MARBLEGATE

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Dragged Out to Sea: The Ongoing Stress and Distress in the U.S. Middle Market – an Update to 2023's *"Riptide: The New Era of Acute Financial and Operating Stress in the U.S. Middle Market"*

Key Takeaways:

- This update to our analysis of data from RapidRatings, a leader in supply chain risk analytics, confirms the ongoing collapse in margins, surging leverage and deteriorating solvency of middle market companies anticipated by our prior research.
- At current leverage ratios, the average middle market company is likely near violating or already breaching covenants and struggling to service their debt. This reality could begin to compromise the broader economic momentum that has been sustained despite higher rates and lingering inflation.
- The new data underscores the investment opportunity in middle market credit driven by the need to reorganize the capital structures and operations of borrowers and drive corporate turnarounds in a challenging operating climate.

Beyond the Break

"As predicted, new data confirms a deterioration in the financial performance of private middle market companies due to the stark impact of elevated input prices, higher interest costs and growing debt burdens."

In the following pages we update our white paper, "*Rip Tide: A New Era of Financial and Operating Stress in the U.S. Middle Market"* (request a copy here) to include full-year 2023 data. Building on our original paper, we partnered with RapidRatings, a leader in supply chain and counterparty risk assessment, to uncover the devastating effects of high inflation and the increased cost of capital on the financial health of U.S. middle-market companies. We compare this to the relatively strong performance of their larger public market peers. As predicted, new data confirms a deterioration in the financial performance of private middle market companies due to the stark impact of elevated input prices, higher interest costs and growing debt burdens. Conversely, it highlights the overall resilience of the larger public companies who have benefited from low-cost capital and the ability to pass on costs to their middle market suppliers or to consumers (Exhibit 1).

Exhibit 1: Summary Findings 2019 vs 2022 & 2023[1]

	2019 vs 2022		2019 vs 2023	
	Middle Market	Public	Middle Market	Public
EBITDA	-24%	+18%	-39%	+16%
EBITDA Margins	-25%	-2%	-38%	-6%
NPAT	-79%	+33%	-233%	+27%
Total Liabilities	+23%	+1%	+45%	+5%
Leverage	+62%	-14%	+139%	-9%
Imp. Rate on Debt	-12%	-11%	+44%	+8%
Interest Coverage	-33%	+35%	-73%	+9%

Along with our original data, we analyzed previously inaccessible full-year 2023 financials gathered by RapidRatings of over 1,200 non-financial private middle market companies valued between $100 million and $750 million based on sales revenue. We compared this with the data of approximately 2,200 non-financial companies within the Russell 3000 Index from 2019 to 2023. This cohort of public peers was screened to eliminate companies that had less than $750 million sales revenue, corporate headquarters outside the United States, trade on a non-U.S. exchange, report in non-USD currency or reported no revenue between 2019 and 2023.

Among each cohort, we looked at trends in the following financials figures and ratios:

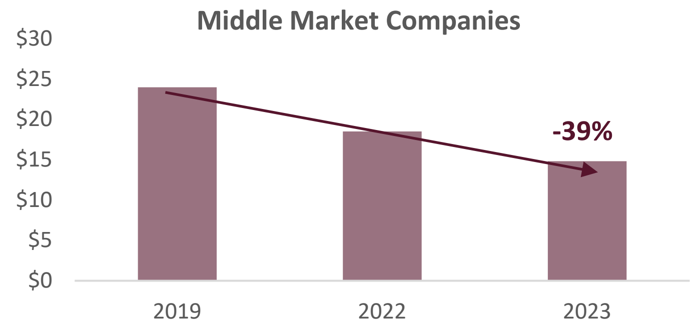
- EBITDA, EBITDA Margins, and Net Profit After Tax (NPAT) to measure earnings power and vulnerability to weakening demand or higher input prices.
- Total Liabilities, Leverage, and Cost of Debt to understand trends in solvency.
- Interest Coverage Ratios to understand the impact of higher interest rates on debt service.

