MV|Credit

# Experienced Managers with A Dose Of "Healthy Paranoia" Will Thrive in the Post-Covid Downturn

## KEY HIGHLIGHTS

- The Covid-19 crisis has triggered a downturn, bringing challenges that experienced managers can overcome with strict investment discipline, partnering with private equity sponsors and active monitoring of credits.
- Highly opportunistic distressed credit strategies may not offer the stable, consistent returns that other credit strategies, such as subordinated credit, can offer.
- Experienced managers focused on non-distressed credit will continue to originate strong transactions for credits in the secondary and primary market.
- Evidence following the Great Financial Crisis ("GFC") can help anticipate what could happen after the current downturn. We expect a more lender-friendly environment with attractive yields, ESG opportunities and strong credit opportunities.

## INTRODUCTION

Since the Covid-19 disease became a pandemic and measures were taken around the world to mitigate its impact, many countries have entered a recession. A greater number of defaults and financial restructurings are likely results. Against this background, attention has turned to the challenges facing private credit managers.

Private credit is certainly a different space compared what it was during the GFC. It has since moved from being specialist and niche to a more established and important component of a diversified investment portfolio. This growth has seen greater commitments to private corporate credit, greater AUM, more opportunities for direct lenders and other non-bank institutional investors, and the establishment of new products and strategies untested by a downturn such as unitranche.

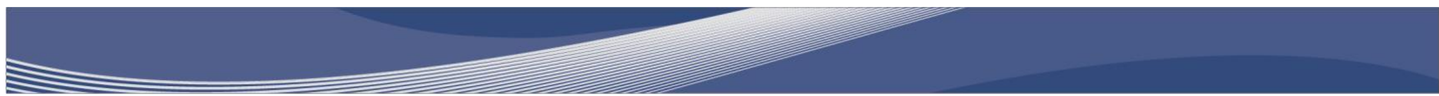
Drawing on our 20 years of experience, we will discuss how managers can take advantage of opportunities and mitigate risks during the downturn. We will explore which strategies are most likely to provide attractive risk-adjusted returns and why now is a particularly attractive time to invest in private credit.

## HOW MANAGERS CAN ADDRESS THE CHALLENGES OF THE DOWNTURN

***Credit Selection is Critical***

Managers should adopt an approach of "healthy paranoia" at all times and ensure selectivity and caution when originating opportunities.

Some industries prove more resilient over the different stages of the credit cycle. For example, healthcare and subscription-based services generally prove more stable than highly cyclical or trend-related industries, such as fashion retail, automotive and leisure and travel. A key lesson we learnt from investing during the GFC was to avoid industries such as household durables, which are more correlated to economic cycles and cannot sustain the leveraged structures deployed by private equity sponsors in a downturn. We also learnt to avoid businesses in the paper and forest products industry, where exposure to raw material price pressure fluctuations contributed to the underperformance of some of our portfolio companies. In comparison, we have never experienced a loss on a company in the Health Care or Information Technology sectors.



