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Intelligent Growth Capital for the Lower Middle-Market

The Lower Middle-Market Opportunity (Q3:2017)

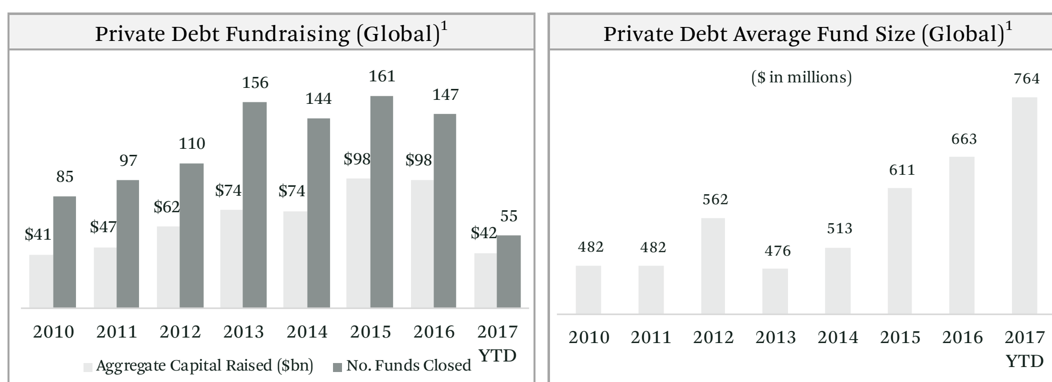
Hunting Dog Capital is a San Francisco-based investment manager that specializes in providing flexible financing, primarily in the form of senior-secured term loans, to lower middle-market U.S. companies. Investment opportunities are generated through a nationwide referral network that the Hunting Dog Capital team has developed and grown since 2004. The referral network is comprised of more than 7,500 contacts that provide investment opportunities from every state and across a wide range of industries. Although we fund only a small percentage of what we review each year, our information access provides a real-time, inside view from the perspective of owners and managers of lower middle-market companies nationwide. Our Q3:2017 white paper analyzes the growth in private debt fundraising and the relatively limited institutional focus on the lower middle-market, which limits competition and pricing pressure, thereby driving compelling risk-adjusted returns.

Private Debt Fundraising & Dry Powder at Historic Levels

Global private debt fundraising and dry powder remained at historically high levels in 2016 and into 2017 YTD. As shown in the charts below, private debt fundraising increased by approximately 138%, from $41 billion in 2010 to $98 billion in 2016[1]. However, the number of private debt funds only increased by approximately 73%, from 85 to 147, over the same period. Thus, the average private debt fund size has increased by approximately 38%, from $482 million in 2010 to $663 million in 2016. In 2017 YTD, the average fund size has increased further to $764 million. In addition, the 10 largest funds closed in 2016 accounted for approximately 47% of overall fundraising, compared with approximately 25% in 2014.

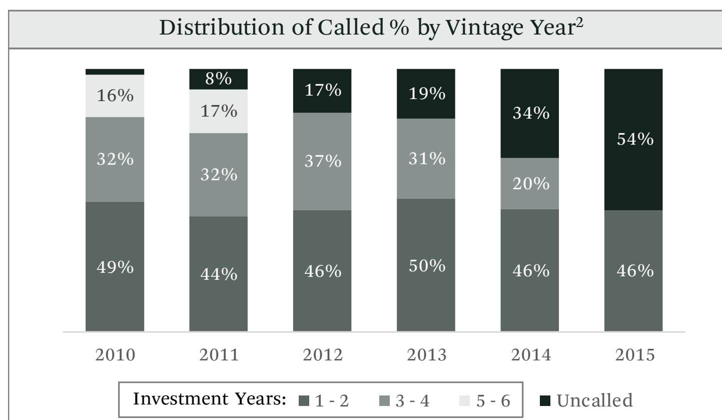
Direct lending funds have been a key contributor to the fundraising growth experienced for private debt funds. Preqin includes the following debt strategies within private debt: direct lending, mezzanine, distressed debt and special situations. Direct lending fundraising increased by approximately 268%, from $7 billion (18% of total private debt fundraising) in 2010 to $27 billion (27% of total) in 2016. With 2017 YTD commitment levels at $23 billion, managers are on pace to finish out the year matching or surpassing previous fundraising totals, which peaked at $38 billion (39% of total) in 2015. Direct lending funds have followed the fund size trends exhibited more broadly, with the average fund size increasing by approximately 29%, from $343 million in 2010 to $442 million in 2016. In 2017 YTD, the average fund size has increased significantly to $719 million.

Larger fund sizes generate more fees for fund managers, and we hypothesize that is one of the key drivers behind the growth in average fund size. Strong investor appetite for debt strategies has also helped to facilitate the growth in average fund size. While fund managers are incentivized by larger management fees to increase capital under management, prudently deploying a much larger fund can be challenging and necessitate a strategy shift to larger deal sizes.



