INVESTMENT PERSPECTIVES

CapitalDynamics
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PRIVATE CREDIT: IN SEARCH OF CALMER WATERS TO WEATHER THE COVID-19 PANDEMIC

KEY COMMENTARY

Middle market direct lending is generally considered an "all-weather" strategy that offers compelling investment opportunities, and risk-adjusted returns, throughout the credit cycle. Irrespective of prevailing market conditions, companies and sponsors require capital to execute buyouts and acquisitions, finance growth, refinance existing or maturing facilities, shore up liquidity, and for a variety of other reasons – all of which provide for a steady flow of potential loan investment opportunities.

Given this backdrop, and despite the market shock resulting from the expected impact of the COVID-19 pandemic, the broader credit markets continue to function reasonably well. The primary impact thus far has been on new issuance, which has been muted, and credit spreads, which have widened considerably, as market participants take stock of the economy and gauge the impact of the virus on industries and companies. Banks and other direct lenders are generally well capitalized, so the risk to the overall financial system seems less acute than in the 2008 crisis, but we do expect lenders with significant loan books to be focused inwardly on portfolio management versus allocating resources to new issuance and adding new loan exposure.

> **"PRIVATE CREDIT HAS PROVEN TO BE RELATIVELY RESILIENT THROUGHOUT TIME, AND OUTPERFORMED ALMOST ALL OTHER PRIVATE AND PUBLICLY TRADED ASSET CLASSES DURING, AND IMMEDIATELY FOLLOWING, THE GREAT FINANCIAL CRISIS."**

Nevertheless, private equity managers continue to have record levels of dry powder available for deployment, either to support their existing portfolio companies or to opportunistically capitalize on attractive investment opportunities that inevitably emerge in volatile times.

This creates a compelling opportunity set for lenders focused on financing private equity-backed companies with the capacity to invest, as the market pivots from a largely borrower-friendly environment pre COVID-19, to an environment where lenders will have greater ability to dictate terms and structure. Private credit has proven to be relatively resilient throughout time, and outperformed almost all other private and publicly traded asset classes during, and immediately following, the Great Financial Crisis ("GFC").[1]

CURRENT MARKET OVERVIEW

BROADLY SYNDICATED LOAN AND HIGH YIELD BOND MARKETS

Similar to its impact on global equity markets, the COVID-19 pandemic and its potential implications for the economy has resulted in credit market dislocations. Spreads in the traded, broadly syndicated loan ("BSL") and high yield ("HY") markets have widened 200-400 basis points as risk is being repriced across all asset classes. Most financing processes (leveraged buyouts, other M&A, and refinancings) have been put on hold as investors gauge the impact of the virus on the economy and on existing or prospective portfolio companies. Lenders have seen borrowers draw on their revolving credit lines in a defensive move to secure liquidity for navigating the current market turmoil. In the US, the Federal Reserve (the "Fed") and the Treasury have injected unprecedented monetary and fiscal stimulus into the economy in an attempt to prop it up as most of the country operates under "shelter-in-place" directives. The Fed lowered rates to 0-0.25% and has committed to buying / guaranteeing non-conventional assets on the balance sheets of banks and other financial institutions; and the Treasury, on the heels of the recent Coronavirus Aid Relief and Economic Security ("CARES") Act, signed into law, is providing short-term relief to consumers and businesses via tax relief and a variety of loan and grant programs. While volatility has spiked, overall market activity has been relatively orderly.

The past two weeks have seen a sharp rally in both US equity and credit markets, as slowing infection and hospitalization rates in certain hotspots (e.g., New York and California) fuel optimism of a partial reopening of the US economy sooner than initially expected. The credit markets gained additional momentum following the Fed's expanded program to purchase the so called "Fallen Angels," which are bonds that were rated investment grade by rating agencies prior to the pandemic, but that have since been downgraded to below investment grade to facilitate orderly market operations. The rally may prove premature but it has helped support investor confidence and, at least for now, may have prevented a more dramatic correction in the context of the potential for a longer lasting shutdown.

1 CLIFFWATER LLC "US DIRECT LENDING: COMPARATIVE PERFORMANCE THROUGH THE FINANCIAL CRISIS" JUNE 2019.

PRIVATE CREDIT MARKET ACTIVITY

The private credit markets (i.e., non-traded corporate credit) have been impacted by the virus in comparable ways. Much like in the public markets, new loan issuance has slowed dramatically as M&A and refinancing processes are being slow-played, delayed or postponed entirely. The few transactions that have closed in the last month have been those that were in advanced stages prior to COVID-19 taking hold. Further, most lenders have turned their attention inwardly to portfolio management and away from adding new loan exposure. Portfolio company management teams are assessing the near- and medium-term impact of the pandemic on their operations, actively managing liquidity and, to the degree possible, bolstering their business continuity and work-from-home infrastructure. That said, while certain industries, such as retail, travel and leisure (i.e., hospitality, airlines, cruise lines, restaurants, etc.), manufacturing, and oil and gas, are experiencing greater disruption than are others, some companies and markets may experience near- and/or longer-term benefits such as IT/software companies, media content producers and streaming service providers, and certain healthcare sectors, including pharma and related services.

