Q+A

Evolving with the Sponsor Community

A Q&A with Twin Brook Capital Partners

Chris Martin
Partner
Twin Brook Capital Partners

Chris Martin joined Twin Brook in 2016 as a managing director in the firm's middle market direct lending loan business. Chris is primarily responsible for originating, evaluating and structuring new lending opportunities with PE sponsors in the Northeast and West Coast regions.

Pete Notter
Partner
Twin Brook Capital Partners

Pete Notter joined Twin Brook in 2016 as a managing director in the firm's middle market direct lending business. Pete is primarily responsible for originating, evaluating and structuring new lending opportunities with PE sponsors in the Northeast and Midwest regions.

What are the primary differences in dealing with sponsors today versus six or seven years ago?

Pete Notter: The areas where we've seen the most dramatic change are in the hold sizes that direct lending firms are willing to take for individual borrowers and, as a result, the process that a sponsor undergoes in sourcing and closing on the debt financing for a transaction. For example, in 2012, a $250 million deal involved a full syndication process whereby a lead agent would ultimately hold $40 million-$50 million after syndicating the transaction to 8-10 other lenders. A confidential information memorandum (CIM) was written, a formal lender presentation was staged, a two-week retail syndication ran its process, and the deal would close after all lenders provided comments on the credit agreement. Today, a deal of that size is typically clubbed together with fewer than four lenders. In fact, there are instances where a single lender has spoken for the entire deal. As Twin Brook has grown, we've been able to manage this competitive dynamic and still maintain a great deal of portfolio diversity among our over 135 borrowers and multiple funds.

Chris Martin: It's certainly been a borrower's market since around 2012, and with the amount of capital that has entered the PE and debt sectors, the middle market M&A ecosystem has adapted to the benefit of sellers during this relatively consistent bull run. In recent years, most of the adaptations have been driven by the need for market speed and efficiency. One of the more notable trends that underscores this need for speed is the emergence of the unitranche product. It has many advantages over the traditional senior/junior debt structure, including obviating the need for dealing with diligence streams of both senior and junior lenders, as well as intercreditor documentation. The product also eliminates the need for a formal syndication, marketing periods and often the need for market flex language. In other words, it is a product that has successfully adapted to the changes in our marketplace.

Over the last few years, what are some other ways in which the sponsor community has changed how it interacts with lenders?

CM: One of the things we've seen as part of the "speed adaptation" is an increase in the number of private equity firms that have their own debt capital markets (DCM) group. Sponsors are emphasizing the need for their deal team members to focus on the seller and/or investment banks, not the lenders. However, we see this occurring primarily in larger PE shops, where more volume runs through the firm via auctions and/or where larger deals—with borrower EBITDA greater than $25 million—are contemplated. For PE sponsors that have DCM teams, there are pros and cons. The main pro is that there is usually one point of contact for an entire firm, so once an originator establishes that point of contact, they will start to see deal flow from all teams in that organization via that DCM group. This means they don't necessarily need to know all of the partners across every industry vertical and office location of a particular firm. The disadvantage of that structure is that the DCM group is highly focused on getting the best possible terms from its lenders, which results in a competitive bake-off of terms. This can cause the process to become more commoditized versus relationship driven. Given where we play in the sub-$25 million of EBITDA space, we tend to avoid a fair amount of this commoditization, which is typically a feature of the upper middle market.

Nonetheless, it sounds competitive. How do you manage to differentiate yourselves among the competition?

PN: There are several ways we do this. As Chris mentioned, our focus is on the lower middle market. The average EBITDA in our portfolio of over 135 borrowers is $17.9 million, but we are willing to look at businesses with as low as $3 million in EBITDA. Our consistency around this strategy is well known in the marketplace, and our firm's senior partners have been focused on this strategy for more than 18 years. While we believe we are selective—we have historically closed on about 3%-4% of the deals we see—we are also willing to roll up our sleeves on storied credits for the right PE firm. Those tougher executions build relationship equity with sponsors. Lastly, given our long history in the sector, we have gone through multiple credit cycles with our PE relationships. This has provided us with substantial knowledge on how to manage credit risk during a downturn, as well as how to work with sponsors to ensure their companies emerge from an economic contraction with the best possible outcome for all parties.

CM: On the front end of transactions, I feel I am working with a very efficient decision-making process. Twin Brook has five senior partners—all based in Chicago—that make decisions on every transaction, and we have the ability to meet with that committee any day of the week. The senior leadership team has been working together for over a decade, so there is a great deal of understanding within the firm about what can get done. That feeling of credit decision makers being on the same page as an originator like myself is rewarding, and it allows us to deliver a great deal of consistency to our sponsor relationships. Developing these relationships can take years and significant work—whether it's reviewing transactions with sponsors, attending management meetings, or working with them on the portfolio side—through both positive and negative situations. I agree with Pete that it's in those latter situations that you generate some of your strongest connections, working together to get through issues or difficult patches in the journey of a company's growth trajectory. Any lender can close a deal—it's the ability to work through the growing pains that strengthens and deepens those relationships.

Given the amount of money that's now in the system, are you seeing more competition emerge in the lower middle market?

PN: I think there is greater competition across the entire system. However, the lower middle market has not become as crowded or commoditized as the broadly syndicated loan (BSL) and upper middle markets. I believe one of the primary reasons for this is that the lower middle market calls for experienced lenders that lead their own deals. Upper middle market and BSL lenders are generally designed to be buyers of paper and, as a result, often don't have the staff or infrastructure for leading deals. Furthermore, hold sizes have increased in recent years. As I mentioned before, this has resulted in one or just a few lenders speaking for an entire deal, meaning there is very little paper for those looking to passively buy in the lower middle market. Additionally, sponsors in this segment have longstanding relationships with a relatively small, established group of lenders, making it very difficult for new entrants. PitchBook's 2018 middle market league tables highlight this dynamic—only two of the top 25 lenders were founded less than a decade ago, with one of them being Twin Brook.

About Twin Brook Capital Partners

Twin Brook Capital Partners is a finance company focused on providing cash-flow based financing solutions for the middle market private equity community. The firm is managed by highly experienced, dedicated professionals who have successfully worked together throughout their careers at leading middle market lending institutions. Twin Brook's flexible product suite allows for tailored financing solutions for leveraged buyouts, recapitalizations, add-on acquisitions, growth capital and other situations.

For more information, visit www.twincp.com.