Finding Alpha in the Less Efficient U.S. Lower Middle-Market

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Executive Summary

Why the Lower Middle-Market?

Middle-Market direct lending growth has been driven by investors demand for yield and commercial banks reducing their exposure.

Private debt AUM has tripled in the past decade, growing from $60.9 billion in 2011 to $191.2 billion globally in 2021. [1]

The core middle-market direct lending space has become a crowded and competitive market with approximately 170 asset managers. [1]

The core middle-market is dominated by private equity firms who search for the cheapest source of capital, resulting in more risky loans.

Leverage has increased, with average multiples at 6.4x in Q4 2021, the highest level recorded since 2005. [2]

Financial covenants has been reduced significantly with “covenant lite” loans at over 80%.

1) PitchBook Global Private Debt Report 2021 Annual. PitchBook. February 15, 2022. **2)** S&P LCD Leveraged Lending Review Q4 2021.

Returns have also been compressed with middle-market loan spreads tightening by ~125 bps since Q2 2020. [1]

However, lending in the U.S. lower middle-market to non-private equity owned companies remains attractive with moderate leverage and stable spreads due to:

- It is large and fragmented with over 200,000 businesses representing one-third of the private sector GDP and employing 48 million. [2]
- Large direct lenders do not focus on the lower middle-market because it is labor-intensive and loan sizes are too small.
- The lower middle-market has lower leverage, lower default rates, more protective financial maintenance covenants.
- Attractive diversification to most of the traditional asset classes including global bonds,, US real estate, global infrastructure, venture capital and macro hedge funds.
- Managers that can provide value-added services to these lower middle-market business can receive equity upside.

1) Lowery, Adrian. “A 3Q 2021 Update on Middle-Market Credit Spreads and Required Returns.” Valuation Research, VCR, November 3, 2021.. **2)** Nesbitt, Stephen L. “Overview of the US Middle-Market Corporate Direct Lending.” Private Debt: Opportunities in Corporate Direct Lending, Wiley, Hoboken, NJ, 2019.

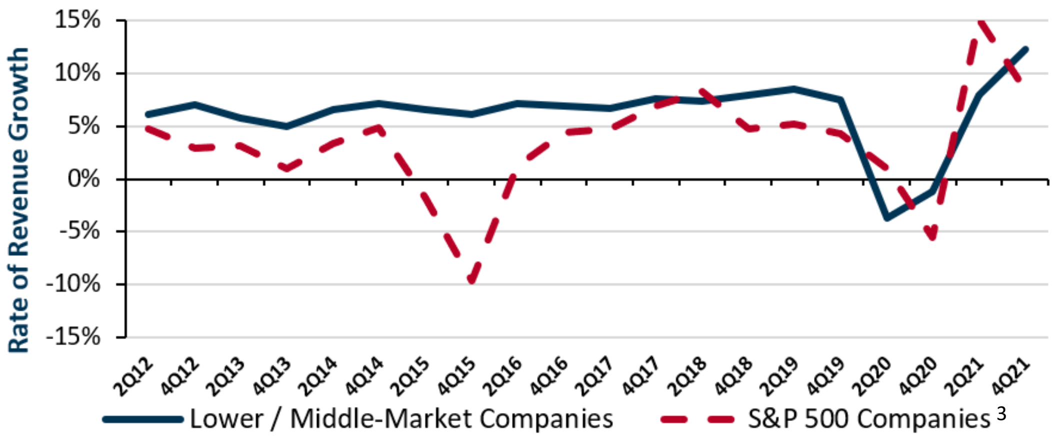
Favorable Characteristics of the Lower-Middle Market

The Lower-Middle Market is Large and Stable

We define LMM as companies with $30 mm to $150 mm in enterprise value and EBITDA between $5 mm and $20 mm annually. The core middle market is greater than $150 million in EV and $20+ million in EBITDA.

