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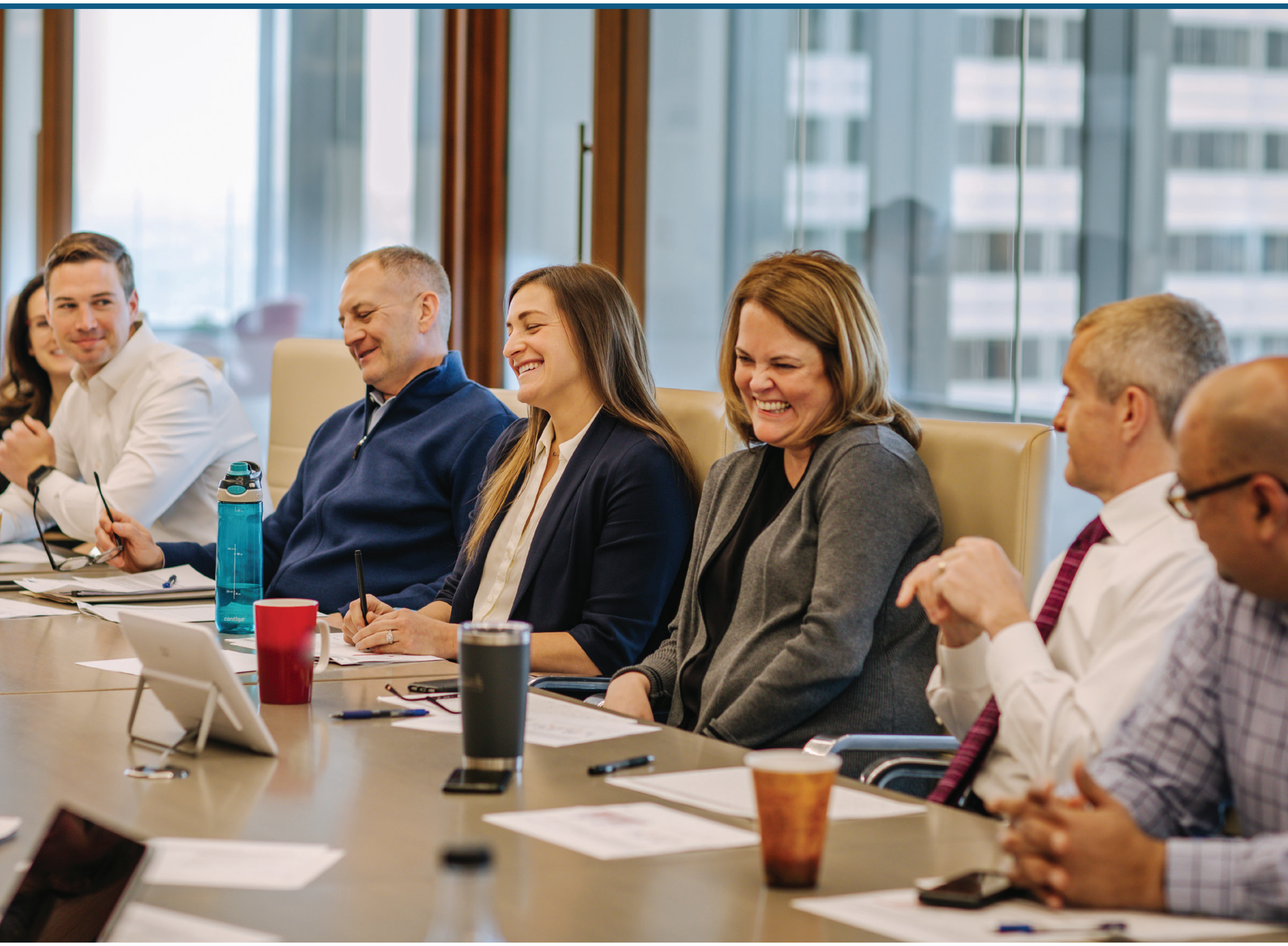

Past, Present, and Future: Financial Services and the Middle Market

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In recent years, financial services has become an increasingly popular sector in the middle market. Twin Brook Capital Partners' Betsy Booth discusses the growth of this industry, current trends, and expectations for the future.

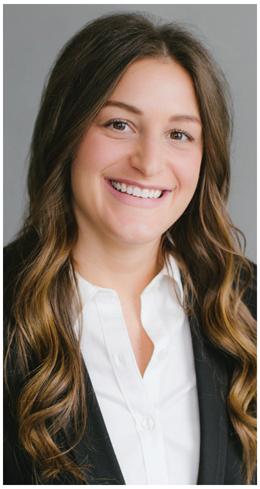
What are some of the most interesting changes or trends you've seen in the financial services industry over the past several years?

