KEYNOTE INTERVIEW

Not all private credit is created equal

Different lending strategies can result in different outcomes, explains Trevor Clark, founder and managing partner at TPG Twin Brook

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Q Private credit can be a catch-all term for various strategies. How do you define it?

Traditionally, private credit has been defined at a high level as a bilaterally-negotiated provision of credit in a non-public form. Generally, private credit is associated with direct lending. While direct lending represents the largest segment within the private credit market, the asset class includes many other strategies, such as asset-backed lending, infrastructure, distressed and mezzanine lending.

Private credit has reshaped the fixed income investing space as more investors have become familiar with the asset class and its attributes. This increasing awareness of private credit has driven increasing allocations from public debt into private credit. As the demand for private credit has increased, this has driven investors to increase their understanding of the differences between different private credit managers.

The past decade has proven that the way in which managers approach the private credit asset class – and direct lending specifically – can have a significant impact on a return profile. Investors now understand that there are vastly different approaches to direct lending, whether that is about targeting the upper mid-market or the lower mid-market, or private equity-backed or non-private equity-backed opportunities.

Looking ahead, we expect to see more return deviation among managers. In a world where there is more uncertainty around individual borrower performance, a lender's approach to deploying capital will matter more than ever.

Q How are direct lenders differentiating themselves and how has that impacted LP capital allocation?

Over the past five years, we have seen direct lenders seek to differentiate themselves in a myriad of ways, including by exploring new vehicle structures, highlighting unique direct loan origination capabilities, and targeting more specific areas of the market into which to deploy capital.

As it relates to vehicle structures, we are seeing the proliferation of more public vehicles, such as BDCs or interval funds, the rise of which has reset what managers' reporting looks like and enhanced LPs' ability to more easily compare performance across different managers. For a long time, LPs focused their analysis of private credit portfolio performance based on a few key statistics, with default history being a primary measurement of performance.

Today, however, particularly in light of the reporting transparency of these public vehicles and a growing understanding of the market, LPs are asking more about what default data represents, what covenants there are in transactions, and a manager's ability to use lender protections to take action.

The reality is that the market has woken up to the fact that not every direct lender operates in the same way, and some investment strategies and approaches provide clear advantages to investors. Historically, many investors were running beta plays into an asset class growing in popularity; now, we are finally starting to see, particularly as capital gets put into fewer and fewer hands, the characteristics that have defined long-term winners.

Our focus at TPG Twin Brook is on the lower mid-market, with an emphasis on high quality borrowers with under $25 million of EBITDA. Our experience has shown that this is the least commoditised part of the direct lending market.

In a typical year we will look at over 1,000 small companies and conduct exhaustive due diligence before committing capital. By putting in this effort, we believe we lend to some of the very best lower mid-market companies in the market and get the added benefit of putting less leverage on these companies.

Q How do factors like sponsor relationships, scale and/or capital flexibility serve to differentiate direct lenders from one another?

We are in a period of time where the value of risk mitigation once again has been brought to the forefront, and lenders who followed riskier strategies to boost their returns or supercharge their platforms' growth have been exposed.

On the topic of sponsor versus non-sponsored transactions, certain lenders have suggested that non-sponsored transactions offer a 'riskless' opportunity to increase returns by taking advantage of a less sophisticated ownership group in negotiating higher lending economics.

> *"The market has woken up to the fact that not every direct lender operates in the same way"*

History would prove that taking a private equity group out of the ownership mix is anything but 'riskless', especially in the lower mid-market.

Our view is that relationships are important, and at TPG Twin Brook, we value a private equity sponsor's expertise in assessing companies alongside us when approaching transactions. We also believe in the ongoing operational benefits that a private equity firm can bring to a company, which are largely related to diligence and oversight, but also via equity support as these companies continue to grow.

Furthermore, at a time when companies are facing numerous headwinds, we think a smart and sophisticated owner helping to support and guide a borrower is advantageous. Our belief is grounded in our long-term experience of witnessing private equity owners' behaviour through multiple economic cycles.

