OF MARKET INSTABILITY

THE PANDEMIC CHANGED THE ECONOMIC LANDSCAPE, FUELING INFLATION

COVID-19 triggered a meaningful shift in the complexion of the U.S. economy, creating an environment that has stoked price increases and changed market expectations for interest rates. The prospect of enduring inflation and a more hawkish Federal Reserve (“Fed”) has implications for investors as inflation dampens real returns and rising interest rates negatively influence asset prices, particularly longer-duration financial assets. For companies, inflation represents a double-edged sword. While it often supports revenue growth as companies increase prices on their goods and services and enjoy robust demand from consumers motivated to spend dollars today that will be worth less tomorrow, it also burdens the expense side of the ledger. Inflation raises the cost of inputs, fuels wage growth and often precipitates interest rate hikes by the Fed, all of which translate into higher operating and financing costs for companies. For consumers, wage increases are a welcome consequence, but if general inflation on goods and services outpaces wage growth and rising interest rates drive up borrowing costs, the U.S. economy is likely to cool off meaningfully. As such, moderate and stable inflation tends to be positive for the economy and financial assets, while rapidly accelerating price environments are a recipe for trouble.

Increasing Volatility Met With Declining Equity and Debt Markets[1]



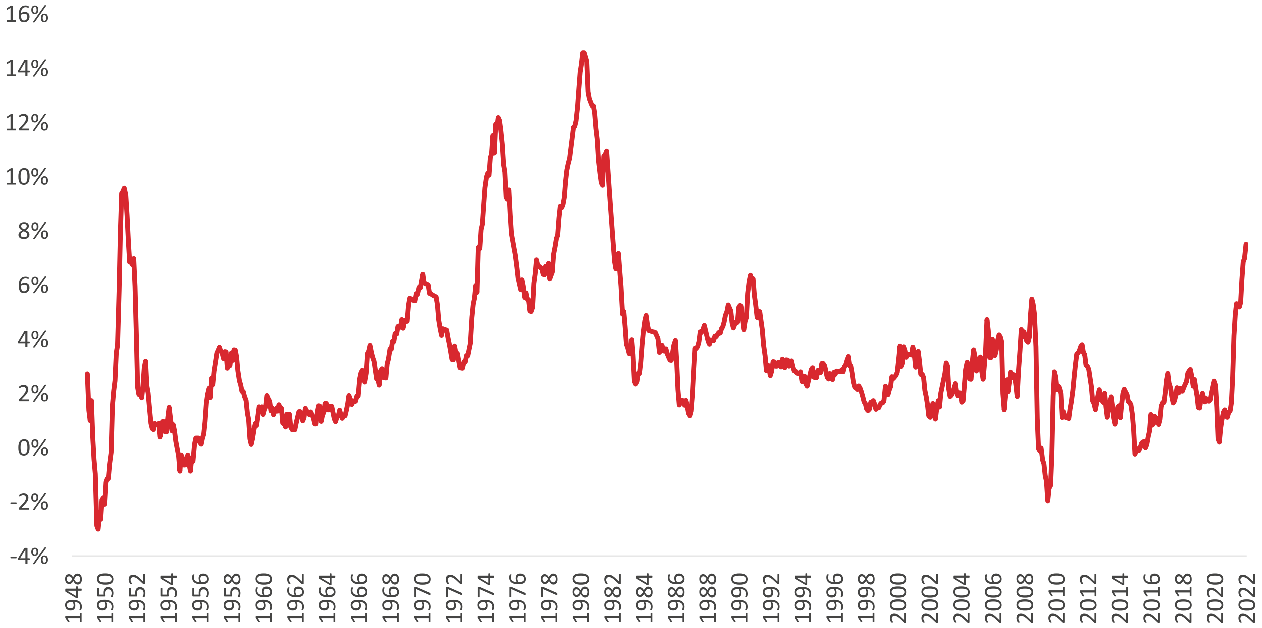
With growth readings for the consumer price index (“CPI”) exceeding 7% in January 2022 and little relief in sight, investors have grown cautious. The effects have already been felt across financial markets, with publicly-traded equities and fixed income delivering negative year-to-date returns, and volatility, as measured by the Chicago Board Options Exchange (CBOE) Volatility Index (“VIX”), spiking to above 30 at the end of January – considered a higher-risk environment. Direct lending, the largest segment within private credit, may offer investors a hedge against inflation and rising rates. In addition to being shorter duration financial instruments (two- to three-year average life), corporate loans typically generate interest income that floats with underlying market rates. Consequently, the leveraged loan asset class generally outperforms other fixed income asset classes during periods of rising interest rates. Furthermore, in the U.S. lower-middle market, supply and demand dynamics provide lenders to companies in that market with greater ability to dictate loan terms and structures than do the competitive dynamics for lenders to companies in the core and upper-middle markets. As such, consistent yield premiums enjoyed in the lower-middle market coupled with rigorous underwriting, driven by longer transaction timelines, and conservative structuring may provide investors further protections against real return erosion and losses stemming from rising input costs (raw materials and wages) and / or economic recessions triggered by overly aggressive interest rate hikes.

