CIFC Asset Management

CIFC Portfolio Intelligence

Direct Lending Opportunities: Not All Created Equal

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As one of the fastest growing asset classes for institutional investors, and now increasingly retail investors, private credit is frequently covered in the press. However, like equities or liquid fixed income, this asset class is broad and includes various sub-segments with distinct characteristics, opportunities, and risks. First, it is important to note that the global private credit universe (approximately $1.6 trillion of AUM globally[1]) includes a variety of strategies, including mezzanine, distressed debt/ special situations, fund of funds, and venture debt. The largest segment, direct lending, represents approximately half of all private credit and can be further divided by geography, structural focus (e.g. asset-based lending "ABL" vs. cash flow lending or senior vs. junior) and, importantly, borrower size. As direct lending has matured as an asset class, the bifurcation between upper middle/upper market direct lending and lower middle market direct lending (our focus at CIFC) has become increasingly pronounced. This dynamic has been exacerbated by the rapid flows of capital into the upper market space, as discussed below. We believe these two markets should be viewed as two distinct opportunities when investors are considering an allocation to the space.

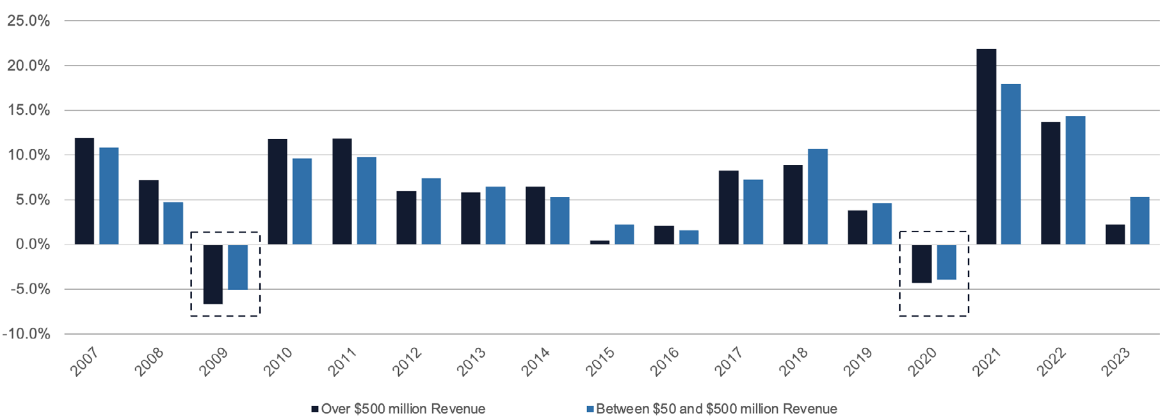
Michael Hertz, Senior Managing Director and Head of U.S. Direct Lending Underwriting

Mr. Hertz is responsible for managing CIFC Direct Lending's research and underwriting function and serves as a member of the Investment Committee. He has been part of the CIFC Direct Lending team for over 16 years. His previous roles include responsibility for sourcing, structuring and negotiating new direct lending investments in the New England region and co-managing the research and underwriting team. Mr. Hertz previously worked at Kroll (formerly Duff & Phelps) in the corporate finance solutions practice focused on transaction opinions. He has over 18 years of experience in M&A and leveraged lending transactions across a wide range of industries. He holds a Bachelor of Science, Finance from the University of Delaware's Alfred Lerner College of Business and Economics.

Market Size and Borrower Universe

Many investors, understandably, gravitate towards the perceived safety and stability of larger, more established borrowers. However, lower middle market companies have demonstrated impressive resilience historically. Public company data suggests that, on average, smaller companies' revenues declined slightly less than larger companies' during the last two recessions (2009 and 2020)[2]. CIFC Direct Lending has been dedicated to this strategy since 2005[3], and we observed similar fortitude in our own diversified lower middle market portfolios through both the GFC and COVID. This may be, in part, a function of proactive private equity owners leveraging the adaptability of smaller, more nimble businesses.

