EXPERT Q&A

Targeting lower middle market borrowers offers a pricing premium and better lender protections, but a long-term commitment to this segment is critical, says Rich Christensen, senior partner at TPG Twin Brook

The lower mid-market offers a compelling opportunity

SPONSOR
TPG TWIN BROOK CAPITAL PARTNERS

Q From a direct lending perspective, how is the middle market segmented?
The middle market is broadly categorised into three segments, delineated by borrower EBITDA size. The upper middle market consists of borrowers with EBITDA between $40 million and $50 million, the core middle market ranges from $25 million to $40 million of EBITDA, and the lower middle market is comprised of borrowers with $25 million of EBITDA or less.

Q What are some of the defining characteristics of the lower mid-market, and why is the segment attractive?
The lower mid-market tends to be less commoditised with fewer competitors. As a result, this segment is typically characterised by much stronger lender protections, more conservative loan structures, and a pricing premium when compared to the upper middle market. Within the lower mid-market, you generally see tighter financial covenant packages and more robust documentation around a range of critical credit terms, including tighter limits on earnings adjustments and various cash leakage provisions.

By contrast, the upper middle market tends to be more transactional and offers significantly fewer lender protections, with covenant-lite loans being commonplace. That segment also largely trades at higher leverage multiples, with more adjustments to earnings, and at a pricing discount to the core and lower middle markets.

In the lower mid-market, consistency of approach and a longstanding commitment to the segment are critical, however, as sponsors in the space tend to be more relationship focused. These PE firms are looking for reliable lending partners that can work with them repeatedly across many deals and support the execution of their value creation plans for businesses. With this in mind, many sponsors work with a limited number of primary lenders, and most credit facilities lend themselves to smaller, more reliable bank groups. Furthermore, having long-term relationships with sponsors and understanding their capabilities and experience are key factors in driving successful outcomes.

Q How has the lower middle market evolved?

The lender landscape has certainly shifted over time. With the pullback of commercial banks following the Global Financial Crisis, the middle market today is largely dominated by commercial finance companies and institutional capital. While commercial banks do continue to maintain a presence, it remains at a much lower level.

Within the direct lender community, we see significant segmentation of lenders by borrower EBITDA size. When it comes to defining what types of companies they will provide financing to, lenders generally have hard-stop EBITDA minimums for borrowers, and we have seen numerous lenders move up market over time – either toward the upper end of the lower mid-market or out of it entirely. Additionally, while we continue to see a lot of lenders coming in and out of the middle market broadly, the lower middle market – given its less commoditised and more relationship-focused nature – remains relatively insulated from new entrants.

As the lender landscape has evolved, so too have credit structures. Unitranche loans have become the dominant structure, versus traditional senior and third-party subordinated debt, as they offer the advantages of a more streamlined debt structure and the ability to scale the debt capital structure with a single lending group.

On the sponsor side, we've seen more sector focus, with an increasing number of PE firms adding to their internal operational resources and placing greater emphasis on the development and execution of strong growth strategies for portfolio companies. Purchase multiples have continued to remain high, which has helped drive the aforementioned trend and put further emphasis on the importance of being able to quickly and efficiently execute on value creation plans.

> *"We think lenders with a long-term commitment to the lower mid-market, a consistent approach, robust deal sourcing capabilities, and a demonstrated ability to scale with borrowers will remain best equipped to maintain and grow market share in this segment"*

Q What is the state of the lower mid-market today? How are businesses in the space faring?

We viewed 2023 as something of a retrenching year, with M&A volumes down year-over-year versus 2022; however, we expect to see a return to more normalised deal volumes this year. In addition to a seemingly optimistic outlook among market participants broadly, we have been observing an uptick in the number of sell-side processes, which seems to support the anticipated increase in transaction activity in 2024.

Overall, we continue to see stability in the underlying financial performance of borrowers. For many companies, 2023 proved to be a more normalised year of performance – with fewer broad market disruptions – providing for a cleaner earnings profile to support sale processes.

Looking ahead, we would expect improved financial performance to drive increases in transaction activity through 2024, with sponsors moving to exit investments that have experienced extended hold periods.

