



Funding the Middle: A Report on the Mid-Market Lending Landscape in Canada and Abroad

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Background:

Understanding the Private Debt Landscape in Canada



How We Got Here

Is there anything sexier than the investment of capital to acquire the debt of private companies? Private debt funds do just that. Designed to provide and manage portfolio loans, these debt funds eschew the unpredictable element of investing in stocks. They're an eye-catching asset class for investors looking for portfolio diversification and high-yield returns that can lift alongside inflation, delivered in income rather than capital appreciation.

Private debt emerged in the late 1980s/early 1990s, transforming into a core asset class after the Global Financial Crisis (GFC). As a result of the GFC, many commercial banks were on the edge of collapse, with solvency issues spelling disaster for traditional debt markets. To shore up the damage, leading banks introduced a series of rate cuts, and the Bank of Canada's policy rate was eventually reduced to its lower bound of 0.25%.

Unable to reduce its monetary policy rate any further, the Bank made a "conditional commitment" to maintain its policy rate at its lower bound until the middle of 2010. As the recovery began to materialize, the economy looked to grow again. Slowly, commercial banks expanded their balance sheets, but focused still on larger corporate borrowers. Debt financing was sorely needed, especially to companies in the \$10-80mm landscape. Private debt funds materialized to meet the demand for capital and to extend credit to companies of all sizes, especially much-overlooked SMBs.

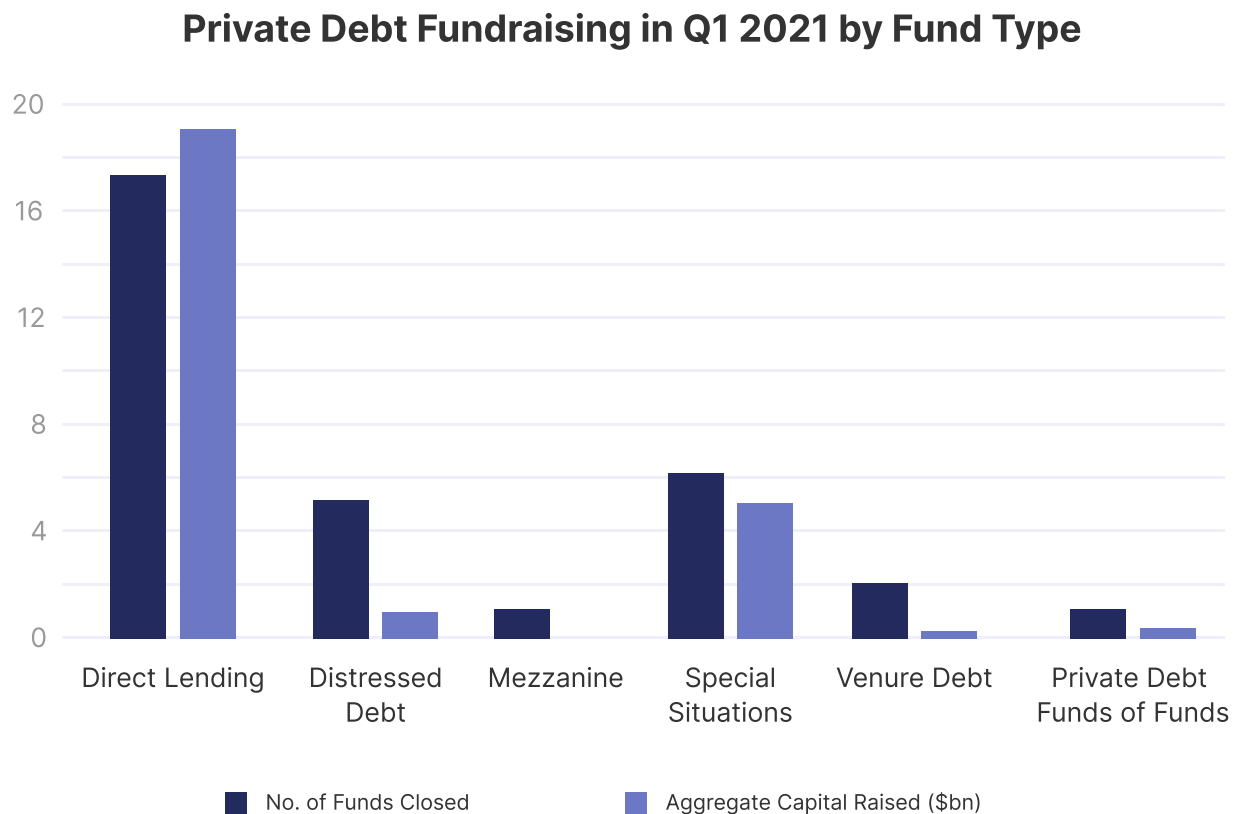
At the beginning, debt financing was primarily offered for special situations and mezzanine funds. Special situations groups had the flexibility to approach credit risks with unconventional structures; mezzanine funds combined traditional bank debt and equity financing, allowing businesses to maximize their leverage and raise financing at a lower cost of capital than equity.

