Private Debt Investor

Covid-19 compendium

A compilation of stories and insights during the early spring coronavirus pandemic

privatedebtinvestor.com/coronavirus-news/

PEI

Letter from the Editors

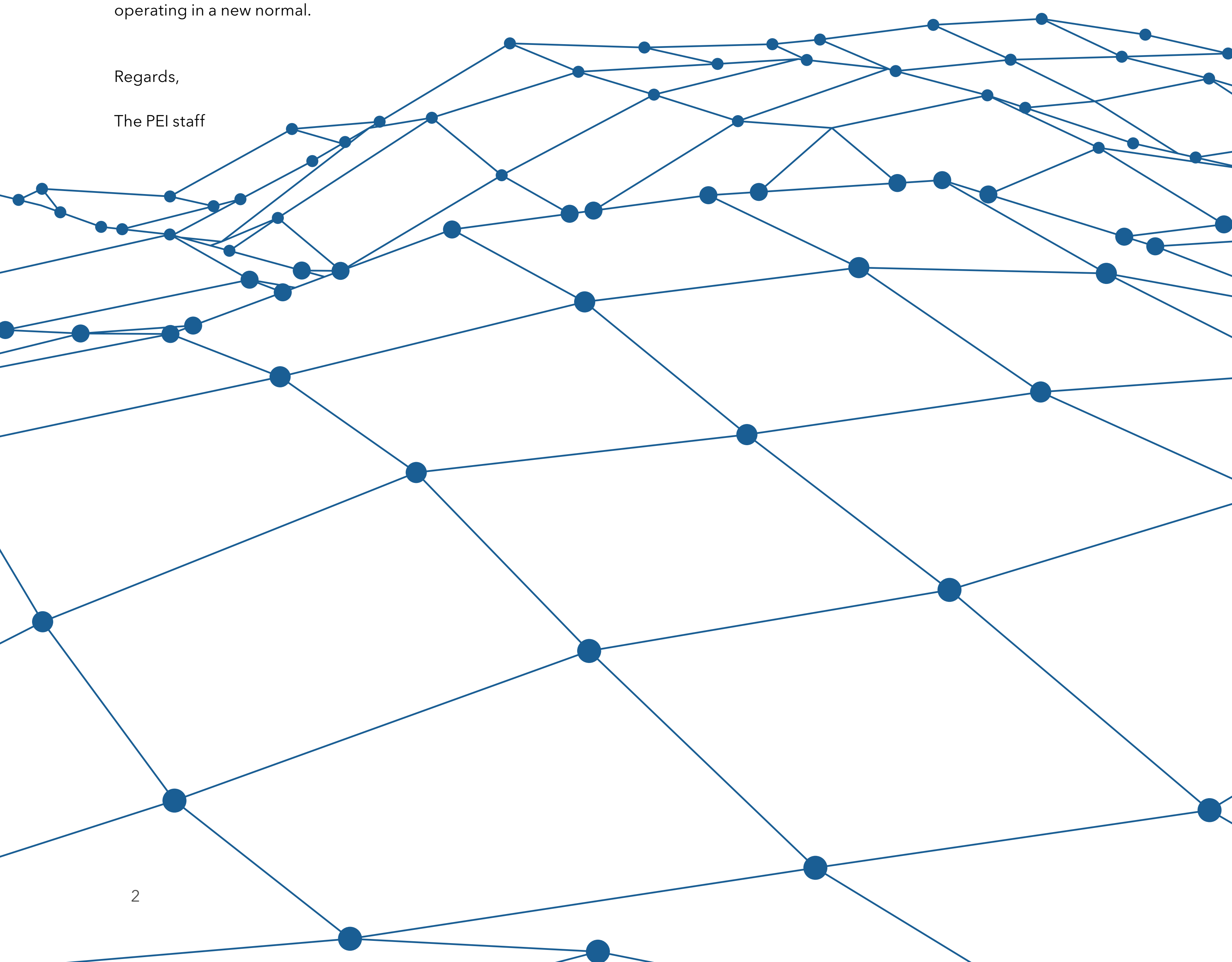
During this time may you and your loved ones stay safe and healthy. The covid-19 pandemic has created so much upheaval in only a few months that one investor remarked to PEI Media: "A day feels like a week and a week feels like a month."

