EXPERT COMMENTARY

From mastering the nuances of deal documentation to making sandwiches for lunch, Stuart Smartt and Linda Chaffin of NXT Capital explore the new realities of life for 'remote' private debt managers

A day in the life of a mid-market direct lender

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The impact upon daily routines and rhythms for most of us, including mid-market direct lenders, has been substantial over the course of 2020. Since the covid-19 outbreak, there has been little or no commuting to the office, in-person meetings or diligence trips. Workspace has a new meaning, with daily tasks being carried out in home offices and more unusual settings such as garages, closets and vehicles.

As anyone who's been on a video call knows, we do not sit quietly alone. Dogs are barking, babies are crying, the internet is flickering, and we are balancing at-home e-learning for our kids. Now more than ever the importance of staying flexible is appreciated because things are changing time and again.

At the highest level, the day-to-day activities of a mid-market direct lending team are manifold. At its core, we seek to consistently lend capital to high-quality borrowers in order to generate attractive risk-adjusted returns. In addition, direct lending plays an important role in supporting mid-market businesses, which represent a large and important part of the US economy.

Though daily tasks will vary, what follows below is a broad outline of what a 'typical' working day – in the midst of pandemic – entails. After checking work emails, catching up on overnight news and prioritising the items on to-do lists, it is time to engage with the day ahead. The clock hits 8.30am and, coffee in hand, the morning officially kicks off by logging into a daily video team call from our now well-worn home office.

Take stock to decide what to do

At NXT Capital, each loan has a designated portfolio monitoring team. There are many calls each day and by now our video conversations are flowing naturally, except when all is quiet and we need to say "you are on mute".

Unlike prior market dislocations, covid-19 presented the US economy with a crisis caused by a global health issue, not an economic one. As a result, the responses and processes of loan portfolio management are different. All industries and businesses have been impacted. Some of the impacts are negative and others positive; some are short-term, others long-term. Although our loan portfolio managers are always actively engaged, since the onset of covid-19 they have been using new tools and analytics.

Looking at financial statements delivered 30-45 days after the month-end no longer works, so our team began to identify key operational metrics that would provide a real-time indication of performance. One key performance indicator we are monitoring closely is reported borrower operating levels and order volume as a proxy for revenue. When compared with prior periods, the current operating level provides real-time insight into the state of borrower operations. The most appropriate operating level metric varies by industry (revenues, order volumes, patient visits, etc) and is more insightful than trailing 12-month financials. The approach of segmenting accounts by operating levels also allows you to focus resources on solutions for the most sensitive situations.

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At NXT Capital, we have been pleased to see continued recovery in our portfolio over the last several months, with the vast majority of companies and most industries now operating back at more than 90 percent of pre-covid levels. Within the healthcare sector, for example, elective procedures and non-emergency visit volumes are proving resilient.

Mid-market loans are governed by a set of legal documents that can be revised and amended from time to time if necessary. Amendments can range from the simple to the more complex. Not surprisingly, portfolio amendment activity is noticeably elevated to extend the runway for impacted businesses. Even for an institution with meaningful resources, reviewing, evaluating and approving requests is time-intensive. Most requests to date are short-term-focused and include flexibility for audit extensions, forbearances, government loans and maturity extensions.

More impacted borrowers tend to be classified as 'double-whammy' situations: the company was struggling prior to the pandemic and then experienced specific challenges exacerbated by covid-19. Here, principal or interest deferrals may be sought. Situations such as these may require the specialised skills of a dedicated workout team in alignment with the private equity firm owner.

Thus far, few comprehensive loan amendments have been executed because the long-term capital needs are hard to quantify, given the uncertainty around the duration of the pandemic. The portfolio management journey since Q1 2020 has had its ups and downs, but overall mid-market companies have once again proven their resiliency.

Key takeaway: Manage the portfolio with real-time metrics, not the rear-view mirror, and the mid-market does not collapse

Underwriting new loan opportunities requires a different process

As I grab lunch from my kitchen – peanut butter and jam again – I reminisce about that great deli down the street from the office. It is time for my next call, so I check myself in the mirror and click on the video to discuss a new loan opportunity.

