EXPERT Q&A

The unspoken strength of the mid-market

The events of the past two years have raised awareness about the importance of a disciplined approach and strong balance sheets, so despite the ongoing pandemic and concerns about certain macroeconomic issues, many direct lenders and middle market companies have headed into 2022 in good shape, says Drew Guyette, chief credit officer and senior partner at Twin Brook Capital Partners

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Q Reflecting on last year, how would you describe the state of the market coming out of 2021?

From an activity perspective, 2021 was very positive. We saw what some may call a return to normalcy with respect to add-on acquisitions, new LBOs, and organic growth at the borrower level. In many ways, 2021 – at a macro level – marked a return to where we left off at the end of 2019.

With respect to the lending environment, we saw structuring generally remain slightly conservative in comparison to two years ago, with many lenders continuing to be modest in terms of their approaches to underwriting and structuring – meaning slightly higher interest rates and tighter covenants and credit agreements.

Across the mid-market, there continue to be some residual impacts of the pandemic that businesses are working through, but many of those challenges eased through last year, so I think – for the most part – company performance remained and remains on a positive trendline. Looking to the market broadly, we saw companies that were more severely affected by covid-19 start to come back in Q3 and Q4, providing a clearer picture of what the new operating model and new

normal could look like for those types of businesses.

After observing the spread and related impacts of Delta and then Omicron, I think one of the defining characteristics of the "new normal", broadly speaking, is an eyes wide open view of the potential for new variants and the unknown that comes with them. The good news is that the first years of the pandemic helped demonstrate and deepen understanding of the appropriate structure and level of cushioning for stability in the face of such uncertainty, so I think many credits and borrowers are now better positioned to withstand the emergence of future variants or shocks.

Q As we've moved into 2022, what are companies focused on?

Heading into 2022, inflation has continued to be a key theme for businesses, and at present, it's difficult to think of a factor or variable relevant to them where some sort of either first- or second-degree impact of inflation isn't being observed. The effects of inflation can be seen in most everything, from the cost of raw materials to the labour market, for example.

On the upside, one of the benefits of the pandemic was the opportunity it presented to reinforce the balance sheets of companies – whether that be through shoring up liquidity, bolstering equity beds, or cleaning up margin profiles – so many of these businesses are now better situated to weather through and contend with these pressures.

Q It sounds like inflation is top of mind for many. Are lenders seeing this impact portfolios?

The impact is not clear right now; I think it's going to take several quarters to understand the true impact of inflation on portfolios, and it will not be the same across the board. I think there are a number of factors that will affect the degree to which inflation impacts a given lender's portfolio, including their historical level of discipline when it comes to credit selection, how they measure cashflows and assess EBITDA adjustments, and what types of risks they seek to account for in their underwriting and portfolio management processes.

I think the segment of the market in which a lender plays and the types of businesses they lend to will also determine what kind of inflationary impact they experience. Thinking about the lower middle market, for example, many of those companies are small, nimble, niche businesses that operate in an environment where they are able to pass through price increases. They frequently operate on purchase order-type arrangements, as opposed to being locked into the long-term contractual relationships larger companies often are, which allows them to adjust for everchanging market dynamics and supports their abilities to maintain their margin profiles.

Q You briefly touched on the labour market. Are you seeing that have an effect on sponsors and businesses? What about lenders?

The labour market is an interesting topic, as I think people are still struggling to understand what's creating the current market conditions and how to interpret the data. Regardless of the cause, we're seeing many borrowers and PE sponsors react to the issue in a similar way – treating it as they would any other supply-demand imbalance or inflationary cost pressure. Labour has become something that businesses have to bake into their normal operating expenses more so than in previous years; thus, rising wages have also become a variable that lenders more commonly consider as they analyse businesses. That said, the topic broadly hasn't been a big concern in our portfolio because of the strength of our borrowers' margin profiles, which enable them to absorb that additional cost.

Q With the current environment and events of the past two years in mind, have there been any notable impacts on the private debt space? And what does this mean for direct lenders moving forward?

Given some of the uncertainty that remains, I think 2022 and likely into 2023 will provide an opportunity to reinforce the value of good decision making and maintaining robust standards across portfolios.

I think this environment has been and will continue to be a proving ground when it comes to demonstrating stability in the direct lending market, highlighting the importance of focusing on borrowers' historic cashflow profiles and identifying solid businesses that are well-run.

When there is an extended period of growth, as we saw in the years leading up to the pandemic, it can be easy for lenders to become lax in their approaches and start investing in companies that have good ideas or products but don't necessarily have their operations in order or the appropriate governance. Over the past two years, I think market participants have witnessed the risks and challenges that can come with doing this, and they now understand why keeping standards with respect to underwriting, credit selection, and structuring consistent – regardless of where we are in the cycle – matters.

With this in mind, we are optimistic about the future of the space and that the growth story remains positive. Mid-market businesses across many industries have stabilised or returned to growth. Additionally, there is a lot of dry powder on the private equity side – as well as in private debt – so we expect that dealflow and the opportunity set for lenders, particularly those that were able to navigate the pandemic and grow market share, will remain robust over the coming year. ■