FOCAL POINT |

Will Private Debt in the Middle Market Return to the "Old Normal"?

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Business contingency preparation has taken a heightened priority position during the first quarter of 2020 due to Covid-19 outbreak. There is now a plethora of webinars, free tools and check-ins focused on aiding and solidifying communication channels and effective financial & operational support networks. Covid-19 aside, many companies do not have contingency planning structures, comprehensive models and response teams at-the-ready. To make contingency plans come to life, several operational questions should be part of "New Normal" reporting.

Portfolio managers and Private Equity (PE) investors must be in synchronicity with a reporting infrastructure in place that ties operational metrics, key trends, and management actions to financial flash reports – providing consistent, timely information flowing from CXOs to PE funders in monthly reporting packages. Within the reporting, comprehensive planning models incorporating more dire variables should begin to be considered more frequently and with more conviction.

Some scenarios to run include:

- What if 30% of your current top line was in jeopardy due to a rapid technology change or wide adoption?
- What if your revenue forecast stream from new products and services had to be shelved for 90 or even 180 days?
- What if cash conversion went the other way and you went from industry standard to a 25% increase in days sales outstanding (DSO) or days inventory outstanding (DIO)?
- What if you had to double the funding of a new product and service launch to take advantage of a trend transforming the industry faster than expected?
- What if high priority strategies (such as customer engagement, human capital or digitalization transformations) had to be course-corrected during implementation and new funding added?

These are issues that come up in the important Year One and Year Two ownership timeframes for PE-backed middle market companies. By this point in the investment timeline, the reporting and optics must be clean. The contingency planning plays and value creation maneuvers in a fiscal year must be exhaustively scrutinized, and most of all, funded. The investment structure and the revenue & cash streams need to be defined and predictable within agreed risk control parameters. The balance of funding plays and ideas (thus contingency) come from the debt stack and growth equity.

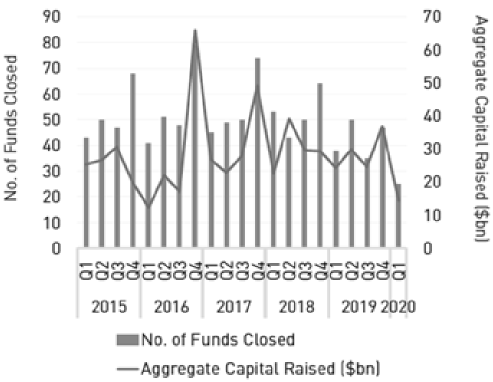
In the current economy, private debt issuers and growth equity providers have both a supply question and a demand quality plus underwriting component to deal with right now.

The post-2008 economic meltdown created some safeguards along with a whole class of non-bank lenders who will take on the unitranche and mezzanine needs of the buyout community for most middle market and upper middle market deals. Their Limited Partners (LPs) may not be in a position (in the immediate future) to continue to be the backbone of the funds as the insurance industry, asset management firms and family office funders may take a pause. That would be detrimental to new deals as lenders focus on working to stabilize existing borrowers to avoid defaults.

Depending on the health of credit funds' portfolios, this raises the following questions:

- Will credit funds build some workout or operations improvement infrastructure as their direct portfolio increases in size?
- How long will they be able to tolerate weaker returns, loan extensions and unsure streams even after Covid-19 health protocols?

Fig. 1: Global Quarterly Private Debt Fundraising, Q1 2015 - Q1 2020



Source: Preqin Pro

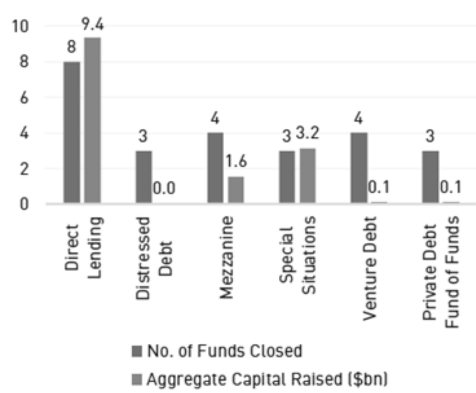
The current capital environment has been challenging for private debt fund managers. The total capital raised in Q1 2020 was 41% lower than in Q1 2019 (1). High-yield debt and syndicated loan providers have also pared their bank offerings as the pandemic expanded and would not suggest a lack of liquidity, but perhaps, a lack of appetite for the lower part of the debt stack (2).

