PREQIN SPECIAL REPORT: GROWING INTEREST IN THE LOWER MIDDLE MARKET

MAY 2017

In association with NXT Capital

NXT CAPITAL

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alternative assets. intelligent data.

FOREWORD

In Q1 2017, Preqin and NXT Capital set out to gauge the attitudes of the institutional investor community towards the US lower-middle-market* direct lending space and surveyed almost 100 institutional investors active in alternatives. Investor types span the full range tracked by Preqin, including asset managers, insurance companies and both public and private sector pension funds.

The growth of the lower-middle-market alternative financing marketplace has truly become a theme, most notably in the US. Since the industry has opened more broadly to institutional investors in the past decade, demand for exposure has been steadily increasing, driven by compelling market fundamentals and strong returns. The majority of investors in this study are highly active in the asset class and keen to continue allocating to the sector for as long as strong results continue.

Preqin's **Private Debt Online** platform is the most comprehensive source for private debt data, including profiles for more than 2,600 active institutional investors in private debt, with detailed allocation and investment plans from investors of all types and sizes around the world. Furthermore, the addition of private debt deal data to the Preqin database covers more than 7,000 transactions, both sponsored and non-sponsored, dating back 30 years.

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**The lower middle market is defined by NXT Capital as companies with sub-$50mn in EBITDA and/or typical transaction sizes between $30mn and $150mn.*

ABOUT PREQIN

Preqin is the alternative assets industry's leading source of data and intelligence. Our products and services are utilized by more than 47,000 professionals located in over 90 countries for a range of activities including investor relations, fundraising and marketing, and market research.

Preqin, founded in 2003, operates from offices in New York, London, Singapore, San Francisco, Hong Kong and Manila. We are an independent business owned by our directors and employees.

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ABOUT NXT

NXT Capital is a leading provider of structured financing to the middle market. The company's asset management platform offers investors proprietary access to primarily first lien senior secured loans that are not broadly traded or otherwise generally available without a loan origination platform. Investment offerings include levered and unlevered funds, separately managed accounts and CLOs. NXT's managed-program investor base includes public and private pension plans, insurance companies, endowments, foundations and other institutional investors. NXT Capital Investment Advisers, LLC, a subsidiary of NXT Capital LLC, is a Registered Investment Adviser.

www.nxtcapital.com

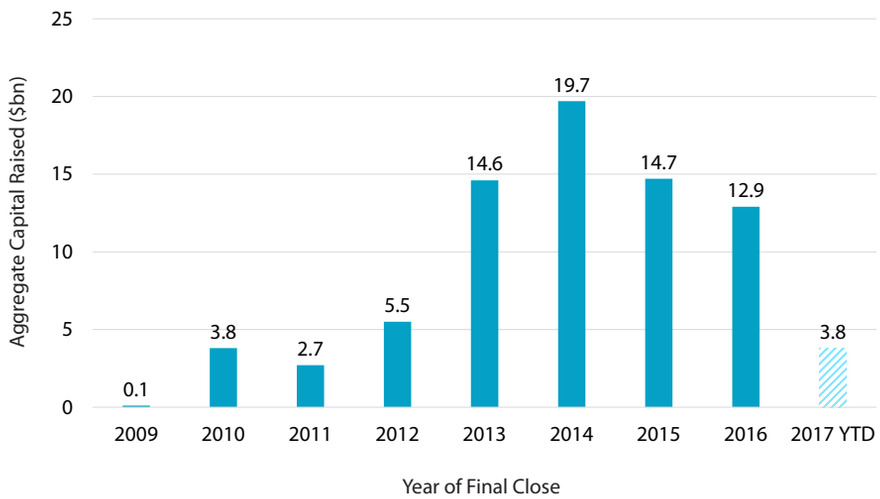
THE DIRECT LENDING OPPORTUNITY

Investor appetite for US lower-middle-market direct lending products has steadily gained momentum in the past decade and, based on the results of this study, appears primed to continue this trend in the near term. Having seen a significant uptick in fundraising in recent years (Fig. 1), it is evident that institutional investors are positive towards fund manager offerings in this space.

