



# Small is Beautiful: Finding Compelling Investment Opportunities in Direct Lending to Small US Companies



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Historically, banks were the primary lenders to small and medium sized businesses.

Ongoing consolidation in the US banking industry and increased regulation are reducing the role of banks in lending to small businesses, while also creating a potentially attractive opportunity for yield-seeking investors. We recently spoke with Sean Greene, Managing Director and head of small business credit opportunities at BNY Mellon's investment management affiliate Siguler Guff about the state of the US direct lending market and his views on the opportunities and risks in this market.

### *What forces are creating opportunity for investors in direct lending?*

Demand for lending from small and medium sized companies is very high right now; in fact, it's back to where it was before the financial crisis. There is a significant amount of private equity activity across various industries and over \$500 billion of US private equity dry powder, which generally translates into a greater number of deals being done. When private equity firms acquire companies, they often finance a portion of each deal with debt. As a result, we expect demand for lending to continue.<sup>1</sup>

There are also meaningful changes taking place in the supply of capital, due to both new regulations and broader changes in the capital markets, as banks make a significant retreat from direct lending.

Historically, banks were the primary lenders to small and medium sized businesses, but the number of banks that lend to those companies has dropped from more than 10,000 in 1994 to 6,000 today. Recent regulatory changes, including the Dodd-Frank Act and the Volcker Rule, require higher capital reserves and make banks more risk averse. Banks view lending to small companies as relatively risky and are increasingly pulling out of the market as new regulations make lending more costly.



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<sup>1</sup> Pitchbook PE & VC Fundraising and Capital Overhang Report 1H 2015.

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***What has replaced the banks as lenders to these types of companies?***

As banks have pulled back, the number of business development companies (BDCs) has increased five-fold over the last ten years,<sup>2</sup> with the bulk of them focused on senior lending to middle market companies. There has also been an increase in capital committed by institutional investors to private credit funds, which are replacing banks as lenders to these companies.

***Given that the shift from bank lending to direct lending has been underway for some time, are compelling opportunities still available for investors?***

We're in the middle of the opportunity. Four or five years ago, there were so many opportunities that investors merely needed to "show up for the party." Now, the market is getting more competitive so there is the question of "which party to go to." In certain segments of the market, the amount of leverage in many M&A transactions has increased significantly over the last two years. In the large corporate and larger end of the traditional middle market, we see more M&A deals where the multiples have increased to pre-crisis levels. Those factors may lead some investors to view the market as a bit frothy and to increase their concern about balancing yield and risk.

That said, we believe there are still many compelling opportunities. Institutional investors continue to have a significant appetite and need for yield, and direct lending offers them a potentially attractive opportunity to get it, particularly if they're willing to tolerate a little more liquidity risk than they've historically been accustomed to.

***How do you as a manager address investors' concerns about risk while also looking to deliver the attractive returns that they seek?***

We start by choosing to specialize in the smaller part of the market. We strongly believe that lending to small companies is an area of the market that faces less competitive pressure, is insulated from some of the frothiness and is less likely to become over-leveraged. Pricing has remained higher and far more stable than in the larger parts of the market. We think the direct lending opportunity to small businesses is compelling because it has the potential to generate compelling yields without some of the risks found in other areas of the market.

***What is your process for sourcing and evaluating opportunities?***

Our strategy focuses on the part of the market driven by private equity sponsors. We specialize there for two reasons. First, we have many sponsor relationships that give us access to deal flow. Second, we believe that having a private equity firm involved in a company can significantly reduce risk. In many cases, a private equity firm can help professionalize a business. Most of our sponsors will put in a new CFO when they invest in a company. They'll improve systems and bring professional governance to the board. A private equity sponsor may also address problems earlier than a standalone company would.

Company selection is also a critically important part of the risk management process. Typically, we target companies with an average age of 30 years. There's probably no single better data point to evaluate risk than a company's age. If the company has been around for 30 years, they're doing something right and have shown the ability to withstand multiple economic cycles.

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<sup>2</sup> Wells Fargo Securities, The Middle Market CLO Desktop Primer, July 24, 2014.

***How does your experience having worked in government at the Small Business Administration (SBA) inform your thinking about investing in direct lending?***

At the SBA, I was responsible for a program that invested \$5 billion into private credit funds. That gave me a unique vantage point on many different strategies and parts of the market. From that perspective, I saw how a highly differentiated, relationship-based strategy in an inefficient, fragmented area of the market could potentially provide compelling returns.

***What will the impact on direct lending be when interest rates start to rise?***

We don't know whether a rate increase will occur in six months or six years, but this is a critically important question. Many of the loans have variable pricing, so they will change as interest rates move. The bigger danger lies with highly leveraged deals. A company that has taken on total debt of six times earnings can afford to cover its interest payments when rates are low. When rates—and total interest payments—start to increase, the debt burden will be significantly higher, leaving much less room for error for those companies' operations. We think the deals that are highly leveraged right now are potentially problematic. Excessive leverage is the biggest risk factor that investors should be focused on, and it's the reason we prefer the market segment where leverage is low.

***So that's one risk you avoid by focusing on small companies. But aren't smaller businesses inherently riskier than larger ones?***

Some managers say so, and that's why they avoid small companies. We believe there are ways to invest in the small part of the market with less risk, but I encourage each investor to understand the dynamics of the risk present in any strategy.

***What does the future hold for US direct lending? Is this a short-term opportunity that will eventually close as the public markets evolve to meet companies' capital needs?***

We believe the small end of the market presents a long-term opportunity because it is structurally inefficient. It was that way thirty years ago and we believe it's probably going to be that way thirty years from now. We like that inefficiency in general, and it is particularly attractive in the current market environment with banks pulling out of direct lending.

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