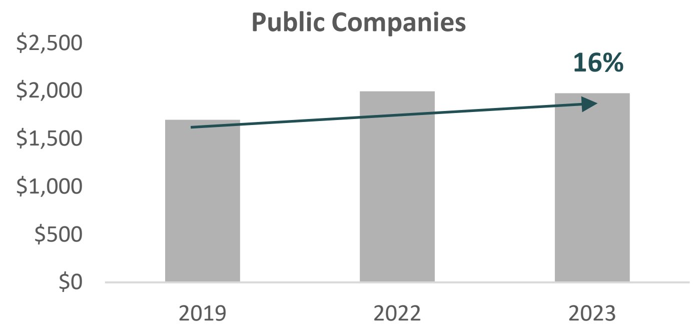
That Sinking Feeling

"Most market participants and the financial media focus their attention on and draw broad conclusions regarding markets from the better performing public companies. This limited perspective overlooks the real and present risks among middle market companies."

As opposed to a crisis with a clear inflection point, the scope and scale of problems among U.S. middle market companies are likely to be a steady but meaningful drag on the U.S. economy. Most market participants and the financial media focus their attention on and draw broad conclusions regarding markets from the better performing public companies. This limited perspective overlooks the real and present risks among middle market companies. As economic growth moderates and cost cuts or pass-throughs at public companies reach their limits – the distress in the middle market could slowly ripple outward. In short, as main street American businesses are submerged under high costs and unmanageable liabilities, the Wall Street-backed companies of the ticker tape economy will likely find themselves out to sea with broken supply chains that could undermine the relatively strong economic growth that has persisted despite higher policy rates and lingering inflation.

Exhibit 2: EBITDA[2,3] (millions)





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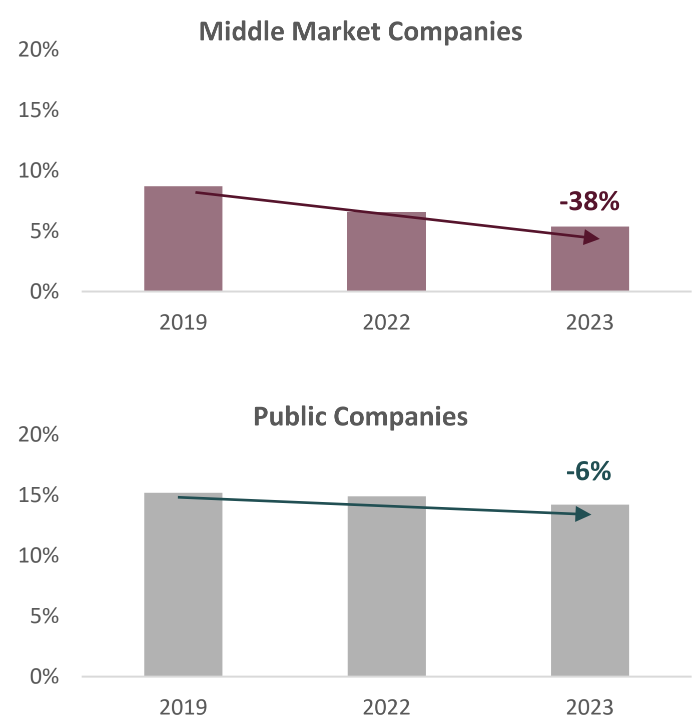
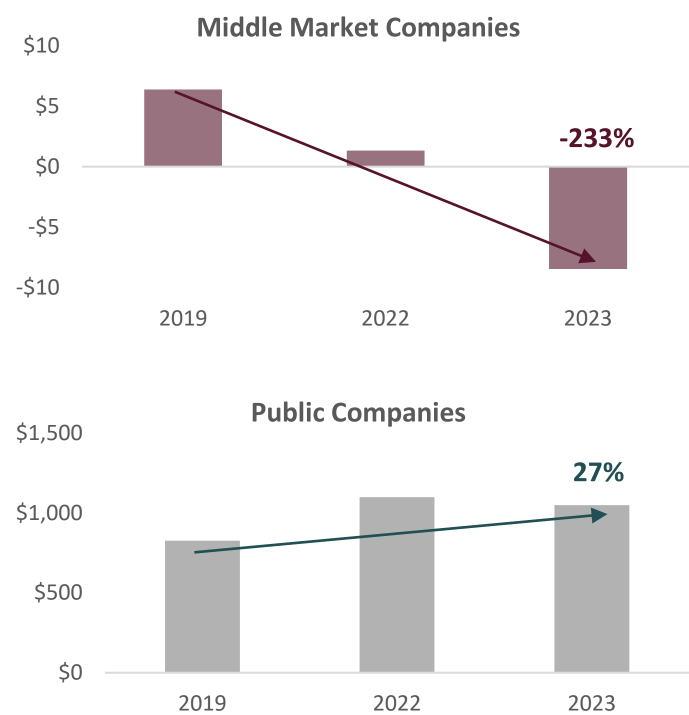
Average EBITDA for middle market companies plummeted 39% from 2019 to 2023 extending the decline we observed in the period from 2019 to 2022. In contrast, public companies enjoyed a solid 16% growth in EBITDA from 2019 to 2023, though momentum softened in 2023. In fact, across most metrics, public companies' absolute performance was weaker year-over-year than the period from 2019 to 2022 yet it remained significantly stronger than their middle market counterparts. While the middle market struggles with the persistent erosion of earnings power, their larger peers continue to operate from a position of relative strength.

