EXPERT Q&A

As pricing and terms in the mid-market revert to the mean, Monroe Capital's Tom Aronson and Carey Davidson explain how experience and relationships can improve outcomes for borrowers and investors alike

Adjusting to the 'new normal'

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The pronounced drop-off in new deal activity has made it hard to coalesce around concrete trends. But as deal volume re-emerges in the second half of the year, it is becoming clear lenders will be rewarded for any added risk against a still-uncertain backdrop.

To learn more about how the market is taking shape, Monroe Capital's Tom Aronson and Carey Davidson spoke with *Private Debt Investor* about what they're seeing at ground level and how the pandemic is reshaping dealflow, influencing borrower preferences and affecting lender appetites, while also reinforcing the importance of relationships and experience to navigate an unprecedented situation.

Q As we enter the second half of the year, there's a sense that deal activity will pick up. What's your view of the new dynamics shaping investment activity?

Tom Aronson: Like any recessionary environment, we're seeing a bifurcation take place in which the companies that have been resilient and have performed well amid the shutdowns are still seeing strong interest from buyers and lenders. The companies that have been affected simply aren't coming to market. There is a new dynamic, however, in which investors are being forced to distinguish between recession-resistant and covid-resistant companies as the pandemic has exposed a number of business models that would normally be protected during a downturn.

Certain segments of healthcare, for instance, have been hit hard as patients put off elective surgeries or doctor/dental visits. Even IT, which is considered recession-resistant and in most cases is covid-resistant, can be exposed if a company's end markets are affected.

At Monroe, even before the coronavirus hit, we had been focusing on less cyclical industries, such as software and technology and certain business services. These sectors, generally, have fared better than most others, so the opportunity set from an industry perspective for us hasn't changed dramatically.

Q For the deals that are getting done, how have terms changed for borrowers?

Carey Davidson: Enterprise values for companies that are showing resiliency are still reasonably close to the multiples sellers had been fetching prior to the pandemic. However, for those companies affected by the pandemic, leverage multiples – at least in the lower-mid and mid-market – have come down by approximately a turn to a turn-and-a-half compared with last year. Lenders are also negotiating for increased pricing to account for higher risks, and seeing financial sponsors contribute more equity as a proportion of the total purchase price, thus bringing overall deal leverage down.

These shifts are pretty common at the onset of any downturn. One of the most notable changes, today, revolves around the tightening of cash and collateral leakage and documentation.

Q What are lenders looking at when it comes to documentation?

CD: Everyone is hyper-focused on cash for obvious reasons amid a liquidity crunch, but this scrutiny extends to underwriting and documentation. At the outset, lenders are going to be less willing to accept addbacks or aggressive EBITDA adjustments. Six months ago, investment banks might have tried to include everything but the kitchen sink to boost purchase prices, but the few adjustments we've seen recently have hard costs tied directly to covid-related issues and the impact of the current covid-related economic environment.

One of the silver linings of a downturn is that these periods help to stress test documentation. And we've heard of several cases in which some lenders have been exposed to significant cash leakage. So, universally, lenders are tightening documents to protect against cash or other assets comprising lender collateral from being transferred out of their purview, be it through dividends, divestitures or other means.

There will always be more discipline during uncertain markets. Today, though, there's also less appetite to hold large credits. This has led to more club deals and a deeper consensus around what is and what isn't market for terms and documentation. We still prefer to maintain a leadership role in deals we source and arrange, but the trend toward partnership eliminates the outliers.

> *"There will always be more discipline during uncertain markets"*
>
> **CAREY DAVIDSON**

Another factor is just the mix of dealflow, which is tilting toward more non-sponsored credits than it has in previous years. Strategic borrowers are generally less likely to push the envelope than financial sponsors. Another interesting dynamic is that much of the PE activity is actually portfolio-driven. Sponsors have been willing to support this activity with additional equity, which represents an about-face from the recent past when add-ons were viewed as a way to add leverage and lower the 'all-in' entry multiple.

Each of these factors – from higher coupons and lower leverage to tighter documents and better protections – explain why institutions are increasingly eager to gain exposure to the private credit asset class.

Q How has the market for unitranche facilities held up amid the uncertainty?

TA: If anything, the disruption has reinforced why borrowers have gravitated to unitranche facilities. When you have one lender who serves as agent and is the main point of contact, it simplifies financing for mid-market companies. This is true during good times but becomes more relevant and evident during economic downturns.

When there are multiple layers of debt – whether it's senior, second-lien debt or mezzanine financing – it creates challenges for borrowers to maintain a consistent dialogue. If various lender groups are pitted against each other in a workout situation, it's even more difficult and limits the alternatives available. With a unitranche arrangement, there's an alignment of interests that serves all involved, not to mention relationships that instil a sense of trust on both sides.

Q Are there any other lessons from the disruption that will endure?

TA: In the mid-market it is crucial to have a consistent dialogue with a high-touch operating model. This allowed us to quickly stabilise when covid hit. There was a coordinated effort in which our 20-plus person origination team, together with our 45-plus team of underwriters and portfolio managers, worked closely with borrowers to be proactive and maintain a dialogue that allowed us to react quickly and with conviction. This communication prevented any surprises to our borrowers or Monroe. Ultimately, this has ensured everyone is prepared as best as possible for the uncertainty that lies ahead.

This is now the third time our team has been through a down credit cycle together since 2000. It's during these transition periods that clients most appreciate the value of a lender that has been there before and won't panic at the first sign of trouble.

CD: Ironically, this is why investors in private debt are so focused on track records, because experience matters. This era, given the disruption, could prove to be among the best vintages for private debt funds over the past decade, marked by better risk-adjusted returns, higher coupons and better documentation, at least for those who are positioned to put capital to work and infuse liquidity into the market. ■

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