There are over 200,000 businesses in the middle-market, making it a massive market of valuable businesses to lend to. Lower middle-market and core middle-market companies contribute over $10 trillion in annual revenue and employ more than 48 million people. [1]

Large direct lending managers don't focus on the lower middle-market due to labor-intensive underwriting process and smaller loan sizes. Both the lower middle-market and core middle-market demonstrated more consistent growth rates relative to the S&P 500 companies. [2, 3]



1) Nesbitt, Stephen L. "Overview of the US Middle-Market Corporate Direct Lending." Private Debt: Opportunities in Corporate Direct Lending, Wiley, Hoboken, NJ, 2019. **2)** National Center for the Middle Market. "The DNA of Middle Market Growth, https://www.middlemarketcenter.org/Media/Documents/three-types-of-growth-champions-and-factors-that-drive-success_NCMM_DNA_of_Growth_FINAL_Web.pdf **3)** National Center for the Middle-Market "4Q 2021 Middle-Market Indicator." As of 12/31/2021.

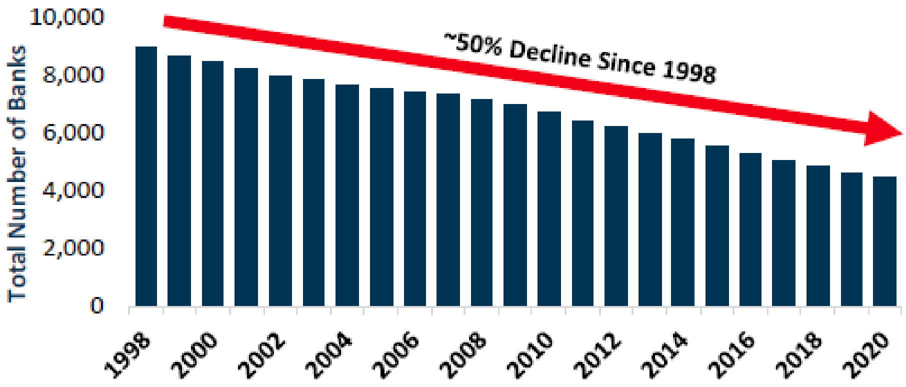
The Lower-Middle Market is Less Competitive vs. Core Middle Market

For larger lenders its difficult, and expensive to deploy multi-billion-dollar funds in the LMM making $20 mm to $30 mm loans over 3-year investment period.

- Larger direct lenders need to focus on core middle-market companies deploying $50 mm to $500+ mm loans to deploy their multi-billion-dollar funds.
- Smaller and mid-sized direct lending managers focus on the LMM because they have smaller amounts of capital and can deploy it making smaller loans.

Another reason the market is so fragmented is because as direct lending managers raise larger pools of capital, they must move into the core middle-market to deploy their capital. Labor-intensive nature and specialization required to originate, underwrite, and manage these loans keeps barriers to entry high

The number of banks have shrunk by 50% over the past 30 years resulting in less bank competition in lower middle-market. [1]



1) Federal Reserve Economic Data on Commercial Banks in the United States, https://fred.stlouisfed.org/series/USNUM. As of 12/31/2021.

The Lower-Middle Market has Excellent Characteristics

Managers willing to invest in the human capital to diligence these LMM businesses can make higher yielding, lower risk loans than the core middle-market.

IDEAL INVESTMENT CHARACTERISTICS:

- Well established businesses with 20+ years of operating history through recessionary periods
- Alignment of business owners who have been running their businesses for multiple decades
- Strong competitive position in their market, a recession-resilient business model and low correlation to other businesses
- Stable and recurring cash flows
- Deep teams with 25 to 200+ employee teams

All they need is a capital partner to successfully finance them and function as a value-added partner over several years

The Case for Investing in a Lower-Middle Market Private Credit Fund

Attractive Risk Characteristics in the Lower Middle-Market

Lower middle-market investments are structured with lower leverage and full set of financial covenants that are tested quarterly, and if breached, puts loan in default.

