E X P E R T Q & A

The lower mid-market presents an attractive opportunity to secure advantageous deal terms in pursuit of higher risk-adjusted returns, says Grier Eliasek, president of Prospect Capital

Small is beautiful

Q Where is the best value right now in the current direct lending market?

We believe the best value in the direct lending market currently lies in the lower mid-market. People define market segments somewhat differently, but we define this area as being below $25 million in annual EBITDA, with the core/traditional mid-market being between $25 million and $50 million, and the upper mid-market being between $50 million and $150 million.

So, why target direct lending in the lower mid-market? Right now, we're witnessing significant capital being raised for direct lending at the upper end of the market, with a convergence occurring between the upper mid-market and the broadly syndicated markets.

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This dynamic is creating spread compression, high debt multiples and a lack of covenants in the upper mid-market.

The lower end of the mid-market, in comparison, offers lower risk and higher returns. Risk is typically lower here because there is often lower leverage and better lender protections available, including financial ratio maintenance covenants. Returns are also typically higher thanks to higher credit spreads and higher SOFR floors. This latter point is very important given that the US Federal Reserve has shifted into rate-cutting mode.

One final reason why we like the lower mid-market is that we also often get the opportunity to invest in equity-linked instruments here, with attractive upside potential, such as convertible debt or convertible preferred stock.

Q In terms of lender protections, what differences do you note between the lower mid-market and the upper mid-market?

In the lower mid-market, we still obtain financial ratio maintenance covenants. Such covenants have largely disappeared from the upper mid-market. At that higher end, if a company has a financial maintenance covenant, the risk profile is almost always much greater.

At the lower end of the mid-market, covenants are important to a lender for playing both defence and offence. On the defensive front, having maintenance covenants gives you a seat at the table if a borrower's results are meaningfully below projected results, enabling you to effect change, push for more invested equity, require a division to be sold to repay debt, and so on. On the offensive front, mid-market covenant packages are designed to be tripped during general economic downturns or in response to company- or industry-specific issues.

This mechanism acts to reprice risk and allows a lender to charge amendment/waiver fees, enhance the spread, and perhaps obtain some upside potential via warrants. We also have proprietary credit agreements that we have honed over the years, with strong lender protections.

While lender documents in the upper mid-market can be like Swiss cheese (with the resulting liability management exercises and other lender headaches), such documents are much tighter at the lower end. For example, our documents typically have a provision called an irrevocable proxy, which gives us the right – in the case of certain defaults – to take control of a company to effect change. Luckily, that doesn't happen often; companies with deal sizes below $100 million exhibit significantly lower default rates. However, a lender must still be ready to take these steps to protect their capital along the way.

Finally, in the lower mid-market, we are often the sole or majority lender, which protects us in the sense that we control any post-closing amendments. That is unlike a loan to a larger company, where you're more likely to be a minority lender with fewer control rights.

Q Within direct lending markets, what strategies are available to enhance returns?

We are focused on debt as the vast bulk of our capital, but we like to have some equity too, as a way to enhance returns. For instance, we have found that we are often able to capture better debt terms when we write a small convertible debt, convertible preferred, or equity cheque alongside our term debt. A company may have a gap that needs to be filled in its capital structure, and a competing lender that would just provide a straight debt-only term sheet may not get a return call. By offering a one-stop shop, our terms allow the entire transaction to successfully close, and we can charge a premium on our debt and other capital for providing this complete solution.

How does one originate these opportunities? Focusing on the lower end of the mid-market is a big part of it, as these types of investments aren't generally available at the higher end. It's also about focusing on certain sponsorship types. A lot of the time, folks talk about sponsored and non-sponsored investments in somewhat dualistic terms. We see it as more of a spectrum, with many different kinds of sponsorship situations, whether it's a smaller funded sponsor, independent sponsor, unsponsored or Prospect-sponsored transaction.

It's also worth remembering that the lower mid-market is a less efficient market, with deals that prove a little more time-consuming to originate, select, diligence and close. At the start of the year, for example, we closed a $65 million investment in Taos Footwear. This investment was unsponsored and directly transacted, with a gestation period of nearly a year and a half.

Likewise, we recently announced a $115 million investment in QC Holdings, having worked on that transaction for more than five years. It sometimes

Q Is there a case to be made for a region-specific approach to direct lending?

Absolutely. The US, for instance, has a very large mid-market, with nearly 200,000 companies. If the US mid-market segment were its own country, it would be the third-largest economy in the world. That scale and breadth gives us a rich hunting ground.

Another reason why we like the lower end of the US mid-market is that these companies may not have a multinational footprint that is vulnerable to tariffs. That doesn't mean every mid-market company is immune, but there are ways to insulate against such issues, not just with size selection but also via industry and company selection.

takes a while for everyone to get on the same page and for all the terms and conditions that we require to pan out. For these reasons, we prefer less efficient markets with less competition and a wide array of opportunities.

Q Given the direct lending market is becoming increasingly competitive, what is required to be successful, or to stand out, in this space?

Experience is crucial. In our case, we have been investing for 37 years, with a track record that spans the global financial crisis, meaning we know how to manage capital through times of severe stress. Of our approximately 150 professionals, nearly 70 are on the investment team. Our senior management team has worked together for 25 years. This longevity and experience across business cycles helps prepare us for future downturns.

When it comes to navigating cyclical down periods, the proof is in the pudding. Our flagship vehicle housing the vast bulk of our mid-market investments has generated a 13 percent unlevered gross annualised internal rate of return on hundreds of realised investments, with more than $10 billion invested in such deals.

Scale of capital is another significant differentiator, especially when it comes to supporting a portfolio company through its growth journey. And how you interact with counterparties is also important in this return-on-effort world. People appreciate when you're making substantial effort that is value-add. We have seen many mid-market lenders simply turn up at private equity sponsors' offices and ask, 'What deals have you got for me?' That approach is incredibly one-sided and transactional, and it ultimately commoditises and cheapens the proposition.

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"Lender documents in the upper mid-market can be like Swiss cheese"

Q What is your general outlook for direct lending opportunities and challenges between now and the end of 2025?

This year has begun with significant uncertainty, making now a tricky time to operate. Unsurprisingly, we are seeing a slowdown in M&A, with more of an emphasis on recapitalisations. No one wants to buy a company, or lend money to a company, if the financial results are dropping or predicted to drop in the very next period. No one wants to sell a company at a lower valuation multiple. That's also why it's important to focus on companies that are less cyclical and more all-weather during downturns.

This uncertainty is not a forever issue, but it's a significant issue right now. Just look at how much optimism there was a few months ago. Economies can change quickly and drastically, as we saw during the pandemic, so you want to construct your portfolios to be all-weather in nature. The way we underwrite is to avoid cyclicals. If the Fed makes interest rate cuts as expected, the larger direct loans and broadly syndicated loans have very low to no SOFR floors.

During the global financial crisis, SOFR's predecessor, LIBOR, was cut heavily and went to near zero. That could easily occur again, and if you haven't negotiated a high enough SOFR floor at either a loan's initial closing or as a result of a maintenance covenant breach, what went up in yield will surely come down.

That said, we still see strong demand from investors for private credit, which has become an established asset class. There are some worries about the private credit space, but that's a typical reaction whenever an industry grows dramatically. Naysayers will always want to shoot down such a growing industry. But if someone thinks private credit has a cold, then private equity has the flu. We would much rather be sitting in the lower-mid-market private credit space than the private equity space at this point in the business cycle, given our many downside protections plus upside potential. ■