KEYNOTE INTERVIEW

Consistency of approach is key for credit managers

With predictions of a choppy period ahead in the macro environment, direct lenders in the mid-market stand to benefit if they remain reliable partners to borrowers and PE sponsors, says Trevor Clark, founder and managing partner at Twin Brook Capital Partners

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Q Given the evolving macroeconomic environment, 2022 thus far has certainly been complex. Can you provide a recap of the first half of the year in terms of middle market direct lending transaction activity and market trends?

In terms of transaction activity, the last quarter of 2021 was a blistering period for the majority of the performing middle market direct lending industry. Going into Q1 2022, we were expecting a quieter period – consistent with historical trends – and that proved true in January and February; since then, however, we've seen a resurgence of deal activity.

This continued uptick has been interesting because it occurred as a number of macroeconomic issues have come to the forefront, with inflation going up, interest rates rising, and supply chain challenges persisting. In light of this, we would typically expect the number of deal processes across the market to decline, but that hasn't played out; we continued to see a fairly robust marketplace through the first half of 2022.

As the Federal Reserve has raised interest rates at a pretty meaningful clip, it has created knock-on effects; for example, in the BSL market, we saw huge discounts being applied on reasonably well-performing companies and on new transactions. As a result, a number of upper-middle market direct lending groups were able to go in and take market share – as they could provide better, reliable execution – which in turn reduced competition in the core and lower middle markets, allowing players in those segments to continue benefiting from more favourable transaction economics.

In terms of company performance in the mid-market, we've found that the impact of these macro issues varies and is really specific to each company and industry. For example, a service company with no supply chain challenges likely is not impacted as much as a manufacturing company, but if you are an interest rate-sensitive company or if currency has an impact on the cost of your product, you are likely more vulnerable.

A large number of companies continue to perform well and grow nicely in the midst of some pretty severe headwinds, though there are certainly some that have had to make operational adjustments or are pivoting their approaches in response to the macroeconomic challenges at hand.

Q How has loan pricing in the market been impacted by rising rates?

For floating rate instruments, which dominate the direct lending space, rising rates are good news because when the base rate goes up, you get the benefit of being paid more. In contrast, fixed rate, fixed income instruments that are marked to market are going to see more volatility.

As a result, we've observed that the direct lending space has continued to perform well from an investor interest perspective, versus other parts of the corporate debt space that may be feeling more pressure and seeing downward mark to market pricing movements on some existing loans.

For borrowers, the cost of borrowing increases in a rising rate environment, which – from a direct lending perspective – highlights the importance of the work that goes into the selection of each individual borrower and the capital structure being put onto those companies. We believe those factors will prove to be differentiators when you look at the impact of rising rates on companies; there are certainly parts of the market where refinancings are going to pick up or restructurings are going to happen, but if companies are in good shape and are not loaded with too much debt, we believe they will not feel that pressure.

For example, all our loans have SOFR floors, so until interest rates exceed those thresholds, our borrowers won't feel too much pressure; still, we recognise not all parts of the market have such floors in place. We also work with our borrowers to have a certain amount of their debt hedged, which helps to avoid undue financial stress.

Q In the event of a recession, why is underwriting important? And how much does where you sit in the capital structure matter?

Underwriting, regardless of market conditions, is always important, but you didn't need to be a great underwriter to produce decent results from 2010 to 2019 because there were such positive market tailwinds driving outcomes. That has certainly changed, and managers now need to be much more discerning; you need the appropriate level of experience to assess risks, and the scale of resources to really dig in on a large number of companies and understand what your experience is telling you.

Structuring is equally important. You can have the best selection criteria, the best companies, the best due diligence, and the best understanding of history, but you can still put an unsustainable capital structure onto a company and cause problems. We believe lenders that can bring those pieces together will be the ones achieving the best outcomes over the next few years.

Q Looking at the direct lending market, what do you think will happen to the default rate in the space in the event of a recession?

Given the varying impact of the structural pressures that we have talked about, defaults are most likely going to be created by individual company performance. The topic of financial covenants continues to be an area of focus in the direct lending space. Five years ago, a common narrative was that covenants don't matter and good companies don't need them; in my mind, that theory has finally been dispelled.

Looking back, we believe whether you were or weren't seeing covenants had more to do with the relationship between a given sponsor and lender, and that the presence of a covenant was really a reflection of how much they did in fact trust each other. Now, we are seeing the introduction of more covenants more consistently across all segments of the market.

As more stress comes into the system, I think we are going to see more losses introduced to some of those covenant-lite structures – where lenders are forced to wait for a payment default before they can take action – versus those where covenants are in place, providing an opportunity for issues to be addressed before there is a payment default.

Q Are there any areas of the market you would be more cautious about deploying capital to, given where we stand today?

When I think about where to be more cautious, given what is taking place, the most obvious one is highly cyclical businesses. That's something experienced lenders probably are not leaning into. Likewise, anything that is particularly interest rate sensitive, with capital equipment manufacturing being a classic example.

If you are a capital expenditure heavy company, where you have to invest a lot to continue to grow your business, again, you are going to be more sensitive to financing costs, and there is going to be a greater focus on what the returns are on those capital expenditures.

Last would be those parts of the market that are seeing significant valuation changes. One that is getting a lot of headlines these days is technology. For example, if you used to be able to sell your company for 20x recurring revenue and had a lender doing enterprise value – as opposed to cashflow – lending against that, and today the valuation has moved significantly inside of that, the value of the company has materially impacted the value of the loan.

> *"If you want to be that long-term, reliable lending partner, you can't come and go from the marketplace"*

Q There's been much discussion about the elevated levels of dry powder and significant deployment in the PE space through the end of 2021. How did that impact sponsor-backed direct lending? And do you expect the pace of activity to pick back up to 2021's levels through year-end?

There is still a huge amount of private equity dry powder out there, and a huge number of PE-backed lower-middle market companies that need to either be sold or transformed in order to generate a return for those sponsors. That will continue to drive add-on activity and a need for financing from direct lenders.

Do we expect 2022 to be as robust as 2021 from an M&A perspective? No, we don't, but we do think there is going to be a similar level of activity to what we saw pre-pandemic. There may be some change of focus for PE sponsors, but they continue to prioritise buying and transforming high-quality companies.

What we are seeing today is similar to what we saw coming out of the GFC, and coming out of the depths of the pandemic in 2020. The really strong credits are concentrating in the hands of long-term, established players, as buyers of these companies want a greater level of confidence when it comes to lenders' surety of execution.

Q Looking ahead, are there any key characteristics or capabilities that you think will support direct lenders' respective abilities to navigate and withstand a recessionary period?

I think consistency of approach is going to be very important. What we have witnessed through past cycles, and also saw during the pandemic, is that there are some direct lenders that decided to go to be distressed lenders for a period of time. PE sponsors and borrowers pay attention to that, and if you want to be that long-term, reliable lending partner, you can't come and go from the marketplace.

We are also seeing a version of that today, with some middle market lenders having taken on significant transaction flow from the BSL market, filled their budgets and essentially put a pause on new activity for the rest of the year. How do you then look to sponsors and say, we can't help you now, but come back to us next year? It will be interesting to see how some of those behaviours potentially impact sponsors' views of lenders moving forward.

Looking to the asset class broadly, I believe direct lending is going to be the beneficiary of what is expected to transpire over the next few years, as a downturn is likely to drive a renewed focus on risk-adjusted, loss-adjusted returns; direct lending is well-positioned for that, and we expect will continue to be an attractive alternative to traditional fixed income. ■