The mechanics of mid-market lending

The investment professionals at Twin Brook Capital Partners, which targets transactions involving a financial sponsor, maintain there are many benefits to working with private equity firms. Richard Christensen, Grant Haggard, and Faraaz Kamran, partners at the Chicago-based firm who focus on originating deals, along with Chris Williams, partner and co-founder (along with Trevor Clark), discuss the mechanics of mid-market financings; from origination and diligence to portfolio management

Q How do mid-market lenders source transactions, and what's important in that process?

Haggard: For us, it starts with established, historical relationships [with private equity sponsors]. We've closed deals with over 225 different sponsors and multiple transactions with most of these firms. These relationships have been built up over many years through multiple credit cycles. Really, the goal on the origination side is to cast as wide of a net as we can with these known sponsors so we can see as many deal opportunities as possible. This is critical when looking to maintain a highly selective process on the underwriting side of the business.

Through meeting with the different firms and analysing transactions, we've built strong, long-lasting relationships. Keeping in mind that all elements of the process are synergistically important – attending deal trips, evaluating different opportunities, the diligence process and ultimately closing multiple transactions. The sponsors rely on you to be there during every step of the process through the closing of their deal.

Q What is it that mid-market lenders such as yourselves look for when you're sourcing that transaction?

Haggard: There's a lot of credit attributes we are looking for in a particular opportunity. Size and type of transaction, along with the industry the company participates in are important. Different credit attributes such as customer diversification, supplier diversification, strong, stable, healthy historical cash flows and real barriers to competition, barriers to entry around the business.

"A COMBINATION OF CLOSING 1,200+ TRANSACTIONS OVER THE LAST 15 YEARS OF OUR CAREERS AND OUR BROAD EXPERIENCE ACROSS MANY DIFFERENT INDUSTRIES CREATES A COMPETITIVE ADVANTAGE"
Richard Christensen

Richard Christensen

Q What is a mid-market lender's due diligence process like?

Haggard: Our typical diligence process is approximately 60 to 90 days. We work hand-in-hand alongside the private equity sponsor, in addition to doing our own third-party work and diligence. Overall, it's a very detailed and active process from start to finish.

One of the things we like most about the lower middle market is that we're able to work directly with the sponsor and the level of access we get with the underlying management teams of potential borrowers. The process really begins with reviewing the offering memorandum. If you qualify the opportunity as a result of this process, you'll go out and meet with the management team for a diligence session.

From there, diligence shifts to a micro level; reviewing the data room and third-party reports, including industry reports, customer calls, accounting reviews, etc., that we have access to in the process. When you think about the sheer number of transactions we have closed over the last 15 years of our careers (1200+), there is a lot of leverage we can gain from historical knowledge and experiences within certain industries. This allows us to work efficiently and effectively.

Q Do most private equity firms mandate a separate approach to the due diligence process, and if so, does that effect Twin Brook's diligence procedure?

Haggard: The diligence process is relatively consistent across different sponsors. We have industry expertise in multiple verticals (healthcare, insurance and financial services, aerospace and defense and software services) that may dictate certain changes in the process but, for the most part, we conduct a similar detailed process for each and every transaction opportunity.

Q How are mid-market deals managed?

Christensen: The transactions we're financing are generally actively managed businesses whereby the sponsor has determined a growth or investment thesis to build value in the company. Most of the transactions we are financing are platform companies for the sponsors. These are active investment strategies, such as a buy-and-build strategy whereby they are identifying potential acquisition candidates, to build-out a product or market expansion strategy.

As we complete our diligence alongside the sponsor, we're actively working with them, understanding what the investment thesis is and how it is going to be executed on by the sponsor and by the lender group. Is this something that can be executed on with the existing management team or are there additional resources needed? It's important for us as a lender to know how we need to structure the transaction in order to provide capital to support the strategy – that may involve acquisition lines, delayed draw term loans, etc., financing capabilities that provide the necessary capital for additional investments.


Grant Haggard

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When we enter transactions, trust between the sponsor and the lender is critical to success. It is impossible to account for everything in a legal document. Therefore, the sponsor likes to work with a lender that understands basic credit and how to get things done in an efficient manner.

The last thing a sponsor wants is to get into a transaction and three months later, the lender is either out of capital or they are no longer supporting a potential add-on or the investment thesis. Bottom line, missing out on an acquisition [the sponsor] wants to close quickly or possibly not having the ability to execute other areas of their growth strategy can be very costly. Most of our sponsors will end up having two to three core lenders they turn to for almost every transaction. The cost of non-execution is too high to risk working with inexperienced lenders.

