E X P E R T Q & A

The key to investing in the mid-market is the ability to pivot across geographies and different industries, says Michael Ewald, a partner and global head of private credit at Bain Capital

The importance of diversification in the core mid-market

Q How do you view the ecosystem of alternative lenders in the global mid-market?

We see a wide range of market participants, with different players in different regions. Some managers prefer to focus on their home markets, while others, like Bain Capital, are more global in nature.

We prefer to evaluate opportunities across geographies and asset classes to source differentiated dealflow and distinctive investments. That doesn't mean we change our allocations between regions on a weekly basis, but we are able to adapt and pivot based on geopolitics, economic conditions, exchange rates and other factors.

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The biggest distinction that we see between managers, though, is really in the way they segment the mid-market and approach its different categories. Historically, the mid-market just referred to smaller deals, but now it is segmented into the lower mid-market at one end and the upper mid-market at the other.

For us, the lower mid-market means companies with less than $25 million in EBITDA, with typically very conservative capital structures and tight documentation. Those deals may not have a highly sophisticated borrower and will not always involve a private equity sponsor.

On the other hand, a small problem can quickly become a big problem for a smaller company, whether that is key person risk or single facility risk. That means theoretically you should add a risk premium for investing in those companies. However, private credit is hot these days, so a lot of new players with smaller funds are going after those deals – it is a particularly competitive segment.

At the other end of the spectrum, the upper mid-market is populated by large-cap corporates and the largest asset managers with sizeable funds. That has worked well in the last few years while the broadly syndicated loan

(BSL) market has been quiet, but that has now picked up, meaning there is a whole different set of competitors. Deals typically involve higher leverage, lower pricing and weaker documentation. There is some lender consensus risk but not the liquidity that goes along with the BSL market, so we shy away from that market.

We have really focused on what we call the core mid-market: companies with $25 million to $75 million in EBITDA, where we can own and control the tranche and drive the documentation as well as the outcomes. Those companies are big enough to be of importance in their own ecosystems and of a size where they can attract quality management teams, but small enough to be nimble and expand geographically and strategically with acquisitions.

There is certainly competition in that market, but the commercial banks have largely exited, and a number of our competitors have raised larger funds, and as a result, have moved up market and away from that core mid-market space.

Q Where do you currently see the greatest lending opportunities in the mid-market?

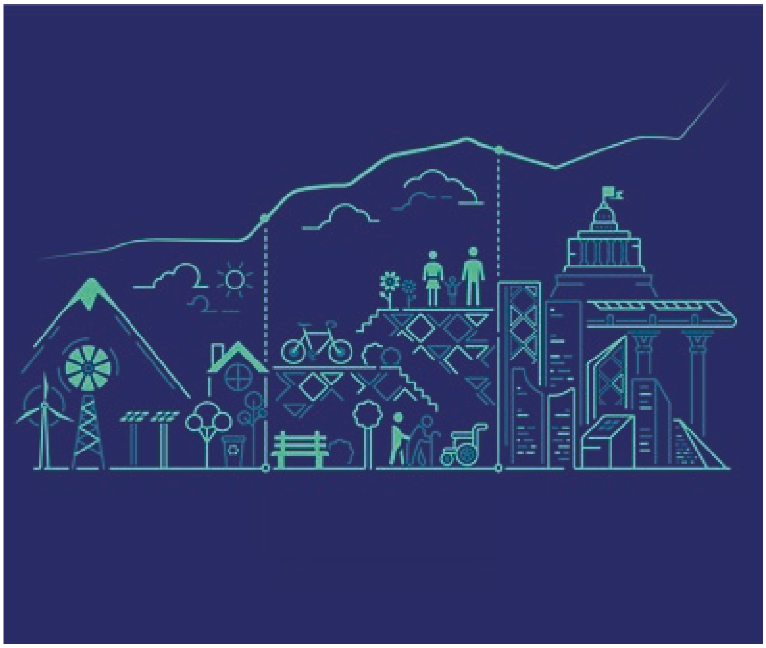
From a global perspective, the regions where we are most active, the US, Europe and Australia and New Zealand, are all equally attractive. More broadly, despite having the largest aggregate credit markets globally – almost the size of European and North American credit markets combined – Asia's private credit sector remains materially underpenetrated. Many mid-market borrowers lack efficient credit solutions, given the constrained bank market coupled with an underdeveloped non-bank market.

