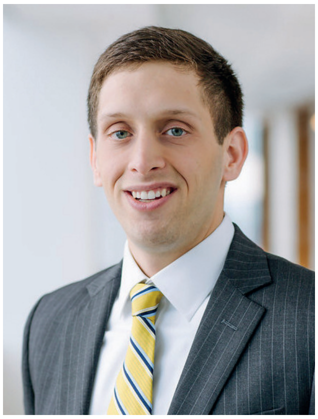
KEYNOTE INTERVIEW

Experience and relationships matter





Navigating the pandemic has highlighted the value of strong relationships and the importance of experience when it comes to underwriting and portfolio management, say Twin Brook Capital Partners' Drew Guyette, Tim Schifer and Tony Maggiore, who joined Private Debt Investor to discuss some of their takeaways from the past 18 months and expectations for the future

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Q Last year was unlike any other. What are your key takeaways?

Tony Maggiore: There are certainly a few. The first is that our underwriting and portfolio management processes are sound, which I believe came through in how we reacted, the critical information we focused on, and the stability of the portfolio as a whole.

The pandemic was unexpected, so the resilience many lower mid-market businesses demonstrated and their ability to be operationally nimble was another major takeaway. The abilities of management teams to quickly pivot from a focus on growth to a focus on liquidity and cost management amid a uniquely challenging time was truly impressive.

Lastly, I think this experience highlighted the importance of sponsor support and relationships. From a portfolio management perspective, the open lines of communication that we have with our sponsors and borrowers are always valuable, but they were particularly critical in the face of the pandemic. Sponsors were essential partners last year, supporting management teams with operational knowhow and, when needed, often stepping up to invest additional capital.

Q Do you think the events of the past year-plus shined a light on the value of experience?

Tim Schifer: Experience proved to be an important element on several fronts.

Every period of disruption is unique, but I think the experience of working through multiple cycles definitely enhances your ability to effectively and efficiently assess, address and manage future situations. It doesn't necessarily provide a precise playbook, but you can certainly draw on what you have done before and some of the capabilities and approaches that have worked in the past.

At Twin Brook, many members of our team have not only spent 20-plus years focused on this space but have also worked together for much of that time. I think that level of shared experience supported our ability to seamlessly transition to a remote environment, continuing to work as a team and serve as a reliable lending partner.

Additionally, I think our depth of experience with many of our sponsors proved to be key, as it meant they came into the pandemic with an understanding of how we operate and an appreciation for the credibility, consistency and reliability we provide.

Q What were the most notable factors impacting lenders' varying abilities to continue doing business and closing new transactions at the height of the pandemic last year and beyond?

Drew Guyette: I think experience, human capital and infrastructure were key differentiators. At a high level, lenders fell into two camps: those with experience and those that were relatively new to the space. I think those with experience benefited in that they generally came into the pandemic with a pre-existing knowledge of and framework for how to handle challenging situations.

Human capital – in terms of team size and expertise – proved to be essential. We saw many lenders challenged by inadequate staffing, whether it be not having enough managers, underwriters, or individuals with workout experience, which impacted their respective abilities to both manage existing portfolios and take on new opportunities.

At Twin Brook, I think this experience highlighted the importance of our team and portfolio construction. The robust nature of our underwriting staff allowed us to simultaneously focus on portfolio management and taking advantage of dealflow, whether it be add-on opportunities via our existing portfolio or new deals as markets reopened.

> *"Human capital – in terms of team size and expertise – proved to be essential"*
>
> DREW GUYETTE

Q Leading up to the pandemic, there was a lot of market dialogue about the loosening of terms around covenants, EBITDA adjustments and other documentation provisions. Did these trends materialise last year?

TM: I think our form document provided us with a lot more tools in the toolbox as compared to those in some other parts of the market. Receiving monthly instead of quarterly financials and having covenants in place allowed us to closely monitor performance trends and be in dialogue with sponsors before enterprise values started to deteriorate; we were able to identify issues sooner and put solutions in place early.