And unlike previous crises, coronavirus has upended everyone's lives, leaving no one unaffected. The outbreak has induced widespread panic because of many unknowns, not the least of which is when covid-19 will cease to be a global threat. Such extreme uncertainty has pushed the world's economy to the brink of recession, with stock markets in chaos and all industries grappling with how to do business in this strange new environment.

Over the next several pages you'll find insight on some of the most pressing issues for private markets arising from the pandemic. From our ongoing conversations with the sector, PDI has gathered insights and anecdotes on the virus's early impacts that we will share. Expect comprehensive coverage in the months to come as the industry adjusts to operating in a new normal.

Regards,

The PEI staff



Debt funds can once again fill the gap

As in the last major crisis, non-bank lenders will be expected to displace the banks as a source of finance.

By Andy Thomson

If all this dislocation and volatility is proving a bit much, you may need to sit down in a quiet corner (kids allowing) and reflect calmly on some of the most recent developments by sifting through the April edition of our magazine here or casting an eye over all our latest reporting on the covid-19 crisis here.

Oaktree Capital's Howard Marks was one of those engaged in a period of reflection this week by way of his latest memo. Marks is not the only one weighing up comparisons between the current situation and the global financial crisis. Speaking of leveraged securitisations, a common feature of both crises, he is inclined to be forgiving this time:

"It's not that the people who structured these entities erred. They merely failed to include an episode like the current one among the scenarios they modelled. How could they? If every business decision had to be made in contemplation of a pandemic, few deals would take place."

It's a fair point but, regardless of how we got here and where blame (if any) for that should attach, the landscape today looks very similar to how it did back when the GFC struck. The most urgent issue for companies is liquidity and that means they are seeking to draw down all manner of existing credit facilities – often provided by banks.

As a new report from fund finance advisory firm, Elm Ridge Advisors, notes: "As credit is drawn and interest is forgiven, bank balance sheets deteriorate under increasing leverage, duration and risk weighted assets. Banks will respond by allocating less balance sheet, resulting in reduced financing availability at a highly inopportune time."

It's seems logical to assume from this that bank retrenchment will be a feature of the current crisis as much as it was the prior one. And once again, non-bank lenders will be called upon to make up a sizeable portion of the slack. GPs which may have been happy to rely on bank financing for single assets within their portfolios may now be faced with a situation in which that financing is not available at the time, or in the form, required.

These are times in which, once again, non-bank lenders' typically higher cost is likely to be considered less important than its flexibility, speed of delivery and ability to offer tailored solutions. There is also, crucially, plenty of dry powder – applying an average from various sources puts that figure at around $250 billion.

One thing's for sure, the demand for capital is there – initially with a probable weighting to rescue finance and subsequently, as the worst effects of the pandemic fade, a change in focus to take advantage of growth and acquisition opportunities. Private debt, especially in Europe, grew to maturity out of the chaos of the GFC as the banks retreated. From the latest crisis, a further advance is possible – at least for firms still in reasonable shape. ■

POBA's Jang: 'If we don't allocate now, it can hurt our performance'

The chief investment officer at the South Korean pension says the covid-19 outbreak is making it hard to execute a planned alternatives ramp-up.

By Adalla Kim

Seven of the world's 22 major pension markets are in the Asia-Pacific region with South Korea the fastest growing, according to a study by Willis Towers Watson.

The advisory firm's Global Pension Assets Study 2020 found South Korea had seen a growth rate of 12.4 percent, compounded annually, since 2009.

Many of these pensions have been engaging much more with private debt in recent years. But covid-19 has changed the game, with private debt fund managers and investors swapping meetings for conference calls and cancelling due diligence trips due to travel bans and social distancing guidelines.

