September 2024

Not all Private Credit Segments Operate in Tandem

Star Mountain's Opinion on Supply & Demand Impacts on Pricing and Risk

There are concerns with certain aspects of the private credit market which we also share and thought you would appreciate some additional context and our perspective.

The bottom line is that the supply and demand characteristics of capital in the larger end of the market are different than the more resource intensive lower end of the market resulting in different risk and reward trends.

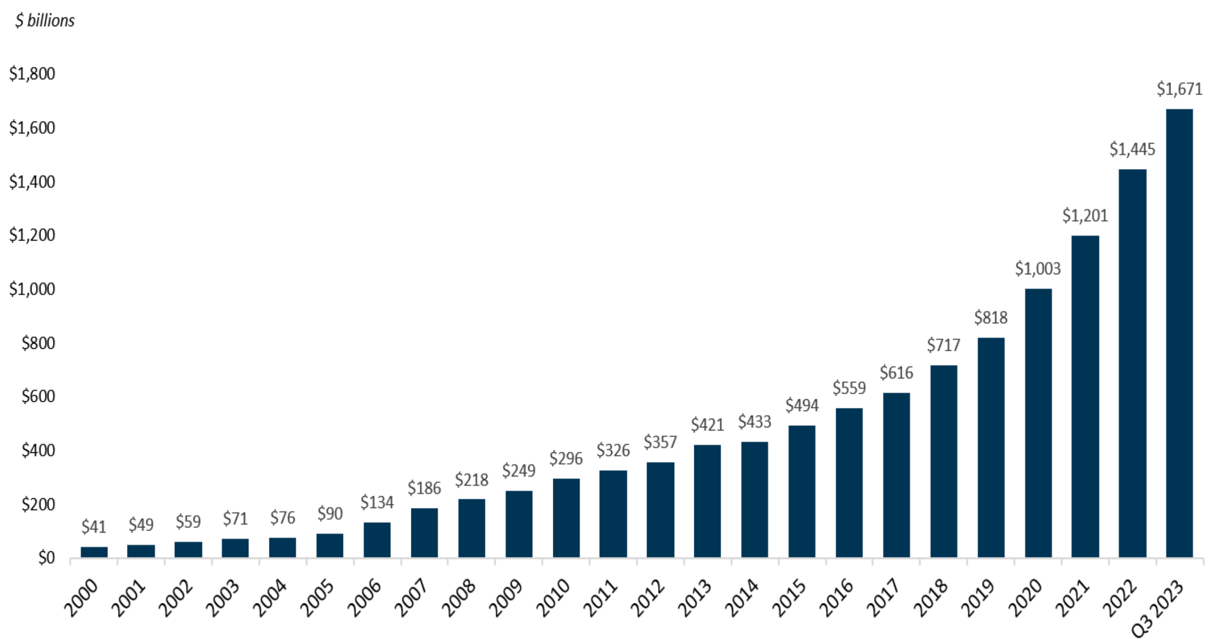
The current landscape of the private credit markets reveals significant differences, especially between the large market and the lower middle-market. These discrepancies are more pronounced now than they have been in a long time, leading to differentiated risks and opportunities.

In the large market, the primary risks stem from falling interest rates, which, due to substantial demand from both lenders and borrowers, exerts pressure on pricing, legal agreements, covenants and the overall quality of loans.

In the lower middle-market, we don't experience the same supply and demand pressures, allowing us to lend differently. However, there are distinct risks, primarily related to evaluating and actively managing companies. We believe a more active management approach is necessary to mitigate these idiosyncratic risks, which allows one to benefit from the supply demand imbalance for capital and capitalize on potential EBITDA multiple expansion valuation arbitrage.

Over the past decade, capital raised by private credit funds has grown significantly as investors have increased their exposure to this asset class to over $1.6 trillion in 2023 as shown in the chart below. As such, some recent press articles have mentioned that the private credit markets are overheated. We agree that is the case in some parts of the U.S. private credit market where the supply of credit is outpacing demand, however, we believe this supply demand dynamic is not the same in all parts of the private credit market, particularly not in the U.S. lower middle-market.

