EXPERT Q&A

A high-touch approach to working with borrowers and private equity sponsors plays a key role in portfolio management, says Kim Trick, co-chief credit officer and head of underwriting at Twin Brook Capital Partners

In the face of uncertainty, relationships matter

SPONSOR
TWIN BROOK CAPITAL PARTNERS

Q How is the macroeconomic environment impacting the private debt space?

Rising interest rates are top of mind for direct lenders, and they've impacted both structuring and spreads. Historically, as interest rates rose, spreads tended to contract; in the current market cycle, we have yet to observe that trend – in part because lenders are being careful about structures and are very focused on interest coverage and protections. As a result, we've seen transaction leverage levels come down relative to where they were a year ago.

Companies are dealing with inflation in the cost of labour and materials as well as supply chain issues. That has impacts on businesses' demand forecasts, so as a lender, we're doing additional diligence around those factors.

Sponsors are also placing renewed focus on how borrowers are managing inflation and supply chain challenges, and they are looking at how those factors affect cashflow generation. The additional stress that higher interest rates have put on companies may mean operational issues are highlighted sooner than they would have been otherwise.

Q Why are underwriting and portfolio management particularly important in periods of market uncertainty?

When it comes to new deals, we believe diligent underwriting is always key, but I think its importance is highlighted in periods of market uncertainty. For example, through our underwriting, we seek to understand how a company's cashflow profile will be affected if higher interest rates continue for three or four years.

We look at a company's historical ability to deal with inflation and pass on price increases. We analyse the competitive dynamics within the industry in which a company operates and also think about whether any post-pandemic recovery in cashflow is sustainable. Ultimately, we want to understand a company's performance and feel confident in that business's ability to maintain its cashflow.

We believe a proactive, high-touch approach is similarly key when it comes to ongoing portfolio management. We've found having strong relationships with our borrowers and PE clients to be incredibly valuable, particularly in challenging periods, as this supports our ability to maintain open lines of communication. We also hold the revolvers on all of the credits in our portfolio and serve as the administrative agent on almost all of our deals, which positions us to receive more real-time financial data from borrowers. We believe this makes us well-positioned to identify and address any potential issues sooner rather than later.

Q How do approaches to underwriting and portfolio management in the lower mid-market compare with those in other market segments?

In the lower mid-market (LMM), the relationship between a lender and a sponsor is more symbiotic than other market segments. Not only are both parties incentivised to support the growth of the underlying borrower, but they are also equally incentivised to protect against the downside, as the leverage levels we typically see in the LMM tend to be lower than those in the upper middle and broadly syndicated loan (BSL) markets; at Twin Brook, for example, the average loan-to-value on our deals is less than 50 percent as of March 2023. If there's a deterioration in a borrower's business, the lender and the PE sponsor are motivated to work together to find a solution.

The other area where we see a difference is in lender protections. Covenants are prevalent in the LMM, whereas deals in BSL market might be covenant-lite. We believe covenants are beneficial to all parties in a deal – not just the lender; the aim is to catch potential challenges early on, before a borrower is facing a major issue and while the sponsor still has significant equity value left. Having that visibility and open dialogue positions a lender, their borrower, and the sponsor to find a solution before there's a serious liquidity problem. When you don't have those checkpoints along the way, it's easier for issues to arise and intensify unchecked.

Q Have you changed your approach to underwriting and portfolio management in light of the macroeconomic environment?

One of the core characteristics of our approach to underwriting and portfolio management at Twin Brook is consistency. Our focus on diligence is unwavering, regardless of where we are in a cycle, so we have not needed to change our approach in order to adapt to current market conditions.

From a strategy perspective, we avoid industries that are more volatile in terms of cyclical demand drivers. Additionally, we exclusively work with sponsor-backed businesses, as we appreciate the support PE sponsors provide both from a resource and capital perspective; the value they bring to bear was demonstrated through the pandemic and as we've entered this volatile macro environment.

Additionally, we've continuously invested in our team as our portfolio has grown – both from a staffing and training perspective. We know how important maintaining a high-touch approach is and want to ensure our team members have the bandwidth to appropriately manage credits regardless of the market environment, so we seek to limit the number of accounts each underwriter works on to between four and six accounts per person.

Q What are some key differentiators when it comes to lenders' respective abilities to manage their portfolios?

I think experience – both in the direct lending space and through prior cycles – is extremely important. Depth of experience can inform a lender's strategy, but it also often goes hand-in-hand with having longstanding relationships with PE sponsors. Having the experience of working with a sponsor repeatedly, across many years and many deals, allows for a level of trust and communication that can be invaluable when it comes to being able to work together and act quickly – whether it be on a new deal or a challenging situation.

Serving as the administrative agent is another differentiator, as being the agent means you are the leader in negotiating the structure and terms of the deal, as well as running point on ongoing management and the navigation of any issues that may arise during the life of that credit. Thus, as the admin agent, a lender also has the ability to materially influence the outcome of a restructuring solution, should it come to that.

We believe providing the revolver is also key. Revolver activity can often be an early indicator of a deterioration in liquidity. Having real-time data on how a company is tapping into that line of credit can provide a real advantage, particularly in a challenging market environment.

Q How do you view the outlook for private debt in 2023?

This has been an interesting time, as we're in a period where spreads haven't come in yet, but leverage is lower. We haven't seen the enterprise values of companies come down yet, so that gap is still being filled by significant equity cheques. All of this provides an attractive backdrop for private debt managers.

As things start to level out, I think we'll see spreads tighten, but it's still a really good time to be in private debt. The credit protections that eroded over the past few years are coming back, which is great to see, and we expect transaction volumes to increase in the second half of the year. We believe there are certainly still a lot of great opportunities. ■