

What recession? COVID premium and tighter docs go out the window as competition for good assets intensifies in direct lending

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When the coronavirus pandemic spilled into the financial markets, direct lenders and banks dialled back, with funds demanding better documentation, higher pricing and lower leverage, and banks turning the underwriting tap off. But a few months later, with the wider markets back up to their pre-COVID highs, the syndicated markets functioning again and banks underwriting, funds' need to deploy means terms and conditions on deals are going back to their pre-COVID levels, according to several market sources.

A lack of quality assets has driven competition even higher than before, as most lenders chase the few assets around. A number of funds in the market take the view that providing financing to a credit deemed 'safe', which traded well through the pandemic, at tight pricing, with higher leverage and loose documentation is preferable to doing a more hairy deal that could be seen as an obvious dud later on.

So the chase for COVID-resilient credits intensifies, at a time where sponsors and corporates are holding onto their best assets.

"The good assets are going absolutely crazy. There's a weird dynamic in that things should price higher with tighter docs but because there's such few good deals out there you are getting a mentality where funds are going – I prefer doing those at bad terms," said a direct lender.

There is also a general consensus that sponsors are taking a 'I'll be even more aggressive than before COVID and let people negotiate me back' type of approach, said the sources.

"It's carnage. PE funds are as ever, mega aggressive. They do their job, call 10 people, sit back and wait for people to outbid the ask," said another direct lender.

Pricing is still a touch higher, which is also reflected in the syndicated markets, but far from the significant premiums talked about in April, following the sell off in secondary. But sponsors are making sure that the extra burden comes with bells and whistles.

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“It’s the continuation of a little bit of a FOMO trend, markets are back up, banks are underwriting again. Private debt lenders are trying to get a bite of the apple before it goes away again,” said Alexander Griffith, a partner at Proskauer. “Pricing is maybe 50bps better but sponsors are like, ‘we will pay you the 50bps and get all the flexibility we want, the addbacks, EBITDA flexibility. And then we’ll refi you with cheaper debt in two years but secure the flexibility we need today’.”

At the start of April, when the average yield on high yield bonds in Europe hit 7%, and loans were in the 4%-7% range depending on calculations, the consensus was that unitranche should be in the 10% mark to offer a premium over the wider syndicated markets.

But secondary markets have recovered, and primary markets are proving a lot more resilient than expected. First lien loans issued in June in Europe paid an average of Euribor/Libor+ 500bps – which is a significant jump from February’s E+/L+ 360bps, although one COVID-hit deal, cruise operator Carnival, eschews the data slightly with its E/L+ 750bps margin, according to *Debtwire Par* data. It is fair to say most deals are pricing with a four-handle.

The cost of borrowing for B rated (B-/B/B+) high yield issuers was on average 5.39% in June compared to 4.1% in February, while BB (BB-/BB/BB+) bonds were issued with an average 3% yield in June, compared to 2.39% in February.

So with the high in high yield only going one way, the private debt markets are following suit.

Back on the list are also mulligan clauses, lofty EBITDA adjustments and the addition of new exceptional items such as catastrophe/pandemic, said the sources.

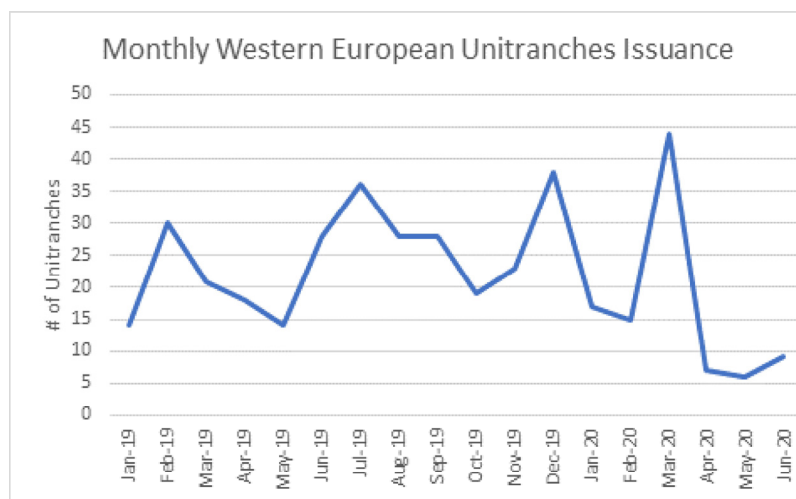
“A lot of lenders are basically saying that if the company is decent, that they’ll do it and show LPs ‘we’re deploying at a time of dislocation’. Everything is back up,” added Griffith.

“There are very few deals out there, we can’t afford to be expecting a big premium on pre-COVID terms. It’s not like 2009, where you name your price. It’s a different situation, a collapse in demand,” added a third direct lender.

Germany is proving particularly competitive, said one of the sources.

“People are taking everything face value – I can’t lose money at 3.5x leverage. Well you can! We’re seeing a fill the hopper type of approach,” said a fourth direct lender.

Unitranche issuance dropped significantly over the lockdown months, with just seven deals done in April, six in May and nine in June, according to *Debtwire Par* data.



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