A road less travelled

With the growth of private lending continuing unabated, buyout funds remain an important part of the market, says Sean Greene, managing director and head of small business credit at Siguler Guff.

Investors considering exposure to a fast-growing alternative asset class could do worse than consider private lending.[1] That's the view of Siguler Guff managing director Sean Greene who highlights a report from the Alternative Credit Council showing the explosive growth in this often overlooked segment. Today, assets under management in the industry stand at US$605.5bn and could reach US$1 trillion by 2020 based on current growth rates.[2]

Traditional banks, struggling under the burden and cost of ever increasing regulation have been stepping back and many have decided it makes more sense to be an originator rather than holder of loans, says Greene. This change in banking business models has had far-reaching consequences. New sources of capital including private credit funds in particular have stepped in to bridge the lending gap and what was once a niche sector has become increasingly mainstream.

For Greene, the most astonishing thing about this momentum is not the rate of expansion but the degree to which it neglects the smaller end of the credit spectrum. In the US, he says, around 90+% of capital raised has gone into funds investing in companies valued in the US$100m-plus category. This is despite the fact smaller companies account for around 90+% of the companies in the US economy, he adds.

In Greene's view, this lack of emphasis on the small business segment presents a compelling opportunity for both private equity and private credit firms willing and able to focus on it. For one thing, entry and exit multiples at the smaller end of the lending spectrum generally tend to be more attractive versus the larger opportunities in the market. He says: "Entry multiples can be about 7x EBITDA in the small business universe compared with around 10-11x in the large cap segment. Generally, you're also looking at a more conservative debt structure in the small business segment with leverage in the region of 4x EBITDA versus 6x EBITDA in larger deals."

Given these possible benefits, why is this part of the market often overlooked? Greene says the answer may be as much about the size of the average private credit fund as anything else. "The larger a fund gets, the larger the size of the cheque it wants to write," he says. "Indeed, larger institutions often have guidelines in place which formally prevent them from considering deals below a certain size. While this might make sense from an efficiency perspective, it also means there are good opportunities missed."

The same holds true for traditional sources of capital such as banks. A wave of consolidation has seen the size of lenders grow in recent years and as they become bigger, smaller companies inevitably drop off the radar.

[1] Private lending is defined as any part of the debt market not serviced by traditional banks, which could include private equity funds.
[2] *Reuters:* 'LPC-Private credit market set to reach US$1trn by 2020', 4 October 2018.

One other consideration that might contribute to the SME (small, medium enterprises) segment being overlooked is that smaller companies can be perceived as higher risk. But there are ways to address that, says Greene. One option is to consider the age of companies. "It sounds obvious but if you can invest in companies and management teams that have shown they can survive multiple economic cycles then that goes some way towards mitigating risk." Lower levels of leverage can also help on this front too. Smaller buyouts generally involve less debt, says Greene, and that means an extra cushion of support during market downturns.

"One approach is to say, yes, there will be a recession at some point soon," he says. "If that is the case, then you want your exposure to be in businesses that have a proven ability to ride the cycle. You also want to have invested at an attractive entry point and with manageable debt obligations."