Traditional banking retrenchment from lower-middle-market lending has been evident since 2007 and has accelerated in the past three years, as the full effect of Dodd-Frank-driven limitations on leveraged lending has taken hold. These regulations created a lending vacuum which has since been filled by non-regulated finance companies and other alternative credit providers. Based on recent Preqin data, these alternative lenders provide the majority of capital to this market today. As at April 2017, Preqin tracks 256 direct lending managers worldwide, 151 (59%) of which participate in or are fundraising to target the North American marketplace. Of those managers, 119 (79%) have a stated preference for lower-middle-market direct lending (does not include distressed debt, mezzanine or infrastructure). The new paradigm has proven to be mutually beneficial for non-bank lenders and borrowers, as non-bank lenders have been able to access and retain a large share of the marketplace while meeting borrowers' needs in innovative ways.

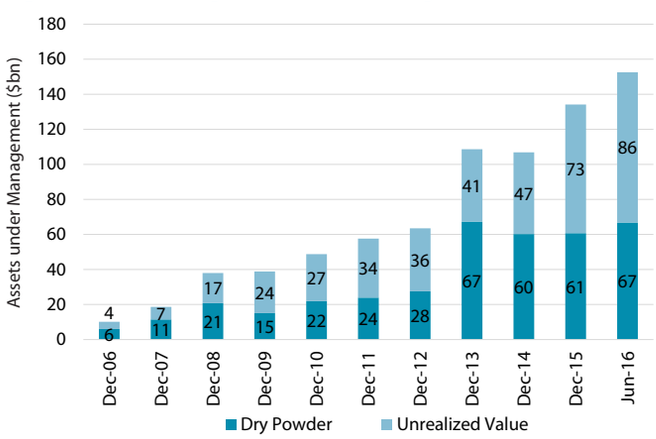
As shown in Fig. 2, since December 2006, assets under management (AUM) among global direct lending managers has grown from $10bn to $153bn as at June 2016 (direct lending category includes funds which may partially operate in other areas of private debt). AUM, as defined by Preqin, is a combination of available capital (dry powder) and unrealized value held in closed-end funds. Notably, some of the largest and most sophisticated institutional investor types have been first to access the market, with insurance companies and pension funds accounting for six of the 10 largest allocators to the asset class. The ability of direct lending to obtain higher returns without necessarily adding additional risk when compared to traditional fixed income investments has been a major motivator for large institutions in search of yield (Fig. 3). Early movers have been rewarded with a median net IRR of 8.9% for fund vintages 2004-2014 and a modest standard deviation compared to other alternative asset classes.

Fig. 1: North America-Focused Direct Lending Fundraising, 2009 - 2017 YTD (As at March 2017)



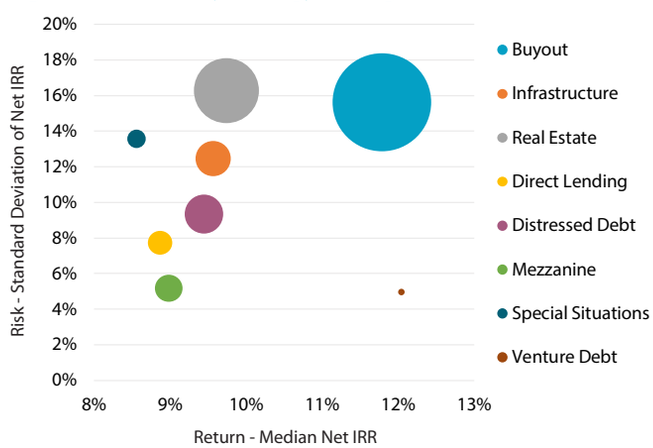
Source: Preqin Private Debt Online

Fig. 2: Direct Lending Assets under Management, 2006 - 2016



Source: Preqin Private Debt Online

Fig. 3: Risk/Return by Strategy (Vintage 2004-2014)



