E X P E R T Q & A

Sponsors can complement good underwriting but not replace it, say Apogem Capital's Bill Kindorf and Adam Willis

Why a credit-first approach matters

Q Why do you believe that lower mid-market direct lending is an attractive investment opportunity today, relative to other parts of the market?

Bill Kindorf: Statistically speaking, there are simply more opportunities in the lower mid-market. We find that the loan-to-value metrics and leverage levels are favourable relative to the upper mid-market. Furthermore, the documentation terms that are prevalent in the lower mid-market are valuable to us, including LME protections and restrictions on add-backs to EBITDA.

In our experience, financial covenants remain prevalent in the lower mid-market, something that tends to fall away in the upper mid-market, and certainly in the broadly syndicated loan market.

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I would add that the lower mid-market tends to be more relationship-orientated. In many cases, we have been working with sponsors for a decade or more, both as lenders and sometimes as investors in their funds. As a result, there is a level of trust that you just don't see in the larger market, which is more transactional in nature.

Q To what extent is origination strategy a differentiator in mid-market direct lending?

Adam Willis: Access to high-quality dealflow is one of the clearest differentiators for a private credit manager. Strong origination creates a broader opportunity set, allowing managers to be more selective while maintaining discipline across market cycles. We have followed the same direct-to-sponsor strategy since the inception of our direct lending business in 2001. During that time, we have built long-standing relationships with more than 650 private equity firms and completed transactions with over 370 of them. This allows for consistent access to quality dealflow even when markets are slower, as they are today.

We also believe deeper sector expertise leads to stronger origination and better credit decisions, which is why we have structured our origination and underwriting teams around dedicated industry verticals including healthcare, insurance and financial services, technology and software, and diversified industries.

Q What makes a good deal for you, and why?

BK: We are looking for strong, predictable cashflow profiles. The real question is: what generates that? We look for diversification in terms of customer base, supplier base, product lines and key employees. We want to verify that businesses have had stable long-term financial performance. We look at the competitive positioning of the company and tend to avoid businesses that are overly exposed to cyclicality. Similarly, we tend to avoid businesses that require large capex spend. That is obviously a direct hit to the cashflow that ultimately supports our loans.

We are also looking for what we would consider to be an appropriate structure, which can be as much an art as a science. We look for at least one financial covenant, set at a meaningful level. We focus on loan-to-value metrics to ensure there is appropriate equity cushion behind our loan. Then we do our modelling of cashflow coverage to ensure it is sufficient in downside scenarios.

Last but not least, we look at the private equity sponsor backing the transaction. We consider what our own experience has been with them over time. How have they behaved when things have not gone as planned? What is their experience in a particular sector? What sort of diligence work or resources are they bringing to the table, and what do they intend to do with the business?

Q To what extent are LPs focused on differentiated origination in today's more challenging fundraising market?

BK: LPs have become very savvy in terms of the data they request as well as the questions that they ask, primarily focusing on two things. First, they want to know that you are seeing the deals that are out in the market. Do you have a good outbound calling function? And, just as importantly, are you in a position to execute on those deals? Do you have an appropriate underwriting team to evaluate and then monitor those assets? Do you have a competitive hold size and do you have established relationships with private equity firms, such that they are willing to place their trust in you?

In our experience, investors are increasingly focused on uniqueness of dealflow. We see more than 1,000 potential transactions every year. That depth of opportunities, we believe, allows us to be more selective while also potentially reducing the likelihood of significant overlap between our portfolio and those of other managers. Investors value those dynamics because they want their manager to be disciplined and they want to avoid unanticipated portfolio overlap among their managers.

"I predict that we will see more platforms with multiple capabilities under one roof as opposed to standalone direct lending businesses"

BILL KINDORF

Q Would you say that your underwriting is credit first, or sponsor first?

AW: Sponsor relationships are important, but every investment must stand on the strength of the underlying business. That credit-first philosophy focuses on attributes such as cashflow durability, competitive positioning, management quality and downside protection. Throughout our 25-year history in direct lending, we have found those characteristics to be key drivers of long-term credit performance.

That said, the sponsor is an important part of the underwriting thesis. We look for sponsors that have consistently improved outcomes through sector expertise, operational enhancement, acquisition execution and financial support during periods of uncertainty. In our view, sponsors complement disciplined underwriting rather than replace it.

Inevitably, we get questions about topics that are in the news headlines. A recent example is the heightened concern around software loans. We are somewhat underweight to software, not driven by a risk-off approach, but really by the fact that we never leapt into the aggressive structuring features that became common in that market, such as recurring revenue loans and payment-in-kind (PIK) toggles.

Investors are interested in the consistency of our strategy, our experience across cycles and how much of our track record is fully realised. They want to ensure that fundraising isn't dictating our investment strategy. They don't want to hear that you have raised so much money that you have been forced out of your core market in order to deploy.

Q Software may be on the wane, but are there other sectors or investment themes dominating your pipeline?

AW: Deal activity has been uneven over the past few years amid macroeconomic and geopolitical uncertainty. Nonetheless, we continue to see robust activity across financial services and healthcare. Those sectors have generally proven more resilient to the macroeconomic headwinds we have been experiencing. Meanwhile, in the absence of broader dealflow, we also see sponsors place greater emphasis on buy-and-build strategies as they pursue portfolio acquisitions to enhance equity returns.

In fact, approximately 40 percent of our deployment comes from existing portfolios, whether supporting add-on acquisitions, refinancing activity or broader strategic initiatives. That means we are not exclusively dependent on market dealflow, which leads to more consistent deployment across cycles. In our view, firms without an established portfolio base can face greater pressure to deploy capital.

In addition, portfolio-based opportunities provide a significant information advantage in our decision-making. Having worked alongside these businesses over time gives us a deeper understanding of their performance, reducing much of the information asymmetry associated with new transactions and allowing us to deploy capital with greater confidence.

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>
> **ADAM WILLIS**

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>
> **BILL KINDORF**

Q How do you see the lower mid-market direct lending space evolving going forward?

BK: I predict that we will see more platforms with multiple capabilities under one roof as opposed to standalone direct lending businesses. Having private equity and private credit strategies within a single firm, as we do, provides a lot of natural synergies in terms of relationships and information sharing, which can put you in a better position to compete across the board.

I also think we will see a bifurcation between winners and losers in the market. I believe investors will be increasingly focused on managers with longer, realised track records and experience working in different cycles, rather than newer entrants with largely unrealised track records built in a low loss-rate environment. Investors will focus on managers that have been committed to the asset class rather than those that have jumped in and out or drifted from their core strategy.

AW: I believe technology will become an increasingly important part of the investment process. Artificial intelligence will increasingly serve as a tool that enhances human judgment. We are already incorporating AI into many aspects of what we do. We do not believe AI alone is the answer for private credit, but by combining AI with the institutional knowledge we have built over the past 25 years, we can go a layer deeper in due diligence, which we believe strengthens our decision-making and diligence process. ■

Bill Kindorf and Adam Willis are co-heads of sponsor coverage at Apogem Capital