Investment INSIGHTS

DIRECT LENDING NICHE OFFERS CONSISTENT RETURNS

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Volatility has been a hallmark of the capital markets this year, with the Federal Reserve battling inflation while concerns linger about the strength of U.S. regional banks, tightening credit markets and a general growth slowdown. For investors seeking consistent returns, navigating this economic environment can be challenging at best. Not all asset classes, however, are subject to the whiplash of short-term market movements.

Direct lending is one such asset class that can provide long-term resilience, according to Drew Guyette, co-chief credit officer and senior partner at Twin Brook Capital Partners — Angelo Gordon's middle market direct lending business. "We think about direct lending in terms of consistency of outcomes and expectations," he said. "In this market, a senior debt position in the capital structures of sponsor-backed businesses coupled with the right experienced lending manager can produce that 'sleep well at night' experience for investors."

A SPECIFIC SEGMENT

Direct lending has been among the fastest-growing asset classes since the Global Financial Crisis, with total assets under management reaching roughly $800 billion by mid-2022, according to Preqin. This large market is typically defined based on borrower ownership — family- or founder-owned (non-sponsored) versus private equity-backed (sponsored) companies — or it is segmented by size, measured by borrower revenue or EBITDA.

When defining the market based on borrower size, it is further delineated into four segments: the broadly syndicated loan, or BSL, market; the upper middle market; the core middle market; and the lower middle market. The BSL market consists of the largest companies — borrowers with greater than $75 million of EBITDA — while the lower middle market is defined as companies with EBITDA of $25 million or less, Guyette said.

It's the lower middle market segment that can offer investors a sweet spot, with lower volatility and consistent returns, he said. In fact, this segment has absorbed the recent shocks of four-decade high inflation followed by sharp and rapid interest rate increases better than other parts of the direct lending market.

"The lower middle market has benefited from the consistency of borrower performance," Guyette said. "Smaller businesses can compete as successfully as their larger counterparts in the marketplace. Additionally, structurally, they have had less pressurized balance sheets and more conservative debt instruments."

COUNTERINTUITIVE VIEW

The fact that smaller borrowers weathered the economic and fiscal storms of the last few years better than their larger counterparts seems counterintuitive. But, according to Guyette, that's where an experienced direct lending manager's process plays a major role.

"Generally, there is an assumption that larger businesses should perform better or be more resilient than smaller businesses," he said. "But if you have the right selection process and the right underwriting structures, you can identify small businesses that are market leaders with demonstrated niche or regional dominance." Twin Brook's unwavering focus on lending to market leaders within this lower middle market segment is one of the major reasons the firm has not only managed through the macroeconomic headwinds of the last few years, but has continued to grow and gain market share, Guyette noted.

"The reality is that these businesses have been challenged by a variety of inflationary factors as well as interest rate policy over the last two years. And they've withstood those tests," he said. "These best-in-class businesses in the lower middle market have value propositions and pricing power that have allowed them to weather the storm." Some of the ways that Twin Brook's portfolio companies have navigated supply chain challenges, the rise in interest rates and volatile capital markets have included passing through price increases to customers, redefining their value propositions, reinforcing customer relationships, and staying small but nimble.

However, Guyette is quick to add that such success isn't seen across the entire lower middle market. With this in mind, investors need to carefully consider a manager's credit selection and underwriting processes, which are key to identifying companies best positioned to perform without the risk — or with a lower risk — of default. As such, they should consider the following about a direct lending manager:

- How much experience do they have in the direct lending space broadly and in the segment of the market on which they focus?
- What's their credit selection process?
- What's their portfolio construction process?
- What is the scale of the infrastructure backing the manager?

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ROBUST DUE DILIGENCE

When it comes to identifying best-in-class small businesses, it's not about looking at a few standalone factors. Lenders need to perform robust due diligence, evaluating upwards of a dozen different factors that all need to be considered in concert, Guyette said.

"It's our institutional belief that you have to get 100% of those dozen-plus different factors right to deliver that consistent underwriting and portfolio management experience," he noted. "And that having a deep relationship with a borrower's PE sponsor — understanding their goals for the company and the value they bring to the table in terms of operating expertise and resources — is key."

However, a manager's job is not complete once they have determined that a borrower meets their standards and finish the initial underwriting process. Ongoing due diligence on the borrower – or portfolio management – is equally important, according to Guyette.

A DEEPER DIVE

Ongoing portfolio management includes in-depth monitoring of a borrower's performance and balance sheet to understand how much, if any, risk the company may be exposed to from outside forces, such as higher interest rates.

"We're always looking at the cash conversion cycle of our borrowers, thinking about their working capital and free cash flow from operations," Guyette explained. "Then we think about how the borrower will interact on its revolving line of credit and use that as a monitoring tool." That process, which Guyette characterized as "preventative maintenance," has served the firm well through the market stresses of the last three years.

"With recent Fed tightening, the question of, 'Is there concern of a future default cycle that direct lending as a whole is possibly facing?' has been a point of much discussion," he said. "Reflecting on the past few years, I think our performance has been supported by our portfolio management style and our ability to spot micro trends and manage through them before the macro trends really set in."

Given the ongoing macro concerns, both private equity firms and direct lenders are taking a more measured due diligence stance and engaging in a deeper evaluation of opportunities, which can result in elongated transaction timelines. Those extended processes could impact the level of market activity this year. "You could extrapolate that the markets are going to experience less volume this year," Guyette added.

EXPERIENCE AND CONSISTENCY

For Twin Brook, consistency of strategy — or not succumbing to style drift — is a key strength, Guyette said.

While investment opportunities exist across different industries in the lower middle market, Guyette warned that trying to capitalize on hot new ideas or sectors can be risky because those opportunities are often less likely to deliver consistent returns with low volatility over the long term. "We try to not chase trends or fads as they relate to specific sectors," he said. "Historically, we've sought to avoid volatile industries or industries that don't line up well with the consistent, stable senior cash flow profiles we target."

Twin Brook takes a generalist approach, focusing on businesses that offer a strong value proposition and have high barriers to entry, but they've also ensured they have the appropriate specialized resources in place where it makes sense. "We believe some sectors require specialized originations, underwriting, and PE support," Guyette said. "When it comes to healthcare, for example, we have the dedicated resources and human capital to specialize in that industry."

In addition to consistency, it is important to focus on a manager's experience, Guyette emphasized. "Longevity and experience are differentiators in the lower middle market. You need to make sure you have deeply knowledgeable professionals that are able to speak to all the nuances of the market in order to deliver on portfolio outcomes." ■

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