The Case for Middle Market Lending

By David Golub

Editor's note: Evercore Wealth Management supplements its core investment capabilities with carefully selected external funds across the range of the firm's asset classes. Here we feature David Golub, President of investment firm Golub Capital, which he runs with his brother, Lawrence Golub, and CEO of Golub Capital BDC (NASDAQ: GBDC). Golub Capital manages over $15 billion of capital, investing in middle market and late-stage lending, broadly syndicated loans, and opportunistic credit investments.

Mr. Golub is a long-standing director of the Michael J. Fox Foundation for Parkinson's Research and has served on the boards of numerous public and private companies. He earned his AB degree in government *magna cum laude* from Harvard College. He received an MPhil in International Relations from Oxford University, where he was a Marshall Scholar, and an MBA from Stanford Graduate School of Business, where he was named an Arjay Miller Scholar.

Jim Grant of *Grant's Interest Rate Observer* recently joked, "I remember interest rates. We used to have them." No kidding. Seven years after the Great Recession, interest rates in the United States remain remarkably low. Investors in traditional fixed income have three basic options: Wait out the low rates and accept lower returns in the meantime; take more interest rate risk; take more credit risk in liquid markets.

In this low interest rate environment, which option offers the best balance of risk and potential return? Our answer is, "none of the above." Instead, we see a compelling case for certain investors to explore nontraditional alternatives to fixed income – specifically, middle market lending. These investments are more illiquid than many traditional fixed income investments but generally carry lower interest rate risk than high-grade bond portfolios and lower credit risk than high-yield bond portfolios.

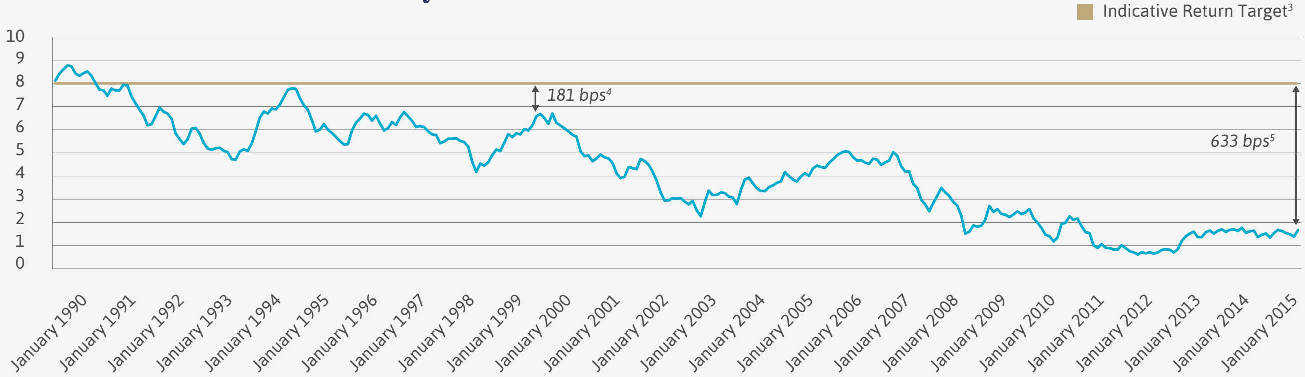
THE FIXED INCOME CONUNDRUM

Central bankers intend for low interest rates to prompt investors to take more risk. The math is simple. Let us assume you target an 8% return on your portfolio over time. Exhibit 1 on page 6, compares the yield on a 5-year U.S. Treasury note to that 8% return target. The gap of more than 6%, as of November 2015, shows just how much ground investors need to make up with riskier assets. For the past few years, that gap has been about 3-4 times wider than at the end of 1999.

Can investors wait out the problem? Unlikely. Exhibit 2 on page 6, compares the same 8% target to the yield the market currently expects a 5-year Treasury note to have 5 and even 10 years from now. The gap narrows, but not by much.

