TALKING POINTS

Nearly six months on from the outbreak of covid-19 in the US, Twin Brook Capital Partners' Garrett Ryan discusses the pandemic's effect on the middle market and the direct lending space thus far

The state of the middle market

Q Looking at activity over the past few months, what would you say are some of the most notable impacts of the pandemic?

The private credit industry experienced a slow start to 2020, with pipelines generally being thinner than usual during January and February. However, it was nothing compared to what lenders experienced as the pandemic's dramatic impact on the US economy began to be felt.

When capital markets plummeted in the third week of March, M&A activity froze as lenders and sponsors alike turned their focus to existing portfolios. Subsequently, deal volume of every kind – both M&A as well as opportunistic – took a hit not seen since the Great Recession. While there has been a gradual, perceptive uptick in overall confidence since June – primarily because of the bounceback in the capital markets – lenders' pipelines remain far from normal as we head into the end of Q3.

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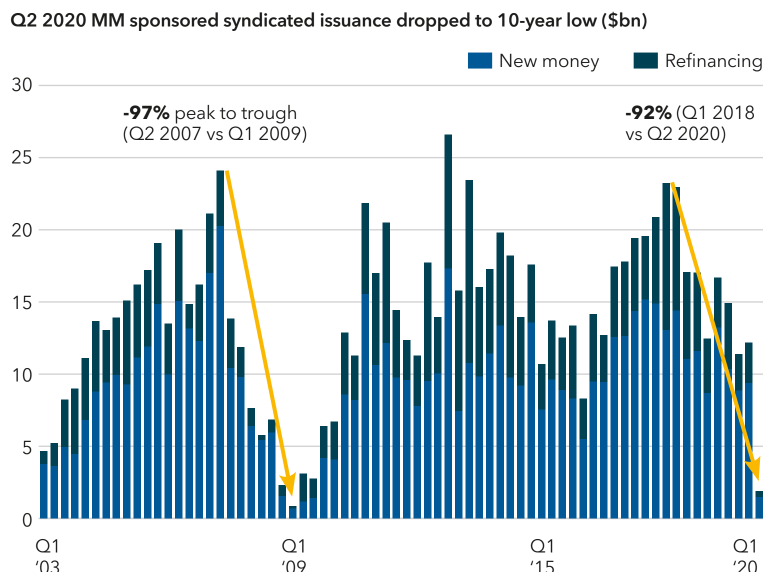
Also of note is the impact that covid-19-related shutdowns and changes in consumer behaviour have had on companies across many industries. Businesses that rely on human travel and congregation – like airlines, ground transportation, and concerts and events – as well as gyms, restaurants, and retail were suddenly and disproportionately affected. Lenders and sponsors are continuing to work with these companies as many try to contend with declining revenues and the ongoing uncertainty spurred by concerns about a resurgence of covid-19. Some borrowers in these sectors have been more resilient than others, but only time will tell what a recovery will look like.

Q Did the deal volume drop-off in March include add-ons? Or was it mainly LBOs?

Add-on activity has seen a dramatic slowdown but not as precipitous as new LBOs. In general, we saw that borrowers that identified good add-on opportunities and had unfunded delayed draw term loans (DDTLs) in place prior to covid-19 were able to execute those deals without opening up their



Source: Refinitiv LPC

existing credit agreements. This was a major advantage for sponsors seeking additional debt financing because it did not require changes to the cost and terms of their portfolio companies' debt.

Sponsors often faced a more challenging situation in cases where there were no DDTLs as part of the existing deal structure and borrowers therefore needed to raise new capital for an add-on. Given the intensity of the early months of the pandemic, it was difficult to attract fresh capital to new deals.

Moreover, the question of how a deal was repriced was a major point of focus in the market when add-ons occurred during that time. The answer to this typically resided in the credit agreement under incremental debt and its related sunset provisions. Oftentimes in the lower middle market, the provisions being more lender-friendly resulted in the entire debt being repriced, which was often a favourable outcome for existing lenders. However, sponsors' and lenders' views on this frequently differed, particularly if the debt needed to finance the add-on was small in relation to the existing debt. Sponsors felt that add-ons were accretive to existing portfolio companies – and therefore credit enhancing to the lender – so didn't believe that entire credit facilities should be repriced. Lenders, on the other hand, were trying to manage their portfolios in the new pricing paradigm, driven by fiduciary responsibilities to shareholders, guidance from leverage providers, and – in the wake of significant pandemic-related uncertainty about cashflows – leverage parameters that were in the existing credit agreement but often at odds with what was acceptable given the current environment.

Q Can you elaborate on that point about leverage? Pre-pandemic, there was much discussion of how terms and pricing had grown increasingly borrower-friendly. Has that changed? How has pricing been affected?

The market is dynamic and constantly shifting, even as this article goes to print. In the early days of the pandemic, the level of uncertainty that gripped much of the lending and sponsor community was unprecedented. In reaction to that, we found the general consensus in the market was that leverage had come down at least 1x, and this was prior to most lenders understanding how their borrowers had performed in April and May – the first real test of many borrowers' resiliency in the face of the pandemic.

As lenders focused on liquidity and revised projections combined with borrowers' early results from those months, the market was able to develop a clearer view of how businesses were holding up, with many falling into one of three categories: in trouble, treading water, and doing fine or thriving.

