

Why lower middle-market ABF spreads can persist

Executive summary

The sustainability of lower middle-market asset-backed finance (LMM ABF) spreads is rooted in market structure rather than a temporary pricing anomaly. In our view, the segment combines a large, under-penetrated financing need with a persistent shortage of appropriately structured capital. Borrower portfolios are typically too small for public securitization, and financing needs are generally below the efficient deployment threshold for larger banks and multi-asset private credit funds. The result is a fragmented, relationship-driven market in which specialized lenders can be compensated for sourcing, structuring, monitoring, and operational expertise.

This differs from large-market ABF and traditional cash-flow/direct lending, where larger transaction sizes with greater standardization and broader syndication, combined with substantial capital deployment needs, make competition on price and terms the norm. We believe LMM ABF spreads can remain attractive over time, provided managers maintain underwriting discipline, preserve capacity constraints, and continue to operate where complexity is economically meaningful.



Jay Braden

Chief Executive Officer,
Co-Chief Investment Officer
Mesirow Alternative Credit



Tim Joyce

Co-Chief Investment Officer
Mesirow Alternative Credit

A structural capital shortage, not simply a cyclical opportunity

Private credit represents only a small fraction of total financing. Bank retrenchment from capital-intensive, non-standard lending has widened the funding gap, particularly for smaller specialty-finance platforms and consumer-facing lenders. There may be ample capital in private credit overall, but not necessarily enough capital willing and able to underwrite the collateral, legal structure, data monitoring, servicing, and operational requirements of smaller facilities.

The borrower universe is broad and includes consumer loans, point-of-sale financing, healthcare receivables, small-business working capital, factoring, revenue-based finance, and other contractual cash flows. These businesses may have revenues ranging from approximately \$5 million to \$1 billion, while borrowing-base facilities in LMM ABF are often in the \$15 million to \$75 million range. The market is therefore large in aggregate, but individual financings are frequently too small to justify the fixed cost of execution for scaled capital providers.

There is an essential distinction between market size and capital availability. A large opportunity set does not automatically attract unlimited competition when each transaction requires bespoke work and relatively modest dollars invested.

Why LMM ABF spreads can persist

The case for durable LMM ABF spreads does not depend on the market remaining undiscovered, or on complexity being the only source of return. It rests more fundamentally on the economics of capital deployment. Spread compression is most likely when capital can be put to work in large, repeatable transactions with standardized underwriting, documentation, and monitoring. LMM ABF is different: the opportunity set is large, but individual facilities are generally modest, heterogeneous, and sourced across a fragmented borrower universe.

That distinction matters for the largest capital providers. A manager with billions of dollars to deploy needs investment opportunities that can absorb meaningful capital through a repeatable process. A \$15 million, \$25 million, or even \$75 million facility may be attractive on its own, but a portfolio of such financings requires substantial sourcing, pacing, concentration management, structuring, data review, and ongoing oversight. Even when a large platform has the technical ability to participate, allocating capital one smaller opportunity at a time may not move the needle relative to its overall asset base. The opportunity cost of doing so can be significant, particularly when larger transactions or more standardized strategies offer a faster and more scalable path to deployment.

The lower middle market often requires the opposite: selective origination, patience, bespoke structuring, detailed collateral and servicing analysis, and a willingness to build exposure facility by facility. As a result, abundant capital at the industry level does not necessarily translate into abundant competition for each smaller financing.

The segment's complexity reinforces this dynamic. Facilities may require tailored eligibility criteria, borrowing-base mechanics, advance rates, concentration limits, performance triggers, cash controls, and lender remedies. The lender must also assess the platform's origination, servicing, reporting, collateral performance and collections performance, and

then monitor those functions over time. These requirements favor managers with specialized systems, operating expertise, and relationships in the specialty-finance ecosystem. They are meaningful barriers to entry, but more importantly, they make the segment difficult to industrialize at the pace and scale demanded by the largest capital providers.

Sourcing is similarly fragmented. Opportunities are often generated through specialty-finance platforms, founders, consultants, and niche intermediaries rather than a small number of standardized auctions conducted by banks and financial sponsors. A specialist that can provide certainty of execution and understand the borrower's operating model may have access to repeat or off-market opportunities that are not readily available to every pool of capital. Competition can increase at the margin, but it is less likely to become uniformly intense across the market.

The result is a pricing environment in which spreads can remain a durable feature of the asset class. The complexity premium is part of the explanation, but the broader point is that the market-clearing price reflects the scarcity of capital that is both willing and well suited to deploy at this scale, in this format, and with this degree of selectivity. We believe competition should remain more limited than in large-market ABF and traditional cash-flow/ direct lending.

The case for durability, and the discipline required to preserve it

LMM ABF spreads will respond to base rates, collateral performance, funding costs, borrower demand, and the availability of competing capital. However, the segment's pricing advantage is supported by barriers that are difficult to remove through capital alone. Complexity, fragmentation, and operational intensity are not readily arbitrated away by managers' whose model necessitates scale and standardization.

The key risk to spread durability is a shift in strategy that causes a manager to leave the lower middle market. The desire to raise and deploy increasingly larger sums of capital can force a move "up-market," where transactions are larger, more standardized, and more heavily competed. Capacity discipline is therefore central to the thesis: a strategy should scale within its sourcing and underwriting edge, not grow beyond the segment that creates that edge.

For institutional investors and consultants, the relevant diligence question is not simply whether today's spread is wide. It is whether the manager has the relationships, analytical infrastructure, operating expertise, and capacity discipline required to continue earning a complexity premium. When those capabilities are present, we believe LMM ABF offers a differentiated and potentially durable source of income that complements, rather than duplicates, large-market ABF and traditional cash-flow/direct lending.

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