[1] *Source: S&P Dow Jones Indices and Federal Reserve Bank of St. Louis. Year to date returns as of February 28th 2022.*

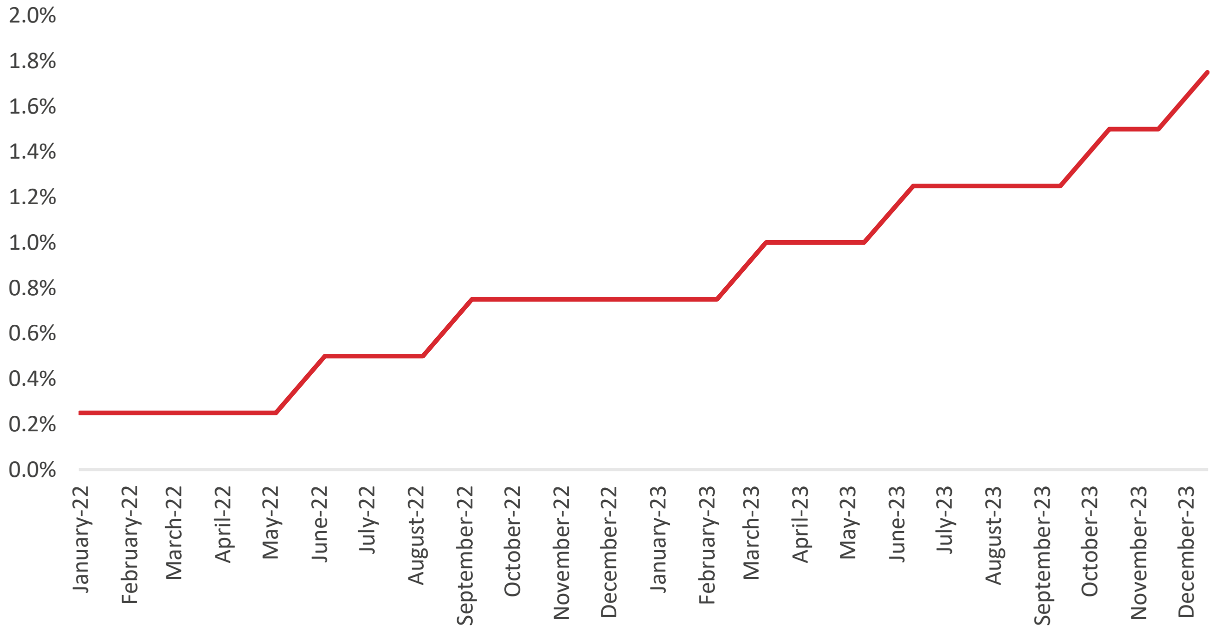
INFLATION AND RISING INTEREST RATES

After more than a decade of largely accommodative monetary policy, there is increased speculation that the Fed is prepared to end quantitative easing and raise interest rates to combat inflation and a potentially overheating economy. A combination of restrictions imposed during the pandemic, fiscal stimulus, a recovering economy, and global supply chain dynamics has pushed CPI growth to levels not seen in 40 years and well above the Fed’s 2%-3% target. Initially, the Fed characterized the environment as transitory but the persistence of increased prices on goods and services led to an acknowledgment that elevated inflation is likely to prevail for longer than originally anticipated. Further complicating the picture are the recent geopolitical developments in the Ukraine, which are adding to the momentum behind commodity price increases and potentially raising the specter of stagflation, or an environment characterized by high inflation and moderating or stagnating growth.