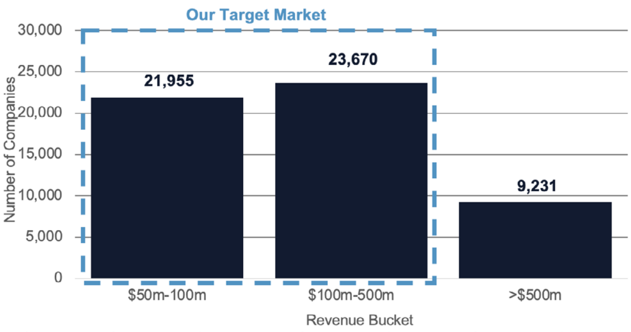
Average revenue growth of public companies by size[2]



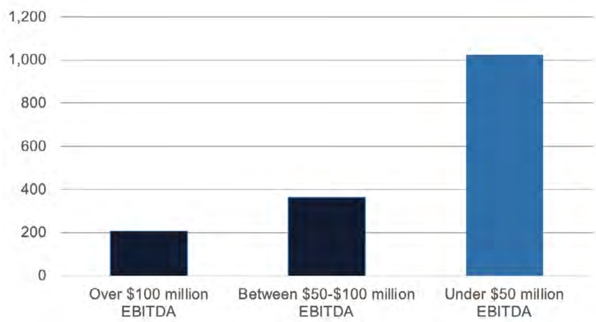
Further, the supply of investment opportunities is more robust in the lower middle market vs. the upper middle / upper market. As shown below, the estimated potential borrower universe is approximately 5x larger for companies with $50-$500 million in revenue vs. larger U.S. companies[4]. This ultimately translates to more targets for private equity and more direct lending deal volume in the lower middle market.

LSEG data suggests that in 2024 there were approximately 5x as many direct lending loans made to borrowers with under $50mm in EBITDA vs borrowers with more than $100mm in EBITDA[5]. While upper middle and upper market deals are, by definition, larger dollar opportunities, there are fewer of such opportunities. This limits this investable universe for upper market lenders and increases the likelihood that multiple lenders must compete for the same deal through the use of increasingly aggressive terms. These trends are only accelerated in a relatively slow M&A environment, like the one we have seen in recent years.

Potential Borrower Universe[4]



2024 deal count by EBITDA size[5]

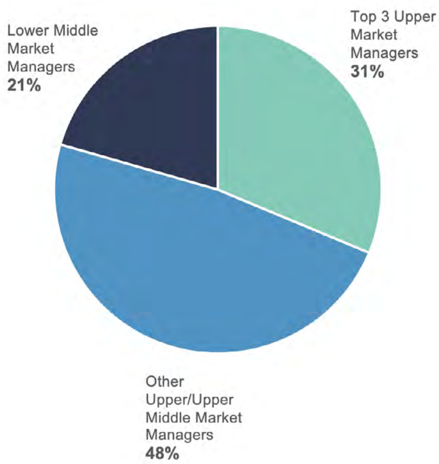


Fundraising Dynamics

As the direct lending asset class has been increasingly embraced by the investor community and allocations to the space have increased, meaningful fundraising activity has taken place. That naturally raises questions regarding rising competition among lenders in the space. However, it is important to note that this new capital has flowed disproportionately towards upper middle / upper market managers. We would highlight that the term "middle market" is defined differently, and used frequently throughout the market, even by lenders focused on larger borrowers.

