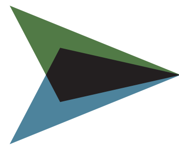
Investment
INSIGHTS



DIRECT LENDING: POISED FOR UPSIDE

Grant Haggard
Senior Partner, Middle-Market Direct Lending, TPG Twin Brook Capital Partners

Direct lending to middle-market companies can be an attractive asset class for institutional investors. Historically, the lower part of the middle market has offered significant advantages versus the middle market's upper tier — companies with EBITDA of $25 million or less compared to those with $40 million to $75 million.

But as conditions in the lower-middle market have evolved in the past few years and deal-making activity has slowed, it has illuminated the need for institutional allocators to partner with an experienced direct-lending manager who can deliver strong, consistent performance across changing market conditions. Working with the right direct-lending manager, said Grant Haggard, senior partner, middle-market direct lending at TPG Twin Brook Capital Partners, can be key.

WHY LOWER MIDDLE MARKET?

TPG Twin Brook has long favored lower-middle-market companies, which tend to be more conservatively structured credits than their upper-middle-market counterparts, Haggard said. For example, lower-middle-market borrowers typically are less leveraged, with debt closer to 4 times earnings before interest, taxes, depreciation and amortization, compared with 5 to 6-plus times EBITDA in the upper-middle market, according to firm data. In the event of default, moreover, their 85% historical recovery rate[1] is meaningfully better than the upper-middle market's 75%.

Lower-middle-market loans are also more lender friendly. Their coupon rates are materially higher. They have strict financial covenants that give lenders key protections, while at the upper-middle level, loans usually have few or no covenants. In addition, financial reporting by borrowers generally is monthly versus quarterly. Finally, there is much less competition for investments because there are fewer competitors in the lower-middle market compared with numerous new entrants in the upper-middle market.

PENT-UP DEMAND

Haggard is bullish on the middle market's prospects, with what he believes is pent-up demand from lenders and investors. To fully appreciate his enthusiasm, it helps to understand what happened in the lean years of late 2022 and 2023.

The catalyst for the decline in the direct-lending market in late 2022 was the Federal Reserve's series of rapid interest rate hikes, which put a big chill into M&A and corporate finance — the dominant sources of demand for direct loans. "Rising interest rates slowed down M&A not only because they were higher, but also because of the uncertainty about how high they might go," Haggard said. "Private equity sellers had little feel for where valuations would settle as rates rose, and there was a ripple effect through the debt markets about how much leverage lenders could put on their companies. Investors became a lot more reluctant to make new capital commitments."

That environment, in turn, left lenders with the choice of whether to try to keep raising funds for new deals or pivot to focus on existing borrowers. "Lenders didn't know where their next round of funding would come from and how long the fundraising markets would remain seized up. You had to be very cautious about where you deployed your capital, so some chose to go to back to their key clients and portfolio companies. That's what we did," Haggard said. "This started in 2022 and continued through at least the first half of 2023, even all of 2023 as M&A really slowed down."

HEALTHY M&A APPETITE

While 2023 turned out to be a slow year for many direct-lending managers, market sentiment began to improve in the year's second half and remains favorable through mid-2024. TPG Twin Brook sees more institutions feeling comfortable with interest rates at current levels and thus they are more confident about deploying capital, Haggard said.

> Investors should allocate to a manager that has the experience, has been through multiple market cycles, has invested with consistency and has the team and infrastructure to manage very active portfolios.

But buyers aren't the only source of demand for direct lending. Haggard also sees a healthy appetite for deals from private equity firms that haven't been able to sell their portfolio companies as easily as they could pre-COVID.

"Going back to COVID, and then the 18 months or so through the end of 2023, it was a tough time to sell your company," he said. "Private equity firms have now held these companies a lot longer than they expected to, and they're getting pressure to return capital from their limited partners. In other words, we believe there's huge pent-up demand to sell companies from private equity firms and private owners. We think this is going to drive M&A activity this year and in 2025 and 2026."

"The M&A markets are certainly up the first part of this year, but not yet to the level we were anticipating. We expect activity to keep growing as debt markets get healthier and there's more visibility on where interest rates are going," he said.

ACROSS RATE SCENARIOS

Speaking of interest rates, recent inflation numbers suggest that the Fed might not start cutting rates this year as quickly or as much as investors anticipate. If so, Haggard said the direct-lending market wouldn't suffer.

He noted that with rates at current levels — and provided that they don't go much higher — it's still a good environment for doing middle-market M&A deals that require direct lending. Leverage levels can support full valuations.

"Many lenders are betting that this is as bad as it's going to get on the interest coverage side," Haggard said. "If we get a little deep on leverage today, hopefully we're doing so behind good, solid companies that should benefit if rates start to come down within 12 to 18 months. Lenders and investors making those bets feel that the market has peaked on the interest rate side and can sustain a year or two of tighter coverage."

CHOOSE THE RIGHT MANAGER

For allocators evaluating direct-lending managers, Haggard recommends a number of key characteristics. Experience is at the top of the list. "Investors should allocate to a manager that has the experience, has been through multiple market cycles, has invested with consistency and has the team and infrastructure to manage very active portfolios."

Size is critical as well, with the manager's ability to take most, or all, of a loan being a major differentiator. "A lender that has the ability to grow with borrowers is a strong value proposition in the lower-middle market," he said.

Managers should have the number and type of personnel needed to do the job, in Haggard's view. "A lot of lenders can raise capital, but it's a whole other deal to actually manage a complex, active portfolio and have the resources to do it. It takes more than an investment team to handle it. We believe you need a variety of specialized personnel to manage everything and make sure you're on top of all the potential issues and working through situations properly," he said.

Finally, a good manager must be able to find deals — meaning that a robust origination capability and established, tight relationships with private equity sponsors are vital to success. As Haggard put it, "Access to capital won't take you far if you can't get deals. Having a strong network of sponsors that you've worked with for many years is mandatory if you want to be competitive in direct lending." ■

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[1]For the period 1987 through September 2021. Source: S&P Global Ratings, S&P Global Market Intelligence's Credit Pro & Ratings Research.

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