SUCCESSFULLY TRANSACTING IN A CROWDED DIRECT LENDING MARKET

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Deerpath Capital

Why does Deerpath Capital focus on lower-middle-market-sized borrowers?
In comparison to larger size loans, we believe the lower middle market offers a more attractive supply/demand balance for lenders. At Deerpath we see more than 1,200 lending opportunities in our size range in a typical year. This is a target-rich segment of the market from which to select deals. On the other hand, the level of competition among lenders is less intense for the smaller size loans. In general, we see lower leverage levels, stronger covenant packages and higher yields in the lower-middle-market segment versus larger loans. Investors sometimes ask us if smaller companies are too risky to be safe borrowers. The key factor for us is that we do not have to lend to every small company that knocks on our door. There are many poor-quality businesses in the lower-middle-market size range, but there are also many good-quality businesses in this same size range. We are able to select the small companies to whom we lend. With the large volume of new opportunities that we see annually, we can be highly selective in choosing good-quality businesses that we can lend to on attractive terms. Our typical borrower has an enterprise value of about $50mn. There are many good quality businesses of this size seeking financing.

The senior debt markets feel overheated today. How has Deerpath responded to this?
One thing we do is to try to focus on deal sizes that are just a bit smaller than where the heavy competition is. In today's environment we believe we are finding a lot of lending opportunities on attractive terms to good-quality businesses where the loan size is in the range of $20-30mn for all of the senior debt. We face competition for these deals, but there is less competition here than we see with larger size loans. A second thing we do is to try to stay constant on our risk metrics and use pricing as the dial we modulate to adjust to changing market environments. There is a certain band where we are comfortable on the key risk factors (quality of the underlying business, owner, position in the capital structure, leverage levels, covenants etc.) and we try to stay inside this band no matter where we are in the credit cycle. We use pricing as the tool to adapt to changes in the environment. We have taken down our pricing today versus what we could capture back in 2008/2009 when it was a more lender-friendly environment than it is today. Nevertheless, we think our yields today are quite attractive compared to what is available in the broader loan market.

What steps can you take to try to avoid credit losses?
Our investment philosophy has always been "safety first." We are not the type of lender that will compromise on risk levels in order to stretch for a higher yield. The most important factor in avoiding losses is to lend to only good-quality businesses. We believe one cannot start with a poor-quality business and make a good cash flow loan out of it because the interest rate is high or the leverage ratio is low. We also care a lot about who the owner of the business is. We want to see an owner with access to additional capital and the economic incentive to provide more capital to support the borrower should an unexpected problem arise. We like our borrower to have many years of operating history. Our typical borrower has 15-20 years or more of operating history, so we can evaluate based on actual historical performance how we think this borrower will fare during a recession. We want to see an experienced management team in place with the proper financial incentives. We structure our loans to maintain a conservative loan size relative to the cash flow and the enterprise value of the business. We have quarterly financial covenants that are set at the time that we make the loan based on the borrower's financing plan. We watch the performance of our portfolio companies closely and move swiftly to address problems. We know it often is easier to fix problems early on, before they grow to become big problems. The quarterly financial covenants are important in this regard.

DEERPATH CAPITAL

Deerpath Capital Management, LP is a leading provider of senior debt financing to US lower-middle-market companies. Since inception, Deerpath has completed 300+ investments, deploying $2.2bn across a broad range of investment products and transaction types.

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