ROUNDTABLE

Debt developments

Covid-19 has turned the dynamics in acquisition finance markets upside down. In a recent Real Deals roundtable discussion, a group of GPs, lenders and advisers dialled in to discuss the changes in the market and how lenders and borrowers are reacting.

SPEAKERS:

Daniel Sinclair,
partner, Ares Management

Peter Brown,
head of private debt, Luxembourg, Aztec Group

Adriana Oller Astort,
partner and founder, Resilience Partners

Tom Cox,
partner, FRP Advisory

Miles Otway,
partner, Connection Capital

Paul Shea,
partner, Beechbrook Capital

Moderator: *Nicholas Neveling*

How many opportunities have there been for lenders to fund new deals? Is it unrealistic to expect much deal activity against the current backdrop, or is there an opportunity to win business and market share for lenders who can keep deploying?

Daniel Sinclair: We strongly believe that times of volatility often result in bank retrenchment and the closing of the liquid markets. When that does happen, we see direct lenders like ourselves, who are well-capitalised and well-positioned, able to step up and fill those gaps in the market. That theme has played out since the start of the Covid-19 pandemic across Europe, so we are actually seeing additional opportunities.

One thing that is really important is flexible capital, and being able to look at a wide range of financing structures across different parts of the capital structure for businesses that are at different stages of their development.

Tom Cox: While deal volumes have started to pick up in more defensive sectors, classic performing mid-market deal opportunities have, perhaps unsurprisingly, been relatively sparse since the start of the crisis. Daniel, can I ask whether the opportunities you are looking at have been mainly at the upper end of the mid-market, or have deals been coming through from across the market?

DS: It has been interesting to observe where deals have come from. We have funded deals in the larger cap space, like Ardonagh, which is the largest ever unitranche deal. So, the larger deals do come through, but the core of what we do, and the Ebitda profiles of the companies we back, has remained consistent over the last five years.

Over the last couple of months, the market has seen relatively few new deals launched. Processes that were in chain paused, and then the high quality transactions in stable sectors picked back up and completed.

Does that chime with what the other investors and lenders on the panel have observed? Have you been able to do any new deals since lockdown, or has there just not been enough M&A activity in the first place?

Adriana Oller Astort: I would echo what Daniel said. Deals went on hold because of uncertainty around current trading and valuations, but deals involving companies that continued to trade well through lockdowns have moved forward. We have done one new deal through this period and are close to securing another one, although both these processes had started pre-Covid. We haven't closed a deal that has been originated post-Covid yet.

Although the themes have been broadly the same, however, there are some specificities in different markets. In Spain, for example, a lot of Covid rescue money has basically been channelled almost exclusively through the banks, which means that banks have been focused on distributing this capital at the expense of other lines of business.

Companies that haven't required rescue funding haven't had many options for lending. They are performing well and need financing, so that has opened up opportunities for us.

Paul Shea: I'd agree with a lot of what's been said. March and April were very quiet. But since then, deal flow has picked up materially. Private equity firms still have dry powder and limited fund lives, so they have to do deals. Sponsorless SMEs have got taxes and rents to pay, which were only postponed, not cancelled, and some businesses are not just resilient, but have actually performed extremely well. They're looking for money to grow and take market share. There are a lot of opportunities.

Some countries are a bit more active than others. Germany's active, Ireland's active, and the UK is increasing. We're mandated on around three transactions at the moment, and hopefully a fourth fairly soon. Things are definitely picking up, and many of the credits look attractive.

It is good to hear that the market is starting to show signs of life, but with personal contact still

Daniel Sinclair,
partner,
Ares Management

Peter Brown,
head of private debt,
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restricted, how difficult is it to get behind a deal when there hasn't been an opportunity to eyeball the management team?

Miles Otway: I think that is more of a challenge for private equity investors. It is less of an issue on the debt side.

For private equity the relationship with management is so important, and that is built up through a process where you can get close to a team, understand their drivers and where you can add value that the next sponsor can't.

It is on the relationship, not the pricing, that you win a deal, and that is the bit that is probably harder for private equity when you can't meet people in person. On the debt side it is still an issue, but less of an issue, because if you are backing assets or a cashflow, you can take more of a view. It is also important to remember that there are other dynamics at play than just the impact of Covid-19.

In the UK, for example, we have had an unconvincing denial from the Treasury that capital gains tax (CGT) is going to rise. That is just one of many factors that will drive deals. I wouldn't be surprised at all if you have a series of cashout deals that have elements of a debt structure and elements of an equity structure to them, in order to appropriately balance the risk of a CGT rise.

Peter, we have heard from the direct lenders and sponsors, and there is clearly the appetite and capability to put money to work despite the challenges posed by Covid-19. How are the banks reacting and how are they positioned?

Peter Brown: The banks are in a somewhat unusual position. On the one hand they are much more resilient than before the financial crisis of 2008. Tier one capital levels were down in the single digits then. Now they are in the mid-teens, so the

Adriana Oller Astort,
partner and founder,
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banks are holding much more capital and are much stronger.

