Industry Overview
Canadian and U.S. Middle Market Private Debt

Alternative Income Group

Ninepoint Partners Industry Overview
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Executive Summary

Private debt has been around for quite some time, but it is only more recently that it has been recognized as its own asset class. Allocation to private debt has dramatically increased over the past two decades. With interest rates near-zero, investors have searched for alternatives to generate strong current income. At the same time, commercial banks that once provided capital to small and mid-size enterprises (SMEs) have largely ceased lending to this market. This has created an opportunity for non-bank lenders, which are not subject to the same capital requirements and stress tests, to fill the void.

Sector Overview

Like public debt securities, private debt has fixed-income characteristics. However, private debt loan transactions are privately negotiated, typically with corporate borrowers. The lender has the ability to structure the transaction to its satisfaction. Pricing, covenants, term and security are all customized to the borrower.

Asset management firms make up a significant portion of non-bank financial intermediation. Given that private debt investments are, historically, long-duration assets, they are typically structured as closed-end investment vehicles that require invested capital to be locked in for five to seven years.

SME Strengths

Canada has achieved significant growth over the past several decades, much of it attributed to the strength of SMEs. As at Q2 2019, default rates are 1.31% for Canadian small businesses and 0.93% for medium-size businesses. Non-bank lenders are generally able to provide investors with strong risk-adjusted returns thanks to stronger pricing as well as enhanced structures and covenant packages.

In the U.S., too, default rates for middle-market transactions (less than US$100 million) are lower than for broadly syndicated transactions (US$500 million or more) — 1.2% vs 3.6% respectively. Middle-market loans have stronger covenant packages, more frequent financial reporting and higher excess cash flow sweep requirements, all of which provide additional protection to lenders.

Impact of COVID-19

Canadian and U.S. businesses have become increasingly levered over the past few decades. As at October 2019, total credit to the private non-financial sector is 215.4% of GDP in Canada and 150.3% of GDP in the U.S. This amount of leverage puts a high burden on corporations, especially during economic stress.

Government stimulus packages in both Canada and the U.S. have allowed these businesses to continue operations despite the pandemic-induced economic slowdown. As the economy reopens, they will be forced to operate at less than full capacity with increased costs to implement and maintain best practices on preventing the spread of COVID-19. Without additional government support, many may struggle to generate profits, putting pressure on liquidity and solvency.

Outlook

The next several months will tell how the economy will fare, as cities and countries begin to open up. With a global slowdown caused by capacity constraints and increased expenses, there is the possibility that some companies may not be able to meet their debt payments.

Transactions will continue to see credit spreads at an elevated level with tighter covenants and structures than in the pre-pandemic world. Until the economy is able to operate at full capacity, stronger risk-adjusted returns are expected to remain. Disciplined private debt managers will strategically deploy their capital to take advantage of the most compelling opportunities while preserving liquidity as the economic recovery unfolds.

Private Debt – Direct Lending to Middle Market Companies

Small and medium sized enterprises ('SMEs') are the backbone of many countries. However, many of these businesses rely on their own capital as traditional lenders have increasingly retracted from the space. Non-bank lenders have been able to fill the void and provide additional sources of financing to borrowers. Most of these businesses will borrow through privately negotiated transactions, which is known as Private Debt.

Private Debt is similar to public debt securities as it has fixed income characteristics, but it is largely differentiated as loan transactions are privately negotiated, typically with corporate borrowers. The lender has the flexibility and control to structure the transaction to its satisfaction. Pricing, covenants, term and security are all customized to the borrower. Returns on the loan are primarily attributed to interest income and facility/underwriting fees on the loan. Private debt is typically less liquid compared to public debt as it is not a publicly traded security. On most occasions, a direct lending strategy will hold the loan until maturity with terms ranging from 12 months – 48 months.

In contrast, publicly traded debt is a fixed income security issued by governments and corporations in the public markets with predetermined features. The government/corporation remains in control of the structure of the issuance and will determine the features of the loan. Investors must then determine whether a specific security will meet its return and risk objectives as it does not have control over the structuring of the investment. In this case, returns are primarily attributed to coupons and capital gain/loss. This type of security will provide investors with liquidity on the open market as it is traded on exchanges. Despite this, publicly traded debt will cause daily fluctuations in the price of the security. The daily mark-to-market will create increased volatility compared to Private Debt, which generally exhibits lower volatility during market stress.

Table 1: Private Debt Comparison to Other Asset Classes

Annualized	Corporate Bonds	High-Yield Bonds	Mid-Market Loans	10 Yr. Treasury Bonds	S&P 500 Index
Mean Return	5.69%	7.14%	8.91%	2.87%	8.59%
Standard Deviation	5.69%	11.30%	3.55%	3.75%	15.92%
Sharpe Ratio	0.98	0.62	2.47	0.73	0.53

Source: Morningstar, TIAA Global Asset Management, Cliffwater Direct Lending Index.

Data reflect performance, volatility, and Sharpe Ratios for the following indexes: S&P 500 Index, BofA Merrill Lynch US High Yield Index, BofA Merrill Lynch US Corporate Bond Index, BofA Merrill Lynch 10Yr US Treasury Index and Cliffwater Direct Lending Index. Performance is based on quarterly returns for the period September 2007 through December 2019.

Investors have increased their allocation to Private Debt as it generates attractive returns in various economic environments that are uncorrelated to traditional asset classes, while providing strong current income and principal protection. However, there are many different types of Private Debt strategies with different investment objectives. These strategies can generate anywhere from a 5% return on direct senior lending to upwards of 25% on various types of lending. The contents of this paper will primarily refer to senior secured direct lending strategies. The following will provide a brief overview of different types of Private Debt strategies:

Direct Lending: The most common form of Private Debt. Direct lending strategies focus on providing loans primarily to established corporations for general working capital, acquisition or growth financing. These borrowers typically have been in operation for some time and have demonstrated the ability to generate revenue and/or cash flow. With direct lending, the lender has the ability to invest across the capital structure, such as investing in senior secured, unitranche or junior debt. As investors venture to lower parts of the capital structure, risks and return profiles also increase.

