COVID-19 – An opportunity to show the adaptability and strength of the finance market?

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As the world watches the spread of COVID-19 across all continents, global economies are reacting to the impact and trying to foresee eventualities to mitigate the inevitable loss. There are some industries that will undoubtedly be more effected than others, and as with any economic crisis this will have a knock-on effect.

In this article we will consider the impact of COVID-19 on the finance industry and what this could mean for lenders and borrowers. Every downturn also brings opportunities, so we will also be speculating as to where we could see an upturn in the near future, not least because there is definitely enough negative news out there!

Outlook for Private Equity:

The COVID-19 pandemic is continually evolving, and the government advice is being updated as the situation develops. What is clear is that industries such as travel, retail, hospitality and aviation will see an immediate impact, with widespread effects as time goes by. The issues for the private equity industry may be less immediately apparent.

Whilst liquidity is drying up for some industries (see our section on '*Outlook for Banks and impact on debt finance*' below) one sector that hasn't lacked liquidity is the private equity space. According to recent data[1], the private equity industry is sitting on an unprecedented $2 trillion cash pile which has not yet been invested. There has long been talk of excess 'dry powder' in the industry, and in the current climate this is no bad thing.

Private equity firms are being presented with opportunities to invest in distressed assets at a lower than market price. Buyout by a private equity firm can also be a saving grace for failing businesses in the current climate, as ultimately a PE's firm's objective is to make a business profitable and eventually sell it on. There are also many industries which will see a boost in profits due to the sudden change in lifestyle that the global population have been forced to make, such as technology, business services and healthcare. We may not see these deals happen immediately, but private equity firms with significant capital will react to the recent significant market movements and prioritise the search for new investment opportunities in these resilient sectors that are less likely to be affected by COVID-19 after the economy levels out.

Outlook for Banks and impact on debt finance:

On 19 March the Bank of England slashed interest rates to 0.1%, the lowest interest rate in history. Whilst this will undoubtedly be causing alarm (particularly for savers), the slash is intended to encourage borrowing and keep the market buoyant. Due to the sudden and unpredicted nature of COVID-19, many businesses have found

[1] https://www.bloomberg.com/news/articles/2020-03-18/private-equity-has-2-trillion-to-deploy-as-buyout-stocks-emerge

that their revenue streams have dried up overnight. With overhead costs that still need to be met, there will be an urgent need for credit, particularly for SMEs. Such a need has been recognised by the UK government, and the 2020 budget included a “temporary coronavirus business interruption loan scheme” for banks to offer loans of up to £1.2million to support SMEs. In addition to SMEs feeling the impact, those that invest in such businesses will also be feeling the knock-on effects.

For private equity funds whose portfolios are made up of businesses in the retail, leisure and travel industries etc., they will suddenly find that such portfolios are not performing as well as they were pre-COVID-19. Most private equity funds will already have facilities in place for working capital purposes. Since the outbreak of COVID-19 there has been a noticeable increase of borrowers drawing on their credit lines and exercising accordion options. It is likely that in the coming weeks and months that existing financings will also be restructured. Taking the example of private equity funds, if several portfolios are suddenly underperforming, it is likely that any performance covenants included in a financing arrangement will no longer be met. In a situation like this, especially for relationship driven financings, banks will be reaching out to their borrowers to discuss options. Whilst there may be some initial scare mongering around whether lenders will start calling in loans, this is not what we are currently seeing in the market and would not be in a lender’s or borrower’s end goal interests. It is also worth noting that the majority of LMA style loans that private equity funds have in place with lenders will use LIBOR (or the equivalent for the relevant currency) as the base rate for interest, which will inevitably be higher than the Bank of England’s base rate due to factoring in the risk to the lender. As most LIBOR provisions will also include a zero floor, the lenders will be protected from negative interest rates.

Although sometimes seen as cumbersome and restrictive in more profitable times, the banking regulations which have been introduced since 2008 stand in good stead to protect both banks and customers from the same types of losses as were seen in the last recession. Capital adequacy requirements mean that financial institutions are more resilient than they were in 2008, and the write-down and conversion powers that EU regulators have over their financial institutions pursuant to the applicable bail-in legislation means that damaging liabilities can be written off to save a bank from failing.

Depending on each individual bank’s risk appetite, many may be more conservative over the coming months and go into self-preservation mode rather than growth mode. This also opens the door to opportunities for non-bank lenders, such as debt funds, who are not bound by the same protective regulations as financial institutions. Our friends at MV Credit have provided their perspective on the current market:

Outlook for Debt Funds and Non-Bank Lenders:

Market Update

After a strong start to 2020 (with both record low yields and allocations), we are now experiencing levels of volatility not seen since the Great Financial Crisis (“GFC”) driven by several factors including: i) overall market sentiment as a result of COVID-19, ii) a deterioration in the oil price and the resulting effects on public markets, and iii) a reduction in the base rate imposed by various central banks.

As a result, new primary transactions have temporarily been paused as underwriting banks are reducing their balance sheet risk and focussing on maintaining liquidity, with further tightening from corporate borrowers looking to draw down their revolving credit lines for working capital purposes. For example, press articles recently highlighted that Blackstone and Carlyle have directed portfolio companies to fully draw their lines in preparation for a prolonged economic slump.

The secondary market has seen a lot of activity (both forced sellers and opportunistic buyers) as the European Leveraged Loan Index ("ELLI") has dropped 15.2% (as at 18th March 2020) since the start of the year (many have called it a "bloodbath"). The resulting impact of depressed pricing has led to attractive all-in yields for high quality assets. Managers are actively monitoring the secondary market to execute across the capital structure (senior and subordinated).

