PRIVATE CREDIT CONNECTIONS

From The Insider's View

Adam Pollock, a managing director at Stellus Capital Management, shares his thoughts on how the private credit landscape has evolved these past few years and the opportunities and headwinds for this asset class in 2025.

How has the competitive landscape for private credit evolved over the past few years?

Private credit as an asset class continues to mature, becoming more defined and accepted in the world of alternative investing. The market trends we recognized when forming our business in 2004 have accelerated over the past three to five years, making this space more attractive. Namely, middle-market businesses continue to provide the growth engine for our country, and regulated banks that once served this segment have largely disappeared, providing an entrée for private credit/direct lenders to fill the void.

As a result, private credit competition has increased as the asset class has matured, particularly at the upper end of the middle market (companies generating >$30 million of EBITDA). Stellus' sweet spot has and continues to be private equity-sponsored, lower-middle-market ($5 million-$30 million of EBITDA) deals where there is less competition and where we see significant private equity capital overhang (~$243 billion of dry powder) relative to lower-middle-market-focused direct lending capacity (~$26 billion).

Adam Pollock

Company & Title: *Stellus Capital Management, LLC ("Stellus"), Managing Director*
Education: *B.S.E. in mechanical engineering from Tufts University and an M.B.A. from McCombs School of Business at The University of Texas at Austin*
Current City: *Houston*
Fun Fact: *I suffer from wanderlust (i.e., I am an avid traveler), which means I've traveled to 49 states and over 50 countries. Further, I can order a beer in multiple languages!*

Private equity funds are strongly incentivized to deploy capital, which should drive strong market activity. Along with less competition in this end of the middle market, we (believe it or not) still find that relationships matter when choosing a capital partner. Private equity firms typically have three to four key lending relationships with whom they share most of their flow.

Regardless of overall market dynamics, we are still finding great opportunities to invest, and where appropriate, we are partnering with other direct lenders (in smaller club deals) and well-heeled commercial banks on unitranche products.

What trends are you seeing in deal flow and transaction volume in the lower middle market?

Clearly, uncertainty related to tariffs has caused some hesitancy and caution in the broader markets. However, a more stable interest rate environment combined with significant private equity "dry powder" continue to drive deal activity around quality assets. We saw a marked increase in 2H 24 activity that has carried over into FY 25. Overall deal flow is up about 30 percent year over year; however, the number of "actionable" opportunities still leaves something to be desired. We remain optimistic about the balance of the year based on our conversations with bankers regarding their deal backlog and an expectation that we gain more clarity around the macro environment over time.

How do you assess and manage risk in your portfolio? Has that changed at all in the past few months with some of the political and economic uncertainty/volatility?

As an asset class, private credit has performed well across macroeconomic cycles and other exogenous events, with the Cliffwater Direct Lending Index producing an annualized 9.4 percent return (unlevered, gross of fees) since 2004.

Our team has invested across multiple macroeconomic cycles over the past 20-plus years. While our approach has largely remained unchanged, we have continued to refine our portfolio construction by incorporating lessons learned which, in turn, has resulted in a portfolio with minimal default rates. Simply put, we focus on providing senior secured loans (top of the balance sheet, low leverage, robust covenant packages and tight documentation) to private equity-backed platforms (well-capitalized) that generate good cash flow (provide a good return of and on our capital).

We try to manage deal risk upfront through (i) detailed diligence (alongside our private equity partners), (ii) underwriting designed to "always expect a downturn" near term, and (iii) tight structuring that gives us an early seat at the table in the face of underperformance, prior to material risk to principal.

Post-close, we actively manage our portfolio, frequently interacting with our private equity partners and management teams to stay apprised of performance and ready to respond to any situation. While rarely needed, my partners and I have approximately 50 years of cumulative restructuring and workout experience that allows us to act quickly and the ability to take over operations and manage troubled portfolio companies to positive outcomes.

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> *– Adam Pollock*

What do you see as the biggest opportunities for private credit funds in the lower middle market over the next one to two years?

We see great opportunities to grow our current platform, as we are one of a few long-tenured active direct lenders in this end of the market. The trends that put private credit on the map over the past 20 years are still accelerating, making this an exciting and relevant place to invest.

About Stellus Capital Management

Stellus Capital Management ("Stellus") is one of the longest tenured direct lenders specializing in senior secured loans in the lower middle market. Formed within the D.E. Shaw Group in 2004, Stellus spun out in 2012 and today manages $3.4 billion across various investment vehicles, including closed-end institutional funds, a public BDC (NYSE: SCM) and a perpetual non-traded private BDC. Stellus is a single-strategy firm and its founding partners have been investing together in the lower middle market for 20-plus years with a track record of $9.8 billion deployed across more than 360 transactions. Stellus is headquartered in Houston, TX with offices in the Washington, D.C. area and Charlotte, NC. Learn more at www.stelluscapital.com.

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Our team is comprised of lawyers based in key financial centers throughout the U.S. and abroad, including Charlotte, Dallas, Denver, Houston, London and New York.

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