Note to clients
Debt capital markets update

25 MARCH 2020

Given the dramatic escalation of the COVID-19 crisis since the start of last week, the UK Debt Capital Markets team have been running a calling programme amongst our direct lending contacts to assess their reaction to events and their scope to be a continued source of liquidity.

Liquidity/activity

Unlike banks, the direct lending market is funded by committed capital, largely from institutional investors. While this puts into focus remaining fund capacity and ultimately the ability of LPs to meet capital calls, the market as a whole has significant dry powder and remains incentivised to put that money to work – at the right price. Dialogue with LPs has increased significantly and some LPs have been keen to stress their caution to their managers. However, ultimately the investment committees have autonomy.

None of the funds we have spoken to have pulled out of live transactions, albeit there are plenty of examples of processes being understandably pulled by sponsors. There are though some instances of banks having pulled-back or re-priced where funds have then filled the gap.

All the funds have the ability to look at new transactions, although the practical reality of that in the short-term means none expect to be starting new processes soon.

During the global financial crisis, a number of direct lending funds focused their strategy on the liquid, secondary market where relative value was far higher. Almost all of the direct lending funds have capacity to invest in this market but, again, the practical reality makes this less likely. The due diligence bar does not drop for liquid deals, however access to current information is more difficult. Also, many funds have other teams already engaged in the liquid markets, so we do not expect there to be significant secondary activity among the direct lending funds, although it will impact pricing.

A number of the funds also have capacity to invest in stressed/distressed situations and be the solution to short-term liquidity needs or help right-size a capital stack. Given the short-term uncertainty, we expect the emergency funding announced by the UK government on 17 March to be the first port of call for many. However, these measures do not currently apply to all borrowers and will not be the long-term solution so this is where the fund market is more likely to be relevant.

Leverage/pricing

The common view from the market is that leverage for any new deals that do start in the near-term will be lower. We do not expect a dramatic change – that impact will be felt more by deals that will now not get done. Rather, for solid credits in robust sectors, we expect general caution to push leverage lower by between 0.25x and 0.75x as compared to pre-crisis.

The question of pricing, however, splits opinion. Some funds believe the challenge has always been finding good credits and not their ability to price risk. So, faced with limited opportunities to invest in strong credits in this market and with the heightened competition that is likely to bring, some would prefer to hold firm on pricing and secure the deal. Others cite obligations to their LPs and the benchmark of the liquid market as suggesting they should be pricing at a premium. One fund that has historically written unitranche deals at an average of L+650bp has suggested new deals would now need to price in the L+700–850bp range.

> The direct lending funds have considerable flexibility in how to deploy their capital and, while a portfolio focus and general caution will drive short-term behaviour, we expect to see new deal activity as soon as the immediate peak of the crisis passes.

ANDREW SHELLARD,
MANAGING PARTNER, UK

ANDREW LYNN,
PARTNER, UK

Portfolio

Despite the discussions around new deal liquidity and pricing, the main focus of the direct lending funds is currently on portfolios.

All have now concluded a full review of the individual credits, risk graded them and in many cases are now having regular, if not daily, calls with both sponsors and management teams. The priority is liquidity management and, where possible, many funds are encouraging borrowers to fully draw RCFs provided by the banks. Some funds which provide the RCFs are reflecting on whether they are obliged to meet draw-down requests given the potential to invoke the MAC.

Softer measures include invoking PIK toggles or agreeing new PIK arrangements to alleviate the short-term cash debt-service burden.

All funds expect most portfolio companies to breach covenants and the sheer scale of this waters down the ultimate reaction. We expect to see considerable forbearance for borrowers that do face liquidity issues.

Unlike for the banks, the way in which direct lending funds are paid (on deployed capital and through carried interest) significantly disincentivises selling distressed credits and no one is expecting that to become a feature of this market. This, however, puts massive pressure on the deal teams, few of which have dedicated restructuring colleagues. Stretched bandwidth, perhaps above anything else, is what will determine a fund's ability to look at new deals, even when conditions do improve.

Conclusion

The last crisis helped accelerate the growth of direct lending funds and the mid-market funding landscape is very different now as a result. Whilst in the very short-term little, if any, new deal activity is expected and the focus will be on supporting portfolio credits, the existing liquidity in direct lending funds will remain in place for when the market does improve.

Alantra Global Debt Advisory team

We advise privately owned companies, private equity-backed businesses, large privately owned corporate groups and public companies on raising and refinancing debt capital.

Andrew Shellard
Managing Partner, United Kingdom
andrew.shellard@alantra.com

Andrew Lynn
Partner, United Kingdom
andrew.lynn@alantra.com

Guy Taylor
Director, United Kingdom
guy.taylor@alantra.com

Scott Hadfield
Managing Director, United States
scott.hadfield@alantra.com

Robert von Finckenstein
Managing Partner, Germany
rvf@alantra.com

Pierre-Louis Nahon
Managing Director, France
pierrelouis.nahon@alantra.com

Javier Garcia-Palencia
Managing Partner, Spain
javier.garcia-palencia@alantra.com

Jack Anstis
Associate, United Kingdom
jack.anstis@alantra.com

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