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COVID-19 Crisis is Severe But Private Credit Remains Resilient

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A month has passed since the outbreak of the COVID-19 pandemic in the United States. The virus has impacted almost every facet of our lives, creating chaos in the financial markets, emptying Main Streets across the nation and changing our daily routines. Unsurprisingly, private credit lenders and their borrower clients have not been left unscathed. Private credit lenders were forced to respond to urgent and rapidly changing circumstances, requests for immediate cash and other relief; encouragingly private credit lenders have thus far shown great resiliency in the face of these challenges.

1. **Pre-COVID-19**. Private credit lenders were well-served by anticipatory actions they took or were in the process of taking to prepare for an economic down turn when COVID-19 hit. Some key steps:
    a. More Conservative Investment Strategy. Many were prepared for headwinds, if not an economic downturn. They were starting to take defensive positions, being more selective in credit quality, looking for ways to tighten structures and terms. Markets were still hot for competitive, quality credits, but investment committees were already beginning to shift strategies. Default rates were extremely low.

    b. Bulked-Up Restructuring Capabilities. In late 2019 many managers began to prepare for the next restructuring cycle by hiring experienced workout and restructuring professionals, including former consultants, turnaround experts, restructuring professionals and bankruptcy attorneys. Going into March 2020, many private credit lenders had the right personnel in place to respond quickly and effectively to the rapidly changing public health and economic crisis and the increasing requests for relief and support being made by their borrower clients.

    c. Improved Internal Processes. We also counseled last year that private credit lenders should install internal procedures for tracking and evaluating credit quality so that they could better track companies, anticipate issues and proactively respond to changes in the broader economy and financial markets, many did by installing more robust credit rating systems, watch lists or other means of grading and following the credit quality of their portfolio.

2. **The Impact of COVID-19**. These proactive and prophylactic measures adopted by private credit lenders have served them well. Over the last few weeks, we have observed the following:

   1. Liquidity, liquidity, liquidity! If there was one word that summed up the urgency of March it was “liquidity”. Many companies were faced with unprecedented circumstances – a sudden collapse of revenue, with some having to close their operations and furlough many, if not all, employees. Many were advised to, and did, draw down on their revolvers. Virtually simultaneous draws created concerns about how private credit lenders that hold revolving commitments would respond to this flood of revolver draw requests. Were they going to fund and, perhaps more importantly, did they have the capacity to meet their funding obligations? Private credit lenders responded admirably by honoring their commitments, in nearly all cases.

   2. “War Room.” Speed of information and decision making was crucial. This was made even more challenging given mandated quarantine and shelter in place rules in most States. Private credit lenders were quick to establish virtual “war rooms” to be able to efficiently address problems as they arose.

   3. Communication and Collaboration. Given the speed at which issues had to be addressed, it was necessary to have candid and sometimes uncomfortable conversations. Largely, sponsors, borrowers and private credit lenders successfully navigated these conversations in these early days and generally the parties constructively addressed the most immediate of issues.

   4. Payment Defaults. Not only were borrowers drawing revolvers, but they were undertaking other steps to preserve liquidity. They included stretching trade payables, deferring rent payments and (not surprisingly) requesting to defer interest and/or principal payments to lenders. Towards the end of March there was frenetic activity to either amend credit agreements or enter into forbearance agreements to defer payment obligations and otherwise offer interim relief.

   5. Assessing/Tightening Documents. In this environment, many of our private credit clients are requiring “red flag” reviews of the loan documents in their portfolios. It is no secret that the documentation tended to be more flexible and borrower friendly in the last several years, so while private credit lenders underwrote to those risks, they are now laser-focused on

anticipating how the flexibility built into the loan documentation may come into play. Particularly as liquidity continues to be an issue, layering of debt, unencumbered collateral and use of proceeds, among other terms, are now front and center. Investment committees are requiring their portfolio managers and investment professionals to refresh on key terms of credit documentation and to tighten up in connection with any amendments, concessions or forbearances.

