Market Intersection:

A Quarterly Look at the U.S. Credit Markets

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2Q20 US syndicated lending activity sinks as pandemic recalibrates markets

Ioana Barza, Head of Market Analysis

Quarterly US syndicated lending activity fell to a five-year low of US$348bn, down 37% from the first quarter and down 46% year over year as the global spread of Covid-19 led companies to seek amendments from their lenders following massive drawdowns on existing facilities and incremental liquidity asks. Leveraged lending shrank to US$114bn of issuance in the second quarter, down 48% year over year and down nearly 60% compared to the prior quarter.

One leveraged lender said that amendment activity, "tripled by number for us from last year versus this year as issuers considered if they should re-open their credit agreement or do a straight refi. But, if you re-open, it would be marked to market versus the great deal you have in place. Why touch it unless you have to? Companies that have proven themselves and are just in a temporary squeeze and need to reset covenant levels but not indefinitely, we brought them back up so they have a bit more room, a 20%-30% cushion, and put ratchets in place so step downs happen over time where there is usually no step up or step down."

As the quarter wrapped up and a rise in new coronavirus cases was reported, lender sentiment shifted. "When we think about the next thing, we are not out of it by the way, the second wave. We are not out of the first wave, so what's going to happen with companies is still a CEO and board issue not an assistant treasurer issue," said one investment grade lender.

Issuers and lenders continue to navigate the uncertainty. "In April and May we were trying to get information from borrowers, get our hands around it and it's extremely cautious," said one asset manager. "Information from borrowers is helpful as to what re-opening and cost basis looks like for companies. But of course, what's recovery? No one has those answers. We had not been buyers of anything but we have moved beyond that now and sold some assets in June and then quickly turned toward income replacement, looking for secondary opportunities. In our own book, there is certainly good value still there but it is so hard to know on new credits."

Fig. 1 Institutional loan issuance

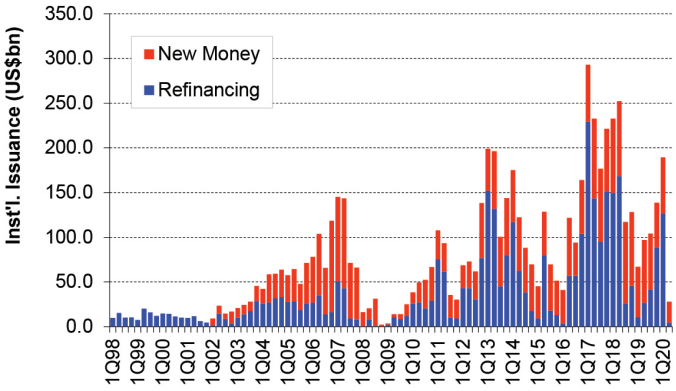
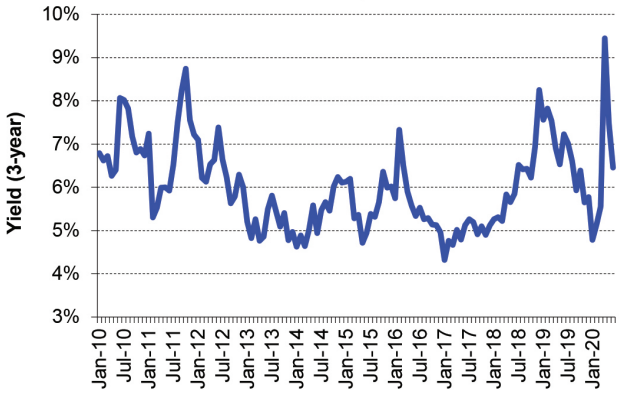


Fig. 2 Primary market yields recover from Apr/May peaks



Source: Refinitiv LPC

Covid-19 brings 2Q20 private equity-backed middle market syndicated lending back to GFC levels

Fran Beyers, Head of Middle Market Analysis

A shutdown of the US economy and quarantine measures created huge obstacles for sponsors and lenders to transact in 2Q20 and syndicated middle market lending came to a screeching halt, just like in 2009. Middle market syndicated sponsored volume only reached US$1.9bn in 2Q20, the lowest level tracked in over 10 years and the second lowest volume on record after 1Q09 (Fig. 3). Meanwhile, direct lending volumes were also quite dire, falling 65% quarter over quarter to $7.9bn, quite a stark contrast from the peak levels tracked in 4Q18 at nearly $30bn. Higher risk deals such as dividend recaps and covenant-lite volumes evaporated for the first time since the Financial Crisis. And the only new M&A deals that could get done had to meet a very strict criterion. They were either teed up and committed to by direct lenders prior to the late-March turmoil or they were "Covid-proof" business models that either benefitted or did not get adversely impacted by the shutdown such as recurring revenue software issuers, delivery services, food/consumer staples and certain healthcare businesses. Conducting due diligence was and still is a huge struggle for both lenders and sponsors.

"No sponsor is going to overpay for anything they have lingering questions on when you are forced to work virtually and you can't kick the tires," said a lender. "Plus, there is limited visibility in what things are going to look like in the third and fourth quarter of this year." So, select deals to get done often involved businesses where sponsors and lenders had already conducted diligence prior to Covid or where both parties already had a deep knowledge/comfort of the business.