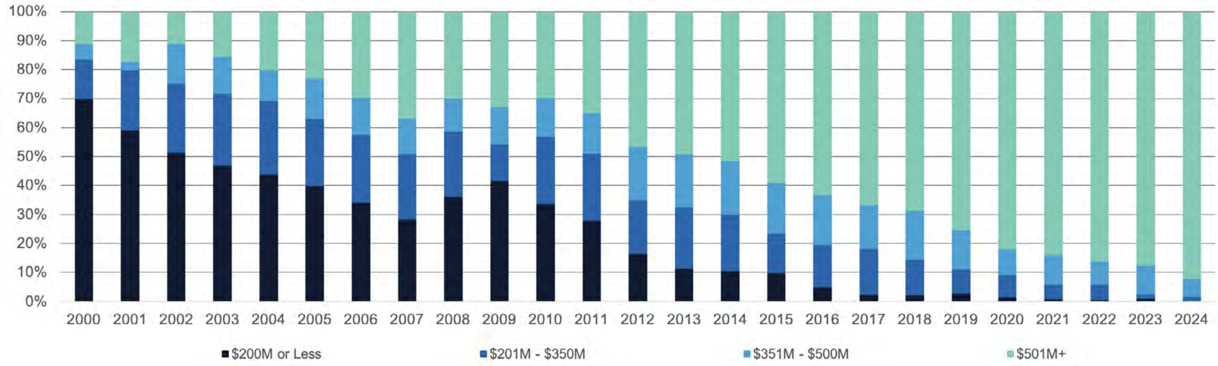
Based on a Pitchbook screen of U.S. focused direct lending managers with relevant strategies (funds vintage 2020-2024), CIFC estimates that approximately 79% of funds were raised by managers we would classify as focused on upper middle or upper market sized deals.[6] Notably the top three managers (all upper market focused) accounted for approximately 39% and 31% of the upper market and total direct lending funds raised, respectively. This concentration of new capital in the upper market is likely to fuel increased competition among larger players. In combination with the more limited number of deals discussed above, we believe that the supply/demand dynamics should be more favorable for the smaller end of the market.

U.S. Direct Lending Fundraising (2020-2024 Vintage)[6]



In addition to the more intense internal competition driven by the upper market fundraising environment, upper market lenders also face external competition from syndicated loans. Broadly syndicated leveraged loans ("BSLs"), while liquid, are lower priced (current average nominal spread of 330bps[7]) and tend to have more aggressive structures. Direct lenders in the upper market may compete directly with BSLs for lending opportunities and potentially need to compromise terms to beat BSL alternatives. They also face the threat of refinancing by BSLs, creating more downward repricing pressure. As shown in the table below, the BSL market for sponsored deals has evolved to focus almost entirely on larger facilities and there is limited BSL activity on smaller deals[8].

% of annual BSL Sponsored deals by size of loan[8]



Structure and Documentation Differences

Given the competitive dynamics discussed above, there are material differences in structural terms between lower middle market and upper middle / upper market direct lending credit documents. Various protections for lenders may be more meaningful (or available at all) in lower middle market documentation when compared to upper market structures. One of the most important of these protections is financial maintenance covenants, which can impact recoveries – as discussed in our Investor Intelligence article dedicated to this topic in July 2024.

Investors should also be aware of the risks of liability management exercises ("LMEs") in upper market credit facilities. LMEs are transactions undertaken by a company/borrower to leverage negotiated exceptions to the negative covenants and other provisions set forth in credit agreements to transfer collateral away from existing lenders. In these situations, lenders may have limited recourse and experience impaired recovery vs. what was expected at original underwriting.

Historically, borrowers have used three main types of LMEs to disadvantage existing lenders:

1. **Drop-down transactions:** moving collateral to unrestricted subsidiaries who have not granted liens to lenders through investment and asset sale baskets

2. **Uptiering transactions:** issuing new debt to certain (majority) existing lenders and priming other existing lenders

3. **Double-dip transactions:** utilizing baskets to incur debt owing to a new lender for which the company is obligated in two ways, directly and indirectly through an intercompany obligation, which allows the new lender to have two ("double-dip") claims on collateral

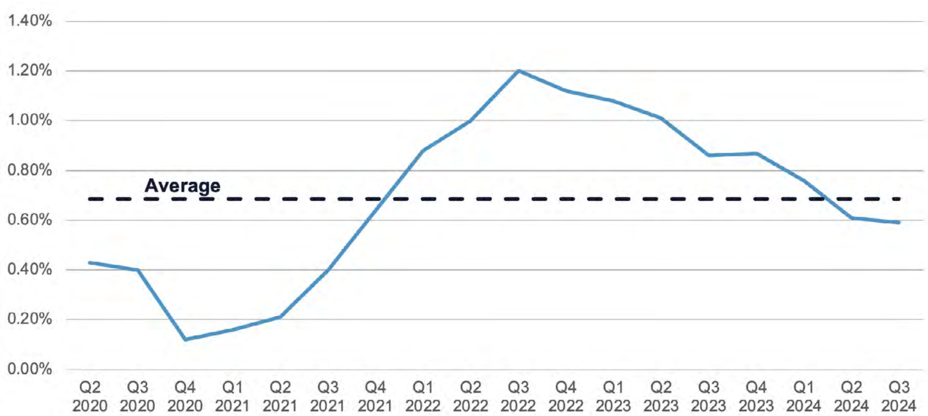
One recent example of a liability management transaction in the direct lending world is PluralSight, a Vista Equity Partners' portfolio company with over $1 billion of debt from large private lenders. In 2024, Vista reportedly transferred certain intellectual property into a new subsidiary (i.e. a drop-down transaction) to secure loans from the sponsor. Given upper market deals typically have looser credit agreement terms, borrowers likely have more flexibility to pursue LMEs. Lower middle market documentation is drafted with protections for lenders and other provisions to prevent LMEs from occurring.