However, they are under significant pressure to deliver government-backed loan schemes and support the wider economy and jobs. This has led to a focus on supporting their existing clients, and made new deals more challenging.

But it is expensive to hold assets on the balance sheet, and corporate loan losses are likely to increase considerably as government support measures fall away and the true economic impact is felt. As credit quality deteriorates, then the capital cost increases which also poses some interesting challenges on returns, and the economics of holding onto assets.

From a leveraged finance perspective, what this all means is that the banks have been more conservative, because it's more expensive to put higher-risk debt out. It absorbs more capital, so they're generally playing at the super-senior and senior part of the capital structure and working alongside private debt players and other credit investors.

I see the trend of the last ten years, where private debt has taken a larger and larger share of the leveraged finance market, continuing as the banks deal with deteriorating credit quality, absorb capital, and see returns fall further.

MO: One thing to add is that there is a growing acceptance of cost for flexibility and headroom. Different direct lenders who have different ways of looking at an opportunity will come to the fore. When the economy is stable and everything is growing at two per cent to three per cent, entrepreneurs want the cheapest debt option and lean towards the banks, but when there is a period of uncertainty borrowers value a more flexible structure – whether that is a bullet or something with a cash sweep.

Businesses are willing to pay a little more for a structure that takes off some of the pressure.

TO: We have certainly seen a shift to that kind of more flexible product, especially in the sponsorless market. Management teams are realising that the old relationship with the bank isn't going to work anymore. They are now much more willing to investigate the options with the institutional market.

This is tracking the massive shift on the sponsor side over the last five to six years. Any statistic you read will say that between half to two thirds of the sponsor backed market is now supported by private credit.

PS: The interesting thing, and this has always been a question borrowers have asked, is how the institutional market will behave? The infrastructure of the direct lenders is going to be a key factor. There are different infrastructure models across the market, and it is going to be interesting to see how the response of the different funds to lockdowns plays out.

What does that mean for what the market looks like in five to six years' time? My perspective has always been that there's likely to be a period of adjustment in the mainstream market, with niche lenders playing into specialist areas. I think that to a certain degree, the level of infrastructure around funds is going to be a driver of that going forward.

That leads nicely onto a question I was really interested in hearing the panel's thoughts on. The number of new lenders has proliferated, and deployment has been crucial for new entrants who have to deploy to secure fee income. What happens when red lights start flashing and credits come under pressure? Does infrastructure and scale become more important, and does that suggest consolidation of the lender universe?

TC: I don't know if there will necessarily be consolidation, but I do think there will be a different structure to the institutional market. The managers with infrastructure will without a doubt be better positioned. It is worth remembering that in the mid-market, the reality is that there isn't actually that much experience in restructuring, because a lot of people have been deploying into a bull market for 10 years. It is going to be quite interesting to see how people cope when everything potentially does start lighting up red.

AOA: The question of consolidation does depend on which region you are operating in. Direct lending in Spain, for example, is still behind markets like the UK and the Nordics. There are fewer funds in our market for starters.

What we have seen is that the London-based, pan-European funds that came out once a month to do sponsor-backed deals with €30m Ebitda have found it difficult to deploy in the current environment without being local.

Then, we have seen the local managers who raised second funds and have moved up the market and want to do bigger deals. They have had to start looking at other markets like France.

There aren't many local mid-market funds around. It can actually be a lonely market, but that works for us, because there are lots of deals to look at and not that many players to fund those deals.

PS: I am not sure if we are going to see consolidation anytime soon either, but I would say that if you are in the middle of the pack and you are only paid fees on invested capital and don't have scale, that can lead to challenges. Where you are in the market and your fee structure are important. We sit down and discuss budgets with our investors, and how we're going to manage their fund, and we have a rational discussion about what's needed, and they support us. We do receive fees on committed capital, so we are not under pressure to deploy. That makes a big difference.

MO: My sense is that you're not going to have an immediate turnaround where a whole bunch of people exit the market overnight, but what you may have is managers slipping away over an extended period of time as those businesses see whether they can work those funds out.

Tom Cox,
partner,
FRP Advisory

The point is that with close-ended 10-year vehicles, unless you have absolutely got the timing terribly wrong, there's quite a long runoff before people have to make the very hard choices.

DS: In response to the infrastructure point specifically, we see the value in scale. A lot of direct lenders at the moment have been focused internally on their own portfolios. We have invested in scale. That gives us the opportunity to continue servicing clients who are looking to do new deals in this market, while retaining focus on the portfolio.

I believe we've got the largest team dedicated to direct lending in Europe. We have just over 60 people in our team dedicated to direct lending, 12 of which are on the portfolio management side, managing north of 100 assets, and four of those are dedicated restructuring people, led by a partner who also sits on the investment committee.

We have that capability in-house and it meant that once the severity of the pandemic dawned on people, we were able to reach out to management teams, get revised forecasts and see if there were any challenges.

The ability to access information and share that with investors has really resonated with them, because they can see how we are managing the portfolio and they take comfort from that.

It also means that we have the bandwidth to keep looking at new deal opportunities. We don't have the entire time completely absorbed with the portfolio.

