Lead Left Interview – Michael Ewald

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This week we chat with Michael Ewald. Michael is a Managing Director, the head of the Private Credit Group and Portfolio Manager for Bain Capital Credit's Middle Market Opportunities and Senior Direct Lending fund strategies. Bain Capital Credit, founded as Sankaty Advisors in 1998, is a leading global credit specialist with over $30 billion in assets under management and has more than 230 employees operating from a network of seven offices around the world.

The Lead Left: Michael, tell us what you see are the current market conditions?

Michael Ewald: Our business is about 80% from private equity sponsored companies, and 20% non-sponsored. It's a good mix, but the focus is primarily sponsored borrowers. There are several reasons for this. First, it's an efficient way for us to source deals. There are over 200,000 middle market companies in the U.S. alone, so unless you're a bank with deposit-taking and fee generation capabilities, that's a tough market to cover. Also, having sponsors with the funds to back-up the companies, to take them through speed bumps and provide additional capital for acquisitions, is extremely helpful. Finally, sponsors tend to have high-powered operating capabilities, particularly in the finance and process management functions, to help professionalize these businesses.

We also see opportunities in the unsponsored space. We like companies with particular niches. For example, we financed a business that has specific brands selling into both CVS and Duane Read with little variability year over year. That business has about $70 million in EBITDA, so it's a sizable company and its customers would care if it went away.

We target companies between $10-$75 million of EBITDA, with $20-60 million being our sweet spot. Unsponsored companies tend to be smaller. You hear people talking at industry conferences about sourcing proprietary deals, but it's hard to say who legitimately does that. Obviously it's more than just picking up the phone with sponsors. We also work with a few fundless sponsors, particularly in packaging and media. We have good relationships in those sectors, with consistent deal flow in both verticals

Within our Credit business, we also have a large broadly syndicated loan practice. Those borrowers are covered by industry teams. Some of our investment opportunities are sourced through their contacts at industry specific conferences and third party advisors. For example, we had a dairy operation in our portfolio that was sourced at an agriculture conference by our food and beverage analyst. The Private Credit Group is like a boutique investment firm with 25 people but it's good to be part of a larger institution like Bain Capital Credit, which is part of the much larger Bain Capital platform (over $75B of AUM), where networking is particularly important, and those are all contacts which we tap into regularly.

TLL: How do you think about your sponsored opportunities?

ME: You can't have a top down thesis in private credit since the market is illiquid. We are clearly reliant on a middle market deal flow, which is down this year. One of the trends we're seeing is relatively large EBITDA add-backs, which can be a concern. Sellers have very high expectations on price. This is a low-growth environment, but that may have changed with Trump's recent election, nevertheless, these add-backs is one way sponsors can try to justify playing a higher price. Otherwise, it can be hard to justify those high multiples. Dividend recaps as an option to selling are up considerably this year given the disconnect between buyer and seller expectations. We won't lever them as aggressively as the rest of the market, because we don't have someone new putting in fresh capital, but we'll consider them. Also, it's important to note that not all deals are alike. We might give credit for cost cuts already implemented that haven't flowed through financials yet but will look with a jaundiced eyes are cuts that are still to be implemented. Some sponsors have pushed the envelope a bit with add-backs but that's just not for us.

Another trend we're seeing is that companies around $50 million EBITDA are being treated like large caps. Fifty used to be a big number. When markets backed up a year ago, shops stepped in providing private options for syndicated loans. We might offer one-stop solutions to sponsors, for example, a unitranche financing at LIBOR +625. That's much better than a senior financing at L+575 with flex given the certainty but sponsors can be enticed by the possibility of a lower rate. We could use more banks to fail with flexes to convince private equity firms that the unitranche is a better option. At any rate, weakening documentation from the lenders perspective can also be a concern in this size realm.

TLL: How do you see supply versus demand? We hear from investors there's too much capital chasing too few deals.

ME: A fair amount of the capital flow is going to Europe. If you're an offshore fund in the US, there are tax issues when trying to invest here. So funds are going over to Europe to take advantage of the relative ease of fundraising. However, right now there's a 50-75 bp premium in the US, even with Brexit and all the low growth environment over there because of that spate of fundraising. And banks are more aggressive in Europe than in the US. We do see more dollars coming into the US, but mostly for smaller firms and smaller opportunities; call it the $500 million to $1B fund size.

Scale matters. For a $100-150 million deal, if a firm offers to invest $20B, that's not as helpful as if someone like us will speak for the whole deal. It does take time to build scale. People also confuse "flow" versus "stock." For example, we have $5B in capacity, including about $1 billion of untapped fresh BDC capital, but the rest is mostly drawn and invested. We are on a hamster wheel of sorts; as we invest capital, it remains outstanding and we need to raise more to continue to be an active leader in the market. A lot of stock is already invested, that's why you need to do continual fundraising.

TLL: Do you see most of this capital going to higher yield investments?

ME: For us, we have both senior and junior capital businesses targeted to the middle market. There can be a fine line between the two at times. Is a second lien note true second lien or is it mezzanine risk masquerading as a second lien security? In senior direct lending, first or second lien, it's very hard to make up for losses. Looking at the competitive landscape, the yield on the underlying assets gives you a clue. What is the average yield? If 50% is designated as first lien, but the yield is high single/low double digits, then you know there's some riskier assets there.

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