PRIVATE CREDIT

All-Weatherproofing Institutional Portfolios

The Lower Middle Market Edge

NEW YORK LIFE Investment Management | Apogem Capital

Introduction

Apogem Capital has spent decades investing in the North American Lower Middle Market (LMM) across both private equity and private credit. This paper draws on that experience to offer an educational perspective – grounded in data – on the structural characteristics and performance attributes of this private markets segment.

While many institutional portfolios already include allocations to private credit, this piece explores how certain strategies focused on the LMM can potentially offer complementary and differentiated exposure. As the overall private credit market has grown and evolved, we believe the opportunity in the Lower Middle Market has become increasingly attractive. The North American LMM is broadly defined as companies with EBITDA of less than $25 million for the purposes of this paper. This market segment has historically featured conservative leverage, better transparency into company financials, higher likelihood of covenants, and sponsors that take a control position and hands-on approach to value creation. Most importantly, we believe that the LMM has historically demonstrated lower correlation to public markets, resilience in down markets, and attractive risk-adjusted returns over time.

Private Credit Evolution Since the Global Financial Crisis (15+ Years)

The private credit market has grown exponentially over the last several years and is expected to reach $2.3 trillion in AUM by 2028.[1] The majority of this growth has come after the Global Financial Crisis when bank consolidation and regulatory restrictions resulted in a significant reduction in the participation of US banks in corporate lending. Non-bank financial companies stepped in to satisfy the need for flexible financing options for private companies.

A number of credit strategies evolved to satisfy the capital needs of private companies including direct lending, mezzanine debt, distressed debt, infrastructure debt and others. Direct lending, or senior secured debt with no intermediary, has become the largest segment of the private credit market, representing over 70% of all private credit capital raised, eclipsing all other strategies combined.[2]

Growth of Direct Lending Programs

Direct lending offers private businesses in the LMM more financing flexibility and speed relative to banks. Another large factor in the growth of direct lending programs is the massive amount of private equity capital that has been raised by private equity managers over the last several years. Private equity sponsor-backed portfolio companies require funding from direct lenders to support acquisitions, dividend recapitalizations, refinancings, and growth initiatives. The significant level of private equity dry powder that has yet to be deployed, over $1.4 trillion according to Pitchbook,[3] suggests that demand for direct lending should continue for many years to come.

Competition within direct lending has become more pronounced as evidenced by record-setting fundraises in 2024. Capital raised by direct lending funds is increasingly concentrated in the upper middle market, particularly fund sizes greater than $5 billion that have been executing mega loan deals. Even as large funds have become larger, there remains a deep pool of small and medium-sized companies that do not have access to that capital. This financing gap has created an attractive and consistent opportunity for direct lending strategies dedicated to the LMM.

The LMM can offer differentiated exposure to small businesses in North America that can be difficult to access through public markets or other segments of private credit. Further, the LMM has historically served as a portfolio diversifier over past market cycles. Based on the structural advantages we believe are inherent in the lower middle market and the migration of large direct lending funds into the upper middle market and away from smaller companies, we believe the ability of the LMM to outperform public credit and larger private credit peers has become more pronounced.

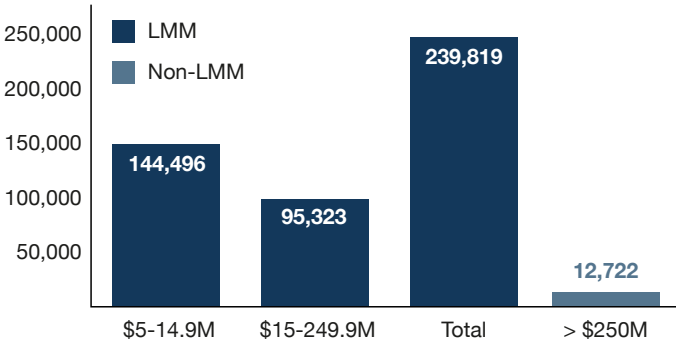
Potential Structural Advantages of the Lower Middle Market

The Lower Middle Market offers several potential advantages relative to larger segments of the North American private credit market. We believe these historical advantages are structural, persist to the present, and are potentially more pronounced in the current environment. In short, through the LMM, the opportunity exists to partner with experienced sponsors to provide financing solutions with attractive terms to small companies to support their growth and operational improvements.