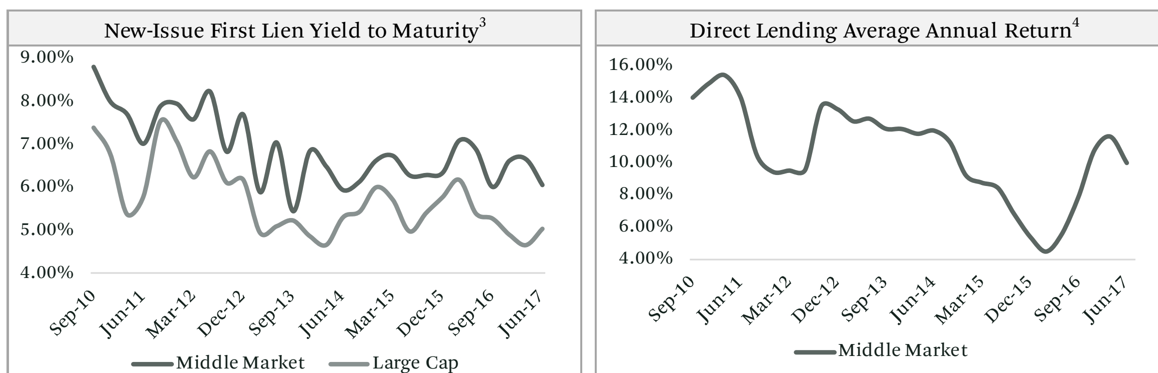
[1] Source: Preqin Private Debt Reports, 2016 and Q2 2017.

The chart below displays called capital distribution by investment year for 2010 to 2015 vintage year private debt funds[2]. The called capital percentage represents the proportion of the aggregate fund commitments that have been invested. We use this statistic to analyze the historical investment pace of private debt funds. Since 2010, the pace of deployment within the first two years of a fund's life has remained relatively stable with average called capital of approximately 47%. Investment years three through four exhibited more variability across vintage years with the highest called capital percentage occurring for 2012 vintage year funds. While the amount of private debt capital raised has grown materially, the rate of deployment has remained relatively consistent since 2010, particularly within the first two years of a fund's life. As a result, the amount of dry powder has increased dramatically. Private debt dry powder is at historically high levels and has increased by approximately 77%, from $116 billion in 2010 to $205 billion in YTD 2017[1].



We believe the growth in average fund size and overhang created by peak levels of dry powder has forced fund managers to increasingly focus on the large and middle-markets (i.e., deal sizes above $15 million) where they can efficiently deploy more capital. In addition, institutional investors tend to primarily invest in funds that focus on the large and middle-markets, which has played a role in increasing competition and driving down returns in these market segments.

As seen in the charts below, both yield to maturity and annual direct lending returns have declined since 2010. The first lien yield to maturity for the middle-market has decreased from 8.8% in 3Q10 to 6.1% in 2Q17. Likewise, the first lien yield to maturity for the large cap market has decreased from 7.4% in 3Q10 to 5.0% in 2Q17[3]. In addition, the direct lending average annual return, as measured by the Cliffwater Direct Lending Index, has decreased from 14.1% in 3Q10 to 10.0% in 2Q17[4]. While the compression in yields and returns is partially a result of changes in the macroeconomic environment, we believe increased competition driven by growing institutional investment in credit funds is also a key driver, particularly within the direct lending space. As a result of the decline in returns, investors are seeking out investment opportunities that can generate superior yields, opportunities we believe exist in the lower middle-market.



[2] Source: Preqin performance data as of September 22, 2017.
[3] Source: S&P Global Market Intelligence High-End Middle Market Lending Review 2Q 2017.
[4] Source: Cliffwater Direct Lending Index comprised of over 6,000 middle-market direct loans valued at $75 billion.

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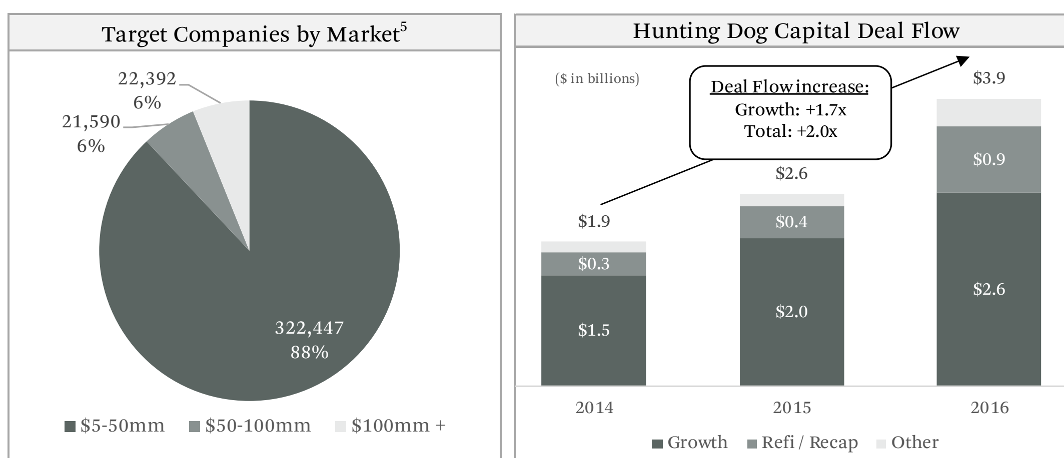
The Lower Middle-Market Opportunity

