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The Great Stay-In (Last of a Series)

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As we wrap up our multi-part series on the COVID-19 crisis, we turn our attention to the path ahead, as unclear as that is. Or as one economist put it succinctly: “Anyone who thinks we’re going to keep moving up in a straight line is living in La-La Land.”

The good news is that the first phase of the crisis is passing. Markets have fully absorbed the initial shock wave of America stuck at home, and its impact on commercial activity. That is generally reflected in public asset valuations.

The emotional discount in secondary loan trading last month has shrunk. Credit investors are left with higher prices, though fewer bargains. What are the revenue and earnings assumptions behind those new values, we wonder?

Credit managers now have a ring-side seat to deteriorating borrower performance and the issuer-friendly terms characteristic of prior-cycle buyout financings. Expect those dynamics to change.

The absence of maintenance financial tests in the vast majority of BSL loans (82% per S&P/LCD) is a major difference between today’s deals and those in 2008 (only 15% cov-lite). Not having a covenant default may relieve an administrative burden, but how will its absence affect future loan recoveries?

In the direct lending market, the highly leveraged unitranche, while a competitive advantage versus the syndicated bank deal, looks riskier in light of COVID-19 adjusted EBITDA (i.e. EBITDAC). Expect new world beneficiaries to include junior capital providers, and senior lenders with lower leverage attachment points.

In the last cycle, we characterized direct lenders expanding their hold levels as an arms race. That’s on hold. Leading credit managers are witnessing the downside of large commitments, particularly hitherto undrawn revolving credits.

As portfolio companies are stabilized, sponsors and lenders can consider new business. This falls into three categories: companies that were challenged before COVID, businesses in the coronavirus cross-hairs, and those less impacted by the pandemic.

Sorting through rescue financings, new platforms, and add-on acquisitions, it’s still early in the virus cycle to pick winners and losers. Credit and equity players are certain to leverage their operating experience to identify survivors of this paradigm shift in how we do business.

Given infection rates, how long will investors wait for America to go back to work? As one observer noted, with so much money raised by private equity and credit, “the incentives to transact will overcome any instinct to sit on the sidelines.”

We also expect reverberations of this crisis to continue well beyond easing of the biological threat. Indeed, socio-economic consequences could last for years, with this investment vintage possibly the best in a decade.