



Why company size matters in direct lending

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The private credit market has grown significantly in recent years as investors search for higher income. Direct lending, through which companies borrow from a smaller group of lenders without a bank intermediary, now represents the largest portion (46%) of the \$1.7 trillion private credit market.¹

Not all direct lending is created equal, however. The size of the borrower may significantly impact the potential risk and ultimate returns for end investors, with smaller borrowers more vulnerable to default in economic slowdowns. By contrast, larger corporate borrowers—often defined as those with earnings before

interest, tax, depreciation, and amortization (EBITDA) in excess of \$50 million—have advantageous features that better position them to retain their value for lenders in challenging environments.

Larger borrowers have also benefited in recent years from the growth of private markets, which are now robust enough to provide complete, scaled solutions to larger borrowers. These solutions may offer borrowers several benefits, including greater customization of loan structure, certainty of execution and terms, direct partnership with lenders, and access to financing through volatile markets.

Typical features of larger borrowers

Several features may better position larger companies to service debt obligations through challenging market environments. These advantages include:



Scale/breadth

Larger borrowers typically have greater market share and more diversified revenue streams, which may enhance their resilience to economic slowdowns, high inflation, and external shocks such as the onset of the COVID-19 pandemic.



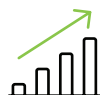
Pricing power

Through their size, larger borrowers may be better positioned to negotiate with customers and suppliers to implement price increases and otherwise manage costs through various economic cycles.



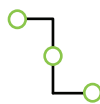
Experienced management

Larger borrowers typically have more experienced management teams that are better positioned to execute on strategic and financial objectives and manage through operating and market challenges.



Economies of scale

As borrowers grow in size, they often benefit from economies of scale that may boost operating margins and enhance cash flows and profits. These efficiencies may enhance the credit worthiness of a larger borrower.



Operational flexibility

Larger borrowers may have a greater ability to adapt and manage their supply chains to enhance and sustain operations through potential disruptions along with typically greater resources for research and development.



Financial resources

Larger companies are more likely to have access to deeper and more diversified financial resources that better position them to operate as market conditions evolve.

We believe these advantages better position larger companies to service debt and enhance their value for lenders in the event of a restructuring. Over the next few pages, we review several metrics—including higher EBITDA margins, stronger EBITDA resilience, and lower default histories—that evidence the relative strength of larger companies.

Higher EBITDA margins

Recent data for private debt issuances show that larger companies consistently have higher EBITDA margins compared with smaller companies.² As demonstrated in Figure 1, EBITDA margins for larger companies have been 1.2 to 1.4x higher than smaller companies that generate less than \$50 million in EBITDA annually. Businesses with higher EBITDA margins generally have more efficient cost structures and are more cash generative. As a result, we believe these companies are better able to service debt and may benefit from greater financial stability and the ability to withstand potential economic headwinds.

For a longer historical perspective across a broader range of companies, the financial performance of equity index constituents is helpful. In the following analysis, Larger Public Companies reflects constituents of the Russell Midcap Index which have a median EBITDA of approximately \$150 million.⁴ Smaller Public Companies reflects companies in the Russell Microcap Index which have a median EBITDA of approximately \$25 million per year.⁵ Figure 2 shows that larger companies have generated consistently higher margins compared with smaller companies. These stronger margins may evidence superior market shares, more control over supply chains, better pricing power, and economies of scale for larger companies. Larger company margins have also been more stable over time, including through periods of market turbulence.

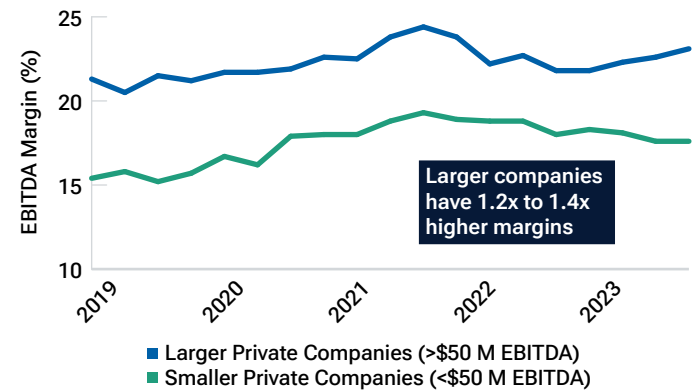
Stronger EBITDA resilience

Larger companies are typically better positioned to withstand challenging economic and market conditions. In each of the four key periods of economic dislocation over the past 15 years, the EBITDA declines of smaller companies have significantly exceeded those of larger companies (Figure 3) in the same equity indices referenced above. The cash flows of smaller companies were hit particularly hard during the energy dislocation in 2014 to 2015 and the COVID-19 pandemic. With quarterly EBITDA declines greater than 100% during these two economic shocks, smaller companies went cash flow negative compared with larger companies which remained cash flow positive across dislocations, illustrated by an EBITDA decline of less than 100%. This suggests there is generally lower potential downside from lending to larger companies.

