All change

As the mid-market debt space matures, **Christopher Taylor**, managing director at Madison Capital Funding, offers insight on an evolving market while reflecting on his own pending ascension to CEO

Christopher Taylor

Q How do you see private credit maturing as an asset class and what are your expectations for the market this year?

I believe the private credit market is going to remain a highly competitive segment for quite some time, and it will continue to attract capital from investors around the world. It will require the leading managers in the market to be flexible and adaptive to changing conditions. The key aspect to remember is that the core of middle market lending is based on people and relationships: having strong partnerships with private equity sponsors and building an organisation that draws the best talent.

We've been operating in a high-leverage and thinly-priced environment for the last few years. I really do not see that changing in 2018. While I don't anticipate dramatic changes in total leverage, I do believe pricing pressure will increase this year, particularly considering an attractive CLO issuance market and potential impacts from the recent regulatory changes around BDCs.

With pricing becoming tighter in 2018, there seems to be a shift from the sponsors to focus on senior-mezzanine or senior-stretch deal financing structures, primarily because senior debt is more attractive in terms of price. The unitranche product has definitely been in favour and remains a competitive product as more capital has come into direct lending, but ultimately if senior debt pricing continues to compress in 2018, I think you'll potentially see a migration back to more traditional debt structures.

Q How do you define the mid-market when looking to make investments?

We segment the market three ways: the broadly syndicated market, the upper middle market and the lower middle market, with the key distinguishing characteristic between the three being borrower EBITDA size.

We define the lower middle market as borrowers with EBITDA of $25 million and less; the upper middle market is $25 million to $50 million and the broadly syndicated market is above $50 million. Aside from the deal size being a distinguishing characteristic [of the market segment], the terms get more aggressive as you move up, and the pricing and the economics get even thinner. In contrast, an economic premium still exists in the lower middle market.

Q How do you feel investor appetite for mid-market private debt has evolved?

More recently, the attraction to US private debt from global investors has been tremendous. As these investors continue to operate in a low-yield environment, private debt has become an attractive asset class for investors chasing higher returns; we believe this trend has created an oversupply of capital, particularly in the upper middle market.

Managers that focus on that segment of the market have attracted a lot of capital for larger borrowers, which is why we focus on deploying capital to borrowers and private equity sponsors in the lower middle market.

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Q How do you deal with the loosening covenants when underwriting loans?

One of the characteristics that is attractive about the lower middle market compared to the other two segments is that most – if not all – the transactions we do have one or two financial covenants in the transactions: one is focused on leverage and the other on cashflow. Where we spend time – acknowledging the financial covenants are wider than they were five to ten years ago – is on the definition of EBITDA and some of the other governors in the credit document. Ultimately, the earnings of the business are how we are repaid in a cashflow debt structure.

Q What do you think the next downturn will look like?

I continue to believe that whatever correction potentially lies ahead will be less severe but drawn out for a longer period of time, rather than the financial crisis of 2008-09, which was more of a V-like correction. In other words, the future correction would be more of a U-shape and will require a heightened focus on borrower liquidity. The last financial crisis was very sector driven in terms of housing, construction and weakness in the financial sector. I don't think the next correction will be driven by the same factors.

Q You're set to take over as CEO this summer. What makes succession planning so important?

I think succession planning in this industry over the next five to 10 years is going to be a very important topic.Senior personnel and younger professionals are going to be looking for opportunities to advance their own careers and firms will be faced with an inevitable transfer of management to the next generation. And ultimately how senior management responds to that within their own firms is going to be very important.

Q Is it appropriate for the top person to step aside fully, or is it better for them to gradually step aside?

We spent a lot of time talking about this as an organisation. My advice to anybody dealing with succession planning is that it needs to be thoughtful, well communicated and ultimately it should not be a surprise, first and foremost, for the employee base and, secondly, for your sponsor and investor base.

Over the last couple of years, [Madison Capital founder and current CEO] Hugh Wade and I worked in tandem to implement that strategy, communicating it appropriately so when it was announced in January of this year, both internally and externally, it wasn't a surprise. Most importantly, Hugh was thoughtful in providing the next generation of leadership latitude in gaining experience at the appropriate time, while continuously providing his support in the background. His approach and mentorship was invaluable to me and the entire senior leadership team.

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Q Was it easy to communicate that succession planning, or was that a difficult conversation?

We're fortunate that our parent and primary capital provider, New York Life, is very supportive of our long-term succession plans. Outside of New York Life, my direct exposure and involvement with LPs increased over time, and I ultimately communicated to them appropriately so that there were no surprises. The worst thing a firm can do in succession planning is to surprise any constituent. The more natural succession planning can be, the better off it is for the organisation.

Q Other than relationships, what were other issues you had to address in succession?

As you talk through leadership planning, if you're going to do it the right way, you have to implement a succession plan over a period of years. That's the best advice I could give another leadership team or firm. When you're looking to build an organisation that lasts decades, even the team that is in place today needs to be thinking out 10 years, 15 years. They need to be asking: "This young talent we have, who is it and how do we develop them?"

I don't think it's fully appreciated how labour intensive and people-oriented direct lending really is. Lower middle-market loans are manufactured products. We have to go out and build relationships with private equity sponsors, source all of our transactions, analyse all the transactions and ultimately monitor and manage them over a three to five-year period.

It is an incredibly people-intensive business and building businesses that are strong and provide a long-term career path for people is extremely important in today's market. As you think about how this asset class evolves, the people and the relationships will really dictate how private credit transforms over time. ■