I think one of the most fascinating aspects of the financial services industry is the continued proliferation when it comes to deal volume and fragmentation. More than ten years ago, sponsors were exploring what was generally viewed as a highly fragmented sector. There was no shortage of small, founder-owned businesses that private equity firms viewed as attractive opportunities to establish platforms and execute on a roll-up strategy. Fast forward to present day, you would think the industry had been largely picked over; however, we continue to see fragmentation in various sectors, as well as consistent activity and interest from sponsors – primarily fueled by the importance of technology, regulatory focus on compliance, and succession planning.

One of the biggest changes we've seen, which is not dissimilar to the broader market, has been the rise in valuations. Originally, sponsors would typically acquire a platform for 6-8x EBITDA, and execute add-ons at 3-4x, resulting in attractive multiple arbitrage. The high level of activity in this space, continued private equity interest, and a more sophisticated ecosystem of buyers, sellers, and advisors, has resulted in an increasingly competitive market and – in many cases – increased acquisition multiples.

Looking beyond fragmentation and the industry being well suited for roll-up strategies, why has this become such a popular sector among middle market private equity firms?

Deals in the financial services space share a number of similar attributes, including recurring revenue and high free cash flow – which are appealing from both a debt and equity perspective. Business models typically include monthly admin fees or fees as a percentage of AUM. High retention rates and customer diversity provide for a stable and consistent installed base. As a result, these businesses typically generate margins north of 25% and don't require much working capital or capex.



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Betsy Booth, Director,
Twin Brook Capital Partners

In addition, increased regulatory requirements have resulted in a greater focus on compliance – which is an area where private equity firms can bring a lot of value. Sponsors can provide the capital and – more importantly – the strategic support required to identify, build, and implement the appropriate compliance framework and resources.

Why is it important to have a lender with sector-specific expertise?

Continued interest in the sector has strengthened our relationships with sponsors, as they value our industry expertise and appreciate that we have the market knowledge needed to understand the opportunities they're pursuing. From a deal perspective, our breadth of experience with similar companies and the space at-large allows us to streamline the diligence process, as we are starting at a higher baseline and can concentrate on the specific deal at hand. As sponsors work to compress, accelerate, or preempt a process, they can be confident in our pre-existing background and ability to deliver consistent, reliable financing solutions.

When it comes to a lender's diligence process, what factors or characteristics do sponsors value?

Beyond being able to streamline the diligence process, having deep industry experience is a key differentiator when it comes to closing and documenting a deal. Given our expertise in the sector, we understand and appreciate that most financial services companies are going to have some level of regulatory exposure, which may need to be addressed in a credit agreement or with specific terms. We've closed a number of financial services deals over the

past five years, so it's unlikely a regulatory issue that we haven't seen before is going to arise, and that's important. Sponsors do not want to be surprised at the last minute or have their deal delayed due to a lender's unfamiliarity with the sector. At Twin Brook, we're able to make the documentation process much more succinct. We know what assets can and can't be used as collateral, so we're able to focus our efforts on making sure we understand a company's capital structure from a legal perspective and, in turn, can deliver a certainty to close to the sponsor.

When it comes to more recent deals, what do you see sponsors looking for? Are they targeting any specific parts of the industry?

One space where there has been a lot of recent activity is at the intersection of healthcare and financial services. For example, there has been an increased focus on voluntary employee benefits or supplemental employee benefits for employer groups' commercial policies. This trend has been driven by the continued shift to high deductible plans, as well as the frothy job market, which has prompted employers to look for cost-effective ways to attract and retain employees.

Another area where we've seen an uptick in deal activity – and that is an extension of the trend around outsourced service providers – is Third Party Administrators (TPAs) and Managed General Agencies (MGAs). These agencies essentially act as an extension of an insurance carrier, delivering a compelling value proposition while representing an attractive profit center to capitalize on.

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Looking to the future, do you think financial services will continue to be an active, growing sector in the middle market?

Certainly. As previously mentioned, while the number of platforms has grown over the past ten years, there continues to be a healthy amount of activity, significant fragmentation, and a lot of opportunity for roll-up strategies. I think the main factor that will fuel continued growth is the regulatory environment. Increasingly complex regulations are difficult for smaller businesses to navigate and create a need for strategic guidance, as well as potential investment in technology and infrastructure. These needs have led to the emergence of more outsourced providers, which have become – and will continue to be – an important tool and area of focus for many businesses.

To Contact Twin Brook: 312-763-5100 | www.twincp.com