Lender's perspectives

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As the impact of COVID-19 first became apparent in mid to late March, private equity portfolio companies and corporate borrowers focused on liquidity management. These borrowers are now focusing on complying with covenants in their existing credit agreements. While cash burn rates will play a role in determining a borrower's options, sponsor and lender relationships will be important when considering alternatives. Borrower and their owners (i.e., PE firms) also should have a good understanding of their bank group, including what type of lender holds the actual loans and whether or not any portion had been sold to a Collateralized Loan Obligation (CLO). Each type of direct lender (banks and credit funds) and various investors (like in a CLO) in the debt markets will have different focus areas while working through waivers and amendments.

	Banks (ABL + Cash Flow)
Current lender environment outlook	— Collaboratively working with borrowers to execute waivers and allowing for over-advances in an effort to provide liquidity—as part of an effort to maintain and strengthen relationships—especially PE backed borrowers — Have been accommodating on waivers given the well capitalized nature of banks and the typically lower leveraged levels — Banks in cash flow deals are looking to convert loans into ABL if enough assets are available
Lender dynamics impact on covenant waiver negotiations	— Banks have flexibility to waive defaults or to keep outstanding via issuing a forbearance in order to keep all enforcement actions available — Fees typically required on amendments in small deals — On large syndicated deals, banks have been more accommodating by waiving amendment fees — Updated field exams and appraisals cannot be requested unless in default or in an over advance situation. This will be a challenging issue during the summer when A/R ages out and inventory valuations come in lower than prior periods, potentially triggering additional equity or collateral
Underwriting standards for new deals	— Limited new deal activity given compliance and over-advance issues on deals. Most banks are currently under staffed as members of ABL teams have been reallocated to focus on SBA and PPP programs — ABL lenders are selectively pursuing new opportunities that were previously cash flow deals, particularly with companies that have quality A/R and Inventory—"good company, bad balance sheet" — Generally an increase in pricing of 50–100 bps on new deals

Credit funds	CLOs[1]
— Focus on portfolio companies and overall liquidity — Some covenant breaches and payment defaults—however, most lenders are expecting a much higher number of covenant breaches and payment defaults in Q2 and Q3'2020 than in Q1'2020 — Numerous highly levered funds infused equity—and capital calls in some instances—with the unprecedented level of revolver draws held by warehouse lines. Unlevered funds typically fared better	— Similar view as Credit Funds — Upcoming collateralization ratio tests will likely trigger the need to sell their lowest rated credit positions to maintain compliance with minimum standards — Covenant waiver negotiation objectives will likely conflict with direct lenders that may have greater flexibility on principal and interest deferrals — Revolvers and delayed draw term loans represent a small portion of CLO holdings because such tranches need to be fully-reserved when securitized. Therefore, CLOs that do hold revolvers did not experience liquidity issues in the recent run-up of drawing down on revolvers
— Typically allowing partial cash interest payments with PIK on the remainder of the interest payment or rescheduling current principal payments in exchange for an amendment fee — Willing to work with borrowers by providing covenant holidays that would kick in later in 2020 or 2021. However, such accommodations will typically require additional equity from sponsor — Not interested in re-writing covenant definitions to include Covid-19 addbacks, etc.	— All CLOs have covenants that require the manger to test the portfolio's ability to cover its interest and principal payments monthly — Thus, it is important to maintain some level of current cash pay (generally at least 2% cash interest with limited flexibility on PIK interest) — In addition, CLO managers need to try to avoid payment defaults and reschedule missed principal payments via a waiver versus keeping them unpaid indefinitely while operating under forbearance
— Pricing on new deals and repricing on amendments to achieve approx. 800bps all-in return, an increase of 200–300 bps — Leverage has generally decreased by 0.5x–2.0x, typically maxing at 4.0x — Desire of adding anti-hoarding provisions in new credit agreements to avoid drawing down on revolvers and accordions solely for liquidity purposes	— Similar view as Credit Funds

[1] A CLO is a portfolio of leveraged loans that is securitized and managed as a fund by a CLO manager.

Frequently asked questions and other observations:

Q1 What are typical amendment fees, how do they differ by loan size and lender type?

Regulated banks are requiring minimal amendment fees on middle market deals—typically 25bps to 75bps. Such fees have been required, and often times waived, on small syndicated deals. Amendment fees required by non-bank capital providers are typically 25 to 50 bps higher than regulated banks. A few lenders are being creative—especially with strong sponsor relationships—by deferring covenant fees to the back end of loans.