Canada's venture capital community differs vastly from the United States'. Currently, the Big 6 command about 80% of the market, while private debt firms own about 20%; almost the inverse in the U.S. This doesn't preclude, however, Canada's debt market being robust and expanding. Private debt companies in Canada come in all shapes and sizes, but the mid-market landscape is arguably the most compelling. For investors seeking returns, companies within the \$10-80mm size comprise a substantial portion of the economy and can be better serviced by private debt lenders.

How We Got Here

According to the [2021 Preqin Global Private Debt Report](#), private debt is now the third largest among the private capital asset classes, behind private equity and real estate. In 2020, industry-wide assets under management (AUM) surpassed \$887bn, with the overall fallout from COVID-19 largely mitigated by government stimulus measures. Moreover, at the beginning of the pandemic, many forecasters expected a devaluation of all companies, which didn't happen.

Below are the fund types that received the most fundraising in Q3 2020 globally:



Source: The Lead Left

As shown above, the highest amount of capital raised was in direct lending. Most direct lenders are non-bank creditors that offer loans to businesses without using an intermediary, such as an investment bank. Corporate borrowers in particular have gotten increasingly involved as direct lenders in recent years.

In 2008-2017, direct lending offered greater security, generating a median Internal Rate of Return (IRR) of 8.3% for vintages, with a standard deviation of only 5.0%. In the same time frame, distressed debt returns were more varied, with a standard deviation of 9.7%, but a higher return of 9.2%.

Overall, the private debt industry has seen increased investment in all categories. With so much investment, it's important to understand the current market participants before entering into the space.

Key Players: Who is Lending?

Borrowers in the private debt market tend to be more highly leveraged than issuers in the broadly syndicated leveraged loan market and fairly small (averaging \$30 million in earnings before interest, taxes, depreciation, and amortization). Most active right now in the private debt landscape are pension funds, foundations, endowments and insurance companies. In 2018, the Canada Pension Plan allocated 11% to the private debt market. There are also a number of specialized companies that focus on certain segments of the economy that can invest in a private debt fund. For example, firms that specialize in real estate investments, such as AB Capital, may handle private debt firms. AB Capital is known for making disciplined investments in the real estate space; the company primarily makes business-purpose, bridge and construction loans secured by commercial, industrial, non-owner occupied residential and urban infill properties. In general, returns in real estate debt consist of steady monthly interest payments against the principal for both individual and commercial homeowners and prospective buyers. This type of investment is popular with borrowers as it provides quick approval and bypasses bank involvement.

Another key segment in the private debt landscape is in e-commerce. One leading investor is Clearco, which has deployed millions of dollars in capital investment for B2C startups. Clearco has used decision-making algorithms to deploy over \$2 billion to 5,500 founders across the world, recently gaining traction in the beauty industry, with a \$50mm revenue deal with Glamnetic.

Finally, debt investments are increasing in the cannabis industry; in 2019, they increased by over 30% to \$3.05bn from \$2.3bn, according to Viridian Capital Advisors. In Canada, Aurora Cannabis issued a \$200mm credit facility through the Bank of Montreal in 2018, and upsized it to \$360mm a year later. Most funding for the cannabis industry has historically come from banks and equity deals. However, as cannabis companies continue looking to scale, debt lenders have stepped in to fill the void in funding.

