Refinitiv LPC's 2Q20 Middle Market Lender Outlook Amid COVID-19

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What is the biggest impact that COVID-19 has had on your business so far in 2020?

Lender Commentary from Survey

Dealflow is down substantially

- Shut down of primary markets, pipeline which was robust in early March has declined by 90%
- Most auction deals have been pulled or are being delayed
- Dealflow slowed dramatically, expect that dealflow will be depressed throughout the second quarter

Market in Price Discovery

- So much uncertainty, no idea where the market will be in ten days and how it relates to any transaction
- Very difficult to price new deals, we have lots of capital but we have no idea how long businesses will be impacted
- Relative value analysis – time spent conceptualizing the opportunity set for new investments and the potential portfolio effects
- With Libor crashing, some direct lenders are discussing 1.5% Libor floors
- Banks are pushing to get Libor floors on non-sponsored loans, but no one wants to be viewed as "price gouging" issuers during difficult economic conditions
- Trying to comp this crisis to 9/11 and to the 08/09 crisis, but very difficult – this is unprecedented
- Asset values are completely up in the air, so hard to assess deal terms and economics

Source: Refinitiv LPC

What is the biggest impact that COVID-19 has had on your business so far in 2020?

Lender survey responses continued

Companies working hard to preserve and acquire more liquidity

- Portfolio companies are all managing liquidity aggressively
- Right now, we are seeing full drawdowns of revolvers which has utilized much of our 2020 cash allocation
- Seeing requests from borrowers to tap accordions
- Drawdowns so far seem largely pre-emptive and defensive, seeing run on the bank revolver draws

Portfolio performance uncertainty

- We have shifted our focus away from new deals to portfolio performance management
- Absolutely no idea how company performance will be impacted and what earnings and cashflow will look like in 2020
- Even strong portfolio companies in very defensive industries will be impacted here, its just too early to assess borrower performance
- Consumer and restaurant deals are going to lose an entire quarter worth of revenue and see liquidity issues
- Some sponsors are telling portfolio companies to not pay their principal and interest
- Financial performance impact will be felt for at least 3-6 months at a minimum

Platform struggles

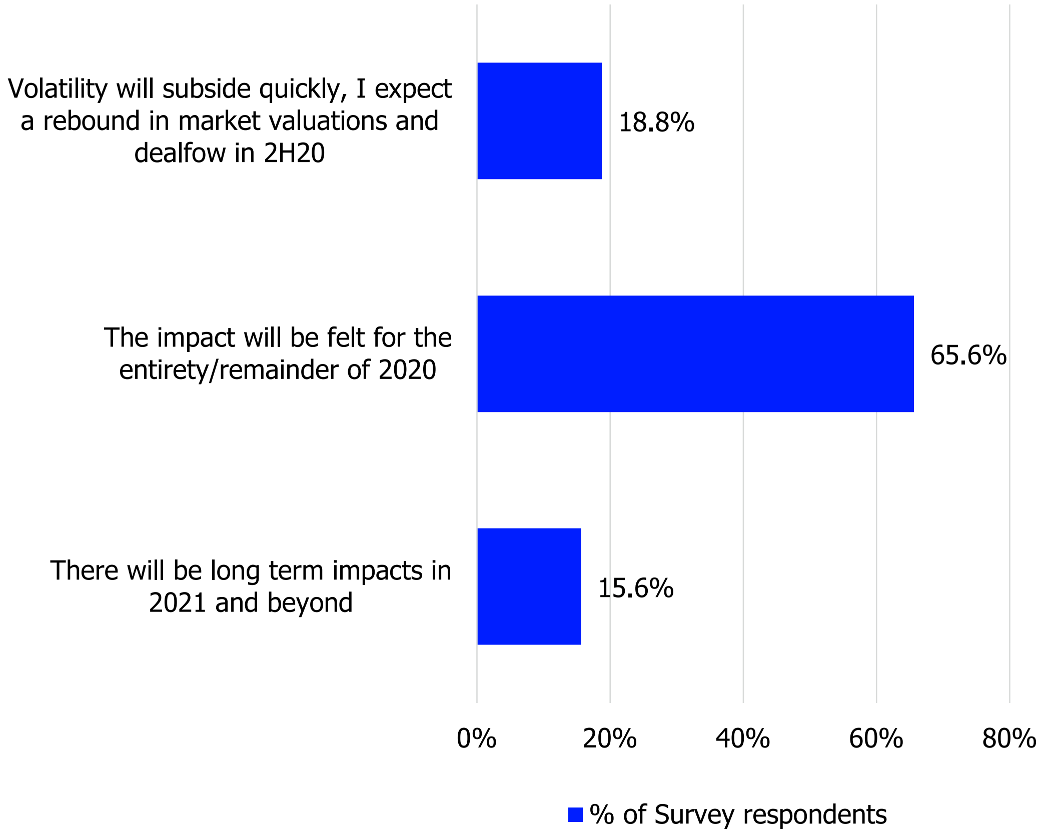
- Acclimation to move to virtual work environment has been tough. Significant ramp up in preparedness for business continuity
- The whole paradigm of how BDCs are perceived has changed to a scorched earth expectation
- LPs are inundating GPs with calls looking for updates

Source: Refinitiv LPC

Do you expect the volatility driven by COVID-19 will subside in 2H20 or do you believe the effects will last beyond the next 1-2 quarters?

Two thirds of lenders believe the impact will be felt for the entirety of 2020, another 16% believe the impacts will continue to be felt into 2021 and beyond

Lender Survey: Do you expect the volatility driven by COVID-19 will subside in 2H20 or do you believe the effects will last beyond the next 1-2 quarters?



Lender commentary:

- The economy is already in a recession; negative GDP in Q1 and Q2 is a certainty, the question becomes do we enter a depression and deflationary stagnation
- The portfolio issues over the next few months will eat up a lot of time and capital from private equity
- There will be a long period of buyer-seller mismatch as valuation fall at least 30% until its clear that businesses have recovered
- Credit issues and defaults will evolve slowly over the next six quarters
- Although this should diminish at some point in the 3rd or 4th quarter, the knock on effect on issuers will have a material impact on the portfolio; many accounts will need to be amended/worked out which will have an impact on the market
- I would expect deal flow to return in 2H20, particularly for industries that are less vulnerable to the pandemic. However, even before March, the pipeline seemed lighter than normal for the time of year.
- I believe the crisis will turn mid-summer, and there will be some level of snap back in Q4, though the election puts a lid on deal flow most likely
- Investors will remain spooked, particularly given the elections, through the end of 2020.
- We have not yet begun to see the impact of European manufacturing shut downs. There will be a significant amount of liquidity issues forthcoming.
- This is a global issue, virus + oil war happening together. We have never had a full sweeping widespread global issue like this before. There are so many impacts that we aren't even thinking about yet.