Q And how do you make sure you're in that three-person Rolodex?

Christensen: Time and experience. We have closed deals with over 225 PE firms because of the depth and experience of our team. We provide quick, timely feedback up front and let the sponsor know if it's an investment thesis we can get behind. A combination of closing 1,200+ transactions over the last 15 years of our careers and our broad experience across many different industries creates a competitive advantage. The sponsors have trust in us. They need to trust that we are going to work efficiently through the entire diligence process (60 – 90 days) and ultimately be there when it is time to close the transaction.

Williams: You asked what makes them choose certain lenders over others in a business in which, at the end of the day, money is a commodity. Basically, it starts and ends with experience and execution.

For an equity firm to have the lender not deliver on what they said they were going to deliver, to change any terms, to not be supportive, is a big deal. It's not just execution at the initial closing of the deal, but it's also execution [of] whatever growth strategy there is, whether it's build-on acquisitions, capital expenditure flexibility, or building a new plant or adding a product line.

I think experience in the space is invaluable to PE firms. They highly value a lender that has been there before, someone who has been their lender through not only good times but also difficult ones as well.

When there's a hiccup, there's a cycle – many of our clients have been through multiple [credit] cycles with us. They've seen how we behave, they've seen how we've been supportive – but also how we've been fair. Ultimately, I think that's how they choose the lenders they trust, the lenders they go to all the time – it's experience and execution.

Q Are a lot of the deals you guys see run through a publicised auction process or are a lot of them proprietary?

Christensen: It's really a mix. A good piece of our business is comprised of broadly auctioned deals; however, there's also a piece where our clients are originating their own proprietary opportunities.

You have sponsors who are actively following an investment thesis, so they might have a target vertical or industry they want to build around. They're looking to find a platform company whereby they can build out that investment thesis. We'll get those in addition to the broadly auctioned opportunities. We also see instances where a deal is only being shown to a small group of firms in a limited auction format.

We see a lot more non-auction activity via portfolio add-ons. [Sponsors have] a portfolio company, it's their platform and they're out executing add-ons that are a little smaller, which they can actively source on a proprietary basis. It's really a broad mix.

Q What are the ways that mid-market lenders look to construct all their investments; what are some of the factors they take into account?

Kamran: I think we start out generally with a pretty good, diversified mix of sponsors, in terms of market and industry focus. As previously mentioned, we have specialised industry verticals in healthcare, insurance and financial services, aerospace and defense and software services. The key for us is diversifying across all fronts. We diversify not only by the industries we invest in but also by the different PE firms we close deals with and individual position sizes.

Faraaz Kamran

"OVERALL, WE THINK THE PE SPONSOR BACKED COMPANIES ARE THE RIGHT PLACE TO BE: MORE DILIGENCE, MORE GOVERNANCE, CAPITAL SUPPORT, EXPERTISE IN TROUBLED TIMES, ETC. AS A FIRST LIEN LENDER WE LIKE ALL THESE ATTRIBUTES"
Faraaz Kamran

Overall, I'd say our largest vertical is healthcare, accounting for approximately 15 to 20 percent of our overall portfolio. Healthcare is such a diversified industry. The investments we make within the sector are wide ranging – from physical therapy providers, medical device manufacturing, home healthcare, etc. Outside of healthcare, the balance of the portfolio is broadly diversified across business services, manufacturing, distribution, etc. As part of our underwriting thesis, we're mining for companies that have a good geographic and product diversification. It's just as important that the companies themselves are well diversified.

Q What are the benefits of sponsored deals versus non-sponsored deals?

Kamran: We're focused on working with private equity clients for many reasons. To start, the level of diligence performed by PE firms when contemplating an investment is very detailed. In addition to hiring top-quality third party diligence professionals, sponsors typically spend anywhere from $500,000 to $1 million on legal diligence for a target company. From our perspective, the credit has been 'diligenced' a lot further versus when a private equity sponsor is not involved.

Beyond that, I think post-close, our private equity clients usually supplement the management teams with additional resources, operating partners, etc. They have a large rolodex of people they can bring on as a supplement to the current management team, or they can bring on experienced executives as a board member and really provide strategic value. Lastly, if there is a hiccup – you find private equity [firms] working with management to right the ship, whether it's bringing in outside consultants, expertise or even capital, to redirect the vessel.

Overall, we think the PE sponsor backed companies are the right place to be: more diligence, more governance, capital support, expertise in troubled times, etc. As a first lien lender we like all these attributes. ■

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