Annual U.S. Consumer Price Index (Inflation Rate %)[2]

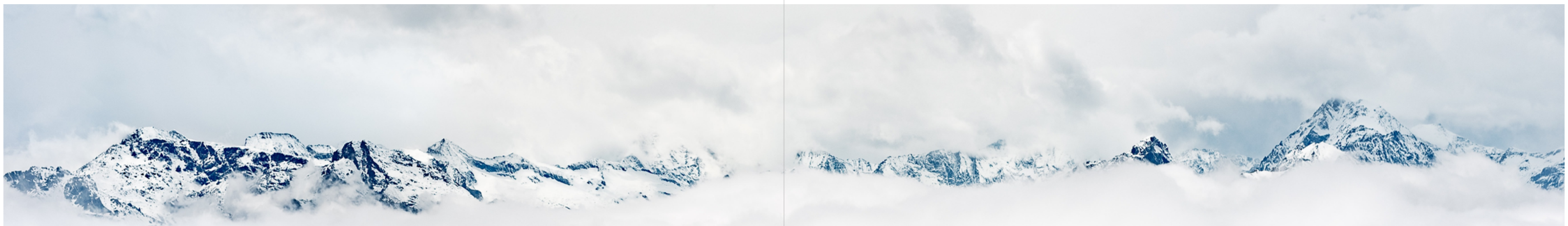


Policy Interest Rates - Forecast[3]



[2] *Source: U.S. Bureau of Labor Statistics, Consumer Price Index as of January 2022. All dates as of January.*

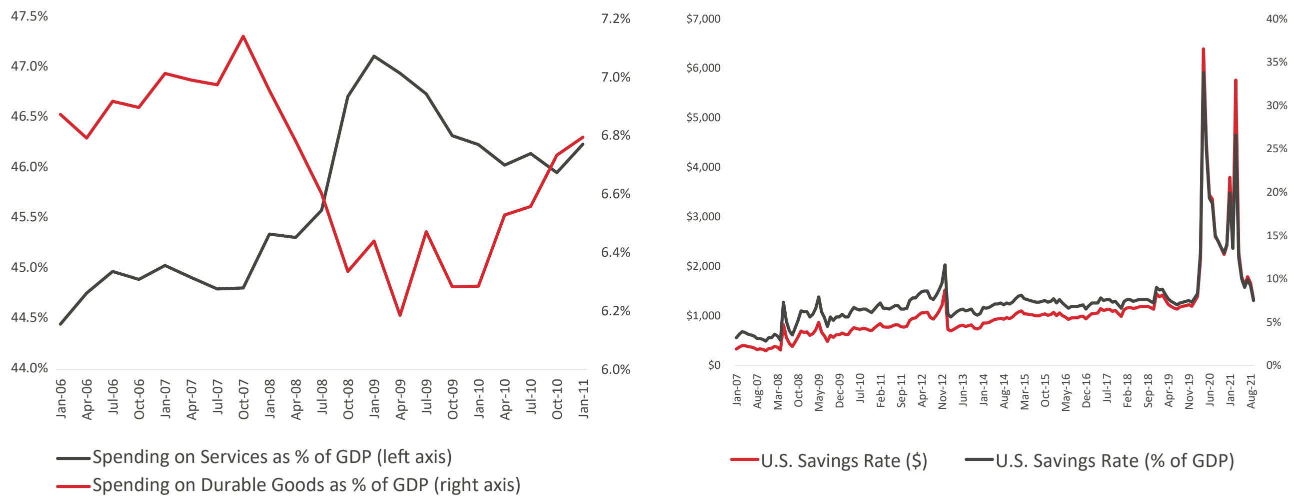
[3] *Source: Note: US policy rate shows the upper bound of the Federal Funds Rate. Source: Fitch Ratings.*