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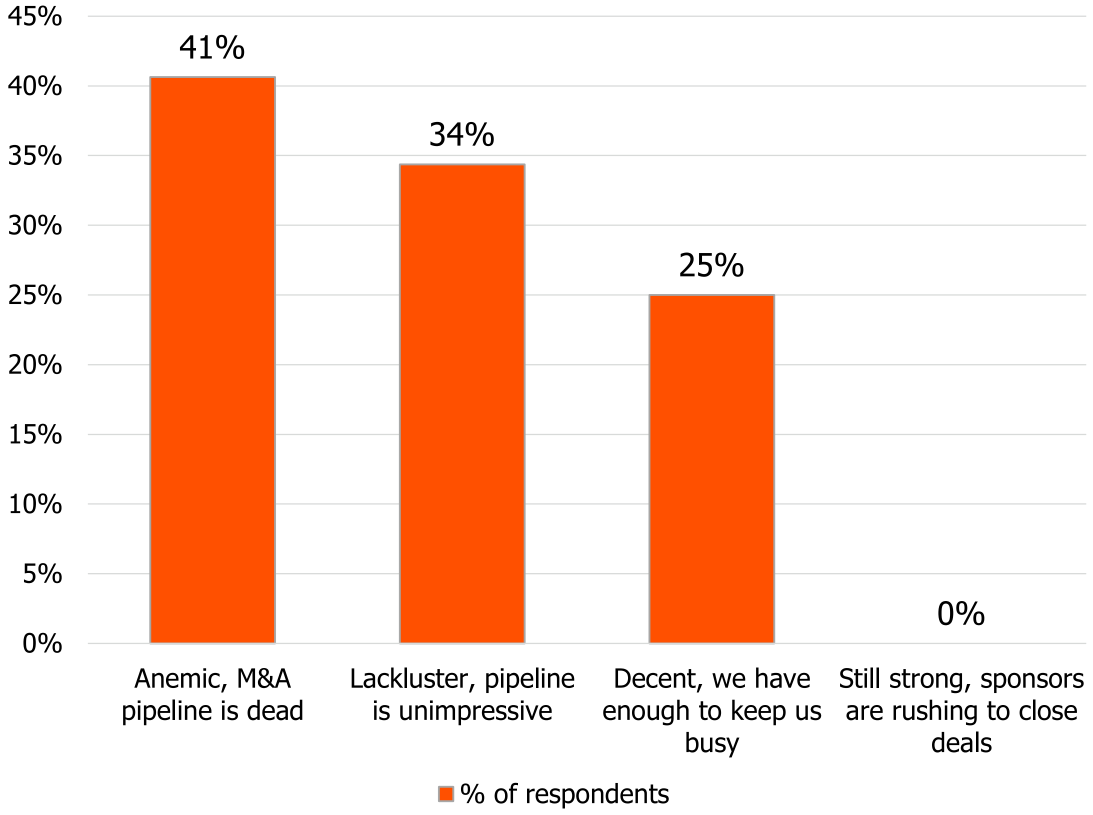
 Source: Refinitiv LPC

Bulk of lenders characterize their M&A pipeline as anemic/dead heading into 2Q20

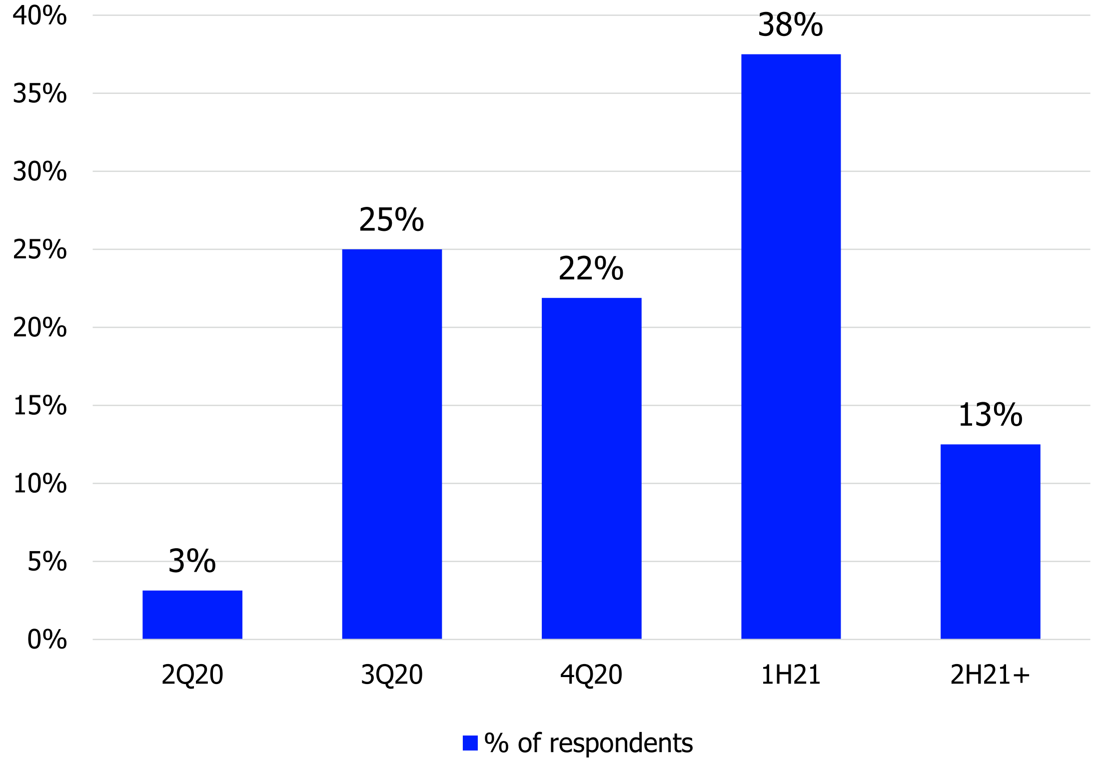
Meanwhile, when it comes predicting when the dealflow picture will return to "business as usual", the most common response by lenders was 1H21

However 47% of respondents were optimistic, saying the dealflow picture could improve to normal levels sometime in 2H20

Lender Survey: How would you characterize your M&A pipeline heading into 2Q20? (% of respondents)



Lender Survey: When do you expect the dealflow pipeline will return to "business as usual" for middle market lenders and issuers?



 Source: Refinitiv LPC

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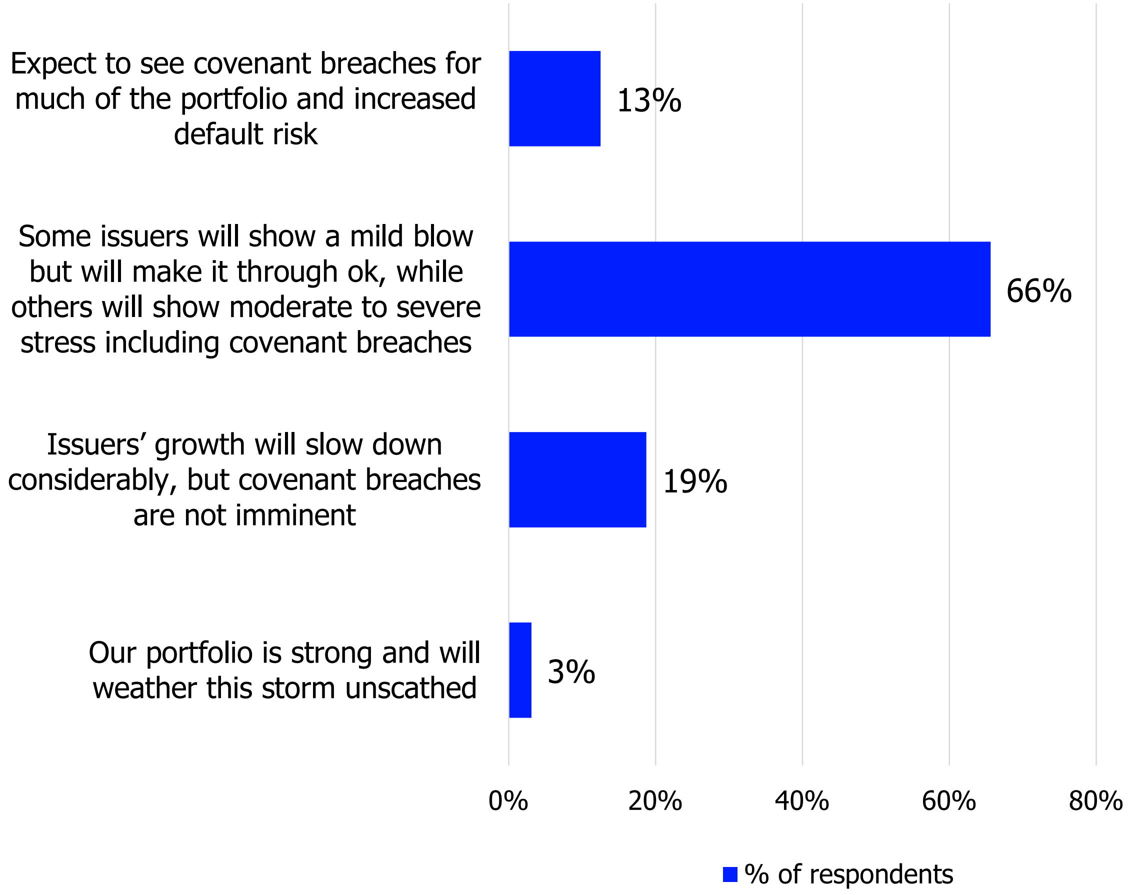
How are you feeling about portfolio performance? How will you help portfolio co's?

