THE CARLYLE GROUP
GLOBAL ALTERNATIVE ASSET MANAGEMENT

Carlyle Comment
December 2017

The Middle Market's 'It' Factor

By Erica Frontiero and Michael Hart

Right now, the US middle market has that certain "It" factor and continues to attract investors and lenders alike. Middle market companies—defined as those with annual revenues under $1 billion or annual EBITDA of $100 million or less—are a core part of the US economy. In fact, by itself the US middle market would be the third largest economy in the world at $5.9 trillion of GDP while employing 48 million people.[1] These mostly privately held companies also outperformed through the financial crisis (2007-2010) by adding 2.2 million jobs across multiple sectors and states nationwide.[2]

These important attributes, coupled with a global search for yield that has pushed investors deeper into nontraditional alternatives, have helped strengthen the middle market's "It" factor of attraction for investors.

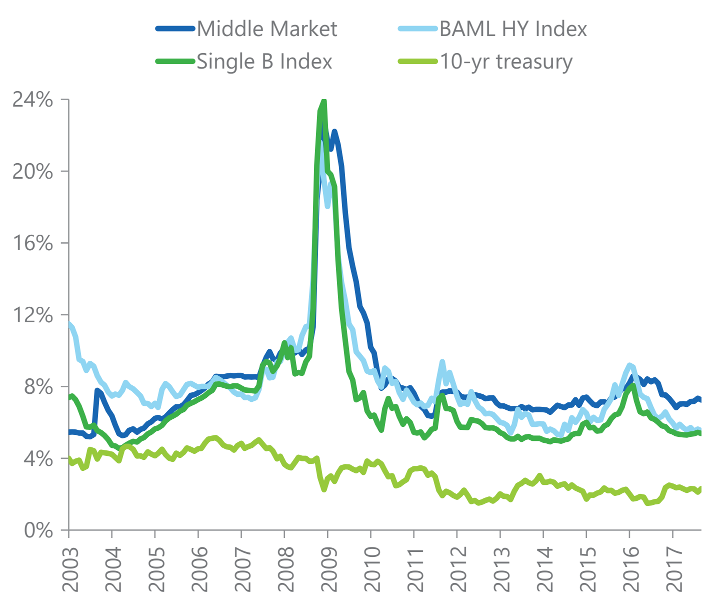
The number of institutions interested in investing in the middle market has expanded, and now includes private equity funds, banks, Business Development Companies (BDCs), CLOs, finance companies, hedge funds, Small Business Investment Company funds, insurance companies, credit opportunity funds, pension funds, endowments and sovereign wealth funds. As a result, middle market lending has become more mainstream.

The segment encountered early concerns (in the early 2000s) around a perceived lack of transparency and metrics, limited secondary liquidity and uncertain recovery rates. These experiences mirrored those of the high-yield market (in its development beyond private placements in the 1980s) and of the broader loan market (as it evolved from a bank-only market in the 1990s), and similar to their evolution, concerns in the middle market have been eased by the market's long-term advances.

The growth of both the broader loan market and in particular the middle market segment, have created a legitimate asset class. The amount of leveraged loans outstanding reached over $940 billion in the third quarter of 2017, up 70% from year-end 2007, and is the most since tracking began (in 1997).[3] The emergence of retail investment opportunities (loan mutual funds, Exchange Traded Funds and BDCs) has helped merge Main Street and Wall Street in this part of the market. Expanded transparency and acceptance, as well as performance over time, have continued to make it an interesting asset class: middle market loans have generated high-single-digit yields for nearly two decades and favorable risk-adjusted returns relative to other fixed income alternatives, as Figure 1 shows.

FIGURE 1

Historical Effective Yields[4]



In the current low interest rate environment, this yield premium offered by middle market loans has proved enticing. The floating rate nature (as loans are priced to a spread over LIBOR or PRIME) acts as a natural hedge as interest rates rise. LIBOR increased to over 1% in 1Q 2017 for the first time in seven years. It moved along with the two Fed funds rate in-

1 National Center for the Middle Market (NCMM)
2 National Center for the Middle Market (NCMM)
3 S&P/LCD
4 S&P/LCD, BAML HY Index, Effective Yields. No assurance is given that this trend will continue.