While most institutional investors continue to focus almost exclusively on the large and middle-markets, the lower middle-market, which we define as businesses that generate between $5 and $50 million in revenue, remains an attractive investment opportunity. As shown on the chart below, the lower middle-market is a large and fragmented market with approximately 322,000 companies and growing[5]. In comparison, the middle and large cap-markets include approximately 21,600 and 22,400 target companies, respectively. **With over 14X the number of companies, the lower middle-market's robust deal flow allows for a high level of selectivity, and broad diversification by industry.** Further, the large number of target companies and relatively limited number of lenders have restrained competition and pricing pressure.

As discussed in a prior white paper, small businesses have continued to grow since the conclusion of the 2008/2009 recession, albeit at a slower rate as compared to pre-recession levels. As a result, growth capital is in strong demand, particularly in the lower middle-market where banks have retrenched and private debt and equity funds have shifted up-market. In our experience, demand for growth capital, particularly from alternative lending sources, continues to increase.

We estimate that our total addressable market within the lower middle-market represents approximately $100 billion in financing annually[6]. Despite the large demand for capital, smaller companies are often overlooked by institutional capital providers and investors. Given the supply and demand imbalance, we expect pricing in the lower middle-market to continue to exceed that of the large and middle-markets, which is a key driver of return outperformance. While there is the potential for competition to increase from new entrants enticed by compelling returns, we believe the market is large enough to allow for additional participants without materially impacting our ability to source and close attractive investment opportunities.

One of the most challenging aspects of investing in the lower middle-market is the ability to effectively screen deal flow. With over 322,000 target companies it can be difficult to identify quality investment opportunities. As a result, we believe establishing an effective sourcing and screening process is critical to building an investment platform focused on the lower middle-market. Hunting Dog Capital's approach has been to systematically build out a referral network (7,500+ contacts) to curate quality investment opportunities across a range of industries. The referral network is versed in Hunting Dog Capital's strategy, which increases the likelihood that the transaction opportunities shown to us are actionable. Over the last three years, our deal flow has increased from approximately $1.9 billion in 2014 to approximately $3.9 billion in 2016. Deal flow continues to grow during 2017, which is a direct result of our efforts to cultivate a well-informed referral network that delivers qualified leads.



[5] Source: US 2012 Census (latest available).

[6] Source: Estimate based on US 2012 Census, Milken Institute Middle Market Report 2015, and internal proprietary data.

Conclusion

Private debt fundraising and dry powder are at historically high levels. The average private debt fund size has increased significantly since 2010, driving credit fund managers to invest further up market within the large and middle-markets. As competition has increased, yields and returns in the large and middle-markets have compressed. The lower middle-market, due to its vast size and lack of institutional focus, has experienced relatively muted increases in competition despite robust growth in private debt capital raised. While the supply of capital available to lower middle-market businesses has not experienced strong growth, demand continues to swell. We estimate the demand for capital within the lower middle-market to be approximately $100 billion in financing annually. The lower middle-market is comprised of approximately 322,000 companies, and growing, which allows for significant and diversified deal flow. Given the high fragmentation, relatively limited competition and minimal pricing pressure, we believe the lower middle-market will continue to offer opportunities for experienced private debt managers to generate compelling risk-adjusted returns for investors in the category.

About Hunting Dog Capital

Hunting Dog Capital is a San Francisco-based investment manager that specializes in providing flexible financing, primarily in the form of senior-secured term loans, to lower middle-market U.S. companies. We partner with business owners and management teams to provide capital that enables their companies to achieve growth objectives. Our dedicated team has the experience to understand unique situations and capital raising challenges faced by lower middle-market businesses. We act quickly to provide the necessary capital when it is most essential. Transactions typically include the following:

Investment Size:	$5+ million
Term:	2 – 5 years, prepay without penalty after the first year
Borrower Profile:	Meaningful tangible assets
Industry:	Agnostic
Geography:	U.S.
Structure:	Senior-secured term loans, typically non-amortizing
Use of Proceeds:	Growth, Refinancing, Acquisition, Working Capital, Buyout
Ownership:	Concentrated with at-risk equity

We differentiate ourselves from other lower middle-market direct lenders by focusing on tangible assets instead of cash flow. If comfortable with the underlying collateral, typically a collateral coverage ratio of 1.1x or greater, we will structure non-amortizing bullets. We believe our terms are especially attractive to businesses owners with substantial at-risk equity as they enable retention of control, delay (or avoidance) of significant equity dilution and capture of equity appreciation as the business grows. We believe this type of liquidity is essential for entrepreneurs to execute their plans, and exceed objectives.

To learn more, please visit our website (www.hdcap.com) or contact us directly.

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