GOLD SHEETS
MIDDLE MARKET REVIEW
Vol XXVIII No. 9 | Your Guide to Refinitiv's LPC Coverage of the Middle Market | September 2021

5 THINGS TO KNOW

1 The recommendation of a term SOFR, and the syndication of multi-billion US dollar SOFR-linked loans, has not deterred market participants from arranging loans tied to other reference rates as a substitute to Libor. p. 8

2 Infrastructure debt is expected to become an even more attractive investment as the US government seeks to improve the country's ageing systems. p. 9

3 An influx of cash into the middle market has eroded returns to investors lending to small and mid-sized businesses, dampening one of the routes institutional investors turned to in hopes of finding additional return. p. 11

4 The US Collateralized Loan Obligation market hit a monthly volume record in August with more than US$19bn of funds issued as firms took advantage of the demand for corporate credit with investment grade ratings. p. 13

5 US leveraged loan investors had at least 15 transactions to choose from as the pipeline gained momentum after a sleepy week leading up to the US Labor Day holiday. p. 17

WHAT TO WATCH

5.87%
3QTD MM first-lien institutional yields

US$161bn
BDC AUM as of 6/30, up from US$134bn to start year

US$27.5bn
3QTD non-sponsored volume, 171% higher YOY

Plane, ships and dentist appointments

– by David Brooke

When the first coronavirus cases were reported in the US, it felt like the sky was falling – and, in the case of airlines, it eventually did. Millions were separated from families and locked indoors. Life went virtual.

Every sector took a hit. Non-emergency dentist services were halted, flights were grounded, live music was silenced and manufacturing paused. It presented a major issue for the US's burgeoning private credit market. Both private equity and direct lending funds got to work on salvaging what they could from their investments in airlines and dentists, helping to preserve them until the worst was over.

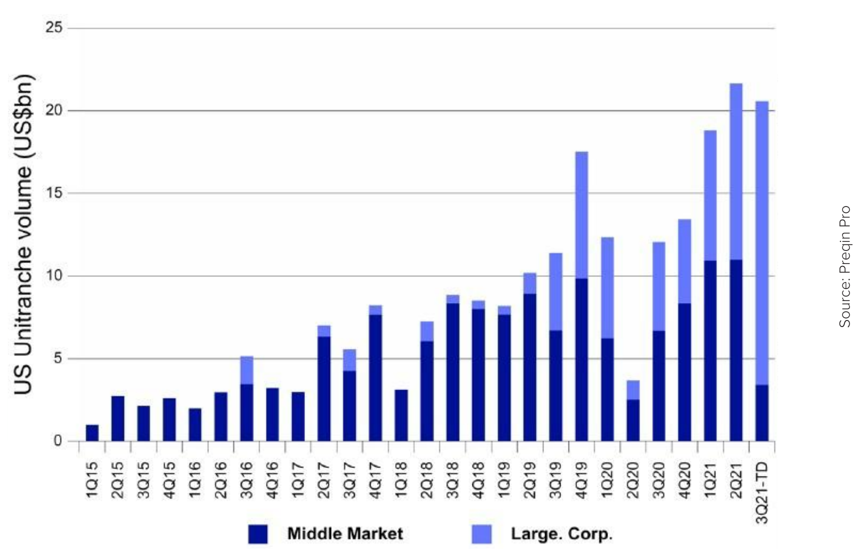
A key factor in private credit absorbing the pain was its close relationship with borrowers. A small club of lenders could get its hands dirty at the height of the pandemic and find a solution quickly.

It's an approach that paid off. As the world moves past the worst of the pandemic, private credit is flourishing at the expense of the syndicated market. Unitranche volumes have so far reached US$21.6bn before the third quarter has ended (Fig. 1), Refinitiv LPC data shows. Direct lending is overtaking the middle market and syndicated market with the former hitting US$17bn (Fig. 2), below the latter's US$23.52bn (Fig. 3) for the second quarter, according to Refinitiv LPC data.

"Sponsors have proven to be an important source of liquidity in the face of a credit

(**REVIEW** cont'd on p. 2)

