EXPERT Q&A

The pandemic may have brought the US deal market to a halt, but it has swiftly resumed. Ted Denniston of NXT Capital reflects on changing dynamics in the wake of the health crisis

A market bouncing back

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Q What opportunities are you seeing in mid-market direct lending today?

We think there are a lot of opportunities. Covid paused what was a very active market. We would typically see 80-100 new opportunities a month and we troughed at probably eight to 10. In other words, we saw our dealflow fall to around 8-10 percent of normal levels through the summer. As we reached fall, we saw dealflow return to pre-pandemic levels. In fact, we exceeded those levels in October and November, which was probably due to a lot of pent-up demand that had been on hold.

What we're seeing now is a very steady and consistent flow comparable to previous years. There's still a tremendous amount of dry powder in the private equity and private debt markets so we think that dealflow will continue strongly through 2021. In terms of sectors, we are seeing a lot of activity in certain areas such as food, technology and healthcare. Each of these sectors had their immediate struggles but are bouncing back very quickly.

Q What difficulties and challenges is the market facing?

We are adjusting to a different style of deal-doing than we were used to. In a typical deal we would go out and meet the management team and tour the facility, and we aren't doing that now. The ability to see operations and walk the factory floor has been put on hold.

You have the challenge of doing due diligence remotely, which is something we're all starting to get used to. It's difficult because you have to be more judicious with the questions you ask and how you figure things out. It's a slightly different style.

Another thing we see is addbacks. A big challenge we're all facing is figuring out what's legitimate in our minds, what addbacks you can look at and say they make sense. We financed some businesses that were shut down, you couldn't even come in the door. As soon as they reopened, business went right back up to where it was previously. So I think we see some of those businesses that will bounce back nicely versus other businesses that may be permanently threatened or at least changed.

Q What is the 'new normal' when it comes to working remotely?

In terms of portfolio monitoring, there are obviously some things that have changed. We used to meet face to face with each borrower at least once a year and meet with the sponsors once a month and talk through what's going on in their portfolios. Now we do some of that via Zoom and a lot of it over the phone.

I would say it really underlines the importance of leading and agenting deals and having established relationships with the private equity groups. When we went into the pandemic our portfolio managers had established relationships with the CFOs and the CEOs of the companies, so they were able to pick up the phone and call them and continue to get valuable insight.

We financed a business that distributes produce to restaurants and when it was shut down the portfolio manager on our end was on the phone with the CFO every week getting updates. I think that's extremely important, learning how to manage those relationships without the benefit of the face-to-face meeting.

Q Did you expect the market to be as resilient as it has proved?

None of us saw this coming or knew how long it would last. I was in Phoenix last February meeting with some people and our conversations around the pandemic were that it would really mess up the supply chain in terms of bringing products in from Asia. All the focus was on the supply chain and not a healthcare crisis. Then a few weeks later it was clear it was a global healthcare crisis.

Am I surprised it's bounced back as quickly as it has? If you asked me that based on what I knew in June of last year, then yes. But I think once we look at why it started to bounce back, it's a supply-demand issue. Some companies were always going to be sold and money was going to be deployed and the market has bounced back a little bit from that standpoint. I think from a sellers' perspective we look at founder-owned businesses and a lot of those founders realised when the income stream stopped coming in month to month, it might be a really good time for them to go ahead and sell the business.

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Q How has the relationship between sponsors and lenders changed?

What I found, and a lot of our competitors found, is that long-term relationships were very beneficial because we had an open dialogue about what was going on. There was one sponsor I had a call with every Friday afternoon just to go through their portfolio and find out what was going on and how they were thinking about things and that helped a lot. I could get real visibility into how their firm was acting and they were comfortable that we were able to communicate openly about things.

I'd say there were probably a handful of sponsors and lenders that did lock horns just because that was the style they chose but for the most part, throughout our portfolio, I saw much more collegial relationships. I think that approach has lasted. From the new deals we're looking at right now, and other conversations I'm hearing about, I think some perceived barriers between lenders and sponsors will be broken down. We've realised that in a lot of ways we are on the same side. The success of the portfolio company is important to both of us so learning to work through challenges together is extremely helpful.

Q What should investors ask when looking at managers?

There are several factors investors can consider when doing diligence on managers. Many managers sound similar, but they are not if you really dig into them and their strategy. In my opinion, it's important to understand the longevity of the team executing the strategy, as well as how deep and strong are their sourcing relationships. Investors should really evaluate the components of track records and returns. Returns are driven by two primary variables, yield and write-offs. Yield comes immediately while it takes time for the losses to flow through the fund. And higher yield typically correlates to higher risk so investors need to really understand a manager's target product and associated risk/return. Loss history is important and understanding the recovery track record of senior debt, junior debt and unitranche is crucial.

Sometimes the immediate benefit of higher pricing is offset three to five years later by higher defaults or lower recoveries. While unitranche structures are very popular, investors should be sure to ask managers their strategy around structuring loans, and the unitranche product in particular. From NXT's perspective unitranche loans make sense for borrowers with certain characteristics, but it is not a 'one size fits all' solution. Lastly, understanding a manager's approach and resources to work out troubled loans is critical. ■

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