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Pandemic Pondering: What's Ahead for the Credit Market

By Christian Kallen, Managing Director | **28 July 2020**

With a global pandemic upending every corner of the financial markets, it is perhaps not surprising that the credit space appears to be at another inflection point. There have been rumblings that we may be at the beginning of a period of compression that could mirror the bank consolidation over the last 30 years.

This time, however, it may happen at warp speed, similar to the rise of the direct lending industry over the last few years. Scale, diversity and access to fresh capital may become essential to survive, and if we were to guess, the already large players will likely play the role of consolidators, strengthening their market positions.

So what do we think will happen? Over the last few years, banks were sideline observers as direct lenders provided leverage to seemingly all the LBOs that the banks – or more accurately, the banks' risk teams – did not want to touch. (Have you ever talked to a risk team at a direct lender?) While everyone likes to talk about the public Business Development Companies (BDCs), they are just the tip of the iceberg and a fraction of the industry. With that being said, the BDC market may be a good leading indicator of what is going to happen to the broader private lending market. While we are only a few months into the pandemic, there already have been some public offerings in the BDC space to fix collateral issues. The private direct lending space, on the other hand, is moving more slowly, potentially signifying challenging times ahead.

The likes of Wells Fargo, Citi, Goldman and Morgan Stanley are mobilizing and keen to get at least some of their money back for the fund leverage provided over the last few years. The one question all LPs should be asking their managers right now is, "How much of the fund leverage is mark-to-market?" as this metric will likely be a driving force in determining the winners and losers in this cycle. For mark-to-market fund leverage, there are typically two kinds of covenants: 1) EBITDA covenants on the underlying companies and 2) covenant relief. For EBITDA covenants, it will likely take two to three quarters before the impact of the pandemic and recession appear in the bottom line; so, while everyone knows it is coming, the banks cannot yet act on it.

In addition, the recovery in the public markets over recent weeks has added additional runway to the direct

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lending industry. At the same time, the second type of covenant relief is already starting to play out, with direct lenders handing out covenant relief as some buyout GPs try to proactively sort out their portfolio companies' balance sheets.

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Taken together, what does this all mean? Whenever a direct lender is granting covenant relief, the bank can revalue that particular asset and ask for more collateral to make up for the mark down (which typically means paying down the revolver by calling capital). Ironically, the direct lenders, who at one point seemingly cared little about covenants and underwrote with few or any, have more time than the more "disciplined" direct lenders.

So what will happen if there is no more capital to be called and the interest yield is not enough to pay down the fund leverage? We are hearing anecdotally that some direct lenders are quietly putting part of their portfolios up for sale. While this will solve the short-term liquidity problem, it may create larger issues down the road. Direct lending is a fairly low margin business, so if the fee income shrinks due to declining AUM and the carry goes out the window (and be prepared for that to happen quickly), how does one continue to pay very expensive originators? On top of this, expenses are increasing as direct lenders have to build out their work-out and asset management capabilities. It's possible that many business models on the smaller end could break down, and the larger direct lenders will be on the sidelines, ready to scoop them up.

Distressed Debt

From a distressed debt point of view, an even larger opportunity may be evolving in the CLO space – with the important caveat that CLOs probably hold some of the least protected and weakest credits in the industry, creating less flexibility for CLO managers than direct lenders to cope with the flood of covenant breaches on the horizon. The CLO market has also grown significantly since the financial crisis, representing more than 60% of loans to sub-investment-grade firms (or approximately $700 billion) today.[1] While the rating agencies are still playing catch up, it seems as though many CLOs have already breached their 7.5% triple-C threshold. When a CLO manager hits this threshold, that manager is not required to sell its downgraded credits, but does have to stop paying the equity, and thus the fee income diminishes.

Time for a quiz.

If a CLO manager has to choose between not getting paid or selling assets on the cheap, what do you think they will do? Bingo! They would sell. This hasn't happened on a large scale yet, as CLOs don't receive too many bids for their triple Cs, and most distressed managers are currently looking for juicier, larger or for-control situations.