Past performance is not indicative of future results. Please refer to the Appendix for additional endnotes.

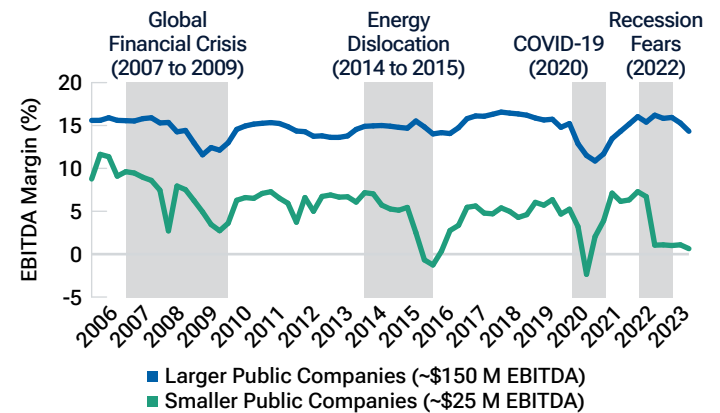
EBITDA margin³

(Fig. 1) 1Q 2019 to 3Q 2023



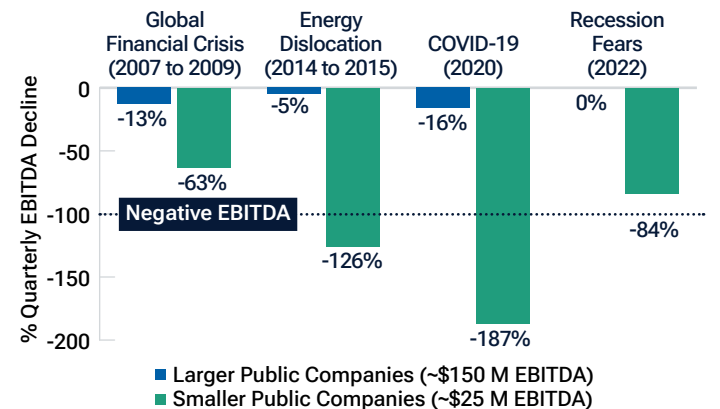
EBITDA margin⁶

(Fig. 2) March 2006 to September 2023



EBITDA performance during downturns⁶

(Fig. 3) Largest % quarterly EBITDA decline⁷



Lower traditional loan default rates

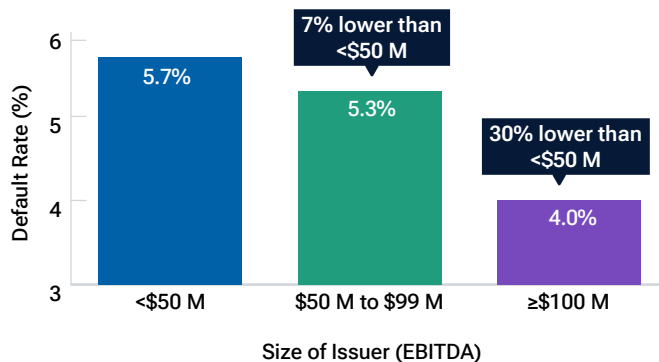
Lower default rates for larger companies historically evidence their stronger credit profiles. Figure 4 shows that larger borrowers had a 30% lower default rate compared with smaller borrowers between 1995 and 2023. We believe these long-term results demonstrate that larger companies have better navigated through market cycles than smaller companies.

Lower private loan default rates

As private credit has matured as an asset class, default data for private financings is now available. In private credit, larger borrowers also consistently demonstrated lower default rates post-pandemic as interest rates and inflation rose (Figure 5).