Source: Preqin Private Debt Online

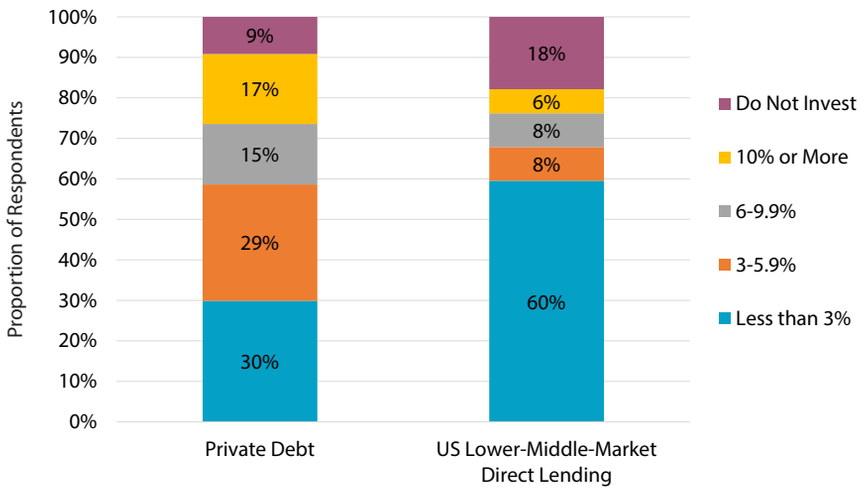
INVESTOR ATTITUDES

INSTITUTIONAL INVESTOR PLANS

For this study, Preqin collected just under 100 responses from a targeted group of institutional investors with past investments in private debt, as well as those planning to invest in the asset class in the future. As seen in Fig. 4, 91% of investors surveyed have defined private debt allocations, with a substantial 17% reporting an allocation of 10% of total assets or more. The weighting towards US lower-middle-market direct lending within this group, however, remains low, with 60% allocating less than 3% of total assets to this specific part of the market. Headroom certainly exists here, as 58% of respondents expect to increase their allocation to US lower-middle-market direct lending in the next 12-24 months. Thirty percent of investors have no plans to change their allocation to this area of the market, while only 2% expect to reduce their exposure.

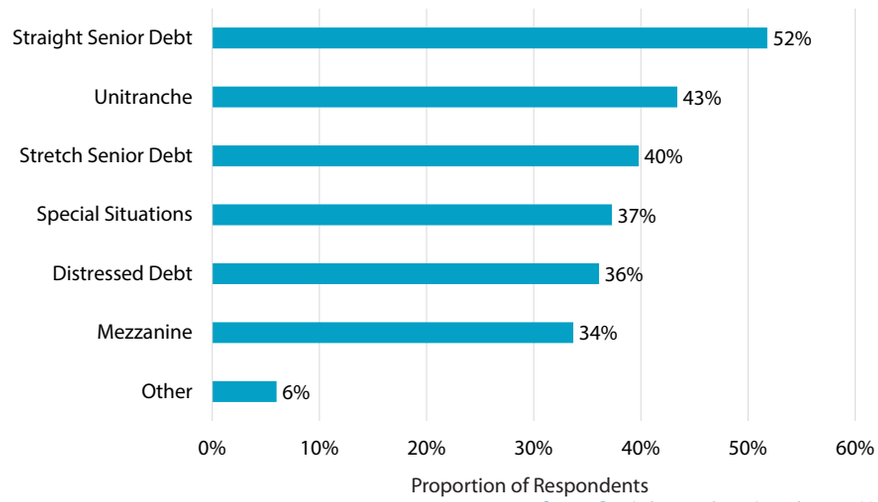
Investors intending to change their US lower-middle-market direct lending allocation in the next 12-24 months are primarily driven by returns and the risk profile of this sector. One public pension fund spoke of "seeking higher returns than traditional fixed income", while a prominent asset manager noted that the "expected risk/reward is attractive". A multi-family office participating in the study is encouraged by the "market opportunity" in addition to the "current yield and total return".

Fig. 4: Investors' Current Allocation to Private Debt (As a % of Total Assets)



Source: Preqin Investor Interviews, January 2017

Fig. 5: Investor Views on the Private Debt Strategies that Will Present the Best Opportunities in the Next 12-24 Months



Source: Preqin Investor Interviews, January 2017

STRATEGY PREFERENCES

Over the next 12-24 months, investors expect senior debt products to present the most attractive opportunities (Fig. 5). Defensive positioning for investors at this point in the debt cycle is prevalent, benefitting those managers and investors that focus on more senior structures in terms of fundraising and investing.

Many investors are seeking to forge new relationships with managers within the US lower middle market in the next two years: more than 3x as many investors are considering adding new managers that are active in this segment of the market than are not considering it than those that are not (Fig. 6). This is a positive indicator for managers that are seeking new capital, particularly those that are able to convey a proven track record and strong market position.

FACTORS FOR INVESTMENT DECISIONS

When deciding whether to commit capital to a US-focused lower-middle-market fund, the factor most considered, as cited by 77% of respondents, was the fund manager's track record (Fig. 7). Other important factors included the opportunity for attractive returns (61%) and a rigorous investment process (52%).

