LOWER-MID MARKET

As larger players move in, the lower mid-market is getting more crowded. But having scale alone does not guarantee success, explains **Grant Haggard**, partner at Twin Brook Capital Partners

In recent years, the mid-market has been separated into the lower mid-market and the upper mid-market. Grant Haggard, partner, Twin Brook Capital, says their characteristics are wildly different and sourcing from the lower-mid market is crucial to avoid the greatest competitive pressures.

Q How has increased competition in the mid-market impacted the way deals are sourced?

The higher end of the middle market is seeing increased competition right now as some of the bigger players move in, trying to source deals within that space. Our focus is on the lower end of the middle market, which has been somewhat insulated from the competition and compression of terms that've dominated the higher end of the market. We spend the majority of our time working with companies between $5 million and $25 million of EBITDA, sourcing deals in this end of the market is much more relationship based. Therefore, you see fewer new entrants within it.

Having a strong originations team is essential to sourcing deals in today's market. Not only is it important that they have the ability to develop deep relationships, but it is also important to have a strong credit and underwriting background. It's important that they

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understand your credit culture and the kind of deals you're willing to do, as well as what your risk tolerances are. As a people business, building a team with the right culture fit is vital, and hiring and promoting from within can facilitate that.

At the larger end of the mid-market, relationships tend to be a little less important in sourcing deals and size, scale and credit terms are typically the differentiating factor. For example, how aggressive can they be on pricing or terms, or how much can they underwrite? As the larger market is also more liquid, it allows new entrants to penetrate this market much easier than the lower middle market.

Q Has the definition "mid-market" been distorted as larger players have sought to enter it? Is this creating a misleading environment for investors?

We've seen many of the bigger players seek to widen their ability to source deals by pushing into the mid-market. We're seeing firms describe deals as large as $100 million of EBITDA as being mid-market. These are often covenant light, syndicated deals that we would never consider to be mid-market, but that is how they're marketed. This is radically

WHAT SKILLSET IS NEEDED TO TARGET MID-MARKET BUSINESSES?

Twin Brook's Grant Haggard highlights the three core skill categories for lower mid-market managers that are raising the barrier to entry

Underwriting

The kind of companies you'll work with in the lower mid-market are often less sophisticated than bigger firms. This commonly manifests itself in the form of relatively patchy financial reporting, incomplete books and a general lack of concrete information on the company's circumstances. Underwriters need to develop the skills and a process to be forensic in the way we analyse businesses. In general, there's more heavy lifting involved in underwriting a lower middle market transaction compared with the larger market to ensure we have the information needed to make a proper credit decision.

Portfolio management

With smaller companies, effective portfolio management is a much more labour intensive process. You're working closely with the borrowers from the beginning, so you have to be appropriately staffed. This runs through the whole business, from originations through operations, all need to be ready to offer a two-way dialogue with borrowers and be responsive to any problems that might arise throughout the life of the transaction.

Credit cycle experience

It's important that lenders have the experience of managing a credit portfolio in an economic downturn as it's an inevitable part of this business. Because it can be a very hands-on process, having a team with the experience of working through past credit cycles is critical to ensuring future success. Being proactive and having the right resources to handle a turn in the economy is critical to the long term success of any middle market lender.

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different from the kind of mid-market deal that we do.

In actuality, today's definition of mid-market is referring to two separate markets, upper and lower, which are very different from one another.

Q Is having scale an advantage in the mid-market?

There are pros and cons to having scale in this space; the biggest advantage of scale is having a larger hold size. This allows you to control the transaction and have a larger influence over credit terms. In the lower middle market, scale can also be an advantage as it allows you to grow with the company throughout the investment. Particularly when you're working with a sponsor that plans to grow the business through acquisitions, it can often be easier if they're able to rely on the same finance partner through each stage of a company's development. They want a long-term lending partner to reduce the friction each time they want to make an add-on acquisition.

A negative aspect of having scale is it drives lenders to move up market in an effort to put larger amounts of capital to work in a single transaction, getting away from the types of transactions that established them as lenders in the first place.

Q Has increased competition driven more mid-market lenders to specialise?

It has driven specialisation, but this can happen across various lines. Some firms will do this based on deal size whereas others might focus on non-sponsored deals or specific industry verticals. Even a relatively sector-agnostic lender, such as our self, can have certain areas with increased experience and specialist knowledge. For example, we consider ourselves a generalist lender, but we have developed an expertise over the years in certain industry verticals including healthcare, insurance and financial services and aerospace and defence. We find these industries to be more nuanced or highly regulated, and having this expertise is critical to properly analyse companies within them.

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$2.3bn
Total capital raised by Twin Brook's AG Direct Lending Fund II

Q Does the amount of dry powder in the market concern you? How can the industry best mitigate the impact of it?

It's certainly an issue we're aware of but at this time, not overly concerned with. The middle market is very large with over 200,000 companies that could be potential borrowers. With banks continuing to pull out of our market there is a lot of empty space still to be filled by alternative lenders. We believe there is room to grow in this market provided you take the right approach. Credit selection is very important in conjunction with a long-term view of each credit.

Over the long term, I think we'll see some managers who struggle when credit conditions tighten, subsequently separating the good from the bad. It seems the dry powder issue will resolve itself as the industry consolidates over time. ■

Grant Haggard joined Twin Brook in April 2015 as a partner in the firm's middle market direct lending loan business. Haggard is responsible for client relationship management and new business development, focusing on originating and structuring transactions with middle market private equity sponsors. Prior to joining Twin Brook, Haggard had been with Ares Management LLC, Madison Capital Funding LLC, a wholly owned subsidiary of New York Life Investors, and has held various positions in originations, loan underwriting and portfolio management at Linsalata Capital Partners and Antares Capital Corporation. Haggard received a BS in Accounting from the University of Cincinnati and an MBA from the Kellogg School of Management at Northwestern University.