Canadian investors are not only investing in niche segments of the economy; they are shelling out big money to private debt funds across the board as part of an overall strategy to build diverse portfolios of sponsor-backed loans. Investment Management Corp. of Ontario (IMCO) recently announced a \$500mm USD platform investment in Chicago-based Antares Capital, an entity that provides financing to mid-market private equity-backed companies in North America. Antares has \$42.9 billion USD AUM, which will give IMCO exposure to the stable returns of private debt, and aligns well with their long-term investing strategy.

Private debt funds run the gamut with regards to their assets, targeted demographics, and strategies. Clearly, the private debt landscape in Canada is multifaceted and expanding. The amount of funds being raised is increasing over time, as seen below:



Source: CEIC Data

For investors interested in taking part, it's important to understand the various structures of these funds.

The Structure of Private Debt Funds



Square One: How Private Debt Funds Are Established




Most private debt funds share the same origin story: they are established by a handful of commercial bankers experienced in asset management and investment banking. Once a core team is assembled, they must look towards the marketplace to raise capital. This capital is generally obtained from independent investors or large public institutions. When enough capital is pooled, the team has an obligation to start making interest payments back to their investors. The fund then deploys loans to companies, making a profit on the interest of these loans. Because of the dependence on outside sources of funding and the immediacy of interest payments, most private debt funds do not have the freedom to be as judicious in their partnerships.

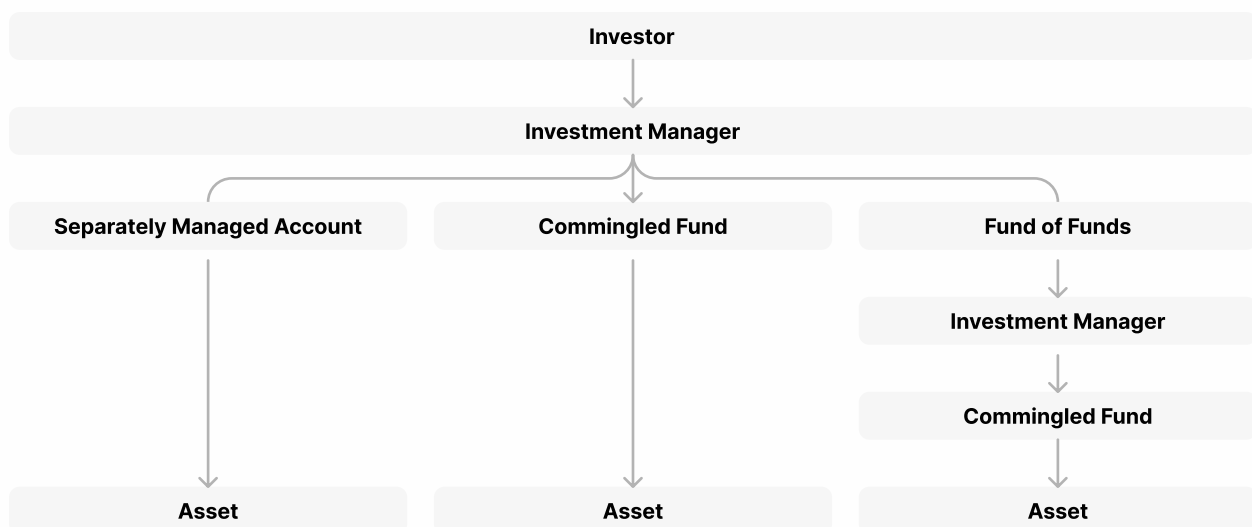
Enlightened Capital flips the script for Canadian private debt funds. By partnering with a Schedule 1 Banking Group, the fund is able to capitalize upon the bank-issued rate of interest and reinvest all its private dollars into the mid-market landscape. Having this institutional partner helps Enlightened Capital lower the cost of funds and increase access to capital for its clients. Operating within that mid-market sweet spot of \$10-80mm, Toronto-based Enlightened Capital is able to reassure borrowers of its stable structure. The company has expanded access to a full suite of private debt products including, bridge loans, portfolio financing and traditional ABL. Borrowers of EC also enjoy access to a full suite of bank products and can receive advice from its entrepreneur founder, Eamonn Glavey.

