EXPERT Q&A

After a record-breaking 2021, a slower start to 2022 should not be viewed as an indicator of the pace of mid-market activity for the balance of the year, says Grant Haggard, senior partner at Twin Brook Capital Partners

Another busy year in sight for the mid-market

Q Despite the ongoing pandemic, 2021 was a busy year for M&A. What did that mean for lenders?

2021 was a great year overall. Across the private debt space, it was extremely active, and for us specifically at Twin Brook, it was a record year. We issued over $9 billion in gross commitments, which amounted to more than $6 billion of net funded commitments across over 75 new platforms. That is up significantly from pre-pandemic deployment levels of about $4 billion of net commitments annually in 2018 and 2019.

Looking to what drove this level of activity, although the timing of the rebounds varied, we saw an uptick in transactions across a variety of industries. About one-third of our 2021 commitments were healthcare-related; that market recovered the fastest, as people quickly started going back to their doctors and other healthcare providers when lockdowns began easing in the second half of 2020, and M&A activity in the space really picked up thereafter in the first quarter of 2021. Businesses across many other sectors – including industrial, distribution, and service companies – generally bounced back later in 2020 and early 2021. As those businesses recovered, the M&A markets progressively picked up, resulting in a more active Q2, followed by a very busy second half of 2021.

We saw a lot of pent-up demand, as companies that were getting ready to sell in early 2020 and had put processes on hold came back to market in 2021. There was also a bit of a pull forward in demand, driven by some business owners' concerns about potential US tax changes in 2022.

The extremely robust levels of deal activity in the second half of 2021 meant lenders and M&A service

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providers were typically spread thin. Everyone was forced to really pick their spots, which created a pretty attractive environment from a lender perspective. Given the wealth of dealflow, we were generally able to pick and choose what to go after and saw more favourable terms and structures.

Transaction timeframes were also really compressed, so we saw the benefits of having a strong capital base and robust internal resources, which – coupled with our deep sponsor relationships – supported our ability to move quickly and take advantage of those situations.

In addition to allowing for greater speed and efficiency, I think working through the pandemic and in this environment has reinforced the value of experience through cycles and those strong relationships for sponsors, many of whom have narrowed the list of lenders they work with coming out of the past two years.

Q As we've moved into 2022, how has the pace of activity held up so far?

In the second half of last year, people were running full speed. Going into 2022, I think the market collectively took a bit of a breather. We anticipate a strong year, but there was so much transaction activity in the fourth quarter of 2021 that I think people were still absorbing that in early Q1 2022. Historically, the first quarter has often been slower, so this wasn't surprising.

A lot of our dealflow through the beginning of the year has been portfolio driven, as we have 200-plus portfolio companies that are very active from an add-on perspective. Overall, that is the part of the market that has been busiest thus far in 2022. There have been fewer new platform deals, though those are starting to pick up as we head into the second quarter.

Although unlikely to reach the record levels seen in 2021, our expectation is that this year will be an active one and that the strong M&A environment will persist. There is still a lot of capital on the sidelines, whether equity or debt, and there are plenty of companies in sponsor portfolios that had their terms extended through the pandemic, so I think we'll start to see more of those businesses initiate sale processes.

"We've seen the scaled, experienced lenders continue to gain market share"

From a purchase price and leverage perspective, the market remains healthy, making this is a good time to sell. Speaking to private equity sponsors and investment banks, they have a solid number of deals ready to come to market, and that is expected to drive a lot of activity this year and next.

We believe geopolitical and macroeconomic issues could affect the pace of activity in the months ahead, so we are watching that closely, but it's too early to predict what the impact might be.

Q How are mid-market companies faring?

We have seen a pretty widespread recovery across industries, with very few sectors lagging. A small handful of areas are not quite fully recovered – like trade show and event businesses and some elements of transportation and hospitality – but they are generally trending in the right direction.

Supply chain issues are certainly having an impact on companies, and we saw inflation start to ripple through the numbers in November and December 2021. Raw material costs have gone up and labour challenges – both from a cost and recruitment perspective – continue to affect businesses across the board, though for the most part thus far, we've seen companies be able to successfully pass that through to customers. The issue of rising interest rates and what that might do to borrowers is also something we are watching closely, though it is too early to tell how that will play out.

That said, most companies have shored up their balance sheets since the onset of the pandemic and we've seen solid margin preservation in the lower mid-market, so we remain confident in our borrowers' and their sponsors' abilities to navigate these issues.

Q In the current environment, what is driving differentiation among lenders?

When it comes to considering direct lenders versus traditional bank lenders, we believe the capital base, flexibility in structuring, ability to accommodate accelerated timelines, and responsiveness in supporting add-on acquisitions that direct lenders bring to bear are key differentiators. We are really set up to support private equity. Having lenders that understand sponsors' value creation strategies is critical, and I think that sets us apart from banks, even in cases where the cost of capital they offer is slightly cheaper.

In the lower mid-market, relationships remain incredibly important. For many sponsors, working through the pandemic-related disruption has reinforced the value of having long-term, reliable lending partners that have a deep knowledge of their businesses and will work hand-in-hand with them through challenging times as well as periods of growth. As a result, we've seen the scaled, experienced lenders continue to gain market share. ■