THE LEAD
https://theleadleft.com/small-portions-last-series/

And Such Small Portions (Last of a Series)

THE LEAD | January 24, 2018

In case our readers missed the reference of our series title, the joke goes like this: Mel and Harry are lunching at a diner. ”The food here stinks,” Mel complains. “Overcooked, expensive, and no taste.” “Yeah,” Harry says. “And such small portions!”

We’ve invoke this old chestnut as a metaphor for the state of middle market loans. On the one hand, as we’ve covered in detail, structures around ebitda adjustments and debt limitations have deteriorated. Pricing, while still at a reasonable premium to broadly syndicated loans, remains a challenge given the higher leverage multiples being demanded.

But loan buyers have raised a significant amount of capital dedicated to direct lending over the past two years. They have a lot of dry powder to put to work – as do their private equity clients – and it’s burning a hole in their numerous pockets. LPs are a pretty demanding bunch. After all, cash doesn’t earn much these days.

To make matters worse, in the syndicated middle market arrangers often go out to as many institutional investors as possible. The goal is to reduce underwriting risk to zero, and keep as large a stable of prospective buyers on the alert for future issuance.

That’s spreading too little butter over too much toast. Allocations for each fund end up being miniscule, even for loans in the $150 million range. It’s insult to injury. You’re forced to accept aggressive terms and tight spreads, and you can’t even get a decent sized asset!

We examined this supply/demand dynamic last week with Kelly Thompson, LevFin Insights’ middle market analyst [link]. Her findings were that $29 billion in sponsored loan volume last year was dwarfed by $43.2 billion in funds – mostly new-issue MM CLOs, credit funds and BDC capacity. While $14 billion doesn’t seem huge in the overall scheme of things, it’s directionally indicative of the too much cash chasing too few deals dilemma.

What about the overall size of the middle market? We asked Kelly for her best estimate, compared to the analysis we undertook in a special white paper on the topic [link].

“Sizing a still largely opaque market is a challenging exercise,” Kelly told us. “Your study was an excellent one, weighing a number of important variables. One straight-forward proxy some managers find useful for the sponsored market is multiplying the total volume of private equity funds raised by the current debt multiples.

“We calculate the average total debt multiple for middle market loans was 5.4x for the fourth quarter of 2017. According to *Buyouts Insider*, there’s $95.2 billion in US middle market private equity funds. Multiply those numbers gets you a universe of about $515 billion.”

What does *Buyouts* call a middle market fund? “The $95.2 billion is all PE funds closed with $3 billion or less,” Kelly said. “That doesn’t include mezzanine and distressed debt funds. The calculation also assumes the $95.2 billion is fully deployed, which it probably isn’t.”

Kelly continued. “*Buyouts* reports there’s also $20 billion in funds still being raised – excluding mezz and distressed. Throw those into the $95.2 billion, and you end up with about $115 billion. If you again multiply that number by our 5.4x leverage metric, now you get a middle market of just over $620 billion.”

That’s a higher number than the estimates we produced for our special *Lead Left* series, that ranged from $410 billion to $518 billion. Still, the bigger the market, the more likely investors will get the size portions they’re hungry for.