KEYNOTE INTERVIEW

The middle market: past and present

Direct lending in the mid-market has changed over the past five years. As Twin Brook Capital Partners approaches a milestone anniversary, founder and managing partner Trevor Clark discusses the state of the industry and how it has evolved since 2014

Q Wasn't the middle market already very crowded in 2014? What inspired you to start Twin Brook?

Although Twin Brook was only founded five years ago, many members of our team have been in the industry for well over a decade. Prior to starting Twin Brook, I had been in the business for over 20 years and helped found Madison Capital, so I was able to bring that industry expertise and experience to Twin Brook.

We brought together a highly motivated, thoughtful group of leaders – all of whom were excited by and committed to executing on the opportunity we saw: to establish a reliable, consistent industry leader dedicated to serving the lower middle market. This was an opportunity specific to the part of the market that we target, and where many of us had operated for years.

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While there were a number of established direct lenders in 2014, there were very few – particularly with our breadth of experience – that were exclusively focusing on the part of the middle market that we were. Many of these lenders, while in existence for a long time, had shifted their strategies to follow where the money was at a given time, floating from the lower middle market to the upper middle market, and sometimes even to the broadly syndicated loan market.

Unlike others, our strategy from the start – and one that we remain committed to today – was focused on sponsor-backed transactions in the middle market, which we define as companies with $3 million to $50 million in EBITDA, with an emphasis on those in the lower middle market – meaning with $25 million of EBITDA and below. Furthermore, in Angelo Gordon, we had the support of a parent company that understood this approach and shared our focus on building a long-term business.

Q Why was - and is - having a lender with experience, specifically in the lower middle market, so important?

There are a large number of companies in the lower middle market, and private equity firms that focus on this sector typically have a very active ownership style.

These sponsors are focused on ways to meaningfully transform these companies – whether that be through add-on acquisitions or projects to improve operations, professionalise management and staff, or enhance infrastructure – which often requires additional financing and ongoing lender interaction.

Because of this, they are looking for a lending partner with a long-term view – one that has a demonstrated ability to work alongside sponsors to grow portfolio companies, and who will be in the trenches with them handling any issues that may arise during this transformation process. Sponsors are also looking to partner with lenders who have a proven ability to manage through multiple credit cycles, particularly in their part of the market. When we started, and still today, there are few lenders that focus on this sector, have been through a full cycle in the space, and can provide the consistency, reliability and expertise we bring to bear.

Q Does that mean you consider experience one of your key differentiators and something you compete on?

Certainly. If you look at the landscape of direct lenders, it's difficult to find firms with leadership teams that have over 20 years of experience executing on the same strategy or focused on the same sector of the market – and this is especially true when it comes to the lower middle market. As a result, our breadth of experience and the length of time that many of our team members have worked in this segment differentiate us from many peers or managers in the broader space.

Q Some might say that deals across the middle market are all alike, regardless of whether they're in the upper or lower middle market. Do you dispute this idea?

Absolutely. The middle market is distinctly bifurcated, and there are clear differences between the upper segment – defined as companies with over $25 million of EBITDA – versus the lower segment – defined as companies with $25 million of EBITDA and below. The upper middle market tends to be more transactional and commoditised when it comes to lending. Sponsors in this market often seek the highest leverage, loosest terms and the lowest interest rate, regardless of a lender's experience. In the lower middle market, we see less of that. Many lower middle market sponsors place greater priority on the quality of their relationship with the lender, whom they've often worked with for many years, across multiple transactions with a variety of portfolio companies. These sponsors are not worried if a lender has a financial covenant because they have worked with them through both good times and bad, and both parties understand – based on previous experiences – how to resolve various credit issues.

"Lower middle market sponsors place greater priority on the quality of their relationship with the lender"

Q Although deals across the market aren't all the same, are there any types of companies or industries that are popular among lenders in a variety of segments?

Many direct lenders are generalists, so few firms focus on just one or a select handful of industries. With that said, healthcare and financial services are two spaces where we have closed a number of deals, and where we have seen significant interest across the broader industry.

Companies in these fields are particularly appealing to us because they are operating in highly regulated industries that require a level of expertise that resonates with the sponsor community. These borrowers provide a good example of characteristics we target in all of our borrowers, including business models with recurring revenue, as well as solid margins and limited needs when it comes to capex or working capital, allowing for high free cashflow.