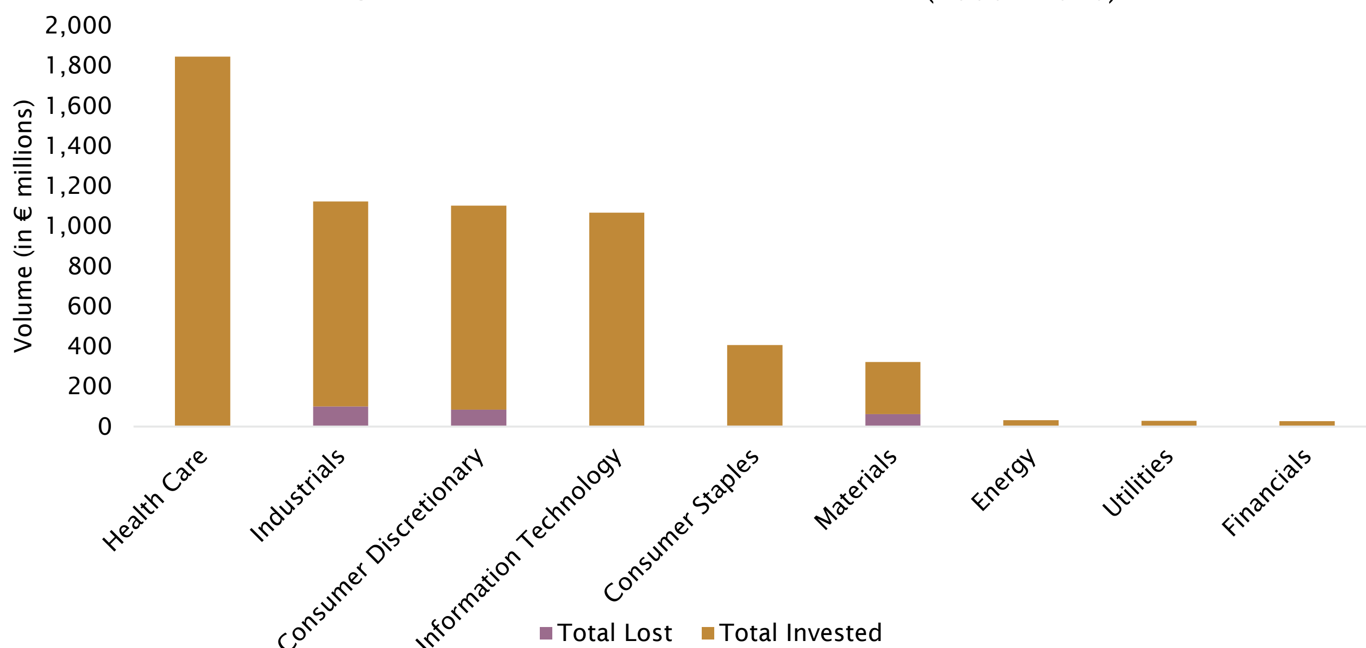



*Figure 1. Source: MV Credit, period between 2000 - 2020. Data as at 30th June 2020 across MV Credit's senior-and subordinated-focused vehicles[1].*

Additionally, we target upper mid-cap companies which typically have lower credit risk than smaller companies. Smaller companies are usually more local or regional in nature and can have revenue streams more reliant on a single geography or single product. Higher revenue diversification and larger scale make borrowers less sensitive to external shocks (such as the Covid-19 pandemic). This would suggest that strategies targeting smaller borrowers, such as unitranche, may not necessarily create a defensive and robust portfolio in a downturn.

***Ensuring Further Downside Protection***

Private credit managers can ensure further downside protection by investing in companies sponsored by private equity investors:

- With the appropriate private equity partner, sponsors can be relied on to manage borrower companies and may be preferable to family-owned businesses, particularly in a stressed environment.
- Private equity sponsors are typically able to reinforce or change a management team to reflect the challenge that a business faces during difficult times. We believe this option is unavailable in a family-owned business where the owners and management are sometimes the person or related.
- The support of private equity sponsors can therefore be crucial to achieving a recovery on an underperforming business. We saw examples of this during the GFC, where some sponsors took supportive steps for underperforming companies such as injecting new equity and even completing credit buy-backs to reduce borrower companies' leverage.

***Monitoring and Proactive Management is Key***

In our experience, private credit managers with strong monitoring processes can usually spot when a borrower company is underperforming by looking out for early warning signals. We have an additional, dedicated and impartial Credit Monitoring Team that systematically reviews and monitors each investment alongside the Deal Team. This ensures that we can proactively address and make decisions concerning troubled credits early, which usually involves triggering a conversation with the private equity sponsor. Looking back on our portfolio during the GFC, on several occasions we initiated conversations with sponsors of companies which went onto underperform; helping us to minimise risk-adjusted losses by taking action early.

## THE PITFALLS OF DISTRESSED CREDIT DURING THE DOWNTURN

As investors seek attractive opportunities to time this moment in the cycle, they may look to opportunistic strategies such as distressed credit. However, we believe that distressed lending has its limitations.

Setting aside the significant ESG concerns with distressed credit managers' investment strategy (which can be viewed as more confrontational towards stakeholders than collaborative with them, and as potentially adding challenges to borrower

companies in a period of stress), there may be factors negatively impacting their performance. Following the last downturn, private equity sponsors restricted transfers to distressed private credit funds[2], which may limit the opportunities available to distressed funds, even in a downturn.

