WHAT TO EXPECT FROM YOUR DIRECT LENDERS WHEN THE CYCLE TURNS

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Direct lending, or senior debt, funds have come to dominate the private credit asset class, capturing significant portfolio allocations and outpacing fundraising of other private credit strategies.[1] However, over the past 18 months, Cambridge Associates (CA) has felt enthusiasm for senior debt allocations cool as discussions turn to senior debt funds' performance through the credit cycle. While CA does not forecast recessions, we are able to offer some guidance as to what limited partners (LPs) can expect to see in their direct lending portfolios as they monitor their senior debt exposures.[2] These expectations may be met, in whole or in part, as the cycle begins to turn, and LPs should use this list to evaluate general partner (GP) performance, frame monitoring questions, and set senior debt fund return expectation through the credit cycle.

BEFORE ACTUAL DEFAULTS—WAIVERS AND AMENDMENTS

Borrowers' earnings will begin to deteriorate ahead of a full economic downturn, reaching low points as the credit cycle approaches its crescendo. Even the strongest loan structures permit some earnings deterioration, meaning that events of default (EoDs) may come later, coinciding with a deepening recession.

However, LPs need not await defaults to identify credit deterioration. Before EoDs begin to increase, borrowers are likely to request amendments to their credit agreements that might reset covenants at more accommodating levels, or they may ask for a covenant to be waived temporarily. Increasing waivers and amendments in a senior debt fund's portfolio could foretell a dawning credit cycle, acting as a leading indicator. However, some amendments and waivers may be required to grow a business: for example, a capital expenditure covenant may need to be waived to permit the purchase of new machinery required to gain new orders from an existing client. Therefore, LPs should ask about waiver and amendment activity unrelated to acquisitions of assets or operating businesses.

Finally, the incidence of amendments and waivers will depend heavily on the underlying strength of the document requiring them! In today's covenant-lite world, this indicator may be less reliable.

EODS, FORBEARANCE AGREEMENTS, AND EQUITY CURES

For purposes of this analysis, EoDs refer to the breaching of certain financial covenants (if there are any) and not to nonpayment of interest or principal or insolvency. EoDs act as early warning systems, allowing lenders a seat at the table in discussing a borrower's future. The most important, and among the most easily tracked, financial covenants are leverage covenants (which govern the amount of debt a borrower can have relative to earnings before interest, tax, depreciation, and amortization [EBITDA]), interest coverage (the ratio of EBITDA to cash interest expense), and fixed charge coverage (calculated

1 For a full discussion of the entire private credit asset class, please see Tod Trabocco, "Private Credit Strategies: An Introduction," Cambridge Associates Research Report, 2017, and Rich Carson and Tod Trabocco, "Private Credit Benchmarks: A User's Guide," Cambridge Associates Research Report, 2019.

2 We offer an idea for an early indicator of a potential credit cycle turn in Tod Trabocco, "Origination Year Defaults: The Canary in the Coalmine?," Cambridge Associates Research Note, September 2018.

differently, but generally the ratio of EBITDA less cash interest and cash taxes to interest and principal). In the last cycle, EoDs were quite common as companies struggled to maintain earnings in the global financial crisis (GFC). As the next credit cycle builds, EoDs should become more prevalent.

However, LPs should understand that EoDs do not necessarily result in lender action. Lenders may elect to forbear or defer their right to act until a future date. This acknowledgement of an EoD and concomitant deferral of creditor rights is typically enshrined in a forbearance agreement.

Finally, documents enable borrowers to "cure" EoDs. In other words, if a borrower breaches a covenant, owners (usually private equity firms) are permitted to contribute fresh equity capital to the borrower. That new capital contribution is added to the actual EBITDA and treated as though the borrower actually earned it through normal business operations. While the borrower failed to generate adequate EBITDA to maintain covenants, the contribution of equity erases the EoD, permitting senior lenders to report to LPs that no EoD has occurred. LPs should therefore enquire as to the incidence of EoDs, forbearance agreements, and equity cures.

CREDIT METRIC MIGRATION

The challenge of relying on EoDs to identify credit trends is that they only exist in the presence of covenants. It is impossible to default on non-existent covenants! While EoDs used to be a good measure for credit stress, covenant-lite structures will likely mask stress until it becomes inescapable. One distressed manager recently identified a covenant–lite broadly syndicated loan (BSL) whose borrowers' earnings had deteriorated to the point that it had trouble paying employees without triggering creditors' rights.

