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Glasses Half Full (First of a Series)

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Our friends at Lincoln International produce a superb report on private market insights from their valuations and opinions group. Derived from their database of hundreds of borrowers as part of their quarterly analyses for managers' portfolio valuations, this data provides helpful guidance on a host of issues such as loan prices, purchase price multiples, and financing terms.

Of particular interest is the revenue and Ebitda performances of these largely privately held, middle market companies, quarter by quarter. Economists, market analysts, credit managers and investors are understandably keen for signs of any deterioration as a result of higher interest rates, inflation-related costs, and/or a general economic slowdown.

As our *Chart of the Week* highlights, over 80% of Lincoln's portfolio companies demonstrated higher sales last year than 2021. Less than that, about two-thirds, reported improved cash flows. This has been interpreted as evidence businesses are being challenged by mounting expenses, including interest and wage pressures.

But the same chart shows 2021 Ebitda up for *fewer* companies vs. 2020 than last year's cohort. Which means the 2022 corporate vintage fared pretty well despite whatever drags the overall economy delivered.

While full year 2022 numbers aren't complete, our own Gryphon Index, a similar measure of portfolio performance, reported the same asymmetric outcomes. Borrowers sported a 40% increase in revenues and a 30% improvement in Ebitda. While including add-ons as well as organic growth, the benefits of more scaled platforms typically accrue to portfolio quality.

Rather than indicating signs of trouble, we suggest cause for optimism. Certainly, the full impact of escalating rates has not been felt. And with the Fed chair's testimony and a 50 bp March hike a real possibility, higher for longer is now more likely.

But in defensive sectors where experienced private managers play, companies are aided by a variety of tailwinds. Those with low capex and labor costs have more room to maneuver when other expenses rise. Their market leadership and value-add products and services allow for pricing power – helpful in navigating the current environment.

Everyone has also forgotten what a "garden variety" recession looks like because it's been so long since, for example, 2001. We expect the asset class to be resilient in such an environment even accompanied by high rates.

It's also instructive to remember that companies don't need to grow to be good credit risks. Indeed, the very high growth businesses tend to be more volatile through economic cycles. Slow growth or even moderately soft operating results don't necessarily lead to loan defaults or losses. As one friend is fond of saying, your horse doesn't have to win, just finish the race.