Pricing Dynamics

In addition to the ability to achieve better structures and more protective documentation, lower middle market transactions also offer a pricing premium to larger deals. This would typically come in the form of higher coupon spread or upfront fees (i.e. OID). While the premium in income return can vary over time depending on market conditions, it has existed in every quarter and averaged around 69bps since Q2 2020.[9]

"In addition to the ability to achieve better structures and more protective documentation, lower middle market transactions also offer a pricing premium to larger deals."

Trailing 4Q Income Return Premium of Lower Middle Market DL over Upper Middle Market DL[9]



Another dynamic in the upper middle and upper market is the more frequent use of paid-in-kind ("PIK") interest. This refers to interest that is not paid in cash but is accrued onto the balance of the loan, intended to be paid at maturity. While commonly used in the past for mezzanine deals and in distressed scenarios, this has become a more common feature on newly originated senior direct lending facilities. We believe this may be a response to higher leverage and tighter cash flows on upper market deals, particularly in a higher base rate environment. In a restructuring scenario, accrued PIK interest essentially becomes more principal that needs to be recovered. CIFC has observed no upfront PIK component of pricing in lower middle market deals. Maintaining coupons as fully cash pay provides more certainty of a return on capital and a less difficult return of capital for investors.

Conclusion

We believe lower middle market direct lending can be viewed as distinct from upper middle / upper market direct lending. The unique borrower universe, broad supply of opportunities, defensive structural attributes and pricing opportunities create a differentiated risk/return profile. As such, we believe that an investment in an upper market direct lender does not provide complete exposure to this increasingly popular asset class. To be fully diversified, investors should seek out exposure to both key segments of the market. Over our 20-year track record, CIFC Direct Lending has remained solely focused on lower middle market direct lending with no style drift. We have observed the evolution of the asset class as a whole, and maintain our conviction that the risk adjusted returns of our core strategy remain attractive and that we are well positioned to take advantage of those opportunities.

1. Per Preqin as of June 2024.
2. Data per CapitalIQ; reflects publicly traded companies in the Russell 3000 index with revenue data available for all periods between 2006 and 2023. Size category data sets include only companies with revenues falling into that size range for all periods. Growth rate represents the average of growth rates for each constituent company (i.e. unweighted average).
3. CIFC Direct Lending was launched with the acquisition of LBC Credit Management in December 2022.
4. Data as of December 2024 (most recent), based on company count by annual sales as published by NAICS Association. The $50-100M company count is extrapolated based on the NAICS $10-100M company count, multiplied by the relative proportion of $10-100M companies with reported revenue between $50-100M per Capital IQ as of January 30, 2025, which represents the number of US-based companies identified in company screening with available LTM revenue data per size category. Excludes companies with no revenue data in Capital IQ.
5. Per LSEG Direct Lending data Q1-Q4 2024.
6. Fundraising data per Pitchbook custom screening performed by CIFC as of March 2025 targeting U.S.-based direct lending funds with vintages 2020-2024 and excluding funds identified by CIFC as having non-comparable strategies to CIFC such as asset-based lending or industry-specific funds. Upper vs. Lower per CIFC classification of manager strategy.
7. Source: LCD, Morningstar LSTA U.S. Leverage Loan Index Data per Pitchbook data as of March 31, 2025. Morningstar LSTA U.S. Leveraged Loan Index is a market value-weighted index designed to measure the performance of the U.S. leveraged loan market based upon market weightings, spreads and interest payments.
8. Source: LCD, Pitchbook data as of December 31, 2024.
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