Increase in yields will attract just so much capital in a time of uncertainty at the macro level and questionable executive leadership and decision-making within the company level.

Questions around possible capital scenarios include:

- Will this lower quality junior debt, masquerading as unitranche and mezzanine, default in a downturn?
- Will a new capital structure with more equity be needed?
- Will the credit markets tighten as lenders and credit funds assess risk in today's market?
- Will there be much more scrutiny in deal underwriting and at what cost to the borrower, when funds are available?
- How will the credit funds react as highly leveraged deals completed in the last several years break covenants?

Fig. 2: Private Debt Fundraising in Q1 2020 by Fund Type



Source: Preqin Pro

This may be the time for valuation correction and realization - precipitated by times of crisis or just over levered firms running out of runway. Furthermore, the current crisis may expose the gap that not enough experienced executive leadership exists to make the marriage of overleverage and internal rate of return (IRR) come together as it has in buyouts. LPs providing the capital funds may create new thresholds, demand greater reporting on cash positions, expect more substantive contingency planning playbooks with more complex business modeling, or simply underwrite to changing markets.

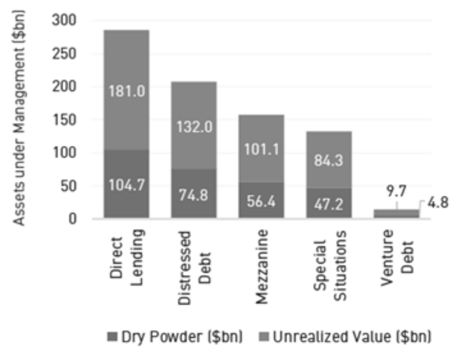
In addition, LPs may, for a period of time, be forced to slow new capital coming into the market due to overall shrinkage in public valuations, thus causing the relative share of PE allocation in their portfolios to increase due to the lag in mark-to-market by General Partners (GPs).

Ultimately, cash flow management at the portfolio company level is expected to become of paramount importance.

A few capital questions springing to mind include:

- Will predatory lending become a significant factor in the market?
- How will distressed debt and special situation funds take advantage of this downturn?
- How will LPs deal with capital calls exceeding distributions?

Fig. 3: Private Debt: Assets under Management by Fund Type



Source: Preqin Pro. Data as of June 2019

There's no going back to the "Old Normal". This crisis will undoubtedly bring into focus some of the issues lenders have had over the last several years of "covenant-light" lending practices as well as GP's propensity over the last 5-7 years to pay significantly higher valuations for assets. The vast majority of deals completed in the last year have been leveraged at over six times EBITDA.

What are implications to deals going forward? We suggest the market will again assess the impact of operations-oriented value creation strategies and cross-portfolio infrastructure - deciding which approaches have been successful and which have not. Due diligence will become even more important – with scope ranging from cash generation, to market elasticity, to supply chain resiliency and to operations.

Firms that weathered the 2008-2009 crisis will have learned lessons we expect will prove valuable and applicable even in today's unprecedented disruption. Firms that have not seen a downturn previously will be learning through a crash course.

Works Cited:
(1) Preqin Quarterly Update: Private Debt Q1 2020
(2) Preqin Quarterly Update: Private Debt Q1 2020

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Steven Koinis leads the Private Equity Practice for Catalyft LLC, a practitioner-led, boutique operating partner firm focused on strategy implementation and operational improvements in middle market businesses acquired by Private Equity, investment firms and Family Offices. Steven has held several senior executive positions with the sovereign wealth fund Abu Dhabi Investment Company, Huron Consulting Group, and as C-level executive and Board member of private firms in the US, Europe and Middle East. Steven earned his MBA from Harvard Business School and has two Bachelor of Science degrees in Mechanical and Materials and Metallurgical Engineering from University of Michigan, Ann Arbor and speaks conversational Greek, German and Arabic.

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