EXPERT COMMENTARY

Lenders who stayed disciplined will reap the rewards in the post-pandemic economy, say Daniel Leger and Gregory Racz of MGG Investment Group

Covid-19: A lesson relearned

The covid-19 pandemic and the ensuing economic fallout have reminded lenders once again the importance of insisting on lender-friendly structures with tight covenants and modest leverage even while times are good and markets are flush with capital.

While no one could have predicted that the longest US bull market would end so abruptly, exogenous shocks are often the trigger for recessions and widespread corporate distress. Lenders must ensure they are properly positioned in all markets, so they can play a meaningful and leading role when the inevitable restructurings follow.

Conservative underwriting, strong covenants and other investor protections can create big opportunities when crises arise. Covenant-lite loans, and other loose lending terms, not only allow problems to persist and grow (while lenders are forced to sit on the sidelines if they lack strong covenants and rights), but they also put lenders at a disadvantage in a restructuring.

SPONSOR
MGG INVESTMENT GROUP

In every economy there are winners and losers. In the arena of private lending, the line cuts across not only different sectors of the economy but also across lenders who stayed disciplined over the last few years and laid a strong foundation at a loan's inception and those who did not. Here's a selection of private lending winners and losers in the post-covid economy:

Losers

Borrower friendly terms: In the preceding few years, the majority of leveraged loans made were so called 'cov-lite', coupon lite or collateral lite or a combination of all three. This has had a number of key implications for lenders in recent months.

- Problems were allowed to fester. When trouble first appears on a balance sheet, or operationally within a business, loose borrowing terms mean that lenders have no legal means to address them. Small problems become big problems;
- When revenue declines sharply and debt payments cannot be sustained, lenders have a weak hand and may find that private equity sponsors or management call the shots;
- With few protections, valuable company assets may be dividended out to the equity owners at existing debtholder's expense, a controversial tactic that is being used more frequently.

Relying on private equity sponsors to re-equitise: A common marketing pitch in the era of easy money and borrower-friendly terms.

- We read daily about PE sponsor firms filing for Chapter 11. Neiman Marcus, Hertz, J Crew, etc. In each case, sponsors made the decision not to invest additional capital into a failing business. This may be precisely what investors want. After all, why invest good money after bad?
- The myth of all that dry powder. Private equity sponsors are often not able to invest additional capital in a troubled company as its committed capital, or dry powder, is tied to separate funds or vintages. Investing cross vintages requires LP approval which may not be forthcoming.

Leverage cuts both ways:

- In an era of low interest rates, modest inflation and stable economic growth, leverage is an important tool for magnifying returns to meet the obligations of the big investors;
- The search for yield leads to inflows into yield producing assets like private lending which, in turn, compresses the spreads that borrowers must pay while failing to compensate debtholders for the risks taken;
- A company levered at 7x, paying a 6 percent yield, which has a 30 percent decline in EBITDA must pay 60 percent of every dollar earned to service its debt.

Winners

Set covenants early, set them tight:

- In contrast, setting tight covenants and other investor protections at a loan's inception means the lender can address business problems early;
- Each breach of a covenant enables the lender to extract either increased economics or non-economic changes to the business to the benefit of the lender or both;
- This not only compensates the lender for the additional risks, it also allows the lender to assist management in charting a different course when necessary and better protect the lender's principal.

Past is prologue

Like it or not, every lender is tied to their problem loans

Like it or not, every lender is tied to their problem loans. The more loans that require a workout during a crisis, the less time and capital a lender will have to invest in new opportunities. Thus the importance of conservative underwriting, modest leverage, establishing a relationship with management, and setting tight covenants upfront is further magnified. Not to mention the detrimental effect that problem loans can have on a private lending firm (think BDCs in the current market) making it very hard for these firms to raise the needed capital to invest when opportunities abound.

Spreads commensurate with risk: A lender needs to be compensated for the risks taken. However, a higher cost of capital has additional benefits:

- Companies that are willing to pay a higher spread on a loan implies an ownership mentality that values the equity of the business even more. The mindset of such a borrower is more likely to be long-term oriented and value conscious;
- When the cost of capital is priced appropriately, its purpose is more clearly focused on real economic growth per share. The bar to new acquisitions or new ventures is higher and better understood;
- Borrowers who pay higher costs mean more and earlier realizations. An oft-forgotten axiom: the more expensive a loan the likelier it is to be refinanced out and/or repaid early. Capital returned can be redeployed to other attractive uses.

More, detailed due diligence upfront, fewer surprises latter: Many borrowers rely on the due diligence performed by a sponsor. A proper due diligence done directly by and on behalf of the lender allows a lender to properly price risk while also offering many less obvious benefits:

- Establish a direct relationship with management. By conducting the primary due diligence itself, a lender can strengthen its relationship with management that will be useful if the business runs into difficulty;
- A thorough due diligence process sets expectations early regarding outcomes and reporting thus making "surprises" less likely;
- Independent due diligence – e.g independent audits, quality of earnings reviews, background checks, and deep-dive industry work - will identify valuable assets and set strict limits about their dispossession.

The time is now

Private lending has never been more critical to mid-market businesses than it is today, nor has the investment opportunity been as favourable since the GFC. The cost of capital has increased markedly in the last few months as its supply has declined. For those managers who have stayed true to the principles above, who have minimised their problem loans in their portfolio, and have the good fortune of having capital to invest, opportunities abound across industries and sectors. In a recent Preqin report, the highest return vintages for private debt have been concurrent with recessions. With the effects of the pandemic on consumer demand and behaviour becoming clearer by the day, the beneficiaries in this economy are looking for growth and bridge capital. The time to invest is now. n

Daniel Leger is managing director and Gregory Racz president and co-founder of MGG Investment Group