Additionally, distressed buyers may invest in more cyclical industries such as hospitality, retail and automotive, as the current downturn has negatively impacted these industries. However, we believe that this downturn and the Covid-19 crisis may dramatically change the business models of such industries, potentially over the long term. This makes distress lenders' investments not comparable on a like-for-like and risk adjusted basis with traditional private credit lending strategies

Finally, subordinated credit funds outperformed distressed credit funds 60% of the time between 2003 and 2017, and their returns were less volatile. Admittedly, distressed credit was higher yielding and slightly less volatile in 2008 (although more volatile in 2007 and 2009, and lower yielding in 2007). Distressed credit is a highly opportunistic asset class and tends to offer less favourable risk-adjusted returns compared to subordinated credit, apart from the odd vintage. Timing this vintage will be crucial to making an attractive investment in distressed credit, but we believe it is impossible for a private credit manager to time the cycle.

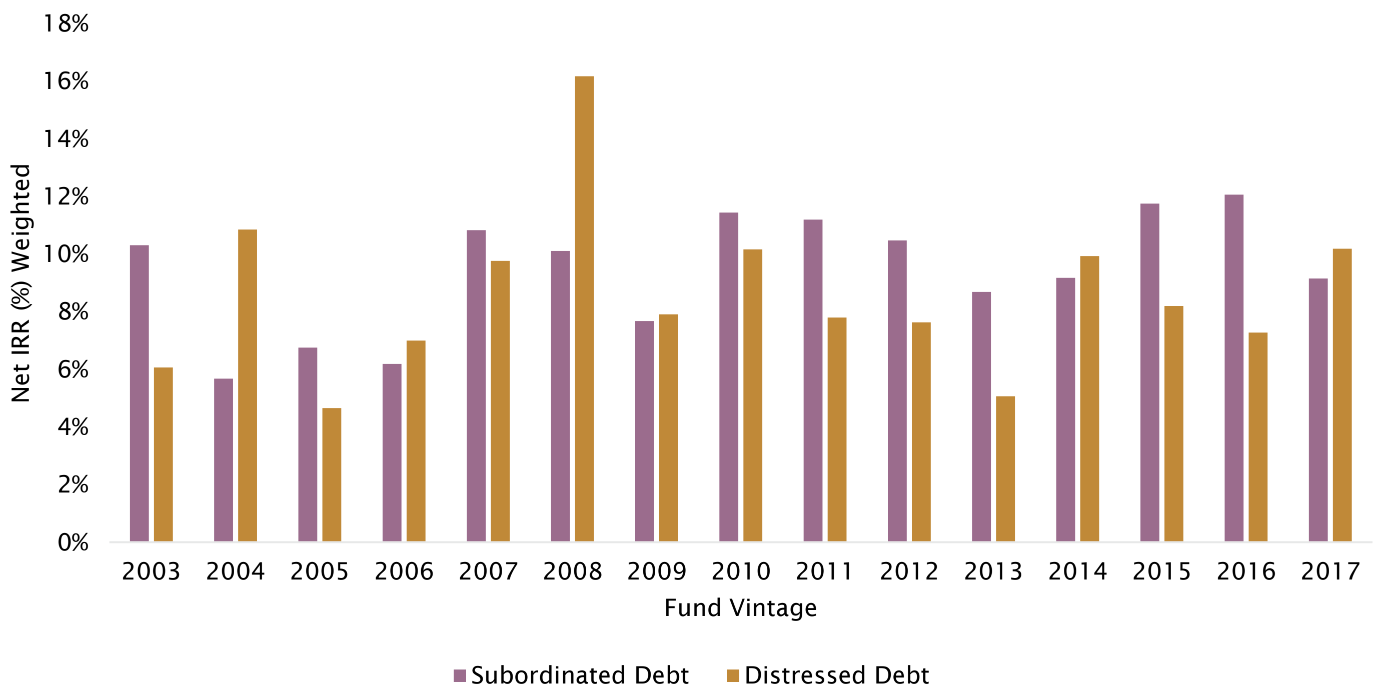



*Figure 2. Source: Preqin. Subordinated Debt universe consists of Global Mezzanine with vintages 2003 - 2017. Performance for funds with vintage year 2018 - 2019 not yet available. Data retrieved 28th July 2020.*

