EXPERT COMMENTARY

Can the statistical model that revolutionised a great American sport be applied to private debt? Tom Quimby, managing partner with Tree Line Capital Partners, thinks it can

Moneyball for portfolio managers seeking yield

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In 2003, the author Michael Lewis published *Moneyball*, a book about the Oakland Athletics' general manager Billy Beane, who pioneered an analytical, evidence-based, 'sabermetric' approach to assembling a competitive baseball team. *Moneyball*'s central thesis was that the collected wisdom of baseball insiders is subjective and flawed, and that a paradigm shift was occurring in how to construct a team and value talent. Beane realised he could spend a fraction of the top payrolls and win by identifying overlooked and undervalued players.

Beane shifted the mindset of his organisation to buying wins versus buying players; and to buy wins, it was necessary to buy runs. As he assembled a small group of undervalued players, many of whom had been rejected as unfit for the big leagues, he proved the strategy worked. The A's created one of the most profitable and successful franchises in Major League Baseball, and in 2004 the Boston Red Sox used the same system to win the World Series.

As we sit in the 10th year of an economic recovery following the global financial crisis, the private credit markets are anything but certain. Looking closely across the asset class, with a focus on the compelling opportunities that exist in the lower middle market, there are lessons that can be learned from *Moneyball*. When applying the philosophy to credit, the shift in mindset is to be guided by data and invest in risk-adjusted returns (ie, wins) rather than simply investing in debt held by large companies regardless of the trends or metrics (ie, players).

It is important to understand how the private credit markets have shifted and matured during this 10-year run. The asset class, which has added $500 billion in capital since 2009, can be split into three categories: the leveraged-loan market (companies with typically $75 million in EBITDA); the mid-market (companies with $25 million to $75 million in EBITDA); and the lower middle market (companies with less than $25 million of EBITDA).

The leveraged-loan market is following pre-crisis trends. In 2018, 73 percent of loans issued were greater than 6x leverage and 41 percent were greater than 7x. The only other time in the last 20 years when this has been the case was in 2007. Moreover, 79 percent of all loans outstanding are cov-lite and on the road to no-document underwriting.

Mid-market direct lenders, which were once said to be filling the void left by bank consolidation following the crisis, are now victims of their own success. This category has attracted investors searching for yield in their droves, but the result has been commoditisation. In a crowded market it doesn't take our friends in private equity long to chip away at terms and effectively gut a lender's rights and the remedies available to it.

When lending becomes competitive, two things are sacrificed: price and structure. Spreads decline first as leverage creeps up and discipline takes a back seat to deployment. Market terms shift, and the rights that are critical during a downturn to equip lenders to act in advance of defaults are watered down, or even eliminated.

Moneyball and the lower middle

The lower middle market is where the moneyball strategy can be put to work. Tree Line Capital Partners is a direct lender and focuses on making senior secured loans to borrowers with between $3 million and $25 million in EBITDA. However, we also find significant advantages in companies with EBITDA of less than $10 million as these companies are predominantly overlooked and undervalued. For those willing to evaluate the data, the lower middle-market delivers a niche opportunity.

In baseball, general managers using a moneyball strategy will seek players who consistently deliver a specific result necessary to produce a run or a win. By focusing on statistics and metrics, general managers can set aside criteria such as size, height or weight, which might play into their preconceived notions of a player's suitability. The objective is to identify overlooked talent at a discount price. For example, a player who walks to reach first base is of equal value to a player who hits a single to reach first base. Beane discovered that on-base percentage was an undervalued asset, and that power hitters were overvalued assets as baseball insiders valued hitting a single over a walk.

In the credit world, a perception can exist that a portfolio carries more risk or volatility if it is comprised of loans to smaller companies. Investors will often take comfort in a belief that larger companies will mitigate risk in a distressed environment. The idea that risk is simply a function of a company's size of revenue and EBITDA is misguided. This ignores critically important credit fundamentals, such as security type, structure, yield, leverage, debt service coverage and covenants. At Tree Line, we apply a data-driven approach to our senior secured lending strategy with a heavy emphasis on leverage, margin, coverage, stability and growth. We measure these factors through a screening algorithm and it delivers a far more comprehensive assessment of a company's health and risk than simply size of EBITDA.

Beane found value in overlooked players and acquired them at a discount. Similarly, lower middle market lenders can invest in underserved companies and earn a premium through favourable credit structures. A willingness to look beyond the size of a company's revenue and EBITDA will provide a more accurate understanding of the risk-adjusted return associated with the lower middle market. This market has provided Tree Line with an opportunity to consistently deploy our investors' capital in senior secured loans with outsized returns and favourable structures. The sheer size of the lower middle market, with approximately 175,000 companies, creates an immediate advantage as it enables disciplined direct lenders to construct a highly selective portfolio.

We have observed significant growth in private equity activity in the lower middle market. New entrants are forming and spinning out of blue-chip middle market private equity firms to chase the large opportunity set, avoid auction-led processes and obtain attractive valuations with the prospect of buy-and-build strategies. The lower middle market private equity community has never been more sophisticated or capable.

Lower middle market lenders are working with companies that are typically smaller but which have established track records and a demonstrated ability to generate consistent cashflow.

In this case, smaller is not synonymous with venture or unproven. Lower middle market companies will typically have revenues of between $10 million and $100 million and are meaningful participants in all sectors of the US economy.

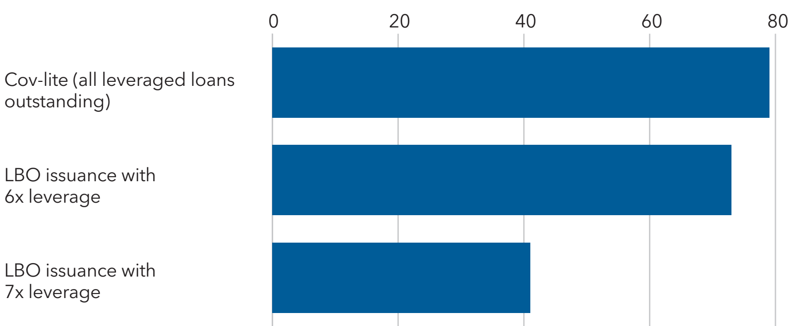
We take comfort in our current weighted average leverage of 3.8x, our weighted average fixed-charge coverage of 2x, our weighted average loan-to-value of 41 percent and the significant cash equity from reputable financial sponsors. These metrics are a result of an intensive, direct underwriting process that has been developed over the course of our careers and is designed to perform in all phases of a cycle.

Putting the philosophy to work

Moneyball has taught us to set aside subjective thinking and look more closely at the ingredients of what it takes to win. In the current environment, we believe niche and specialised strategies will outperform over the long term.

Simply flocking to platforms and companies with size will not get it done in the face of 7x leverage, cov-lite loans. As the prevailing conversation is focused on the frothy conditions of the leveraged-loan market and the mid-market, the lower middle market presents an opportunity to capture alpha in disciplined structures for those willing to take a moneyball approach. ■

The leveraged-loan market reflects pre-crisis trends (%)



Source: Tree Line Capital Partners