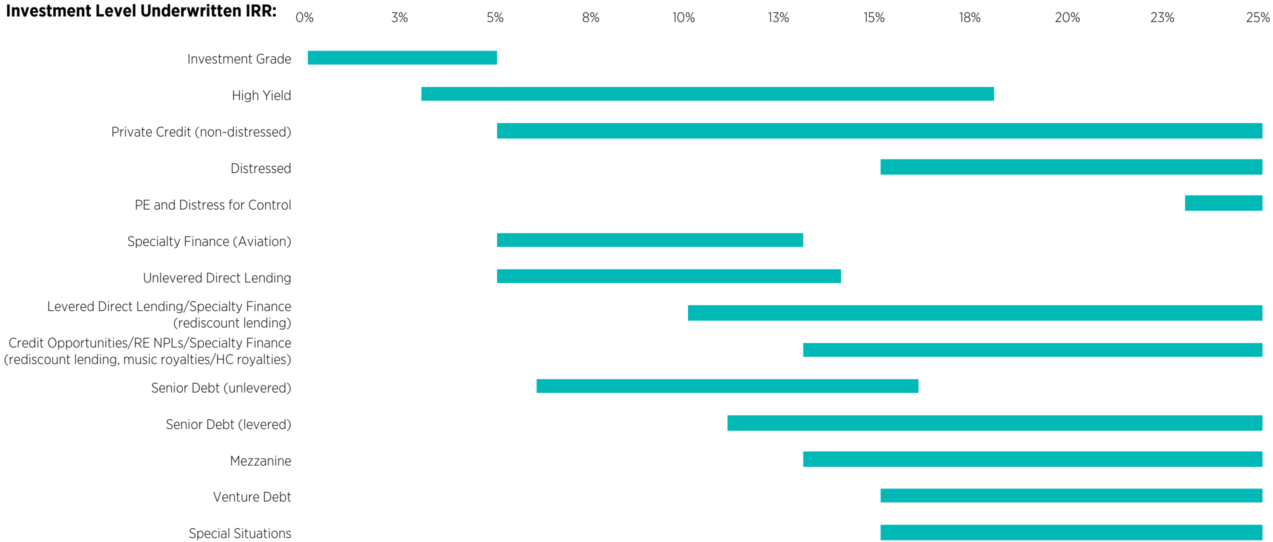
Mezzanine Debt: This is a hybrid type of financing with both fixed income and equity like characteristics. The debt portion of the transaction will generally be subordinated while having embedded equity instruments attached. Borrowers tend to be more levered compared to transactions in the direct lending space as borrowers seek additional financing.

Distressed Debt: The purchase of existing debt at significant discounts of borrowers that have not performed and have defaulted on their loan is known as distressed debt. Borrowers are typically under financial distress or in bankruptcy proceedings. Given that these borrowers are having issues meeting their financial obligations and operate as going concern, loans can be acquired at a significant discount. Investors that purchase these loans at a discount will typically have developed a plan for the borrower to restructure its business and overcome its issues.

Special Situations: Similarly, special situation strategies will provide distressed companies with debt and/or equity financing that it perceives to be undervalued. Investors will have a focus on taking control or have significant influence on the company with a catalyst to drive value.

Venture Debt: Financing provided to early-stage companies or start-ups generally for growth capital is known as Venture Debt. This type of financing provides borrowers with flexibility and capital without surrendering ownership or diluting existing shareholders. Lenders will typically receive warrants or equity upside as part of the loan as it funds the company through its growth plan.

Figure 1: Private Debt Return Spectrum



Source: Cambridge Associates and Green Eight Capital.

Canadian Market Overview

Canadian Banking System

In Canada, the banking system is largely dominated by the "Big 6 Banks":

- Royal Bank of Canada
- Toronto Dominion Bank
- Bank of Nova Scotia
- Bank of Montreal
- Canadian Imperial Bank of Commerce
- National Bank of Canada

In addition to the Big 6 Banks, there are Tier II banks and credit unions, totaling to 88 banks in Canada[1]. Banks are regulated at a federal level whereas credit unions are largely regulated provincially. Assets are heavily concentrated in Canada's 5 Biggest Banks (excluding National Bank of Canada), which account for approximately 83% of total Canadian assets[2]. Although concentrated, the businesses of Canadian Banks are much more diversified when compared to the U.S. with operations in wealth management, insurance, brokerage services and deposits & loans. In the corporate landscape, domestic banks make up CA$79.2 trillion of the CA$141 trillion disbursed to all businesses[3].

Figure 2: Canadian Banking System Overview – Value of Credit Disbursed to All Businesses

Source: Government of Canada: Biannual Survey of Suppliers of Business Financing – Data Analysis, First half 2019.

The Canadian banking system has historically been conservative. Canada's ability to withstand the Global Financial Crisis in comparison to its global counterparts is a testament to its banking system structure. In the United States, the impact of the crisis was much more widespread as nearly 500 banks[4] failed from 2008 through 2013 including large financial institutions such as Lehman Brothers whereas Canada had no bank failures. In response to the crisis, the government passed the Emergency Economic Stabilization Act which provided the banks with a US$700 billion bailout[5].

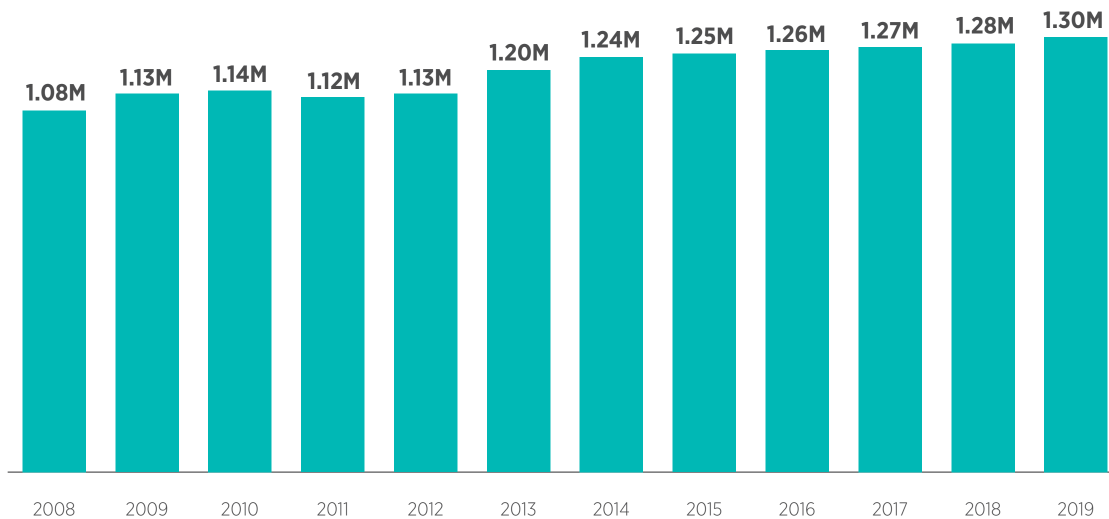
Canadian banks adhere to the Basel III liquidity rules to ensure that there is sufficient liquidity to tolerate periods of economic turmoil. The Basel III Act outlines liquidity requirements for Canadian banks[6] including:

1. The minimum Liquidity Coverage Ratio (LCR) which must equal to at least 100% as of 2019. This ensures that financial institutions have sufficient high-quality liquid assets (HQLA) to survive a scenario of high economic burden for at least one month.
2. The Net Stable Funding Ratio (NSFR) which is required to be equal to at least 100%. The aim of this requirement is to allow banks to fund their operations with more stable sources of funding on a continuous basis.