In this new environment, Private Debt Investor asked private debt investors in the Asia-Pacific region about their top investment challenges amid the coronavirus pandemic.

The first interview in our series is with Dong-Hun Jang, chief investment officer of the Public Officials Benefits Association, based in Seoul.

Last year, POBA announced two requests for proposals for private debt investments, one in February the other in November. How have you been carrying out this year's offshore alternative allocation plans considering the disruption?

Jang: We did not stop issuing RFPs. And yet it is early in the year. Still, the majority of our new investment plans are going through the RFP process along with the next rounds of quantitative and qualitative assessments of GPs, such as on-site presentations and Q&A sessions.

We are worried about how to keep [the process] going in case the situation continues throughout the second half of the year.

We are under pressure with our focus on investing in alternatives [amid the coronavirus impact] because if we do not allocate capital now, this can hurt the future performance of the investment portfolios. This is the biggest concern that we have now.

Which sub-strategies in private debt are you mostly focusing on?

Jang: Mainly we have been looking at real asset-backed debt, including residential real estate assets in the US, logistics, and infrastructure-related assets.

What's the situation with the offshore alternative investments through co-investment partnerships and the Memorandums of Understanding?

Jang: Things are slower than we expected with the JV and other partnerships due to the outbreak situation. It is impossible to proceed with investments if local GPs and their operational service providers cannot do business as usual, even if we want to carry on with local deals there.

As per the official statements from late last year, POBA plans to allocate as much as 59 percent of its AUM to global alternatives. How is the situation in the domestic alternatives market?

Jang: It is difficult for us to meet the target return rates by investing in domestic alternatives such as real estate assets due to the low interest rates in Korea. On the domestic alternatives side, things are not as bad as offshore markets where we stopped all planned due diligence trips due to the coronavirus disruption.

Have any of the GPs that you work with communicated with you and your team about their solutions to the current situation?

Jang: Many of them are working from home and focusing on emails and phone calls. They seem to be managing situations with portfolio companies, if any, and focusing on risk management. My understanding is that the GPs' activities on new deal sourcing are very limited now.

We now see higher volatility and fluctuation in short-term liquidity in the public markets. Looking across the current investment environment, what is your view on investing in private debt strategies?

Jang: Our track record shows that risk management during 2008 was successful. I think our exposure to liquidity and volatility risks are very limited as our private debt allocation has been mainly on unlevered senior secured investments.

It has been a borrowers' market. We have seen cov-lite deals and greater liquidity has flown into private debt strategies. However, this market situation can offer a good chance for mid-market lending businesses [to deploy the dry powder that has piled up for years], not only in the North American region but also across Europe.

I see a correction in the private debt market as well, in the sense that things are now shifting from a borrowers' market towards normalisation with an adequate risk-return spectrum. And GPs should be able to get back on track and actively look to deploy capital, using the dry powder in private debt.

Anything else to add?

Jang: Typically, we have a lower investment flow during January and February. There are very few investment committee meetings that are in their final rounds scheduled for early April, for instance.

If the coronavirus outbreak goes on till the year-end, we might not be able to schedule any investment committee meetings for a while. It is concerning as we work with foreign GPs on various aspects.

We might do more re-ups with the GPs that we have worked with. It is still a concern for me that capital deployment might get slower. This is the biggest concern for us because we are holding a lot of cash now. ■

Venture debt will surf, not drown, in covid-19's wake

Amidst startup layoffs and drying up deal opportunities in the time of the coronavirus pandemic, venture debt is blossoming.

Amidst start-up layoffs and drying up deal opportunities in the era of the coronavirus pandemic, venture debt looks like a beacon of light reports PDI's sister publication, Venture Capital Journal.

Venture debt lenders have reported seeing a general pickup in activity throughout Q1 as venture equity investors are tightening the purse strings and the market is putting companies in a squeeze.

Firms are seeing increasing outreach as companies impacted by the market uncertainty look to extend their runway or beef up their balance sheets.