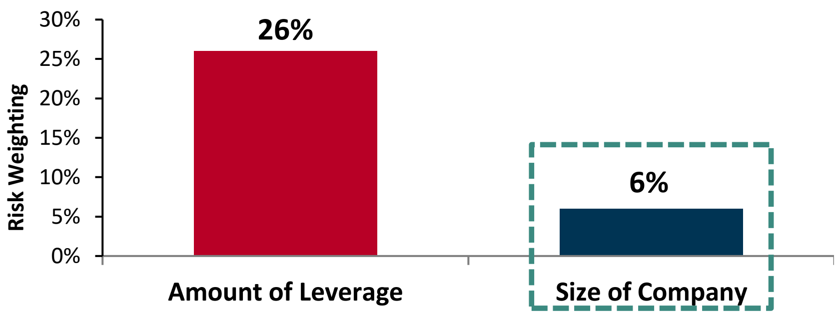
- Typical covenants in the lower middle-market include leverage, fixed charge, limitation on capital expenditures and minimum EBITDA.
- Financial covenants help catch a problem early, work with the owner to find a solution and help the owner implement the turnaround plan.
- Core middle-market loans are 80%+ covenant lite – making it very difficult to identify a problem and fix it before problem is serious.

LOWER LEVERAGE = "HISTORICALLY LESS RISK"

Moody's Research on Defaults Collected over 25 Years Determined that Leverage is

4x More Relevant

in Predicting Default Risk than Size of Company. [1]

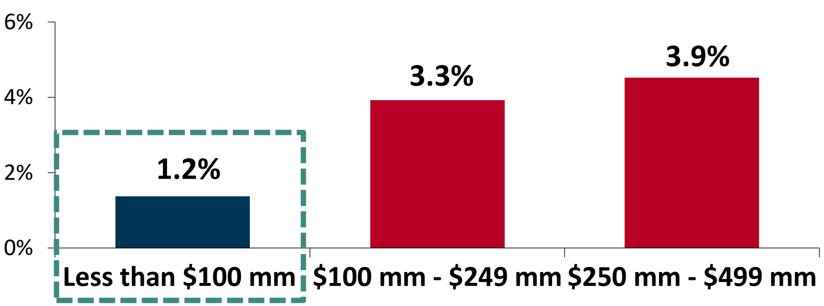


SMALLER LOANS HISTORICALLY HAVE FEWER DEFAULTS

S&P Research from 1995 to 2018 Found that Larger Loans Had Nearly a

3x Higher Default Rate

than Smaller Loans. [2]



1) Moody's Analytics, Moody's Analytics RiskCalc 4.0 U.S, April 30, 2012. Based on private firm data, including 110,000 financial statements, 25,000 firms, and 1,600 defaults collected over 25 years. Size of company is measured in total assets. **2)** S&P LCD Institutional Loan Default Review; comprises all loans closed between 1995 and Q3 2018. Independent axis labels reflect loan amount ranges.

Direct Lending has Low Correlation to Public and Private Markets

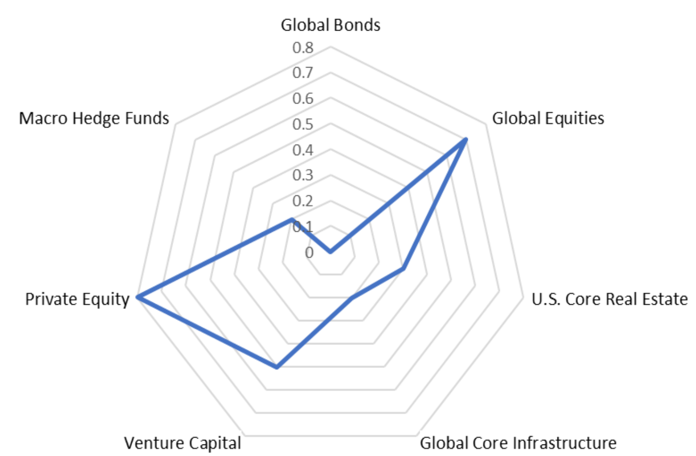
Additionally, lower spreads in the core middle-market leave less cushion to absorb potential losses. There are risks associated with investing in the lower middle-market including limited access to capital, customer concentration and industry obsolescence.