Canadian Middle Market

Canada has achieved significant growth over the past several decades and it is largely attributed to the growth of small and medium sized enterprises (SMEs). Since 2008, the number of Canadian SMEs have increased 21% by 2019 to 1.31 million. In Canada, businesses with less than 500 employees are considered to be small to medium sized. In addition, small businesses typically generate less than $5 million in annual revenue and medium sized businesses generate between $5 million and $25 million[7]. In comparison, Canada's SME/middle market businesses are closer in size to the lower middle market companies in the United States. These companies contribute a significant portion of the country's GDP production, accounting for 54.9% or estimated at CA$1.04 trillion[3].

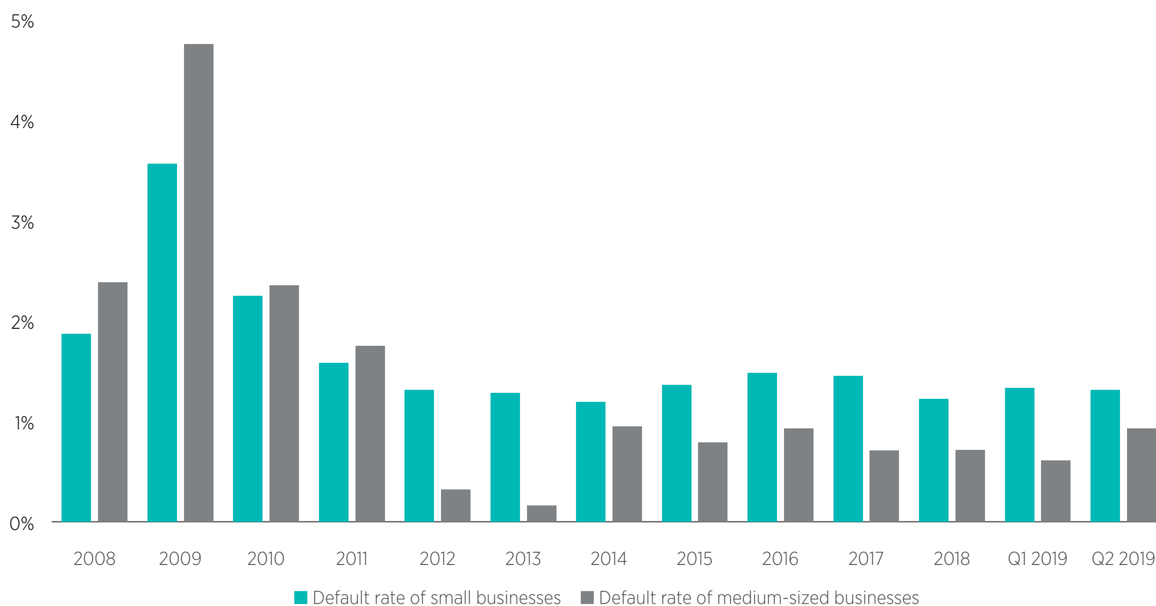
Figure 3: Growth of SMEs in Canada from 2008 – 2019



Source: Statistics Canada: Key Small Business Statistics – November 2019.

As at Q2 2019, default rates for Canadian small businesses are at 1.30% and 0.93% for medium sized businesses. This fares quite well compared the U.S. large-cap market with a default rate of 3.6% for transactions greater than US$500 million. Due to the Canadian banking landscape, non-bank lenders are generally able to provide investors with strong risk-adjusted returns due to stronger pricing as well as enhanced structures and covenant packages. Borrowers unable to meet the Big 5 Banks' underwriting criteria will have fewer options and thus gives non-bank lenders negotiating power on transactions.

Figure 4: Canada Small and Medium Sized Enterprise Default Rates



Source: Government of Canada: Biannual Survey of Suppliers of Business Financing – Data Analysis, First half 2019.

U.S. Market Overview

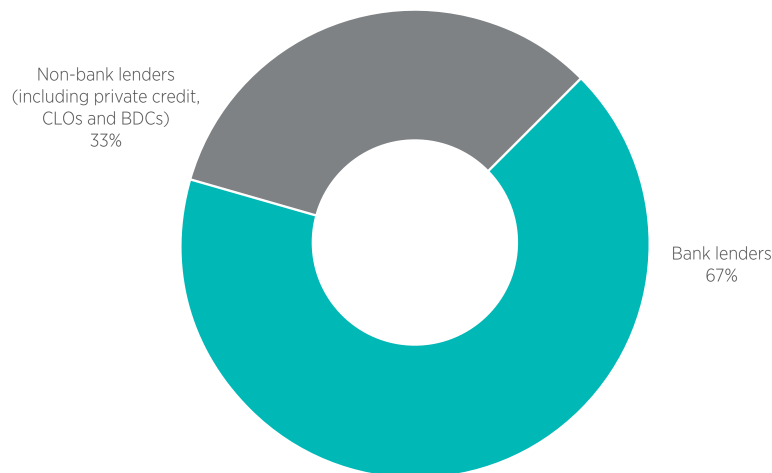
U.S. Banking System

The structure of the U.S. banking system is set up slightly different than in Canada. Banks are chartered and supervised at two different levels, at a national level and at a state level. In addition to the large multinational banks, there are also super regional and regional banks, thus creating a highly fragmented market. In total, there are approximately 4500 banks in the United States[6]. The largest in the country is composed of the "Big 4 Banks":

- JP Morgan Chase
- Bank of America
- Citigroup
- Wells Fargo

Unlike Canada, the five largest banks in the U.S. account for 43% of the total commercial banking assets[8]. Despite the competitive banking landscape, the number of commercial banks have significantly decreased over the past several decades from 8500 commercial banks in the year 2000 to approximately 4500 at the end of 2019[6]. These banks represent 67% of the lenders in the US$1.2 trillion institutional loan market[9].

Figure 5: Breakdown of Bank Lenders vs. Non-Bank Lenders in U.S.



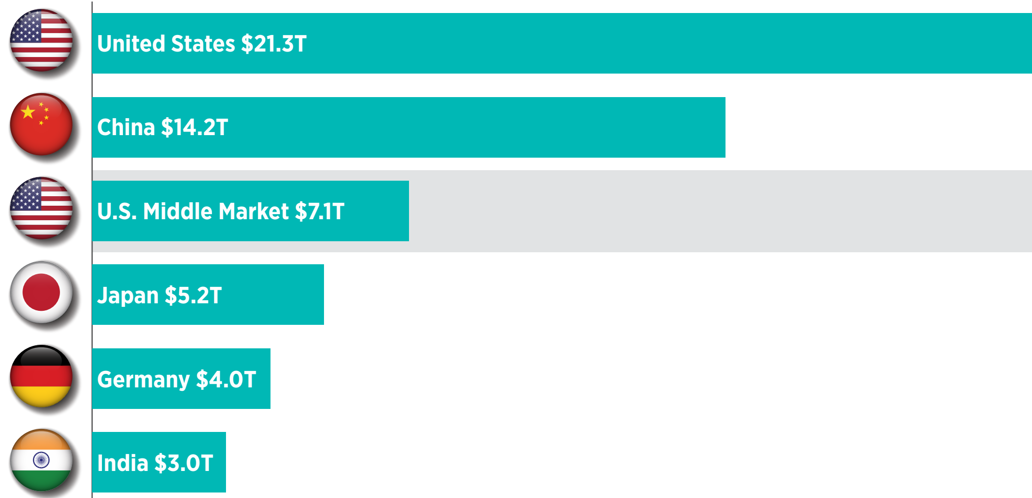
Source: FTI Consulting – U.S. Loan Market Survey June 2019.

