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The OG of Private Credit: (Smaller) Size Matters

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As we highlighted last week, the zero-rate period post-GFC allowed private equity firms to buy companies with higher leverage and sell them at higher multiples. For the largest direct lenders, this included mega software businesses with increasingly borrower-friendly financing terms.

Reality returned in 2022 as SOFR soared from zero to 5%. Financing costs became headwinds, borrower leverage shrunk, and the upward march of purchase price multiples halted. Public credit markets shut down. Private markets remained open, but with M&A slowing, competition among upper-market lenders surged, resulting in 60% portfolio overlap (see *Chart of the Week*).

The core middle market is relationship driven. Sponsors and lenders are long-term holders so successful outcomes require alignment of interests. A solid partnership of trust is more valuable than squeezing the last turn of pricing or leverage. Sectors and borrowers must prove resilience through cycles because, unlike large caps, you can’t easily sell an “overweight” position.

For years lenders demanded an illiquidity premium for mid-caps, anywhere from 100-300 bps. And more protection: maintenance financial covenants, security on all assets and cash flows, and lower leverage. But *liquidity risk* is different from *credit risk*. In fact, default and loss rates are historically *lower* for middle market loans than broadly syndicated loans. In part this is thanks to the cooperation between lenders and borrowers to get through tough times.

These relationships also limit deal overlap among middle market managers to 30% – half of the upper market. (Being an LP in 350 top-tier PE GPs reduces our own portfolio overlap to 6%; less than the lower MM). This points to the fundamentally different origination models, competitive environments, borrower profiles, and risk characteristics in mid-caps versus large caps.

Deal sourcing in the core MM is not dependent on market momentum. Activity is consistent regardless of cycles because experienced managers diversify portfolios across defensive sectors. This reduces concentration risk in ways that bank/bond replacement platforms can’t.

The rush of retail money into those platforms worsens this dynamic. The tyranny of dry powder is the relentless quantity-over-quality pressure to put money to work. In contrast, only 5% of all middle market companies are owned by PE firms, creating a natural supply/demand balance.

Today’s credit concerns stem from four years of higher rates in higher risk portfolios, particularly AI-sensitive sectors. Flashing red lights for PIK loans, non-accruals, and default rates are signs of stress. Our own portfolio performance suggests the core middle market remains more resilient given its broader base of less tech-centric service companies.

Next week, we explore how financing terms for borrowers, in both middle and large cap markets, translate to terms for investors.