Attractive Supply / Demand Dynamics

Deep Pool of Potential Opportunities – the Lower Middle Market has a deeper pool of potential opportunities than the larger end of the market. In the following example, the LMM is represented as companies with revenues between $5 and $250 million, a segment with over 15 times more businesses than the larger part of the market (or companies with over $250 million in revenue).[4] (see **Figure 1**)

Figure 1: Number of Companies by Revenue

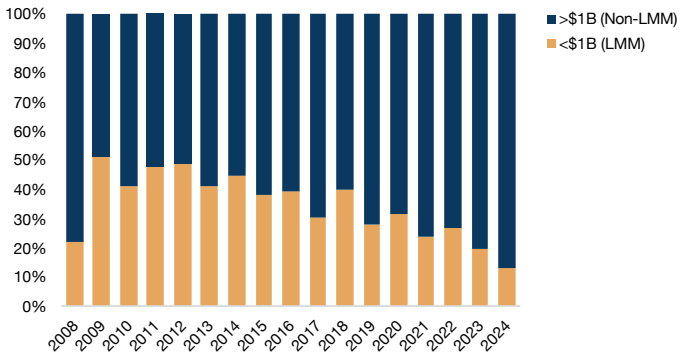


Source: Capital IQ. Accessed March 2025. Analysis includes estimated number of North American (U.S. and Canada) companies with $5 million and greater of revenue.

These businesses typically represent family and founder-owned companies where private equity sponsors provide the first institutional capital. Private equity investment in family and founder-owned businesses proved relatively resilient in 2022 and 2023, with deal volume falling less than 10% annually from 2021 relative to annual declines of 20 – 30% for deal activity from some institutional sources (e.g., PE or VC-backed companies).[5] This dynamic supports robust direct lending deal flow in the LMM for lenders that have established private equity sponsor networks.

Capital Constrained – Similar to private equity, the majority of the capital raised within direct lending is increasingly focused on the upper middle to large end of the market as fund sizes have grown. In 2024, nearly 50% of all direct lending capital raised was for funds of $5 billion or more, while less than 15% was raised by funds of less than $1 billion (see **Figure 2**).[6] This has created a financing gap for smaller businesses that are too small to garner attention from large direct lenders and unable to access broadly syndicated loans or the high yield market.

Figure 2: Share of private debt capital raised by size bucket



Source: Pitchbook. Geography: Global. As of September 30, 2024.

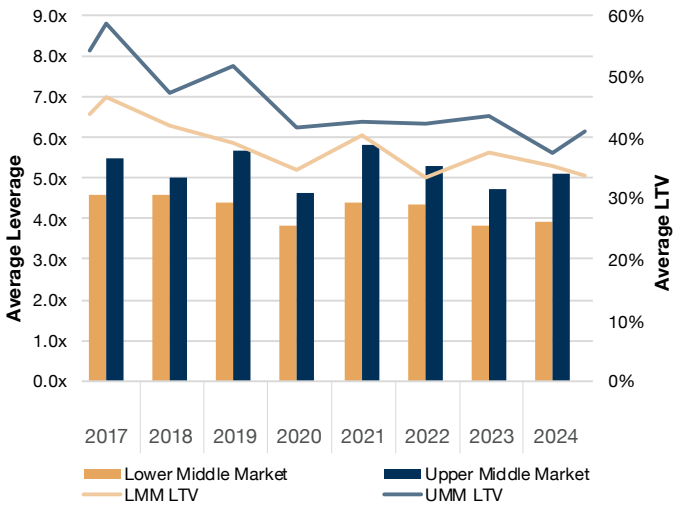
We believe this supply/demand imbalance is favorable for direct lending managers focused on the LMM, often allowing for a higher degree of selectivity, more negotiating power, collateral protections and covenants, and the potential for higher spreads. Meanwhile, the upper middle market has historically exhibited higher loan-to-value ("LTV") ratios and leverage metrics than the LMM (see **Figure 3**).

Healthy Businesses with Conservative Debt

While LMM businesses are smaller and generally less built out than businesses targeted by larger PE firms, these are not new businesses or startups. Based on Apogem's data, companies acquired by LMM PE funds typically have approximately 30 years of operating history, EBITDA margins in excess of 20%, and conservative capital structures. Lending in the LMM tends to be more conservative. Loan-to-value ratios typically average around 35% compared to ~45% in larger deals.[8] Leverage is also more closely monitored, particularly given that EBITDA adjustments are less aggressive than in larger deals.