Despite the liquidity challenges associated with higher interest rates, we continue to see resiliency in the lower middle market, in part because – even before entering into this period of elevated rates – loan structures have generally been more conservative.

Q Are there any specific industries or types of businesses that you have found excel in the lower mid-market?

We are less focused on picking specific industry verticals, and instead concentrate on looking at the underlying fundamentals of companies. Rather than targeting particular industries, we believe it is important to look for companies that have predictable cashflows and strong historical performance. From a general profile perspective, we are focused on diversification and identifying non-cyclical businesses with robust competitive differentiation.

During underwriting, we work to develop a deep understanding of a borrower's business, their underlying markets, and their competitive position. We believe the ability to maintain competitive positioning and margins is key, thus we seek to identify businesses that have historically demonstrated pricing power and that have been capable of passing through or absorbing fluctuations in underlying costs.

We also believe it's important to consider the sponsor's experience within a company's specific industry or segment of the market. As mentioned earlier, it is not uncommon for sponsors to

Q What is your outlook for the lower mid-market and direct lenders focused on the segment?

As noted earlier, in terms of deal volume, we are expecting to see a rebound in 2024. While it is still early in the year and thus largely anecdotal at this point, volumes appear to be ticking up, and we are seeing sell-side activity across existing PE portfolios gathering pace.

The number of sponsor-backed businesses that have had elongated investment holding periods remains elevated, and 2024 should be a solid year for those companies to come to market.

LP interest in direct lending broadly has continued to grow through the past two decades, and with that, we've seen increased investor focus on both the nuances of the asset class and manager differentiation. Historically, many abided by the general assumption that larger businesses should perform better, and the lower middle market had been an area that received less attention. In time, however, that view – from an educational and demonstrated performance standpoint – has shifted. Witnessing the resilience of many smaller companies over the past few years, as well as how experienced lenders focused on the lower mid-market have been able to manage through market disruption, has driven greater LP interest in this segment. With

more knowledge and understanding of the space, has come greater appreciation of some of the attractive attributes that characterise it – such as lower leverage levels, more favourable pricing, and better lender protections.

Against this backdrop, we believe managers that have a long-term focus on this segment, consistent strategy, demonstrated ability to manage portfolios through cycles, and rigorous credit selection process will be well positioned for the road ahead.

be sector focused, and we think there's value in that – not only in terms of being equipped to support the growth of the business, but also because it provides an additional layer of expertise when it comes to assessing and underwriting lending opportunities.

Despite the slowdown in M&A through last year, we continued to observe a good mix of opportunities across a broad spectrum of industries in this segment of the middle market. Moving forward, I think a focus on underwriting to stable underlying cashflows and maintaining a diversified portfolio will continue to be elements critical to success in the lower-mid market.

Q What are some of the key factors driving lender or manager differentiation in the lower mid-market?

I think consistency of approach is certainly at the top of the list. For example, we believe a rigorous underwriting philosophy with a commitment to conservative loan structures – regardless of the market environment – is critical to long-term success. Additionally, we view maintaining a consistent presence in the lower mid-market – not having style drift – as an important competitive differentiator, as it supports a lender's ability to develop and maintain long-term sponsor relationships.

Having a robust deal sourcing network and strong direct origination capabilities are also key points of differentiation, as this allows a manager to drive consistent dealflow and maintain much greater credit selectivity. A long-term commitment to the lower middle market is again critical to success here, as it supports a lender's ability to maintain and source dealflow across a stable sponsor relationship base.

Additionally, we believe being able to act as the administrative agent or in a lead agent role puts a lender in a much better position to drive enhanced economics, maintain control of deal structures and documentation, and more effectively manage credit outcomes. More than ever, scale matters when it comes to winning these mandates. It is not uncommon to see credit facilities double in size over the course of an investment period, so having a demonstrated ability to increase hold sizes, manage larger bank groups, and provide borrowers with access to additional capital when needed is an important differentiator for PE sponsors when selecting lenders for lead roles.

In short, we think lenders with a long-term commitment to the lower mid-market, a consistent approach, robust deal sourcing capabilities, and a demonstrated ability to scale with borrowers will remain best equipped to maintain and grow market share in this segment. ■