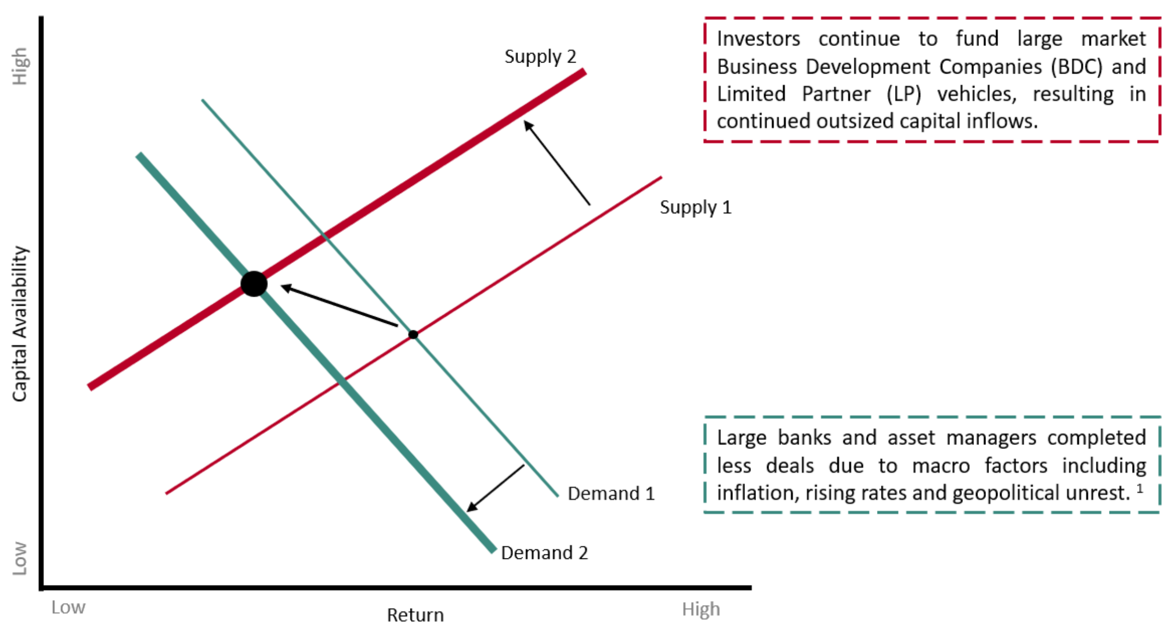
Figure 1: Significant Growth in Private Credit Fundraising [1]



Source: Preqin. July 3, 2024.

At the upper end of the market, large banks are well capitalized, bringing in large volumes of capital to lend to larger companies. Conversely, smaller banks that focus on smaller businesses often face capital constraints and have been struggling with liquidity limitations. In addition, the smaller banks on average typically have less capabilities and resources to lend to these smaller businesses, which leads to capital inefficiency at the lower end of the market.

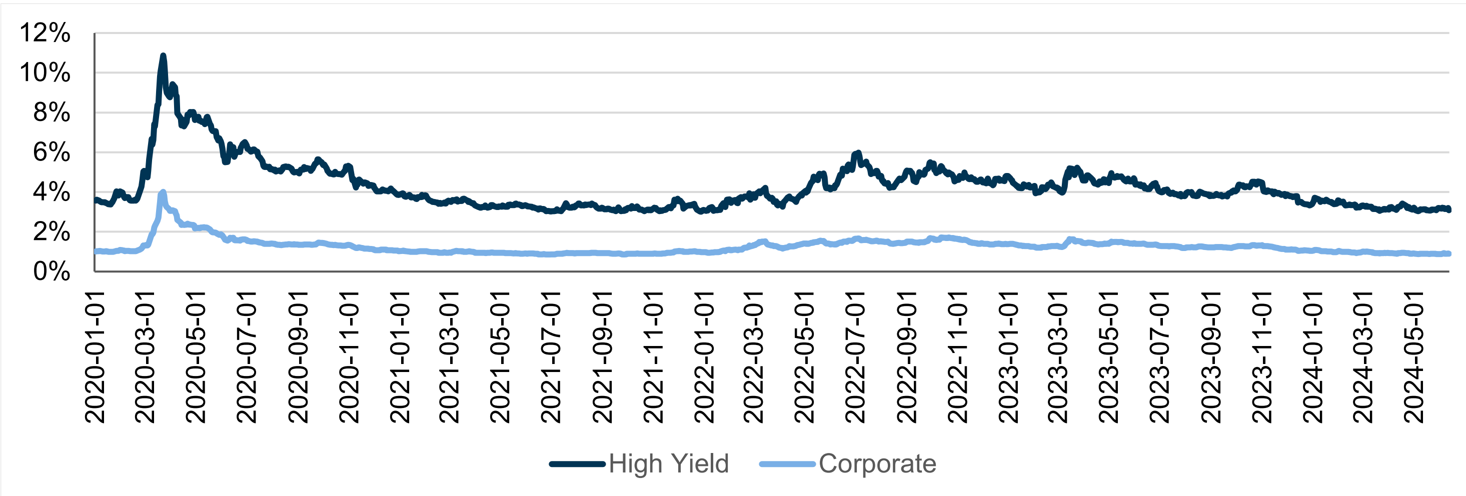
Figure 2: Supply & Demand Dynamics in the Larger Private Credit Markets