> **"DESPITE A WEAKER NEW ISSUE MARKET, WE ARE SEEING A STEADY TRICKLE OF OPPORTUNITIES FROM OUR PRIVATE EQUITY PARTNERS LOOKING TO TAKE ADVANTAGE OF CURRENT MARKET CONDITIONS TO MAKE OPPORTUNISTIC ACQUISITIONS."**

Volatility in the private credit markets is limited; nevertheless, we do expect Q1 2020 valuations to be negatively impacted by a combination of higher yield expectation from the repricing of market risk, and a softening economic demand picture weakening the prospects for portfolio companies. Despite a weaker new issue market, we are seeing a steady trickle of opportunities from our private equity partners looking to take advantage of current market conditions to make opportunistic acquisitions. It is too early to tell how these transactions will evolve or if they will close, but what is clear is that valuations have come in, and lenders will likely be very selective in their investment decisions and disciplined in their structuring and underwriting. In a recent survey of over 100 middle market direct lenders conducted by law firm Proskauer, market participants indicated that spreads on senior secured first lien and unitranche loans will likely price 100-200 basis points wide of where they were at this time a year ago, and that leverage levels will likely be lower by 0.5x-1.0x. Importantly, we expect lenders to renew their focus on tightening documentation, including increasing scrutiny of EBITDA definitions and limitations on addbacks, tightening financial maintenance covenants, strengthening prohibitions on restricted payments and incurring additional debt.

DEFAULTS: "BSL" AND "HY" BOND MARKETS VS PRIVATE CREDIT MARKETS

The current backdrop is also fueling speculation regarding sharp increases in corporate default rates. Rating agencies have been active, with the upgrade / downgrade ratio – a signal of credit market strength or weakness – rapidly accelerating a declining trend that started in the latter part of 2019. The economic shock of the pandemic is unprecedented and the consequences, therefore, are difficult to assess. The duration of the shutdown will almost certainly affect corporate liquidity, and companies unable to access cash will struggle to maintain operations and are likely to seek protection from creditors by filing for bankruptcy. Despite the positive tone in the HY markets, the first two weeks of April saw a USD 45 billion surge in HY defaults and / or companies operating with creditors offering a grace period for interest payments, according to Credit Suisse. While energy companies, suffering from oil prices dropping below USD 20 / barrel , dominated that universe of borrowers by number, three telecom companies, including Intelsat, Digicel and Frontier Communications, accounted for over USD 30 billion of the reported USD 45 billion in defaulted / grace period bond issuances. Subsequently, oil prices have turned shortly negative for the first time in market history indicating more distress situations are expected for petroleum companies in the months ahead.

While rating agencies provide valuable information regarding borrowers' prospects and their ability to service their debt obligations, they can also precipitate technical market dislocation as corporate credit ratings impact regulatory capital treatment for banks and insurance companies, for example, and collateral support calculations for a variety of leveraged investment vehicles, including collateralized loan obligations ("CLOs"). This can cause unnatural behavior among lenders, potentially leading to forced selling of higher quality loans and bonds to shore up collateral and / or capital, and resulting in those credits trading at attractive prices. As discussed below, we are already seeing compelling opportunities to acquire first-lien senior secured loans to fundamentally sound companies at considerable discounts in the secondary market, and would not be surprised to see that opportunity set increase in the near-term.

> **"WHILE COMPANIES IN THE MIDDLE AND LOWER MIDDLE MARKET MAY BE MORE VULNERABLE TO ECONOMIC SHOCKS, MORE CONSERVATIVE STRUCTURING AND STRONGER INVESTOR PROTECTIONS SHOULD HELP SUPPORT RECOVERY RATES SIMILAR TO THOSE OBSERVED IN PRIOR CYCLES."**

A critical driver of private credit returns through a credit cycle are recovery rates upon default (also known as loss-given defaults). According to a report by Moody's and the Loan Sales and Trading Association ("LSTA"), historical recovery rates for first-lien senior secured loans have been between 75% and 85%, with lower middle market loans outperforming upper middle market and BSL loans, while senior secured and senior unsecured HY bonds recovered in the mid-60% range and mid-40% range, respectively, over the same period. One important distinction in the BSL market today versus the market prior to the 2008-2009 financial crisis is that the vast majority of BSL loans today lack maintenance covenants (also known as covenant-lite). While that provides borrowers and, if applicable, their private equity owners, with greater flexibility to maneuver if the business starts to underperform, it also means that lenders have few opportunities to inject themselves in the dialogue and drive recoveries in their favor. Companies in that market will only need to contend with lenders if they encounter a liquidity issue and are unable to service their debt obligations (interest and / or amortization payments).