In response to covenant-lite structures, LPs should consider asking senior debt funds for a migration analysis or migration report: an analysis of trends in key credit metrics, such as leverage and coverage ratios, typically enshrined in covenants. Senior debt funds should be able to provide leverage and coverage ratios at a loan's closing and at every subsequent borrower reporting date (assuming that covenant-lite structures have not eradicated financial reporting covenants). LPs can ask for this information periodically, enabling them to track the migration of these key credit metrics. In the absence of reportable EoDs, LPs may find this analysis useful in formulating an opinion as to each borrower's health. This information should not be too burdensome to provide as it is commonly used by portfolio leverage providers. Migrations are likely the best leading indicator of souring credit quality and can point to EoDs that should have occurred had covenants been in place.

ACTUAL DEFAULTS

Actual defaults refer not to covenant breaches (EoDs), but to the declaration of bankruptcy, missed interest or principal, or the distressed exchange of one instrument for another. LPs can expect actual defaults to rise in a credit cycle. In fact, rising defaults define the credit cycle! LPs should therefore ask for an updated list of actual defaults as they monitor their portfolios, and LPs should be aware of the nuances of each type of default.

The most straightforward of the three types of actual default is bankruptcy. LPs can ask for a "direct" answer when asking if any borrowers have filed for bankruptcy. However, middle-market companies tend to file less frequently than larger companies because the expense of the bankruptcy process may be too burdensome for them or because the value of the enterprise may be too small to survive a protracted process. As a result, distressed middle-market borrowers may undergo informal restructuring processes outside of bankruptcy protection.

Missed interest or principal repayments may also be less obvious. It is not uncommon for senior lenders to permit stressed borrowers to pay interest in-kind (i.e., payment-in-kind [PIK]) for a period. Under this agreement, lenders permit the interest due to be added to the outstanding loan balance rather than be paid in cash. Technically, there is no missed interest payment even though the borrower lacked funds to make the payment.

Distressed exchanges should be more commonly observed in portfolios of senior lenders with exposure to BSLs and less common in portfolios of senior debt funds focused on the middle market. Senior debt funds targeting the middle market tend to retain more control over their documentation and are likely to resolve issues through amendments and waivers to existing instrument rather than exchanging one loan for another. As a result, distressed exchanges may not be as useful in evaluating rising distress in the portfolios of certain senior debt funds.

Luckily for LPs, informal restructurings, conversion of interest from cash to PIK, and other changes of original loan terms must be documented. CA refers to these changes as material modifications and uses them as a proxy for credit stress when evaluating managers.[3]

MATERIAL MODIFICATIONS

Before actual defaults occur, senior debt funds may be tempted to modify their loan agreements in order to accommodate a borrower's putative temporary financial difficulties. CA defines modifications as those that are made to the widely recognized "sacred rights" and converting interest to PIK at the lender's discretion.

Sacred rights are those terms and conditions in a loan agreement that have two characteristics. First, their alteration will affect the economics of the loan and can include maturity, interest rate, amortization, other repayment terms, collateral packages, liens, etc. Second, their alteration tends to require unanimous lender approval, not just some majority. These types of material modifications were concisely encapsulated in the last downturn as "amend and extend" or even "amend, extend and pretend". LPs can expect to see similar behavior as the cycle turns and should ask senior debt funds about this "amend and extend" activity.

3 Please see Tod Trabocco, "Stress and Loss Among Middle-Market Senior and Unitranche Loans: Introducing Cambridge Associates' New Database," Cambridge Associates' Research Report, 2019.

PIKing at the lender's discretion is also a good harbinger of actual default. Lenders may have perfectly sound reasons to permit a borrower not to pay interest (i.e., an opportunistic transaction or accelerated capital expenditures), and others that augur less positively. LPs can expect to see PIKing and enquire as to any loans where the lender permits. PIKing at the borrower's option is not great either, but that is a failing of the original documentation.

Furthermore, as noted above, material modifications to documents can occur in lieu of an actual default. In many ways, material modifications can act as mutual agreements between a borrower and a senior debt fund that an actual default has (or would have) occurred. LPs can therefore enquire as to material modifications. However, not all material modifications are bad, so LPs should be sure to ascertain the reasons for each modification.

