EXPERT Q&A

Overlooked by many firms, the US lower mid-market can be a fertile hunting ground, according to Metropolitan Partners Group's Paul Lisiak

Why empathy is crucial in the US lower mid-market

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There is often a strong focus on scale in the private debt world, with firms eager to grow and source the biggest deals possible. However, this can leave parts of the market neglected where profitable lending opportunities can still be sought. Metropolitan Partners Group's managing partner and chief investment officer Paul Lisiak explains what is needed to successfully invest in the US lower mid-market and why having the right mindset is crucial to success.

Q What are some of the compelling characteristics of the US lower mid-market?

The US lower mid-market is segmented into sponsored and non-sponsored spaces, though the latter is more prevalent. That's a very attractive area for us, because with non-sponsored lower mid-market businesses, you're dealing with the owner-operators. These individuals are likely have the majority of their net worth invested in the business, and, as such, they tend to favour flexible partnerships and certainty around closing as opposed to strictly optimising for cost of capital.

Financial investors underestimate opportunity costs associated with offering private businesses access to capital. Businesses at the lower end of the market are very good at what they do, but they are not structured in a way that grants them easy access to the capital markets. A six- to nine-month capital raise process would be an extremely expensive opportunity cost proposition for them. Therefore, if a capital provider can show partnership and a path to 'get to yes', a borrower may overpay for the cost of capital relative to the risk.

The traditional lending standards that exist in the broader mid-market are completely different to what we look for in the lower mid-market. We operate in real-world terms, rather than being satisfied with just seeing things laid out on a spreadsheet.

Q What is required to successfully invest in this space?

Empathy is crucial when it comes to investing in lower mid-market businesses, where you are dealing with people who are successful and have a great track record but the last thing they want is to work with someone who comes into the partnership with the wrong attitude. Financial professionals are often guilty of thinking 'we have the money, so we make the rules', but that's the wrong mindset to adopt when you are often the first institutional capital.

You need to be transparent and show these owner-operators the respect and appreciation they deserve. And, of course, it goes both ways – we need these companies to be transparent with us, and that only happens through building trust and showing them appreciation for their hard work while helping them institutionalise the business.

It's also important to note that heavy covenant packages are needed to govern these companies. We don't take board seats, due to lender liability, so instead we negotiate this into loan covenants and set them tight. If companies deviate from their core execution plan, they will bump into those covenants, which gives us the chance to step in.

We can then handle these conversations in an empathetic way and look for a solution together. Amending loan documents is a normal process for us because typical path dependencies require Metropolitan to adapt to the real-world circumstances, be they better or worse than originally expected.

Q How competitive is the US lower mid-market?

A lot of upstart managers launch by investing small amounts of capital at this end of the market. Inevitably, as firms build a track record, the overall economics of asset management skew towards gathering AUM. We've seen a lot of former competitors come up through our market only to drift towards the mid-market or just on-the-run transactions in general. Our focus has always remained on alpha, rather than AUM, and this means that we want to remain in the lower mid-market, where we see lots of opportunities and our LPs are paid a 'complexity premium'.

Q Where do you see the best opportunities?

When we come across a deal or two that we like within a certain sector or subsector that we think demonstrates positive tailwinds, we identify that as a kind of 'fishing hole'. It's a vernacular that came from one of our LPs that once asked whether Metropolitan is better at finding those under-fished fishing holes or just a better fisherman around the most popular holes. As bottom-up investors, we are definitely the former, and our generalist approach means we are always looking for new fishing holes. That said, there are a number of areas we avoid, such as sponsored deals, biotech, pharma, cannabis, cryptocurrency and oil and gas.

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One thematic that cuts across a number of these fishing holes is the delayed retirement of mom-and-pop business owners in the US. In 2019, the average business owner in their late sixties would be talking about their retirement, but the covid-19 pandemic and high inflation meant that they have been unable – or unwilling – to retire. This has resulted in a long tail of mom-and-pop businesses in the lower mid-market that could present compelling opportunities.

Q What is your outlook for the US lower mid-market over the next 12 months, and what risks are you mindful of?

Since just before last year's US presidential election, deal activity in the lower mid-market has been very high and shows little evidence of slowing down. US tariff policy has had little impact and may be incrementally beneficial to the domestic businesses we typically lend to. The biggest tailwind, however, is the rapid consolidation among our (former) peers, as private credit manager get gobbled up by insurance companies and other, larger credit managers.

Generally, while lot of capital is flowing into private credit, especially to the core and upper sponsored-back market, the market is experiencing a kind of paralysis. A number of our portfolio companies are looking for extensions on our debt simply because they don't want to go out into the market to seek refinancing. That is starting to change as base rates come down further, but there can be reluctance to go to market as finding a new capital partner is scarcer than flow data might suggest.

We've never been particularly dependent on rates, but with base rates coming down with the forward curve, we benefit as we price our loans based on the temporary profit share, rather than specifically on a spread basis. While spread based loans might be the focus of intentional LPs, we believe another round of wage inflation may be forthcoming, which would increase the risk for beta-based lenders.

We are moderately concerned about certain aspects of the macroeconomic picture and remain selective to only deploy capital to nimble companies that may achieve escape velocity through immediate catalytic events, asset acquisitions or fundamental growth. ■