Fig. 1: US unitranche volume showing record issuance



*3Q21TD data is based on submissions to the public database

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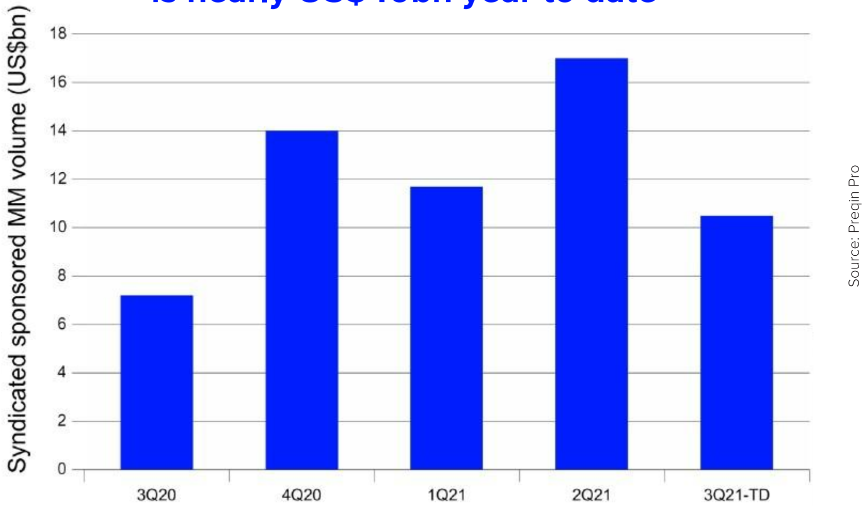
Fig. 2: Syndicated sponsored middle market volume is nearly US$40bn year to date



event, and many direct lenders have shown a willingness to continue funding under circumstances where the end game might be unclear," said Rick Hyman, partner at law firm Crowell & Moring.

"Banks cannot do that. As regulated institutions, they have less ability and willingness than direct lenders to lend additional funds into a troubled credit without a clear exit path."

ROLL UP, ROLL UP

Prior to the pandemic, a particularly favorite investment for direct lenders and middle market private equity firms was the roll-up dental strategy. Simply, a private equity firm will buy a number of independent clinics and bring them under one house, and then pursue an aggressive buy-and-build strategy to boost the Ebitda total and prepare for a larger exit to another sponsor.

Once taking over, a sponsor is dedicated to centralizing the back-office administrative functions dentists may need to perform and one- or two-clinic practices. This burdens the dentists with work beyond caring for the people that visit their clinic. But the overall strategy is to let dentists focus on what they love: taking care of patients.

The investment thesis behind dental practices is partially rooted in their ability to have well-established market share because the practices are part of the community, according to Reed Van Gorden, head of origination, credit underwriting and research at lower middle market lender Deerpath Capital Management.

Van Gorden said in an email that a "local or regional dental organization can have strong market share as well as longevity due to the local nature of dental services. Someone won't fly to another city to see the dentist."

Much of the industry returned to pre-pandemic business levels within six months, though re-openings have varied by region, Van Gorden said. More suburban and rural dentists have returned to "business as usual" than urban practices, according to data from the American Dental Association.

For the week of September 13, 55.6% of private practices in the top 20 cities were fully open, while 69.7% of suburban and 65.1% of rural private practices were operating at full capacity.

General dental practices faced difficulties different from other healthcare areas once the stay-at-home orders were lifted, said Faraaz Kamron, a Twin Brook Capital Partners' senior partner that focuses on healthcare investing.

Specialty areas of care – such as oral surgery, ophthalmology and dermatology – rebounded quicker than expected, as those doctors and healthcare providers tend to deal with more urgent procedures and issues than general dentists may.

"Where you saw a faster bounce-back was in the specialties," he said. "The logic there is you cannot delay the emergency procedures specialists often do. For dentists, a lot of the money coming in the door is for preventive care. The bounce-back was flatter for dental practices than for the specialties."

TAKING OFF

The airline sector was one of the largest industries hit by the pandemic. But the increasingly optimistic outlook as more people take to the skies is welcome news to non-bank lenders, who had to weather the storm.

BDC airline marks reflect a reversal in market sentiment in the sector. The average fair value was 104.1% for the second quarter

INSIDE

Refinitiv LPC

MIDDLE MARKET REVIEW

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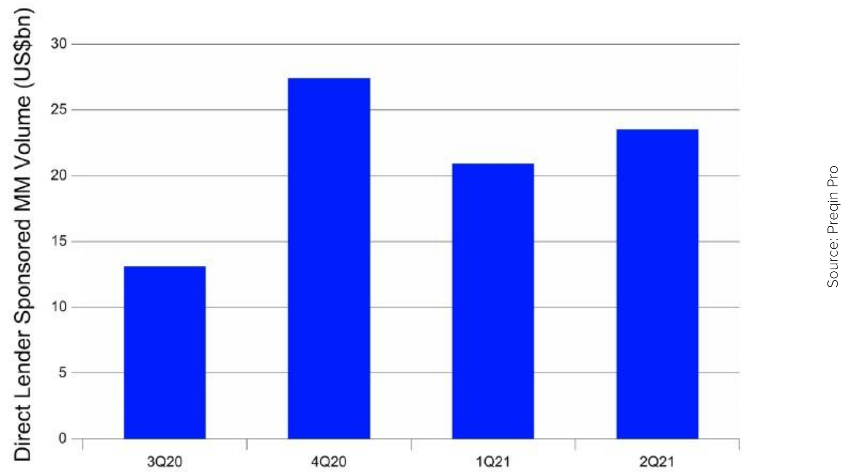
Fig. 3: Direct lending is outpacing sponsored volume this year



*3Q21 direct lending data will be reported in October

(Fig. 4), steadily increasing from the nadir of 95.98% at the height of the pandemic, according to BDC Collateral data.