Exhibit 3: EBITDA Margins[2,3]



Undoubtedly, public companies are weathering the storm considerably better than their middle-market counterparts. While public companies experienced a manageable 6% decline in EBITDA margins (Exhibit 3), middle-market margins plummeted by a staggering 38% – more than six times greater. This dramatic decline for middle-market companies likely reflects a combination of higher input costs, increased debt service expense and limited pricing power. As a result, Net Profit After Tax (NPAT) (Exhibit 4) for middle-market companies has collapsed, suggesting decreasing efficiency and higher overall costs. This trend signifies a growing risk of financial distress for many middle-market businesses. Conversely, public companies have demonstrated stronger cost controls and maintained profitability despite some moderation in growth compared to pre-2022 levels.

Exhibit 4: Net Profit After Tax[2,3] (millions)



Plunging profitability and rising liabilities will prove to be a toxic combination especially while interest rates remain high. As earnings sank and margins shrunk, the average private middle market companies' liabilities surged 45% (Exhibit 5). Public companies, in contrast, saw a more modest increase in liabilities easily outpaced by earnings growth despite margins narrowing. The financial strain on middle market companies is also evident in leverage ratios (Exhibit 6). With EBITDA declining by nearly 40% and total liabilities growing by approximately 45%, private middle market companies' financial leverage has exploded to astronomically high levels. At these current leverage ratios, the average middle market company is likely near violating or already breaching covenants and struggling to service its debt. On the other hand, public companies' growing earnings and relatively flat liabilities led to a 9% improvement in total debt–to–EBITDA ratios.

Exhibit 5: Total Liabilities[3,4] (millions)