Post the Global Financial crisis, many restrictions and requirements were set in place to protect the financial stability of the United States. Regulatory reforms including the 2010 Dodd Frank Act and 2018 Basel III have altered financial institution's ability to invest in certain areas. Most of these restrictions involve common equity Tier I capital which refers to the highest quality of regulatory capital due to its ability to absorb losses immediately when they occur[10]. It is most commonly in the form of shares or retained earnings. As of January 1, 2019, banks are required to hold a capital conservation buffer in the form of common equity Tier I capital of 2.5%. Any institution that fails to adhere to this requirement will be restricted from its ability to make capital distributions or pay executive bonuses. U.S. lawmakers also have the ability to impose another countercyclical capital buffer of up to 2.5%[10]. Furthermore, the largest U.S. banks (at least US$700 billion in total assets or US$10 trillion in assets under custody) are subject to an enhanced leverage ratio of at least 5% and depository institutions are required to maintain a minimum leverage ratio of 6%[10]. Although there were some recent changes to the Dodd Frank Act in 2018, which eased some of the requirements, banks continued to be heavily regulated by these reforms. These changes will provide banks with greater flexibility as they are able to free up capital with reduced margin requirements. In addition, the ability to invest in covered funds such as credit and venture capital will create more activity in the respective asset classes and spur additional growth. However, this implicitly adds illiquid strategies and embedded leverage onto the bank's balance sheet. It is still too early to tell what is to come, but the financial soundness of these banks will have to be monitored with the implementation of these changes.

U.S. Middle Market

The U.S. middle market is larger and much more developed compared to Canada. There are over 200,000 middle market firms in the U.S. equating to the world's third largest economy in size, generating US$7.1 trillion. These businesses should not be confused with start-ups. They generally have been in operation for long periods of time and generate between US$10 million to US$1 billion in revenue. It is a creation of a more developed economy with a diversified pool of businesses that focuses on a wide array of industries, unlike Canada, where most of the economy is driven from natural resources and manufacturing.

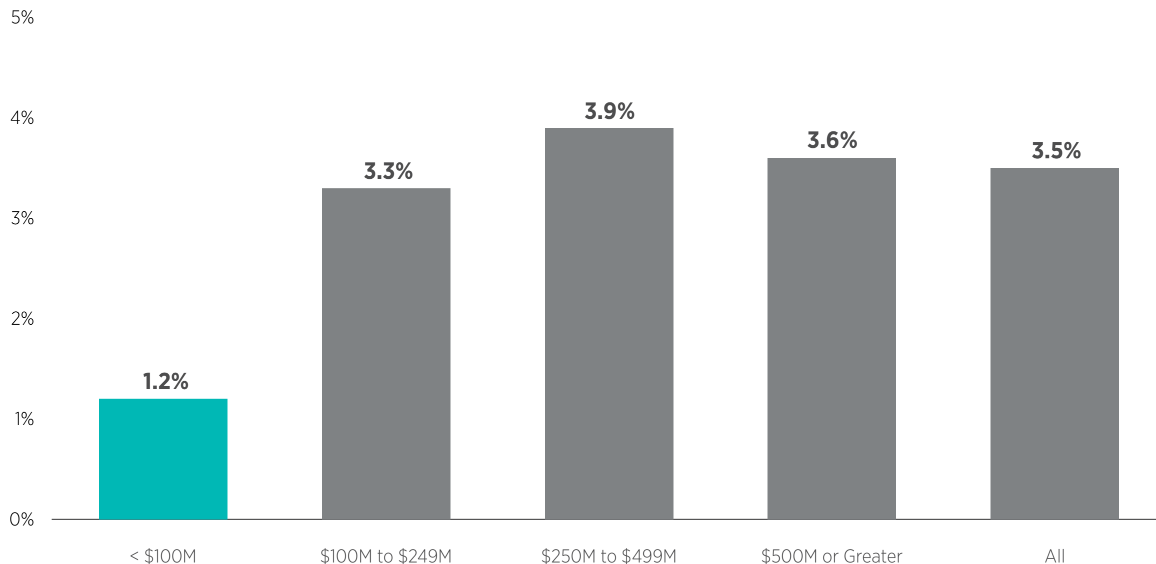
Figure 6: World's Largest Economies



Source: National Center for the Middle Market: Q3'19 Middle Market Indicator, The Middle Market Power Index: American Express and Dun & Bradstreet. IMF: World Economic Outlook, April 2019 GDP. Monroe Capital.

Similar to Canada, loans to the U.S. middle market have lower default rates compared to broadly syndicated transactions as they have stronger covenant packages, more frequent financial reporting and higher excess cash flow sweep requirements. The additional protection provides lower default rates compared to larger sized transactions. Businesses with loans less than US$100 million have an average rate of default of 1.2% vs. 3.6% for transactions that are US$500 million or greater.

Figure 7: Average Default Rates by Loan Size

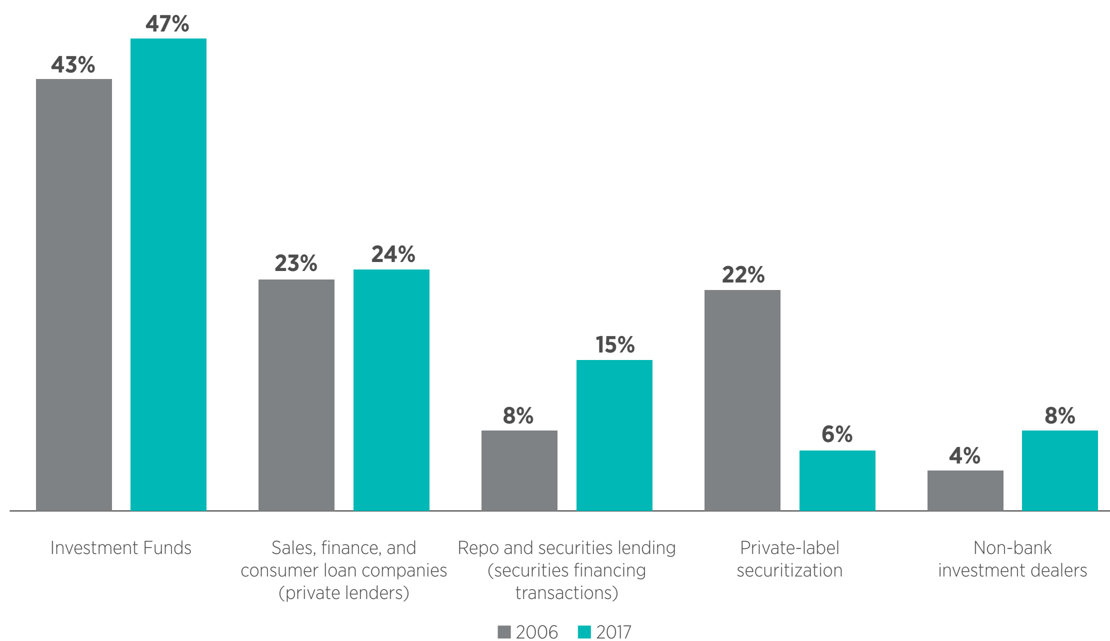


Source: S&P LCD: Default Review 1Q20. Monroe Capital.

