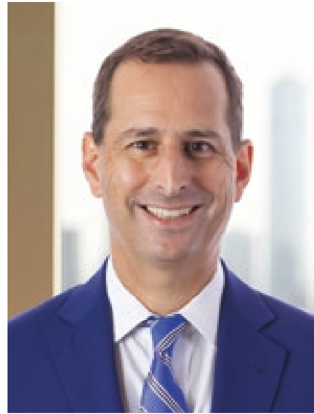
EXPERT COMMENTARY

Lenders to sponsors face declining odds and a rise in creditor-on-creditor violence, says Greg Racz, president and co-founder, and Daniel Leger, managing director at MGG Investment Group



Let the private credit Hunger Games begin

The science fiction series *The Hunger Games* offers many pearls of wisdom, some of which are apt to describe the increasing creditor-on-creditor violence we are witnessing in the sponsor-backed private lending market.

With priming loans, endless equity cures, open market transactions, up-tier exchanges, unilateral right to PIK cash interest/amortisation and creative corporate restructurings, the number of ways for lenders to lose increases almost daily.

For example, the recent Robertshaw case has led to accusations of betrayal as a rival group worked with ownership to manoeuvre around restrictions that

explicitly prohibit companies from taking on fresh debt to repay the required lender for the sole purpose of avoiding a Chapter 11 filing – much to the owner's delight. In such a hostile lending environment, let us remember this dictum from the movie series: "Happy Hunger Games! And may the odds be ever in your favour."

Gauging the odds is getting harder and harder to do as borrowers buckle under the combined weight of excessive leverage and loose lender protections (cov-lite, cov-wide, cov-loose) from the era of free money.

Even today, with base interest rates at more than 5 percent, sophisticated borrowers demand and routinely get cov-lite loans priced to perfection with leverage levels that are uncomfortably high. While private equity owners understand better than anyone that time is their friend and the enemy of their lenders, private lenders would do well to consider Haymitch Abernathy's counsel in *The Hunger Games* to Katniss Everdeen and Peeta Mellark: "Remember who the real enemy is."

As the Robertshaw deal reminds us, the enemy in stressed/distressed

situations is increasingly other first-lien lenders who may choose to strike perfectly legal arrangements with PE ownership that push other lenders down the capital structure or leave them tethered to a company that has had its most valuable assets stripped and moved to an unrestricted subsidiary.

But it may be games victor Finnick Odair who offers the wisest counsel as relates to private lending, when he tells Katniss, "it takes 10 times as long to put yourself back together than it does to fall apart". Strong covenants, modest amounts of leverage and spreads that compensate lenders for the risks they are taking are still the best ways to avoid falling apart as borrowers falter.

Without these lender protections, the risks of being denied a seat at the table well in advance of principal loss, or in the worst-case scenario, not having the rights you believed were yours (eg Serta Simmons), increase substantially.

The need to deploy capital, regardless of the opportunity set, often leads lenders to accept terms and conditions that no lender should. The pressure to deploy capital comes both internally and externally, and for many private lenders, it is the core mandate of their business. But as President Snow says: "It's the things we love most that destroy us."

While lenders are only paid on deployed capital, and while it is critical to their business model that they "play ball" with their private equity clients, the regular deployment of capital irrespective of market conditions can weaken discipline and underwriting standards. Although the US economy has thus far avoided a recession, and therefore many of the bad practices listed above have not been fully felt, there are plenty of market signals that tell us we are about to enter a much more difficult lending environment and lower realisations.

For example, according to Lincoln Financial, close to 50 percent of sponsor-backed loans are below 1.0x their fixed coverage ratios. Interest rate coverage, according to NEPC, has declined from over 3.5x to approximately 1.4x in the past two years. Moreover, leverage levels, when excluding (often wildly) optimistic adjustments to EBITDA are routinely over 7x depending on the sector. These are early warning signs. But without numerous, tight covenants, and other investor protections, it will be increasingly hard for many private lenders to heed Haymitch's sage advice: "Stay alive!"

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The non-sponsor lower and core mid-market: underserved with compelling risk/reward characteristics

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 and core 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 because 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 non-sponsor lower and core mid-market remains underserved because of increased regulatory pressure and market dynamics that have reduced the number of small and mid-size banks in the US and have made the remaining ones very reluctant to provide long-term business loans. As Jamie Dimon, CEO of JPMorgan, recently said, according to recent Fed proposals, "almost all loans (by banks) are bad".

Additionally, the core and lower mid-market requires tremendous focus and experience to source good businesses and to underwrite them conservatively. At MGG, 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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