David Spreng, chairman, CEO and CIO of Runway Growth, said they have seen an uptick from both existing borrowers and new firms.

He said that they had been seeing a gradual increase in requests for venture debt since the market pivoted toward profitability over growth following the WeWork meltdown last year, but that accelerated quickly in Q1 as the general market started to sour.

"March was a dramatic uptick in outreach from VCs to us," Spreng said.

He said existing VC relationships have reached out about their portfolio companies. In addition, new firms that maybe would have used cheaper bank debt previously are getting in touch as they feel more safe using a venture debt financing at this time. Spreng said this mirrors what he saw in 2000 and 2008.

While Runway Growth can write checks up to $75 million and typically play in the later-stages, early-stage lenders like Lighter Capital are seeing the boom, too.

"VCs are slowing the amount of deals they are doing and that growth capital is still needed," said Thor Culverhouse, the CEO of Lighter Capital. "The number of originations is going up and the number of applications. This is creating a larger need for growth stage capital."

Business has been so healthy for the online lender, that the company went ahead with its planned expansion into Canada last week.
"We put forth some plans several months ago," Culverhouse said. "Frankly there are a number of early-stage companies that will suffer without important growth capital, we just decided to forge ahead and continue on with our plans."

The expansion will allow Canadian tech companies, that are growing at a 50 to 60 percent year-over-year rate, to access loans that range from $50,0000 to $3 million.

"There is a huge need for capital," Culverhouse said. "We are going to be a little bit more precise and selective around which verticals we think are going to do well."

Spreng said Runway will be looking closer at this, as well. They are also tweaking how they ask about downside protection.

"Late last year we would have been asking 'What if the revenue is below plan by 10, 20 percent will you still be able to pay the debt," Spreng said. "In today's environment, what if in the decline you start down 20 percent and go 30, 40, 50 [percent]."

In addition to new business, the two lenders said that they are also focused on helping their existing borrowers as best as they can.

Culverhouse said that Lighter is striving to overcommunicate with its borrowers and help them refinance if they need it. Spreng agreed and added that they anticipate their existing companies will look to add extra cash to their balance sheets.

While the market is changing daily, industry predictions are hard to make. Both investors aren't sure what the market will look like in Q2 or Q3. But they expect venture debt will fare just fine.

"We are expecting that 2020 will end up being a bigger year than we had expected it to be two months ago,' Spreng said.

Credit fund stress tests may be 'overly optimistic'

Although valuations are unlikely to fall in the short term, managers should be wary of expecting a rapid recovery in the global economy.

By John Bakie

Private credit managers' stress scenarios may be overly optimistic in reflecting the crisis caused by the coronavirus, according to research by bfinance.

In a note on private markets, bfinance's senior director of private markets, Trevor Castledine, wrote that Q1 private credit portfolios are, with some justification, unlikely to be subject to major valuation reductions. However, he added that managers should be conscious that existing stress models may reflect a shorter period of reduced economic activity and a faster recovery than may be possible.

"Predictions are challenging due to uncertainty on how long social restrictions will stay in place," said Castledine. "Figures from the [global financial crisis] are not hugely helpful due to the different root causes of that crisis, today's lower interest rates and the relative immaturity of the mid- and lower-mid market at that time."

The firm reports that, so far, there have been few defaults and that most of these have come from positions that were already on watchlists. However, defaults are expected to rise, though private credit has a higher expectation of recovery than high-yield bonds or leveraged loans.

Nevertheless, bfinance expects significant variability between managers. It also expects those managers without in-house restructuring expertise to struggle and end up being forced to sell positions they are unable to manage.

