Twin Brook's Drew Guyette on Current Market Conditions

Drew Guyette
Partner and Chief Credit Officer, Twin Brook Capital Partners

Drew Guyette joined Twin Brook in 2015 as a Partner and Chief Credit Officer in the firm's middle market direct lending loan business. Prior to joining Twin Brook, Drew had been with Madison Capital Funding LLC, a wholly owned subsidiary of New York Life Investments, since 2007. Drew's primary responsibilities at Madison Capital included structuring, underwriting, negotiating, and managing client relationships, where he focused on generalist and technology transactions with middle market private equity sponsors. Additionally, Drew managed one of Madison's Underwriting Teams of professionals. Prior to joining Madison Capital, Drew held a variety of positions at MB Financial Bank, N.A., including underwriting, portfolio management, and new business development. Drew received a B.S. in Finance from the University of Illinois, Urbana-Champaign.

How has Twin Brook's approach to underwriting credit changed in light of increased fundraising in the private and direct lending space?

For the senior professionals at Twin Brook, our approach hasn't changed. We as a group have been working together for 10 to 15 years, including the last three years at Twin Brook, but that experience has been primarily concentrated in the lower middle market and lending to PE firms looking to acquire sustainable, well-established cash-flow businesses. Over the last 15 years of our careers, we've implemented a thorough, consistent underwriting approach through multiple credit cycles, where other competitors have come and gone and offered different lending approaches. So part of our advantage is that our approach to underwriting and credit has already been tested and proven during these different market conditions. We've always focused on identifying core middle market borrowers with an established value proposition, a history of sustainable cash flow, barriers to entry and a niche presence. The underwriting approach has to start with company selection and lending experience to a broad array of industries. In addition, our credit process includes a concerted focus on underwriting to the PE firms that we work with. We look to understand where they are in their fund lifecycle and their respective growth strategy for the investment to really ensure the borrower's core attributes match up to those of the PE fund.

We aren't experiencing much in the way of increased competition. Much of the fundraising that we've seen take place exists in the upper ends of the middle market, or even in the larger market, where it's easier to access loans via participation. The reality is that our part of the market is highly fragmented and relies on established relationships. Critical decision-making factors for PE firms include execution and relationships; existence and presence of capital aren't large enough components for someone to break through and garner much market share.

Has portfolio monitoring changed?

On the portfolio side, our approach remains very intense and rigorous. The types of borrowers we work with are providing us regular monthly and quarterly financial statements and financial performance covenants, the last of which is important to our credit profiles and structures. We haven't experienced sensitivity or softness in our portfolio, which has much to do with the diversification of the portfolio and backing market-leading PE groups. We are a generalist firm with some sub-specialties; we have a very diversified set of end markets that we lend into, with no unique industry representing an outside concentration. So we're not seeing sensitivities on that side. The nature of the types of borrowers and growth strategies that we underwrite are generally acquisitive in nature. A PE firm will make an investment in a platform company with a growth strategy of bolt-on acquisitions or de novo expansions, so each time they come to us with a new opportunity to acquire, that gives us the ability to reevaluate the initial platform business as well as perform a deep-dive on the targeted business being acquired. To summarize, on the portfolio monitoring side, not only are you going through the regular blocking and tackling of monitoring the borrower, but evaluating additional credits generated by the portfolio's acquisitive movements. Growth through add-ons represents the majority of the investment thesis for PE firms in our portion of the market. Over 65% of our borrowers have made an acquisition since the time we've closed the initial transaction.

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How are documentation terms and covenants influenced by today's market trends?
We certainly see some pressure as it relates to credit terms and covenants, however, the vast majority of the movement toward a borrower-friendly market is occurring in the larger markets. Specific to the lower middle market where we exist, all our borrowers still have two to three financial covenants, so we aren't seeing any pressure in that respect. The concept of financial covenants is very important to what we do in terms of our approach to creditworthiness, overall quality and monitoring. These financial covenants are one of the most important things in allowing us to get back to the table with the borrower and PE firm before a more serious deterioration develops. When a borrower first shows signs of distress, the financial covenants allow all parties of the capital structure to have a dialogue on the appropriate plan of action. We have observed in the larger market more single-covenant and covenant-lite transactions.

When it comes to documentation, what we've seen in the larger market—or the broadly syndicated market—is a more aggressive push for looser ways to define key terms associated with those covenants. We've seen PE groups push further for broader definitions of EBITDA or more creative EBITDA adjustments. In the lower middle market, we continue to push back against that trend. Your percentage of adjustments used to calculate EBITDA and your ability to determine how much of that is cash EBITDA are both incredibly important. Where you see aggressive documentation terms occur in the larger market is the usage of an inflated EBITDA concept at the time of close, as well as putting a lot of assumptions and projections into the EBITDA number. We're not seeing that on the lower side of the middle market.

Furthermore, our core value for PE firms is our ability to execute flexibly alongside them as they pursue their growth strategy. We're insulated from many of these watering-down concepts that take place in the larger market, where you're striving for the highest leverage and lowest yield associated with your debt. In our market, relationships and execution are much more valuable.

Are stretch senior and unitranche structures continuing to take market share from traditional third party structures?

We do see an increase in senior stretch and unitranche structures across the board. Specifically for Twin Brook, we continue to focus primarily on senior stretch while avoiding unitranche structures. There's more dialog in the larger market that has crept down to the middle market regarding unitranche structures, but we haven't participated in these deeper-levered unitranches. That is evidenced by where our average attachment is, which tends to be around four times or four-and-a-quarter times for our senior profiles, coupled with where our loan-to-values are in relation to the enterprise ratio, which is still well below 50%. So we aren't participating as much in deeper unitranche structures, but the senior-only and senior stretch remains popular in general, primarily because it's easier to execute with one lending partner.

Moreover, in these unitranche structures, we're still seeing a number of split-lean and bifurcated structures, which is an area that we don't participate in. By splitting the lien, we think you're introducing an increase in the risk profile associated with the credit. Since we provide the revolver tranche for all our transactions, part of our credit and underwriting thesis is to take the first-dollar exposure on all our transactions. It has been our experience through multiple credit cycles that simply trying to increase the economics of a particular deal by selling off the revolver and creating a split-lien structure introduces an added level of risk. We prefer to control the liquidity and revolver fundings for our borrowers during times of distress.

Is the firm experiencing structuring pressure on leverage and pricing?
There's always some level of pressure, but execution, structure flexibility and long-term relationships are the key decision-making factors for our clients. As the market continues to observe an increase in overall enterprise values, we're not seeing leverage move up in lockstep. Our senior profile attaches at roughly the same leverage multiple, even in light of increasing enterprise values. You're always going to feel some degree of pressure on pricing, but more of that is in larger, upper middle market, or broadly syndicated loan markets, whereas the lower middle market remains fairly insulated.

What recent trends have you seen in your portfolio?
We still see strong underlying fundamentals with all of our platforms, which speaks to the benefits of our approach in general, especially in picking good PE partners. Our portfolio remains very acquisitive. About 30% to 40% of our activity is driven by add-ons, with the balance being origination work to expand the portfolio. There are pockets and strategies that lend themselves to roll-ups by PE, specifically vision, dermatology and orthodontia practices in healthcare. That is largely because it is a very fragmented, unique business model predicated on location. There is no broader theme at a macro level for the PE firm regarding add-ons—it is very sub-sector specific.

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