KEYNOTE INTERVIEW

We believe lending to smaller business has some distinct advantages for investors, says Trevor Clark, founder of TPG Twin Brook

The lower mid-market offers LPs an attractive diversification play

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Q How do you define the lower mid-market and how does it differ from the core mid-market and upper mid-market?

We define the lower mid-market as companies with EBITDA of $25 million or below. The core and upper mid-market are a bit more difficult to define, given that direct lenders playing in those markets are increasingly competing with the broadly syndicated loan market. We are now routinely seeing direct lenders supporting companies with EBITDAs of $200 million or more. As a result, in the upper mid-market we are finding that the borrower-lender relationship is becoming more commoditised. Ultimately, for a lender that means the interest and the fees you get paid go down as the size of your borrower increases.

There is also a structural risk component that differentiates the core and upper mid-markets from the lower mid-market. In upper mid-market companies, you typically see more debt as a multiple of cashflow, which increases financial risk. You also typically have more covenant-lite packages with unrestricted subsidiaries and the ability to add debt at the same level as other lenders in the syndicate, creating less lender protection. So, in our view, you're ultimately getting paid less for effectively taking on more risk.

On the flip side, in the lower mid-market there is typically a strong borrower-lender relationship and lender protections are standard practice, so we believe you ultimately get paid more for effectively taking on less risk.

Q What is the appetite among institutional investors for lower mid-market lending?

We have been lower middle market lenders for over 20 years and raising capital from a broad institutional base for the last decade. In the last three years, we have seen clear recognition that the lower mid-market is offering a very different opportunity compared with that which many of the large

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global asset managers active in the upper mid-market are offering.

Whether that recognition is due to the portfolio overlap analysis, which shows many of those managers present in the same transactions, or whether it is due to lenders moving down the balance sheet, adjustments to cashflow or the volatility of returns, the upper mid-market is getting called into question. We believe the differentiation that a scaled lower mid-market lender can bring is now really clear to institutional investors.

Many large global institutional investors entered the private credit market via an allocation to upper mid-market direct lenders, but those investors are now looking to lower mid-market lenders for a compelling diversification play. We are seeing allocation sizes to the lower mid-market increase, with some of the largest global investors allocating larger amounts of capital to this market segment.

Q Some lenders have moved upmarket in pursuit of larger transactions. Is that impacting lower mid-market participants?

Over the past few years, the so-called forcing of certain lenders upmarket is related to two factors: the first being the large amount of capital raised in such a short period of time, which meant a number of managers had to speed up their pace of deployment; and the second being the fact that these managers didn't need large teams to be successful at transacting. With the broadly syndicated market dislocated, many upper mid-market lenders were able to quickly move in and fill that void.

We see less of that today. With the broadly syndicated market now open, many large direct lending credit facilities have been refinanced out, and the shift upmarket has reversed, with upper mid-market lenders moving downmarket to fill their deployment needs.

While that downmarket movement has impacted the core mid-market, it has had less of an impact on the lower mid-market, where the strength of the borrower-lender relationship is highly valued. What I mean by this is that at the top end of the market the amount of debt and the cost of debt is baked into decision-making processes. In the lower mid-market, however, the borrower relies much more on its lender for support alongside the private equity sponsor executing the borrower's growth strategy.

Lower mid-market borrowers need to know their direct lender is going to support them over a growth horizon, including with potential add-on acquisitions, team expansion, and diversification of product lines. These borrowers require a lender with experience to support that exercise, and few lenders have that capacity. That is why the competition is a bit less severe in the lower mid-market, even as the upper mid-market has started competing with core mid-market players.

Q Do you expect the opportunity set in the lower mid-market will continue to evolve?

For the aforementioned reasons, we continue to see a lot of white space for lenders to successfully transact in the lower mid-market, and we expect those opportunities to multiply in the remainder of this year and into the next.

While we know that longer hold periods, the impact of higher interest rates for longer, and the misalignment of buyer and seller expectations are still an issue, especially in private equity, our expectation is that these trends cannot continue. There are only so many continuation vehicles to be executed and private equity can only sit on assets for so long.

We believe that we are going to see a change in the interest rate policies in the US, and as interest rates come down, it will generate more M&A activity, which will allow the lower mid-market leaders to deploy capital in their traditional target markets.

While deployment opportunities will likely expand, both deployment opportunities and fundraising dollars are increasingly accumulating in the hands of fewer market leaders. Given the sheer number of managers that have been created in recent years and the advantages veteran market leaders offer, we foresee a much clearer delineation of the winners in the lower middle market and elsewhere.

Q How do deal structures in the lower mid-market compare with those upmarket?

Part of the potential benefit of investing in the lower mid-market versus the upper mid-market is better economics, lower leverage and stronger lender protections. As market factors ebb and flow, so too can differences in leverage and pricing.

Over time, those differences are driven by the sheer flow of capital, so when large volumes of capital are flowing into the upper mid-market, pricing comes down very quickly and leverage starts to go up. You have less of those swings in the lower mid-market.

For a period of time, there was around a 30-basis point difference between loans getting closed in the upper mid-market versus those in the lower mid-market, which felt very tight. For loans printed over the last quarter that premium was small, but you still had meaningfully more leverage on upper mid-market companies than on lower mid-market companies. All this is to say that it's important not to look at one factor in isolation but to examine risk as a whole.

Q Are you finding dispersion of performance between market segments?

There are many ways a lender can structurally address a potential weakness in a portfolio. While there has been some dispersion of performance among different market segments, in our experience in the lower mid-market, we have seen stable, experienced managers able to deal with portfolio pressures and navigate the macro shifts effectively.

Moving upmarket, we are seeing investors really digging into amendment activity in portfolios, what proportion of portfolios have PIK interest components, what the non-accrual percentages look like, and the overall leverage levels. There is also a greater focus on valuation methodology, what is happening to marks, and whether a third party is involved. There are plenty of early warning signs now for investors assessing their credit portfolios.

The lower mid-market, on an apples-to-apples basis, has smaller degrees of PIK and smaller amounts of non-accruals because there is less debt in companies and more covenants and triggers that allow lenders to quickly engage with borrowers.

This harkens back to my earlier point: we believe the lower mid-market can offer an attractive diversification play for investors, particularly given that we believe you take on less risk for higher reward. ■

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Q Are certain sectors offering more opportunity to lower mid-market lending today?

We are cashflow lenders to any industry, subject to certain industries that typically violate our strict underwriting standards, and we find the largest lenders globally have tended to do the same, whether that's focusing on healthcare, technology, or business services. Of course, industries with a large market presence, many companies, and long histories of performance, are typically the ones generating the most activity for lender participation.

At the same time, there are other industries that are growing – such as sports, insurance, and financial services – but we are yet to see a new sector emerge that fundamentally shifts where the most active lenders are transacting. We believe that the greatest opportunities for a lender come from a lender's ability to originate dealflow, and that origination comes from scale, experience and track record.

Trevor Clark is founder and managing partner of TPG Twin Brook, TPG's middle market direct lending business.