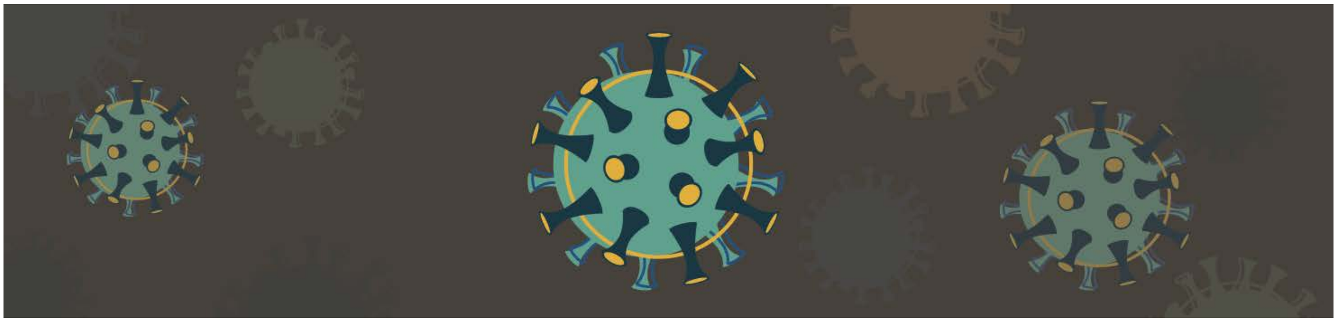
It does not expect earnings erosion for borrowers to be a big problem for credit funds. This is because bfinance believes lower interest rates should give more cashflow headroom, depending on the extent of EBITDA adjustments, and because portfolios have recently positioned for a downturn with reduced exposure to cyclical sectors.

The firm reported that managers it has spoken to are seeing requests for extra liquidity from their portfolio companies. The latter are usually seeking a cash injection from a private equity sponsor, though some lenders are also providing short-term liquidity facilities.

It also warned that levered strategies face a significant risk that one or two defaulting positions could lead to their lenders tightening their credit lines and drive forced selling.

Refinancing risk is another potential problem. High volumes of dry powder make it more likely that refinancing will happen, but this may not be on terms borrowers like and some may seek out short-term bridge financing instead.

According to bfinance, investors may consider investments in opportunistic strategies in the coming months, with a time lag before most problem positions become apparent. It believes these investments could provide exceptional returns. ■



Fundraising to focus on existing LPs during pandemic – Dechert

Firms will have to change their approach to fundraising and portfolio company monitoring until the coronavirus outbreak recedes.

By John Bakie

Fundraising is set to be more heavily biased towards existing investor relationships for the duration of the coronavirus pandemic, according to advice from law firm Dechert.

In a note to fund managers operating in private markets, Dechert said travel bans mean fundraisers will find it difficult to forge new relationships and so should focus on existing investors or new prospects already well advanced in due diligence before the crisis hit.

Dechert also said fundraisers which have yet to hold a formal first close may want to extend the fundraising period. Funds that are yet to launch may wish to review fund terms to increase the period between first and final close or an extended investment period to maximise fund flexibility.

Funds that are already in their investment period may seek an extension to their commitment period to give investors time to deal with liquidity constraints. Revisiting other aspects of documentation such as drawdowns and deployment of capital may also help enable funds to take a more flexible approach to investing.

End of life funds may need to consider extending their drawdown periods and revising existing strategies for portfolios. Other options to consider to increase the flexibility for a mid or end of life portfolio could include co-investments, GP-led secondaries or annex funds that can provide follow-on finance.

Beyond fundraising, Dechert also advised managers to consider how they can effectively monitor portfolio companies in a world where travel is heavily restricted. Reporting obligations and processes to the fund should be a top priority to ensure they can work effectively in an environment where many staff are working remotely.

Business plans and strategies for portfolio companies may also need to be revised to reflect market disruption. Managers should consider and analyse business continuity, contingency planning, IT security, insurance, litigation, reporting deadlines and PR issues more carefully than usual, according to Dechert. ■

Australia changes bankruptcy law amid crisis

Temporary protections will aim to curb rising bankruptcies of individuals and businesses that have been hit by coronavirus disruption.

By Adalla Kim

As part of its economic response to the coronavirus outbreak, the Australian government has made changes to the country's bankruptcy law this week that affects both individuals and businesses. The changes are temporary and aimed primarily at the next six months, starting from 25 March.

