KEYNOTE INTERVIEW

A shift in thinking for debt finance

As mid-market focus moves from portfolio health to new opportunities, funds are finding lenders in a collaborative mood, say Baker McKenzie's Michael Fieweger and Andrew Sagor

Q How has covid-19 affected mid-market activity?

Michael Fieweger: In March, the initial response in the mid-market, and across private equity generally, was to focus on triage in the portfolio. Some industries have obviously felt the effects of the pandemic more acutely than others – for investments in retail or hospitality it was mission critical. Managers were trying to get a handle on what was happening and there were questions around the availability of liquidity. Today, managers have figured out where the problems lie and are taking steps to address these. They are now starting to look for opportunities.

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The mid-market is a little tougher than the top end of the market, where deals are happening and money is being put to work. Mid-market funds are more active in areas such as bankruptcy and distressed situations, but buyout activity is still slow. If you do not have to sell, you are not selling in this market. And if a manager had not previously engaged in a dialogue with a target, developing the necessary relationships to start deals is challenging without being able to travel and meet in person. This segment of the market is reliant on management teams and family-owned businesses where people want to build trust face to face. A lot of activity is going to be difficult to build out until there is more certainty on valuations and the ability to get out and create relationships.

Q What about the impact on debt finance markets?

Andrew Sagor: The thinking initially was that covid-19 risk could be accounted for by increasing pricing and tightening covenants. As we moved forward, the thinking shifted from risk premiums to focusing on the earnings picture, because many businesses faced a black swan event with earnings going to practically zero.

Deal activity paused in the leveraged loan market as lenders and borrowers had conversations about the earnings picture. When earnings are clear, EBITDA provisions make up the fundamental building blocks of financial covenants, so when they are hazy it is hard to price deals and figure out the covenants.

At the same time, we were advising clients on the use of revolvers, waivers and financial covenant relief. There was plenty of counselling around ways to relieve pressure, to maximise operating headroom under covenants, and thinking through requests to lenders about delaying payments.

Some new deals are being done, albeit predominantly involving either rescue financing for distressed credits or refinancings for well-known leveraged loan market participants with pending maturities. There is a tentative reopening going on, but the focus is on amendments to relieve pressure as the effects of covid-19 impact the balance sheets of borrowers.

Q Where do you see signs of activity returning?

MF: Some areas of the market have not been hit as hard, such as business services and technology, and investments continue apace. We may also see activity returning more quickly in the add-on space if managers have already identified where they want to build on their existing platforms.

Across private equity generally, we expect more minority acquisitions, joint ventures, PIPEs and other such structures that allow firms to put capital to work, address liquidity issues in a target and get closer to a management team despite the misalignment around valuations. There is increasing creativity around how deals are structured, using the opportunities that exist today to create a base to do something larger down the line. Ultimately, this market represents a big opportunity for private equity because everyone believes valuations will eventually come down.

AS: What would have been thought of as non-traditional opportunities may now supplant traditional investment strategies. We expect more hybrid capital transactions to account for the fact that cash-strapped companies do not want to sell equity at rock-bottom prices and may have run out of covenant room, while lenders may have liquidity issues themselves. There is an opportunity for investors to play a leading role in preferred stock deals and for preferred equity to become its own distinct asset class.

We have seen exponential growth in the credit markets in the last decade, direct lenders have permanent capital behind them and the assets under management in the private capital space are now much greater. Because this crisis is borne of a pandemic rather than a misallocation of capital, there are opportunistic funds that see this as a good opportunity, and some experienced credit professionals that want to make investments rather than pull back.

Q What is happening with deal terms and covenants?

AS: There has been a tightening of terms to provide for less risky deal structures – we are seeing lower leverage levels, high minimum equity requirements and increased pricing to the tune of several hundred basis points. We are also occasionally seeing lower tenures of 4-5 years rather than 6-7 years, and some European financing features that are less borrower friendly coming into US deals, such as anti-cash hoarding provisions. In general, this has been a time of collaborative relationships around financial covenants and relief, with borrowers and lenders implementing constructive solutions.

Q Is there growing interest in distressed situations in the mid-market?

> *"There is increasing creativity around how deals are structured"*
>
> **Michael Fieweger**

MF: We are starting to see more distressed opportunities coming to market and we are working on bids for companies that are in bankruptcy where investors are interested in those opportunities. It is difficult for mid-market funds to become credible players in those expedited processes if they have not been there before. Assuming you can find a lender willing to take on the risk, it is challenging to get lenders up to speed in this environment in time to put forward a fully-financed bid.

AS: In the context of syndicated deals, there are additional layers of complication that come with new deal activity or refinancing considerations, because in addition to the upfront diligence that needs to be done there is all the thinking that needs to go into who is going to want it and who is going to be willing to commit upfront to an instrument when they know they can snap it up cheaper in the secondary market. A lot of the activity we are seeing is more in the direct lending space and less in the syndicated environment in terms of potential new deals. ■

Michael Fieweger is chairman of the North American private equity practice and Andrew Sagor is co-chairman of the North American leveraged finance practice at Baker McKenzie