PILFOR
LENDING SOUNDNESS

May 2020

Monthly Market Insights

Primary debt capital markets

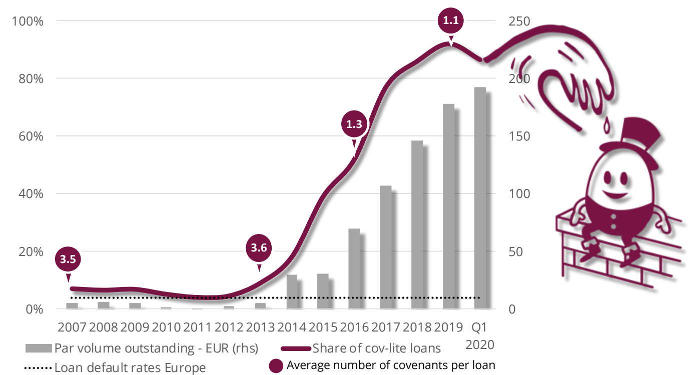
2020 has seen a record in terms of new debt issued. US IG corporate bond volume for example, exceeded USD 1 tn, setting the fastest pace in history. Access to capital markets proved a life-line for the pandemic ravaged corporate landscape. For now, central bank interventions avoided turning liquidity issues into solvency risks. However, the boost in borrowing is also drawing dark clouds. As of late May, 1792 rated issuers by S&P were at risk of a downgrade or downgraded, surpassing 2009 levels. Rating erosions are more than likely over the coming months. A growing number of companies are utilizing another source of liquidity by means of disposing their large stakes in listed companies as they focus on core business. So far investors have been very willing buyers, while sellers welcome the market's current high valuations. Liquidity might not always be at the forefront, but rather boosting war chests for M&A opportunities, once reality catches up with markets.

Record issuance of debt within first 5 months of 2020

Wobbling cov-lite loans and EBITDA add-backs

Companies got rough wake-up calls forcing them to scramble for measures aimed at staying afloat. Gone are the days of ultra-low risk premiums, investors buying into high risk classes and defined by “optimal capital structures”, resulted in the growth of the “B” empire. To further enhance financial leeway for LBOs and M&A, cov-lite structures and EBITDA add-backs worked their way through leveraged loans and HY bonds right through to the investor, proving successful and accepted in calm waters as long as there was some yield in the game. Cutting down on covenants has largely deprived investors from early warning signs, while add-backs served as steroids to take on even more debt on what is often a rather fragile credit profile labelled “B”. Woe and be hoe, for anyone knowing but ignoring what happened to “Humpty Dumpty” when the bricks - or rather the loads of debt weighing on fragile capital structures - collapsed under him as the tidal waves of a virus-infected environment struck.

Looming washdown risks are mounting



Source: Fitch, Moody’s, S&P, LCD, M&G

Direct lending standing the test of time

The next quarters will prove whether looser underwriting policies by some direct debt lenders targeting the riskier side of the credit spectrum was the right strategy. Direct debt lenders that are forced to provide additional cash to their battered mid-sized borrowers to keep them afloat may find themselves sidelined by larger firms enjoying larger scale, relationships and reach required in this market environment. In the near future the market is likely to see some consolidation / M&A among direct debt lenders, as weaker positioned participants struggle with their credit portfolios or lack of scale. Lenders able to deploy cash are well placed to benefit from this development and further grow their market share. We see some interesting spotlights shifts by a number of direct debt companies like sector focus shift (i.e. more defensive characteristics), re-evaluation of debt instruments, heightened attention / avoidance of cov-lite structures & EBITDA add-backs (incl. EBITDAC) or stronger c-metrics.

Caution working its way through underwriting policies

PILFOR is an independent and specialized debt & capital advisor establishing and optimizing
funding access - financial flexibility - financing costs

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