Specifically, the period of bankruptcy protection and for responding to a creditor's bankruptcy notice have both changed to six months from 21 days. The threshold that triggers bankruptcies has also increased to A$20,000 ($12,000; €11,000) from A$5,000, according to a statement released by the Australian Financial Security Authority (AFSA) on 25 March.

The changes are not only applied to personal insolvencies but also to small businesses that have been affected by disruptions caused by the coronavirus outbreak, according to the AFSA statement Friday.

The Australian taxation office defines small businesses as those with an aggregated turnover of less than A$10 million and small- and medium-sized businesses (SMEs) as those with turnover of less than A$50 million. There are as many as 3.3 million Australian businesses that fall into the SME category.

The number of new personal bankruptcies in Australia was on a downward trend from September 2017 to December 2019, official statistics showed. During 2019, there were 5,198 new personal insolvencies – bankruptcies, debt agreements and personal insolvency agreements – and 25 percent of those bankruptcies were business related.

Notably, between 9 and 22 March this year, 887 people entered into a new personal insolvency, the latest available data as of 27 March showed. Over this period, 230 of the cases involved a business. The most common industry affected was construction.

The latest available statistics on corporate bankruptcies show that, in 2018, 2,011 cases entered into the Entering External Administration process, which includes liquidations.

Among mid-sized companies that have access to bank debt, Retail Food Group Limited (RFG), a Queensland-headquartered food and beverage company, restructured its existing debt and raised new capital, according to the firm's latest earnings results as of 27 February.

It showed that the company spent A$20.3 million in restructuring costs. The firm also added a new A$75.5 million debt facility that matures in November 2022. RFG reported a statutory net profit after tax of A$14.3m in the first half of 2020 (fiscal year runs from 1 July to 30 June).

According to Deal Report: Retail Food Group Capital Raising & Recapitalisation, published this month by law firm Gilbert + Tobin, the borrower's existing lenders, National Australia Bank and Westpac, agreed to write off A$71.8 million of the existing debt as part of the recapitalisation.

However, among the private capital market advisors that provide advice to SMEs across Asia-Pacific, Michael Marquardt, Zerobridge Partners' chief operating officer and partner, told Private Debt Investor that SMEs should take a step back and proactively assess risks, options and cash levels with advisors first before reaching out to existing lenders or seeking immediate funding solutions.

"If you jump out and call your bank saying I am in trouble and I need help without a plan, the bank may put you on a watch list and consider freezing your [credit] lines," he noted. "Remember, their foremost job is to protect their exposures and often work to firm-wide risk policies that may not suit all situations." ■

Australia applies temporary protections to reduce insolvencies of individuals and businesses

Temporary changes to Australian bankruptcy law	Before	After
Debt threshold for creditors to apply for a bankruptcy notice against a debtor	A$5,000	A$20,000
Timeframe for a debtor to respond to a bankruptcy notice before a creditor can commence bankruptcy proceedings	21 days	6 months
Temporary protection period procedure available for debtors to prevent recovery action by unsecured creditors	21 days	6 months

Chart source: The Australian Financial Security Authority, 25 March 2020

PODCAST: LP defaults, force majeure and over-collateralization amid covid-19

Our senior editorial teams covering PE, private debt, infrastructure, real estate and secondaries discuss the latest in how private markets are responding to the coronavirus pandemic. Plus, ways firms are helping people out in the crisis.

By Adam Le

Our latest coronavirus special podcast looks into LP defaults, how they might play out and what this could mean for GPs and their subscription credit lines. We delve into the rise of digital infrastructure funds and how they're experiencing a boon as covid-19 forces more than half the world's population to work from home.

Listen to the podcast **here**.

We also examine the private debt collateralized loan obligation market, the impact of tenants defaulting on rent payments and what that means for private real estate funds, and some of the ways private markets firms are doing good deeds during the crisis.

Listen to our first podcast on the impact of the coronavirus **here.**