Private Debt Investor

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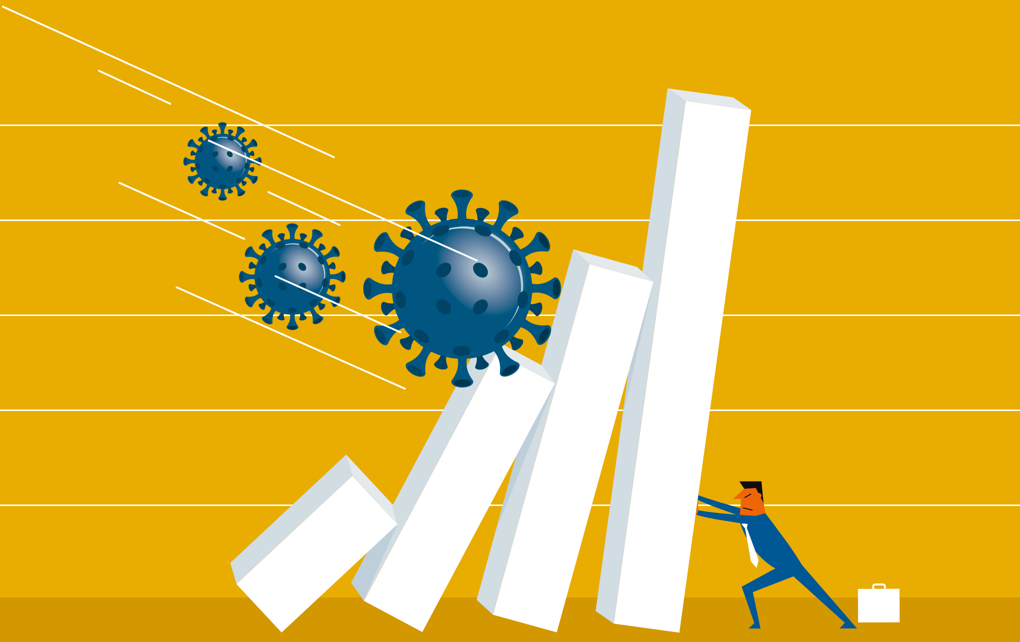
Private debt insiders' perspective and planning during the pandemic

» Five fast themes on coronavirus's impact on mid-market direct lending

» How to handle distressed debt during the covid-19 crisis

» Debt leader perspectives on allocations and fund trends in H2



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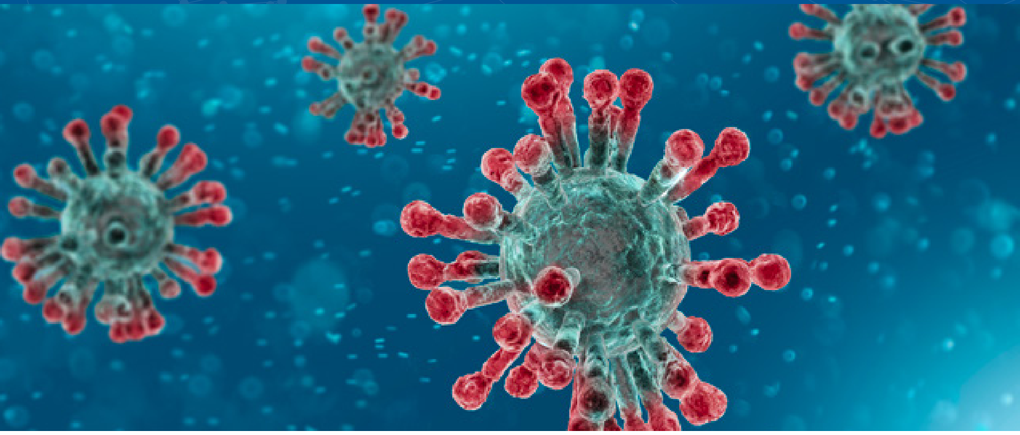


Five fast themes on the coronavirus's impact on mid-market direct lending

Covid-19 and the fallout from a global economic downturn are set to weigh heavily on LPs' and GPs' minds in 2020.

1 April 2020

1. Pandemic fear

We are now all too familiar with how this story is playing out. Covid-19 is described in this report as possibly the toughest test the mid-market direct lending space has faced in the past decade – one that may tip the global economy into the long-anticipated downturn.

