Different views of the mid-market

What qualifies as the 'mid-market' can be vastly different based on who you ask. **Tim Healy**, a managing director at Twin Brook, offers his definition

Q How well educated do you feel investors are on the idea of mid-market debt, and is there always consensus on its meaning?

The definition of the mid-market is very fluid. Generally speaking, over $50 million of EBITDA deals are a feature of the liquid, broadly-syndicated market. Less than $50 million of EBITDA means no liquidity and it is typically the domain of traditional middle market lenders.

However, the definition has evolved as different issuers/lenders/consultants have taken liberties to adjust the definition to suit their own specific demands. An example of this would be an asset manager/lender that represents they are a middle market direct lender but defines their target market as companies with EBITDA between $50 million and $100 million to $125 million because that is where they have historically sourced transactions.

With the desire to more accurately define market participants, the consultant community has further eroded the definition of middle market by adding such qualifiers as lower middle market and upper middle market. The net result is that the once static term "middle market" is now subject to varying degrees of interpretation and will oftentimes be specifically defined in presentations and articles to avoid confusion about what size of companies are being referenced.

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Q Have you found that the definition of the mid-market has changed over time?

Twin Brook's senior management team has primarily focused on companies with EBITDA between $5 million and $25 million for the last 18 years.

However, given the significant differences today, versus five to six years ago, between lower middle market (less than $25 million of EBITDA) and upper middle market ($25 million to $50 million of EBITDA), we like to emphasise that we are lower middle market driven. The upper middle market has become more commoditised and less relationship driven. The legal documents mimic those of the BSL market, where there are far fewer lender protections. The lower middle market still maintains the traditional protections that, as a lender, we feel are critical to manage credit risk.

Q Many lower mid-market lenders maintain that the space is underserved and there isn't too much competition yet. Is that something you've found as well?

I think all market segments have become more competitive, but the lower middle market is less crowded than other segments. There are a few reasons for this. The upper/BSL middle market attracts lending platforms that are built to be "buyers" of paper rather than lead their own deals. This is because there is more paper to distribute, buyers of paper don't need to invest in staff and infrastructure because they are not leading deals, and there is little room for new and unproven lenders in the lower middle market.

This is further underscored by the fact that hold sizes have increased significantly in recent years so that, in lower middle market transactions, a single lender can take down the entire

credit facility, meaning there is little to no paper for traditional, passive buyers. The data backs this up. If you look at the 2018 middle market PitchBook league tables, there is only one lender – apart from Twin Brook – in the top 25 that has not been around for more than 10 years.

Having come from the private equity side, I can tell you that sponsors are interested in building long-term lending relationships with firms that have been through multiple credit cycles.

Q Do you think the volatility in the broadly-syndicated market at the end of 2018 had an impact on the mid-market?

The short answer is no. Middle market lenders briefly felt emboldened to ask for modestly more economics in January as a result of the BSL dislocation, but by mid-to-late January, that had all disappeared. The dislocation had little impact because there was very little new dealflow coming off the holidays; mid-market lending is awash with capital, so that tends to offset relative value decision making; and mid-market lending yields typically don't correlate with the BSL/high yield market. In fact, in Q1 2016, when the market went through a much larger and prolonged dislocation, there was only a 50 basis point increase in pricing on middle market deals. Asset prices in the middle market are typically immune from large market or high yield swings.

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Q Are there any specific sectors or industries that you think are finding more success than others in the mid-market?

Since we are now 11 years past the last recession, there is a flight to industries that tend to demonstrate counter-cyclical trends. We favour two sectors where we have deep industry expertise: healthcare and financial services – which are sectors that tend to perform well during cyclical downturns. We continue to be bearish on sectors such as retail, restaurants, building products, oil and gas, and fad-consumer.

Given where we are in the cycle right now, we believe the companies that showed strong resilience through The Great Recession or generally exhibit strong counter-cyclical attributes are finding greater success. Having the right financial sponsor associated with these borrowers is also important, not just for their expertise, but their willingness to support the company with follow-on capital, if necessary.

Q How has this flight to industries with counter-cyclical attributes impacted origination, particularly with respect to private equity sponsored deals?