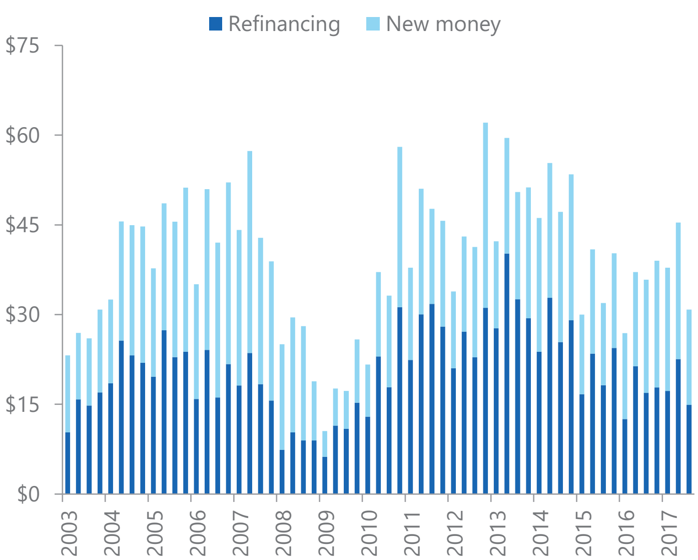
creases executed by the Federal Open Market Committee in 2017, and it is widely expected that rates will rise again at its next meeting in December (as both market FED analytic tools and The FOMC minutes from the September meeting suggest). Further, the lower credit risk (asset security, senior positon in the capital structure, tighter credit agreements including covenants), private equity sponsorship, lower volatility (given the smaller more private nature of the market) and shorter duration (average maturity of three to seven years), especially relative to HY bonds, all contribute to the "It" factor of middle market credit. As a result, fundraising has been robust, with dry powder in the market for private debt alone conservatively estimated at $230 billion as of December 2017.[5] This has created increased competition for investment assets, put some pressure on structure and yields, and raised questions as to whether a supply/demand imbalance has created an overheated market.

Before we address those concerns, let us first turn toward current trends.

Looking first at the supply side of the equation, annual middle market new issue volume has averaged a total of $150 billion post crisis and is up 14% year over year in the first nine months of 2017 to $114 billion, as noted in Figure 2. Like the broader loan market, the majority of issuance year to date has consisted of opportunistic refinancings, but unlike the broader market, the middle market has experienced less pure repricing activity, as many middle market loans have more rigorous call protection provisions and smaller, more long-term focused lending groups. (The wider loan market saw over $400 billion, or 42% of total loans outstanding, reprice in the first nine months of 2017).[6]

FIGURE 2

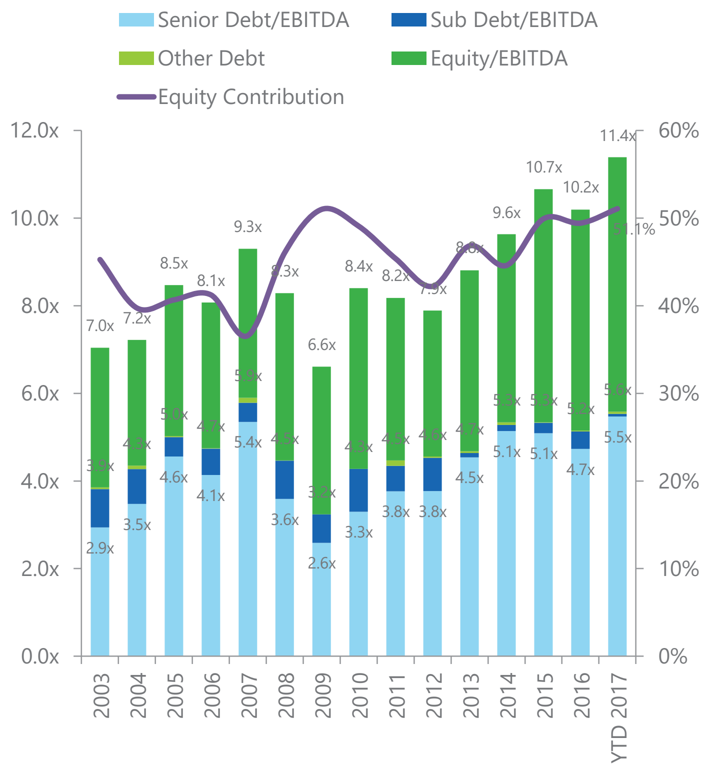
MM Quarterly Issuance[7]