Q Has the lower middle market experienced the same trends as the upper middle market, including a reduction in covenants and loosening documentation?

It would be a fallacy to say our documents look exactly the same as they did in 2014, but that's not to say all parts of the market behave the same way when it comes to lender protections. In the lower middle market, there are still the traditional lender protections that we believe are key to managing credit risk. We may be seeing slightly fewer financial covenants – one or two instead of three or four – but we are avoiding transactions that are covenant-lite and covenant-wide. Other sectors – including

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the upper middle market – have seen more significant shifts. In these sectors, pricing is more dynamic, lender protections have eroded dramatically, EBITDA definitions are highly problematic and covenants are far less frequent – all of which can affect the risk profile of assets.

Q Do you think there will be more covenant reductions and loosening of documentation among direct lenders as a whole? In the industry at large, are there any other trends or behaviours you have concerns about?

As mentioned before, we have definitely seen a shift away from covenants in other parts of the middle market, and I would not be surprised if the trend towards looser documentation continues in those segments. However, many of the managers abandoning covenants or not using lender protections have not lent in an environment where they needed them. These lenders typically were not in the market in the early to mid-2000s, as we navigated the global financial crisis, and may have never worked through a downturn. This is the crux of the issue, as you cannot truly understand the importance of something you've given up until you are put in a situation where you need it.

In particular, the number and size of EBITDA add-backs that market participants are being asked to accept – from both an acquisition and leverage perspective – has significantly evolved and certainly been a topic of much discussion in the upper middle market. For those lending based on enterprise value, this raises questions and concerns about how sustainable those values are in the long term. Again, in the lower middle market you are shielded from most of those issues, but we always thoroughly analyse the quality of a company's earnings and make sure we clearly understand how EBITDA is being defined, as it can impact the borrower's debt service coverage covenants.

Q Looking at other changes in the market, do you find that sponsors emphasise speed more than before?

Increasingly, sponsors want a lender that has the ability to compress the timeframe between first receiving a term sheet and closing a deal. We typically process a deal – start to finish – in approximately 60 to 90 days, but we have recently shown that we can compress that timeline down to as little as three weeks. Our team in Chicago currently includes over 60 people and we have access to Angelo Gordon's outstanding infrastructure, so we can bring forth the resources needed to get through due diligence both quickly and thoroughly.

Additionally, sponsors are getting better at knowing what information lenders need and getting it to them quickly. However, not every sponsor runs the same process, so having long-standing relationships with many private equity firms helps us come to understand how each individual sponsor's process works.

Q Beyond building sponsor relationships, what do you consider to be key growth drivers of Twin Brook? What are you doing to keep the firm healthy through the ups and downs of the coming years?

Since 2014, we've closed over 370 transactions, issued total commitments of approximately $10.4 billion, and built a stable platform with the wherewithal to survive economic cycles. There are a number of actions that have enabled this progress, though I believe two of the most important ones are the assembling of our world-class team and our commitment to the lower middle market.

From a risk management perspective, our team's extensive experience is critical when it comes to managing a downturn. By attracting, retaining, developing, and motivating a highly skilled team, we limit the impact of market cycles.

It is key to ensure that for each borrower in a lender's portfolio, there is a committed team with deep knowledge of the company, and that your people have the bandwidth to manage those credits.

At Twin Brook, the lead originator and underwriter on each deal stay with that borrower post-close, and individual underwriters are responsible for overseeing no more than five to seven borrowers. We believe that this underwriter-to-borrower ratio is one of the most compelling aspects of our ability to manage through a downturn. If distress or another issue presents itself during the life of a loan, additional resources and people are at the ready to be brought in. As a result, we believe that we have built a scalable, proven model that is well-positioned for the future. ■

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Founder and managing partner Trevor Clark is a member of Twin Brook's Investment and Executive Committees and has been responsible for overall operations of the firm since its inception in 2014. Previously, he was a co-founder and CEO of Madison Capital Funding, overseeing operational and strategic activities of the middle market lending operation, and held positions in loan underwriting and origination at Antares Capital, GE Capital and Bank of America