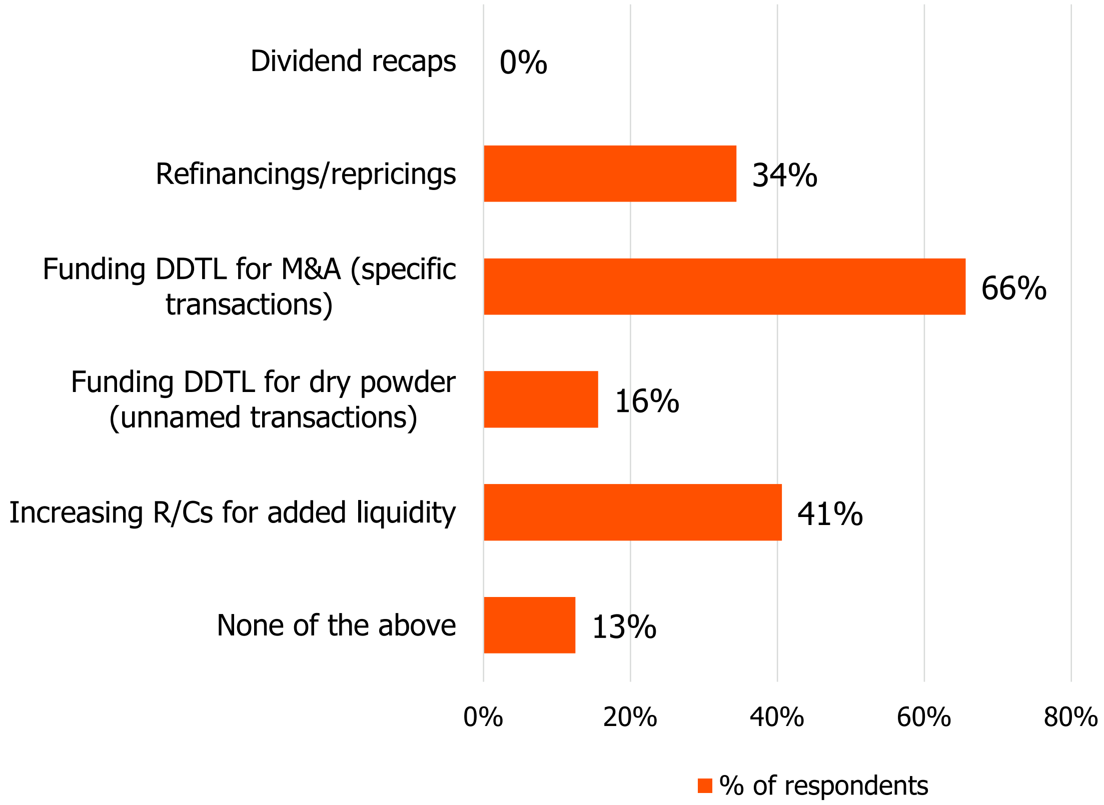
Two thirds of lenders believe some issuers will show a mild blow to performance but make it through this ok, while others will show more moderate to severe distress and covenant breaches; another 13% of respondents said they expect to see widespread default risk for much of the portfolio

Meanwhile, when it comes to lending to existing portfolio companies, two thirds of lenders say they will still fund DDTLs for specific M&A deals, one third will still lend for refinancings, and 41% said they are willing to increase revolving credit facilities to issuers to help provide added liquidity

Lender Survey: How are you feeling about portfolio performance?



Lender Survey: Which opportunistic transactions are lenders still willing to execute on today? (select all that apply)



Source: Refinitiv LPC

What surprising sectors (outside of energy and travel-related) do you think will be most affected by COVID-19 issues?

Most lenders agree that pretty much all sectors will be impacted in some way, some may benefit in the short-run while the vast majority will be adversely impacted

Positive impact:

- Online gaming
- Food delivery
- Consumer staples: canned goods, paper products, hand sanitizer, etc.
- Transportation of goods for delivery / certain logistic companies
- Supermarkets
- Online learning
- Software / computer products
- Hospitals

Negative impact:

- Consumer discretionary (appliances, sporting equipment, etc.)
- Retail & Restaurants
- Discretionary healthcare practices such as dental, cosmetic surgery, physical therapy, gyms, anything physician visit related
- Industrials, OEMs
- Airlines
- Automotive
- Energy
- Business services / Services
- Churches
- Distributors
- Real Estate
- Payment processing
- Out of home consumer services
- Event planning / Live entertainment
- Leisure / Cruises / Hotels

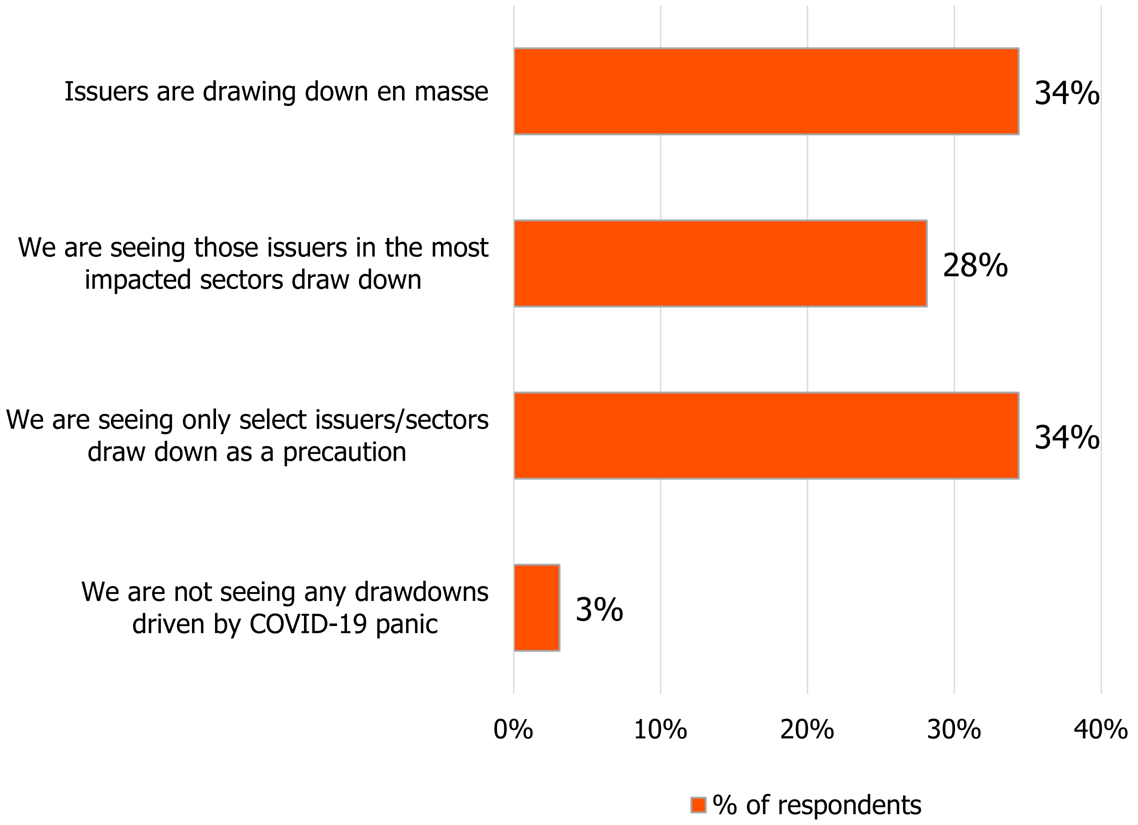
 Source: Refinitiv LPC

To what extent are issuers asking to draw down revolving credit facilities?