Source: "Global Private Equity Deal Activity Plunges in 2023," S&P Global Market Intelligence, January 16, 2024.

At the larger end of the credit market, where there are much fewer companies (~10,000), spreads are compressing as banks and other private credit managers flush with capital drive yields down as shown in the chart below.

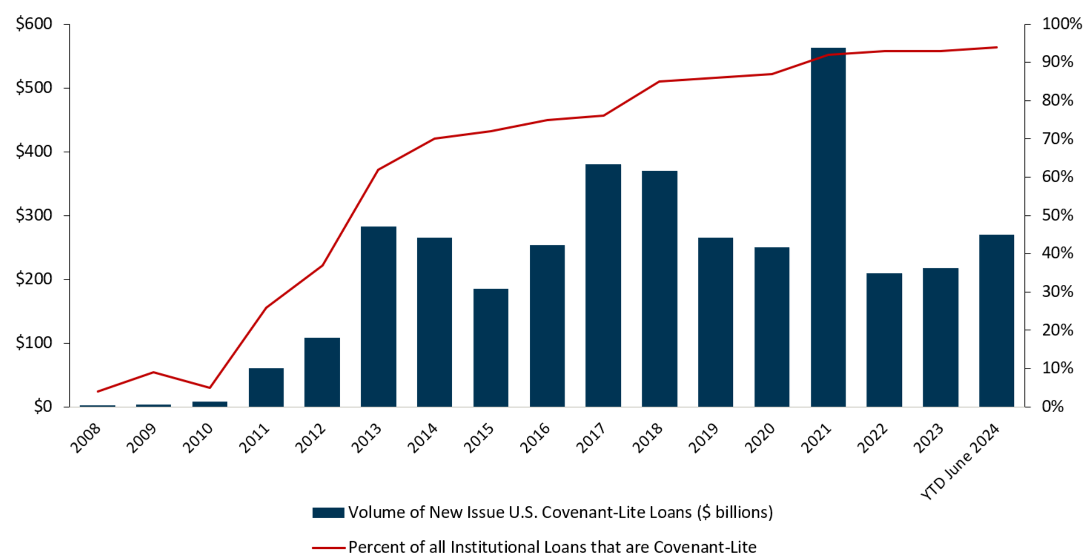
Figure 3: U.S. High Yield & Corporate Bond Spreads Continue to Tighten [3,4]



Source: Federal Reserve Economic Data, June 13, 2024

A long stretch of historically low interest rates and defaults, combined with growing demand for loans among institutional investors, fueled a surge in "covenant-lite" loan structures in the years after the Global Financial Crisis. Historical data supports the view that absence of financial maintenance covenants weighs on ultimate recovery rates for defaulted first-lien term loans. As shown in the chart below, as of June 30, 2024, more than 90% of broadly syndicated loans are covenant-lite, this bodes ill for investors in companies that eventually default.