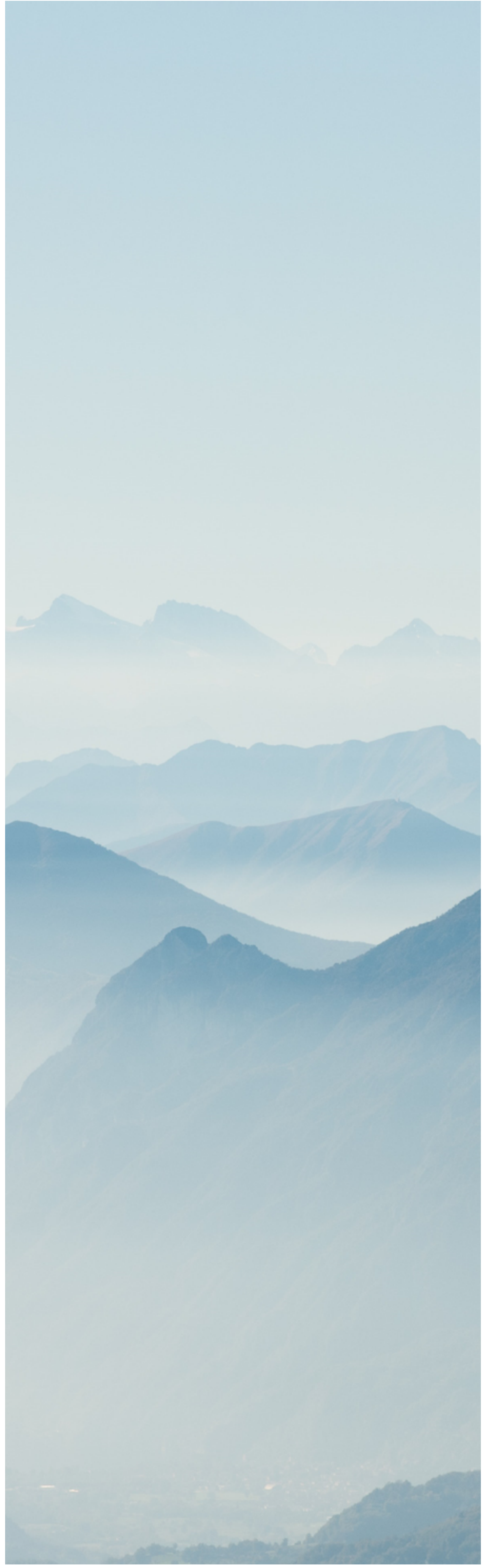
Some of the economic idiosyncrasies of the pandemic likely informed the Fed's early perspectives.

Consumers, sequestered to their homes during lockdowns and with limited opportunities to spend excess earnings on travel and leisure, even after lockdowns were lifted, dramatically changed their purchasing habits. Online and, to a lesser degree, in-store shopping for discretionary goods largely replaced spending on, for example, dining, concerts, movies and vacations, interrupting a secular trend toward U.S. consumers spending on experiential activities as opposed to material goods. Significant fiscal stimulus funneled through various economic aid packages such as the Coronavirus Aid, Relief, and Economic Security (CARES) Act, also pushed household savings rates higher, increasing consumer spending power and further fueling consumption on goods and services that improved the home, enhanced the work-from-home experience, or promoted socially-distanced activities. Meanwhile, companies spent heavily on technology and tools to facilitate work-from-home capabilities or to reconfigure floorplans to provide safer workplaces for their employees. Employers also had to contend with a reluctant workforce that, for a period, was earning the equivalent or more by staying home rather than coming to work. This dynamic drove up employee costs, as higher wages were required to entice workers to return to work or overtime was paid to existing workers to sustain operations.

Impact of 2008-2009 Global Financial Crisis on Consumer Spending[4]



[4] *Source: U.S. Bureau of Economic Analysis, Real Gross Domestic Product [GDPC1], Real Personal Consumption Expenditures: Durable Goods [PCEDGC96], Real Personal Consumption Expenditures: Services [PCESC96], retrieved from FRED. Personal Saving retrieved from FRED, Federal Reserve Bank of St. Louis*



Changing consumer spending behaviors also stressed supply chains. Today's global supply chains are designed to be as lean and capital efficient as possible, with just-in-time manufacturing and shipping tied to real-time demand data. The shift in purchasing patterns, coupled with interruptions from manufacturing plant shutdowns in China and Southeast Asia (resulting from strict COVID lockdown protocols and energy disruptions) and staffing shortages and infrastructure deficiencies at global ports, overwhelmed the system, compounding supply and demand imbalances and causing additional inflationary pressures.