The signs at the time of writing are that this has come to fruition, with a recession a likely scenario. Understandably, there is uncertainty about exactly how this will impact the private debt market, but as EQT partner Paul Johnson says: "The months ahead will be all about understanding the risks."

2. Deployment challenge

Many funds are sitting on dry powder and eager to put capital to work, which could prove a challenge in the current climate. Merger and acquisition activity is likely to slow up, and companies' growth ambitions and investment activities put on hold. So, borrowing needs may be more measured.

On the flip side, otherwise sound companies might need to borrow to come through a difficult period. If banks are cautious in coming to the party, opportunities may well open up for funds to plug the lending gap.

3. Defensive positions

Uncertainty is likely to push lenders towards deploying capital in countercyclical sectors – education, healthcare, software and technology, for instance – and away from market segments such as retail, travel, tourism and hospitality, which are set to take a hit as shoppers stay away from the high street and travelers opt to stay at home. "You're not going to find a lot of overtly consumer-oriented deals in our portfolios", says Mike Dennis, co-head of European credit at Ares Management. Competition for these assets may also heat up among private equity sponsors and lenders.

4. Special situations appeal

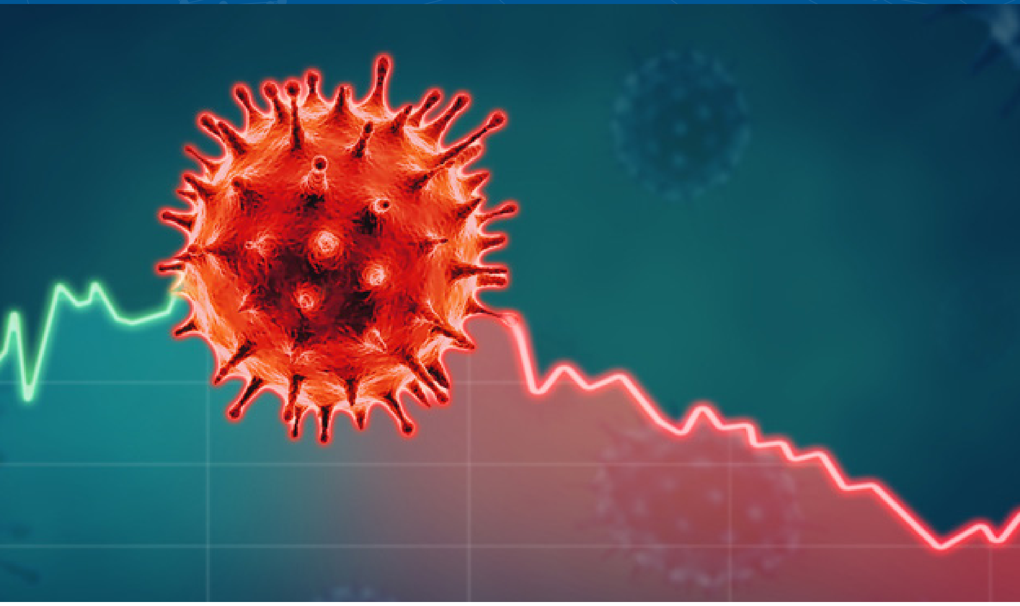
Despite the trepidation in the overall private credit markets, the climate could prove a fruitful one for those active in the special situations and distressed space. Jaime Prieto, founding partner at Kartesia, says the European market is ripe for an uptick: "It is probably the most favourable market that we have seen over the last four years. [We] feel the conditions are there for special situations funds to be pretty optimistic about the year head."

5. Focus on portfolio management

Portfolios are going to be tested this year with a growing need to analyse and mitigate risk held within them. So, it is not surprising that managers' portfolio management expertise has risen up the agenda with both sponsors and limited partners.

Twin Brook Capital Partner's chief credit officer Drew Guyette explains there is now "greater awareness of how important portfolio management experience can be when it comes to effective positive outcomes through both periods of growth and distress".

Technology and data analytics will come into play much more as managers try to better understand at an earlier stage how these developing trends will impact their portfolios. ■



How to handle distressed debt during the covid-19 crisis

The coronavirus crisis is creating unprecedented financial distress across markets and provides the first key test of private credit's ability to manage a downturn.