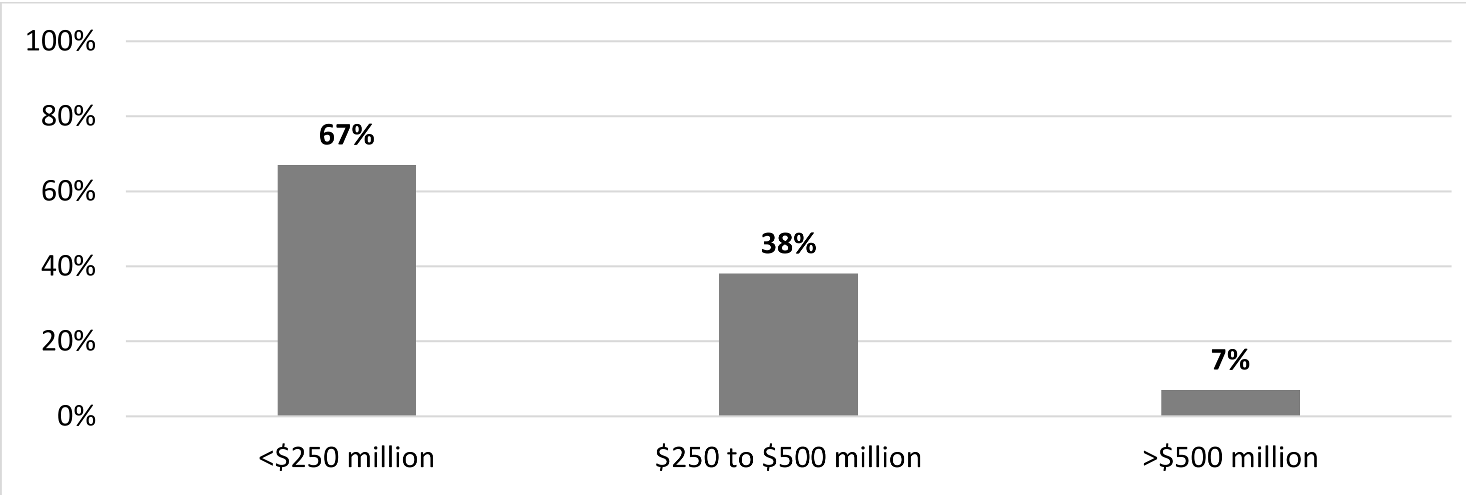
Figure 4: Covenant-Lite Loans Have Increased Substantially [5]



Source: Pitchbook. LCD. U.S. Leveraged Loan Quarterly Trend Lines. Q2 2024. Excludes existing tranches of add-ons, amendments & restatements with no new money, as well as DIPs, second liens and unsecured transactions. These numbers comprise loans denominated in all currencies, converted to USD, and are subject to revision as LCD collects additional data.

Larger market loans have increasingly less maintenance covenants due to the increased efficiency and competitive nature as shown in the chart below.

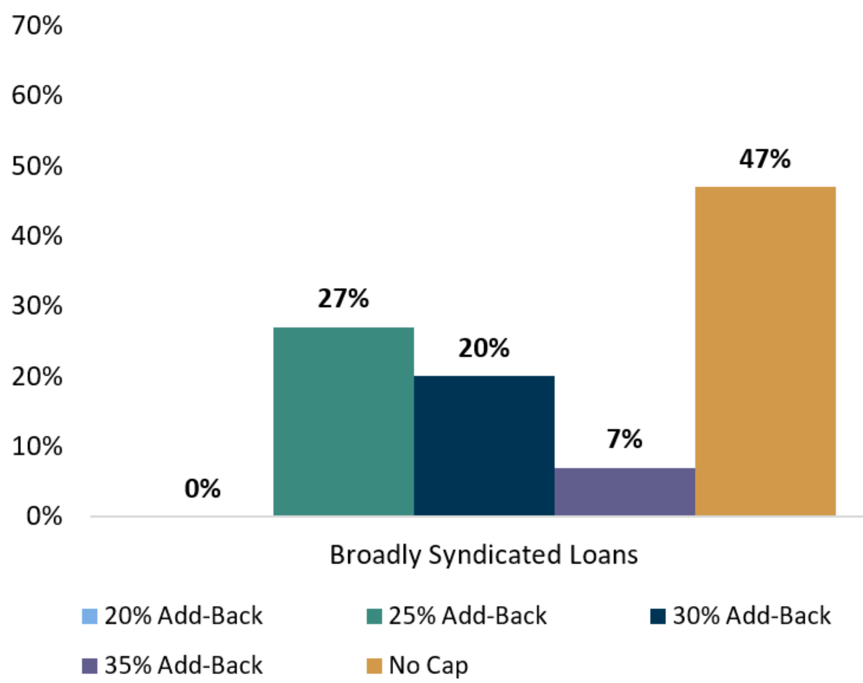
Figure 5: Risk Considerations: Maintenance Covenants [6]