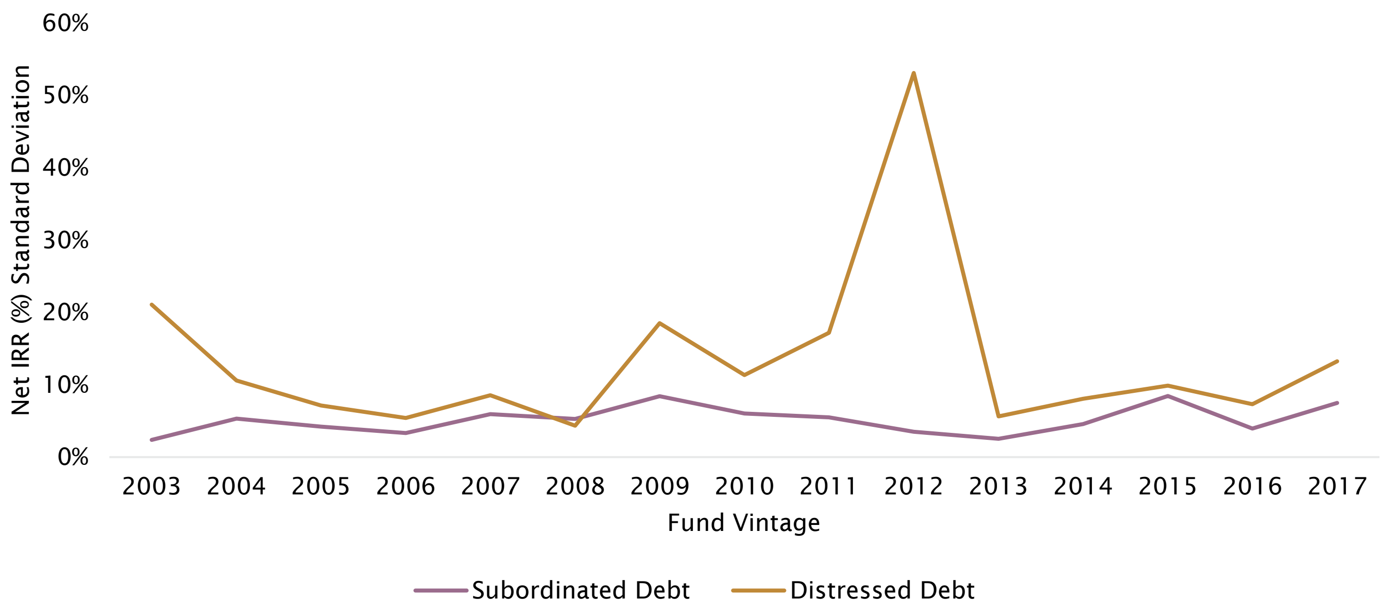



*Figure 3. Source: Preqin. Subordinated Debt universe consists of Global Mezzanine with vintages 2003 - 2017. Standard deviation for funds with vintage year 2018 - 2019 not yet available. Data retrieved 28th July 2020.*

## SOURCING ATTRACTIVE OPPORTUNITIES: PRIVATE CREDIT MANAGERS IN A DOWNTURN

Investors do not need to commit to distressed credit managers to take advantage of private credit opportunities during a downturn. Admittedly during a downturn, volume and issuance of loans initially decreases, with M&A activity subdued during the initial period of uncertainty (Figure 4). However, a good private credit manager can leverage existing relationships to create their own opportunities. For example, we have originated and closed attractive investments, both on the primary and secondary market, during times of market distress (including the Covid-19 crisis).