While the factors contributing to rising inflation were observable and predictable, it would have been reasonable to assume that their impact would be transient in nature. With the approval of vaccines and treatment therapies that shortened the course and severity of COVID-19 infections, expectations were that economies would reopen and life would revert to "normal." Consumers would pivot away from product purchases and resume spending on experiential activities; ebbing stimulus would dampen demand and push workers back into the workforce; and slowing goods purchases, coupled with re-staffing and investment in logistics infrastructure would alleviate supply chain congestion. Instead, new variants of the virus led to further restrictions and consumers, again unable to travel, doubled down on existing behavior, including ramping up goods purchases for the holidays to compensate for close to two years of COVID-related misery. Workers also continued to be wary of returning to work, with many employees choosing to leave the workforce entirely, either because they were close to retirement, for fear of being infected, or because the on-and-off school schedules created too many headaches for working parents to manage.

Fundamentals, however, suggest that inflationary pressures are set to ease in the medium term. U.S. demographics remain unchanged with a large segment of the population aging into a life stage where saving will take precedence over consumption. The secular trend of spending on experiences rather than material goods also remains intact, and lagging supply chains are likely to catch up to slowing goods demand. A level of wage inflation is likely to be permanent going forward, however, as those same demographic trends (aging population nearing retirement) coupled with lower labor participation levels, and slower immigration will lead to diminished workforce supply. Despite these dynamics, the Fed finds itself in the challenging position of having to thread the needle of moderating demand and short-term overheated inflation, without tipping the economy into a recession. The market appears to believe that the Fed is falling behind the curve in that regard, and that it will need to take dramatic steps. Prognosticators are projecting anywhere from two and seven Fed rate hikes of between 25 to 50 basis points ("bps") each in 2022. That said, the crisis unfolding in the Ukraine may auger more cautious Fed action in the near term, and investors now expect a 25 bps hike at the scheduled March meeting of central bankers versus earlier expectations of a more dramatic 50 basis move. The larger question in the context of these uncertainties is whether the Fed will be able to orchestrate a soft landing.

There is no way of knowing what lies ahead, but the uncertainty is likely to result in significant market turmoil and volatility over the next 12 to 18 months. Compounding that uncertainty is geopolitical risk, including Russia's military ambitions in the Ukraine and potentially beyond, which may further fuel inflation, most notably in energy costs, and disrupt global markets and economies.