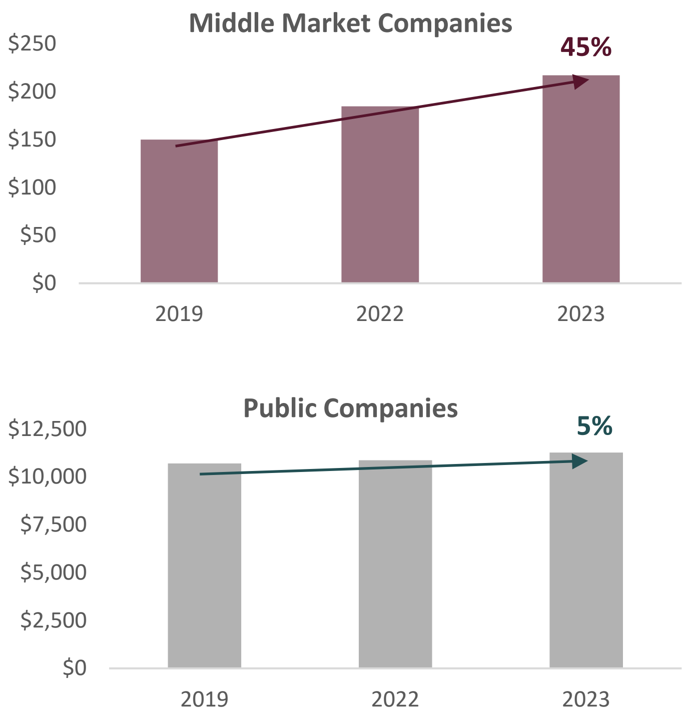
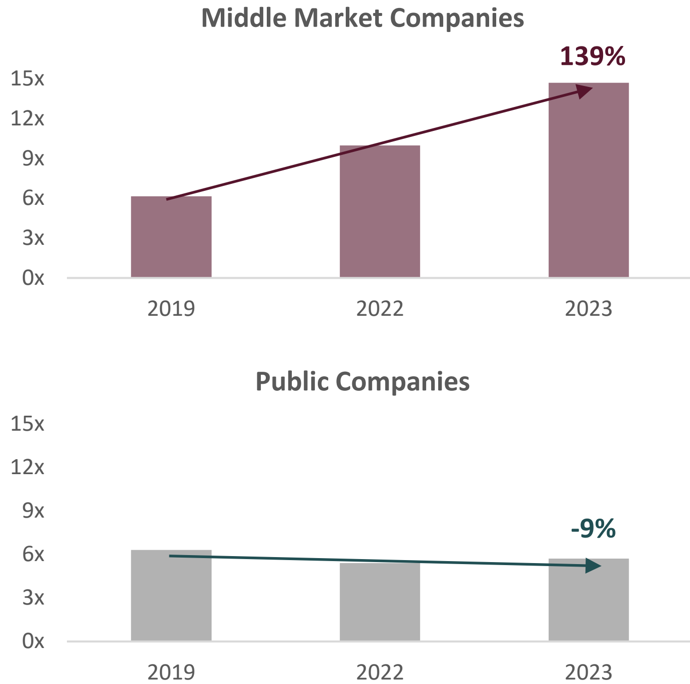


Exhibit 6: Leverage[3,4] (Total Liabilities to EBITDA)



Our original analysis estimated that borrowing costs for middle market companies who rely principally on floating-rate bank debt would potentially increase more than 50% by 2023 due to rising interest rates. The new data confirms this trend revealing an approximate 44% jump in costs raising the average implied rate of debt (Exhibit 7) to over 10% in 2023, in line with our estimates. Our earlier analysis also indicated – and subsequent data confirms - that public companies' cost of debt would remain low given their access to long-term fixed rate financing that had been available in the bond markets prior to the beginning of the Fed's hiking cycle.

