Lead Left Interview – Chris Flynn and Sam Tillinghast (Part 2)

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This week we continue our conversation with Chris Flynn and Sam Tillinghast, co-CEOs and co-CIOs of THL Credit. Headquartered in Boston, with investment teams in Chicago, New York, Los Angeles and Houston, THL Credit manages a BDC that invests primarily in middle market mezzanine debt for companies seeking capital for growth and acquisitions.

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The Lead Left: The demand side does drive crazy structures and pricing at times.

Chris Flynn: We struggle when you tell us that 70% of the capital structure is debt and carries a cost of 6% and 30% of the capital structure is equity with a target return north of 25%. Lots of people are chasing deals, but it's up to the senior managements of these firms to incentive people the right way.

TLL: Do you think the pressure on leveraged lending guidelines will restore some sanity?

Sam Tillinghast: The pressure from regulators does appear to be getting more focus, so we're seeing pushback on structures. The opportunity for us is to come in with more flexibility to give sponsors more room and potential alternatives to traditional bank financing.

CF: As an example, banks require amortization. So on a 3.5x/4.5-5.0x [multiple of Ebitda] transaction, the 3.5x will be a first-lien bank tranche with substantial amortization. We'll instead offer 4.5x with all one tranche that requires minimal amortization. That's particularly helpful for sponsors looking for the ability to reinvest cash flow.

TLL: What are the leverage parameters on your overall portfolio?

ST: The BDC portfolio averages around 4.5x. Again, we're at the lower end of the middle market with EBITDA in the $5 – $35 million range.

CF: It certainly depends on the deal. We won't necessarily go deeper to win a deal.

ST: Energy is a good example. We've only done three energy transactions in the last three years. Certainly we may have missed some opportunities, and faced some skeptics, but glad we stayed conservative especially given the recent drop in oil prices. We may only be in the first innings of that correction.

CF: We will look at more energy deals, but will stick with a diversified strategy across basins. And we expect to deploy only first lien debt.

TLL: With all the new capital coming into the middle market, you must be finding a lot of competition.

CF: It's tough to find out how much there is out there. We know it's hard to unseat an incumbent. We've been at this for seven years at THL Credit. It's a function of maintaining good relationships, so it's an uphill battle for the new guys to unseat long term relationships.

TLL: How many deals have you closed this year?

ST: We've closed 15 new transactions plus several add-on investments, which is down from prior years.

CF: But we've reviewed significantly more transactions this year. We are consistently lumpy by design. Some quarters we like the quality of deals better than others. We figure out what makes sense to do.

TLL: Do you view yourselves as more originators or asset managers?

CF: We really think of ourselves as investors. Origination is a huge component of being a good investor,being given more opportunities allows you to be more selective. We will also partner with other investors and lenders to finance other parts of the capital structure when it makes sense.

TLL: Does it help to have an affiliation with a top branded private equity firm?

ST: There are certainly advantages, particularly from a resource perspective. Thomas H. Lee Partners has deep industry expertise combined with their vast network of industry contacts and investment banking relationships.

TLL: What do you think of BDCs as an asset class?

CF: It's still a drop in the bucket compare to other asset classes. BDCs are still at the beginning of something here. You need to take a longer view. There's more flexibility with BDC structures.

TLL: OK, guys, what's been your biggest surprise of the year?

ST: How poorly BDC stocks have traded. There's not much differentiation between those BDCs who have been conservative with their money, and those who haven't. Some of the sell off has occurred because of the expectation of rising rates. But BDCs are generally yielding double digits. There's also a negative outlook on the credit sector in general, despite the fact that most BDC portfolios are primarily secured paper (72% secured for us). It doesn't make sense for the sector to be trading so far below book value.

CF: If you look at the high-yield index, BDC dividend yields are much wider, despite having secured and floating rate assets.

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