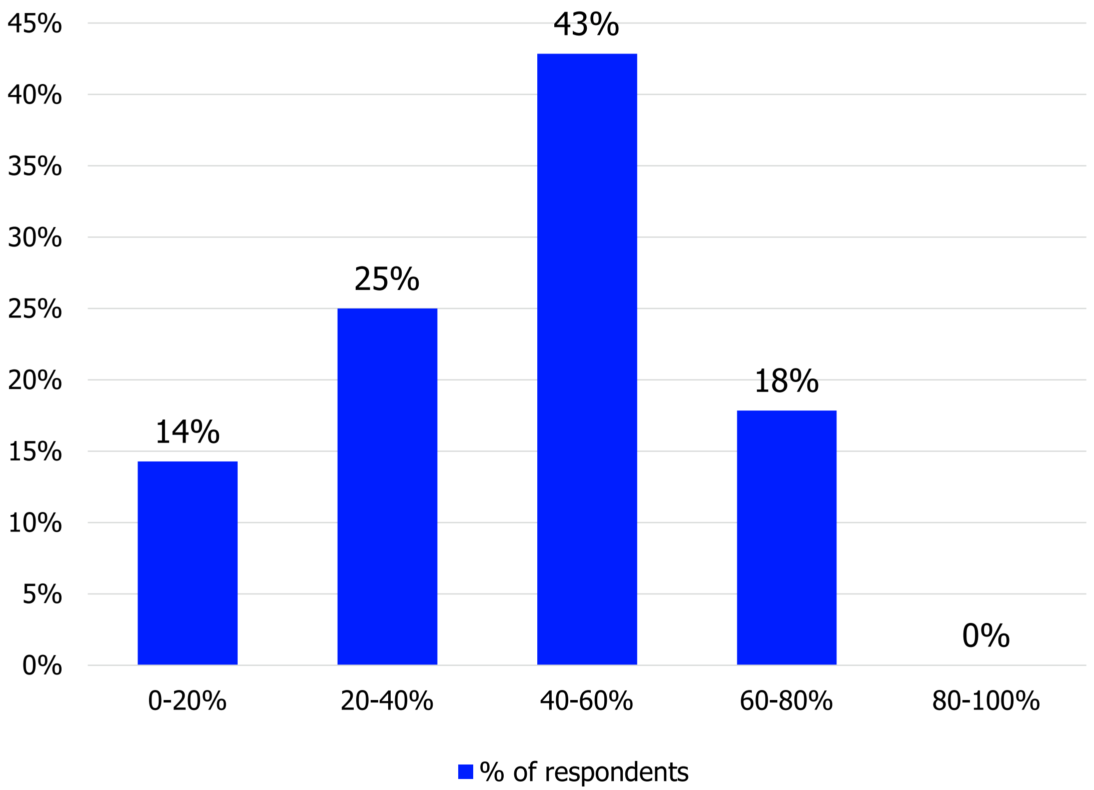
Most survey results were taken last week, so the numbers could be higher this week, but it is clear that almost all lenders were seeing issuers drawing down on revolvers at a frantic level

Last week, 43% of lenders said revolvers were 40-60% drawn with nearly 20% of lenders saying 60-80% were drawn

Lender Survey: To what extent are issuers asking to draw down on revolving credit facilities?



Lender Survey: What percent of your total issuers' revolving credit commitments are currently drawn down?



Source: Refinitiv LPC

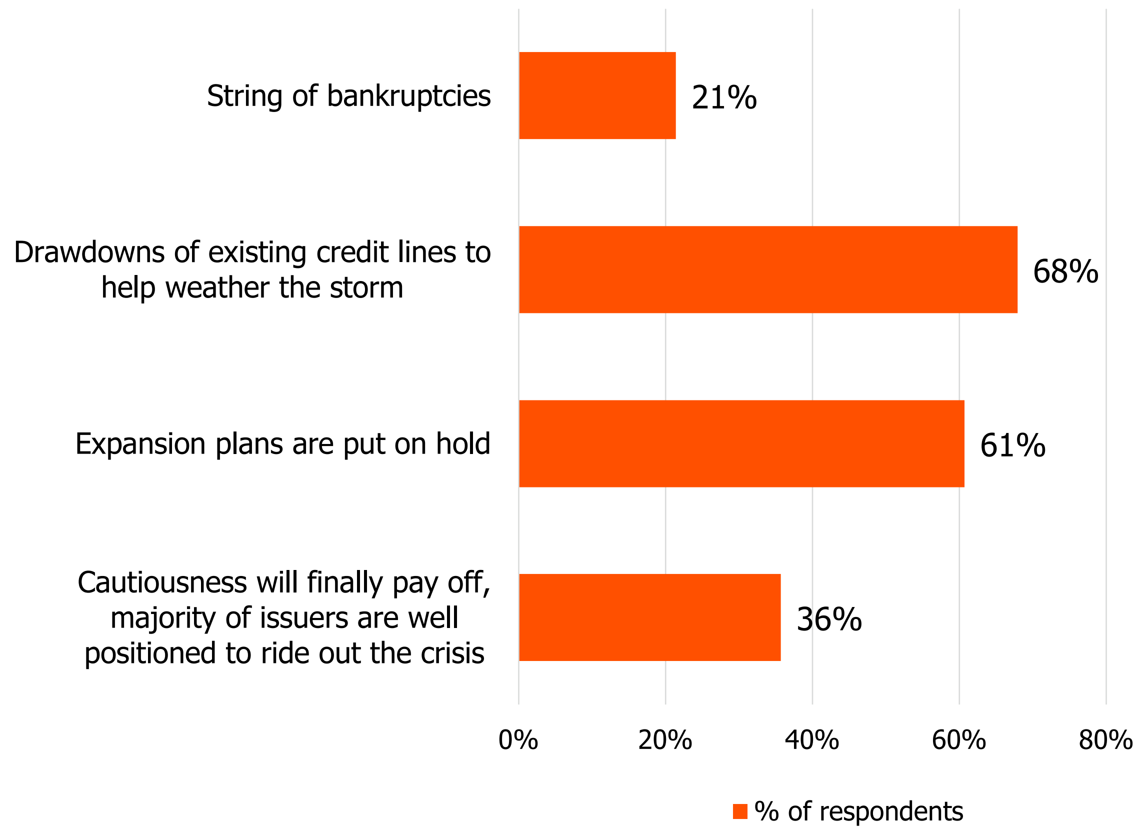
What will be the effect of COVID-19 on the non-sponsored market?

Nearly two thirds of lenders believe that non-sponsored issuers are also drawing down credit lines to help weather this storm

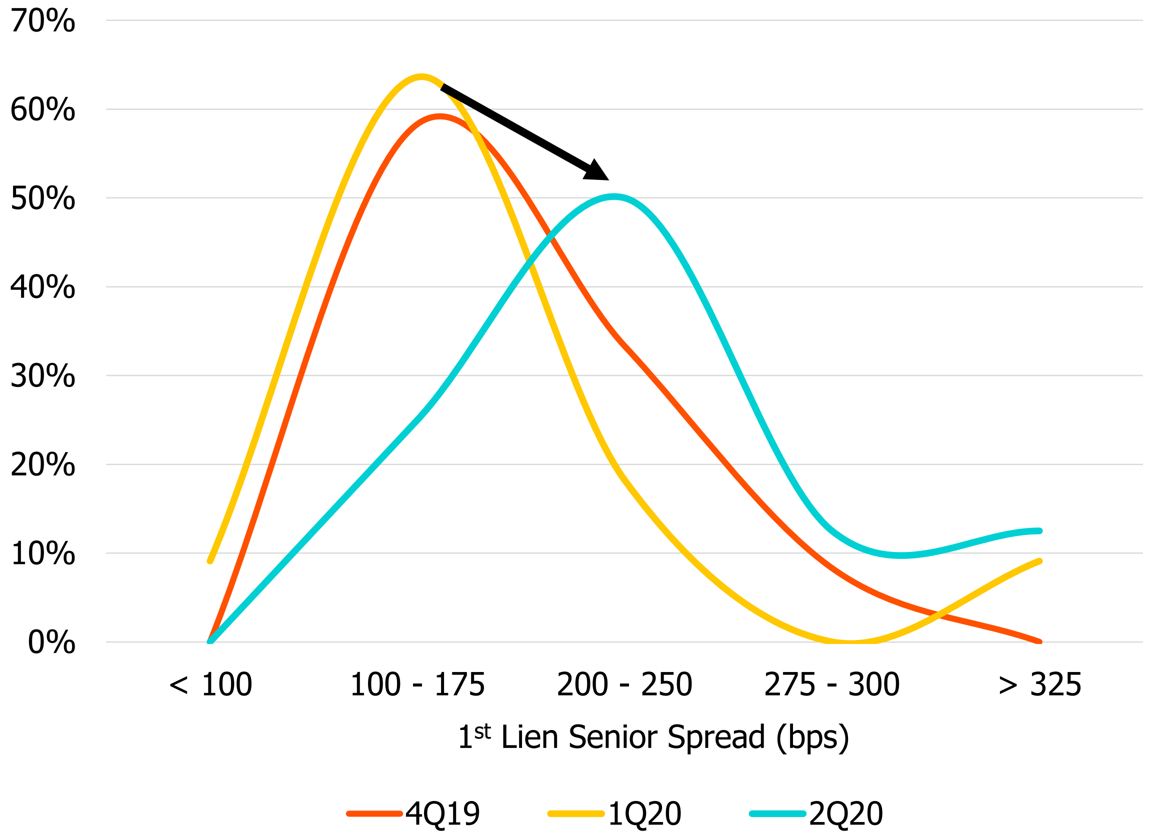
Most believe expansions plans will be put on hold while 21% of lenders think we could see a string of bankruptcies