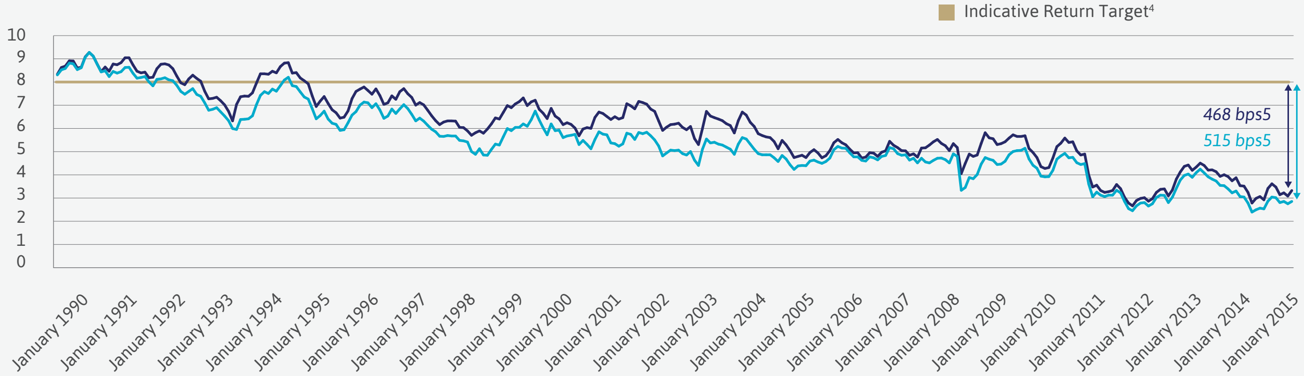
How about extending duration? Not promising. The yield curve is rather flat. Thirty-year U.S. Treasury bonds today yield about 3%, only a small premium to the 5-year yield. An investor still faces a yawning gap to that 8% target, but now also has exposure to severe interest rate risk. As shown in Exhibit 3 on page 7, a small move in long-term interest rates could wipe out several years' worth of coupon payments. A shift of just 100 basis points could cause a 30-year bond to lose nearly 20% of its value, with only meager income to cushion the impact on total return.

Intermediate U.S. Treasury Yield[1]



[1] Yield for a Constant Maturity Treasury ("CMT") as calculated and reported monthly by the U.S. Treasury Office of Debt Management
[2] At constant maturity
[3] Assumes an indicative long-term nominal return target of 8%
[4] As of December 31, 1999
[5] As of November 30, 2015
Sources: Bloomberg, Golub Capital internal analysis

Implied Future Yield of 5-year Treasury[1]



[1] At constant maturity
[2] The 5y5y UST forward rate in each period represents the market's expectation of the interest rate on a 5-year Treasury (UST) issued five years in the future. In each period, it is defined as the interest rate, r, such that a 10-year UST (at the then-current, or "spot" interest rate) would be equivalent in present value terms to a 5-year UST (at the spot rate) plus a 5-year UST issued five years in the future (at interest rate r). There is no guarantee that it would have been possible to make an investment in a future 5-year UST at the 5y5y forward rate in any period.
[3] The 5y10y UST forward rate is defined as the interest rate, r, such that a 15-year UST (at the spot rate) would be equivalent in present value terms to a 10-year UST (at the spot rate) plus a 5-year UST issued ten years in the future (at interest rate r). The spot rate for the 15-year UST is interpolated by cubic regression on the spot UST rates at 1, 5, 10, 20 and 30 years. There is no guarantee that it would have been possible to make an investment in a future 5-year UST at the 5y10y forward rate in any period.
[4] As of November 30, 2015
[5] As of November 30, 2015
Sources: Bloomberg, Golub Capital internal analysis

Finally, how about adding credit risk? For a time, this worked well, as we were in the "everyone is a genius" part of the credit cycle. No more. Fundamentals and standard credit metrics appear to be deteriorating. We are not predicting an imminent recession, but we are keenly aware that we are not in the early innings of this credit cycle. For example, many fixed income investors received an unwelcome surprise in 2015, as weak commodity prices strained issuers in the energy and basic industry sectors. These sectors, which constituted more than 22% of the Barclays U.S. High-Yield index as of November 30, 2014, delivered total returns of -18.3% and -16.6%, respectively, over the following 12 months.