Understanding Fund Types

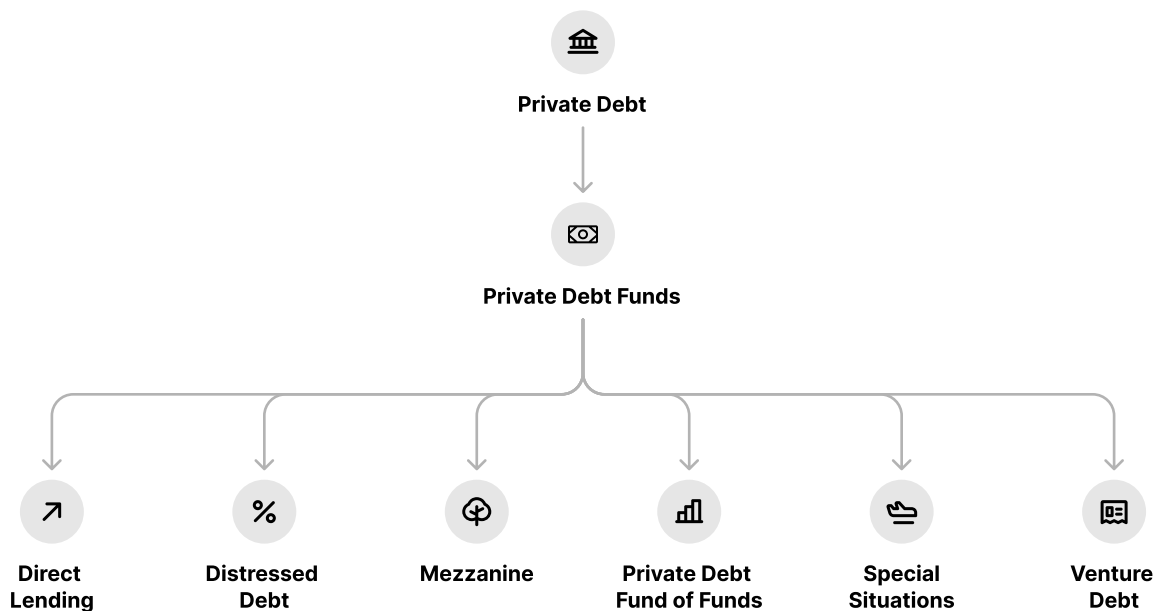
As shown, private debt funds come in various shapes and sizes: some provide capital to venture-backed borrowers, others invest in the debt of distressed companies, and some lend directly for real estate acquisitions. As in public markets, investors can access private capital asset classes through listed funds available from an exchange, but the **most common route is through private, unlisted funds**. Alternatively, they can invest **directly** in an asset class.

The structure of private debt funds can vary. Here are some ways in which private debt funds are commonly organized:

-  **Commingled funds:**
When capital from multiple investors is pooled to form a fund that is invested in aggregate.
-  **Fund of funds:**
A fund of funds is a two-tier commingled fund structure, in which capital from multiple investors is pooled together to form a fund that invests in other private capital funds, as opposed to making direct investments.
-  **Separately managed accounts:**
When capital from one investor is managed by one fund manager.



For investors who are new to the private debt universe, it is important to be aware of the vast array of fund types to select from; these include: direct lending, mezzanine debt, leverage loans, high-yield bonds, distressed debt, real estate and infrastructure projects. The way in which debt products are structured does not differ too much from securities funds. Successful private debt funds are able to provide a structure that does not increase the tax burden on investors in comparison to a direct investment; funds should ensure that investors have access to limited liability protection, and loans should be simple to administer.



Upward Spiral: How to Build a Solid Foundation

To be successful in the emerging private debt industry, a robust governance structure is essential. A good governance structure should leverage the right group of investment and credit managers that are experienced with facilitating direct investments. This is the necessary foundation in which investors can trust that the company is a reliable, well-oiled machine.

The vast majority of private debt funds are formally subject to regulatory supervision, and borrowers are safeguarded by the same protection laws when working with private lenders as they would with any other provider of capital. Loan terms can be governed by financial covenants, as debt providers take stock of each borrower's risk profile and individually assess their needs. On the whole, private debt funds tend to have more leniency in providing longer term and amortization periods.