Source: Pension & Investments, Private Credit Lenders Demand Greater Protections for Smaller Loans, November 2023.

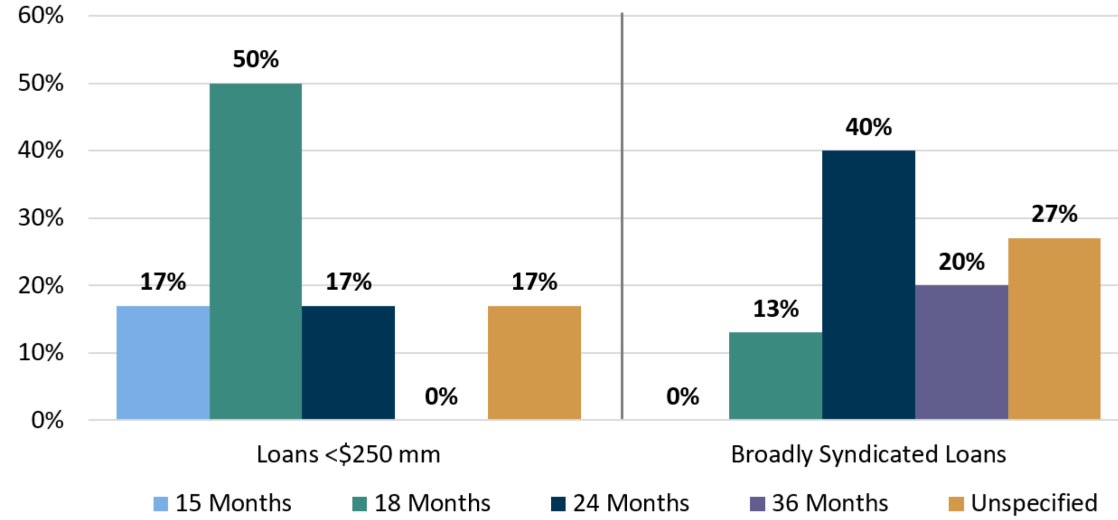
A potential benefit of the less competitive end of the market is the potential for more conservative EBITDA calculations. This often results in a more accurate financial picture for investors and stakeholders. In contrast, nearly 50% of broadly syndicated loans had no cap on the amount of EBITDA adjustments, which can lead to inflated financial metrics as shown below.

Figure 6: Permitted Add-Backs to EBITDA In Broadly Syndicated Market [7]



Source: Pension & Investments, Private Credit Lenders Demand Greater Protections for Smaller Loans, November 2023.

Figure 7: EBITDA Add-Back Look Forward [8]



Source: Pension & Investments, Private Credit Lenders Demand Greater Protections for Smaller Loans, November 2023.

