KEYNOTE INTERVIEW

Remaining disciplined in the face of headwinds

As competition for capital intensifies, private debt managers need to have the scale, flexibility and experience to meet investors varying needs and navigate a challenging environment, says Jeff Frank, head of capital solutions & strategy at Twin Brook

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Q The direct lending space has grown tremendously since the global financial crisis (GFC). What are some of the primary drivers of this trend?

In the wake of the GFC, there have been several trend lines that have helped drive the growth of the direct lending space. We had bank retrenchment from small and mid-market businesses – paving the way for private credit managers – and at the same time, we had investors searching for yield in a historically low-rate environment. Additionally, private equity sponsors wanted more flexible, reliable sources of financing. All of these inter-connected factors drove more capital into the direct lending asset class.

How the industry forms capital has also materially changed since the GFC. A decade ago, the only way to invest in direct lending was to commit to closed-end, PE-style funds. Fast forward to today, there is now an array of different products and access points for investors, including but not limited to BDCs, evergreen funds, rated products, interval funds, and separately managed accounts. This product development has been driven by a combination of investor demand for flexibility and the aforementioned macro trends that led to more capital allocations to direct lending strategies, especially those focused on the lower and core mid-market.

Q Looking back, aside from the growth of the asset class, what are some of the most notable trends or changes you would point to?

A decade ago, private credit was not widely considered part of the alternative investment asset class. Alternative investment allocations back then mainly referred to PE, within which you had growth strategies, distressed and so on. Today, you have a bifurcation within the alternatives universe, between private equity and private credit, and the private credit landscape is then further divided into direct lending, structured credit, opportunistic credit and a number of other strategies.

Another trend we've witnessed has been greater manager consolidation, as institutional investors increasingly seek to subscribe to alternatives platforms via which they can access more than one sleeve of alternatives risk.

Additionally, we've seen greater differentiation within direct lending specifically. Five years ago, the direct lending space was viewed as relatively homogeneous, with little differentiation among market segments, like the upper, core and lower mid-market. All of those market segments have nuances in how they operate, and investors now understand those differences and see the value in balancing portfolios across the direct lending spectrum.

Q You mentioned that investor demand for flexibility has been on the rise. What do you mean by that?

Competition for investor capital is intense among direct lenders. Investors, and especially institutional investors, come with unique needs from both a portfolio allocation and organisational perspective. As a result, investor demand for greater manager flexibility – in terms of helping them solve for their specific needs – has been on the rise, and the range of access points for direct lending has in turn evolved and expanded.

This is why, from a direct lending manager perspective, you need to demonstrate scale and flexibility – meaning the ability to deliver a variety of different product offerings. For example, sizeable institutions that have the ability to write large commitments need a manager to be able to design separately managed accounts with specific investment guidelines and economics. Investor demand for flexibility has thus compelled managers to operate at greater scale from a technology, infrastructure and operational point of view.

Q As we head toward year end and into 2024, what is your outlook for the private debt space at-large?

Over the next 12-18 months, we expect there will be headwinds pressuring many lenders' current portfolios. We believe those that adopted looser underwriting standards over the last few years will be punished, and there will be an uptick in defaults. The exact timing of that trend depends on Federal Reserve policy, among other things, but there is little doubt defaults will come as companies face elevated borrowing costs for a sustained period of time.

This is where we expect to see increased separation among managers. Over the last three to five years, poor underwriting standards went largely unpunished. Going forward, however, there will be greater manager dispersion within market segments, and LPs will be able to see the results of past actions.

Q What are some other areas or issues investors are focused on when it comes to the direct lending market today?

I think macro market themes and manager selection are two things that are top of mind. From a macro perspective, the focus is on the major issues at hand – the interest rate environment, inflation, labour costs, the forward interest rate curve – and trying to assess how the M&A market and companies' will be impacted by all of those headwinds.

When it comes to manager selection, the themes of scale and structural leadership have come to the forefront. The current market environment has certainly spurred greater focus on investment discipline around interest coverage charges, default rates, deployment pace and watchlist additions, among other factors. All of those things link back to operating scale.

Similarly, we're seeing more attention paid to whether a manager plays a leadership role in credits, which supports their ability to drive outcomes by being proactive about addressing potential issues. There's also the question of, if a credit does underperform, does the manager have in-house workout capabilities? Is your team appropriately resourced and in place, and does that team have the experience of working through previous cycles together?

Q What are some of the key factors that will affect lenders' abilities to effectively manage portfolios through the current market environment?

I would highlight two key factors: Did the manager have investment discipline in the years leading up to today? And does the manager have the infrastructure to meet current market demands?

On the investment discipline front, questions to consider are: Did the manager loosen underwriting standards when the market was flowing? And did they provide more flex to companies at the expense of structural protections? As we contend with current headwinds, managers that loosened underwriting standards or had opportunistic style drift will experience stress in their portfolios.

When it comes to manager infrastructure, some key factors include headcount, systems and expertise. Assuming a manager has the appropriate structural features – like being the revolving lender – and processes in place, they need to have the accompanying human capital to proactively identify and swiftly address a credit's potential underperformance. Active portfolio management and how many resources are dedicated to each underlying borrower are also important; being mindful of not overloading individual underwriters and portfolio management professionals with too many credits is critical when it comes to being able to effectuate change before it's too late.

Five years ago, LPs were primarily focused on deployment pace and whether a manager could keep up with an active M&A market. Now, the pendulum has swung to investors asking: Do you have the ability, the personnel and the processes to manage through a persistently challenging market environment?

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Q In light of the current market environment, have managers been forced to change their approaches?

We saw some managers change their investment discipline and respective approaches leading up to and through the early stages of the current environment. In recent history, the prevailing trend had been a shift toward a high risk/return profile; with 2021 and 2022 being particularly high-volume origination years, in order to keep deployment at pace with investor capital, many moved toward covenant-lite or covenant-wide loans and much more borrower-friendly terms.

While not all lenders were compensated for that risk, it had so far gone unpunished given the relatively benign credit environment. Now, in the face of a more challenging environment, we believe those that amended their lending standards or "traded" into a temporary market opportunity are likely to feel stress and be impacted by those decisions in the near to medium term.

Q Has Twin Brook made any adjustments to its approach?

Our focus has long been on consistency through market cycles, so we really haven't made any material adjustments to our operating model or underwriting standards. One of the benefits we have with our team is that many of our professionals have been investing in this space for a long time – in some cases, working together for 15-20 years – and they have seen what happens if you try to trade into market cycles. A key tenet of Twin Brook's investment philosophy is delivering stable results through cycles. Volatility is something we focus on daily, and how to craft stability is of the utmost importance to us.

While other groups strayed from their existing approaches – going deeper into the capital stack, participating in more transactions with looser underwriting standards, or lending to larger companies – we instead made the deliberate decision to maintain our historical risk/return profile.

Q Thinking about manager selection moving ahead, what do you believe will be key differentiators?

To date, the pendulum has certainly swung toward investors focusing on elements like portfolio management, infrastructure, scale, experience and consistency of approach. Experience is particularly important as LPs seek to understand how long the team has been investing and managing portfolios together, especially through past cycles.

On consistency of approach, style drift will also be a focus. If you have a direct lender that has opportunistically gone into a new market segment with a team that is inexperienced or has not worked through a cycle together before, investors will dig in on those factors. As a result, style drift will lead investors to focus on current portfolio health and accompanying marks.

Moving forward, I think the priorities are going to be investment discipline, lending standards and the strength of the current portfolio – those will be some of the key drivers of manager selection. ■