Depending on the structure of private funds, they are governed by different bodies of regulators and subject to sufficient oversight to ensure that borrowers are able to repay their loans. There's some variation in governance structures at extant private debt funds in Canada, making certain companies more reliable than others. The governance structure of Enlightened is very similar to that of a bank: there is an investment committee, a credit committee to approve the funds that get deployed, and a group that publishes term sheets. Enlightened Capital's investment committee comprises a hybrid mix of several bank members and the Enlightened team; its credit committee is composed primarily of bank members. Employing bank staff to oversee capital deployment reduces risk in transactions and ensures stronger checks and balances. In contrast, when companies fill their credit committees primarily with internal staff, there's a higher likelihood of foul play and/or deal bias.

Fund managers are obligated to implement adequate procedures to identify, measure, and appropriately manage all risks including market risk, liquidity risk and

operational risk. This ensures that funds can be properly allocated and borrowers won't be misled. Not all funds are created equally, and it's important to know these risks before investing in or borrowing from a private debt fund.

Since lenders typically lend with the objective to hold debt to maturity, private debt loans are usually less liquid than broadly syndicated loans. For investors with an appetite for high yields who can withstand some illiquidity, private debt has the potential for high returns.

Why Private Debt Matters

Beyond just providing stable ROI for investors, private debt solutions matter to the companies who can't otherwise be serviced by big banks. Banks typically offer traditional debt, whereas private debt companies can offer customized solutions for borrowers with less covenants attached. Private lenders that offer mid-level pricing can be more expensive, but are generally able to deploy more capital, at higher levels of risk, to get companies accelerated. With a wide selection of industry players that require debt financing, and are unable to obtain loans from the strictly-regulated banks, the need for private debt in the Canadian capital market is paramount.

To begin integrating private debt into any loan portfolio, the general recommendation is to invest between 5-25%.

	Traditional Debt	Private Debt
Industry	Banks would have limitations on specific industries and at time exit from specific industry due to concentration risk or losses.	Less restrictions and typically focused on industries where banks have stepped back.
Margin/loan to value	Traditional bank formula (i.e., up to 75% of assets)	Can go up to 100%
Interest rate	Traditional bank pricing, lower single digits	Ranges from 8% to 25%
Security	Secured, typically in first position	Secured, can be first or second and unsecured
Financial covenants	3-4 covenants that cover balance sheet, income statement and cash flow	Secured, can be first or second and unsecured
Structure	Have flexibility; however, governed by covenants that meets the bank's risk appetite	Greater flexibility; governed by a couple of financial covenants as the debt provider understands the risk profile of the borrower and can offer longer and amortization periods

Source: EY Canada

“Rented Equity”

Private debt offers many key benefits to borrowers. For one, the interest payments on debt financing are tax-deductible. Debt financing is also more accessible to small businesses than selling equity; only 0.07% of small businesses ever access the venture capital market in search of equity financing, the rest opt heavily for debt financing. Moreover, business owners generally have more leeway in maintaining autonomy of their operations with debt deals, and can improve their business credit score by handling payments on time.

Despite all these advantages, there can be an educational onus to overcome, in which companies erroneously take pride in being debt-free. This should not be the case. If companies are not accessing debt capital whenever they can access it, it's almost an irresponsible use of capital structure, according to Karanjit Bhugra of Echelon Wealth Partners. The more pressing question then becomes: when is the best time to access debt capital, from a borrower's perspective?

Certainly, it depends on the company's needs and size, but in general, it's a good idea to seek out private debt solutions when there is a need to fund sales and marketing growth, or to buy out shareholders. Debt can reduce the dilution a growing business takes on. The hands-off approach of many private debt providers can allow a company to scale without overbearing terms. Many private debt sources of capital are 'covenant-lite,' says Garron Helman, CEO at Venbridge, "We very rarely get involved in our portfolio businesses, especially on the bridge financing side. We just want to be there to support the companies, and if they have any questions we're happy to help."

New companies can become overwhelmed with where and when to start looking for funding. Deciding who to partner with and when to partner with them depends on the size of the company and the stage of its growth. On the whole, however, taking on debt capital helps companies scale and can be thought of as much-needed "gasoline in the tank" to prepare them for institutional type lending.