Together with migration, material modifications may act as a leading indicator. Moreover, depending on the severity of the stress sought to be alleviated by a material modification, return expectations may need to be re-evaluated.

NEW LOANS TO EXISTING BORROWERS

Senior lenders may feel compelled to fund new instruments (beyond delayed draw facilities agreed to at initial financing) to provide liquidity for a borrower to survive, repay an aggressive lender, or make a rescue acquisition. An owner that has recouped a return through fees and dividends may wish to invest scarce capital elsewhere, leaving senior debt funds to fend for themselves. In these cases, senior debt funds may wish to provide additional financing to support the borrower through its difficulties. This new capital can frequently take the form of junior financing.

Asset-based lenders and revolving lenders can challenge term lenders, such as senior debt funds, and their removal from the capital structure often simplifies negotiations between a borrower and a direct lender. So, LPs can expect to see senior debt funds exercising buy-out rights, resulting in new or increased loans.

As a result, LPs should track the appearance of new loans to an existing borrower and query the rationale behind such financings.

NON-ACCRUALS, WATCHLISTS, AND INTERNAL AND EXTERNAL RISK RATINGS

Even without financial covenants, direct lenders can track borrowers' financial performance if they receive quarterly financial reports. Quality senior debt funds will take measures to address deterioration that LPs can expect to see and which they can test empirically. For example, if a direct lender is following best practices, it should stop accruing interest on its balance sheet when the receipt of interest becomes doubtful. LPs can expect to see a rise in non-accruals and should certainly ask their senior debt fund GPs about any new non-accruals in their portfolio.

The best senior debt funds typically have an internal risk rating system. Some use a numeric system ranging from one to five, one to seven, one to ten, etc. Some may only have a rudimentary system that categorizes borrowers as either performing or on a "watchlist." LPs can expect to see the average internal risk rating of their direct lenders' portfolio decline with the credit cycle and should certainly enquire as to these trends. If a senior debt fund has publicly rated debt, then LPs can expect to see borrowers downgraded or placed on notice for a potential downgrade.

VALUATIONS

Valuations should naturally reflect the diminution in credit quality that accompanies a credit cycle and LPs should look closely at their senior debt funds' quarterly and annual reports. Senior debt funds' and third-party valuation providers should reflect diminution of borrower credit quality as a reduction in outstanding par value (which should then appear in fund income statements as a non-cash charge against current income). Some senior debt funds that do not adhere to a non-accrual policy may rely more heavily on valuations to reflect values, particularly if they can mark their assets to market. In this case, LPs should check if the discount to par exceeds the coupon rate on the loan (technically, the credit spread over the reference rate). This may be a sign that principal is at risk, indicating that interest cannot compensate for principal loss, a core tenet of credit risk asset pricing.

DECLINING YIELDS, TRAPPED CASH, AND BORROWING BASE COMPLIANCE

Virtually every senior debt fund offers a levered vehicle. Commercial and investment banks provide leverage collateralized by a pool of loans originated or purchased by the fund. These leverage providers assiduously monitor the value of that collateral, and as a result, may identify credit stress before LPs. In the event of a turn in the credit cycle and deterioration in loan quality, LPs can expect leverage providers to reject certain collateral or require their leverage to be repaid more quickly to preserve their collateral coverage.

LPs can identify these actions in two ways: (1) The current yield that they receive may decline as leverage providers trap interest and principal payments from the underlying loans to repay their leverage lines more aggressively; and (2) If they perceive deterioration in current yield, LPs can ask if senior debt funds are in compliance with the borrowing bases/credit agreements with their leverage providers. If a senior debt fund responds to this question in the negative, LPs can have a broader discussion as to the underlying causes.

Naturally, interest and principal payments diverted away from LPs and to leverage providers will depress current yields and should cause LPs to recalibrate return expectations.

CAPITAL CALLS AFTER THE INVESTMENT PERIOD

Leverage providers for senior debt funds generally retain some creditor rights, even if those facilities are not framed as "mark-to-market." Because leverage providers take as collateral the loans made by the senior debt funds, they have rights to enforce the collateral under certain conditions. Many of the facilities are analogous to margin loans, where a diminution in the value of the underlying collateral can require the borrowing senior debt fund to exchange collateral or to repay the loan.