Middle Market Funding Gap

Private debt has been around for quite some time, but it has not been recognized as its own asset class until more recently as institutions flooded into the space. In the aftermath of the Global Financial Crisis, we have seen numerous regulatory reforms to address the financial stability of our countries. Financial institutions are subject to stress tests and are mandated to maintain strict capital requirements. In addition, lending in the middle market space requires significant investment in infrastructure to originate, manage and monitor these transactions. For that reason, commercial banks that have once provided capital to businesses in the middle market have ceased lending to this space and have focused more on the broadly syndicated market and pristine credit. This has created an opportunity for non-bank lenders, which are not subject to the same capital requirements and stress tests, to fill the void left by traditional institutions. This has spurred the popularity and growth of Private Debt in the last decade. The asset class has grown from US$36.3 billion to US$513 billion assets under management in North America alone and totals US$853.8 billion globally[11]. This primarily consists of non-bank lenders managing investment funds as they are not subject to the same capital requirements. In 2017, investment funds accounted for 47% of Canada's Non-Bank Financial Intermediation.

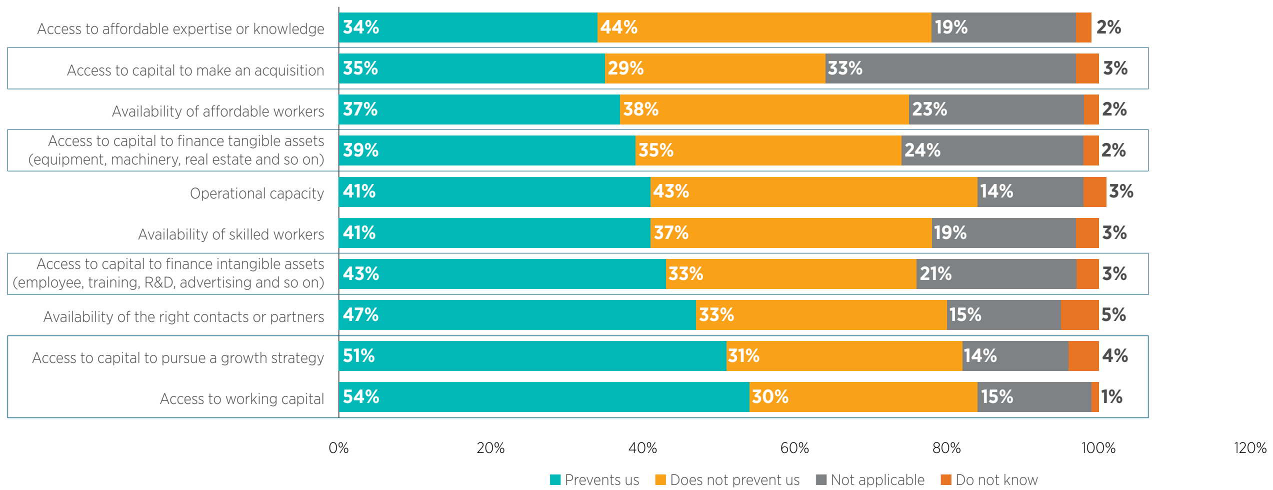
Figure 8: Composition of Non-Bank Financial Intermediation in Canada between 2006 to 2017



Source: Bank of Canada: Non-Bank Financial Intermediation in Canada.

In Canada, many foreign entities have retracted from the country due to their own balance sheet issues from the impact of the Global Financial Crisis while the Big 6 Banks have increasingly focused on meeting strict capital requirements; thus, limiting investment in the middle market space. Based on a survey conducted by Business Development Canada, the main obstacle for SMEs in Canada is the lack of access to financing.

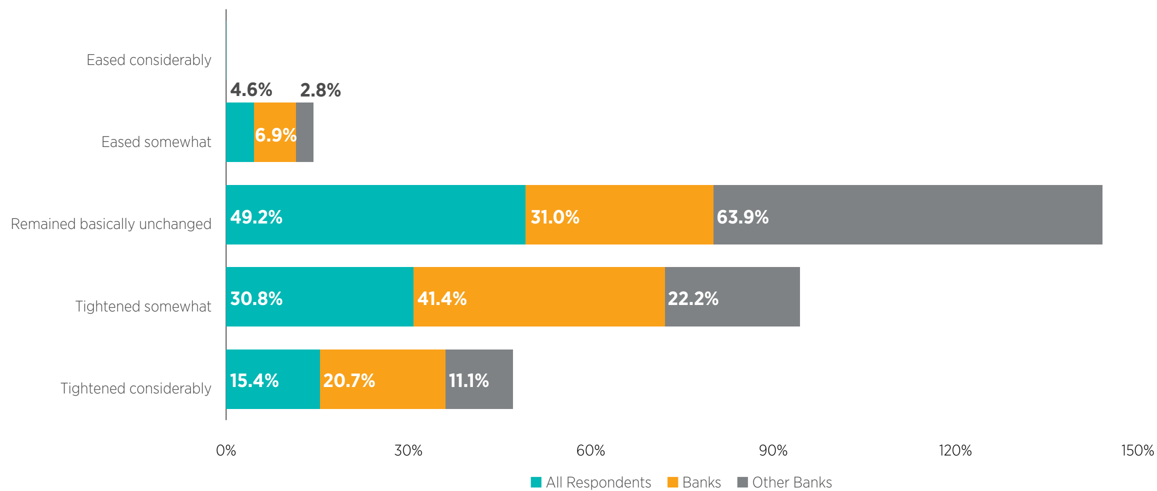
Figure 9: The Main Perceived Obstacles of SMEs in Canada



Source: BDC – SME Needs and Potential Solutions, May 2018.

In the United States, multinational banks have also retracted from the middle market space due to similar constraints. Small and regional banks are not subject to the same tests and are still able to provide funding for these borrowers in certain areas. This creates a more competitive environment in the United States. However, opportunities remain as credit standards of the banks have tightened up over the past several years. Based on a survey conducted by the U.S. Federal Reserve, only 4.6% of all respondents have eased its credit standards for applications to C&I loans.

Figure 10: Changes to Bank Credit Standards for Approving Applications for C&I Loans Survey



Source: Federal Reserve: Senior Loan Officer Opinion Survey on Bank Lending Practices – April 2020.