While private equity or sponsor-related M&A activity has increased in the second and third quarter of 2017, reaching levels not seen since 2007, there is demand for more. The improved performance of many companies post downturn, and the fundraising by private equity and debt providers, have combined to push purchase multiples to historical highs and have subsequently increased average leverage multiples, as demonstrated in Figure 3.

FIGURE 3

Figure 3: MM LBO Purchase and Debt Multiples[8]



Leverage ratios have expanded overall, but the middle market average still trails the broader leveraged loan market (average debt multiples in the middle market expanded to 5.6x EBITDA in the third quarter 2017 vs. 5.2x EBITDA at the end of 2016 and 6x EBITDA in the broader market this quarter). Additionally, loan-to-value ratios for credit investors have become more attractive as the average equity contribution in deals has reached a historical high of 51%.

Along with this growth in multiples, the market is also gaining acceptance amid a loosening of other structural provisions such as covenant lite, which generally refers to restrictions only on incurring additional debt, not limitations on maintaining certain leverage levels. These "incurrence-only" tests were historically reserved for bond issuances and first crept into the broader market and are now moving into the middle market. In 2007, prior to the Global Financial Crisis, only 25% of all first lien loan issuance was covenant lite; now it is up to 70%[9] while in the middle market, cove-

5 Preqin
6 LPC/Thomson Reuters
7 S&P/LCD
8 S&P/LCD
9 S&P/LCD

nant lite accounted for 21% of third quarter volume.[10]

Additionally, flexibility within other details of the credit agreement, like allowing incremental debt without having to seek permission for potential acquisitions or dividends, and limited restrictions on pricing future *pari passu* (equal priority) debt, have increasingly moved down market. That is not to say that credit discipline has been fully compromised, but rather as each respective market has matured, and competition for deals among lenders has intensified, so too has acceptance of some risk, much like the evolution of the markets themselves. These structural allowances, however, have generally been more concentrated among issuers with over $40 million of EBITDA.

Therefore, while the number of entrants into the market has certainly increased, putting a squeeze on supply, the demand for alternatives (private equity and private debt) globally is expanding the market as a whole with long-term, committed capital. The demand, it seems, is largely here to stay.

Estimates for total global private equity dry powder range from $600 billion to upwards of $1 trillion. Historically, 46%[11] of private equity deals have been valued at less than $1 billion, implying that there is at least $275 billion to $460 billion of dry powder for middle market private equity that will be in need of financing—and that is prior to making any assumptions on leverage for a given transaction. Which, if one conservatively assumed the historical average dating back to 2000 of 55% debt-to-equity for each deal, would create a potential multiplier effect of at least 1.2x to that dry powder.

Thus, though the velocity of deals may not be quick enough to prevent some competitive tension and supply/demand imbalance in the short term, private equity dry powder should ensure a greater supply of deals needing to be financed over the long term. Notably, this excludes expected refinancings of existing deals, which have averaged $75 billion annually over the past three years. (The middle market refinancing "wall of maturities"—or debt coming due—is currently estimated at over $530 billion through 2021).[12] While most asset managers and economists agree that we are closer to the end of this bull credit and economic cycle than the beginning, there is little to point to beyond an exogenous shock that would sharply change the current environment.

With low average leveraged loan default rates (currently 1.9%)[13] and heightened competition for assets, there is pressure on producing enhanced risk-adjusted returns . It is important for asset managers to remain disciplined and flexible in their approach to avoid chasing the market downward. Those asset managers with deep experience and relationships in the middle market and an integrated platform to invest across the spectrum of credit (par, distressed, opportunistic, structured) and across a variety of products (first lien, second lien, unitranche, mezzanine) will be well-positioned as they seek to generate positive returns and minimize credit losses, especially in the long term. Having a broad platform with multiple strategies can also help credit managers make informed investment and portfolio management decisions and provides the ability to pivot within changing market conditions, and not be pushed to invest in any one strategy or structure. To date, the middle market's tighter structures, senior security, reduced market volatility, shorter duration, lower historical default rates, strong recovery rates, yield premium, patient and resilient ways (investors committed to holding through maturity) and GDP/job creation, have underpinned its "It" status and broad acceptance as a proven asset class. These are more than just attractive qualities; they are, in fact, hallmarks of a successful, permanent, investment opportunity.