Given current market conditions, private debt funds are working hard to assess the impact on their portfolio companies. This includes analysing the effects on revenues, raw materials, supply chain, customers, logistics, working capital, liquidity and potential covenant headroom.

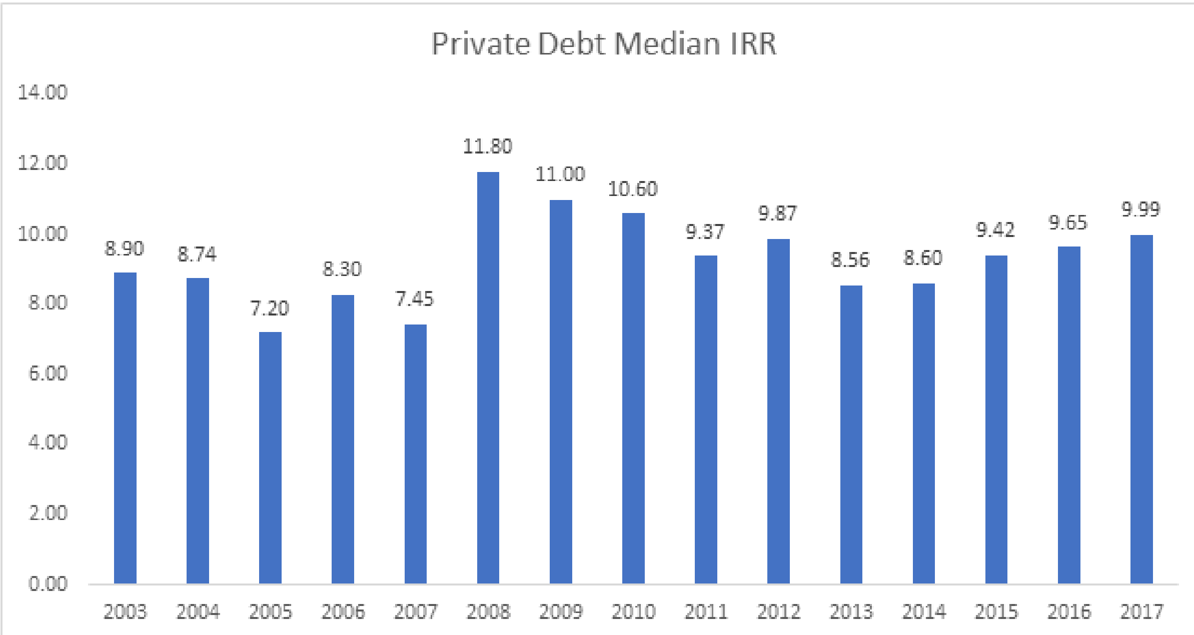
Private debt investing through a crisis

Equity markets collapsed on both sides of the Atlantic this week as the FTSE 100 fell 33.2% (YTD as at 18th March 2020) and the S&P 500 stumbled 26.4% over the same period. An investor in public markets (both debt and equity) would currently be sitting on heavy losses owing to the mark-to-market nature of their portfolios.

Private capital offers some respite from such market volatility as funds are typically marked-to-model (i.e. driven by fundamentals rather than investor sentiment). In the case of private debt, loans to companies that are fundamentally sound are held around par and not marked down due to market conditions which don't have a major impact of the performance of the company and are outside their control. This is particularly valuable in market conditions such as this where good assets are marked down leaving investors suffering unrealised losses.

For example, some CLO investors may be forced to exit (at potentially unattractive prices) assets due to restrictive covenants that require them to have a minimum WARF ("weighted average rating factor") across the portfolio (assets may experience stress but not be at risk of default). This provides further opportunities for investors (such as private debt funds) to step in with patient capital happy to wait until assets repay or return to par. A long time horizon can both smooth volatility and enhance returns.

Vintages that launched during 2008-2009 performed remarkably well, capitalising on the dislocation in the market. Please see below for median private debt returns per vintage based on IRR.



Source: Preqin, global private debt funds, 2003-2017 vintages, (808 constituents)[2]

In addition, the private debt market has been overheated as record amounts of cash has poured in over the last few years. A crisis of this magnitude should cause the power dynamic to shift back towards private debt funds as stricter covenants and wider pricing can be demanded to fund a market where players have pulled back.

Last week Houlihan Lokey's debt advisory team surveyed debt funds to gauge their ability to deploy capital given the macroeconomic environment. The survey categorised lenders into the following categories: those open for business; those very strongly focussed on relative value of public market investments who are very cautious in making new investments; and those who are not making any new investments. The groups were split 30/50/20 according to Debtwire. It is important to stay relevant and remain flexible with existing borrowers (i.e. offering the ability to PIK interest payments if necessary), particularly in a time of crisis.

Private debt can offer a safe harbour in a volatile environment, offering stable and consistent risk-adjusted returns over the long term in comparison to other asset classes.

Conclusion:

In summary, whilst there is a lot of information and news out there which can cause panic in the market, there is also hope that this is a short-term crisis. The world has learnt lessons from 2008 and the sensible approach

[2] Performance data shown represents past performance and is no guarantee of, and not necessarily indicative of future performance.

now is to look at a longer-term view and work towards recovery. There will undoubtedly be large losses and months of uncertainty, but there are also opportunities for all players in the financial market to re-group, strategize, and get back out there!

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