By John Bakie - 9 April 2020

As covid-19 ravages economies across the world many firms will become distressed, both within and outside of private debt portfolios. Being able to handle these distressed situations effectively will be what determines who come out the other side of this crisis with a strong track record and satisfied investors.

The first concern for many fund managers is companies in existing portfolios that are suffering liquidity issues as a result of the pandemic.

Cedric Henley, partner in Solar Capital Partners' commercial finance business, said: "On a day-to-day basis we've been focused on managing our portfolio of existing names. It's important we understand their liquidity profiles and ability to weather the viral infection crisis.

"Some of our borrowers are applying for government support programs to keep them going while the shutdowns persist, we continue to engage with them as we monitor the portfolio."

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The coronavirus shutdown is likely to be one of the first major tests of much of the loan documentation used by alternative lenders, especially covenant-lite loans which have become a major feature of the market in recent years, according to Treabhor Mac Eochaidh, head of debt services at MUFG Investor Services.

"For many direct lenders, this is the first time these documents have been tested to see how well they protect them," he said.

"The speed at which this downturn is unfolding probably means that covenant-lite loans will trigger quicker than expected. Lenders on these loans will be able to look at the price of the collateral which will have dropped considerably and use that to trigger."

The speed at which covid-19 shutdowns have been implemented by governments across the world, and uncertainty about how long they will last, is one of the biggest factors putting stress on both portfolio companies and fund managers. Ted Goldthorpe, head of BC Partners Credit, said even banks will find it difficult to cope with the scale of the problem.

"The big banks are really well capitalised and have a lot of liquidity but they might struggle when it comes to handling defaults," he said. "The sheer number of defaults means credit departments are already overwhelmed. This is worse than 2008 as it's all unfolded in just a few weeks whereas the GFC [global financial crisis] took 18 months."

While fund managers typically have smaller and more concentrated portfolios than banks, they also have smaller teams. Those without internal resources that have experience dealing with companies in distress may struggle.

"The challenge that some lenders may soon face is dealing with a lot of restructurings all at once," said Henley.

Early signs in the market indicate constructive dialogues are already beginning between sponsors and their lenders to determine the best course of action for portfolio companies struggling with liquidity issues.

Goldthorpe added: "Mid-market direct lenders have not been rolling over to help the sponsors. There's a constructive dialogue going on but sponsors are going to have to be realistic in their expectations of getting more support from their lenders."

However, the distress and dislocation being experienced across world markets could also provide a major opportunity for alternative lenders in both the distressed and direct lending space.

Solar Capital reports that it has already entered into discussion with companies that it would not typically lend to.

"We're talking to companies that we would not usually as they normally can go to the bank and get a loan for 200 bps above LIBOR but now they're coming to us for structured solutions," said Henley.

Mac Eochaidh said many firms are already getting prepared to meet the upswing in markets and deploy capital to where it will be needed as coronavirus restrictions come to an end.

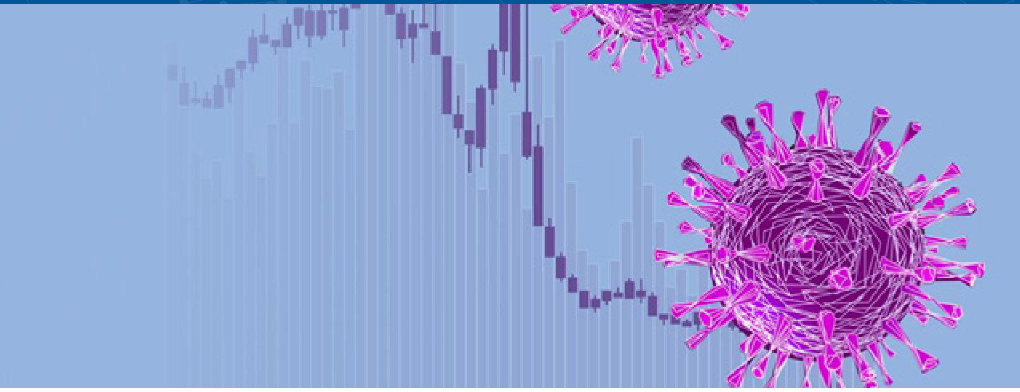
"Managers are going to be focused on being opportunistic. They'll be looking at how they can best handle opportunities coming down the road, looking at which companies are breaching covenants, but it's going to take a while before loans become distressed."