With regards to 1st lien pricing non-sponsored loans, banks are clearly pushing spreads higher into the 200-250bps area from 100-175bps last quarter

Lender Survey: What will be the effect of COVID-19 on the **non-sponsored** market? (select all that apply)



Lender Survey (Banks only): What is your 1st lien senior spread requirement on corporate MM deals?



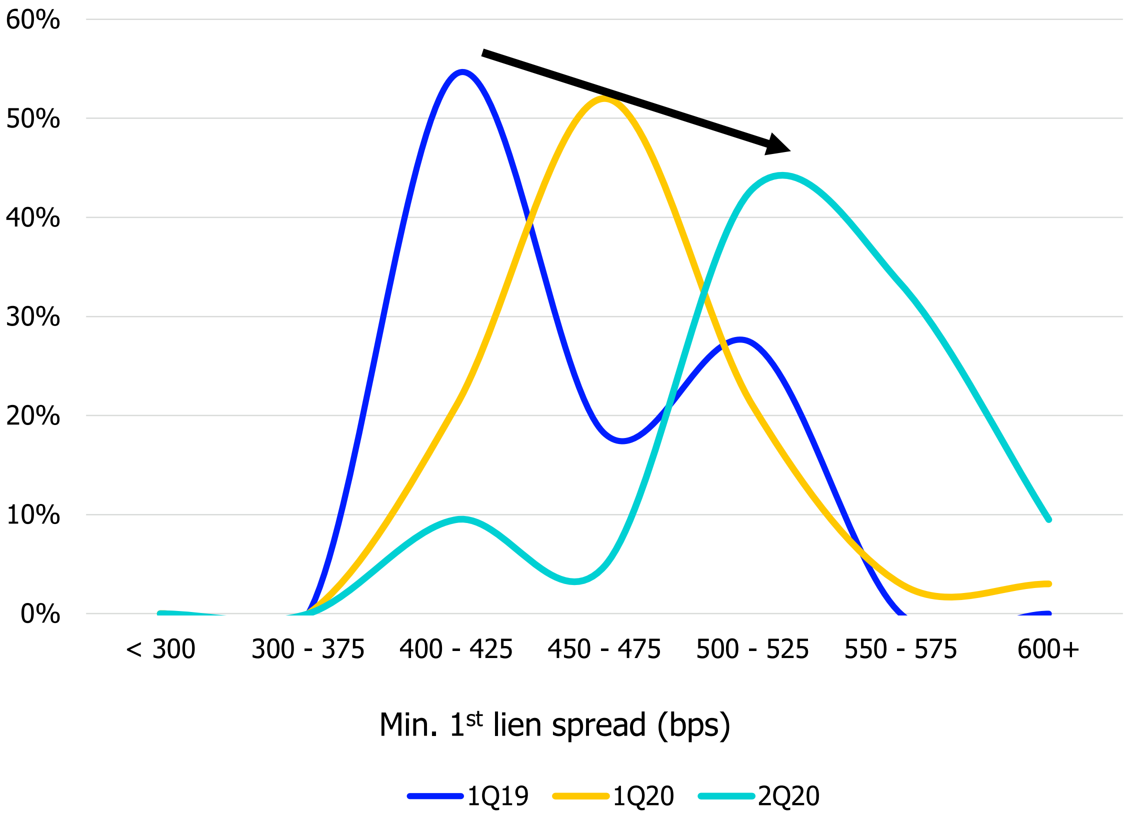
Source: Refinitiv LPC

Both banks & direct lenders are pushing up 1st lien spreads on sponsored loans

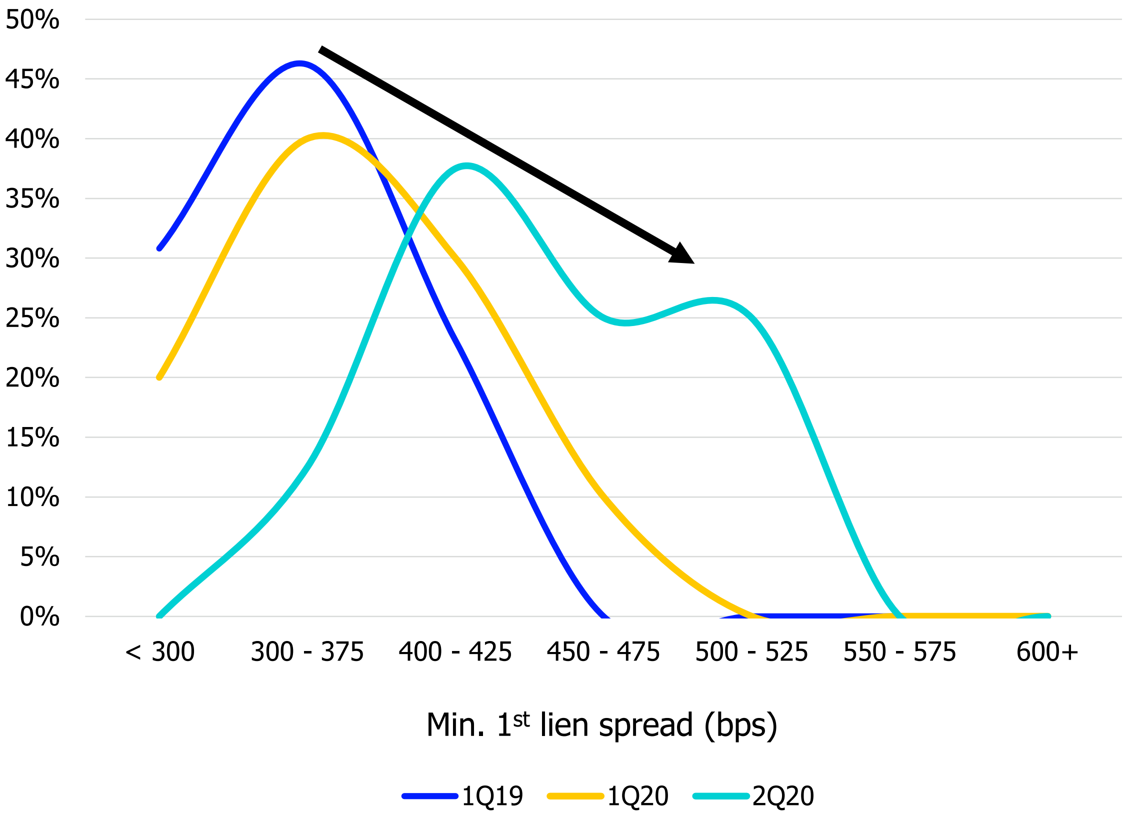
43% of direct lenders are pushing 1st lien spreads up to the 500-525bps area from 450-475bps last quarter; while 33% are even asking for 550-575bps

Meanwhile, bank lenders are providing a bigger range on sponsored deals. While most were lending in the 300-375bps area at the beginning of the year, banks are now running the gamut: 38% said 400-425bps at a minimum, while 25% said 450-475bps and another 25% said 500-525bps heading into 2Q20

Direct Lender Survey: What is your minimum 1st lien senior spread on **MM sponsored** loans in 2Q20?