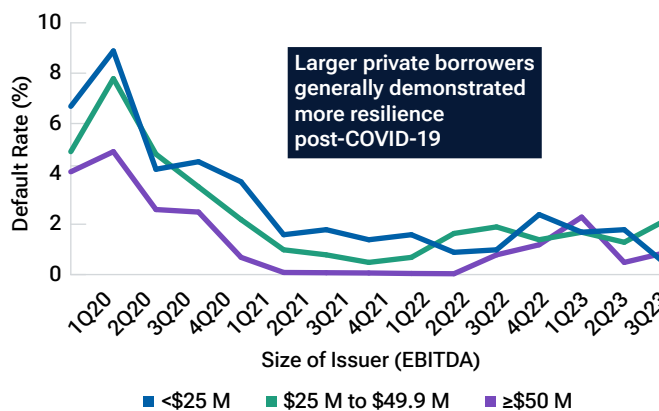
Traditional loan defaults by borrower size^{8, 9}

(Fig. 4) 1Q 1995 to 3Q 2023



Private credit defaults by borrower size^{10, 11}

(Fig. 5) 1Q 2020 to 3Q 2023



Overall, investing in direct lending that focuses on larger companies could be a relative source of stability compared with smaller companies. Historical performance suggests that larger companies would be less susceptible to default on their debt through challenging market environments due to the characteristics discussed above. These may include, but are not limited to, diverse revenue streams, better pricing power, and better economies of scale that drive more resilient cash flows at larger companies.

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Investors can access private credit through open-end and closed-end fund structures, but should consult with their financial professional to learn more.



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Appendix and Endnotes

- ¹ Source: Prequin as of June 30, 2023.
- ² EBITDA margin is defined as a company's operating profit as a percentage of its revenue.
- ³ Source: Lincoln International as of September 30, 2023. Larger companies are defined as companies with greater than \$50 million in LTM (last 12 month) EBITDA. Smaller companies are defined as companies with less than \$50 million in LTM EBITDA. Median EBITDA shown for Lincoln International Valuations and Opinions Group (VOG) private market proprietary data. Contains the same companies quarter over quarter.
- ⁴ Russell Midcap Index: As of September 30, 2023, consists of the 800 smallest market cap companies in the Russell 1000 Index, which contains the 1,000 largest market cap companies in the Russell 3000. The Russell 3000 consists of the 3,000 largest publicly traded U.S. companies by market cap.
- ⁵ Russell Microcap Index: As of September 30, 2023, consists of the 1,000 smallest market cap companies in the Russell 2000 plus the next 1,000 smaller market cap companies.
- ⁶ Source: OHA analysis of Bloomberg data as of September 30, 2023. Larger Borrowers represent companies in the Russell Midcap Index that have a median EBITDA of \$150 million. Smaller Borrowers represent companies in the Russell Microcap Index that have a median EBITDA of \$25 million.
- ⁷ Represents the largest quarter-over-quarter EBITDA decline (i.e., the lowest negative EBITDA percent change over the previous quarter).
- ⁸ Source: Pitchbook LCD as of September 30, 2023. Data shown is from LCD Default Review 3Q23. Comprises loans closed between 1Q 1995 and 3Q 2023. Default rates are calculated by dividing the number of defaulted loans by the aggregate number of loans in the Index.
- ⁹ LCD Default Review: As of September 30, 2023, consists of approximately 544 institutional loan defaults dating from 1998 to 2023.
- ¹⁰ Source: Proskauer Private Credit Default Index as of September 30, 2023. Default rates are calculated by dividing the number of defaulted loans by the aggregate number of loans in the index.
- ¹¹ Proskauer Private Credit Default Index: As of September 30, 2023, approximately ~970 active U.S. dollar-denominated senior secured and unitranche loans. Default rates are calculated by dividing the number of defaulted loans by the aggregate number of loans in the index. The index includes loans that have a payment, financial covenant or bankruptcy default, loans that are otherwise in default if the default is expected to continue for more than 30 days (excludes immaterial defaults), and loans that were amended in anticipation of a default. A default is assumed to take place on the earliest of:
 - a. The date a debt payment was missed
 - b. The date a distressed restructuring occurs
 - c. The date the borrower filed for, or was forced into, bankruptcy
 - d. The date a financial covenant default occurs
 - e. The date that a default occurs if that default is expected to continue for more than 30 days (excludes immaterial defaults)
 - f. The date the loan is modified in anticipation of a default
 - g. For the purposes of the index, if a borrower reemerges from bankruptcy, or otherwise restructures its defaulted debt, and reestablishes regular, timely payment of all its debts, the borrower is reclassified as a non-defaulted borrower as of the date of emergence or restructure.



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Appendix and Endnotes (continued)

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