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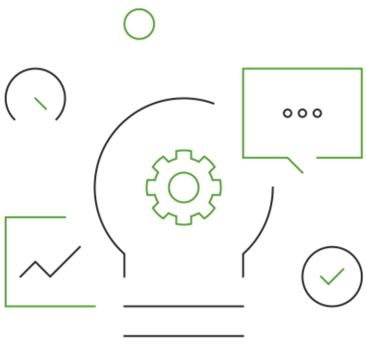
Investment Banking



Four Market Trends to Watch: Navigating the Private Debt Markets in the Wake of COVID-19

While much of the published research has been focused on publicly traded securities, FocalPoint's Capital Markets group has conducted extensive calls with a wide spectrum of middle market lenders and investors to understand how COVID-19 has impacted their current and prospective investments, resulting in several common themes.

Capital Markets Insights

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Rajesh Sood
Managing Partner
O 310-405-7050
rsood@focalpointllc.com

Michael Brill
Managing Director
O 646-343-9848
mbrill@focalpointllc.com

Clay Bryan
Managing Director
O 310-405-7085
cbryan@focalpointllc.com

Thomas Mills
Managing Director
O 312-508-5777
tmills@focalpointllc.com

After the largest asset sell-off in history and plunging equity values across all sectors, it has become apparent that the COVID-19 pandemic poses a significant threat to both human health and the global economy. Within the consumer sector, travel and leisure industries have seen a dramatic drop in demand, and retail foot traffic has plummeted, shutting down service industries including restaurants and retail. Supply chains for manufacturers have been disrupted, and oil and gas prices are the lowest seen in a generation. The sudden constraint on cash flow will have many private equity sponsors and middle market companies searching for liquidity and credit options.

According to LCD[1], only about $8.6 billion of leveraged loans hit the market in March 2020 compared with $81.4 billion in January 2020. Juxtaposing these negative impacts, Pitchbook's recent Global Private Fund Strategies Report notes that "over $2.4 trillion of dry powder is sitting in private vehicles. Private debt funds are also sitting on record capital bases ($275 billion) by year-end[2]." At a time of such great turbulence and uncertainty, we expect to see a dramatic decrease in leverage profiles and increased scrutiny on underwriting. Beyond that, we thought it would be instrumental to highlight some of the not-so-obvious trends in the private debt markets. In the last couple of weeks, the Capital Markets team at FocalPoint has spoken to numerous lenders across the private credit spectrum, and we thought it was worthwhile to share some of the following insights.

1. "Leveraged Loan Trends," LCD. Accessed April 3, 2020.
2. Pitchbook Q1 2020

1. Investors and lenders are currently focused on their existing portfolios

New deal flow is nearly non-existent, and many investors and borrowers have put new deals coming to market on hold. Most investment banks are delaying their M&A sale processes because of the uncertainty of how the businesses will really perform through an extended downturn. Those that have not been pulled are facing longer timelines, as investors continue to delay processes, waiting for more visibility. For many investors, it has been an “all hands on deck” exercise to quantify potential risks and liquidity needs in the portfolio.

Highly leveraged borrowers, particularly private equity-owned businesses, are actively working with their lenders to waive principal and interest payments for a 90-day period to preserve liquidity; this is happening in real time. For the most part, lenders seem to be accommodating in some form, especially with longstanding relationships.

Lenders are not holding to covenant defaults. Most lenders are suggesting that it will take 60 to 90 days for them to fully assess the impact to their portfolios and consider actions for their borrowers. Since they do not have real-time financials, they realize their strategy must be developed on a case-by-case basis.

2. Existing deals are on hold or are being materially renegotiated

In most cases, deal terms are being revisited by investment committees, and term sheets are being withdrawn due to a lack of primary market visibility. In deals where term sheets were delivered before the impact of COVID-19 was fully realized, many investment committees have either withdrawn those term sheets or materially revised the terms and widened spreads. Even for deals where approval was already granted by the investment committee and where capital has been called, lenders are attempting to be constructive and so are repricing deals or putting them on hold temporarily. Many lenders are also seeing fair value from the secondary market, and so many have focused capital deployment efforts away from direct origination to buying paper in the secondary market given the relative liquidity and returns.

Many of the market-clearing new deal structures are asset-backed loans, as lenders are anxious about putting capital to work in leveraged loan structures in this environment.