Bank Lender Survey: What is your minimum 1st lien senior spread on **MM sponsored** loans in 2Q20?



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 Source: Refinitiv LPC

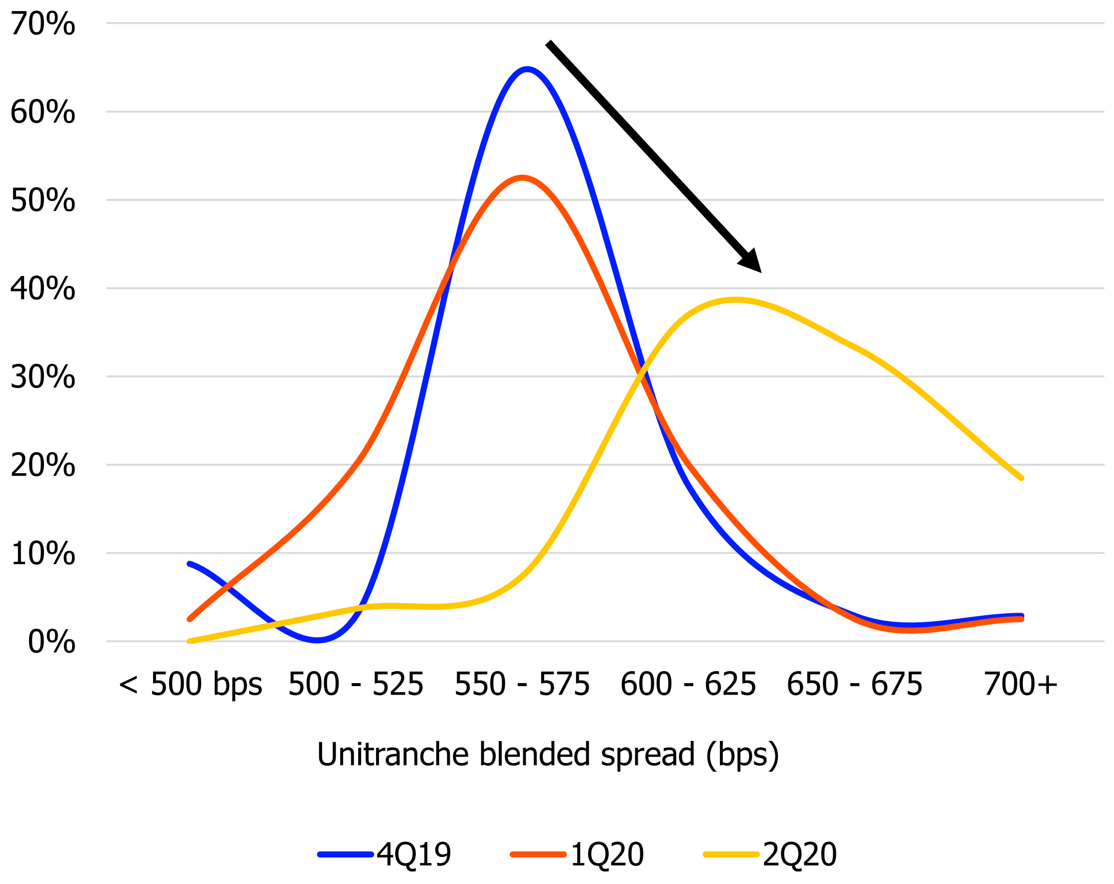
Lenders have pushed unitranche spreads to the 600-675bps range from 550-575bps

37% of lenders said 600-625bps was their minimum spread requirement on unitranche loans in 2Q20 while another 33% said 650-675bps; 19% said 700bps+

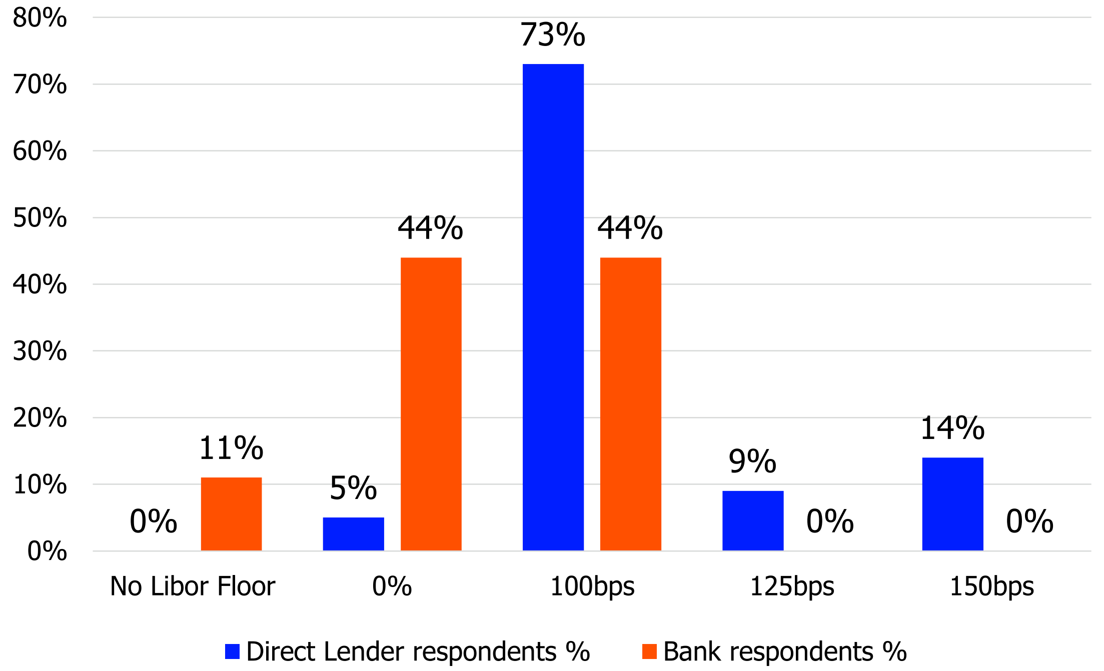
Libor Floors: 73% of direct lender survey respondents say 100bps is enough for Libor floors, but 9% are asking for 125bps and another 14% want 150bps

Meanwhile, banks want to add Libor floors, but are nervous about perception. 44% said they are doing zero for floors, and another 44% said 100bps

Lender Survey: What is your minimum spread threshold for unitranches in 2Q20?



Lender Survey: What are you requiring in terms of **Libor floors** on new deals?



"Banks want 100bp Libor floors, but are worried about the perception of hitting issuers with floors at a time of economic weakness – we have to do it on a case by case basis" – said a bank lender.