From a structural perspective, what we do see today are some interesting junior capital opportunities available for those that can tolerate non-cash pay instruments. With base rates high, senior debt is expensive and companies can't lever up as much as they might otherwise do. Meanwhile, purchase price multiples have remained high so there is a gap in capital structures that can't remain cash pay, creating opportunities for those able to tolerate PIK facilities or preferred equity.

I do worry that some senior lenders are getting particularly aggressive and offering PIK capital to their senior facilities, but if those companies cannot afford their debt, then lenders need to appreciate that as junior capital risk masquerading as senior securities.

Q How important is industry diversification? Which sectors do you see as most interesting?

Diversification of all sorts is certainly important for us. There is a portfolio effect and just as we like being global, we also proactively invest in a variety of



Q What role does ESG play in your business and in decision-making?

As a private partnership, we have always been ESG conscious and, in the last few years, we have really codified that approach. We have a global head of ESG for Bain Capital and an ESG lead for each of our business units.

It is no longer just a case of good or bad – it is much more involved than that. Each of our investment committee memos has a section dedicated to ESG, considering each company's intersection with ESG concerns, and that leads to an ESG score that can be a limiting factor in our investment decision-making.

ESG is not just a moral decision, it makes good business sense as well. To some extent, we are beholden to the dealflow that comes in our direction, but in the energy space, for example, we are more constructive around segments like pipeline repair businesses, flow control businesses that prevent leaks and others that are trying to be a bit more ESG-forward. So ESG is critical to our investment decisions and to the way we support the businesses that we lend to.

industries where we can call on expertise across our firm. It does take a more methodical approach, but there are a few sectors where we are more bullish and have more differentiated insights.

One example would be aerospace, which is a complicated industry with a sophisticated, long-dated global supply chain; if a customer orders a plane today, it is going to take seven or eight years for it to be delivered. That means a lot of lenders find it too complicated.

We have a long-standing and well established aerospace and defence group at Bain Capital, and within private credit we have done a number of deals. We are constructive lenders because we have a view around commercial aerospace, where growth in regions including the Far East and Middle East is going to lead to robust order books.

We can get to a granular level if an aerospace engines parts company comes to us, and we can do the analysis to get comfortable with the prospects for that business. It is not simple but having that resource internally gives us a real competitive advantage.

For us, sectors are also important in the context of past default cycles. When defaults spike there is usually a certain industry-specific catalyst, so if you are overweight in a particular segment, you are in danger of outsized defaults in the event of a spike.

Q What else can direct lenders do to build resilience and maximise returns during times of macroeconomic uncertainty?

It all starts with making smart credit decisions, because if you identify the right credits, you will be okay.

Then the other element is structure. We strive to be in control of our documents and we get that by being the majority lender. We serve as the majority lender in three out of four of our deals, which is different from being lead lender where you're the agent, and means you have fiduciary responsibility to other lenders.

We like to control the tranche and drive the documents to include financial covenants, while also getting to dictate what happens if deals do breach covenants. We are not just along for the ride.

So, in three out of four deals, we are majority lender, and in another 15 percent, we hold 33-50 percent of the tranche, meaning we are a required lender in any vote. That control is an important element of our strategy.

The other thing is to vigilantly monitor company performance, having regular conversations with sponsors to understand what is going on with portfolio companies. We are always performing analyses across the portfolio on maturities coming up and who will have liquidity problems if interest rates stay higher for longer, for example. That way we aren't blind-sided.

> *"We strive to be in control of our documents and we get that by being the majority lender"*

Q What should LPs look for in mid-market private credit managers when seeking to develop relationships?

Private credit has certainly increased in popularity and there has been an increase in awareness of the asset class, generated in large part by low base rates and a lower yield environment that has led LPs to look for additional returns. With mid-market loans, you typically get an illiquidity premium while taking less risk than the broadly syndicated loan market, and that has proved attractive. Investors came around to private credit when rates were low pre-covid, and that has continued now that floating rates make private credit even more attractive.

When it comes to distinguishing managers, track record is key, not just in terms of quantity of returns but also quality.

Having a broadly diversified portfolio is also important – we have a portfolio of more than 200 companies. As our portfolio companies are growing and looking for support, we are naturally able to provide funding to future transactions. So, that is a good source of dealflow.

Having a large team, not just of originators but also of underwriters due diligencing the deals, is key. In our model, everyone on the investment team is both an originator and an underwriter, which leads to a consistent set of metrics in terms of how we evaluate performance.

Beyond that, having workout experience is also useful. You don't need that until you need it, but when situations arise, we are able to draw on our large global special situations team as needed. ■