LMM companies with conservative capital structures may have more operating flexibility to act defensively

Figure 3: Lower vs Upper Middle Market[7]

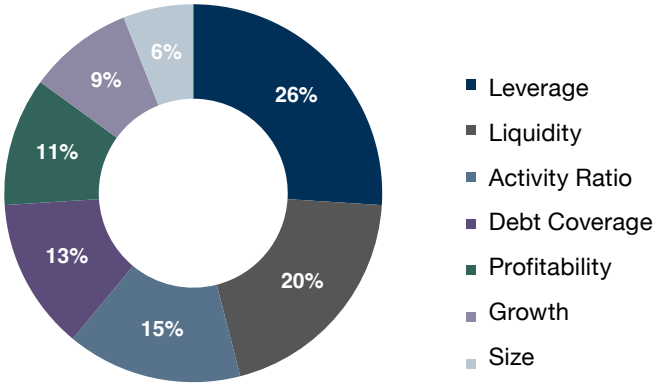


Source: LSEG LPC's 4Q24 US Sponsored Middle Market Private Deals Analysis, December 2024.

(e.g., shore up company finances) or offensively (e.g., acquire smaller companies, invest in personnel, marketing, or other initiatives to grow market share) in challenging environments.

Conversely, larger businesses typically carry more leverage relative to LMM companies. While larger, highly levered businesses can perform well in periods of low interest rates and steady economic growth, these companies may struggle in higher rate environments or economic downturns, as a greater share of the company's cash flow must be allocated to paying interest on debt. In fact, a study performed by Moody's which covered 130,000+ borrowers over a 16-year period found that the most frequent factor that determined the likelihood of default was not the company's size, but the amount of leverage utilized by a company. Apogem believes that these findings remain relevant today (see **Figure 4**).

Figure 4: Moody's Loan Default Frequency Factors[9]



Source: Campbell Lutyens, Moody's Analytic RiskCalc 4.0 U.S., 4/30/2012. a quantitative study of default history covering over 133,000 borrowers and 9,000 defaults over a 16-year period (1994-2010). Data provided by over ten large national and regional banks on borrowers in the lower middle market segment, as well as larger companies. Activity ratio defined as Inventory/sales, Current liabilities/Sales, or Change in Working Capital/Sales. Debt coverage defined as EBITDA/Interest Expense

Stronger Covenants and Better Transparency

Financial covenants remain common in the LMM with approximately 95% of deals containing at least one or more covenants.[10] These covenants are critical tools that force dialogue between lenders, sponsors and borrowers in times of underperformance, enhancing credit protection.

From a risk management perspective, LMM lenders typically benefit from more direct relationships with private equity sponsors and company management, which provides more frequent access to information. In this segment, enhanced transparency includes full monthly or quarterly financials on the businesses. In situations where the borrower's financial position weakens, sponsors can take a larger role in the operational and financial turnaround of the business.

LMM companies tend to have slightly less complexity in their business models and capital structures, which makes it easier to gain insight into aspects of the business such as supply chains and customer bases. This clarity is important when determining exposure to external market factors such as tariffs or other legislative or regulatory changes. Additionally, the ability of a LMM business to pivot operationally (such as making a change to a supply chain) can potentially give them an edge over larger, more complex enterprises.

Origination and Underwriting in the LMM

As referenced previously, the LMM boasts a significantly larger number of potential company targets relative to the larger market. While this offers a significant opportunity set, it also creates underwriting challenges for new direct entrants or mangers who do not have a dedicated focus on the LMM. An established direct origination capability remains one of the most critical aspects of success in LMM direct lending. Firms with deep, experienced origination teams and strong sponsor relationships are best positioned to access high-volume deal flow, enabling them to be highly selective in their investment decisions.

Similarly, underwriting expertise and processes that are tailored to effectively analyze and assess the unique risks and characteristics of LMM deals—both in terms of sponsors and companies—are necessary for success. As defaults rise, direct lending managers with these skill sets will begin to differentiate themselves. According to a recent Moody's report, the average risk of default for US public companies hit 9.2% at year-end 2024 – the highest point since the global financial crisis.[11] In challenging times, direct lending managers with dedicated and proven workout capabilities can react more quickly to maximize value and minimize loss rates.