To mitigate these risks lower middle-market lenders must look for companies with:

- Long operating histories.
- Diverse customer bases.
- Knowledgeable and talented management.
- Defensible market position.

As an additional risk mitigant, direct lending has a low correlation to global bonds, macro hedge funds, U.S. core real estate, global infrastructure and venture capital. This lower correlation promotes an even more attractive opportunity in the lower middle-market by pointing towards lower risks compared to investing in larger market companies that have a higher degree of correlation to public markets. [1]

Direct Lending Correlation to Public and Private Markets



1) JPMorgan Asset Management Market Insights. *Guide to Alternatives.* November 30, 2021.

Managers Who Can Provide Value-Added Services Earn Enhanced Returns

Strategic Advice to LMM Companies Can Result in Equity Upside

Highly valued lower middle-market lenders typically have specialization and can work with the business owners to help grow their company as most lower middle-market businesses do not have access to investment banking and advisory services.

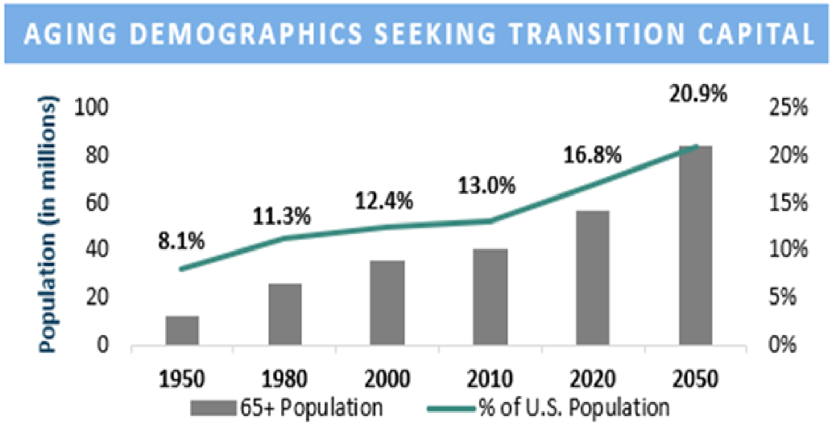
Lenders who have a senior team with deep investment banking, private equity, and C-suite operating experience can offer those value-added services to LMM businesses to differentiate them.

These value-added services can include institutionalizing their businesses such as recruiting senior operating leaders and independent board members and assisting with growth initiatives through identifying, analyzing, executing, and integrating acquisitions of competitors, and organic growth.

Lower middle-market lenders who have this specialization can generate higher returns through their equity upside.

There is market dynamics and structural demographic trends that support value-added lower middle-market managers. Many lower middle-market businesses are owned by baby boomers who have operated their businesses over decades and may be interested in selling as they look to retire.

As of 2020, those above the age of 65 (including most of the baby boomer generation), represent approximately 16.8% of the U.S. population expected to increase to 20.9% of the population by 2050. [1]



We believe there is a valuation arbitrage between lower middle-market and core middle-market companies of approximately 25% allowing lower middle-market businesses owners that are looking to retire in the coming years can take advantage of this premium by growing into a core middle market to take advantage of this premium.

Owners are willing to offer equity in their business to lending partners who can help them grow into middle-market companies and capture that premium

1) U.S. Census Bureau, 65+ in the United States: 2010, June 2014.

Why Lower Middle-Market vs. Core Middle-Market?

We believe lower middle-market direct lending is more attractive from a risk / return and absolute return perspective than the core middle-market because it:

1. Has lower leverage and a full set of financial covenants tested quarterly.
2. Offers higher yields.
3. Enhances total return through equity upside.
4. Offers low correlation to most asset classes.