Add-on acquisitions with existing sponsor relationships was the easiest trade to execute on in 2Q20. But lenders grappled with things like MFN provisions and how to price and structure deals in such an uncertain environment. "Each deal was situational, and lenders had to find creative solutions such as charging more in upfront fees, issuing a 'note' which doesn't trigger MFN language, allowing the sponsors to use available baskets or altering the pricing grid in case leverage spikes" said a second lender. Early in the quarter, sponsors tried hard to avoid re-opening credit agreements which would force them to reprice entire deals higher. But as the quarter progressed, they became more accepting, "Sponsors know our capital is scarcer and our costs have gone up, so they became more willing to reprice entire deals as the quarter progressed," said a third lender. To further add to the strain, middle market lenders did not have the same pockets of capital they were accustomed to for the past five years. BDC share prices sunk well below NAV, asset values took a hit and leverage providers reigned in their risk by asking BDCs and other levered funds to make paydowns on credit facilities. Meanwhile, rising CCC buckets and breached OC levels shrunk capacity within middle market CLOs. And the fundraising funnel slowed dramatically as LPs became more cautious, downsizing checks and limiting managers they want to work with moving forward. This all hampered middle market lenders' hold sizes. While over 40% of direct lenders said they could hold greater than US$100m in 2019, that universe shrunk to only 18% in 2020, with the majority only willing to hold between US$25-$75m in 2020 (Fig. 4). This, in turn, hurt both direct lenders' and banks' ability to underwrite deals in 2Q20 with club executions likely to gain more popularity this year. And with so much uncertainty early in the quarter on portfolio performance, direct lenders had to balance putting precious capital to work in new deals versus how much they needed to preserve for portfolio liquidity/workouts if the sponsor was unwilling to support portfolio companies.

Fig. 3: 2Q20 middle market sponsored syndicated issuance sees lowest levels since GFC

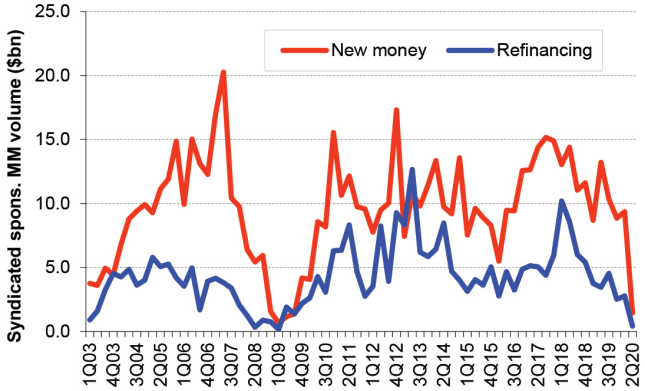
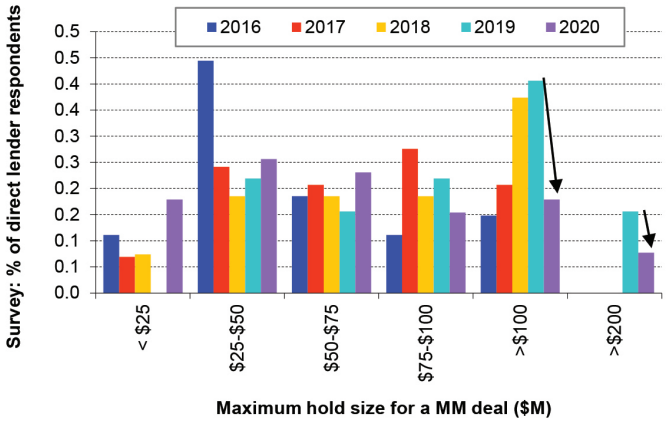


Fig. 4: Direct lenders see their hold levels come way down in 2020



Source: Refinitiv LPC

The Legal Corner

The beginning of the second quarter of 2020 was relatively busy as the vast majority of M&A transactions and financings already in progress proceeded to closing. That activity was coupled with significant amendment activity, with borrowers enhancing their liquidity position by drawing down on revolvers, deferring principal and interest payments or seeking additional availability under their credit facilities or liquidity through government stimulus programs.

As the quarter progressed, market participants saw that the economic shutdown accelerated the deterioration of the financial performance of borrowers who were suffering prior to the COVID-19 pandemic, and a number of out-of-court restructurings and bankruptcies emerged more quickly than expected. At the same time, deal activity essentially halted as many lenders, private equity groups and companies put a hold on new deals while trying to understand the potential ramifications of the economic shutdown.

The end of the quarter saw a slight pick-up in deal activity, with certain lenders engaging in opportunistic activity or competing for deals in bright spot industries – many of them technology or healthcare based. New deal terms are somewhat more conservative – particularly around reporting, testing of financial metrics, caps on EBITDA addbacks, restricted payment capacity, pricing and call protection. However, the tightening has not yet been dramatic. Much of the M&A activity in the quarter was add-on acquisitions, with brand new acquisitions by private equity groups continuing to be extremely slow.

There has been much discourse in the market regarding COVID-19 related changes to loan documents, such as COVID-19 carve outs to the material adverse effect definition or the events of default or COVID-19 related addbacks to EBITDA. To date these provisions have been used somewhat sparingly. Many market participants were unnerved by Serta's use of incremental equivalent debt provisions to incur indebtedness pari to an existing term loan facility, but senior to such term loan facility in the waterfall. This caused many lenders to scrub their loan documents to see if the amendment restrictions would be sufficient to prevent them from getting layered (i.e., that such provisions require the consent of all lenders or all affected lenders to approve subordination of the credit facility debt or liens).

As the COVID-19 pandemic surged through the second quarter of 2020, it became clear that the U.S. economy was in the midst of a substantial downturn. Unfortunately, the economic downturn's depth and duration is uncertain and lenders expect that most industries will be adversely affected, though the situation is still evolving. The positive is that many market participants and companies are adapting and there should be opportunistic deals as well as activity in certain resilient or essential industries.

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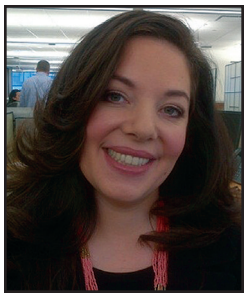

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