

E X P E R T Q & A

Lower mid-market direct lending provides investors with exposure to parts of the real economy that are underrepresented in public markets and at an earlier stage of value creation, say Apogem Capital's Josh Niedner and Rob Douglass



Taking the long view on private debt

Q How has lower mid-market direct lending evolved over the years, and why do you believe this to be a particularly attractive area within the private credit ecosystem?

Josh Niedner: The market has evolved significantly. Our direct lending business was founded in 2001. At that time, we were one of only a small number of what are now called direct lenders, and commercial banks were our primary competitors.

As more direct lenders entered the market and banks became less competitive in the space amid an evolving

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regulatory landscape, direct lenders have increasingly been able to provide borrowers with more flexible financial solutions and to deliver differentiated value and efficiency, pricing those solutions accordingly. This, in turn, has made direct lending increasingly interesting to investors over the years and attracted capital to the asset class.

The private equity industry has also expanded significantly over this same time period, in terms of both

the number of firms and volume of investments, which has helped drive increased size and scope of the addressable market for direct lenders.

Additionally, large capital aggregators that previously competed in the lower and core mid-market within direct lending have moved up in scale over time and have shifted more of their focus to larger deals outside of our core market.

The net effect of the evolution in these various market dynamics is that we have an expanded opportunity set in a market that has consistently shown strong relative value. This provides us with the ability to continue to deliver

that value in a highly diversified manner and in a market that has truly been time tested.

Q What lessons have you been able to take from previous periods of volatility, applying them to the current situation?

Rob Douglass: Since the earliest days of our platform, we have stressed the importance of building out the right infrastructure and processes to manage through periods of volatility. For example, we established a dedicated workout team in 2004, preceding any stress in the portfolio. In reality, we did not experience any meaningful issues until the onset of the global financial crisis in 2007. Therefore, when the crisis struck, we were well prepared to manage through that period, as opposed to dealing with problems reactively.

Additionally, we think it's important to track data from the portfolio to inform investment decision-making. In our case, we track upwards of 175 data points for each of our 300 borrowers. We mine data from the roughly 3,000 transactions we have closed over the course of the past 25 years. For example, we conduct a monthly analysis of the organic growth for each borrower. Since portfolio companies are often highly acquisitive, it can be difficult to discern true performance of the underlying borrower.

We use this monthly financial reporting to differentiate between organic growth and acquisitive growth, which we believe provides a more instructive diagnosis of macro and micro themes within industry subsectors. We use historical portfolio data to isolate challenges in subsectors and subsequently avoid those industries.

Q How do you expect lower mid-market direct lending to fare in the current macroeconomic and geopolitical environment,

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ROB DOUGLASS

and what capabilities and strategies are best positioned to succeed?

RD: It is worth noting that many lower mid-market companies have proven adept at navigating recent economic uncertainty, be it supply disruption coming out of the pandemic, the ensuing elevated rate environment or evolving trade policy. We believe this underscores the resilience of mid-market companies and their ability to manage through volatility and economic shocks.

Having said that, there has been a proliferation of direct lending managers in recent years that may result in excessive risk-taking by newer managers seeking to raise or ramp up their funds. This strategy may prove to be poorly timed from a macroeconomic perspective. While we are not overly bearish on the US economy, costs and uncertainty are rising and we believe those dynamics are likely to persist for the foreseeable future.

Ultimately, that means credit selectivity will become increasingly important and investor discipline will be paramount when selecting direct lending managers.

We expect the strategies that will

work best in the current environment will be those with strong origination networks that provide recurring dealflow without needing to venture up the riskspectrum. Additionally, our view is that managers with large, seasoned portfolios will benefit from steady follow-on deployment opportunities, in terms of add-on acquisitions, continuation vehicle transactions and sponsor-to-sponsor trades, even in a slow M&A environment.

Q What is your approach to origination, and how are you able to leverage your history to inform deal selection?

JN: We primarily focus on sponsor-backed opportunities, which offer benefits in the form of institutional ownership, diligence and governance. We cover more than 650 sponsors and see benefits in terms of recurring and diversified dealflow.

In terms of leveraging our history, we have reviewed thousands of investments over the past 25 years. Many of the deals we see have been in the market before with previous owners, so we have been able to evaluate and follow these opportunities over time. That allows us to get up to speed on transactions very quickly, giving comfort to the borrowers and private equity sponsors that we work with.

Q How would you describe investor appetite for private credit, and what are investors looking for in a manager in the current environment?

JN: In many ways, investors are looking for the same things they have always looked for in a direct lending manager – strong returns, limited volatility and healthy diversity. I would say investors are now also placing greater emphasis on a manager's experience through the cycles and the capabilities required to navigate those cycles, such as workout teams.

Q Which sectors are proving to be particularly interesting in terms of dealflow?

RD: Having initially slowed following US President Donald Trump's 'Liberation Day' announcements, dealflow has stabilised more recently and has begun to pick up once again. That rebound has been fairly balanced across different end markets.

In addition to our diversified industry teams, we have established three specialised industry verticals: healthcare, financial services and software and technology. We established the healthcare group in 2007. Within the healthcare sector, we focus on subsectors such as medical device manufacturers, outsourced pharma services, home health and healthcare IT. We have also de-emphasised certain healthcare subsectors such as physician practice management, where modest growth trends, reimbursement risk, high labour demands and execution strategies that often involve building out infrastructure proved challenging when operating in a levered environment.

We entered the financial services vertical in 2008. Within this sector, we focus on insurance distribution and investment adviser platforms, together with companies providing services to those end markets. These types of businesses have proven resilient across different economic environments, given their recurring revenue models, high margins, low capital intensity and favourable free cashflow.

Finally, within software and technology, which is a speciality we launched in 2016, we increasingly pursue software businesses that are vertically focused on a particular end market. We like these opportunities because borrowers operate in niche industries and have custom-developed solutions tailored for a specific purpose or sector.



Q What do you believe the future holds for lower mid-market direct lending?

RD: In the short to medium term, we are focused on how late-stage business cycle dynamics and policy changes will affect the mid-market. We remain

optimistic because many mid-market companies operate localised business models, making them inherently less vulnerable to geopolitical risk such as shifts in trade policy.

Over the medium to long term, we believe private markets, including

direct lending, will continue to democratise. Advances in product design and technology are making private markets more accessible than ever before. Evergreen fund structures and digital platforms are fuelling strong demand for the asset class, with wealth investors now one of the fastest growing investor segments. Potential changes in US regulatory policy, including the executive order on private assets in 401(k) plans, should further fuel that expansion.

We believe the most compelling private markets opportunities in retirement portfolios will be those that enhance diversification and provide exposure to the parts of the real economy that are underrepresented in the public markets. The lower mid-market stands out as particularly attractive by providing access to mainstream businesses at earlier stages of value creation.

Finally, I would say that artificial intelligence (AI) is going to be highly impactful in the direct lending asset class. From a macro perspective, credit selection needs to consider how certain industries may be disrupted. Meanwhile, in terms of execution, we are focused on the use of AI to enhance client service through tailored reporting and communications. Equally, we see it as important to utilise AI to leverage our historical portfolio data in decision-making processes, ultimately helping to drive underwriting and origination alpha.

Speed of execution has become critically important in the competition to win deals in this space, so we are investing heavily in AI resources to augment our due diligence processes and streamline closing deliverables. Ultimately, we believe direct lending managers with consistent, time-tested underwriting, deep data bases and robust credit infrastructure will be best prepared to weather any future uncertainty in the evolution of credit markets. ■

Josh Niedner is chief executive officer at Apogem Capital and Rob Douglass is chief credit officer at the firm