Data from the Bureau of Transportation Statistics (BTS) showed a 607% increase in both domestic and international air passenger numbers in May 2021 compared with the year before.

Yet the BTS data shows the industry is still not back to pre-Covid levels. The May 2021 figure is still 30% down on May 2019 totals.

At the peak of the pandemic, many lenders were cautious about predicting a renormalization of the aircraft sector post-pandemic.

"We could never be certain, but we believed the challenges around the virus could be weathered by the industry, albeit with some changes to business plans to adapt to the new world," said Armin Rothauser, head of lending at investment firm Castlelake.

Merx, the aircraft financing subsidy owned by Apollo Global Management, turned towards nursing its troubled assets and shutting its doors, the firm reported through its business development company (BDC) earnings last year.

The BDC's valuation on its portfolio investment fell from US$363.06m pre-pandemic to US$314.34m as of June 2021. The BDC's executives, however, are optimistic with losses on lease revenue now "stabilized" and that airline exposures have "undergone restructurings," said Apollo's Chief Investment Officer Tanner Powell in the August call.

That optimism is shared across the rest of the non-bank lending market. White Oak's aviation division is seeing increased opportunities in the sale leaseback space and in direct financing to companies, with the latter expected to grow, said Greg Byrnes, chief financial officer at White Oak Aviation Management Services.

"Looking forward we have a cautious confidence in growth," he said. "Our portfolio is balanced 50-50 between the asset side and direct lending side, but we expect more of the latter to grow."

Castlelake also sees opportunities in lending directly to companies in the aircraft sector and launched a strategy

*(**REVIEW** cont'd on page 4)*

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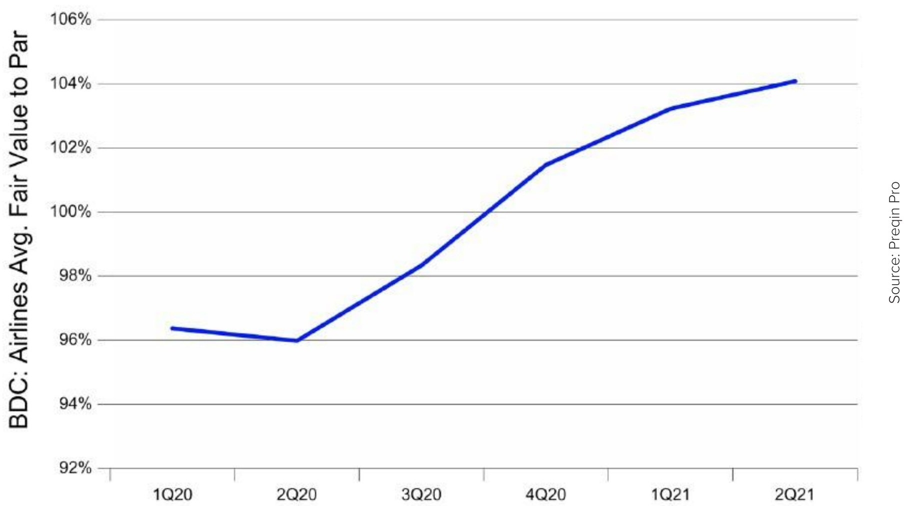
Fig. 4: BDC airline volumes



to capitalize on the flourishing space. What perhaps helped indirectly with the recovery of the sector was the Suez Canal crisis earlier this year, where the Ever Given tanker blocked the waterway and brought global supply chains to a standstill. Over those eight days international companies had a chance to ponder the vulnerability of shipping and look more closely at the air transportation to move cargo.

"It is fair to say the Suez incident had an impact on the perception of the reliability of shipping. Supply chains are moving more towards air flight," said White Oak's Byrnes. "But with demand outstripping supply the risk adjusted returns in the freight space is very attractive."

BRAVE NEW VIRTUAL WORLD

As the private credit market has grown since the financial aftermath, the excitement has been tempered with the looming question of how lenders would manage a downturn.

A once in a hundred-year pandemic was not modelled by firms, but the highly liquid and flexible private credit market helped companies weather the worst. It's fair to say private credit has passed the test.

And you could forgive lenders for believing that people would always fly and that people will always need their teeth cleaned. The sudden closures of both sectors were unprecedented.

Now that both have reversed course, the question is now on the residual effect of consumer and business behavior. Will we keep putting off visits to the dentists? Will we all continue to conduct meetings and family gatherings on Zoom?

Castelake's Rothauser says that while "video conferencing capabilities allow businesses and consumers to connect more easily across geographies, we also believe in-person meetings are important. Therefore, we don't envision a full return to pre-Covid business travel but could see close to a 70-80% return once the pandemic comes under control."

(Andrew Hedlund also contributed to this report.)