Investment INSIGHTS

LOWER MIDDLE MARKET DIRECT LENDING: A RESILIENT OPPORTUNITY SPARKING ALLOCATOR INTEREST

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As private credit strategies continue to capture the attention of institutional investors, lower middle market direct lending is gaining traction as a growing sector that can offer attractive return opportunities with lower leverage. It also has the ability to provide consistent current income with simpler debt structures and tighter financial covenants in comparison to the upper middle market.

"We believe the lower middle market continues to offer attractive returns with lower leverage profiles and stronger lender protections versus the upper middle market," said Rich Christensen, senior partner at TPG Twin Brook Capital Partners. "As an asset class, we believe direct lending has gained broad acceptance; and within the asset class, we believe the lower middle market, given a favorable competitive landscape, leads to a pricing premium and favorable risk-return profile."

What's more, the sector is primed for a solid year. In 2024, deal volumes picked up, recovering from a sluggish 2023. That momentum is expected to continue this year, offering investors opportunities to pick up yield and return.

"We saw deal volumes experience a broad recovery in 2024 and an acceleration of momentum in the latter half of the year," Christensen said. "The broad market expectation for this year is that M&A volumes should be consistent or increase over 2024."

A DISCIPLINED APPROACH

Yet investors are cognizant of potential headwinds that could impact the direct lending market, given uncertainty around economic growth, inflation, interest rates and geopolitical turbulence.

For these reasons and more, it is critical to work with an experienced manager. "The underlying economy and the various disruptions that we've seen over the last four years are key considerations as we assess individual credit opportunities," Christensen noted. "These uncertainties are not factors that we can ignore but rather ones that we must be prepared for. We have established a process and a credit discipline that we believe allows us to lend through most economic cycles."

COMPARATIVE STRENGTH

A key aspect of lower middle market lending that not all institutional investors may realize is that this segment performed well even through the COVID pandemic and ensuing years when inflation spiked, interest rates rose sharply and economic growth stalled.

"In recent years, we have seen that the lower middle market has been adept at managing through a range of market challenges, including material supply disruptions, labor challenges and a challenging inflationary environment," Christensen said.

The concept that smaller borrowers can be less risky than larger ones may be counterintuitive, because institutional investors typically equate the lower middle market with a higher risk profile based on the smaller size of the underlying borrowers, he added. But in fact, strong investor safeguards, combined with a focus on more conservative debt structures and smaller lender groups as compared to those in the upper middle market, provide significant enhancements to borrower risk profiles for lower middle market lenders.

DEEPER UNDERSTANDING

Direct lending as an asset class has experienced strong growth, gaining broad acceptance from both institutional and high-net-worth investors.

"Managers must continually educate investors and provide them with a better understanding of the enhanced lender protections and favorable return profile that's available in the lower middle market," Christensen said. "Bringing nuanced discussions to the table and providing a clearer understanding of the credit risk management and enhanced lender protections available in the lower middle market versus typical structures available in the upper end of the middle market is important."

> The lower middle market has the potential to offer a higher risk-adjusted return over the upper middle market, with lower leverage profiles, simpler debt structures and stronger lender protections helping to drive higher overall recovery rates.

"As investors who may have only had direct lending exposure to the upper middle market become familiar with the lower middle market's attractive credit return profiles, we are seeing an increase in allocations trickle down into the lower middle market," he said.

"The lower middle market has the potential to offer a higher risk-adjusted return over the upper middle market, with lower leverage profiles, simpler debt structures and stronger lender protections helping to drive higher overall recovery rates," he added. "Both pre- and post-pandemic, the lower middle market demonstrated higher recovery rates compared to loans to larger companies."

Beyond simply understanding the market's characteristics, return potential and risk factors is the importance of how a manager sources transactions as well as that manager's credit rigor and risk management. "Managers providing a clear understanding of how credit risk is managed with lower middle market borrowers is a critical aspect of demonstrating the value proposition of the lower middle market over alternative upper middle market strategies," Christensen said.

PROCESS MATTERS

Investors considering an allocation to the direct lending asset class should have insight into a manager's process and understand how borrower relationships are managed over time, how the portfolio is built and the nuances of lending in the lower middle market — all key dimensions to help them fully assess the risk profile compared with upper middle market strategies.

The manager's deal pipeline is an important component. "Scale matters more than ever," Christensen said. "On the manager side, the scale to drive efficient and consistent capital formation is critical. However, equally as important is having an effective origination capability to generate consistent and diversified deal volume. Maintaining a strong deal flow is absolutely critical to managing risk and achieving higher return thresholds."

LOOKING AHEAD

In Christensen's view, the opportunity set looks positive for the lower middle market. If M&A activity continues to strengthen this year, as expected, a key driver of new deal volume will be liquidity from investors exiting their existing portfolio positions and looking for new opportunities. Additionally, refinancing activity is expected to remain an ongoing driver of deal volume.

"One theme we expect to see play out this year is increased sponsor exits from existing portfolio investments," Christensen said. "The economic and market disruptions over the last four years has pushed investment periods out beyond normalized hold periods and as such, we expect to see private equity firms take advantage of stronger market conditions in 2025 to exit a higher number of portfolio investments."

"That should be a broad theme in terms of what holds market activity up," Christensen said. "As we talk to market constituents, there is optimism for some continuation of the volume trends in 2025 that we saw in the back half of 2024." ■

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