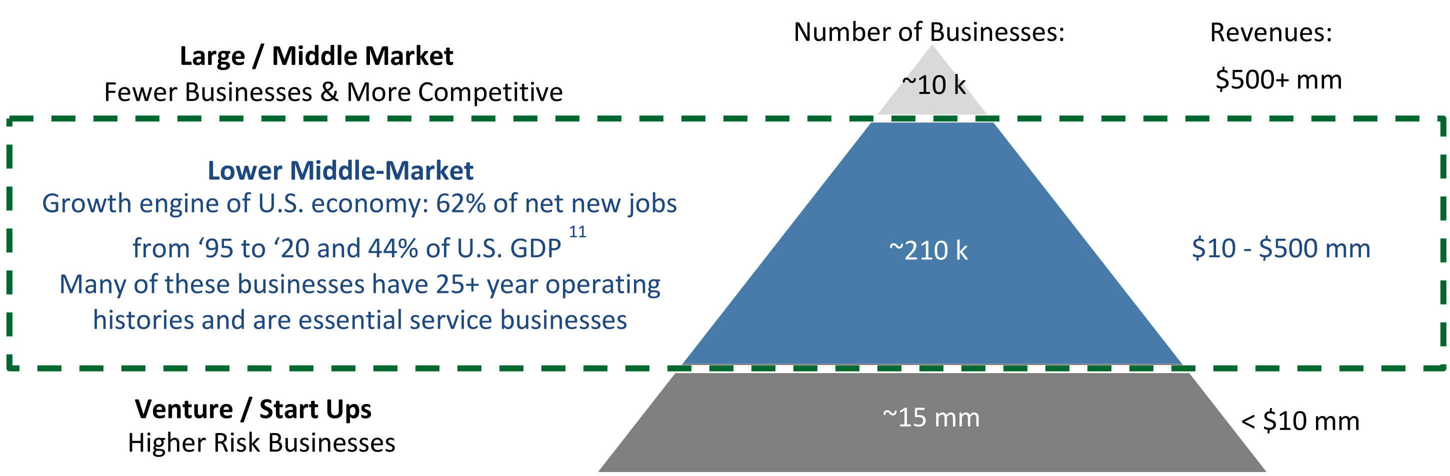
As shown above, nearly 70% of the smaller loan segment required EBITDA adjustments to materialize within 18 months compared to the larger market where at least 60% were allowed to have at least two years.

The average bid prices for defaulted syndicated loans have decreased substantially. As mentioned in a recent Bloomberg article, recovery rates for investors in defaulted first-lien debt in the U.S. and Canada, could be as low as 35% of their investment compared to 72% from 2018 – 2022. [9] Star Mountain believes this is particularly driven by high EBITDA adjustments which can lead to leverage being much higher than stated.

Opportunities in the Lower Middle-Market

As shown in chart below the lower middle-market is a large and fragmented market of ~ 210,000 companies representing ~ 50% of U.S. GDP.

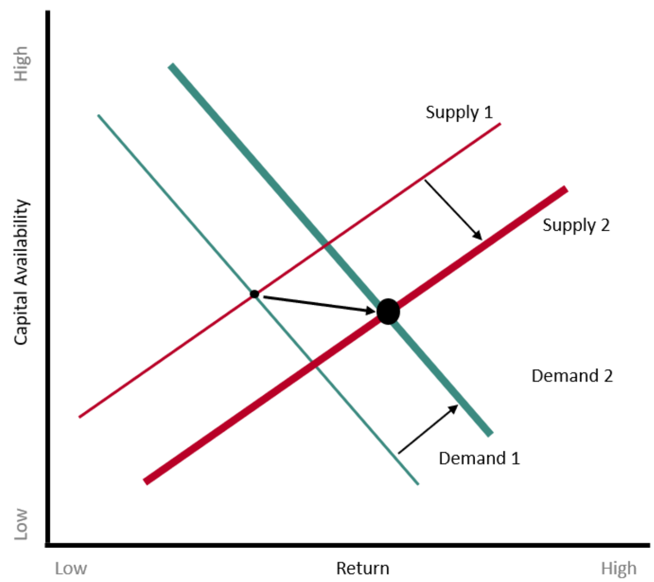
Figure 8: Lower Middle-Market: Large & Inefficient Market with Many Recession-Resilient Businesses [10]



Source: NAICS. As of March 2023. Diagram not to scale.
Source: U.S. Small Business Administration, December 2021. Small businesses defined as an independent business having fewer than 500 employees.

In the larger broadly syndicated loan market, the supply of capital is growing and is not commensurate with demand. In the lower middle-market, the supply of capital continues to be limited, and the demand continues to increase, and this supply/demand imbalance provides pricing and structuring benefits to investors.

