Strong Pace Persists in the Mid-Market

FOR MANY PRIVATE EQUITY SPONSORS AND DIRECT LENDERS, THE PAST NINE MONTHS HAVE BEEN TREMENDOUSLY BUSY. DESPITE THE ONGOING GLOBAL PANDEMIC, COMPANY PERFORMANCE ACROSS MOST SECTORS HAS BOUNCED BACK AND DEAL FLOW HAS BEEN CONSISTENTLY ROBUST. HEADING INTO THE FINAL QUARTER OF 2021, TWIN BROOK CAPITAL PARTNERS' GRANT HAGGARD DISCUSSES MIDDLE MARKET ACTIVITY TO DATE, THE CURRENT ENVIRONMENT, AND HIS EXPECTATIONS FOR THE FUTURE.

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As a Senior Partner and a member of Twin Brook's Investment Committee, Grant Haggard oversees the firm's generalist origination activity.

Setting the stage, how would you characterize the state of the market going into the end of the year? What has it been like for the past 12 months or so?

Looking back to last year, we were very focused on our portfolio and monitoring how companies were faring as everyone was working through the early months of the pandemic and the challenges that came with that. Heading into 2021, that was certainly still a continued point of focus, although by that time, we started seeing most of the businesses across our portfolio improve month-by-month, which has been very positive. I think that trajectory has been relatively consistent across the mid-market and direct lending industry, as we've seen a lot of companies that performed well through the pandemic or that have really recovered on a comparative basis relative to last year.

The other topic I'd touch on is deal activity. We saw transaction activity, particularly in the healthcare sector, pick up in earnest in the fourth quarter of last year; that industry rebounded quickly as initial lockdowns were eased, and it has continued to be a very active space throughout 2021. On the generalist side, we saw a few sectors – like distribution, business services, and manufacturing – that were a little slower to recover. Some of those businesses were hit a bit harder and didn't rebound quite as quickly, but we started seeing activity in those types of spaces pick up in the second quarter of this year, and we've continued to see that grow to date.

Can you tell us a little bit about the deal flow you've been seeing and your expectations for the coming months?

Deal flow has been strong and slowly building throughout 2021; we've been having a record year in terms of deployment and overall deals reviewed. Two things are driving this. First, companies that were positioned to be sold going into 2020 that got shelved are now being brought back to market. This is combined with the fact that there's anticipation of a meaningful tax change in 2022. As a result, we're seeing some deals be pulled forward from next year in an effort to take advantage of current tax rates – similar to the trend witnessed in 2012. We expect a continued flurry of activity as we get closer to the end of this year, driven by those factors.

Additionally, I think the overall amount of capital that has been raised in the middle market M&A space – across both the private equity and private debt markets – is driving transaction activity, whether it be LBOs, add-ons, or dividend recaps. I think this has contributed to the market being very active this year and will do so next year as well.

Are there any specific sectors where you are seeing extraordinary growth or, conversely, continued challenges?

Interestingly – and in contrast to the past – I think persistent challenges were not nearly as widespread this cycle and were pretty specific to certain sectors. Coming out of the second quarter of 2020, we found that the vast majority of the companies across our portfolio had returned to solid ground and fared pretty well. Whether it's specialty chemicals, distribution, business services, digital marketing services, or tech-enabled services, businesses in all those sectors held up pretty well, and we've seen them continue to grow and be active on the transaction front. On the struggling side, it's things like restaurants, retail, gyms, outdoor events, and trade shows; I think those types of companies have been a little slower to recover for obvious reasons.

We expect to see those deals continue to trend up for the remainder of the year, though the one caveat is around the proliferation of the Delta variant. There's a little concern and hesitation about what that might mean for social gatherings, travel, outdoor events – things of that nature – that I think may set those sectors back a bit.

In such a competitive environment, how do lenders differentiate themselves?

In our view, relationships are always a key differentiator, particularly in the lower middle market – which is what we focus on and where we have built long-term relationships with a lot of sponsors. I think they value what we bring to the table in terms of our execution, our capital base, and our ability to support their growth and value creation plans. This was highlighted through the past 18 months, as we were pretty long in the tooth in terms of when the last cycle was relative to this most recent one. I think going through a disruption reminded sponsors of the value of strong relationships and having lenders that are patient and will work hand-in-hand with them to support their portfolio companies, whether that entail navigating issues or providing financing for new opportunities.

Additionally, I think the market being so busy has served to reinforce the importance of resourcing and infrastructure. Heading into the end of the year, many – from sponsors, to lenders, to lawyers, to consultants – are spread pretty thin, so having a robust, thoughtfully structured team already in place has proved to be key. We saw how valuable human capital was at the height of the pandemic, when all hands needed to be on deck to help companies navigate an unprecedented situation, and we're seeing that similarly play out now, as businesses have generally returned to growth, and they and their sponsors are looking to capitalize on opportunities and do so on accelerated timelines.

What are some of the issues private equity firms and company management teams have been focused on or contending with as of late?

I think one that's probably top of mind for a lot of folks is the hiring shortage we're seeing in the marketplace across a lot of different industries, particularly for some businesses that are human capital intensive – finding labor as those companies' end markets and businesses recover has been a challenge. Increased wage rates are a related issue that we've seen sponsors have to manage through. The good thing is that the demand in a lot of end markets is strong, so companies have been able to pass along those wage increases and maintain their margins by doing so.

The issue of pandemic-related supply chain disruptions is another one that has come up often, as have rising raw material costs. But again, given current demand levels, we've generally seen our sponsors and borrowers be able to pass those price increases on to customers.

As a lender, how do you support those sponsors and the growth of their portfolio companies in today's environment and going forward?

We do this in a couple different ways. For example, we're seeing many companies that performed well though the pandemic and that have strong PE sponsor backing trying to take advantage of disrupted industries and looking for opportunities to acquire competitors to build scale, generate synergies, and diversify. Supporting our borrowers through add-on acquisitions – providing the capital needed for that type of acquisition growth – is a core part of our model.

We also provide all of our borrowers with revolving lines of credit, which is key when they're trying to build working capital, as the revolver allows them to do so without the sponsor needing to inject additional equity. This is particularly helpful for companies that that experienced or are experiencing a strong rebound, and we are more than happy to support that working capital growth. ■

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