There is expected to be a lag before distressed situations come to market. As the crisis erupted in mid-March, first-quarter earnings may not be severely impacted and it is second-quarter earnings which could be the trigger that causes many firms to start seeking specialist turnaround help. In the short term, significant payment defaults are expected as firms wait to claim any government support packages they can.

BC Partners has already been active in buying loans on the secondary market but expects origination opportunities to grow as well as the crisis unfolds.

"On the secondary-side of the business we're seeing a lot of dislocation and have used the opportunity to buy loans in defensive sectors like software or insurance. On the origination side we're finding a lot of new opportunities as a lot of companies are in need of liquidity," explained Goldthorpe.

"We have spent some time looking at some of the directly impacted industries and think there will be an opportunity to buy there eventually." ■



Debt leader perspectives on allocations and fund trends in H2

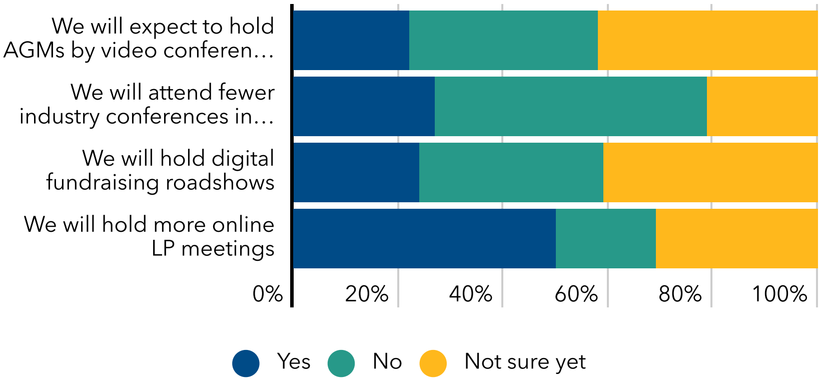
14 April 2020

According to PEI's Covid-19 Study captured fund manager, allocators' sentiment by gathering insight on how institutions are responding to this market inflection point. See how the GPs and LPs say and response.

The new normal

A large proportion of managers surveyed are looking to change the way they interact with LPs, with half looking to hold more online LP meetings.

Which of the following do you expect to do once "normal" business life returns?



Source: Private Equity International's Covid-19 Study

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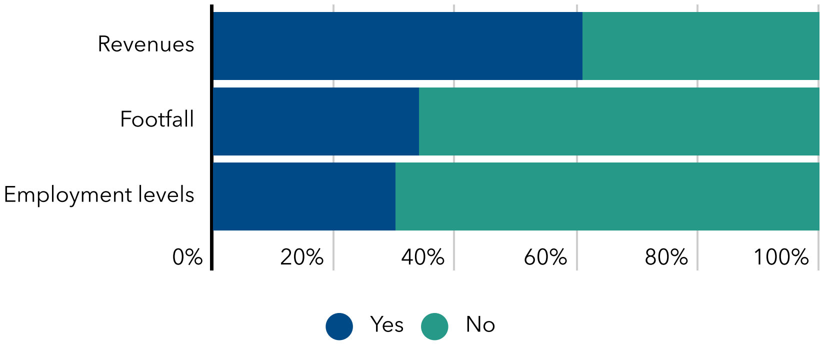
What LPs are asking of their managers

Almost two-thirds of investors in the LP version of our survey did not feel they had good visibility on the impact of covid-19 on their funds' portfolio companies. When asked about their correspondence with investors, 61 percent of fund managers stated they were being asked by LPs for more frequent reporting of portfolio company revenues in light of covid-19.

Due to covid-19, are you being asked by LPs for more frequent reporting on the following portfolio company metrics?



Source: Private Equity International's Covid-19 Study

About the Covid-19 study

For this 2020 study, PEI surveyed 120 fund managers who have raised a private equity fund in excess of $100 million over the past five years. Fieldwork was carried out between 25 and 27 March 2020. Participation was anonymous, with the findings amalgamated and presented in the special report How covid-19 will impact GPs. ■

VIEW THE FULL REPORT