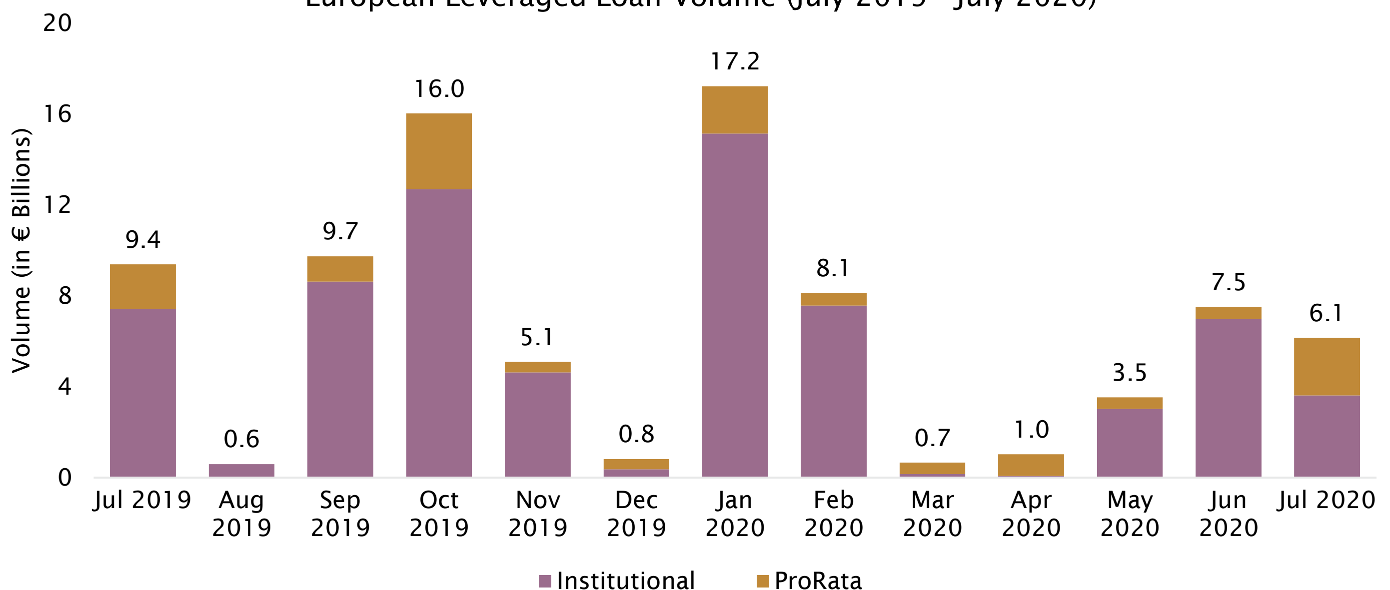



*Figure 4. Source: LCD, an offering of S&P Global Market Intelligence. Data retrieved 28th July 2020.*

***Discounted Secondary Market***

The average bid price for the leveraged loans in the ELLI took a sharp nosedive in Q1 2020, falling to 78.92 in March 2020 before rebounding somewhat[3]. However, we were able to commit to a number of high-quality investments at attractive

yields on the secondary market. Experienced managers with a focused database of credits are in a particularly strong position, as they have tracked some companies for years. For example, our co-mingled senior-focused vehicle is committed to senior-secured assets in 7 high conviction, well-known companies, which were originated at discounted prices on the secondary market[4].

***Relationship-Led Primary Market***

Private credit managers with a reputation for being reliable and constructive during the credit structuring process are still able to originate attractive investments. Also important are strong relationships with private equity sponsors. Examples of opportunities we have seen since Q2 2020 include restructuring failed syndications which were not launched due to the Covid-19 crisis and top-up financing to support potential expansion or partial dividend recapitalisations. We have recently been able to offer bespoke financing to support the refinancing of an upper mid-cap subscription-based business. Since March 2020 we have committed to 5[5] new portfolio companies on the primary market, with these companies offering attractive yields in stable sectors, sponsored by reputable private equity investors.

## LOOKING AHEAD: RESET CREDIT CYCLE

***Evidence from the Last Crisis***

Following a downturn, the credit cycle enters a period of repair and recovery. After the GFC, demand amongst private credit managers for new credits rose slowly and MV Credit expects a similar trend following the current downturn.

This period was marked by better economics which drove attractive returns for private credit, with 2008 vintages notable for their high returns (Figure 5). Whilst this data is for global private credit funds, we expect European funds to follow a similar trend. We believe that 2020/2021 vintages will also be high returning in a similarly favourable environment.