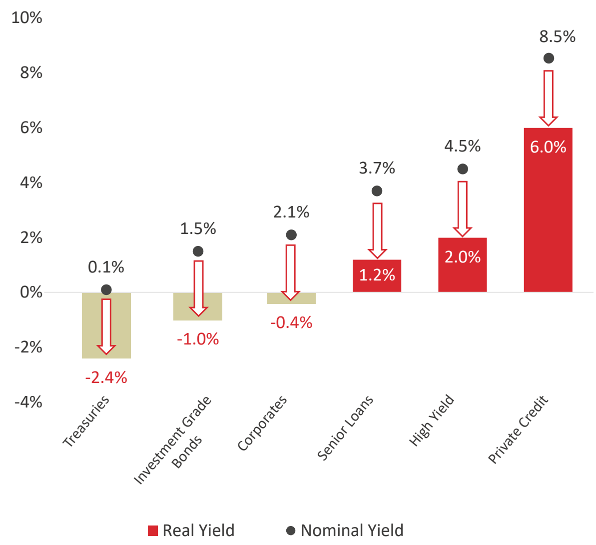
DIRECT LENDING OUTPERFORMS IN RISING INTEREST-RATE ENVIRONMENTS

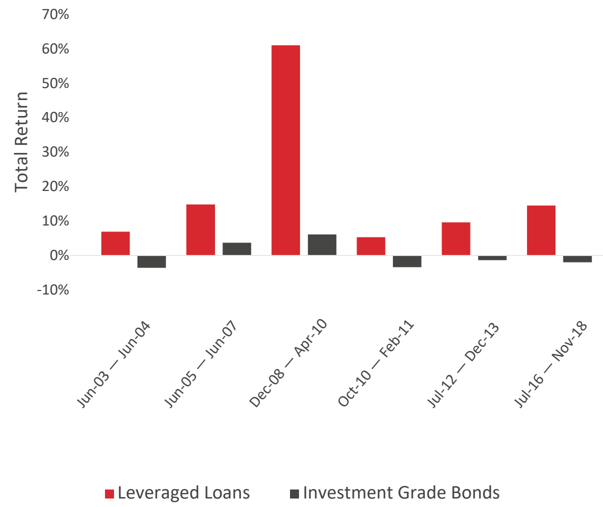
The current market environment poses a challenge for both consumers and investors. Modest inflation, when coupled with wage growth, stimulates economic expansion, as consumers feel wealthier and are encouraged to spend money before the prices go up and their dollar is worth less. However, when inflation exceeds wage growth as is currently the case, consumers are likely to pare back discretionary spending and focus deflating resources on essential items like food, gas and lodging, thereby dampening economic activity. Similarly, for investors, inflation mutes returns on financial assets. Modest inflation and wage growth is generally positive for financial assets and the wealth effect mentioned above, but rapidly accelerating prices typically leads to asset price declines. An important factor driving those declines is the expectation that the Fed will increase interest rates to cool economic activity and stabilize prices. Increased interest rates will negatively influence financial asset prices, particularly longer duration assets and traditional fixed income. Higher interest rates also increase borrowing costs for consumers, reducing their purchasing power, potentially further suppressing economic activity.

Conventional investment wisdom suggests that a pivot from growth stocks to commodities, cyclicals and staples is appropriate in a recovering economy. Increasing interest rates also favor financial companies, as they are able to earn higher spreads on the loans they issue relative to their own cost of capital. Recent market performance offers some corroboration as technology stocks, whose values are tied to longer-term growth prospects, underperformed, while commodities and financials outperformed. That said, the specter of rising rates tends to hurt valuations more broadly and the uncertainty around the pace and magnitude of rate hikes and their impact on the economy likely makes for a bumpy ride in equities.

On the fixed income side, longer-duration, traditional fixed-income assets like investment-grade and high- yield corporate bonds become vulnerable in inflationary and rising rate environments. Real rates (calculated as nominal rates minus inflation) are pressured by rising inflation and higher market interest rates result in devaluation of bonds as future cash flows are discounted at higher rates available for equivalent issues in the market. Loans, however, with shorter duration (two- to three-year average life) and interest incomes that float with prevailing rate changes generally outperform in rising rate environments, potentially providing investors with an attractive hedge. Furthermore, direct lending, the largest asset class within private credit, consistently offers premium yields relative to its fixed income alternatives, which helps offset the impact of inflation on real returns.

Real Yield and Rising Rates Presents Challenges for Fixed Income Investors [5]





LOWER MIDDLE DIRECT LENDING MAY PROVIDE ADDITIONAL PROTECTIONS FOR INVESTORS

For companies, inflation represents a double-edged sword. While it often supports revenue growth as companies increase prices on their goods and services and enjoy robust demand from consumers motivated to spend dollars today that will be worth less tomorrow, it also burdens the expense side of the ledger. Inflation raises the cost of inputs, fuels wage growth and often precipitates interest rate hikes by the Fed, all of which translates into higher operating and financing costs for companies. Furthermore, an over-correction by the Fed could cause the economy to stall, potentially ushering in a recession.

[5] *Source: Federal Reserve Bank of St. Louis, 5-Year Breakeven Inflation Rate [T5YIE], retrieved from FRED, Federal Reserve Bank of St. Louis; https://fred.stlouisfed.org/series/T5YIE, February 2, 2022. "Treasuries" is represented by the Risk-free Rate, "Investment Grade Bonds" is represented by S&P 500 US Aggregate Bond Index, "Corporates" is represented by S&P 500 Investment Grade Corporate Bond Index, "Senior Loans" is represented by the S&P/LSTA Leveraged Loan 100 Index, "High Yield" is represented by the S&P 500 High Yield Corporate Bond Index, Private Credit is represented by Cliffwater Direct Lending Index. All data is as of September 30, 2021. Fidelity Viewpoints, Investing In Loans: Leveraged loans may offer higher yields and inflation protection, published September 13, 2021. Investment Grade Bonds represented by S&P US Aggregate Bond Index.*

In addition to offering a hedge against inflation and rising rates, lower middle-market direct lending may provide investors with additional protections against possible negative consequences to portfolio companies of the current economic environment. The structure of the lower middle market provides lenders to companies in that market with compelling advantages, including:

- **Portfolio construction / diversification:** The U.S. lower middle market is vast and highly diversified. An important driver of credit performance is constructing a diversified portfolio with limited correlation among assets. Like any shock or economic crisis, the inflation spike has not impacted all industries equally. Labor shortages, for example, have been most pronounced for industries employing low-skilled workers (basic manufacturing, warehouse management, etc.) and/or those where risk of exposure to the virus are more pronounced (healthcare, hospitality, leisure, restaurants, etc.). Companies with offshore sourcing have been challenged with rolling shutdowns at manufacturing sites due to COVID flare-ups and energy shortages (e.g., China and Vietnam) and by congested ports in both Asia and North America. Companies relying on commodity inputs to produce products have seen the cost of those inputs rise because of both supply constraints and investor speculation. Furthermore, the crisis unfolding in the Ukraine may exacerbate those commodity price increases given the importance of both countries in supplying global economies with a wide range of commodities. Diversification across industries and credit selection, of course, will dampen the impacts of inflation and other economic shocks across the portfolio. For experienced managers with differentiated sourcing, therefore, the U.S. lower middle market offers the opportunity to build portfolios that are more resilient to economic shocks.

- **Underwriting / Structuring:** Meaningful supply and demand imbalance in the smaller end of the credit market provides lenders with the opportunity to have significantly more say in dictating the process, terms, and structuring of corporate loans. For experienced lenders, this can represent an important advantage in (i) identifying companies that are likely to outperform their peers and be more resilient to economic dislocations, and (ii) structuring loans in a manner that offers borrowers more flexibility to navigate challenging market environments.

    o *Credit selection:* Longer transaction processes in the lower middle market, extending from multiple weeks to months, allows lenders to conduct thorough diligence and, importantly, validate each investment's underwriting merits. This dynamic has been particularly helpful in the current environment as the passage of time allowed investment teams, before committing to an opportunity, to observe and corroborate, among other factors: (i) the management team's and private equity sponsor's ability to manage through significant market dislocations, such as the one presented by the pandemic; (ii) the borrower's market position and ability to pass through price increases to offset rising input cost and wages; (iii) the company's ability to attract and retain talent in tumultuous labor markets; (iv) the company's cost structure and ability to flex up and down depending on the underlying demand picture; and (v) the capacity for the borrower to source products in a timely and cost efficient manner while supply chains experience unprecedented headwinds.

    o Loan structuring: Competitive dynamics in the lower middle market provide for more conservative loan structures, including: (i) lower average debt-to-EBITDA metrics; (ii) greater equity cushions and lower loan-to-value parameters; and, importantly, (iii) the inclusion of investor protections, like financial maintenance covenants. While maintenance covenants have largely been abandoned in the core and upper middle markets, they remain a fixture in the lower middle market. Maintenance covenants can be an important driver of credit performance, allowing lenders to intervene early if borrowers starts to underperform and providing more degrees of freedom for lenders when seeking to preserve capital or maximize recoveries for their investors during events of default. In addition, maintenance covenants can provide lenders with an opportunity to adjust pricing on the fly when dislocations occur, like COVID-19, to reflect the fact that markets have fundamentally repriced risk. In addition, while leverage metrics are compelling, the averages belie the bespoke nature of loan transactions in the lower middle market. Each structure is tailored specifically to the borrower's profile, ensuring that companies have ample flexibility to maneuver challenging market conditions.

- **ESG overlay:** While screening companies for ESG risk has long been employed by lenders as a means to eliminate investments from consideration, using ESG profiles to identify companies that are likely to outperform their peers and command premium valuations over time and across cycles is an emerging and valuable tool in credit investment selection and underwriting. Companies with favorable and improving corporate ESG profiles are often rewarded with enhanced financial performance, valuation multiple expansion and greater access to capital markets. This, in turn, provides such companies with greater operating and financial flexibility when navigating challenging market environments. Lower middle-market dynamics provide lenders with the opportunity to not only screen prospective portfolio companies for ESG attributes, but also exercise their influence to motivate management teams and private equity sponsors to implement strategies to enhance these attributes post-closing of a transaction, thereby building more resilient portfolio portfolios. Please click here to read our recent thought leadership paper on the topic – *The Evolution of ESG in Lower Middle-Market Direct Lending.*

CONCLUSION

While the inflation environment has not changed Capital Dynamics' approach to credit underwriting, industry focus and/or portfolio construction, it has informed the private credit team's diligence efforts and structuring parameters. We have increased scrutiny of, among other factors, price elasticity of demand for the borrowers' goods and services, supplier diversification, labor relations/turnover statistics, cost structure flexibility, etc. The core tenets of credit selection, structuring and portfolio construction, however, remain critical to investment performance. We believe the strength of our multi-strategy private market platform, including differentiated sourcing and a significant information advantage, allows Capital Dynamics' private credit team to maintain focus on those priorities and build investment portfolios that are resilient to market shocks and that will outperform over time.

