Invesco

Strategy Insights | Direct Lending

Why pursue direct lending in the core middle market?

Overview

- The core middle market presents a large and fragmented opportunity set and attractive competitive dynamics vs. the upper middle market.
- Potential total return advantages include high current income relative to liquid markets with lower volatility.
- Sourcing and due diligence expertise is essential for success in this space due to the idiosyncratic nature of investment opportunities, while ESG experience can also differentiate lenders.

The overall scale of the middle market and tailwind of private equity (PE) sponsor transaction activity has created an ever-present need for middle market debt financing. But the middle market is vast, comprising companies that range from as small as $100 million to as large as $1 billion in enterprise value. By pursuing direct lending opportunities in the core middle market, investors may benefit from a fragmented opportunity set, a more favorable competitive environment, and attractive yields, among other potential advantages.

Here, we define the core middle market, describe the development of the market landscape, and identify essential ingredients for success when pursuing a direct lending strategy in the core middle market.

What is the core middle market?

We define the core middle market as companies with between $100 million–$750 million in enterprise value and generating annual revenues between $10 million–$1 billion. The universe of companies in this segment is highly fragmented and represents a wide range of sectors and industries.

Relative to the lower middle market, companies in the core middle market have more robust infrastructure and governance and therefore tend to be less exposed to negative idiosyncratic events. Relative to the upper middle market, the core middle market is more fragmented and features a friendlier competitive environment.

Segmenting the direct lending market

	Lower middle market	Core middle market	Upper middle market
Company enterprise value	< $100 million	$100 million – $750 million	$750 million – $3.0 billion
Company debt facility	< $50 million	$50 million – $400 million	$400 million – $1.5 billion
Company exposure to negative idiosyncratic risks	High	Medium	Low
Company infrastructure and governance	Limited	Developed	Advanced
Competitive landscape for deals	• Highly fragmented • Strategy specific	• Fragmented • Less competitive due to club transaction focus	• More concentrated • Highly competitive • AUM growth focus
Participants	Small BDCs, small loan managers, and junior capital providers	Stand-alone credit platforms and medium-sized BDCs	Largest diversified credit platforms, regional/investment banks, large BDCs, and CLOs

Market landscape

Large, fragmented market with attractive characteristics.

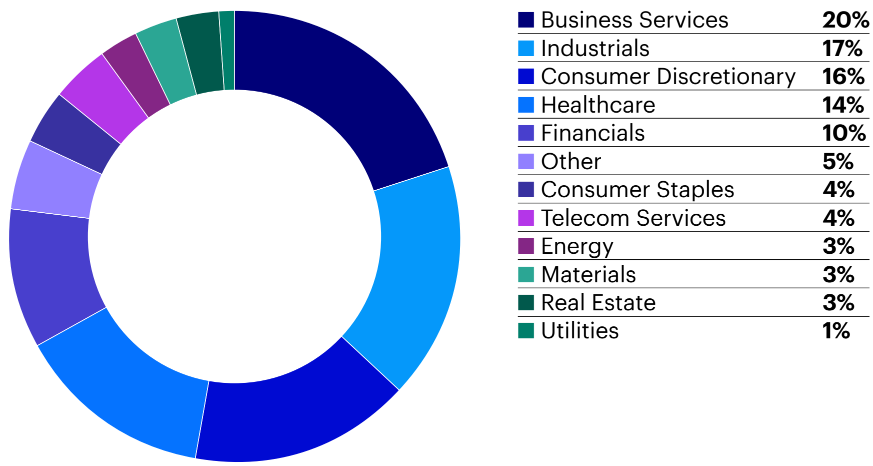
The US middle market is a large and diverse ecosystem that represents virtually every industry, including business services, industrials, healthcare, consumer, and financial services.

The US middle market at a glance

200,000	33%	48 million
US Middle Market companies	of US Private Sector GDP	Employees

Source: National Center for the Middle Market, as of December 2022.

Sector diversity of direct lending



Source: Cliffwater 2022 Q3 Report on U.S. Direct Lending.

Potential structural advantages of middle market senior secured loans

Middle market senior secured loans offer structural advantages that have the potential to meaningfully mitigate downside risk.

- **Senior position in the capital structure:** Middle market senior secured loans sit atop the capital structure and are secured against substantially all of the assets of the company.
- **Terms:** As bespoke arrangements created by a small group of lenders, terms are generally more favorable relative to the upper middle market—perhaps most importantly in the ability to include covenants that provide the lender an ability to proactively engage with the borrower should circumstances of the company change.
- **Inflation hedge:** Middle market loans are floating rate instruments that can help to hedge against inflationary risk
- **Attractive spreads:** To compensate investors for the market's illiquidity and inefficiency, the direct lending asset class generally provides a yield premium relative to more liquid debt offerings
- **Prepayment protection:** Middle market loans often provide mechanisms such as call protection to compensate lenders for prepayment, limiting reinvestment risk.

Comparing lending terms in the core vs. upper middle market

Terms in the core middle market are generally more attractive relative to the upper middle market, which is a more competitive space due to the larger size of deals and availability of traditional capital financing for many deals. For example, maintenance covenants continue to persist in the core middle market while there has been erosion in the ability to obtain meaningful maintenance covenants in the upper middle market.

Why are these covenants significant? They can help lenders:

- Proactively address problems early
- Limit cash leakage
- Preserve collateral value
- Force deleveraging when necessary

Key ingredients for success in middle market direct lending

We believe success in middle market direct lending requires two core areas of expertise: sourcing and due diligence.

Sourcing capabilities

The core middle market is extremely relationship-driven. Origination in the middle market requires strong connectivity and direct relationships with a broad base of private equity sponsors, networks of advisors, service providers, and management teams. Sponsors continuously seek to receive financing from lending professionals and platforms with whom they have had extensive experience—relationships driven by longevity, reputation, and trust. Credit platforms that offer borrowers a range of capital sources and are staffed with professionals who maintain close relationships with sponsors and issuers are particularly well-positioned.

Due diligence expertise

Middle market underwriting requires bottom up, fundamental diligence to comprehensively evaluate the health of the borrower. Unlike traditional debt strategies, middle market loan portfolios tend to be comprised of illiquid positions, meaning that a lender is likely to maintain an investment until repayment. A comprehensive evaluation of the issuer is needed to understand the sustainability of the business model and any potential issues that could impact the borrower's ability to service its debt obligations. Sector knowledge is required to review an issuer's performance, risks, and sector-specific concerns. Private credit platforms that possess sector-specific expertise and extensive industry relationships tend to be favored by deal sponsors as they can effectively and efficiently underwrite transactions.

Learn more about Invesco Direct Lending

The Invesco Direct Lending team has more than 25 years of experience lending to middle market companies. We structure our core middle market loans to sit atop of the capital structure of fundamentally sound companies alongside trusted private equity sponsors. We underwrite our deals to conservative credit metrics and leverage our experienced team to drive differentiated sourcing and enable rigorous diligence, including full integration of ESG considerations. This allows us to construct conservative and durable portfolios with meaningful downside mitigation while targeting attractive current income.

We believe middle market direct lending can offer investors a compelling opportunity to generate significant income potential with lower volatility relative to traditional fixed income. To learn more about Invesco's direct lending approach in the core middle market, please contact your Invesco representative.

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