Q2 How are CLOs structured, and what potential issues will private equity funds face if and when CLOs are distressed, and their credits are non-performing/non-compliant?

CLOs are structured in tranches by rating (A, BBB, BB, B, CCC, etc.) which are filled based upon the ratings of the individual investments. The CCC basket—or the amount of CCC loans allowed in a large broadly syndicated CLO is typically around 7.5%. In the current market, most of these CLOs CCC baskets are north of 15% given recent market instability and credit downgrades. Middle market CLO's have a higher percentage of CCC baskets—usually 15% to 20%. Most middle market CLO's are still in compliance but that could change next quarter if there is a spike in default rates. If this occurs, CLOs will be focused on either infusing equity or selling off lower tranches within the CLO at a discount in order to meet its various collateral tests.

CLOs can allow for waivers to reschedule principal and interest payments but they need a minimum amount of cash interest (usually at least 2%), and therefore will be less flexible with a high portion of PIK interest.

Q3 What issues are some (not all) credit funds and CLO's having with borrower's fully drawing their revolver capacity?

The run up in middle market revolver draws has caused some levered credit funds to enforce equity capital calls to be in compliance with revolver warehouse line limits. Most credit funds typically allow unfunded, cash flow revolvers to be included in an overall credit facility. Historically these revolvers were less than 5% drawn at any one time. Overnight the revolver draws reached as high as 90% to 95% which caused the liquidity crunch. Going forward on new deals, expect to see new 'anti hoarding' provisions to avoid such revolver draws purely to hold cash.

Unlike credit funds, CLOs did not have liquidity issues with revolver draws since both revolvers and delayed draw loans need to be fully reserved.

Q4 What are lenders requesting, in relation to granting multi-quarter covenant waiver letters and extending bullet payments and maturities?

Lenders are being relatively accommodating with Q1 waivers but if they are being asked to amend multi quarter waivers they will require some form of equity support from the sponsor. Partial cash interest payments with PIK and back loading principal payments are the norm. Most lenders are not interested in re-writing covenant definitions to include Covid-19 addbacks, etc.

Q5 What are the implications of covenant breaches? What are the lenders seeking as remedies, and what are the associated sensitivities for our private equity funds?

Covenants help lenders protect their investments, and the implications of covenant breaches depends on the situation. If the covenant breaches are expected to be temporary, then usually the lender and borrower will negotiate temporary reliefs, such as waiving a financial covenant breach for a short period of time or partially PIK interest until the borrower is able to improve cash flow and liquidity. In more dire situations whereby the updated financial projections do not support the existing capital structure, either an equity infusion from owner or a restructuring of debt will be needed.

Remedies are negotiated between the lender and borrower, and could include: amendment fees, interest rate increases, increase of collateral coverage, equity infusion, as well as other negotiated terms.

In general, private equity funds and other borrowers will capitalize on their lender relationships to successfully negotiate credit agreement amendments. The size of future bank groups and relationships with each participant will also be revisited given it is much easier to negotiate an amendment with a small/single lender that you know well versus a broadly syndicated bank group.

Q6 When amending and refinancing cash flow loans (with no conversions to ABLs), how are lenders assessing leverage ratios? To what degree have lenders formed views on acceptable adjustments to Q2 EBITDA for CV19?

At this point lenders are not interested in adjusting definitions or leverage levels, and instead are focused on rescheduling interest and amortization payments if necessary or offering covenant holidays that would kick in later in 2020 or 2021. An amendment fee will be required and in some cases new equity by the sponsors.

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  – Negotiating amendments/extensions on existing credit agreements
  – Advising on capital allocation strategy, capital structure optimization and other balance sheet matters

— With decades of experience sourcing capital and negotiating with creditor constituencies we can help KPMG client teams objectively evaluate all possible credit alternatives and chart a path to preserve value for businesses

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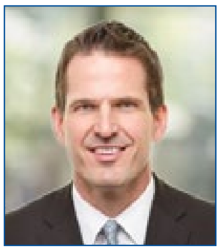

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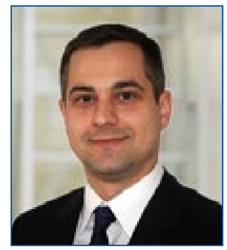

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