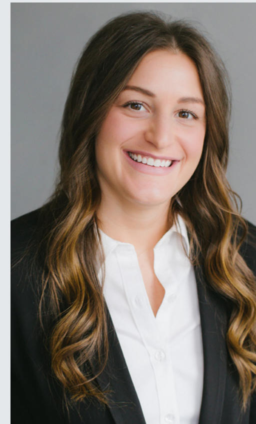
Twin Brook Capital Partners Q&A: Financial services—A hot sector in an active market

With large amounts of dry powder ready to be put to work, PE sponsors continue to hunt for attractive deals, including opportunities in the financial services sector. Twin Brook Capital Partners' Betsy Booth discusses why this industry has garnered so much attention, recent trends and her experience working with sponsors active in the space.



Betsy Booth
Director
Twin Brook Capital Partners

Betsy focuses on the origination, evaluation and structuring of new loan opportunities with PE sponsors. Prior to joining Twin Brook in 2015, Betsy was at Ares Management LLC, where she underwrote senior debt and unitranche credit facilities supporting PE-backed transactions in the middle-market space across a variety of industries.

The financial services industry isn't a new area of interest for PE. We've seen healthy deal activity in the space for many years. What makes this sector so attractive?

Financial services companies generally have a number of characteristics that make them appealing from both a debt and equity perspective, including recurring revenue and high free cash flow. Their business models often include monthly admin fees or fees as a percentage of AUM, providing a steady, reliable stream of revenue. With significant customer diversification and high retention rates, these companies tend to have a stable and consistent client base, and combined with limited working capital and capex requirements, these factors typically contribute to businesses generating greater than 25% margins.

In addition, expanded regulatory requirements have led to an increased focus on compliance, which is an area where PE firms can bring significant value. Over the past decade, it has become increasingly important for businesses to ensure that they have, build or outsource the technology required to adhere to evolving industry regulations. Sponsors can provide the funding and substantial strategic guidance needed to identify, establish and implement the proper compliance resources and infrastructure.

Twin Brook typically focuses on middle-market—specifically lower middle-market—companies. Given the propensity for roll-up strategies, why haven't we seen a drop-off in financial services deals in that segment of the market, with many platforms and potential add-on targets growing beyond the sub-$25 million of EBITDA category?

I think one of the most fascinating aspects of the financial services industry is, in some respects, the relatively limited level of change when it comes to fragmentation and transaction volume. We've historically seen, and continue to see, a lot of activity in the wealth management and registered investment advisor (RIA) spaces. In the early 2000s, PE firms were delving into highly fragmented industries with no shortage of small, founder-owned businesses, which sponsors viewed as compelling opportunities to establish platforms and execute on roll-up strategies. By now, you would think the space had been picked over—with all the smaller players rolled up and the platforms outgrowing the middle market—but in our experience, that has not been the case.

We've continued to see fragmentation in several sectors, as well as healthy sponsor interest and activity. We believe this continued focus on the space has been driven by the importance of technology, regulatory focus on compliance and succession planning, and I think the activity of the past decade has led to other niches becoming clear targets for roll-up strategies. Wealth management and property and casualty insurers are some of the oldest platforms that were built via roll-ups, and the success achieved there has spurred many sponsors to employ the same strategy with other middle-market financial services businesses with similar dynamics.

It sounds like you continue to see a lot of sponsor activity in the space. In terms of recent dealmaking, have you seen any interesting trends or changes?

I believe the most notable trend this year is the number of add-on acquisitions that are occurring across all industries. Sponsors are being forced, through competitive auctions, to acquire platform businesses at competitive multiples. By subsequently acquiring a number of smaller tuck-in acquisitions at lower multiples, buyers can lower their entry multiple into a sector and benefit from the overall arbitrage of this strategy when they exit the business several years later. Add-on activity has contributed to a significant level of assets deployed in private credit this year versus other years.

Are there any specific parts of the financial services industry that have garnered increased interest as of late?

One space where we've seen increased deal activity is third party administrators (TPAs) and managed general agencies (MGAs). We believe this is also a continuation of the trend around outsourced service providers, as these agencies function as extensions of insurance carriers, thereby offering a strong value proposition and appealing profit center for said carriers to capitalize on.

The intersection of healthcare and financial services is another area where there has been substantial activity, as we've witnessed the rise of voluntary employee benefits or supplemental employee benefits for employer groups' commercial policies. We attribute the increased focus on these benefits to the continued shift to high-deductible health insurance plans and the frothy job market, which has motivated employers to search for economical ways to attract and retain employees.

Are you seeing more sponsors establish sector-specific teams? Or are new firms that focus exclusively on financial services emerging?

There is a relatively stable, consistent group of financial services-focused PE firms that have been in the market for the past 10 to 20 years, and there have not been many new entrants. However, we have seen a rise in generalist firms gaining comfort with the financial services space—from a knowledge and background perspective—who will pursue a transaction when they identify an attractive opportunity. These generalist sponsors may have an in-house team or individual that leads their financial services efforts, but they typically aren't creating new, industry-specific verticals or redefining their overall strategies.

How has this increased focus on financial services impacted your relationships with sponsors and what they are looking for in a direct lender?

Overall, the increased focus on financial services has strengthened our relationships with sponsors. These sponsors value our industry expertise and can be confident that we have the market knowledge needed to understand the opportunities they're pursuing, without them needing to explain all the nuances, trends and details of the broader space. From a deal perspective, our breadth of experience with similar companies and the sector at-large allows us to streamline the diligence process, as we can cut out much of the industry research and concentrate on the specific transaction at hand. Given sponsors' ever-increasing focus on time, this is very important. If a sponsor is looking to compress, accelerate or preempt a process, they know we have the resources and expertise needed to do that.

As we look to the future, do you think the financial services industry will continue to grow and be an area of interest for PE sponsors?

Despite the proliferation of activity and sponsor interest in the space over the past 10-plus years, I don't anticipate a near-term reversal of the trend. Although the number of established platforms has increased over the past decade, we've seen deal volume remain at healthy levels, as sponsors continue to see substantial fragmentation and plenty of opportunity for roll-up strategies. Moving forward, I believe one of the primary factors driving continued industry growth will be the regulatory environment. Small businesses often struggle to navigate increasingly complex regulations, creating a need for strategic guidance and potential investment in infrastructure and technology. As a result, we continue to see more outsourced providers emerge. We believe these providers have become, and will continue to be, a key tool for smaller businesses and an area of focus for many PE sponsors.