PB: That is an important point. In the last crisis we saw this happen across the banking market. The banks benefited from their scale and flexibility with many of the origination teams being pulled into portfolio management and restructuring to help clients through the crisis.

This time around, the banks are at the lower risk end of the capital structure, but there is nevertheless quite a lot of work to do with the existing portfolio, particularly given that they are often managing their position alongside other lenders, and the equity sponsors further up

Miles Otway,
partner,
Connection Capital

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the risk curve.

Of course, many of the direct lenders will be facing these pressures for the first time. If you are an established fund with scale across the team and dedicated portfolio resources, you should be well placed to weather the storm.

For smaller players with heavily exposed portfolios, they may struggle as they need to restructure assets, which is incredibly time consuming. If they suffer large losses, raising a new fund will also be a challenge.

Some of the newer players with a few assets in the portfolio, but who have capital to deploy could find themselves in a good position as opportunities arise. Some of the best deals done in the last 10 years could well be done in 2021.

My sense is that the last financial crisis was a true test of the banking market and that this will be a real test for the direct lender market.

Can we expect to see more restructuring and distress emerging?

DS: Robust underwriting has seen our portfolio demonstrate strong levels of resilience, and in the small number of companies that have needed support, we have seen sponsors work constructively and make meaningful capital injections in almost all circumstances.

What has been interesting to observe is that companies and sponsors are not just focusing on modelling Ebitda forecasts for the next 12 months. They are looking at what the balance sheet looks like. Through the bull market, the balance sheet has been the forgotten financial statement, but I think there will be a real focus on that for the rest of this year and going into 2021.

PB: It is too early to predict what it is going to look like. There have been some restructurings and a few pre-pack administrations, but lenders have put in a lot of work over the last three months to stabilise businesses and give them some breathing space. There is a focus on forbearance and managing short-term cashflow issues in a positive way. 'Cash is king', and making sure that businesses have support and cash headroom to see them through is a priority.

We have to wait and see what the medium and long-term impact is, but as government support falls away and the real economic impact is felt, there will be more restructuring and a considerable increase in provisions and losses across the market.

However, this also presents an opportunity for fresh capital to support this restructuring activity and we have seen a number of funds raise capital to deploy in this area.

One thing that we may see is banks and funds selling assets. The banks could look to trading portfolios of loans, and the funds have the option of exploring secondary trades. Ultimately, it comes down to the individual lender and their circumstances.

AOA: It is an interesting time. You would expect, for example, that loan-to-own funds would be incredibly busy right now, but because of substantial financial support packages from governments, these funds are actually in limbo.

We have seen very few restructurings. It could take a year, once government support measures unwind, before there is a clear picture of restructuring volumes.

TC: Given our practice at FRP, I have quite a lot of intelligence around the insolvency market, and insolvency appointments in June were some of the lowest of all time. It suggests people are at least coping with perceived stress in the short term, but the genuine stress in portfolios hasn't really emerged yet, and to Adriana's point, I think we will only really be able to tell when state support starts to roll back.

So far, though, we have seen a collaborative approach from GPs and lenders to chart a way through this and plot an exit.

Paul Shea,
partner,
Beechbrook Capital

Finally, I had a question about how investors are looking at private debt and whether there is still the same level of appetite for the strategy post-Covid?

PB: What we have seen across our client base is that if you are an established manager with an existing investor base and you are in the process of a fundraise, then you will have a good chance of closing a fund. I suspect many closes that we have seen recently were in train pre-lockdown and involved managers with good track records.

There are, however, also a cohort of new managers looking to raise. Nothing has happened in this area for three months, but conversations with investors are starting up again.

Ultimately, I think there will be more bank retrenchment over the next 12 to 18 months, so there remains a great opportunity in the market for private debt funds to invest. This is not just for sponsor-backed deals, but also sponsorless, and in areas like asset finance, renewable energy, and infrastructure funding.

There is a lot of money for investors to deploy, and with a repricing of risk upwards, potentially attractive returns on loan investments over the next few years.

AOA: My view is that this is crunch time for the private debt asset class. We need to show that we can deliver for investors and ensure that distributions keep coming.

It's been a bull market, and now we need to prove that what we offer works for companies and that we can be flexible, but also get our money back for investors.

Uncertainty doesn't help fundraising, but if you have performance and performance is going well, I think things will fall into place.

MO: Connection Capital also has a fund of funds business on its platform and it comes down to quality.

What infrastructure does a direct lender have and is it able to work through this downturn?

We saw it after the financial crisis. There was a flight to quality and a bifurcation of the market. The good funds found it very easy to raise. The ones who had sketchy back stories didn't. It was as simple as that, and I don't think it is very different now.

PS: The hunt for yield continues, and the long-term dynamics remain very positive, particularly for direct lending, which doesn't have the volatility of the other big markets.

Also, there's limited denominator effect this time, because equity prices have held up, so the alternatives bucket isn't collapsing like it was previously.

I agree that there's a current wall as the uncertainty persists. But once that passes, I think the long-term dynamics are very positive.