EXPERT Q&A

Twin Brook Capital Partners founder and managing partner Trevor Clark discusses working through the unprecedented events of last year and the state of the market moving into 2021

A different kind of contraction

Q Last year was unlike any other. What did this mean for direct lenders?

Reflecting on 2020 from the direct lending perspective, while the cause of the economic slowdown was very unique, in our view the results of it bore many of the hallmarks of previous economic cycles, which I think gave experienced lenders a sense of comfort in that they were familiar with how to address borrower-specific issues. That said, last year's dislocation certainly had some singular characteristics, starting with the pace at which the US and global economy shut down. When you combined that with pandemic-related lockdown orders and the need to change workplace logistics overnight, there was an abrupt and very real impact on some borrowers, and direct lenders had to respond accordingly.

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Q Did this lead lenders to make changes in terms of strategy or approaches to credit selection, underwriting and portfolio management?

From late March through late summer, there was a limited amount of new deal activity; we saw that lenders were generally spending most of their time focused on what was transpiring across existing portfolio accounts and trying to be a source of support for those businesses. For established firms, I'd say there was little change in terms of strategy, as they dug in and managed portfolios in the way you would expect. We did, however, observe some shifts in strategy from less established players, who sought to leverage the disruption and begin portraying themselves more like opportunistic credit shops in hopes of differentiating their platforms.

Q How did experience come into play for lenders navigating the pandemic?

We have long highlighted the importance of experience in the direct lending space, and especially in the lower mid-market, where we've found that private equity sponsors are typically focused on building long-term lending relationships, as their value creation strategies often necessitate continued lender interaction and additional financing. These firms are looking for lending partners that are committed to working hand-in-hand with them as they seek to transform portfolio companies, through both periods of growth and stress.

Many members of our team have worked through multiple credit cycles, so all aspects of our approach – from relationship building, to comprehensive and methodical underwriting, to active post-close monitoring – are informed by our belief that when it comes to being able to manage a portfolio and serve as a consistent, reliable partner regardless of the market environment, having the right people, resources, processes and infrastructure in place is critical.

With this in mind, we were surprised to see a number of managers looking to scale up their distressed credit management capabilities after the pandemic erupted – effectively waiting for a fire before buying a fire extinguisher. Not surprisingly, top workout professionals were not readily available, making those that had proactively invested in personnel better positioned.

Q Looking at activity in the mid-market and across the direct lending landscape in 2020, what were the most notable impacts of the pandemic?

Some industries have certainly fared better than others, as we witnessed restaurants, retail, fitness clubs and almost anything reliant on social gatherings feel an immediate and longer lasting impact. In contrast, we saw other types of businesses – like those in the healthcare space – that were affected by early shutdowns but quickly bounced back as pandemic-related lockdown measures were eased.

I think the health of companies coming into the pandemic was also clearly a factor, as was the amount of debt and availability of sponsor support. This most recent contraction served as a reminder of the significant influence that private equity firms can have on borrower outcomes, as we found that the quick actions many sponsors took – whether it be injecting capital, providing operational expertise or working with management teams to reduce costs and implement liquidity preservation strategies – were critical to companies' abilities to survive and return to growth.

Q Uncertainty persists in early 2021. How would you characterise the current market environment?

I think it can be best described as incongruous. New deal activity is strong, lending competition has returned to pre-pandemic levels and we see clear signs of a healthy, performing market. Meanwhile, we are still in the midst of a pandemic, with people continuing to work remotely and many groups dealing with lingering portfolio issues. Having those two forces at play at the same time seems counterintuitive.

> *"We believe robust direct origination capabilities will continue to be a point of differentiation for managers"*

Q What impact do you think the ongoing pandemic environment will have when it comes to lenders' portfolios and deployment across the mid-market?

We expect several things will happen, the first being that lenders will gain back some ground from a credit protection point of view, and we have seen some of that already. This includes increasing recognition of the fact that covenants do matter; if you have a strong relationship with a borrower and its sponsor, we believe the idea that a covenant is a negative thing is a fallacy. It seems that there is also growing acknowledgement that EBITDA adjustments, or adjustments to historic cashflows, have not always represented real cashflows. When deciding how much debt to put onto a company, we believe you need to be aware of what true cashflows are rather than accepting aggressive adjustments.

Finally, we've seen some groups kicking the can down the road on portfolio issues, and eventually that game ends. You can only amend and extend for a certain amount of time, so we expect to see a number of companies sold or restructured through this year.

Q In such an environment, has the dialogue around manager and lender selection changed? What factors will drive differentiation moving forward?

I think investors and sponsors have become even more focused on portfolio company outcomes, including how and why performance varied in the face of the pandemic. Across the private debt space, we've also seen manager compensation and incentive alignment garner increased attention from investors.

Looking to the future, I think consistency and stability on a number of fronts will be key; this includes stability with respect to managers' teams and strategies – as we witnessed how impactful both of those things have been when it came to navigating this pandemic – and having a demonstrated ability to manage through entire cycles, not just the periods of growth between contractions. Additionally, we believe robust direct origination capabilities will continue to be a point of differentiation for managers, as we've seen how relying on other institutions to create dealflow can leave less room for selectivity and make it more challenging to deploy capital, especially when M&A slows. ■