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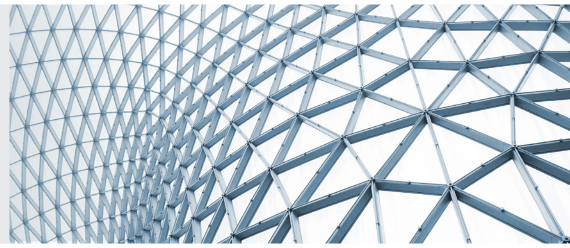

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Lenders should look beyond covenants for downside protection

While the eyes of many are on loan documentation, Nicole Downer of MV Credit says the focus should be elsewhere, including fostering solid relationships with sponsors.

Key Takeaways:

- Lenders are unlikely to be able to use covenants to force private equity sponsors to inject new money into a company.
- The global financial crisis in 2008/9 underlined that credit selection is key to minimising the risk of default in the event of a downturn.
- Downside protection is more likely to be achieved by investing in creditworthy companies and working with the right sponsors.

At the turn of the year, discussion of a looming and significant downturn in the global economy was already commonplace among economists, traders and money managers from financial institutions large and small. However, the form it is now likely to take, shaped by a pandemic with truly global reach, was forecast by no one, and many industries are facing challenges on a scale and structure never experienced before.

The protracted shutdown of significant portions of economies as a consequence of covid-19 is perhaps the most unprecedented element of the crisis, and after more than a decade of strong growth for the likes of the private equity industry, many asset owners suddenly find themselves fighting to keep their portfolios afloat. It is in times like these that it becomes clear which investment strategies are resilient and which are exposed to market conditions and cyclicality.

As a result of business fragility not seen since the depths of the global financial crisis, when many traditional lenders pulled back, a growing number of reports suggest there are demands across the private debt industry for more 'lender-friendly' documentation.

In light of this, it's a pertinent time to look at covenant arrangements and stress that, despite common perceptions and

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even in the exceptional context of a crisis such as the current one, they do not give back control to lenders.

'Lender-friendly' documentation is no silver bullet

Let's take a closer look at these risks. Many lenders to small and medium-sized companies in particular will be wary of the current heightened risk and will already be executing plans to shelter their own LPs from significant potential downside. However, lenders cannot shield themselves with covenants alone through times like these.

Over-reliance on covenants can lull a manager into a false sense of security.

There is, for example, a misconception that lenders can force private equity sponsors to inject new money into a company as a result of covenants, but this is often unlikely to be the case. Firstly, there can be a lack of visibility on the part of the lenders if there is no liquidity issue;

and secondly, sponsors may feel that the lenders could take the business away.

As we have seen in previous cycles such as during the GFC, sponsors or shareholders typically request 'covenant holidays' for a specific time to assess the situation where there are no strong liquidity pressures. In our experience, for some of these companies, the waiver/ reset was sufficient to allow them breathing room through the GFC and to eventual recovery. The remaining companies required further restructuring. Additionally, given the unprecedented circumstances, an unnecessary amount of technical covenant waivers adds an administrative burden and could distract from managing the portfolio.

The restructurings will always depend on the specific needs of each business and may include a variety of options, such as a sponsor injecting new money in exchange for limited concessions from the group of lenders (for example, capitalisation of interest or payment in kind) or more severe restructurings requiring a rearrangement of existing debt facilities in order to accommodate new money. In our experience, most restructuring solutions involve working with the other lenders and private equity sponsors to formulate a plan to assist the company.

Strong relationships go further than legal frameworks

Instead of the discussion on covenants, we believe in paying attention to conservative investment standards. Originating good credits and implementing downside protection can ultimately be done by investing in creditworthy companies and working with the right sponsors which are adequately incentivised to support their portfolio companies.

It is in times of crisis when decisions can be hot-headed, and the risk of knee-jerk reactions increases. However, the very nature of private capital investments (both equity and debt) allows investors to have a long-term view and focus on the resilience of strong businesses as well as the opportunities that may arise once the crisis has passed its peak. If a business is fundamentally sound, then a good sponsor and lender will not let it fail. We are seeing this across our portfolio as our relationship sponsors adopt a 'whatever it takes' approach.

In preserving such market standards, the importance of understanding the private equity industry and safeguarding the relationship it has built with private debt providers over the last couple of decades should not be underestimated. For example, through healthy and collaborative relationships with private equity sponsors, firms can negotiate strong reporting packages and undertakings to strengthen invaluable monitoring capabilities. We see these as long-term relationships that will continue to grow for years to come.

Our experience in the GFC underlined that credit selection is key to minimising the risk of default in the event of a downturn. Therefore, rather than requesting control through financial covenants, investors' key focus should be an investment strategy rooted in strong due diligence which identifies good partners and best-in-class investment monitoring. At MV Credit, we target sponsored upper mid-cap companies (EBITDA €30 million to €100 million) which have pan-European or even globally diversified revenue streams and are therefore more resilient to external shocks than small-cap companies which are regional in nature.

Industry selection is also key to a company's performance, with some sectors proving more resilient and secure over the course of multiple economic cycles. We believe that industries such as healthcare and subscription-based services sectors generally prove more stable than sectors that are highly seasonal, technology-driven or trend-related, such as chemicals, media and sports clubs. Defensive industries generally provide better protection for investors in the event of a downturn.

From the private debt perspective, the focus should be capital preservation. Even the best documentation and structure cannot make up for a bad credit. A fund's investment strategy (such as a focus on non-cyclical industries in the upper mid-cap) and loan documentation should consistently be reviewed in anticipation of economic cyclicality, whether in an up or down market, not in reaction to ongoing events. The right approach to investing is strong origination, active monitoring and partnering with the right private equity sponsor.

Written on July 2020

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