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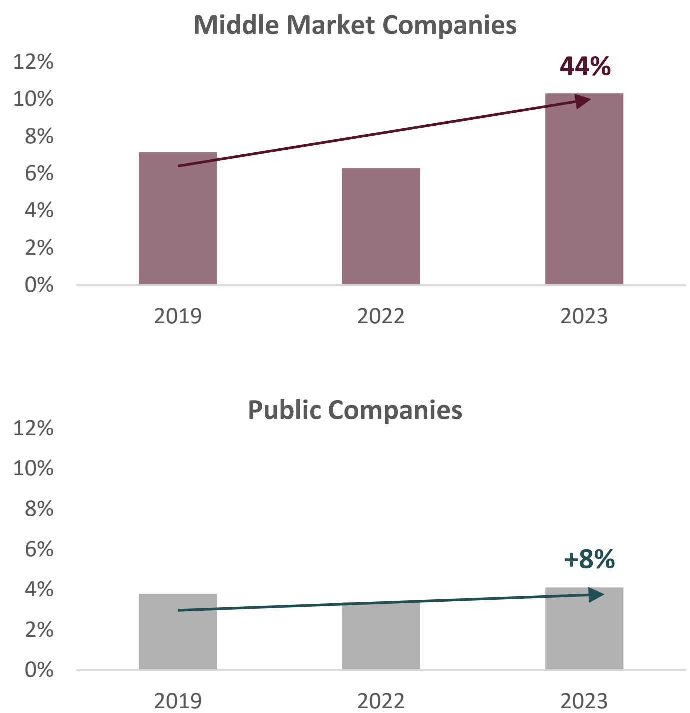
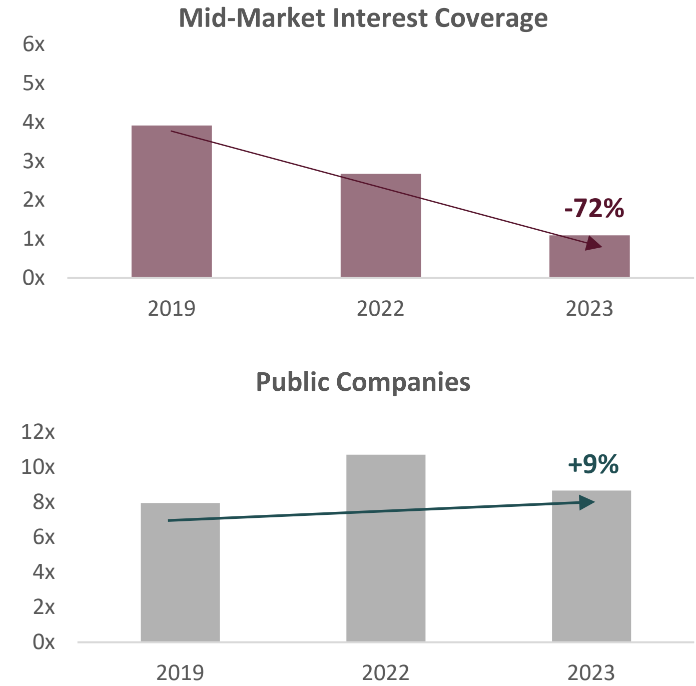
Exhibit 7: Implied Average Rate on Debt [3,4]



Middle market companies' ability to service their debt has declined at an accelerating pace. From 2019 to 2022, the Interest Coverage Ratio for middle market companies fell by 33% from approximately 4.0x to just over 2.5x. According to data from Professor Aswath Damodaran of NYU's Stern School of Business, this suggests a decline in coverage from that of a BB-rated company to a Single-B credit during that period.[4] The impact of interest rate hikes took an additional toll in 2023 pushing middle market companies' average interest coverage ratio down to an alarming 1.0x - a decline of over 70% since 2019. This is equivalent to a CC-rated credit[4], or a company on the brink of insolvency. At such a coverage ratio, middle market companies are unlikely to be able to maintain their current indebtedness without amendments, waivers, or default.

Exhibit 8: Interest Coverage Ratio[3,4]



Said differently, the average middle market company simply cannot pay its bills without resizing their debt or changing the cash payment terms, and a large and growing group of companies are nearing insolvency. In 2023, nearly 25% of the companies analyzed already had a coverage ratio below 1x[3]. With base rates remaining stubbornly high and labor and input prices elevated, this cohort of companies with less than 1x coverage will likely increase in the coming quarters as earnings continue to decline at the pace witnessed from 2019 through 2023 leading to a wave of restructurings. Conversely, public companies have maintained relatively healthy coverage ratios as their liabilities grew only slightly and their cost of debt remained relatively flat.

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A Long Way to the Shore

"After decades of free money where many decisions carried no cost, these same decisions – staffing, CAPEX, technology – today, carry ever higher costs and with them greater consequences."

The 2023 full year financial data from RapidRatings show a continued decline in earnings power and solvency for middle market companies. Though hopes of Fed rate cuts may have recently offered some temporary respite to struggling companies, persistent high rates and stubborn inflation will likely continue to pressure financial results and operational flexibility. Declining EBITDA, shrinking margins, eroding profitability and unsustainable indebtedness will drive scores of middle market companies into restructurings. Undoubtedly, large numbers of middle market companies are teetering on the brink of insolvency, grappling with financial and operating challenges.