Economic and market views and forecasts reflect our judgment as of the date of this presentation and are subject to change without notice. In particular, forecasts are estimated, based on assumptions, and may change materially as economic and market conditions change. The Carlyle Group has no obligation to provide updates or changes to these forecasts.

Certain information contained herein has been obtained from sources prepared by other parties, which in certain cases have not been updated through the date hereof. While such information is believed to be reliable for the purpose used herein, The Carlyle Group and its affiliates assume no responsibility for the accuracy, completeness or fairness of such information.

References to particular portfolio companies are not intended as, and should not be construed as, recommendations for any particular company, investment, or security. The investments described herein were not made by a single investment fund or other product and do not represent all of the investments purchased or sold by any fund or product.

This material should not be construed as an offer to sell or the solicitation of an offer to buy any security in any jurisdiction where such an offer or solicitation would be illegal. We are not soliciting any action based on this material. It is for the general information of clients of The Carlyle Group. It does not constitute a personal recommendation or take into account the particular investment objectives, financial situations, or needs of individual investors.

10 LPC/Thomson Reuters
11 Preqin
12 LPC/Thomson Reuters
13 S&P/LCD

Erica Frontiero is a Managing Director and the Head of Capital Markets for Carlyle Global Credit. She is based in New York.

Prior to joining Carlyle in 2016, Ms. Frontiero spent twelve years with Antares/GE Capital in Capital Markets, structuring, syndicating, and trading leveraged loans, across a wide spectrum of industries to investors including, banks, hedge funds, pension funds and other financial institutions. She began her professional career at Banc of America Securities (Bank of America Merrill Lynch) in leveraged finance, in New York and in London.

She is currently a member of the Board of Directors of Dress for Success Worldwide and a member of the 2016 class of WomeninPower.org, an executive fellowship program created by the 92Y in Manhattan. Ms. Frontiero is also one of the founding members of the creative advisory board for Orchid Worldwide, a boutique, sales, marketing and travel company, and a member of the inaugural class of Pipeline Angels, which aims to increase the number of women angel investors and social entrepreneurs in the US.

Ms. Frontiero received a Bachelor of Arts in economics with a minor in politics from Wake Forest University. Ms. Frontiero holds Series 7 and 63 licenses.

Michael Hart is a Managing Director of Global Market Strategies. He is based in New York.

Mr. Hart has over 20 years of capital markets, corporate finance, M&A, risk management, accounting and managerial experience.

Prior to joining Carlyle in 2014, Mr. Hart was a Managing Director in the Financial Markets Advisory group at BlackRock Solutions, where he served as co-head of the U.S. advisory practice and was a member of the BlackRock Solutions Operating Committee. Prior to joining BlackRock Solutions, Mr. Hart spent 12 years with Morgan Stanley where his responsibilities included Global Co-Head of Leveraged and Acquisition Finance, Global Head of Loan Products Group and Co-Chairman of the Firm's Capital Commitment Committee. At Morgan Stanley, Mr. Hart managed a group of 125 professionals in the United States, Europe and Asia who were responsible for the originiation, execution and risk management of all non-investment grade bank and bond financings. Prior to joining Morgan Stanley, Mr. Hart worked at the Chase Manhattan Bank in the Merchant Banking Group where he originated and executed LBO financings for the firm's private equity clients.

Mr. Hart was a Certified Public Accountant with the Firm of Ernst & Whinney, prior to business school. Mr. Hart graduated with a bachelor's degree in accounting from Duquesne University in 1983 and received his MBA from Duke University's Fuqua School of Business in 1990.

THE CARLYLE GROUP

GLOBAL ALTERNATIVE ASSET MANAGEMENT