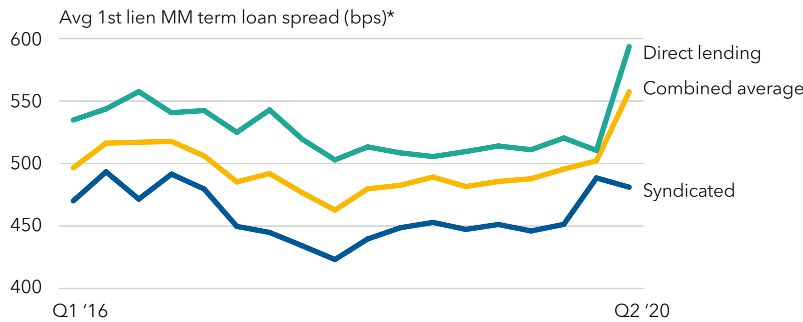
Bolstered by regular 13-week cashflow forecasts, management teams' heightened focus on expenses and frequent sponsor communication, we saw lenders start to become more comfortable, particularly as both debt and equity capital markets demonstrated continued signs of stability.

Moving through July and August, lenders' visibility as to how their portfolio companies were managing the storm generally further improved. Today, we believe the private debt industry is somewhat bifurcated between the haves and have-nots, in terms of both borrowers' industries and resilience. We have seen some recent transactions in the broadly syndicated (BSL) market that look very similar to pre-pandemic transactions. However, these choice credits are part of a supply-demand equation in which very little supply is resulting in an oversubscription of demand for solid credits.

Via this small data set, we saw signs of lenders in the upper middle market increasing leverage for favoured credits emerging in the late-summer months. It appears the lower middle market, however, has stayed more moderated in terms of its leverage view, as lenders remain cautious about leverage levels. Additionally, their decisions and the enterprise values (EVs) of borrowers are increasingly driven by LTV calculations. As EVs decline, leverage follows.

With respect to pricing, lenders generally coalesced on pricing for middle market credits through June. LIBOR margins vary by tranche structure, but we found that pricing generally widened by 150-200 basis points

Spreads moved higher in the direct lending market in Q2 2020



* Syndicated + direct: Data calculated by combining private data submissions with league table/syndicated deals. Excludes unitranche loans.

Source: Refinitiv LPC

in Q2. Since July, it appears there has been a notable divergence among lenders in terms of pricing guidance.

We believe this has been driven by a number of factors, such as the relative value to the BSL market, more clarity around portfolio performance, the prospects for a particular borrower, the lack of supply in the market, and – at some basic level – the desire to print a new deal in a market that has seen the lowest number of transactions completed since the Great Recession. We are seeing erosion in upper middle market pricing as a result of its proximity to syndicated transactions, which are typically a 'lowest common denominator' solution, mainly competing on price and involving a larger group of lenders. In contrast, you typically see a more relationship-focused approach in the lower middle market, which has therefore retained more discipline on yield.

Q Have lenders' individual hold levels changed?

We've seen hold levels generally come down. Fundamentally, the private credit industry today is more reliant on third-party capital and the capital markets than it was during the Great Recession, when there was a larger presence of traditional balance sheet capital from banks, insurance companies and corporations.

Therefore, we believe lender appetite for transactions is very much impacted by how much dry powder a manager has and the broader fundraising environment. Lenders across the board have taken a more cautious approach to hold levels since the outbreak of covid-19. According to a Refinitiv LPC survey, 40 percent of lenders indicated that they could comfortably hold over $100 million for a single transaction in 2019. Today, that number is significantly smaller, so more lenders are needed to fill out a club deal.

Q Have recent stresses and market uncertainty impacted lenders' tolerance for underwriting risk?

I believe they have. Compounding the lower hold issue for borrowers is that it appears many lenders are currently more averse to underwriting and distributing a transaction. If they are willing to take syndication risk, in our experience it typically comes with reinforced market flex language that will enable the agent to reach a comfortable target hold.

Moving through July and August, it appears lenders started to be more comfortable about full underwrites and hold levels, but there continues to be a lot of uncertainty in the market. Today, we believe it is primarily a 'club market', with sponsors turning to lenders that they have a history of working with and where both sides have therefore seen how their counterpart reacts to a downturn.

Q What do you think all of this will mean for lenders' portfolios moving forward?

Overall, I believe market consensus is that portfolio companies have held up pretty well in the face of the pandemic. We've found that sponsors have been a key part of this and that their presence often contributes to future recoveries, whether that be through providing capital, expense control or maintaining an open line of communication – which is something that also supports lenders' portfolio management efforts. There are a number of other interesting dynamics at play within the private debt sector that will influence recoveries, many of which are related to the type of credit agreements that govern a borrower.

Pre-pandemic, there was much discussion about the lack of lender controls, wide covenants and highly adjusted EBITDA definitions that had become prevalent in recent years, the impacts of which are coming home to roost following Q2 reporting and entering into Q3. We believe the lower middle market will have an easier time restructuring and repricing credit versus its larger brethren. Control is also becoming a clear differentiator, highlighting the advantages of being the administrative agent on a deal. Another factor that is complicating and frequently slowing down portfolio modifications is the number of lenders in a deal and the presence of junior capital. In an environment where private credit providers often have very diverse views on how to restructure or reprice a transaction, having fewer lenders to bring to the table is an advantage in quickly resolving a credit issue.

With these dynamics in mind – and consistent with Twin Brook's historical view – we believe that experienced lenders that have strong sponsor relationships, have maintained stringent underwriting standards, frequently hold the administrative agent role on their credits or have sole lender arrangements, and have extensive workout expertise will be well-positioned to navigate the current environment. ■