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Middle Market Insight: 2023 May Bring a Wave of Amendments for Direct Lending

Andrew Hedlund
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Direct lenders and their borrowers in 2023 may need to contend with the first sustained period of corporate distress, arising from a unique set of circumstances, since direct lending became a cornerstone of the capital markets.

Many anticipated the onset of the pandemic in March 2020 would produce the next distressed cycle. But central banks cut interest rates, and governments turned on the fiscal stimulus taps, quickly ending the turmoil. Now, the Federal Reserve and other central banks are raising interest rates at a time when the economic outlook is uncertain.

“This is the first sustained period of stress we've really seen since the GFC. And I'd say the reality is, in a lot of ways, it's even trickier for some companies today than those during that period,” Bardin Hill Investment Partners CEO and CIO Jason Dillow said.

During the GFC, interest rates from around went from 5.25% to near-zero. This time, the situation is different, he said.

“In the GFC, you kept your business going, revenues were down, profits were down and cash flows were down, but your debt service costs were also lower. Today, we're in the opposite environment,” he said, noting most middle market borrowers do not hedge interest-rate exposures.

That lack of hedges can cost borrowers dearly.

Three-month SOFR and three-month LIBOR ended 2022 at 459 bps and 475 bps, respectively, up from eight bps and 22 bps at the end of 2021. As of Tuesday, they were 4.63% and 4.79%, respectively.

In an example of how debt payments can weigh on a balance sheet, publicly traded life sciences company Lifecore Biomedical amended its $170 million term loan to forestall amortization payments. Principal repayments for the loan, from Goldman Sachs Specialty Lending Group and Guggenheim Partners, were scheduled to begin in March. By pushing it out until the first quarter of 2025, the company will save $2.2 million in quarterly debt repayments.

“Direct lenders don’t want to be forced to report defaults, and as such will work with companies to amend documents, as needed,” Dillow said. “We’re interested to see what the cost is for these amendments and if an increase in spread or early principal paydowns put companies in an even more challenging position over the longer term.”

In November, lender SLR Capital Partners agreed to let publicly traded life sciences company Vapotherm PIK up to 8% of its interest on a $100 million facility and reduced the minimum liquidity covenant. This is how direct lending amendments work: The borrower and lender hash out a deal.

Working out direct lending deals is logistically simpler than those in the broadly syndicated market, Dillow said. In addition, because of the presence of financial covenants, issuers will likely be forced to the table sooner than the broadly syndicated market.

Data from LFI sister publication Covenant Review shows some 63% of middle market borrowers, those with EBITDA of $75 million or under, have maintenance covenant testing.

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For broadly syndicated loans in 2022, of 1,698 facilities, 330 loans had covenants, constituting 19% of the market, according to the Credit Suisse Index. In 2010, 89% of facilities had covenants.

Fitch Ratings anticipates the default rate for syndicated large middle market deals, generally loans from $100 million to $500 million, could reach 5%. This exceeds the anticipated 2.5% to 3% default rate for broadly syndicated loans, deals of over $500 million.

While these large middle market loans are not direct lending loans, the numbers provide a useful proxy, as many direct lending loans are within that size range.

The questions of inflation and rising costs do not capture the complete picture though, according to Colbeck Capital Managing Director Tony Hokayem.

> "It's really looking at the underlying business model and saying to yourself, 'Does this business have the ability to pass costs along to its consumers?,' which is directly addressing the inflation question," he said.
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> If the business cannot pass on costs, is a low-margin entity or operates with high fixed costs, inflation's impact presents a different reality for those companies and investment partners, Hokayem said. Cost of capital can impact whether these businesses do expansion projects or even stay keep their doors open, as they are particularly sensitive to inflation and higher rates, he added.

In addition, the smaller lender cadres in private credit result in less credit-on-creditor violence. One aspect of this emerged in a tussle between a group of lenders in a $450 million first-lien term loan issued in 2018 by Oaktree Capital Management-backed Boardriders to fund an acquisition and refinancing.

A group of first-lien lenders holding $85 million of debt filed suit in a New York state court against another group of lenders that held $321 million under the same credit agreement. The defendants in August 2020 had "rolled up" their debt while investing another $110 million in a move that primed the non-participating lenders.

With direct lending deals, many of these disputes can be avoided.

"There aren't creditor winners and creditor losers," Bardin Hill's Dillow said. "The creditor and the company are working together to create the best solution for the company and for the creditor's investors. It's a one-on-one conversation. I'd say that's a huge positive overall."

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