Defining “New Normal” in Private Credit Markets

Author

There is no doubt that COVID-19 and the volatility in the publicly traded markets have captivated everyone’s attention in recent months. Private credit markets are similarly dealing with unprecedented dynamics. This article reviews the historic magnitude of the dislocation and what might be in store for the future.

Dislocation in Credit Markets

Although public markets function separately from the private markets, they act as an important barometer. First, they reflect investor sentiment and risk appetite. Secondly, they influence pricing on the private side and function as reliable indicators of new loan issuance. We have observed some common trends such as the widening in spreads and pricing and the deceleration in new issuance. The private-debt market tends to “lag” the liquid market in terms of pricing; however, this time private-market spreads reacted more rapidly.

From the borrowers’ side, companies will have to tap into their lines of credit to meet their financial obligations as they focus on maintaining liquidity. In addition, most companies are drawing on credit revolvers and unfunded terms loans. In this context, we are comfortable regarding our ability to fund these requests given that we had entered the new year conservatively positioned with unfunded capital commitments from our investors

Effect in Private Debt Portfolios and Opportunity Set

COVID 19’s impact on businesses and industries will differ significantly. We believe private debt portfolios should be assessed on that basis.

As we head into an uncertain time, we continue to see a few bright spots in addition to new potential areas of investment.

Hung Deals

When financing packages are underwritten by banks, lead arrangers bear the risk of funding the full amount of the deal. In practice, they end up selling their committed amounts to other participants and ultimately hold a smaller amount on their balance sheet. In a “normal” market, the syndication process is agreed upon prior to deal funding; however, we expect that banks might potentially get “hung” on deals because of market participants backing away. As of the initial publishing of this article, we estimated that there were roughly $25 billion of hung commitments on bank balance sheets. Banks have strict risk-weighted asset limitation and to offload their risk they could be willing to negotiate terms of their deals. We can often achieve very attractive upfront economics in the form of Original Issue Discount.

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Liquidity Bridges

Many middle-market companies have viable businesses that will likely be able to resume once the economy reopens. Those companies owned by sponsors are evaluating liquidity bridges, which are short-term secured financings to alleviate short-term liquidity challenges. We find these opportunities to be particularly attractive in terms of pricing with the potential for additional upside via warrants. These deals are typically structured favourably with seniority ahead of existing debt.

Opportunistic M&A Financing

Lastly, many of our existing portfolio companies are seeking to take advantage of the dislocation to buy companies which they believe to be undervalued. In addition, we are beginning to see the new deal M&A market open up slowly. For us, this is an opportunity to refinance the entire debt stack at higher yields and with more lender-friendly documentation.

How Will This Change Direct Lending?

No one knows for sure how much our industry will change because of COVID-19. Below is a summary of certain dynamics which we are experiencing or expect to observe.

1. **Better Terms:** as companies approach creditors to seek amendments or relief on certain terms in its credit agreement, lenders have the opportunity to request certain credit enhancements in exchange such as more prevalent financial maintenance covenants, tight cushions to performance projections, or restricted payments to equity owners.
2. **Better Pricing:** over the course of 2019, much of the illiquidity premium associated with middle-market deals had eroded with frothiness in the market. We expect that this will now normalize. Based on information from SPP Capital Partners[1], unitranche pricing on directly originated loans for issuers with >$20 million in EBITDA ranged from L+600 to L+800 vs L+500 to L+650 from the previous month.
3. **Less aggressive leverage:** tolerance for leverage among lenders has decreased. as of 5/31/20, the he market had brought the Debt/EBITDA multiple for issuers with >$20 million in EBITDA to a range of 4.0x to 5.0x vs 4.5x to 6.0x compared to the previous month[2].
4. **Industry Focus:** there continue to be several industries, such as energy-related businesses, that we might completely avoid.

About BSP

Benefit Street Partners L.L.C. (“BSP”) is a leading credit-focused alternative asset management firm with over $28 billion in assets under management as of August 31, 2020. BSP is a wholly owned subsidiary of Franklin Templeton.

FOOTNOTE

1 Source: SPP Capital Partners. As of May 31, 2020

2 Source: SPP Capital Partners. As of May 31, 2020.

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