A company's finances are generally a reflection of its management's decisions. Ballooning leverage and weak interest coverage are as much a product of the size of a company's indebtedness as it is management's ability to effectively generate revenue and manage costs. After decades of free money where many decisions carried no cost, these same decisions – staffing, CAPEX, technology – today, carry ever higher costs and with them greater consequences. Given the profound shifts in labor and financial markets over the past four years, many middle market companies lack the skill or experience to manage in such an environment thereby undermining their ability to survive and thrive. Right sizing financial liabilities in the absence of improving the operational performance will simply not be enough to save many good companies beset by misfortune or misallocated resources. In fact, for most middle market companies, financial restructuring alone is the equivalent of being far from shore with a flotation device but without the skill or stamina to swim – in the absence of outside intervention, survival remains highly uncertain.

During this period of grinding dissolution, investors who can address the unique financial and operational challenges facing middle market companies will find attractive investment opportunities among critical links in larger supply chains or among leaders in niche industries that often go overlooked. The tools and techniques of distressed investing will remain as relevant as ever, as will hands-on operational professionals who can identify and prioritize the levers of value to turn around struggling businesses. These investments can produce attractive returns that capitalize on the problems plaguing middle market businesses in a prolonged era of financial and operational stress.

About Marblegate

Marblegate Asset Management is an alternative investment firm specializing in middle market private credit and special opportunities. With more than $2.5 billion in assets under management, Marblegate invests in troubled middle market assets sourced directly from banks and other firms. We utilize in-house financial and operational restructuring expertise to turnaround troubled companies and to provide agile capital solutions and organizational leadership. Marblegate provides investors with unique exposures and outcomes uncorrelated to traditional distressed and private credit funds. We transform complexity to create value.

Andrew Milgram

Andrew Milgram is Managing Partner and Chief Investment Officer of Marblegate Asset Management.

Andrew co-founded Marblegate in 2008, building a firm that has established itself as an industry leader in distressed investing and special situations. Andrew also serves as CEO of Marblegate Acquisition Corporation and is currently Chairman of the Board of Millennium Health, Ancora Education and PSS Industrial. In addition, he serves on the board of Britax Child Safety.

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In Collaboration with RapidRatings

RAPIDRATINGS®

RapidRatings sets the standard for financial health transparency between business partners, transforming the way leading companies manage enterprise and financial risk. The company provides the most sophisticated analysis of the financial health of public and private companies in over 140 countries worldwide. Through RapidRatings' FHR Exchange, an innovative and secure membership platform, businesses can build more meaningful relationships and gain visibility into the financial stability of global suppliers, vendors, and other third parties. Learn more at www.rapidratings.com.

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Footnotes:

1. All companies met specific financial guidelines including non-zero Sales Revenue and Assets to be included in the dataset. Underlying data is comprised of non-financial private and public companies in the United States rated by RapidRatings between 2019-2023 with sales revenue between $100mm and $750mm (Private) and greater than $750mm (Public) which was anonymized and provided on a secured server.
2. Source: RapidRatings International, Inc. (https://www.rapidratings.com/). Underlying data is comprised of non-financial private companies in the United States rated by RapidRatings between 2019-2023 with sales revenue between $100mm and $750mm which was anonymized and provided on a secured server. Analysis of the data was performed by Marblegate Asset Management and reviewed by RapidRatings. Companies rated by RapidRatings International can drop from their client base at any point in time and are not static in relation to this analysis.
3. Source: RapidRatings International, Inc. (https://www.rapidratings.com/). Underlying data is comprised of non-financial public companies in the United States rated by RapidRatings between 2019-2023 with sales revenue greater than $750mm which was anonymized and provided on a secured server. Analysis of the data was performed by Marblegate Asset Management and reviewed by RapidRatings. Companies rated by RapidRatings International can drop from their client base at any point in time and are not static in relation to this analysis.
4. Professor A. Damodaran, NYU Stern https://www.stern.nyu.edu/~adamodar/pc/datasets/margin.xls