But if someone bids, more than likely, CLO managers sell. This leaves the underlying buyout GPs scratching their heads, asking why CLOs are selling some of the position at these prices, and supporting the earlier arguments that CLO managers are not worried about the long-term impact on their portfolio as long as they can get the fees flowing again. One distressed GP was looking at a triple-C rated, first-lien loan to a data center company. The underlying company was solid; it just had a lot of debt (thus the triple-C rating). The distressed GP can create the company at an EV of 6-7x, while such assets trade at 12-14x EBITDA (and data centers are one of the few areas investors are really interested in right now). A more conservative investor would not sell this paper in the low 70s, but some CLOs do. There are a lot of other smaller capital structures out there with good coverage, but as of this writing, volume continues to be stubbornly low.

How Might This Play Out?

While volumes are low for now, CLOs' inability or unwillingness to support the underlying companies with desperately needed fresh capital down the road could likely drive a large rescue financing opportunity. Why? This crisis, unlike the GFC, did not start in the finance sector and this time liquidity is intact, given the Fed's aggressive moves early on, so the pressure to sell positions is muted. On the other hand, history may show that corporate America (and the global economy broadly) probably took its biggest hit on record this year, with shutdowns around the world depleting cash reserves and ballooning liabilities, chipping away at the equity cushion in the process. Equity holders will do whatever they can to keep the lights on, but eventually they'll need fresh capital and to restructure their balance sheets to adapt to the new normal. Their CLO lenders, which represent a large part of the market, are likely not able or willing to provide that fresh capital, as this is likely a triple-C credit. The second-lien lenders below the CLOs may finally realize that their second lien is worth close to, well, nothing, and that they're in the same boat as the equity holders.

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Depending on the industry of the underlying companies and the nature of the cost structures, we are talking months, quarters, or possibly years until they have to act. The question then is whether the "nice guys," e.g., the traditional direct lenders, mezzanine providers, etc., prevail, or the distressed guys buy enough of the first liens beforehand to control the restructuring in order to take home the pot. We've already seen some distressed investors making aggressive moves to take advantage of CLO managers' Achilles heels—a.k.a. loose credit documents — diluting down their positions. It seems as though CLO managers have started crying foul to seek protection, which may be granted if they are going to be considered crucial to the finance system.

While this all sounds exciting for the distressed world, the verdict is still out on whether and when we'll see any notable amount of volume. CLOs, given how they are structured today, won't be forced to sell; however, they will likely sell in order to get back to receiving fees. We don't expect, though, to see the panic sales we saw in '08/'09. Chances are, this cycle may look much more like Europe in the GFC, where the opportunity was more of a trickle, stretched out over a longer period of time, which ultimately muted the performance of distressed debt funds focusing on Europe.

Playbooks from prior recessions may work, but in our view, it's just as likely that they won't, given these truly unchartered waters.

Time and duration is the distressed debt investors' worst enemy, but is moving quickly really the right thing to do -- especially during what is probably the most uncertain backdrop in a lifetime, while also relying heavily on the hope that the government and Fed continue to support the financial system with all their might? We still are only a few months into the pandemic and in the early phase of a recession. Playbooks from prior recessions may work, but, in our view, it's just as likely that they won't given these truly unchartered waters.

In case we haven't seemed precautionary enough, let us leave you with this: "FOMO," or the "fear of missing out" for our less hip audience, is not your friend. And while it may have served you well in hindsight, looking at the performance of trades done in March and April, is it really worth the risk? Either way – and despite not having a crystal ball during this uncertain and unprecedented time – we can observe that a diversified approach to investing has historically served private markets investors well.

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[1]https://www.washingtonpost.com/business/why-leveraged-loans-clos-feed-worries-in-virus-slump/2020/04/06/af9ccfa2-780f-11ea-a311-adb1344719a9_story.html

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