Having come from the sponsor side and now living on the debt side, I have gained valuable new insight and developed a more well-rounded perspective when it comes to this topic. We continue to work with both generalist and specialised private equity shops. However, there are an ever-increasing number of industry-focused firms.

This proliferation of specialised shops has been a trend for the past several years. As a result, we continue to see the proportion of our dealflow coming from sector-specific private equity groups growing every year. In 2018, Twin Brook closed 142 deals, 45 of which

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were healthcare or financial services focused transactions. With that said, we believe this phenomenon is a result of the increasing number of specialised private equity shops, not a sourcing advantage over generalist firms.

Q Looking more at industry focus, do you anticipate more specialisation happening as more managers are coming into play, or as competition continues to grow?

You need to specialise and invest in personnel for certain industries, so when you lead a deal or are competing for a deal, you can demonstrate the ability and have the experience to understand the sponsor's investment thesis. Your industry knowledge will result in better credit decisions and can position you to lead deals because of that creditability. We

DEALS

have certain individuals who – due to their previous experience – will focus on specific sectors, such as healthcare or financial services.

Having said that, there is only so much sector specialisation that you can do. The reality is that the majority of transactions that undergo a sales process are generalist in nature.

Q With so much manager and GP consolidation happening, have you seen any impact on mid-market opportunities because of this?

We really haven't. I think there have been a couple of transactions in the mid-market, but I think that's a more relevant topic for larger US direct lending groups and those in Europe where, in both instances, there is fiercer competition against investment banks. There have been some recent acquisitions in the middle market, but they have had minimal impact on our sector.

Q Where in the mid-market right now are you seeing the most pressure regarding deal terms?

Again, it's a function of where you play. In the $50 million to $125 million market, which is sometimes referred to as "mid-market", there are very few lender protections in place and deal terms tend to be at the lowest common denominator.

As you move below the $50 million level, the biggest pain points tend to be covenant levels and the definitions of EBITDA, which drive the covenant calculation. $25 million to 450 million EBITDA issuers can get covenant-wide structures where the cushion is up to 40 percent. Below $25 million of EBITDA, transactions tend to retain an acceptable level of traditional middle market discipline.

Q Have you seen an evolution of EBITDA add-backs?

Absolutely. We have seen the number and size of add-backs that are included in the definition of EBITDA grow over time, and the topic has certainly become more prevalent and widely discussed.

As I mentioned before, how EBITDA is defined can impact what your fixed charge, your leverage, and your covenant may be, so it's often an important conversation to have with borrowers. When we are looking at the quality of earnings, there are some *pro forma* metrics that can be difficult to evaluate, but there are also a number of identifiable items that are easy to confirm. ■

A decade in the making

What has been one of the most interesting changes you've seen in the mid-market landscape since the last recession?

I think it's the speed required to complete transactions and the M&A process. Sellers and their investment banks are driving very competitive and accelerated timeframes to secure a buyer. As a result, the arrangement for debt financing as part of this process has also been expedited. This is key in a competitive auction process when the buyer is trying to differentiate itself in a crowded and competitive field.

For buyers, paying attention to sellers and understanding the keys to value creation are paramount and – in a robust loan market – take priority over securing debt capital. In this regard, the sponsor community has evolved in a number of ways. Many firms now have in-house capabilities on the debt capital markets side. In addition, this drive for more speed and efficiency continues to be pushed forward by several emerging trends, including:

- Sponsor law firms originating the term sheet for a deal, as opposed to receiving five to six different "form documents" from as many lenders;
- Adopting "documentation principles" for deals, thereby avoiding the lender's credit agreement and the lengthy back and forth negotiation;
- Avoiding a formal syndication or a traditional "marketing period" by clubbing lenders or selecting one lender that has the capital to take down the entire facility;
- Opting for unitranche structures, thereby eliminating the need to deal with intercreditor issues and multiple diligence streams for both senior and junior lenders.

Overall, I believe speed, efficiency and reliability are key elements for the private equity community when considering debt today, especially if a sponsor decides to pre-empt a sales process. The debt markets have evolved to meet those demands.