The M&A deal process under covid-19 has been tactically reinvented to accommodate the need for personal safety. Deal timelines have somewhat slowed as the ability of dealmakers to provide information is hindered and access to management teams is constricted to fewer potential buyers and their third-party diligence providers. In response, direct lenders have worked to revise their playbooks.

'Meeting' management teams and touring facilities can look different. Virtual data rooms are still the norm, but thoroughly assessing the present and future financial performance of a business before, during and after covid is challenging. Fortunately, a direct lender's existing portfolio provides an unobstructed view into industries and trends.

Transactions being marketed with EBITDA adjustments related to covid, known in the industry as EBITDAC, are taking different forms. Many are expense-based, noting that the cost of doing business increased as a result of the pandemic. Others are seeking to offset lost revenue by using prior or future periods as a proxy. It is impossible to have a uniform response on proposed adjustments, so each must be carefully evaluated, leaning in on the underwriting standards that we believe have served NXT Capital well.

During the new deal pre-screening process, we decide this new opportunity looks promising and will move ahead with our diligence. Stacking my lunch dishes in the sink, this is a good time to call the private equity sponsor to share our initial feedback on the deal.

Key takeaway: Use a disciplined and straightforward process

New business is a top priority

While hoping that the broadband connection doesn't suffer any further hiccups today, it is time to work on building the pipeline of new opportunities. Each day new deal opportunities are emerging at a pace that is accelerating as we head into autumn. Adjusting my sitting desk to a standing desk by stacking a few cardboard boxes, it's time to call a sponsor I've covered for over 20 years.

Direct lenders began 2020 with healthy amounts of capital available, benefitting from several years of robust fundraising activity. Despite full coffers, virtually all direct lenders were essentially 'closed' to new business in March and April. So much was this the case that private equity groups have become accustomed to asking direct lenders if they are open for new business. For those lenders that are open, each day the origination pipelines continue to gather steam as private equity sponsors and borrowers gain a better understanding of businesses in a covid world and look for growth opportunities.

The draw of more attractive loan terms stemming from quarters of uncertainty and subdued lending activity has resulted in increased activity for both current portfolio companies and other private equity-backed platforms. Since mid-March, the tone of the market has changed materially, resulting in more lender-friendly deal terms. Leverage has moderated by 1.0-1.5 turns of EBITDA, coupons have expanded by 100-200 basis points, and deals are further enhanced by what we consider more attractive original issue discounts, call protection and legal documentation terms.

The age-old proverb 'all good things must come to an end' is beginning to be whispered in the mid-market. Despite renewed lender appetite in recent months, leveraged buyout activity is falling short of demand. According to a Refinitiv LPC report published on 14 September, mid-market sponsored loan issuance was down 54 percent since the start of the year. This supply/demand imbalance is driving a migration of deal terms away from the lender-friendly levels exhibited earlier in the year towards pre-pandemic levels.

As we enter the fourth quarter, direct lenders competing to win new business are challenged with having to adapt to rapidly evolving terms. The competitive forces are intensifying amid the scarcity of credits that pass muster given the overhang of covid. The efficiency in the marketplace earlier in the year has been replaced by significant variability of deal terms by lender, issuer and transaction characteristics. The dynamic state of the mid-market requires direct lenders to revisit term sheets every week or two to ensure proposals remain relevant.

Though some are lamenting an eventual return to pre-pandemic deal terms, that chapter has yet to be written. With a US presidential election looming (sure to be one of the most intriguing in recent history), high unemployment creating concerns, vaccine timing hotly debated, and the possibility of a widespread 'second wave', there is likely to be continued inefficiency in the private credit market.

Absent significant developments on those fronts, increased buyout activity could extend supply, thereby extending the opportunity. With sectors and businesses affected in different manners and with meaningful dry powder – private equity firms have raised about $240 billion in 2020 after a record $376 billion in 2019, according to Refinitiv LPC – the stage is set for a more active deal environment.

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Key takeaway: Be active and build upon past success

As you can see, with a commitment to making a difference each day for our clients, the work of a direct lender is varied and important. After organising the calendar for tomorrow, it's time to hustle away for family, friends, exercise and other free time – all at an appropriate distance, of course. The workday isn't over, the laptop is always on and multitasking to the end of the night is the name of the game. Before heading to bed, email is checked one more time making sure everything is cleaned up to start fresh in the morning. ■

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