It is therefore likely, given this sentiment, that established fund managers will have an advantage in the fundraising process, although newer fund managers should be encouraged by the fact that 22% of surveyed investors in this sector will consider making a commitment to a

first-time fund. Fees and the alignment of interests between fund managers and investors, as well as the quality of the management team at the firm, are also relevant considerations for investors.

PROMINENT MANAGERS

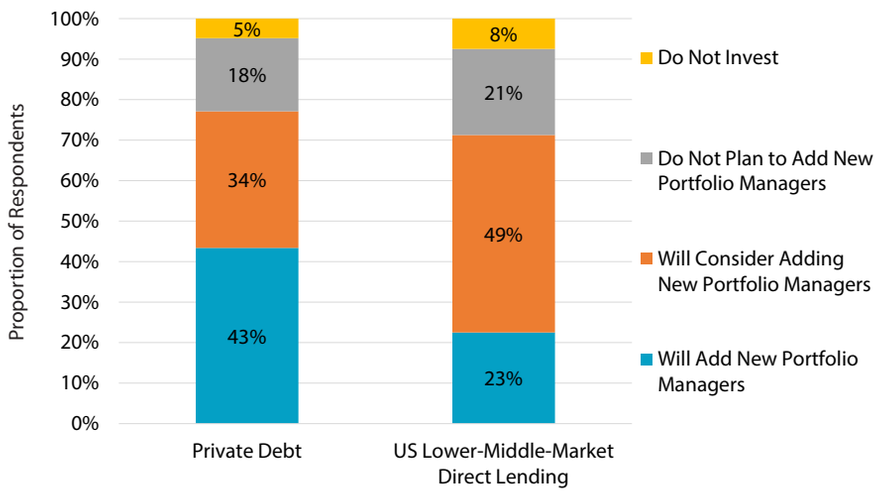
When investors were asked to list specific fund managers associated with offering access to lower-middle-market direct lending opportunities in the US, a total of 57 unique fund managers were cited. Five of these managers were mentioned more than four times, but the range of responses suggests that no single US-focused lower-middle-market direct lending fund manager has managed to consistently stand out from the crowd in the minds of investors at this point.

In part, this is likely attributable to the diversity of the segment and sub-strategies available (sponsored vs. non-sponsored, senior vs. unitranche, generalist vs. niche focus, mezzanine etc.). However, we expect that as the private debt asset class matures, and performance becomes more transparent, top performing managers will visibly emerge and command a greater share of mind and wallet. It will also become more apparent which managers are best equipped to manage the specific sub-strategies to be found in the market as mentioned above.

FUND STRUCTURE PREFERENCES

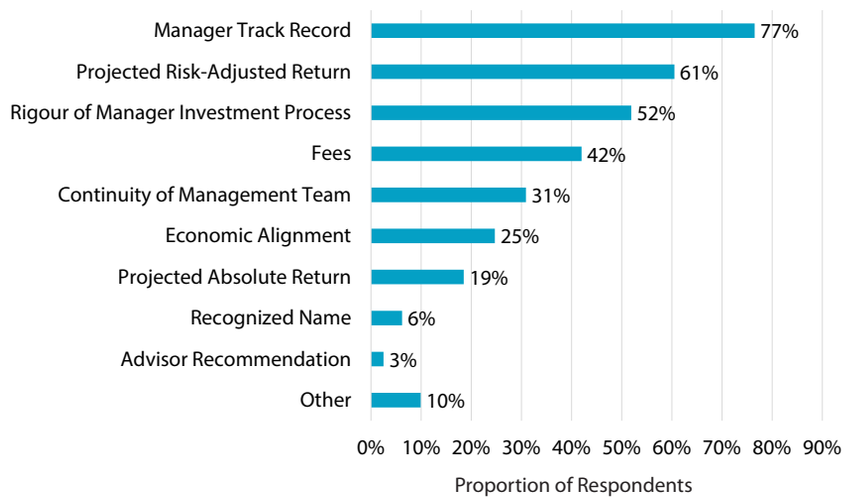
Seventy percent of active and potential investors in US lower-middle-market

Fig. 6: Investor Plans for Adding New Portfolio Managers in the Next 12-24 Months