We also provide the revolvers on almost all of our transactions, as opposed to having those subject to a third party, so we could see the need for and importance of liquidity in the first few months of the pandemic, specifically for those businesses that were impacted over a longer term. The real-time reporting that came with providing those revolvers helped us assess our entire portfolio more effectively and on a name-by-name basis.

Q Have the events of the past 18 months led you to make any changes to your approach or strategy? Or have you seen others forced to change course?

TM: If anything, I think this experience reaffirmed our approach and processes on the underwriting and portfolio management front. The depth and amount of upfront diligence we do helps us understand what matters to a business, what questions we should be asking and what we need to focus on with that credit when it faces headwinds.

TS: When it comes to new deal underwriting and ongoing portfolio management, we have always been very proactive. Rather than waiting to react, we are actively trying to anticipate what issues might arise and working with our borrowers and sponsors to get ahead of them. While no one could have specifically predicted the eruption and effects of a global pandemic, the idea that there could be an economic downturn and how that could impact particular businesses is certainly something we account for.

DG: Looking at managers that had to change to adapt, we saw it was typically those with less focused, disciplined strategies – those that were lending across several parts of the capital structure versus strictly focusing on one tranche or one type of borrower and financing structure. From a strategy perspective, we saw the value of being the administrative agent, being the revolving lender, and solely working with PE-backed borrowers reinforced. We've long emphasised the importance of consistency, as we believe the absence of style drift means fewer surprises.

Q What do you expect the future to look like in the private debt space?

DG: No matter which set of constituents you are looking at – from PE sponsors, to senior lenders, to LPs – I think the outlook remains positive. We believe this asset class continues to be attractive, especially in a low interest rate environment.

The past 18 months have provided a great opportunity to reflect on the preservation of capital and ability of the asset class to withstand shocks. The lower mid-market fared well, and I think 2021 will continue to be robust, not least because of postponed LBO activity being rolled into this year. Into future years, I think we can expect to see continued growth and focus on this asset class.

Q Turning to company performance and valuations, have you seen any variation in the rebound across different parts of the market or across industries?

TS: Generally speaking, we've seen companies' recent financial performance look very positive, reflective of the improving business environment. On the debt valuation front, we saw mark downs in Q1 and Q2 of last year – primarily driven by the negative impact of covid-19 on financial results at the time as well as uncertainty about future performance. Since then, however, we have seen valuations stabilise, with many now returning to or exceeding pre-pandemic levels.

As you would expect, not all industries or markets are at the same stage of stability – some businesses have bounced back faster than others. For example, we saw physician practice management companies rapidly rebound upon reopening, with patient visits quickly returning to pre-pandemic levels. Conversely, we've seen other types of businesses – like those associated with in-person events – that have experienced a slower recovery.

Q How would you describe the current market environment?

DG: From a transaction volume perspective, the market is currently very active and performing similarly to how it was in 2019. I think one of the upsides coming out of the last 18 months is that the PE community has responded really positively to relationship lending and their experiences working with trusted partners; the current environment reflects this, and we're seeing lenders with strong relationships continue to benefit as a result.

TS: There's a huge overhang of private equity capital to deploy, which is frequently and – in my opinion – correctly cited as a major driver of deal activity and valuations. Additionally, there are a lot of well-capitalised sponsor-backed businesses that are looking to grow, so in addition to new LBO activity, we continue to see healthy demand for add-ons coming from our existing portfolio companies. I think the robust and accelerating deal activity that we've been seeing since late 2020 is yet another indicator of overall market confidence and the generally positive outlook at present.

Q In this environment and moving forward, why do relationships matter?

TM: You can't have a good relationship without good communication, and good communication is critical to us knowing what's going on in a business. We find the regular performance and outlook-related calls we have with management teams extremely helpful, and we can similarly provide value to sponsors. Sometimes we will see something come up across our portfolio and are able to bring it to their attention.

A current example would be challenges in the labour market, which is something we have been bringing up with sponsors early, asking if they are demand planning, what sort of revenues they can satisfy with their current labour base, etc. We have found raising points like that with sponsors before they are even seeing them as an issue adds value. ■