We think this may result in lower recovery rates for BSL loans than was observed in prior credit cycles. While companies in the middle and lower middle market may be more vulnerable to economic shocks, more conservative structuring and stronger investor protections should help support recovery rates similar to those observed in prior cycles. This includes lower leverage, large equity cushions and less complex capital structures allowing for more expeditious decision-making, along with more robust financial maintenance covenants, more traditional EBITDA definitions, and limited flexibility to incur additional debt to make restricted payments.

These default concerns notwithstanding, we think that, to the extent the financial impact of the virus can be reasonably contained, the combination of significant fiscal and monetary support, and peak liquidity among capital providers (private equity managers, banks, and direct lenders) will help soften the longer-term consequences of the pandemic. Companies with fundamentally sound business models, strong market positions, and a "reason to exist" are likely to experience robust growth from pent-up demand once the economy starts to reopen. We believe this will encourage capital providers to support such portfolio companies with any near-term liquidity needs. Private equity and private credit managers have record levels of dry powder and we expect that an amount of that capital will need to be allocated to address the near-term challenges presented by the pandemic.

OPPORTUNITIES

Current market conditions represent a challenge for direct lenders along several dimensions. Existing portfolio companies need to be underwritten again in the context of the COVID-19 environment. Adjustments to business models, including staffing, sales and marketing strategies, sourcing, logistics, fulfillment, business continuity plans, to name a few, need to be considered, and contingency plans need to be formulated to address the variety of potential outcomes related to the timing, pace and complexity of any re-starting of the economy following the pandemic. Investment cadence will likely be slow to begin with but, as more certainty builds, we expect loan demand to accelerate as healthy companies refocus on growth. Finally, new issue underwriting will require contending with a variety of unknowns regarding prospects for not only individual companies, but also for broader sectors in the post COVID-19 environment. Certain industries, such as those that are facilities-based, travel-related, or require significant human interaction, will continue to experience more acute challenges in the near-term, while others, like healthcare, business services, and software / technology will be less impacted and may, in fact, experience increased demand for their products and services in the current environment.

Notwithstanding these challenges, current market conditions also present direct lenders who have experience navigating previous downturns and continued capacity to lend (i.e., dry powder) an opportunity to invest in loans to fundamentally resilient companies with very attractive relative risk-adjusted return profiles through three primary channels:

(i) financing leveraged buyouts of portfolio companies for sponsors that remain active and opportunistic through market cycles;

(ii) providing short-term liquidity solutions for companies and sponsors in need; and,

(iii) exploring purchases of loans in the secondary market.

Current lending markets are characterized by a dearth of capital as market participants focus on portfolio management and de-emphasize new issue origination. The opportunity set is particularly fertile for lenders focused on private equity-backed lending, as financial sponsors remain active and, in many instances, accelerate investment activity during market dislocations where assets are repriced and sellers are more compelled to transact. By contrast, entrepreneur and family-owned companies tend to be more risk averse in uncertain times and generally lack the resources and management infrastructure to opportunistically take advantage of market dislocations.

In the current market, sponsors are likely to pursue two complementary sourcing angles to maximize the opportunity set and potential to capitalize on near-term volatility. First, we expect sponsor platform companies to accelerate dialogue with tack-on acquisition prospects as targets become more receptive to transacting at relatively attractive valuations. This provides sponsors with the ability to lower the cost basis in their current investments, while filling gaps in the portfolio companies' product or service offerings, geographic footprints, or operating infrastructure.

> **"THE COMBINATION OF SPONSOR DEMAND FOR LOANS IN A MARKET SHORT ON SUPPLY, AND AN ENVIRONMENT WHERE SPEED AND CERTAINTY OUTWEIGH THE COST OF FUNDS, CREATES A FAVORABLE BACKDROP WHERE LENDERS CAN EARN HIGHER RELATIVE RETURNS, WITH STRONG INVESTOR PROTECTIONS."**

Second, and related, we think that discussions that were initiated with target portfolio companies prior to the COVID-19 crisis, and that were placed on hold over the past month, are more likely to advance to a transaction as entrepreneurs factor recent market volatility into their risk / reward analysis. We believe the combination of sponsor demand for loans in a market short on supply, and an environment where speed and certainty outweigh the cost of funds in driving return on investment for a sponsor, creates a favorable backdrop where lenders can earn higher relative returns, with strong investor protections.