Figure 9: Supply & Demand Dynamics in Lower Middle-Market Private Credit



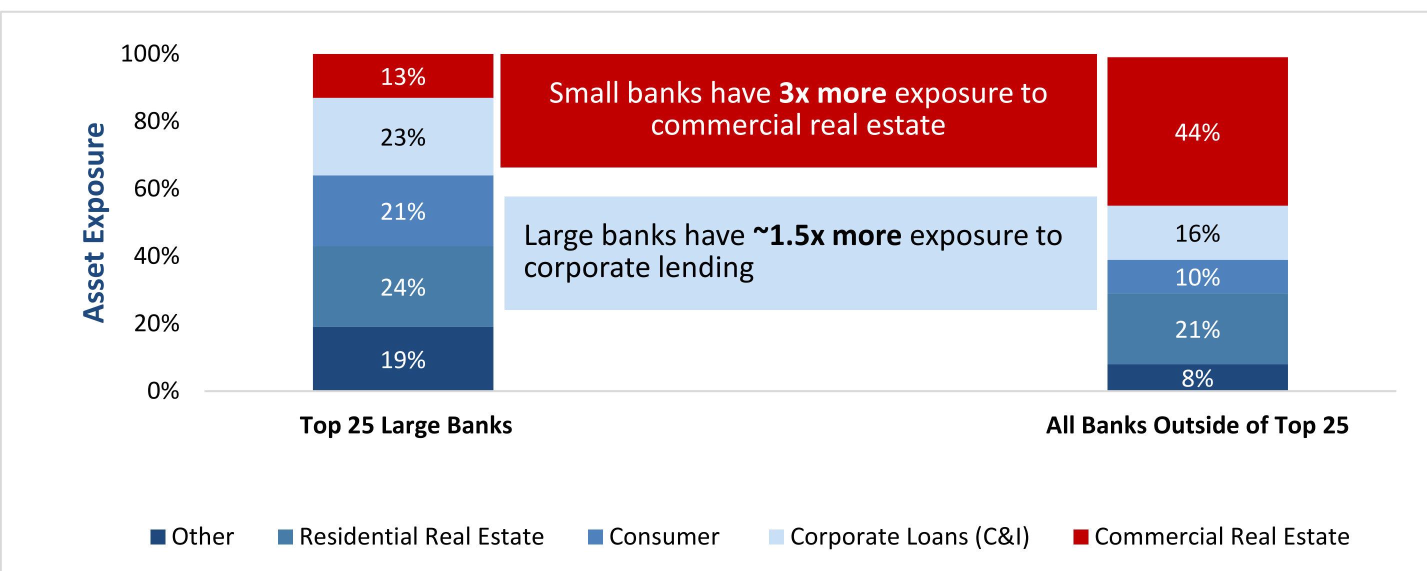
The decline in liquidity for smaller commercial banks, coupled with limited ancillary revenue opportunities has substantially restricted capital availability.

Similarly, larger asset managers have limited their lending / investments into high-quality smaller businesses.

There are approximately 210,000 businesses in the LMM seeking growth and acquisition capital as business owners age into retirement.

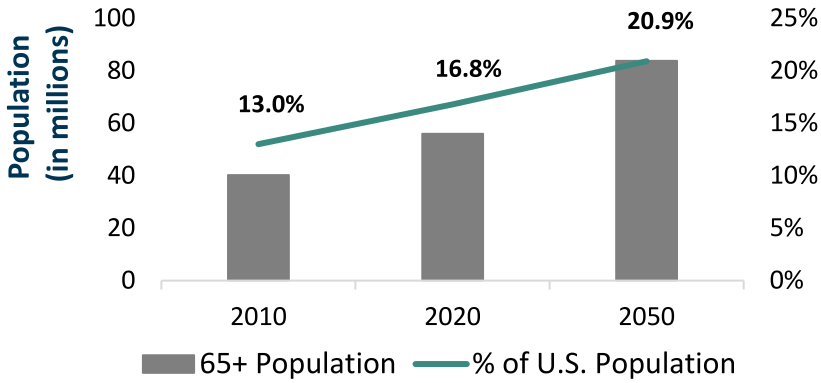
As shown below, at the lower end of the market the reduction in bank lending and a continued need for strategic value-added capital from lower middle-market businesses is due to several factors, including a retiring demographic of "baby boomer" business owners that have created potential acquisition opportunities at attractive valuations. These attractive valuations are driven by the arbitrage between less-valued smaller and more highly valued larger businesses mainly due to the increased efficiency and availability of buyers and acquisition capital in the larger market compared to the smaller company marketplace.