Partnership documents can permit the calling of capital after the conclusion of the investment period under certain circumstances, including to repay liabilities. LPs should not be surprised to get a capital call after the investment is used to repay a leverage lender. LPs should certainly follow up that call with a telephone call of their own!

CHANGES IN LEVERAGE PROVIDERS

In the vein of leverage providers exercising creditor rights against senior debt funds, it is possible that some providers will simply not want to continue relationships with some senior debt funds. This happens between companies and lenders quite frequently and is referred to as lender fatigue. A fatigued leverage provider may want to terminate its relationship with a senior debt fund and that fund will have little choice but to find another lender. Much like a company changing auditors, LPs should explore the causes of the change in a fund leverage provider. This is more likely to occur with smaller senior debt funds.

LOAN EXTENSIONS

At CA, we struggle to recall one senior debt fund that has vocally assumed that individual loans will run to maturity of five to seven years. To the best of our recollection, virtually every single one has assumed a loan life of between three and four years. Reasons for this tend to vary, but much of the justification for this assumption can be laid at the feet of the benevolent capital markets, which ease refinancing risk and support acquisitions. As the credit cycle turns and markets wane accommodative, refinancings and acquisitions will become less common and expected loan lives will extend.

This has four implications for senior debt funds. First, return expectations at the portfolio level (and therefore net to investors) are set based on the expected yield-to-maturity of a loan, an equation that requires at least five inputs (we will assume loans have no or almost no amortization): term structure of a reference rate (typically LIBOR), spread over the reference rate, upfront fee, life of loan, and loss expectations. As loans extend, the term structure of LIBOR looms larger, particularly in the absence of a floor. Second, the upfront fee (usually around 1.0%–1.5% in the United States and 3.0% in Europe) is divided by the expected life of the loan and added to expected average LIBOR and the spread. This calculation can raise the expected yield to maturity from 50 to 100 basis points (bps). So, a loan with an assumed average LIBOR rate of 2%, a spread of 6%, an upfront fee of 1.5%, and an expected life of three years has an expected yield of 8.5% in the United States and 9% in Europe. If the loan runs to a five-year maturity, then expected yield-to-maturity will decline by 20 bps in

the United States to 40 bps in Europe. At a seven-year maturity, the yield-to-maturity will decline by an additional 9 bps and 17 bps, respectively. Third, as refinancing capital recedes, marginal loans will ripen and loss expectations should grow, further compressing return expectations. Finally, as loan lives extend and repayments decline, senior debt funds will be less able to recycle capital and drive greater multiples on invested capital. LPs can track loan lives as part of their monitoring.

FUND EXTENSIONS

Senior debt funds have tended to shorten their overall fund lives. At least one direct lender has a five-year fund life, including the investment period. This means that any loans made in the second (and final) year of the investment period must be repaid as expected, not as documented, for the GP to avoid using its discretion to extend the fund's life. As described above, quick repayments require ample refinancing and acquisition capital. Credit cycles are virtually defined by a contraction in both, and LPs can expect to see fund lives extended. As intimated above, fund life extension driven by asset extension will impact returns.

DEPARTURES

LPs can expect to see personnel turnover in some senior debt funds if credit deterioration and fund extension depresses returns and related carried interest expectations. Lower returns can also complicate future fundraising, particularly in the middle of, or just after, a credit cycle. Fidgety employees may seek greener pastures. LPs can therefore expect to see some level of staff turnover as a credit cycle begins. In the depth of a credit cycle, job opportunities dwindle and so should departures!

CONCLUSION

Some senior debt funds demonstrated remarkable resilience in the GFC, and we expect the best to survive the next downturn. Nevertheless, every senior debt fund will experience some level of credit deterioration that LPs can monitor. These include:

- Prevalent "migration" in key financial indicators ahead of a credit cycle;
- Rising amendments and waivers in the earlier stages of a credit cycle;
- Increasing EoDs, actual defaults, material modifications, loan extensions, and weakening valuations/credit scores or rising non-accruals as the cycle gains steam; and
- Staff departures, actions by leverage providers, new "rescue" financings, and fund extensions as the cycle deepens.

Naturally, this list is not exhaustive and new covenant-lite structures, greater competition, new entrants, and other market dynamics may render some of these indicators more or less important in the next credit cycle. ■

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