Another feature of current market conditions that is likely to become more pronounced if the economic shutdown is extended is the potential demand for short-duration liquidity solutions. Companies with:

(i) no liquidity facilities (or that have fully drawn on their working capital revolvers);

(ii) no sponsors or sponsors with limited capital reserved in their funds to support the needs of existing portfolio companies; and, if applicable,

(iii) a lender (or lender group) that is unable to increase its commitments / exposure, may seek cost effective alternatives to bringing in dilutive equity to meet short-term capital needs.

This presents an opportunity for experienced lenders to deliver solutions that not only allow them to strengthen relationships with the borrowers and sponsors, but that also offer access to investments with very attractive risk-adjusted returns. These facilities tend to have their own collateral and security packages (or, in some cases, prime security interests from existing lenders), be very conservatively structured (low loan-to-value; i.e., strong asset coverage), have shorter durations with contractual repayment schedules, and be priced at very attractive yields given the cost of alternative funding options.

Finally, we expect purchases of existing loans in the secondary market from lenders that are "forced sellers" to represent a near-term compelling investment opportunity. These are loans to fundamentally strong companies, but where an incumbent lender has a mandate to sell the position for a variety of reasons other than those related to the credit profile or economic prospects of the underlying borrower. Those reasons may include portfolio concentration limits (e.g., industry or single name borrower concentrations), balance sheet / risk-weighted capital considerations (e.g., "hung" middle market loan syndications), liquidity to support redemptions in tradeable private-loan investment vehicles, and collateral coverage considerations in the context of asset revaluations on the heels of the current market turmoil. Secondary market purchases provide direct lenders with an opportunity to acquire seasoned senior secured loans to sponsor-backed companies with shorter duration and at discounted prices that offer attractive all-in yields.

MARKET OUTLOOK

We expect the market outlook for direct lending to be very favorable in the medium- to long-term. Even if the market recovery post-pandemic is "U-shaped," we believe that companies and industries will emerge from the crisis with tremendous growth capital needs, a large proportion of which will be satisfied by capital from the private markets, including direct lending and private equity. We expect leveraged buyout activity to accelerate dramatically post-crisis, due to a combination of continued elevated levels of dry powder and an attractive investment environment where company valuations will have been adjusted in the sponsors' favor and where sellers will be motivated to transact. Experience from prior financial crises suggest that private credit markets will enjoy strong tailwinds going into, and emerging from, these dislocations. We expect a favorable pricing environment with conservative structuring and strong downside protection to prevail for the foreseeable future, setting the stage for an attractive vintage of direct lending loans. Of course, significant uncertainty remains with respect to when and how the economy will restart, and how the economic prospects of companies, industries and geographies will have changed post crisis. As mentioned above, we expect capital to be in short supply for companies in industries that are the hardest hit by the COVID-19 pandemic in the near-term, but many of those sectors will inevitably rebound, fueling incremental capital needs and creating new lending opportunities at attractive risk-adjusted returns over the longer term.

CONCLUSION

While the COVID-19 pandemic has resulted in a temporary freeze in the markets, we believe the current environment will give way to compelling near- and medium-term investment opportunities for direct lenders as markets regain their footing, and uncertainties surrounding the impact of the virus ebb. Supply / demand imbalances are likely to be the dominant driver of near-term lending opportunities, as market participants focus inwardly on portfolio management, while sponsors continue to actively invest in new leveraged buyouts to capitalize on attractive opportunities resulting from current market turmoil. Over the medium- to long-term; however, we expect capital needs to continue to outstrip loan supply as the economy reopens and sponsor investment normalizes. We continue to believe that private markets, including private credit, provide investors with uncorrelated returns and the ability to avoid the erratic volatility experienced in the publicly traded markets driven by rapidly shifting investor sentiment. That said, we do expect near-term loan portfolio valuations to experience pressure and investors to absorb unrealized losses, as risk is temporarily being repriced and economic prospects are less certain. However, lenders with patient capital in prior cycles emerged with attractive relative risk-adjusted performance, including limited losses of principal. History has shown that senior secured loans and private credit perform well (relative to other asset classes) through downturns, and outperformed most other asset classes during the 2007-2011 timeframe surrounding the GFC.

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In 2019, Capital Dynamics was awarded the highest corporate rating (A+) from the UN-supported Principles for Responsible Investment, while the firm's clean energy infrastructure platform received top rankings from GRESB (the ESG benchmark for real assets) for commitment to sustainability. For more information, please visit: www.capdyn.com

[1]As of December 31, 2019.

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