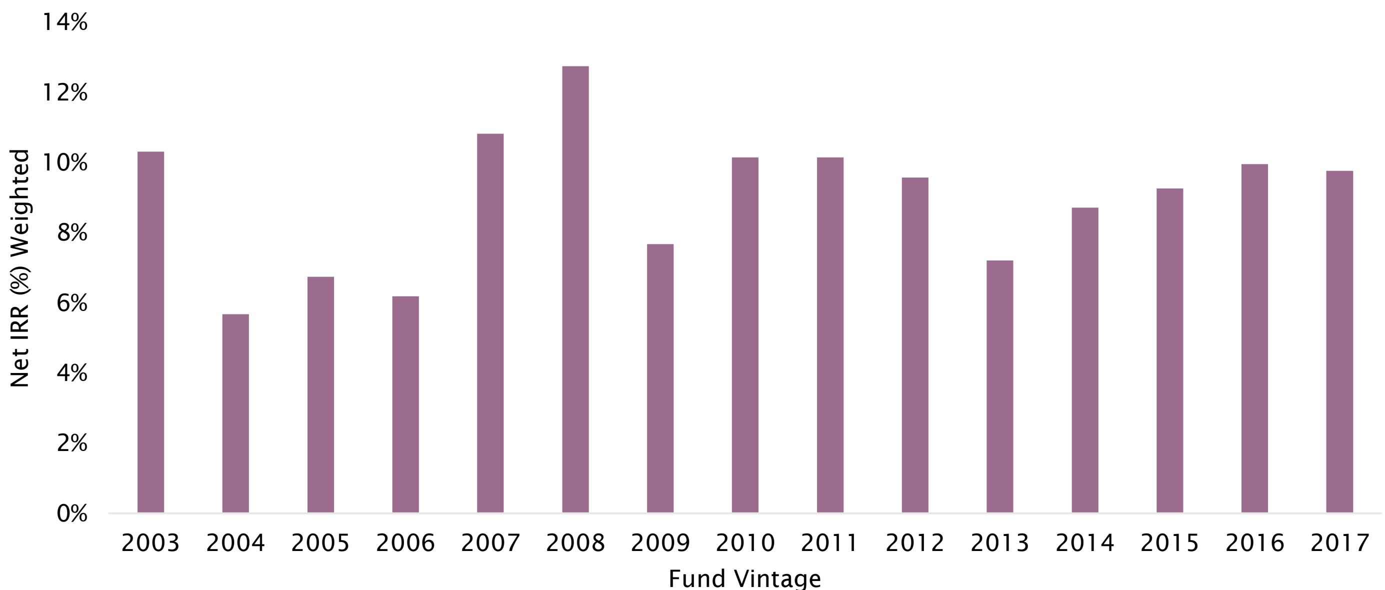



*Figure 5. Source: Preqin. Universe consists of Global Mezzanine and Direct Lending funds with vintages 2003 - 2017. Performance for funds with vintage year 2018 - 2019 not yet available. Data retrieved 28th July 2020.*[6]

***Opportunities for Private Credit Lenders***

Despite a downturn presenting challenges for private credit managers, new investments are expected to generate higher yields, with more favourable lending terms and in credits that will be reviewed against a "post-Covid" economic environment. Coming out of the downturn, we expect the strongest credits to come to market first with portfolios that invest in cyclical industries struggling and assets in more cyclical industries likely to have trouble sourcing financing.

Lenders may gain improved positions when making investments and may gain more information rights and other documentation rights (such as reducing cash leakage). ESG will likely remain an important consideration for private credit managers, with ESG alignment key to securing returns. Borrower companies that are found lacking in ESG can pose a risk to returns if their business model is unsustainable. Over time, we expect this to become more formalised, with a more lender-friendly environment potentially supporting a push by managers.

## CONCLUSION

We believe that now is a particularly attractive time to invest in private credit to secure attractive risk-adjusted returns. The best managers can draw on significant investment experience across cycles and aim to build and pro-actively manage resilient portfolios.

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1 Figure 1: Past performance is not indicative of future results and there can be no assurance that any historical trends will continue. The sectors shown are those through which MV Credit funds have invested. Losses and defaults refer to losses experienced by MV Credit funds. Sector classifications are defined by MV Credit. Losses are defined as realised investments which achieved TVPI of less than 1x, calculated as total distributed minus total invested.
2 Source: https://uk.reuters.com/article/sponsors-restrict-loan-sales-in-private-idUKL8N29E35W
3 Source: LCD, an offering of S&P Global Market Intelligence; S&P European Leveraged Loan Index. Data retrieved 28th July 2020.
4 Source: MV Credit propriety data, as at 28th July 2020.
5 Source: MV Credit propriety data, as at 28th July 2020.
6 Figure 5: Performance data shown represents past performance and is no guarantee of, and not necessarily indicative of future results.

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