3. **Where Do We Go From Here**? In many ways the greatest pain is still yet to come. Borrowers and lenders are continuing to assess the short-term and long-term impact of the COVID-19 pandemic and how they can best position themselves for the days, weeks and months ahead. As this continues to unfold, difficult conversations and decisions will be unavoidable. Some key considerations will impact how private credit lenders will react, including:

    1. Capital Allocation. As we enter the second quarter, private credit lenders are going to have to confront how to allocate their capital. One of the advantages of private credit lenders (as compared to banks, CLOs, mutual funds and pension funds) is that they have significant “dry powder” to invest, including for follow-on investments in existing portfolio companies. According to Prequin, private credit lenders had an aggregate of $261 billion of dry powder as of December 2019. During the last two weeks, we conducted a survey of private credit lenders. Of the over 110 private credit respondents, 97% responded that they would be willing to make additional investments in their portfolio companies. However, private credit lenders will need to determine which companies to support and how best to allocate their capital (see discussion on opportunistic financings below). Not surprisingly, sponsors will be doing the same. In this regard, valuation and cost of capital will be a significant issue.

    2. Personnel Allocation. Private credit lenders will also have to decide how much human capital to allocate to any particular credit. Workouts and restructurings are time-consuming endeavors, often requiring senior resources to be fully dedicated for many months. Human capital may prove to be more scarce than investment capital, and devoting too many resources to workouts and restructurings, especially those with limited upside, may be a diversion from other, more profitable endeavors. Private credit lenders will have to determine whether the benefits of restructuring outweigh the costs on a company by company basis.

3. <u>More Frequent Limited Partner Communication</u>. Private credit lenders will also have to manage their limited partners. Limited partners will undoubtedly be hungry for information and may seek to make their own determinations about investment performance. The need for information at all levels will stress management of companies that are otherwise focused on survival and rehabilitation.

4. <u>Pivot to Rescue and Opportunistic Financings</u>. Borrowers will be focused on finding ways to bridge the next quarter or two, primarily with respect to liquidity as management looks to resuscitate operations. Many private credit lenders are well-positioned to take advantage of these opportunities. In our recent survey, almost 48% of respondents indicated that they were interested in providing special situation loans. These lenders will look for opportunities to lend against unencumbered collateral, typically on a priming basis, and other means to layer into existing capital structures.

5. <u>New Deals Still Getting Done</u>. Notably, while there has been a significant decline in M&A and related financings, there are new deals that have, and will, get done. More than 70% of respondents in our survey indicated that they are still looking for new acquisition financing opportunities. Recurring revenue deals, certain health care deals and financial services deals are proceeding. Moreover, it has been reported that private equity fund have over $2.5 trillion in “dry powder”. This environment may present very attractive acquisition opportunities, which will require financing.These activities will pick up as the market stabilizes and sponsors and lenders digest the immediate impact of market volatility, business and consumer demand (or lack thereof) and the impact of the federal stimulus programs.

4. **Looking Ahead**. In the current market, borrowers will continue to focus on maximizing and stretching liquidity and managing their creditors in order to best position themselves to survive the economic fallout caused by the COVID-19 pandemic. No one can predict when the economy may emerge from this pandemic or the extent of the collateral damage on the global economy. Companies that entered this cycle in a weakened state are particularly vulnerable. We predict tough and potentially prolonged negotiations among private credit lenders, sponsors and borrowers in the months ahead, and likely a spike in corporate bankruptcies, particularly in the energy, retail, hospitality and lodging, and auto supply industries. However, the best solution for many companies will be out-of-court, consensual restructurings. Private credit lenders, often as the fulcrum security, with available “dry powder” and operational resources, will be a major constituent at the negotiating table. At the same time, some private credit lenders are well-positioned to provide rescue or special situation financings as

well as to take advantage of new opportunities as the M&A market regains its footing.

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