EXPERT Q&A

Default rates are starting to increase in the upper mid-market, making credit terms more important than ever, says TPG Twin Brook Capital Partners' Kim Trick

Capital structures remain key to recovery

Q Historically, how have capital structures and credit terms across the mid-market compared? Have you traditionally seen variations across market segments?

As you compare capital structures across different segments of the middle market, you will see a number of differences across leverage, terms and pricing. Comparing the lower mid-market versus the upper mid-market, generally speaking, lower mid-market deals have more conservative leverage structures, more lender protections and premium pricing.

This is in part a function of company size. There is certainly a bias towards larger borrowers, as many believe the largest companies don't need things like financial covenants because they are the best credits. It is in the lower parts of the mid-market that you see more protections for lenders in the form of financial covenants and lower leverage at loan origination.

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The combination of those factors has generally resulted in higher recoveries in the lower middle market. Covenants give lenders the opportunity to evaluate changes in the risk profile before a payment default occurs, whereas in the upper part of the market, if there is no financial covenant, payment defaults might be the first sign of distress. This can give the lender, borrower and sponsor more time to construct a solution, before the deterioration has become so severe that the business cannot pay principal and interest.

Q Looking back over the past few years, have you seen any changes there? Or has this remained relatively consistent over time?

Over the last five years there has definitely been a deterioration in credit protections. This is more noticeable in the upper middle market driven largely by increased lender competition as capital has shifted away from banks. In the

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lower middle market, we haven't seen as much of this, primarily because it is a much more difficult space for new entrants to rapidly scale and the relationship-oriented nature of lenders and sponsors in this part of the market.

The deterioration in credit terms is most evident in the overall leverage profile of borrowers increasing. It is also evident in the finer points of the credit agreement, whether in relation to cash leakage through restricted payments or increased flexibility that borrowers have to take on additional debt. Collateral protection is another area that has weakened in upper parts of the market, while we haven't seen the same in the lower mid-market.

Q How have the differences in terms led to different outcomes in this interest rate environment?

Looking at macro factors, everyone is talking about the impact of interest rates, especially for those with higher leverage. But interest rates are not the only reason that some companies are struggling. In 2023, many companies were still facing challenges as a result of inflation, supply chain disruption and changes in demand coming out of covid.

As you look at those larger companies that are arguably more suited to withstand bumps in macro environments, we are seeing it is their capital structures that are having a more pronounced impact on performance. If you look at the technology sector, for example, where a lot of loans were underwritten based on recurring revenues rather than cashflow generation, those businesses are now having a difficult time as their interest burden has grown substantially.

The same thing is happening in some parts of healthcare, where businesses were underwritten on highly adjusted earnings numbers and the actual cash generation of those businesses hasn't been sufficient to cover the increased interest burden. We are not seeing those challenges so much in the lower mid-market because loans were underwritten with much less aggressive structures.

Q How can market participants track this? What measures do you focus on to understand what is happening in terms of outcomes across the market?

The data that we are tracking to figure out what exactly is going on with a lot of these factors is changing. Historically, defaults and non-accruals were an easy way to track this, but going through covid we saw that different managers had different definitions of what was non-accrual and even what constituted a default. That makes it difficult for anyone watching any part of the market to figure out exactly what is going on.

A newer area that we are spending a lot of time tracking is payment-in-kind (PIK) data, as borrowers move cash interest payments into structures that are non-cash. If interest rates come down, increased cashflow can better support interest payments, however, if a borrower has shifted a lot into PIK, then that is instead adding to the balance of the debt. That will be reflected in the ultimate leverage number because it is an obligation that is going to have to be refinanced unless lenders decide to write off that portion of the debt.

We are also really focused on how loans have been modified to avoid reporting on some of these categories of distress, such as non-accruals and defaults. That has become quite a widespread issue – there was a recent situation reported where four different managers in the same underlying borrower had all marked the accrual status differently. We need a little more truth and clarity around exactly how these loans are being restructured.

Q Looking to the future, do you think the lenders' approaches to terms and structures today will be a key point of differentiation moving ahead? And how so?

Yes I do, especially for new entrants that maybe got into direct lending in the last two or three years, where portfolios are younger and are yet to grow into distressed situations. What will differentiate managers is their track record and how those past deals are playing out.

In the upper middle market, we are starting to see default rates and PIK data increase for deals that were done on more aggressive terms. In the lower middle market, we are seeing the positive impact of more conservative structuring, because we typically see covenant defaults before we see payment defaults. That gives more time and therefore enhances a manager's ability to adjust the economics and bring in equity support if necessary, ultimately leading to better outcomes.

Given that lenders raise capital based on that track record, we will start to see its impact moving forward. There will be some lower middle market lenders that don't perform well because they didn't underwrite with those conservative capital structures, and there will be upper mid-market lenders that do well as a result of better structuring. What is clear is that capital structures and terms are what is going to drive recoveries and differentiation in the years to come, and the lower middle market is broadly well-positioned. ■

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