Figure 10: Smaller Banks with Limited Capital & Resources Invest More in Real Estate and Less in Corporate Loans [12]



Source: JPMorgan Asset Management, Q4 2023 Guide to the Markets.

Figure 11: Strong Demand for Capital Amplified by Aging Demographics [13]



- With ~210,000 LMM businesses, there is a high demand for capital, particularly from strategic investors, who can assist business owners to grow / acquire and aging demographic business owners to sell (an estimated 60 million people in the U.S. are over the age of 65).

Source: U.S. Census Bureau, 65+ in the United States: 2010, June 2014.

One of the reasons the lower middle-market is so inefficient is because of its labor-intensive nature. This requires a large, sophisticated, resource-intensive team to identify companies and prudently underwrite them, create customized investment structures and actively manage them.

To prudently underwrite these smaller companies and deploy smaller amounts of capital per loan, we have found one needs the right type of firm that has a highly aligned culture. This includes employees with personal capital invested, loans that generate favorable economics from successful repayment and equity upside attached to the loans. But it is the ease of putting large amounts of capital to work with larger companies that continues to lead to more and more capital coming to this part of the market. This supply/demand dynamic is leading to a more overheated larger private credit market while the smaller end of the market continues to experience the opposite effect.

In conclusion, we believe that the lower middle-market offers several unique advantages. First, it provides access to a less correlated segment of the economy, which can enhance diversification attributes in an investment portfolio. Additionally, this market includes newer economy businesses that have become fundamental over the past 10-15 years. Moreover, investments in the lower middle-market can offer yield protection and asymmetrical upside, particularly valuable in a declining spread and rate environment. These factors collectively may make the lower middle-market an attractive and strategic investment segment of the private credit market.

End Notes and Disclosures

1) Preqin. July 3, 2024.

2) "Global Private Equity Deal Activity Plunges in 2023," S&P Global Market Intelligence, January 16, 2024.

3) Federal Reserve Economic Data. ICE Bank of America US High Yield Index Option-Adjusted Spread. ICE Data Indices, LLC, June 13, 2024, https://fred.stlouisfed.org/series/BAMLH0A0HYM2#0.

4) Federal Reserve Economic Data. ICE Bank of America US Corporate Index Option-Adjusted Spread. ICE Data Indices, LLC, June 13, 2024, https://fred.stlouisfed.org/series/BAMLC0A0CM#0.

5) Pitchbook. LCD. U.S. Leveraged Loan Quarterly Trend Lines. Q2 2024. Excludes existing tranches of add-ons, amendments & restatements with no new money, as well as DIPs, second liens and unsecured transactions. These numbers comprise loans denominated in all currencies, converted to USD, and are subject to revision as LCD collects additional data.

6) Pension & Investments, Private Credit Lenders Demand Greater Protections for Smaller Loans, November 2023.

7) Pension & Investments, Private Credit Lenders Demand Greater Protections for Smaller Loans, November 2023.

8) Pension & Investments, Private Credit Lenders Demand Greater Protections for Smaller Loans, November 2023.

9) Loan Frenzy Masks Rising Losses on Defaults: Credit Weekly - Bloomberg

10) NAICS. As of March 2023.

11) U.S. Small Business Administration, December 2021. Small businesses defined as an independent business having fewer than 500 employees.

12) JPMorgan Asset Management, Q4 2023 Guide to the Markets. Bank asset exposure is based on monthly H.8 report by the Federal Reserve. Large banks are defined as the top 25 domestically charted commercial banks ranked by domestic assets while small banks are defined as all other domestically charted commercial banks.

13) U.S. Census Bureau, 65+ in the United States: 2010, June 2014.

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