Private Debt Market Landscape

Asset management firms make up a significant portion of non-bank financial intermediation. Given that Private Debt investments are typically long duration assets, historically, they are structured as closed-end investment vehicles that require a 5 to 7 year lock up of invested capital. Managers have also explored other avenues to gather assets and introduced Business Development Corporations ("BDC") to provide investors with liquidity through a public market offering. Over the past several years, the North American managers that have raised the highest amount of capital are all based in the United States and have raised capital across multiple strategies including direct lending, mezzanine, and distressed debt. These managers may participate in transactions in Canada, however, they are generally focused on the United States. However due to their size, many strategies focus on the upper middle market or broadly syndicated market.

Table 2: North American Private Debt Managers Ranked by Capital Raised in January 2014 to June 2019

2019 Rank	Firm	**Capital Raised** (US$ Million)
1	Ares Management Corporation	$48,230
2	Blackstone	$45,164
3	Goldman Sachs Merchant Banking Division	$44,466
4	Lone Star Funds	$39,250
5	HPS Investment Partners	$34,592
6	Oaktree Capital Management	$31,070
7	Cerberus Capital Management	$26,202
8	Apollo Global Management	$24,592
9	TPG Six Street Partners	$22,000
10	Fortress Investment Group	$20,386

Source: Private Debt Investor: PDI 50 – December 2019/January 2020.

In Canada, Ninepoint Partners manages many Private Debt funds in partnership with third party firms with AUM in Private Debt strategies totaling CA$1.8 billion. Table 3 and Table 4 will provide a sample of Private Debt firms in the Canadian and U.S. middle market.

Table 3: Sample of Canadian Middle Market Private Debt Firms

Firm	**AUM** ($ Million)
Northleaf Capital	US$2,200
Third Eye Capital	$2,400
Callidus Capital	$420*
Accord Financial	$380**
Waygar Capital	$250

Source: Financial Post: "*Northleaf Capital boosts private credit program*" & "*Callidus Capital shareholder reaches deal to take company private as debt mounts*". Ninepoint Partners. Accord Financial 2019 Annual Report.

* As at August 2019.

** Average funds employed in 2019.

Table 4: Sample of U.S. Middle Market Private Debt Firms

Firm	**AUM/Committed Capital** (US$ Million)
Churchill Asset Management	$24,000
Twin Brook Capital Partners	$13,200*
Monroe Capital	$9,300
Main Street Capital Corporation	$4,000
Deerpath Capital Management	$3,000*

Source: Monroe Capital. Twin Brook Capital Partners. Deerpath Capital Management. Main Street Capital. Churchill Asset Management.

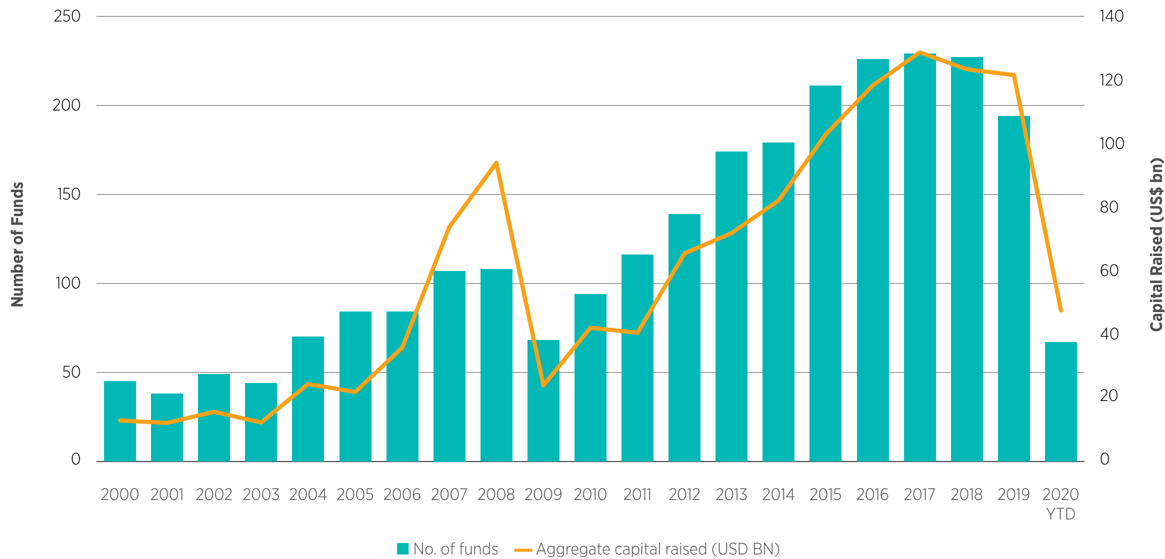
* Commitments issued since inception.

Recent Market Developments

Allocation to Private Debt

Allocation to Private Debt has drastically increased over the past two decades, especially post the Global Financial Crisis. With interest rates near-zero, investors have searched for alternatives to generate strong current income in a low yielding environment. In 2019, fundraising has increased to US$122 billion; an increase from US$24 billion in 2009.

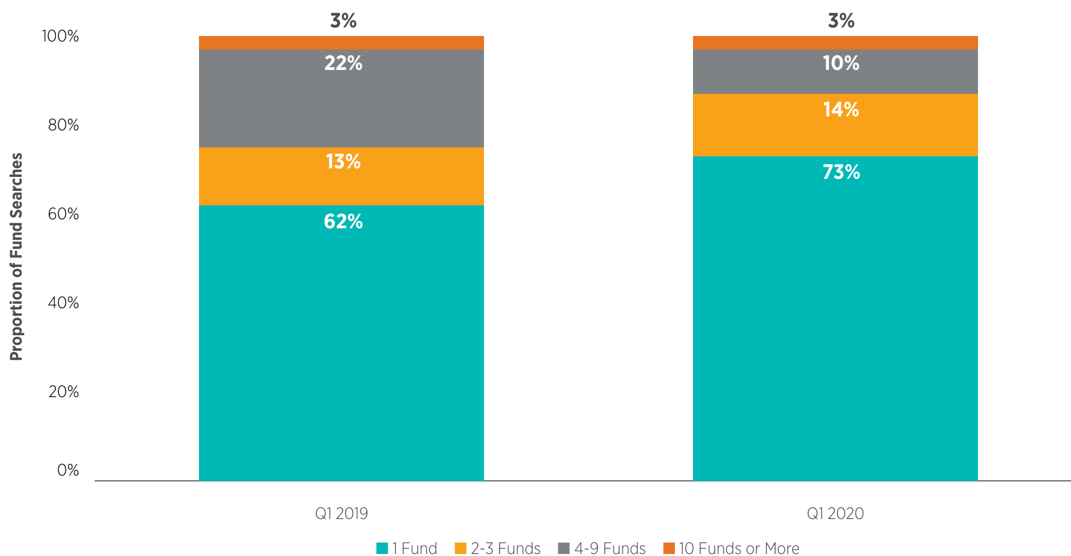
Figure 11: Historical Global Fundraising



Source: Preqin Pro. As at June 8th, 2020.