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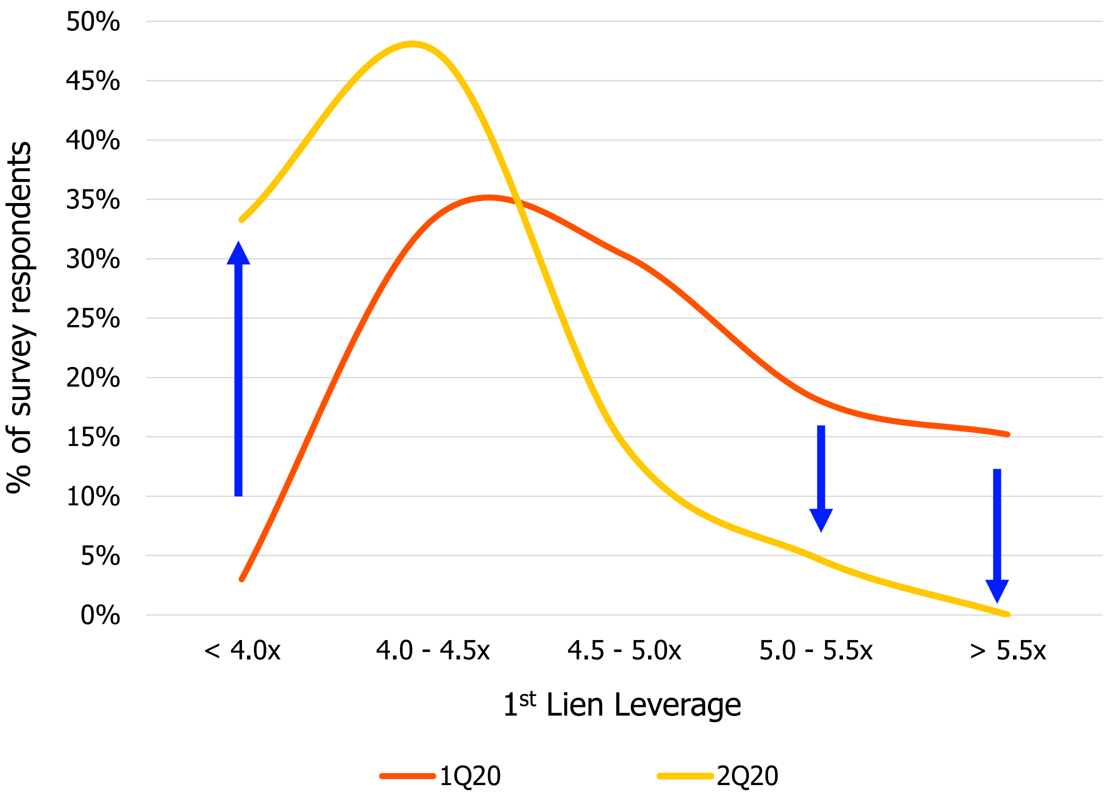
 Source: Refinitiv LPC

Direct lenders dial back their 1st lien & total leverage tolerance in a major way on middle market loans heading into 2Q20

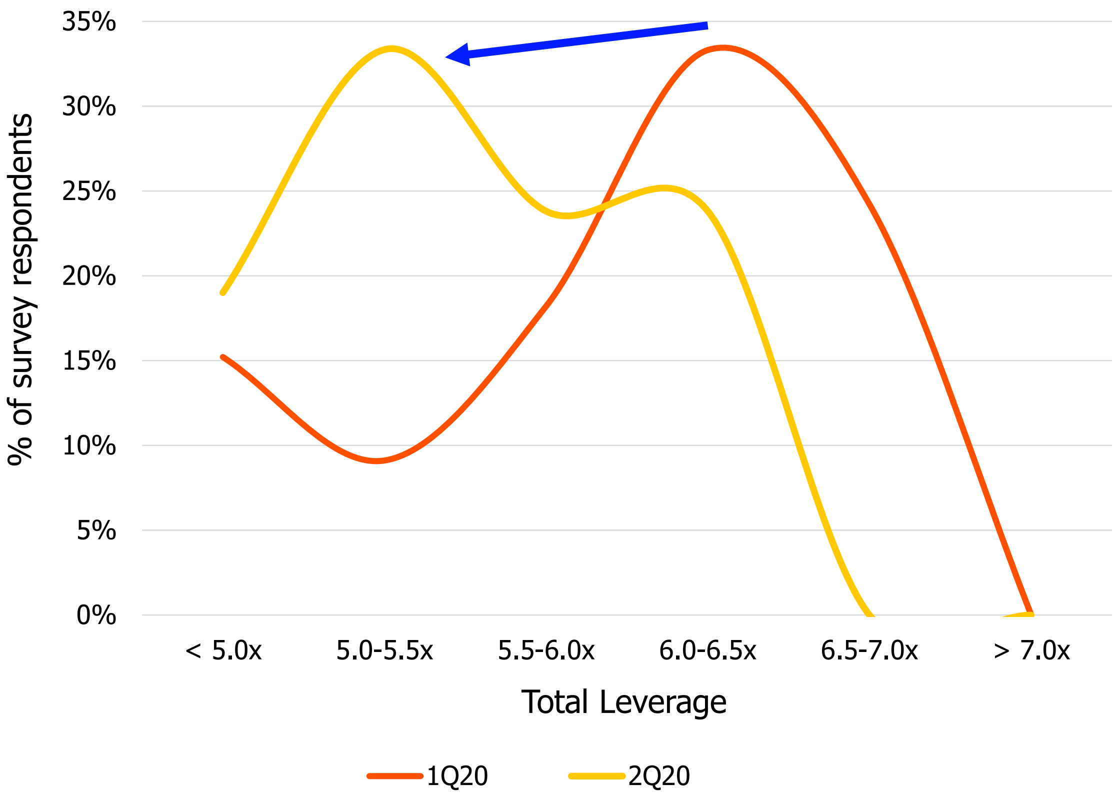
On a first lien leverage basis, one third of direct lenders now say 1st lien leverage should be less than 4.0x vs. only 3% of lenders saying that earlier this year

The bulk say 4.0-4.5x is the new norm on a first lien basis, and on a total leverage basis, one third said 5.0-5.5x, while 24% said 5.5-6.0x and 24% said 6.0-6.5x

Direct Lender Survey: What is your maximum **first lien leverage** tolerance on MM deals in 2Q20?



Direct Lender Survey: What is your maximum **total leverage tolerance** on MM deals in 2Q20?



 Source: Refinitiv LPC

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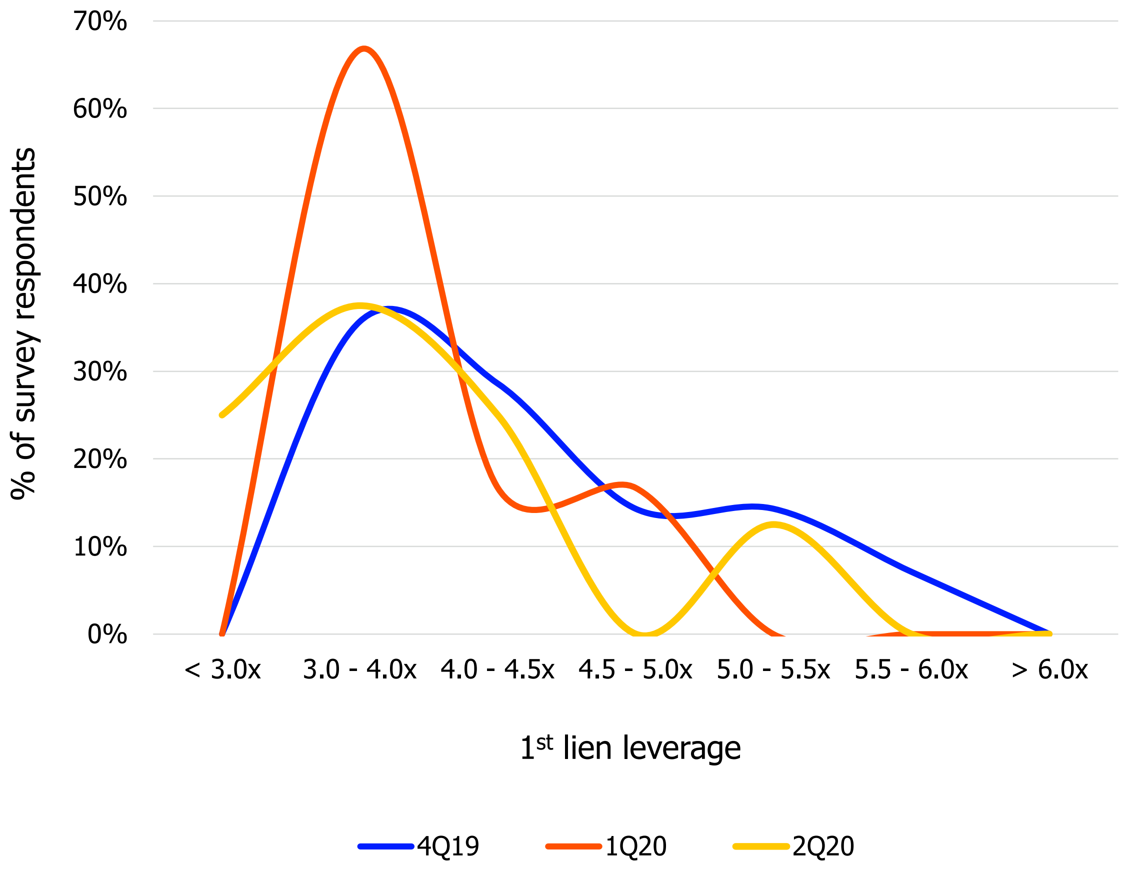
After banks lowered their leverage tolerance in 1Q20, they are further dialing it back heading into 2Q20

