Hot middle market lending environment comes with competition and new challenges

A Q&A with Twin Brook Capital Partners

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Jessica joined Twin Brook Capital Partners in 2015 and is a Director on the Capital Markets team. She is responsible for structuring, underwriting, documenting and syndicating leveraged finance transactions for middle market private equity sponsors.

Previously, Jessica was in the underwriting group at Twin Brook. Prior to joining the firm, Jessica held various roles at BMO Harris Bank, Antares Capital and GE Capital. Jessica earned a B.S. in finance and accounting from the University of Wisconsin-Madison and received an M.B.A. in finance and economics from the University of Chicago Booth School of Business.

2018 has set the economy on a new course. Recent legislative changes lowered corporate taxes; tensions among trade partners have stirred into the possibility of a trade war; and interest rates have risen. These shifts present challenges throughout the financial world, including the debt market, where lenders will have to adapt in order to succeed. Jessica Nels provides thoughts on how recent changes will affect the overall lending marketing, with a special focus on the middle market.

Thus far in 2018, what is your take on lending activity within the US middle market?

2018 has been a busy year. The beginning of the year was marked by deal flow carried over from the fourth quarter of 2017, particularly as the community questioned the impact of tax change. Since then, much of the activity has been driven by repricings, refinancings, and add-on acquisitions. We expect strong M&A activity through the remainder of the year. Senior stretch and unitranche are the favored structures utilized by sponsors given the ease of execution for the original platform and for future acquisitions to support the growth strategy. First-lien/second lien structures provide the most leverage for transactions with higher purchase multiples. However, given the rise in LIBOR rates, fixed-rate mezzanine debt is becoming more cost competitive relative to second lien.

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Before we get granular, what's your opinion of where we are at in the credit cycle and how that will impact middle market lending? What about broader economic trends?

2018 has been a strong year to date, and we expect positive performance through the course of the year. It seems everyone is on pins and needles waiting for a downturn based on where we are in the current credit cycle along with noise around inflation, interest rates, rising trade tariffs, and a potential trade war. You cannot mitigate an economic correction, however, you can back the right company, management team and sponsor, particularly those that have experience working through (and emerging from) an economic downturn. The senior professionals at Twin Brook have been focused on the middle market for the last 20+ years and have been through multiple cycles. We are not afraid of another downturn because of that experience. Unlike many new entrant middle market firms, we have invested in staff and resources that follow a "credit first" mentality in a both a down market as well as a bull market. We are committed to a long-term strategy. We strongly believe that the lower end of the market is in a much better position as it relates to the basic protections that exist in our credit agreements, which makes us far more resilient in the face of a market correction.

> *We strongly believe that the lower end of the market is a much better position*

Given the level of competition in the current environment, particularly with newer entrants into private debt, what do you think will help firms achieve differentiation?

The reality is that most of the new money we see coming into the middle market is directed to the upper end of the market. Why? This is where more syndicated transactions occur that require participants who are happy to play that role. New entrants are not staffed for a direct origination model, nor do they have the depth of sponsor relationships or years of experience in middle market cultivating those relationships. If you review the top 15 lenders in the middle market league tables, you will notice that all of those lenders have been in existence for more than 10 years. There are no new entrants that are taking share in the middle market. To that end, we believe what matters most are reputation, relationships, and the strength of the originations platform. As we continue to grow our portfolio and increase the number of relationships, being the incumbent is also meaningful. b. Across the Twin Brook platform to date, we are the Administrative Agent/Co-lead Arranger in 89% of our transactions. The incumbent lender has the advantage of knowledge of the business, familiarity with the management team, and speed of execution. In summary, Twin Brook's sponsor relationships and experience in the lower middle market, our role as an administrative agent, and our desire to stay focused on the same strategy that we have pursued for 15+ years differentiates us from a competitive perspective.

> *What matters most is reputation, relationships and the strength of the originations platform.*

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Within the middle market, are you seeing increased stratification across structures, terms and the like according to each segment, i.e. lower, core and upper middle market segments? If not, what are your conclusions?

We see the middle market divided up into three categories based on EBITDA size. First, the upper middle market we define as borrowers with greater than $40 million of EBITDA. This segment of the market is effectively a broadly syndicated loan (BSL) market, i.e. cov-lite transactions, very loose structures (negative covenants, EBITDA definitions, etc.), arrangers that negotiate credit agreements but hold less than 10% of the paper, broadly distributed and, in this market, oversubscribed resulting in yield compression. Second, the core middle market, is generally comprised of issuers with EBITDA between $25 million and $40 million. This segment of the market tends to have a single covenant but generally at large (35%-40%) cushions with little to no step-downs (commonly referred to as covenant-wide). The core middle market tends to derive its credit agreements from the BSL market, so the overall protections are weak. Finally, the lower middle market (where Twin Brook focuses) is dramatically different in terms of overall structure and financial covenants (multiple covenants with lower cushions and step-downs). The credit agreements are much tighter than the aforementioned segments of the market and arrangers typically hold 50%-100% of the transaction. The yield on these deals reflects the size of the issuers but more importantly there tends not to be the bake-off or auction-type process that dictates the pricing in the core and upper middle market.

> *Twin Brook maintains its credit discipline and prides itself on being highly selective*

What concerns you the most when you consider what could impact your firm's prospects in the rest of 2018?

The primary challenge that any lending firm has in a "hot" credit environment is that there are far more sub-optimal transactions that come to market. When (i) leverage markets are awash with money, (ii) PE firms are eager to deploy capital, and (iii) purchase price multiples are at an all-time high, these weaker borrowers stand a much better chance of trading and/or getting financed. The outcome of this is that we need to say "no" more often to our sponsors or possibly deploy resources triaging deals that we would not normally spend time on. Twin Brook maintains its credit discipline and prides itself on being highly selective, generally booking less than 4% of the transactions it sees in any given year. The flood of weaker deals can put pressure on resources and underwriting bandwidth.

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About Twin Brook Capital Partners

Twin Brook Capital Partners is a finance company focused on providing cash-flow based financing solutions for the middle market private equity community. The firm is managed by highly experienced, dedicated professionals who have successfully worked together throughout their careers at leading middle market lending institutions. Twin Brook's flexible product suite allows for tailored financing solutions for leveraged buyouts, recapitalizations, add-on acquisitions, growth capital and other situations.

Twin Brook focuses on loans to private equity-owned companies with EBITDA between $3 million and $50 million, with an emphasis on companies with $25 million of EBITDA and below. Since inception in the fourth quarter of 2014, Twin Brook has acted as Lead/Co-Lead Arranger on 89% of deals funded (2015-2018), acquired $5.8 billion of committed capital, and closed 195 transactions.

For more information, visit twincp.com