EXPERT COMMENTARY

The time for lender protections is before the economic downturn, say MGG Investment Group's Daniel Leger and Gregory Racz

Closing the barn door after the horse bolts

Interest rates rose at their fastest pace in history in 2022, putting an emphatic end to the era of free money. The hangover of the 'free money' modern era, however, is only beginning to be felt in the economy, and in the credit markets as a whole. Highly levered businesses must now deal with a cost of capital that is as much as 60 percent higher than a year ago, while the delayed effect of the Fed's aggressive rate hikes begins to bite.

In the era of free money, credit agreements became ever more favourable to the borrower. Cov-lite, cov-loose, even cov-wide became standard across the industry. Private equity buyers sought, and received, the cheapest cost of capital with few or no real lender protections. In the world of sponsor-backed lending, the clients became the private equity firms that provided a constant source of dealflow and fees to private lenders. This led to higher and higher levels of borrowed money for private equity businesses, as much as 7x EBITDA (often highly adjusted, not real) on average by the end of 2021, according to PitchBook data.

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Now that the era of free money is over, these levels of debt are becoming a burden that will reshape the outcomes of countless businesses across many sectors of the economy. Many of these businesses may not survive, or will need to be restructured, as higher rates, inflation, a declining economy and more stringent credit markets negatively impact company margins and revenue in 2023 and beyond. So, naturally, the question arises: what to do after the horse bolts from the barn? Closing the barn door and looking for a new horse to ride will be more challenging than many expect.

Learning to love covenants again: When a highly levered business feels the effect of declining demand and higher rates, nostalgia for tighter covenants is natural. But the time for covenants with real teeth based on reasonable growth expectations is before the cost of capital soars and the economy declines.

At MGG, we are pleased to see a rediscovered appreciation in our industry for the importance of conservative underwriting; nonetheless, past excesses are quickly becoming present reality and no amount of future prudence can wave away the effects that high levels of debt have on a business when faced with declining demand and higher costs. We are only in the beginning of what is likely to be the first real business cycle that most folks working in private lending have experienced.

Avoiding trap doors: Loose documentation became the norm across the private lending industry during the era of free money. Loan agreements must always be written with an appreciation that any ambiguity will permit enterprising lawyers to find enough 'trap doors' to move valuable assets out of the reach of lenders, giving struggling businesses access to fresh capital at the expense of the current lenders.

The book, *The Caesars Palace Coup: How a Billionaire Brawl Over the Famous Casino Exposed the Power and Greed of Wall Street* by Max Frumes and Sujeet Indap, brings to life something we are likely to see more of during this cycle, as do several recent articles in the business press. It should come as no surprise to lenders that loan agreements, written to be borrower-friendly from the outset, are then interpreted as such when businesses need some financial relief.

Irrational exuberance: Recalling the famous words of Jerome Powell's predecessor, Alan Greenspan, there was lots of exuberance to go around during the era of free money. And who can blame investors, especially private lenders? After all, the sector has performed remarkably well across the last two recessions. But that outperformance occurred against the backdrop of an extremely accommodative Fed that intervened directly in the credit and mortgage markets.

While the covid pandemic and economic lockdowns did not expose the cov-lite, highly levered loans due to the enormity of the economic stimulus, this time is likely to be different (or should we say the same as it once was before cov-lite ate the world). After several years of lending at high levels of debt to EBITDA, based on increasingly optimistic forecasts, what follows is likely to stretch the limits of the amend and extend playbook for most private lenders. As interest rates remain elevated, the burden of supporting unreasonably high levels of debt will be felt across the entire capital structure, and write-downs will be inevitable.

Finding a new horse: Higher interest rates impact not only the cost of capital, but also dealflow – the life blood of any sponsor-backed private lender. Declining dealflow of course blunts the power of the lender to get tighter covenants and better terms as competition increases for what remains. After all, the industry must put to work the more than $1.2 trillion in assets that has been raised, a number expected to rise to more than $2.5 trillion by 2026, according to Preqin. So, what's a sponsor-backed lender to do? Rediscover the virtues of the non-sponsor lending market, that's what. This would represent a return to the early days of private lending, a world that some of us have never left.

But this new (old) horse is not so easy to ride! Dealflow must be generated in the non-sponsor segment of the market and this requires relationships built over many decades. This cannot just be created overnight as these relationships reside with the senior professionals who have built them over several decades of experience. In this context, it is a mistake to believe that a business development office can quickly pivot and generate meaningful dealflow in the non-sponsor segment of the market. Tourists fare poorly.

Moreover, in this segment of the market, performing primary due diligence is the responsibility of the private lender as there is no private equity firm to do it. The rigor needed to properly underwrite a credit is also something that cannot be easily created because of a lull in private equity buyouts.

The non-sponsor lower mid-market: Underserved with more modest debt levels

As investors look to add capital to their private lending portfolios, or for investors looking to invest in the sector for the first time, the underserved non-sponsor, US lower mid-market still offers compelling risk-adjusted returns. The debt and leverage multiples are typically much lower in the non-sponsor segment of the market as family-owned and entrepreneur-led businesses are more conservative and jealously husband their equity. It is also much easier to negotiate tight covenants with real teeth in this segment of the market.

The lower mid-market remains underserved, notwithstanding the rediscovered interest in it by lenders previously focused solely on sponsor-backed or BSL segments, because the LMM, especially non-sponsor markets, requires tremendous focus and experience to source good businesses and to underwrite them conservatively. While MGG welcomes the newfound interest in this segment of the market, we proceed apace, comfortable that our highly experienced team will continue to deliver superior risk-adjusted returns for our limited partners. ■

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