ABOUT CAPITAL DYNAMICS

Capital Dynamics is an independent global asset management firm focusing on private assets, including private equity (primaries, secondaries co-investments), private credit, and clean energy. The Firm has been investing in middle and lower middle market private assets for over 30 years. The private credit group within Capital Dynamics provides tailored, one-stop financing solutions to private equity-backed lower middle market companies, focusing on financings that support leveraged buyouts, acquisitions, business expansions, re-financings, and short-to-medium term liquidity needs. Capital Dynamics private credit offers directly originated, senior secured loans, including first lien, unitranche, and second lien, as well as other flexible capital solutions.

Comprised of over ten professionals based in New York, London, and Zug, Capital Dynamics private credit draws upon its vast experience investing across the capital structure and in a wide array of industries to deliver flexible, value-added solutions customized to fit the unique needs of each borrower.

AUTHORS

Jens Ernberg
Managing Director
Co-Head of Private Credit

+1 212 798 3400
jernberg@capdyn.com

Thomas Hall
Managing Director
Co-Head of Private Credit

+1 212 798 3400
thall@capdyn.com

DISCLAIMER

"Capital Dynamics" comprises Capital Dynamics Holding AG and its affiliates.

The information contained herein is provided for informational purposes only and is not and may not be relied on as investment advice, as an offer to sell, or a solicitation of an offer to buy securities. Any such offer or solicitation shall be made pursuant to a private placement memorandum furnished by Capital Dynamics. No person has been authorized to make any statement concerning the information contained herein other than as set forth herein, and any such statement, if made, may not be relied upon. This document is strictly confidential, is intended only for the person to whom it has been addressed and may not be shown, reproduced or redistributed in whole or in part (whether in electronic or hard copy form) to any person other than the authorized recipient, or used for any purpose other than the authorized purpose, without the prior written consent of Capital Dynamics.

The recipient should not construe the contents of this document as legal, tax, accounting, investment or other advice. Each investor should make its own enquiries and consult its advisers as to any legal, tax, financial and other relevant matters concerning an investment in any fund or other investment vehicle. Capital Dynamics does not render advice on tax accounting matters to clients. This document is not intended or written to be used, and it cannot be used by any taxpayer for the purpose of avoiding penalties which may be imposed on the taxpayer under said individual's tax laws. Federal and state tax laws are complex and constantly changing. The recipient should always consult with a legal or tax adviser for information concerning its individual situation.

When considering alternative investments, such as private equity funds, the recipient should consider various risks including the fact that some funds: may use leverage and engage in a substantial degree of speculation that may increase the risk of investment loss; can be illiquid; are not required by law to provide periodic pricing or valuation information to investors; may involve complex tax structures and delays in distributing important tax information; and often charge high fees, and in many cases the underlying investments are not transparent and are known only to the investment manager. Any such investment involves significant risks, including the risk that an investor will lose its entire investment.

For more information, please visit: www.capdyn.com

CONTACTS

NORTH AMERICA

Susan Giacin
North America
sgiacin@capdyn.com

EUROPE & AUSTRALIA

Klaus Gierling
DACH, Nordics & Benelux
kgierling@capdyn.com

Martine Sessin-Caracci
France
msessin-caracci@capdyn.com

Robert H. Berlé
Italy
rberle@capdyn.com

Carolyn Skuce
UK (LGPS) & Australia
cskuce@capdyn.com

Jean-Yves Lagache
France
jlagache@capdyn.com

ASIA

David Jung
Korea, Hong Kong, Taiwan & Singapore
djung@capdyn.com

Eiichiro Hara
Japan
ehara@capdyn.com

TRULY INVESTED.

www.capdyn.com

Birmingham | Dubai | Florida | Hong Kong | London | Luxembourg |
Milan | Munich | New York | Paris | San Francisco | Seoul | Tokyo | Zug