Understanding the Borrower

From beginning to end, the journey of each borrower will look different. What companies need from their investors depends on their unique situation, but can be grouped into general categories. A more hands-on approach might be best for companies that are looking to restructure before going back into a bank partnership. For those clients, more advice might be necessary, and they might need more guidance and for the private debt partner to take on an advisory role. Similarly, distressed companies might benefit from this approach as well. These companies often need to continue using their assets during a restructuring, to maintain the liquidity necessary for running the business in the interim, and need an understanding investor.

Another category of borrower is a start-up, which often looks to fuel growth potential and avoid the dilution of equity. Start-ups are typically best supported by low-covenant terms. They can be considered good candidates for a looser-rein approach if they're using the capital to fund sales and marketing growth, to buy out shareholders, and are able to provide detailed metrics on their margins and growth projections.

Similar methods can also be used when preparing companies to grow into a future bank partnership. While the ideal journey of an originator with a startup is to have an idea, and six months later to sell it for a billion dollars, that's not the trajectory of most businesses in reality. Here's more what it looks like:

- 1 Identify a gap in the market, develop a product
- 2 Acquire seed capital to build brand and product (i.e. savings and/or friends, family)
- 3 Source initial growth capital (i.e. family office or VC)
- 4 Improve systems/invest in management team
- 5 Source strategic private debt to accelerate expansion

Whether a company is seeking venture debt or restructuring to reenter a bank partnership, more traditional lenders often expect to invest in companies that are run with precision. But no one actually teaches companies how to get there. That's why good private debt partners can assess whether their borrowers just need capital, or more guidance. Enlightened Capital can help drop the cost of capital for its clients while advising on how to scale. Its ideal candidate is post-beta, has graduated from friends/family/family office sources of capital, and is poised for growth with a solid management team and systems in place to facilitate this. The borrower can work in any sector: auto, home, credit cards, or anything considered alternative finance.

The Future of Private Debt

The future is bright for private debt funds, as well as for the companies that partner with them. One can speculate that more banks will step into the role as institutional partners in order to diversify their portfolios and generate stable investments.

According to Preqin, the private debt industry is projected to increase 11.4% annually, reaching \$1.46tn by the end of 2025. Beyond changes to scale, the face of private debt will likely look different in 2025 than it does today.

At this point, education still remains one of the main challenges to the private debt industry. Most entrepreneurs aren't aware of the advantages of private debt, partially because it is not covered in business schools. As the industry continues to increase in size, this educational gap will start to close.

Macro & Micro Shifts

To begin with, it's likely that Environmental, Social and Governance (ESG) criteria will continue to gain prominence within the next five years. Investors will increasingly apply these non-financial factors into their analyses to identify opportunities for growth and risk. The space will see more adoption (whether by becoming a signatory or by incorporating ESG principles into their governing charter) of the UN's Principles for Responsible Investment, one of which is to promote acceptance and implementation of the principles within the investment industry.

ESG is all about responsible investment. But that doesn't mean it has to be viewed as a rigid, 'one size fits all' model of issues to be considered in isolation. Instead, it's an overarching framework that can be tailored to each company, with the expectation of compliance proportional to company size and capability.

An eye towards ESG provides an investment opportunity with new companies focused on building a more sustainable world. This is called impact investing, in which companies bridge the gap between investing and philanthropy by pursuing investments that create social benefits alongside profit generation.

Another key development in private debt likely to continue accelerating is automation. Automation, in addition to AI/ML capabilities will continue to drive down prices, improve credit monitoring and efficiency and become an even bigger part of the lending machine in the future. This will give entrepreneurs better prices and investors better returns.

With post-pandemic volatility, moreover, there will likely be more deals in distressed debt. Distressed debt has been an area of growth for private credit managers, increasing by \$9bn over 2020 to June, driven by a 15% increase in undeployed capital.

With increased demand for portfolio diversification, it is impossible to ignore the value-add that private debt offers Canadian investors. Whether they seek involvement in the private debt market as an add-on to their suite of investment types, or as the primary form of lending, smart Canadian investors are getting more involved. For borrowers, finding the right private debt partner can be the game changer they need to get their business back on track, or to accelerate their company on a path of growth.



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Contact us at
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