Investment
INSIGHTS

THE EVOLUTION OF PRIVATE DEBT

TREVOR CLARK
Founder and Managing Partner
Twin Brook Capital Partners

Institutional investors continue to pour assets into the private credit space, drawn to its uncorrelated returns and higher yields versus public fixed income. Looking ahead, private credit remains an appealing alternative on a relative basis, considering the prospect of higher interest rates and market volatility from the ongoing pandemic, as well as macro issues such as supply chain disruption. However, the universe of options within this space is broad and diverse, so the importance of carefully selecting the type of private credit to invest in and the manager to do so with has come into greater focus.

At a basic level, private credit is "a debt-like return that's created in a non-public, non-traded world," said Trevor Clark, founder and managing partner at Twin Brook Capital Partners, Angelo Gordon's middle market direct lending subsidiary. A more specific definition of private credit will likely depend on who you ask, as the landscape has evolved and expanded significantly, though the primary driver of institutional investor interest in private credit is risk-adjusted return, he said.

Direct lending — also termed private debt — is the largest subset of private credit, and returns in the space have historically been considered attractive and stable, especially from a fixed-income standpoint. Additionally, much like the private credit universe broadly, both the number of firms and types of strategies within the space have grown over the years.

With a greater number of opportunities, managers need to have more specialized experience in the specific areas of private debt in which they play. "The investor universe is getting more discerning," said Clark. "They are not just trying to access the asset class broadly or with any manager, they are being more selective both in terms of the types of strategies they are looking at and the managers they are working with."

UNPACKING DIRECT LENDING

Private debt, or direct lending, typically refers to the provision of private, non-traded loans to companies — often in the middle market — by non-bank lenders.

There are many different types of managers within the space — some focus on specific segments of the mid-market, industries, or types of businesses (private equity-sponsored versus non-sponsored) — though, on the whole, direct lending is differentiated from other areas of private credit by its longevity and consistency, said Clark. "Many of the established players in the direct lending space have been doing this for 20-plus years. That track record and the scale that they've achieved is difficult to match. The same goes for the consistently high demand we've seen from companies seeking direct lending."

Although private debt can be broken down in a few different ways, it is frequently segmented by size of borrower. Lower middle-market borrowers are typically defined as businesses with EBITDA of $25 million or less, the core middle market is comprised of those with $25 million to $50 million in EBITDA, and the upper middle-market consists of those with greater than $50 million in EBITDA.

UNCOVERING OPPORTUNITIES

The Twin Brook team invests across a broad range of industries but focuses on private equity-backed borrowers that typically have EBITDA between $3 million and $50 million, with an emphasis on companies with $25 million of EBITDA and below — or those in the lower middle market.

Looking at the market today from an industry standpoint, there are a few outperformers in terms of growth and stability. "Healthcare would absolutely be one of those industries," Clark said. "The amount of private transaction activity taking place within the world of healthcare has been huge, and it continues to be a growing space." He noted that business services and technology have also been active sectors that have positive growth prospects.

Although there are opportunities across all segments of the mid-market, the Twin Brook team has maintained its focus on the lower middle market because of both the robust opportunity set and nature of the space. "As you move up market, we've typically seen lending become increasingly commoditized," Clark said, "whereas in the lower middle market, we've found that borrowers and their PE sponsors generally take a more relationship-focused approach. We focus on that part of the market because of these dynamics."

Company ownership can also be a differentiator. Some may assume that private equity firms are focused strictly on finding the cheapest financing, but that is not always the case. "We've found that lower middle market-focused private equity groups tend to look at their lenders as important pieces of their growth strategies for businesses. Their value creation strategies often include initiatives that require additional financial and ongoing lender interaction, so they want a reliable partner that understands their approach and will work hand-in-hand with them and their portfolio companies," Clark said. Conversely, he notes that Twin Brook exclusively serves private equity-backed borrowers because they have found that "the operational expertise and capital support sponsors bring, as well as their strategies for growth, are really critical."

The world of private debt has come to be seen as a natural fit for these investors.

As the private debt space has evolved and attracted more capital, investors have become increasingly aware of these types of considerations. "They don't just want unfocused exposure to direct lending," said Clark. Instead, there has been greater focus on diversification. For example, he noted, "An investor that currently has exposure to only the core middle market may look to incorporate options that offer exposure to the lower or upper middle market, or vice-versa, as their total allocation to private debt expands."

BRINGING IN THE MACRO PICTURE

What do current macroeconomic concerns, such as disruption from the ongoing pandemic and the expected rise in interest rates due to higher inflation, mean for private debt?

While the outbreak of the pandemic may have driven some in the private debt space to alter their approach, Twin Brook's investment processes — which are informed by the senior management team's 20-plus years of experience through cycles — did not change. "We are senior debt lenders that are always focused on limiting downside," Clark said.

Looking ahead, when it comes to inflation and interest rates, the impact varies by industry and company, so expected outcomes can't be generalized across the board in the direct lending space, he added. "The impact of inflation and interest rate changes will be tied to what type of lender you are, what type of risk profile you bake into your portfolio, and how you run different scenarios to account for such risks during the underwriting process."

Private equity groups can play a critical role in making sure that companies are well positioned to respond to rising rates or inflationary pressures. Additionally, the structuring of transactions is important in this regard, Clark said, including building in ample cash flow cushions and covenants, which give lenders the ability to take action and work closely with borrowers in situations of underperformance.

Private debt's overall resiliency after the COVID-19 pandemic first broke out holds some key lessons. "Prior [to that event], I think some may have believed that private debt had attractive returns, but that at the first sign of trouble, those returns were going to evaporate," Clark said. "That did not happen. Across the space generally, the risk-adjusted returns not only held up, but they held up with less variability than in the public corporate debt world."

LESSONS LEARNED

"Experience matters," Clark bluntly put it. "Coming through the pandemic, we've seen the well-known, experienced managers with scale continue to win market share." Historically, investors might have focused primarily on the allocation decision rather than the manager-selection decision. "That has changed. The pandemic has highlighted that there are clear differences in managers and their approaches, and [those factors] have a direct impact on outcomes."

The experience of the past two years has also shined a light on the importance of human capital. "Having sufficient staff to actively manage a portfolio through both periods of growth and challenging times is key," said Clark. Additionally, distressed credit management experience is essential. "If you have only been in the direct lending space over the last 10 years, you don't have the experience of working through a significant downturn to inform how you are selecting and managing credits."

Access to a consistent flow of transactions has been another differentiator among managers. The breakout of the pandemic in early 2020 resulted in some private equity groups "down selecting" — narrowing the field of choices — to work predominantly with their most consistent and reliable lenders, said Clark, "We've seen demand for our product in the private equity universe continue to grow — both among existing and new sponsor clients — and that, coupled with robust M&A activity, led to a record year in 2021, with net funded commitments totaling $6 billion."

With this, has come increasing awareness of the opportunities in private debt. "With interest rates so low, I think the performance of private debt overall over the last few years — including the sustainability of returns, the lack of volatility, the lack of mark-to-market risk, and the floating-rate nature of the loans — has reinforced the appeal of the asset class," said Clark. Fixed-income allocations by institutional investors no longer have to predominantly take the form of public corporate debt, he added, "and I think the world of private debt has come to be seen as a natural fit for these investors." ■

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