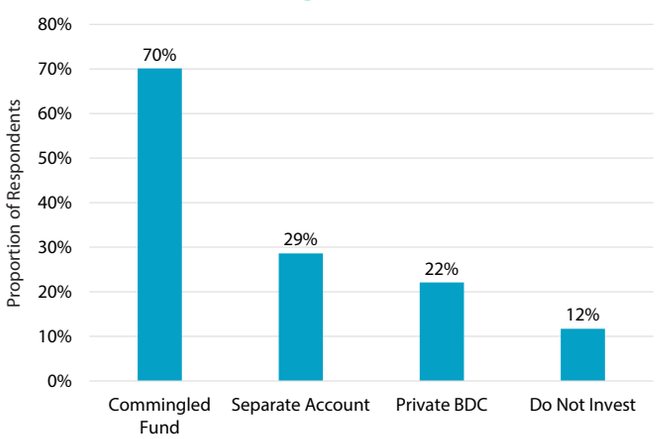
Source: Preqin Investor Interviews, January 2017

Fig. 7: Investor Views on the Most Important Factors to Consider when Assessing US Lower-Middle-Market Direct Lending Fund Managers



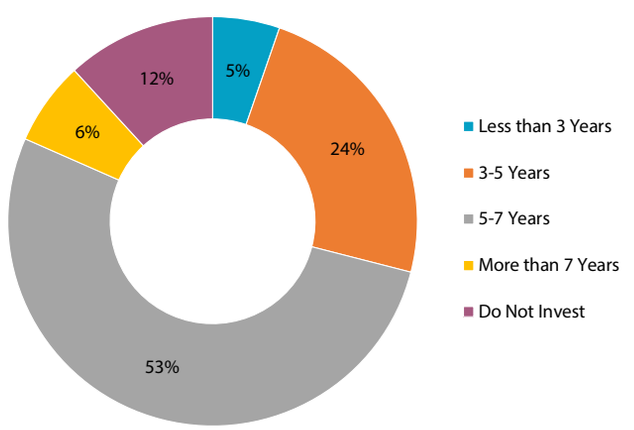
Source: Preqin Investor Interviews, January 2017

Fig. 8: Investors' Preferred Investment Structures for US Lower-Middle-Market Direct Lending



Source: Preqin Investor Interviews, January 2017

Fig. 9: Investors' Preferred Term Length for a US Lower-Middle-Market Direct Lending Fund



Source: Preqin Investor Interviews, January 2017

direct lending indicated a preference for commingled funds as their route to access the market (Fig. 8). Separate accounts and private BDCs saw support from 29% and 22% of respondents respectively. The strong signals for commingled structures could indicate that investors prefer to make smaller individual capital commitments, allowing for diversification among managers and various sub-strategies within direct lending. Although there is interest in establishing separately managed accounts, typically the very largest institutions able to carve out commitments of a considerable size will be able to invest in the asset class via this method. Therefore, commingled funds are often the better, or the only practical, choice for many investors.

With regards to transaction types, 74% of investors expressed a preference for strategies focused on private equity-sponsored transactions within US lower-middle-market direct lending funds, while 57% of investors would explore non-sponsored lending opportunities.