Active investors are primarily engaging with businesses that show neutral to negative correlation to the potential virus impact (such as healthcare, technology and staple food products) or with relationships where they have had great success in the past.

3. Dodd-Frank served to preserve capital strength at the banks

Commercial banks are more conservatively capitalized, unlike during the prior financial crisis in 2008; liquidity in debt markets is more diverse and larger than the last recession, with non-bank entities holding the riskiest assets.

Interestingly, some banks may find themselves outperforming their budgets during the first half of the year, as borrowers have suddenly and aggressively been drawing down on their lines of credit. Banks may benefit from this trend in the short-term if the loans are conforming. They seem to have little cause for concern for now.

The private credit funds and BDCs, however, are increasingly facing headwinds. BDCs risk running afoul of the 2:1 leverage cap so will need to raise equity, even if that comes at a steep discount to book, fair market value or current trading levels. We have also heard that some private credit funds are entering into capital calls or asset sales.

4. Identifying the universe of active investors and/or lenders will be challenging

Private equity will be challenged to underwrite equity risk or relative value on new investments until there is some sustained stability in the public equity market. Even many special situations funds will need to see an amount of moderation in volatility in order to put capital to work.

We expect that special situations lenders will be the first wave of new liquidity into the marketplace as they have raised significant undeployed capital recently. However, until there is some basis for assessing liquidation values, any capital investment will prove to be a challenge.

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Takeaways

While the overall market reaction to the $2 trillion U.S. stimulus package was positively received by the public markets, most middle market businesses are still facing significant disruptions. Business owners are currently deciphering how to take advantage of the CARES Act and enhance short-term liquidity. These stimulus measures, together with the liquidity actions taken by the Federal Reserve, are much larger and were introduced much faster than during the prior financial crisis. As such, these monetary and fiscal measures are expected to temper the declines in the economic activity. This is leading some to believe that it is likely to be more of a V-shaped recovery commencing in the third and fourth quarters of this year. While no one has a crystal ball, the broad consensus in the market is that there is significant pent-up demand, and business owners and sponsors would be well advised to take advantage of the current dislocation to undertake preparations for accessing the private capital markets in the second half of this year.

The market remains in a price and leverage discovery mode—new cash equity and liquidity are paramount. However, we continue to speak with lenders daily, and we are seeing increasingly that funds have plenty of dry powder to deploy. While there is likely to be a decline in leverage and an increase in the cost of capital, many lenders are selectively looking to take advantage of the current conditions and lean into good companies that have near-term challenges or opportunistic needs. FocalPoint has one of the largest and most experienced capital markets teams in the lower middle market.

FocalPoint can provide guidance to both business owners and sponsors on navigating through these turbulent times with lenders, assist parties with incumbent debt modification discussions, advise on the active lender universe in the current market or help borrowers get a head start on preparing to access the markets in the second half of this year.

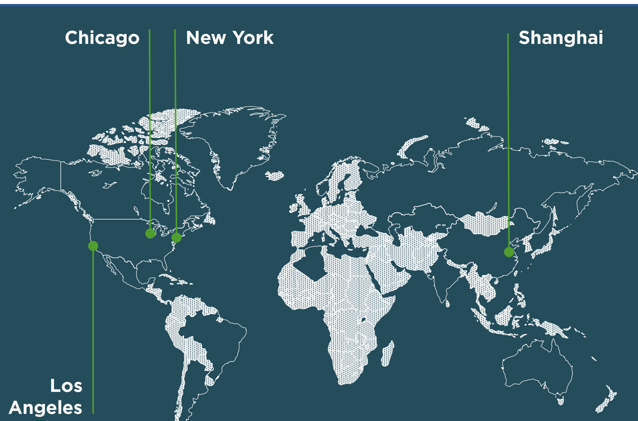
Select Capital Markets Transactions

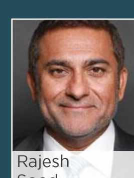
An affiliate of NEXUS CAPITAL has raised a credit facility from CERBERUS Capital Management, L.P. to acquire certain assets of FTD under §363 of the Bankruptcy Code

CITIXSYS a portfolio company of HOUSATONIC has secured financing from Goldman Sachs

Education Dynamics a portfolio company of MUIRLANDS capital, Prudential Private Capital has acquired certain assets of Thruline Marketing with financing from WHITEHORSE CAPITAL

carbonLITE has secured financing from ORION ENERGY PARTNERS





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