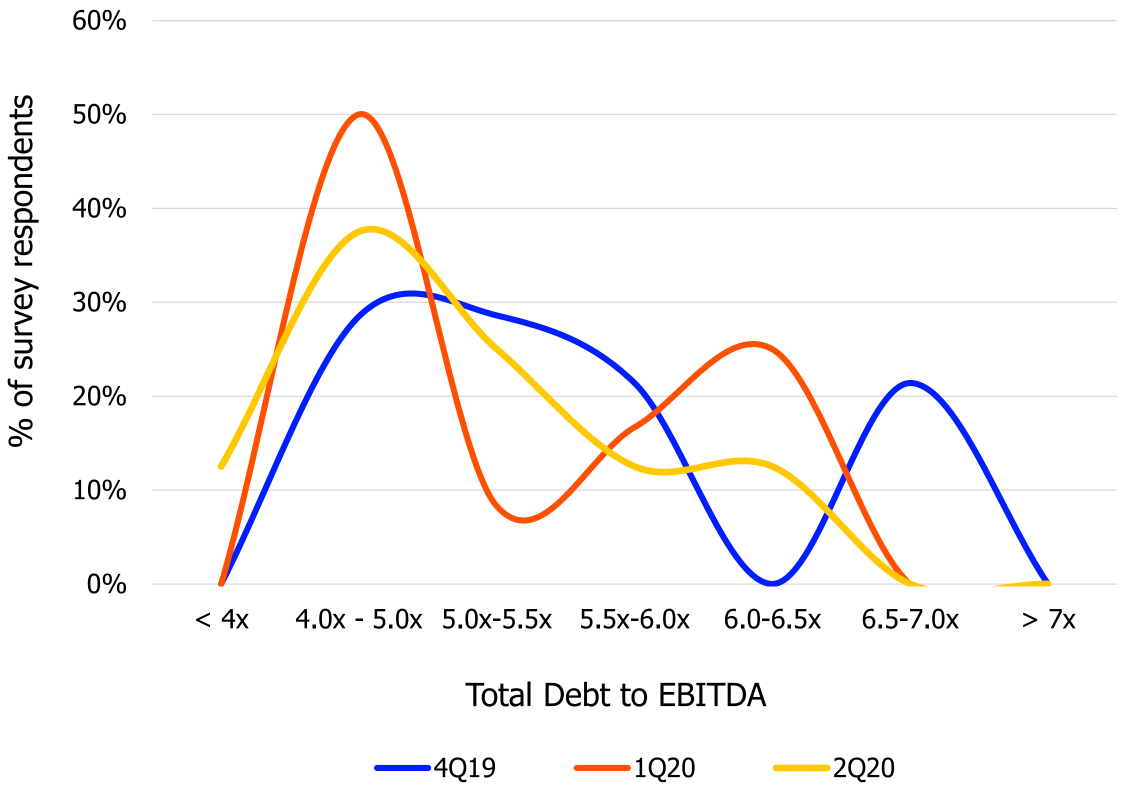
Roughly one quarter of bank respondents said they are keeping first lien leverage under 3.0x in 2Q20 – no one said this at the beginning of the year

However, the bulk will still lend in the 4.0-5.0x total leverage area in 2Q20, but a much lower share will take leverage up to over 6.0x vs. 1Q20 levels

Bank Survey: What is your **first lien leverage** tolerance on middle market deals heading into 2Q20?



Bank Survey: What is your **total leverage** tolerance on middle market deals heading into 1Q20?



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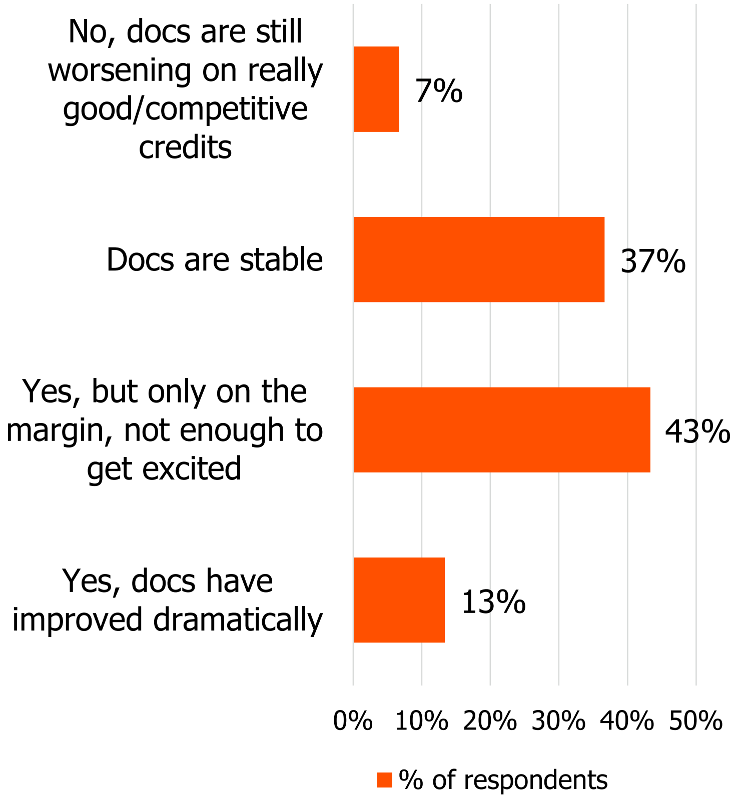
 Source: Refinitiv LPC

Lenders believe they are seeing some improvement to docs so far as a result of the volatility, but its only on the margin and not enough to get excited just yet

In terms of document loopholes, lenders are most concerned about the level of EBITDA add-backs

Lender Survey: Have you seen any improvement to loan documents or do you feel terms are still bad?



If you believe docs are changing, what are you seeing that is new/different?

- Too early to tell
- Reduction in some baskets, MFN and carveouts
- Lenders will regain some ground on things like EBITDA definitions, debt layering, etc.
- Definition of EBITDA getting better
- Covenants are getting added
- Free and clear amounts are shrinking
- Better flex
- Smaller baskets
- Libor floors
- Tightening of restricted payment baskets and anything that is viewed as leakage is a huge focus now
- Anti-hoarding provisions
- Better reps and warranties around DDTLs and RLOCs

Are there any document loopholes you are particularly worried about impacting issuer performance /compliance certificates?

- Ridiculous EBITDA definitions
- Open ended/uncapped EBITDA addbacks for extraordinary items such that COVID-19 would be captured
- Lenders should worry about every loophole
- Cov-lite in the upper middle market
- Cures and debt layering
- Cash and asset leakage provisions
- Draw down of revolvers – pro forma compliance is not needed to draw down entire commitment
- Priming debt
- Unrestricted subsidiaries
- Debt buybacks

 Source: Refinitiv LPC

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Let's look on the bright side - What do you see as the biggest opportunity for middle market lenders in light of this volatility?

Better terms and conditions:

- I think it will provide a reset to market conditions, not just temporary
- Better pricing
- Real covenants
- Lower leverage
- Better risk/reward
- More dealflow will move from the syndicated market to the direct lending market
- An ability to reprice debt that is below market as issuers tap the market for additional liquidity
- Ability to pick up quality assets at a discount in the secondary market

Rebalancing of the lending landscape:

- Hopefully reduces the fundraising machine so lending levels don't get stupid again
- Those lenders that were patient and disciplined will come out looking great
- Lenders with stable sources of funding can be opportunistic
- Those that stand by their clients and come through in difficult times will have great reputations for the next decade
- Pullback in market and fewer players to provide capital will lead to more rational terms moving foward
- Private credit behavior will be watched carefully by sponsors as well as traditional syndicators
- Banks may take some market share back as they are liquid

 Source: Refinitiv LPC

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