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DEAL FLOW

Middle-Market Musings

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Overall, median earnings have surged by more than 20% over the past two years for middle-market companies that are owned by private equity firms, driven by explosive growth in tech. But it's a very different story in the industrials sector. There, median earnings actually declined more than 5% between the fourth quarter of 2019 and the fourth quarter of 2021—a sign of how backed-up supply chains have made it impossible for manufacturers to keep up with demand.

That's all via the latest edition of Golub Capital's , a quarterly look at how mid-sized companies in Golub's loan portfolio are faring. The report compares the final quarter of last year to the last full quarter before COVID-19 began to sweep the globe, offering a snapshot of how the market has changed during the pandemic.

I caught up yesterday with Lawrence Golub, the chief executive of the $45 billion credit firm, to get his thoughts about the new numbers.

A 5.3% drop in earnings isn't the only sign that the industrials segment has struggled. Revenue is up 11% compared to two years ago, but that doesn't account for inflation—inflation that has disproportionately affected the manufacture of goods. The way Golub sees it, from a unit-production point of view, the sector has hardly grown at all.

"That's actually pretty striking, to say that with a robust economy, and things like consumer spending booming, industrial production is flat from two years ago," Golub said. "Now, flat's not a disaster. But it's not great. And that helps explain why profit margins are down so much. Because if you're producing the same quantity of goods, and your costs have gone up, cost increases are not offset at all."

Golub expects supply chains to remain unsettled during the first quarter of this year due to the continuing spread of the omicron variant. He also expects omicron to drive more short-term changes in consumer behavior. The bull market of 2021 might not come to a screeching halt. But some more bumps might begin to appear on the road.

"The underlying tide is one of economic strength that's broad, sustainable and likely to be sustained all through at least 2022," Golub said. "But I think the things we're going to see in Q1 are disruptors, as opposed to normalizers. We're going to see disruptors in certain segments of consumer behavior, like travel, like in-restaurant dining."

In the years to come, Golub Capital will have an even larger population of middle-market companies to survey. That's because the firm set new records last year by committing more than $36 billion in loans across 371 different transactions, including $15 billion in the fourth quarter alone.

Moving away from the middle market and into a higher paygrade, more than 10% of those transactions were unitranche loans of more than $500 million, also the firm's most ever. The private lending market has been booming for two decades, but Lawrence Golub called the rise of these massive loans "a much more recent phenomenon." The maturation of the direct lending space is helping fuel the ongoing boom in private equity. The easy availability of big loans, after all, makes it easier to do big deals.

"It's really only in the past five years that lenders like us have had the scale to do deals of that size," Golub said. "The larger deal segment is growing faster than the overall private lending market." F