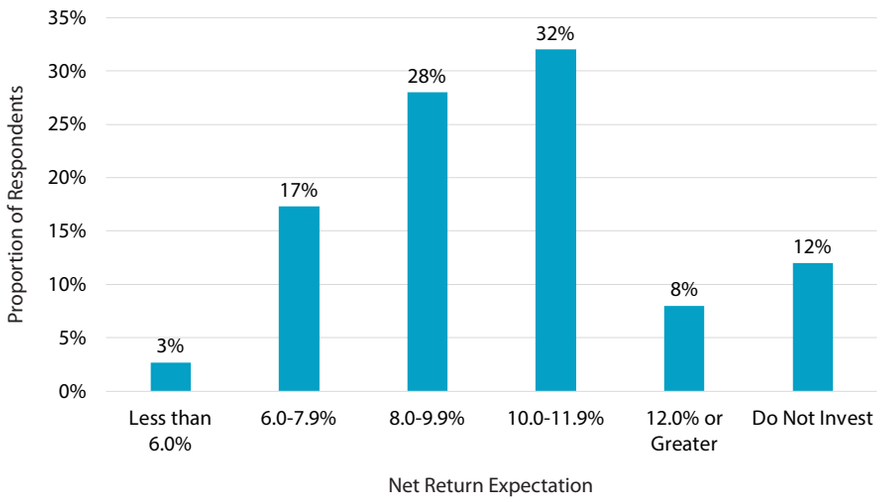
TERM LENGTH AND LEVERAGE

More than half (53%) of investors prefer a five- to seven-year term length when selecting a US lower-middle-market direct lending vehicle, while a further 24% prefer a term of three to five years (Fig. 9). Investors' recognition of the potential to capture illiquidity premiums in longer-dated vehicles is apparent, although this condition has not always been the case. As allocations in the past could have potentially come from fixed income baskets, liquidity and fund term length had been issues worthy of mention for would-be investors. However, the growth of the segment since 2007 has sparked a trend of standalone private debt allocations, for which appropriately dated commitments can fit mandates more closely.

RETURN EXPECTATIONS

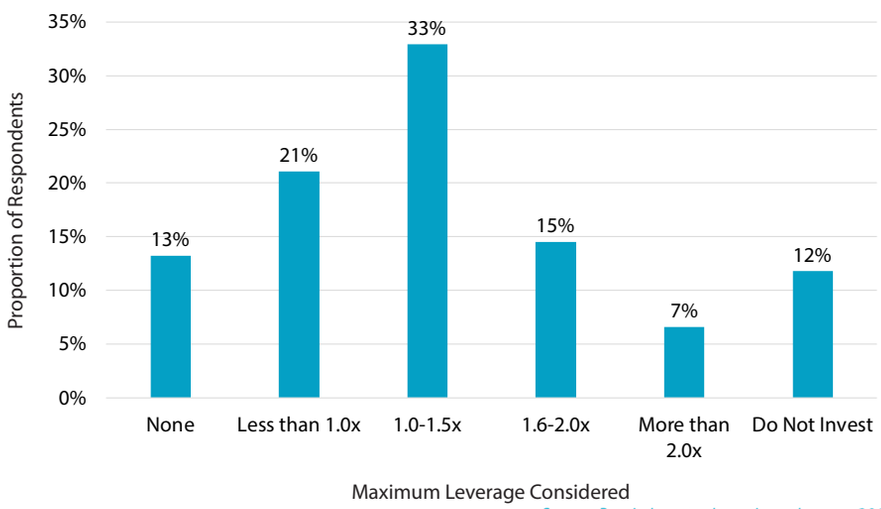
As seen in Fig. 10, net return expectations for 77% of respondents fall into the 8-12% range, in what has become a benchmark for US lower-middle-market direct lending return expectations. Investors are comfortable adjusting leverage tolerance to hit the higher end of this range, typically up to about 1.5x at the fund level (Fig. 11). Twenty-two percent of respondents consider leverage above the 1.5x mark. When compared to larger and more broadly syndicated loans, lower-middle-market senior loans offer a trifecta for the investor: more moderate leverage, downside protection in the form of seniority and collateral and a more attractive yield on a net return basis.

Fig. 10: Investors' Net Return Expectations from US Lower-Middle-Market Direct Lending Investments



Source: Preqin Investor Interviews, January 2017

Fig. 11: Maximum Leverage Considered by Investors for US Lower-Middle-Market Direct Lending Funds



Source: Preqin Investor Interviews, January 2017

OUTLOOK

This first ever study of investor interest in US lower-middle-market private debt sheds light on a growing demand for this appealing alternative to traditional fixed income investments. Based on investor feedback, the asset class is currently underweighted in many portfolios. There is every indication that managers will enjoy consistent tailwinds in their fundraising efforts as many investors seek to deploy more capital in this space, particularly in senior secured debt.

That said, it is unlikely all managers will benefit to the same degree. The maturation of many early funds has enabled greater transparency around fund performance. More than ever, it is now possible to identify fund managers that have a proven track record of effectively deploying capital and generating targeted returns, as well as fund managers that also have the broad-based direct origination capability and rigorous investment standards required for long-term success. This will likely result in a shakeout, with select managers commanding a larger share of new capital committed to the asset class over time.

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PREQIN

Alternative Assets Data & Intelligence

Preqin provides information, products and services to fund managers, investors, consultants and service providers across six main areas:

- **Investors** – Allocations, Strategies/Plans and Current Portfolios
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- **Funds** – Fundraising, Performance and Terms & Conditions
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