EXPERT Q&A

Time-tested underwriting principles, conservative leverage structures and active portfolio management will differentiate managers in volatile markets, say TPG Twin Brook's Christopher Hendrix, Tony Maggiore and Evan Larsen

Looking beyond the cycle

Q How would you describe competitive dynamics in lower mid-market direct lending today, and how is this impacting pricing and terms?

Christopher Hendrix: The lower mid-market, which we define as borrowers with less than $25 million in EBITDA, continues to be highly fragmented and relationship-driven. Competition tends to be sponsor-specific, shaped largely by which lenders have established trust and credibility with a given private equity firm.

After two years of pricing compression following historically elevated yields in 2023, the lower mid-market has seen pricing stabilise and spreads firm up by 25-50 basis points to start 2026. That shift is partly attributable to an easing of competition following some of the redemption pressure in the core and upper mid-market, which has begun to filter down.

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In addition to the premium yield within the lower mid-market, the overall leverage structures that we continue to observe and underwrite have remained conservative with average leverage around 3.5-4.5x, reflecting lower levels of structural risk than the core and upper mid-market.

Q How are players differentiating themselves in this environment?

CH: Execution remains paramount, including the efficiency of new deal underwriting and the certainty of feedback provided to the sponsor, both of which are supported by long-term track records lending to businesses in underlying industries. Pricing and credit terms will always factor into sponsor decision-making, too.

Beyond execution, the ability to support a private equity firm's value creation plan is increasingly important. This means scaling alongside portfolio companies, particularly in the lower mid-market, where there are opportunities for meaningful growth.

Finally, having deep relationships and success with helping lower mid-market companies navigate any situation they might face are foundational to growing and maintaining a long-term client base in terms of both sponsors and LPs.

Q How important is sector specialisation in the

context of lower mid-market lending?

CH: Sector specialisation can be examined from two different perspectives. The first is risk management: deep sector expertise enables more nuanced underwriting and more efficient and informed due diligence. The second is portfolio management: that same expertise can be brought to bear working with businesses post-close.

We find sector specialisation to be particularly important in certain industries – for example, around a third of our originators and underwriters are healthcare experts. We look at 1,000-1,500 new opportunities per year, which allows us to build a continuously growing library of content that supports comparable analysis across industries and benchmarking within specific subsectors – from manufacturing to marketing and residential services to building products. We also have deep domain expertise in areas such as insurance, auto aftermarket and speciality chemicals.

Regulatory complexity, reimbursement, human capital and any number of long-term structural trends all demonstrate the importance of having deep background in the sectors in which we operate, and that knowledge is essential to driving successful outcomes.

Q Against that backdrop, where are you seeing the most interesting opportunities to lend, and are there areas you are actively avoiding?

CH: We focus on building a diversified portfolio across sectors that we deem

Q How are you thinking about the AI theme more broadly as a firm?

Tony Maggiore: When underwriting new deals, the first step is to determine whether a business can be disintermediated, which requires an assessment of its technical durability and resilience to AI disruption.

We also look carefully at how well a management team knows its customers and their needs. Where pricing compression is an identified risk, we must consider how we factor that into any downside scenario we model.

Based on analysis of our portfolio companies, we believe the vast majority are at no risk of negative AI impacts. As Chris mentioned, we have very few software businesses in our book. At the same time, there will be positive effects where management teams deploy AI to increase efficiency. We are already starting to see traction there, although adoption has been relatively slow, in line with broader trends.

Emerging data shows a meaningful difference between private equity-backed businesses and founder-owned businesses with respect to AI utilisation. When you think about incremental margin improvement over time, we expect the companies we back to be ahead of the curve.

We are constantly evaluating ways to leverage AI across our underwriting process. We have deployed a proprietary tool that incorporates a number of different large language models, and that is already making us smarter and faster.

'non-cyclical' with proven historical cashflow generation. That said, certain industries are more attractive than others in the current environment, largely due to the noise around artificial intelligence. Some of the more traditional businesses with a physical product or service are seeing particular demand for that reason.

Historically, we have mostly avoided software – not because we have viewed it as a weak end market, but because the structure of many of those deals, particularly with regard to leverage and payment-in-kind at origination, is not consistent with our approach. More broadly, we tend to avoid industries that are highly commoditised, have high fixed cost bases, or are cyclical or exposed to fad risk.

In an inflationary environment or one characterised by uncertain input costs, our underwriting bar rises across the board. In this type of environment, the textbook framework of Porter's five forces becomes a lens that we are acutely focused on: competitive landscape, customer/supplier leverage, barriers to entry and the threat of substitutes.

Q The private credit market has seen some notable stress in recent months. How do you talk to your investors about these situations?

TM: The first thing we emphasise is that not all private credit managers operate the same way – investment discipline and approach often vary, and outcomes tend to reflect that. We focus exclusively on cashflow lending against current earnings, we typically do not originate upfront PIK, and we place considerable emphasis on documentation and credit protections. We believe this approach enables us to effectively manage risk over the long term.

Q How should investors be evaluating managers now?

Evan Larsen: Investors are understandably taking a closer look at managers in light of recent market dynamics. Transparency and track record are paramount – and public BDC data, for example, provides a level playing field from a reporting perspective that we believe is healthy for the market overall.

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>
> **EVAN LARSEN**

Investors are also looking closely at valuation policies. Independent third-party valuation across the entire portfolio on a quarterly basis has become an important marker of credibility. Managers who can demonstrate that rigour tend to hold up well to scrutiny. On balance, despite the noise, investor appetite for the asset class remains strong overall.

Q Why do you think the lower mid-market is the place for investors to be, in particular?

EL: Companies in the lower mid-market have shown resilience over the past few years, despite multiple years of macroeconomic challenges, including the covid-19 pandemic, supply chain disruption, inflation, tariffs and geopolitical conflict, driven largely by loan structures that have been shown to be more resilient given lower leverage.

Refinancing is relatively uncommon in the lower mid-market, which is built around long-term relationships. Pair that with higher recovery rates, better portfolio visibility through monthly financial reporting, financial covenants in every deal and legal documentation to prevent collateral leakage and you get what we believe is a compelling risk-adjusted profile that is difficult to match elsewhere in credit.

The sponsor-backed market, in particular, is attractive in our view, providing access to well-capitalised companies supported by sophisticated managers, as compared with privately held, founder-owned businesses.

Q Looking ahead, how do you see the lower mid-market direct lending space evolving with respect to a potential banking resurgence?

EL: We believe demand for private credit will continue, supported by the depth of expertise that exists across the sector. We see little reason for capital supply to diminish meaningfully.

While the banking market has undergone a structural shift in the wake of the global financial crisis – with a number of commercial banks having exited the market entirely – we do not view potential regulatory easing as a short-term threat. Rebuilding the necessary infrastructure, institutional knowledge and talent base is a substantial undertaking, and private credit managers have already invested that time. As such, a quick recapture of market share is unlikely in the near term. ■

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