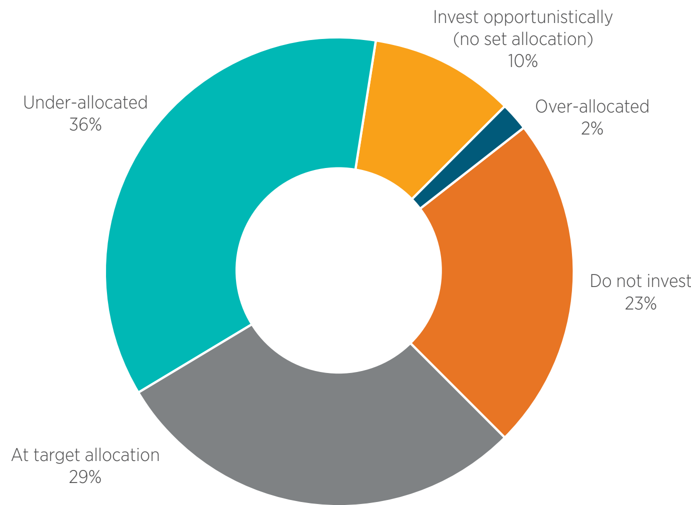
In Q1 2020, institutional investors have remained cautious and expect to allocate to fewer Private Debt funds over the next 12 months compared to the year prior. However, based on the PDI LP Perspective Survey 2020, 36% of the respondents believe they are under-allocated to Private Debt and 10% will invest opportunistically. Although economic uncertainty from COVID-19 remains, investors expect to continue to allocate towards this asset class, albeit slower than in recent years.

Figure 12: Number of Private Debt Funds Investors Plan to Commit to Over the Next 12 Months



Source: Preqin: Quarterly Update: Private Debt, Q1 2020.

Figure 13: Investor's Current Allocation Position to Private Debt

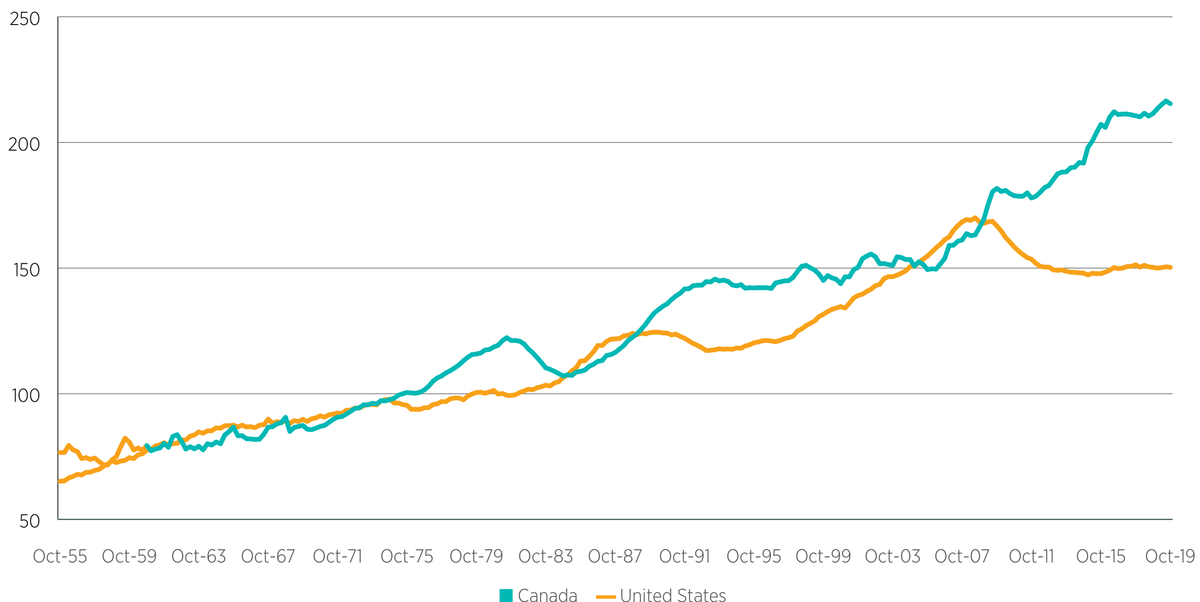


Source: Private Debt Investor: PDI LP Perspectives Survey 2020.

Health of Canadian and U.S. Businesses

Canadian and U.S. businesses have become increasingly more levered over the past few decades. As at October 2019, the total credit to private non-financial sector is at 215.4% of GDP for Canada and 150.3% of GDP for the U.S. This amount of leverage will put high burden on corporations, especially during economic stress. In today's environment, many of these companies are expected to struggle even with the reopening of the economy as they may be forced to operate below full capacity.

Figure 14: Total Credit to Private Non-Financial Sector for Canada and United States



Source: FRED: Total Credit to Private Non-Financial Sector, Adjusted for Breaks for Canada & United States.

In 2020, Canada has seen fewer proposals and bankruptcies by businesses in the past several years. Surprisingly, fewer businesses have filed for bankruptcy/proposals in April 2020, a total of 164 businesses, which is a decrease of 55% from the year prior. Filings for Chapter 11 in the U.S. have come down over the past several years since 2011. Through the first five months of 2020, we have seen a slight pickup with May 2020 filings at 722, 48% above the historical average of 564[12].

Figure 15: Canadian Businesses Filing for Proposal or Bankruptcy

Source: Government of Canada: Insolvency Statistics in Canada – April 2020.

Figure 16: U.S. Chapter 11 Filings by Month

Source: Epiq Systems, Inc: May 2020 Bankruptcy Statistics – State and District.

With the economy coming to a halt for three months, one would expect filings to drastically increase. The reason we have yet to see this is due to the implementation of the stimulus package, totaling US$2.3 trillion through the CARES Act and US$483 billion through the Paycheck Protection Program and Health Care Enhancement Act ("PPP") in the United States, which is approximately 13% of its GDP[13]. In Canada, the government provided CA$263 billion in support, equating to approximately 12% of its GDP through programs such as the Canada Emergency Response Benefit ("CERB") and Canada Emergency Wage Subsidy ("CEWS").

The PPP program only provides an amount that equates to 2.5 times the average monthly payroll costs, up to US$10 million[3]. Through this program, there have been 4.5 million approved loans with the average loan size at US$112,700[14]. The CEWS covers 75% of an employee's wage up to CA$847/week for eligible employers[15]. For a typical SME, these programs may only provide a few months of relief. Despite the reopening of the economy, these

businesses will be forced to operate at less than full capacity with increased costs to implement and maintain best-practices on preventing the spread of COVID-19. Without additional support from the government, we expect a continued increase in filings over the next several months in both Canada and the U.S.