When it comes to scale, it has become clear that in both capital formation and capital deployment, the largest direct lenders are controlling an increasing part of the market. This consolidation of market share may continue to benefit market leaders where the ability to raise capital is tied to the lenders' ability to deploy the capital raised while not exhibiting style drift.

While scale and market leadership are important, investors have also become increasingly sensitive to portfolio overlap between direct lending managers. Some of the largest direct lenders have proven to have great capital formation capabilities and less developed loan origination capabilities – and these groups turn to other lenders to help source their dealflow. The result is that several of the largest direct lenders find their portfolios have significant overlap with other lenders and thus create potential position concentration risk when an investor makes an investment with these overlapping lenders.

Q We are seeing new strategies and structures emerge in private credit, such as structured notes, the growth of BDCs and evergreen funds, and so on. Why have these emerged, and how do they benefit investors?

We see non-traded BDCs receiving significant attention today. The most obvious benefit of the non-traded BDC is that it allows the retail investor community to access these private, strong-returning assets that they could not invest in previously. For the non-institutional community, access is provided via lower investment minimums within a tax-efficient, transparent, semi-liquid structure. Further, non-traded BDCs allow investors to be fully funded immediately and are not subject to capital calls.

We have also seen evergreen structures grow in prominence, offering investors greater efficiencies in terms of deployment and returns. Once you get into an evergreen fund as an investor, you can get fully invested quickly and stay fully invested until you raise your hand and say you want out. Many institutional investors have found this structure to be optimal in managing their private debt allocations versus the traditional closed-end vehicle.

Finally, looking at capital flexibility, if an investor wanted to access a direct lending platform 10 years ago, they had two options: a commingled fund or a separately managed account (SMA). Today, there is still that SMA option, but within the commingled option an LP can choose onshore or offshore, levered or unlevered, an evergreen structure, or an Article 8 fund in some cases. All those different access points give investors structural flexibility, and not every GP can offer that, or is scaled enough in those solutions to meet investor demand.

Taken together, sponsor relationships, scale and capital flexibility can be a very powerful point of manager differentiation.

Q In a higher-for-longer rate environment, what can investors expect in the lower mid-market?

We believe the fact that we are now in a higher-for-longer interest rate environment means that private credit managers operating in the lower mid-market are not only often being paid more compared with lenders operating in other areas of the mid-market, but also that interest coverage is higher.

The adjustments to cashflow that lenders are being asked to underwrite in the lower mid-market also differs from those in the upper mid-market. Not only is a lender's advertised leverage higher in the upper mid-market, but adjustments to cashflow are also higher, so your unadvertised leverage is even higher, which can add additional risk.

Then you add in the fact that many of those upper mid-market transactions are entering initial deals at interest rate levels that cashflows cannot support, so you are seeing payment-in-kind being used from day one. Those are markedly different structures to those being used in the lower mid-market, where there are different risk criteria.

In the lower mid-market, lenders are not trying to max out the debt that can be put onto companies – rather, the focus is on executing growth strategies. So, we believe that investors can benefit from more flexibility and higher interest rates.

Q Where do you see the next wave of opportunity coming from in private credit?

We believe there is a significant opportunity to further open up the private credit asset class to retail investors who have not had a natural or simple way to access private credit in the past. From a structuring standpoint, we are seeing many more lenders bringing interval funds to market and expect lenders will continue to build and transform their product suite with the goal of broadening their investor base.

We also expect more opportunities to emerge for managers of scale that run multiple private credit strategies. We are seeing LPs wanting to further diversify their types of private credit allocations, but to do so with one manager. For example, we are finding that while our lower mid-market story continues to resonate, LPs want to tap into other areas of private credit, like asset-based lending and credit solutions. We believe that having a large, trusted and multi-strategy credit platform will be important in capturing this growing opportunity going forward. ■