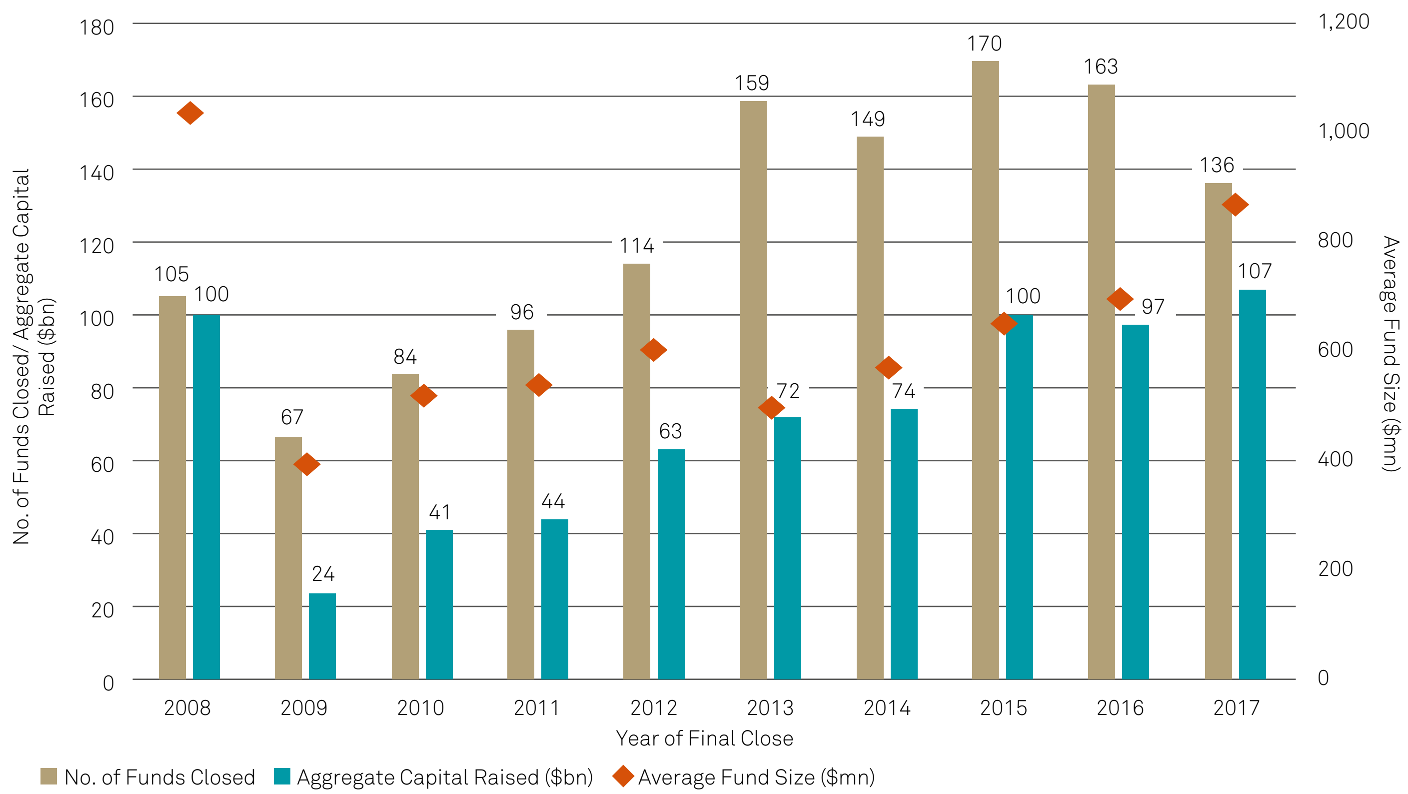
Greene notes that many of the opportunities found at the smaller end of the market are often family-owned businesses tapping institutional capital for the first time. He cites the example of one 80-year-old manufacturing company based in the Pacific Northwest whose owner needed capital to grow. "With certain deals," he says, "investors may look to partner with a local buyout firm with good local knowledge that can source the opportunity. Then, in terms of the opportunity itself, a preference can be for expert management teams getting familiar with a company's history with their customers and comfortable that their business model can deliver predictability and profitability."

One obvious comparison, according to Greene, is with the 'Mittelstand' companies of the German speaking world.[3] Here succession issues "are a big deal", he says. "Quite often it's an intergenerational thing. The founder or owner wants to retire and pass a business on to their children while taking some money off the table. In other cases, there are no family members to pass the company on to and that's where private capital really comes into its own. Often, the buyout firm can help find a replacement CEO or help with the process of allowing internal candidates to step up to the plate. The ultimate aim is to foster an environment where the business and the people who work there can thrive."

Involving buyout funds has other advantages. Often it means there's scope to professionalise management structures – bringing in outsiders with a fresh perspective or adding new board members. Nominally non-core areas such as marketing can also be strengthened. Says Greene: "There are a whole range of options to supplement existing capabilities that are often overlooked in the day-to-day running of a small business. Essentially, following a buyout you're looking at ways of supercharging organic growth but M&A can be an option too."

For the end investor, the benefits can be significant. Says Greene: "Our view on the small business private credit segment is that it brings a wealth of often unexplored opportunities to the door of investors. It's an area where we think net returns in the low double digits and quarterly cash yield of 8% and above are attainable. In a low yield world, that's pretty compelling."

ANNUAL PRIVATE DEBT FUND RAISING, 2008-2017



Source: *Preqin* global private debt report 2018 as at 31 January 2018.

[3] The term Mittelstand commonly refers to small and medium-sized enterprises in German-speaking countries, especially in Germany, Austria and Switzerland. Typically these companies have annual revenues of around €50m and up to 500 employees.