Investors are hard pressed to find the least bad answer to the fixed income conundrum. We see a better way – middle market lending as an alternative to traditional fixed income.

THE MIDDLE MARKET ALTERNATIVE

What is "middle market" lending, and why should investors know about it?

The U.S. "middle market" consists of around 200,000 businesses, which are privately held and generally classified by revenue (e.g., under $1 billion) or EBITDA (e.g., $5-50 million). The U.S. middle market produces about one-third of private sector GDP, but many investors have no exposure to this market. Not only is the middle market large, it is also healthy. The middle market companies in the Golub Capital Altman Index increased revenues by nearly 8% year-over-year in Q3 2015 – outpacing most of the world's fastest-growing economies.

At Golub Capital, we have invested in U.S. middle market companies for more than 20 years. In our view, middle market senior secured loans can help investors fix the fixed income conundrum. Compared to traditional options, we see several advantages:

- **Superior income.** Middle market senior loans may carry a premium yield to high-yield bonds and large leveraged loans, as lenders do not compete only on price.
- **Low interest rate risk.** Loans are typically floating rate, not fixed.
- **Relatively low credit risk.** While all of these corporate issuers employ leverage, the senior secured loans are at the top of the capital structure, and middle market lenders often insist on strong covenants.
- **Sponsor support.** We focus on lending to companies backed by private equity sponsors with proven expertise and a significant equity investment behind us.
- **Favorable supply-demand dynamics.** As banks have withdrawn from middle market lending due to changes in the regulatory landscape, a handful of market leaders have emerged in their place. We believe the market leaders have scale, relationships and expertise that are very hard to replicate.

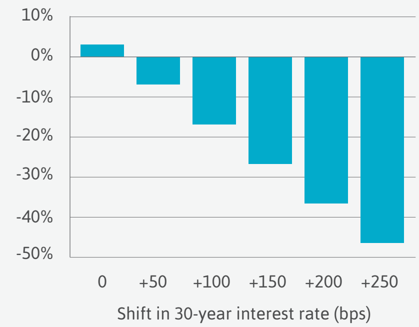
THE RIGHT PARTNER

In our judgment, the true test of a lender is performance over the full business cycle – and the key driver of long-term performance is minimizing credit losses. Because past performance does not guarantee future results, we believe investors should seek to understand how the lender is positioned to handle a turn in the credit cycle. Here are some questions to consider:

- Do the manager's relationships, capabilities and scale position it to source and win high-quality deal flow?
- Is there a consistent, comprehensive underwriting process, with appropriate emphasis on performance in distress scenarios?
- How are the incentives of the manager and its investment professionals aligned with investors' long-term net returns?

Scenario Total Return[1]

30-year Treasury Interest Rate Risk Scenarios[2]



[1] *Scenario total return includes a market value return equal to the change in interest rate multiplied by the modified duration of the bond (at issue, i.e., 19.69) and an interest return equal to one year of coupon income.*
[2] *Scenarios are based on a 30-year Treasury with 3% coupon, purchased at par when issued.*
Sources: Bloomberg, Golub Capital internal analysis

Low interest rates have created a conundrum for fixed income investors. With the right partner, a middle market lending strategy could be a compelling alternative.

The essay above represents the views of David Golub, and not necessarily the views of Golub Capital. No investment product is being offered as a result of this publication, and is only offered in connection with full definitive documentation. Investment carries with it the risk of loss.

To learn more about investing in credit strategies and the Evercore Wealth Management Efficient Architecture approach to asset allocation, contact **Brian Pollak** at brian.pollak@evercore.com.