EXPERT Q&A

These are the best lending conditions for years, say Gregory Racz, president and co-founder, and Daniel Leger, managing director of MGG Investment Group

Why higher rates lead to more non-sponsored opportunities

Q Is what is happening to US regional banks good or bad for private credit? And for non-sponsor lenders in particular?

What happened this spring is a continuation of a 40-year consolidation cycle driven by bank failures and regulation. The recent failures just exacerbate the absence of bank lending for mid-market businesses, and most expect small and mid-sized banks in the US to get further regulated.

In the US, we have gone from more than 14,000 banks in the late 1980s to around 4,000 today, and those banks don't really lend money to businesses in the way that we expect. They own a lot of commercial real estate loans, but they don't serve middle market business loans the way they used to.

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All of this is good for private credit because it continues to create an opportunity for us to step in and take what was once the natural role of banks. For non-sponsor lenders, it is particularly powerful because we already operate in a less competitive space. Most of the capital raised for private credit is going to large, sponsor-backed lenders and largely bypasses the non-sponsored space. While more challenging to source the opportunities, the US mid-market is estimated to be worth about $10 trillion, making it an economy larger than that of Japan. There are more than 200,000 businesses, and only 5 percent of these are owned by private equity, so there is a huge opportunity.

Q Overall, how does this environment compare with others for private credit?

This is the best environment for what we do since 2009-10. With interest rates having risen and capital scarce because of the pressure on banks, we can get paid more, and it is easier to negotiate the tight covenants and other investor protections that are standard in our loan agreements. We are finding we can get better origination fees and higher floors, so the packaging overall is more favourable to the lenders.

Q If base rates stay elevated, what does this mean for US lower mid-market borrowers?

In our current loans, we find the interest rate to be sustainable because the growth rates of these businesses are substantially above the cost of capital, with very healthy mid-20s EBITDA margins. With the amount of debt we provide, which is typically about only four turns, this can be supported by the cashflows of the business.

For borrowers, it obviously means the cost of capital is going to remain high and we may reach a point at which companies choose to issue equity or not borrow. We don't believe we have reached that point yet, but we are getting closer to it. But over time, borrowers are going to be more cautious about how much debt they take on.

Q What do elevated base rates mean for the majority of lenders? Will defaults increase substantially?

Many often sponsor-backed businesses took on as much as seven turns of debt before interest rates went up and at that level you are going to have a lot of workouts. Given how few covenants those sponsor-backed lenders have, by the time they take possession of assets, the recovery rates are likely we believe going to be substantially below historic levels. Recovery rates used to be around 70 percent and we are now looking at potentially between 20-40 percent.

There have not been many bankruptcies yet but when they occur, the lenders are recovering a lot less. When you add to the mix the threat of creditor-on-creditor violence in the sponsor-backed world – given the lack of covenants and protections that went into those deals – by the time private equity owners hand over the keys there may not be much value remaining.

We think the low default rates are thus far providing false comfort. They will go up, though perhaps not as much or as fast as people think because private equity sponsors have so many rights in existing structures. This may deliver better outcomes for private equity but not necessarily for their lenders.

"This is the best environment for what we do since 2009-10"

Q What does this environment mean for mid-market businesses that need both debt and equity financing?

There are a number of issues driving demand. Obviously, the cost of borrowing has gone up and there are fewer sources of capital. The increasing number of issues in lenders' portfolios also means they have less capital to lend because they have things to address. Equity financing in the public markets has also been difficult, with the IPO market all but closed, and selling to strategics is less attractive to businesses still looking to grow not sell. So, if you are a business looking for debt and equity capital, you will have trouble finding equity at an acceptable price.

This means it is a really good moment to be a lender that provides both debt and equity financing to growing mid-market businesses. We call these types of investments structured solutions. It allows us to support growing mid-market businesses and become a one-stop shop for them, where we can get paid well on the debt (with all the lender protections) while also purchasing equity at very attractive mid-single-digit multiples. We find that is a powerful offering right now, with a lot of demand with few other options for the business owner (and much less dilutive for the owner versus pure equity financing).

Q There have been reports about sponsor-backed lenders looking to do more non-sponsor deals. Are you seeing that? And what about the reverse? Are there more sponsor-backed opportunities for MGG in this market?

We are not seeing evidence of that yet. There are two important reasons to be cautious about moving into non-sponsored lending. One is sourcing because it is hard to find businesses in the numbers you need – we saw 1,400 deals last year and ended up funding 18. There is little room for tourists.

Two, you need to do all your own due diligence because you can't rely on a private equity firm's due diligence package. That is resource-intensive and challenging for typical sponsor-backed lenders.

On the other hand, we are seeing more sponsors willing to accept our terms, in part because we have the capital and, in part, because other folks are nursing portfolios that need a lot more attention. So, we have looked at more sponsor-backed deals in the last year than we have previously.

Q How will a higher-rate environment impact the private credit market longer term?

If rates stay higher for longer, this is going to be a really great asset class to invest in. Even rates a couple of hundred basis points below where they are now means a cash pay in low double-digits, which is very attractive in almost any environment.

From a regulatory standpoint, the government is going to continue to want private credit to support businesses more than banks, so we see a huge opportunity for many years to come, particularly in non-sponsored lending. ■

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