Lower Middle Market: Historically Attractive Returns & Portfolio Diversification

The LMM has been historically underserved, which Apogem believes provides opportunities for higher yields, lower default rates, and higher recovery rates than the broadly syndicated corporate loan market, particularly for managers that are able to effectively source and underwrite these transactions. The diverse nature of the small to medium-sized businesses that make up the LMM, their more conservative capital structures, and the specialized nature of the direct lending deals themselves has produced a performance profile that has been less correlated to larger credit market segments and public credit.

With the ultra-low interest rates of the last decade, investor appetite for the attractive risk-adjusted returns offered by direct lending strategies has increased considerably. Companies with weaker balance sheets have been able to secure loans with few investor protections. Some lenders have offered substantial earnings add-backs that have expanded EBITDA and made leverage levels appear lower. As interest rates have risen and are likely to remain higher for longer, defaults will inevitably increase and lenders who have loosened standards may face more challenges in their portfolio. Conversely we believe that LMM companies with healthy balance sheets, cash reserves and low levels of leverage are better positioned to weather more challenging environments and generate consistently strong performance over the long-term.

ENDNOTES

1. Source: PitchBook, Private Capital's Path to $20 Trillion report.

2. Source: PitchBook, Q3 2024 Global Private Market Fundraising Report.

3. Source: PitchBook, Q3 2024 Global Private Market Fundraising Report.

4. Source: Capital IQ as of December 31, 2024. Analysis includes estimated number of North American (U.S. and Canada) companies with $5 million and greater of revenue

5. Source: Pitchbook, "US PE Breakdown, Q1 2025." As of March 31, 2025.

6. Private Credit Capital Raised by Fund Size, Pitchbook's Global Private Market Fundraising Report 3Q24.

7. LSEG LPC's 4Q24 US Sponsored Middle Market Private Deals Analysis, December 2024.

8. Market characteristics are based on Apogem internal proprietary data as well as the views and opinions of Apogem investment professionals and should not be relied upon.

9. Campbell Lutyens, Moody's Analytic RiskCalc 4.0 U.S., 4/30/2012. a quantitative study of default history covering over 133,000 borrowers and 9,000 defaults over a 16-year period (1994-2010). Data provided by over ten large national and regional banks on borrowers in the lower middle market segment, as well as larger companies. Activity ratio defined as Inventory/sales, Current liabilities/ Sales, or Change in Working Capital/Sales. Debt coverage defined as EBITDA/Interest Expense.

10. Estimated based on the percentage of loans in Apogem's current senior loan portfolio as of 12/31/2024.

11. Source: Moody's Special Report, "US firm's default risk…", Published March 4, 2025, www.moodys.com.

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Apogem relative performance figures measured by comparing the long-term pooled return for the respective benchmark to the pooled performance of the Apogem funds referenced over the same period. For comparisons against public markets, a Public Market Equivalent ("PME") calculation is utilized. See the Public Market Equivalent Calculation Disclosure for more information.

Index Definitions

S&P 500 Total Return Index (or "S&P 500 TR") – The index is an unmanaged index of 500 common stocks that is generally considered representative of the U.S. stock market. The index is heavily weighted towards stocks with large market capitalizations. The index assumes reinvestment of dividends and capital gains at net asset values. You cannot invest directly in the Index.

Cambridge Associates Benchmarks – Cambridge Associates Benchmark Statistics represents a robust collection of institutional quality private fund performance and are based on data compiled from institutional-quality funds formed since 1986. The benchmark aggregates portfolio-level performance information. Fund and investment-level performance information is drawn from the quarterly and audited annual financial statements of the fund managers and each manager's reported performance numbers are independently recreated from the financial statements and verified by Cambridge Associates.

Note: Performance of broad public market indices, such as the S&P 500, are for informational purposes only and do not provide a basis of comparison for private equity fund investments as the market volatility, liquidity and other characteristics of private equity fund investments are materially different from those of broad public market indices. Comparisons to alternative investment indices/ benchmarks are subject to material inherent limitations. Data included in alternative investment indices or benchmarks generally do not represent the returns of all funds but rather only those to which the index/benchmark provider has access. The number of funds included in the index/benchmark data for a specific vintage year will likely vary. Moreover, performance information for all funds within a specific category may differ from those reported by the index/benchmark provider. Additionally, the universe from which the components of an alternative investment index/benchmark are selected include a significant element of "survivor bias" into the reported levels of an index/benchmark, as generally only successful funds will continue to report for the required period. Accordingly, indexation of alternative investment strategies tends to overstate the beneficial aspects of these strategies while obscuring certain risks, including the "risk of ruin."

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