Pricing & Structure

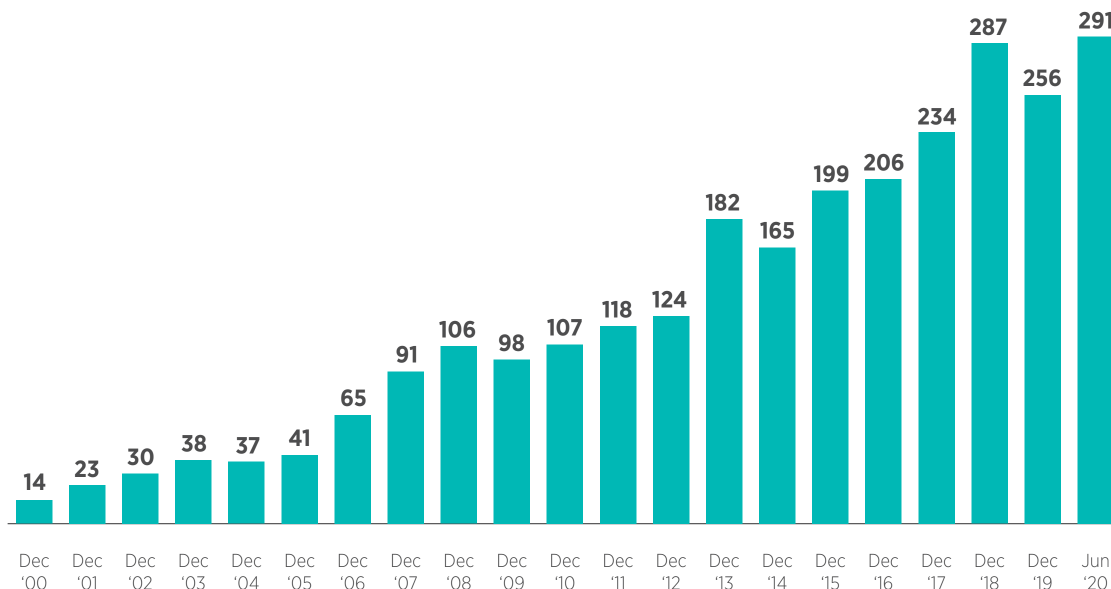
Recent events have allowed for the repricing of risk in private markets. Based on a survey of 50 market participants in the U.S. and Europe, opportunities in Private Debt have become increasingly more lender friendly with stronger risk-adjusted returns and documentation. Transactions on average have seen a 100bps to 200bps increase in pricing along with stronger documentation including higher LIBOR floors and clauses for increase in pricing if EBITDA drops below the base case expectation[16]. In addition, transactions have tighter covenant cushions, call protections and fewer EBITDA add-backs. Leverage is also expected to be reduced with requirements to maintain 35 to 40 percent equity cushions and >2x cash interest coverage levels. Based on our discussions with market participants, we expect similar trends in the Canadian Private Debt market.

Industries that have been more apparent to issues caused by COVID-19 have seen an even larger increase in credit spreads and tighter terms. Managers have looked to decrease exposure to these areas, which has created strong opportunities for industry specialists that are able to identify undervalued borrowers.

Dry Powder

The search for strong current income in a low yielding environment has driven investors to this asset class at a rapid rate. Global dry powder in Private Debt has increased to US$291 billion as of June 2020. The slowdown in fundraising (due to COVID-19) in unison with increased borrower draws on committed capital is expected to cause managers to deploy its dry powder. However, managers continue to find ways to preserve liquidity as they have no clear view on requests to draw and on borrowers seeking additional advances. We do not foresee borrower requests to materially affect the cash position as the pandemic has created more opportunities for new transactions and an increase in demand to draw on existing facilities. Managers in the space have gone to market with large fundraising targets to take advantage of the upcoming opportunities in the Private Debt space. We expect the need for liquidity combined with increased opportunities to decrease dry powder over the next 6 – 12 months.

Figure 17: Global Dry Powder in Private Debt (USD bn)



Source: Preqin Pro. As at June 8, 2020.

Outlook

The next several months will tell how the economy will fare as cities and countries begin to open up. Whether the spread of the pandemic will exponentially increase as lockdown measures are lifted is yet to be determined. Overall, we expect demand for goods to remain depressed going into the second half of the year as consumers remain hesitant to return to "normal". Many cities and countries that have eased lockdown measures have seen a reversal of confirmed cases after the initial flattening of the curve. Many cities in these areas will be forced to take increased precautions and pull back some of its plans to reopen. This will put significant pressure on small to medium sized enterprises without the infrastructure to operate at full capacity during these times. In turn, we expect to see an increasing amount of businesses to file for creditor protection over the next several months without additional assistance from the government. Businesses in Canada and the United States have both continued to operate at high levels of leverage with the aid of government programs. With a global slowdown caused by capacity constraints and increased expenses, there is the possibility that these companies will not be able to meet required debt payments and rent obligations. Companies that are unable to operate at full capacity will continue to struggle with generating profits as increases in COVID related expenses put great pressure on businesses' liquidity and solvency. Companies that are in industries such as travel & leisure, restaurants and entertainment may be hit hard as we expect consumers to be slow in returning to "normal". Companies that are unable to receive additional financing or support will be forced into creditor protection and we have begun to see this play out with companies like Hertz, J.C. Penney, Chesapeake Energy and GNC. Companies will be forced to restructure and adapt to the newer environment, with many operating at a lower capacity until a vaccine is developed. Private Debt managers that have remained disciplined in their underwriting should be able to weather the storm. The remaining managers are expected to struggle in managing their portfolio of companies with potential for principal loss especially if the economy experiences a prolonged recovery.

In addition, we expect an inflow of capital into the asset class over the next year with the changes of the Volcker Rule. U.S. banks will increase its exposure to Private Debt through investment funds. It is estimated by Wall Street banks that the changes will free up US$40 billion from its balance sheet[17]. The capital will be invested over time as we continue to deal with the effects of the pandemic. It is only prudent for banks to maintain liquidity and improve its financial position during uncertain times. The entire amount will not be invested into a single asset class; thus, we do not see a direct material effect to competition in Private Debt. Nonetheless, this will free up capital on its balance sheets and provide them the ability to directly invest more capital in other areas of the business including direct lending.

However, this is also expected to generate a large opportunity for distressed investing over the next 12 months and we have already seen several distressed lenders initiate fundraising in preparation for these opportunities. In addition, this uncertainty will cause traditional lenders to tighten up their credit requirements in the short term and create a larger funding gap, especially towards the middle market. Lenders should see an increase in deal flow and attractive opportunities that were once considered bankable.

Transactions will continue to see credit spreads at an elevated level with tighter covenants and structures compared to the pre-pandemic world. Until the economy is able to operate at full capacity, stronger risk-adjusted returns are expected to remain. We have seen loan pricing in the secondary market trade at a discount due to the increase in credit spreads. As such, we expect managers to strategically allocate a significant amount of their dry powder on new transactions, both in the primary and secondary markets. With the ongoing impact of the pandemic, many businesses may continue to draw on committed capital to increase liquidity, further decreasing the dry powder of the manager. Certain managers may be forced to sit back on newly priced transactions in order to manage liquidity of the investment vehicle. Disciplined managers will strategically deploy their capital to take advantage of the most compelling opportunities while preserving liquidity as the economic recovery unfolds. ■

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FOOTNOTES

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