

# EXPERT COMMENTARY

*Tree Line's Tom Quimby on why it is incumbent on direct lenders and LPs to place a premium on the fundamentals in order to deal with unforeseen events, like covid-19*



## Prepare for the unexpected

Covid-19 has put the credit market in an “if you don’t know, don’t go” mindset. It has become difficult to price risk and model what’s ahead. In March, the value of US 10-year Treasury bonds dropped to an all-time low and appears to be trapped below 1 percent. Equity markets have been whipsawing for weeks and have corrected to the point where the 11-year bull run in the US has ended. Yet many are predicting a v-shaped recovery, while others are binge-buying necessities and survival gear.

Direct lending investors will not have the benefit of looking at a ticker or index to understand the value of their underlying assets. This will be an active and ongoing exercise that will take several quarters.

Reflecting on the catalysts that have disrupted markets in the last 20 years, they were almost uniformly described as unforeseen. Asset managers look for a pass and ask, ‘How could we have possibly forecast such an event?’ SARS, 9/11,

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the global financial crisis and, yes, covid-19, to name a few, were all unforeseen events. It’s been quite some time since markets have faced a challenge of this magnitude. The tide looks to be going out, and quickly. And as Warren Buffet would note, we’re soon to find out who’s been swimming naked. In the end, for all the debate around private credit, its frothiness and where we are in the cycle, it will simply come down to the fundamentals.

The question is this: at what frequency do unforeseen events need to occur for them to be foreseen? As direct lenders, this is a topic we’re particularly passionate about as Tree Line’s entire value proposition is built around delivering consistent yield in all phases of a cycle. It’s incumbent on us to not only model in unforeseen events but to embed

them in our portfolio construction. This translates into a focus on the fundamentals. In recent years, some of the largest credit platforms have created a narrative that lending on an loan-to-value basis in covenant-lite structures with record levels of leverage is nothing to fret about. Well, that’s true, until it isn’t.

At Tree Line, we fully acknowledge that covid-19 is in a category of its own and are approaching it with great respect. However, we prepare for the unforeseen in our daily approach and believe it’s what the DNA of a lender should be. Our team has been involved in direct lending before, during and after the global financial crisis, which gave us a unique opportunity to study data and reshape our portfolio construction strategy. While we have been active lenders to the lower mid-market, having issued \$1.6 billion across 104 companies, we have taken a markedly different approach from the vast majority in the market to prepare for this day. After all,

the unforeseen strikes quick and hard. By this time, LPs have no doubt tried to assess the quality of their underlying credit portfolios, but it's a multi-variable equation to be solved until actual data can be reported. So, below are the key questions LPs will need to address to better understand the underlying health of their direct lending portfolios as financial performance rolls in over the coming quarters as a result of covid-19.

### Assessing credit performance: Six LP questions

#### 1 What segment of the market does a direct lender play - broadly syndicated, mid-market or lower mid-market?

Different areas of focus will be needed depending on where the direct lender is invested. Broadly syndicated lenders are likely to lack covenants or LIBOR floors, and may participate in all sectors due to the size of their platform. Lower mid-market direct lenders making loans to smaller companies will have needed to avoid cyclical sectors and maintain a disciplined approach with low leverage and high free cash with active and capable sponsors. Independent sponsors lacking captive funds may place a disproportionate amount of pressure on a direct lender. Mid-market lenders are likely to represent a mix of both concerns.

#### 2 What exposure does a direct lender have to cyclical industries that will incur a day-one impact?

Retail, travel, tourism and hospitality will feel an immediate impact on their performance. Others, like tech-enabled services, software and healthcare, may be better positioned to withstand a general economic slowdown predominantly led by consumer behaviour. Companies with a sales model built on customer contracts, recurring revenues and subscription agreements to a diverse customer base are positioned to outperform. The psychological impact on the

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consumer following these events takes on a life of its own and, from a market perspective, may be a bigger issue than covid-19 itself.

#### 3 What percentage of the portfolio is senior secured, first lien?

If the structure is a split-collateral loan, where a revolving lender has a first lien on current assets and a term loan lender has a first lien on all other assets, it will be key to know how working capital-intensive the business is and if the revolving lender is tightening the borrowing base. Typically, revolving lenders have the right to reduce availability at any time and this would be one of those times. If the structure is a unitranche senior secured term loan where there is a first-out/last-out provision, it will be key to know what the triggering events are in the agreement among lenders and where the first-out lender detaches – that is, how much leverage is ahead of the last-out lender.

#### 4 Have LIBOR floors been utilised and at what rate?

The 10-year Treasury bill dropped off a cliff in March to below 1 percent, the lowest level on record. Three-month LIBOR declined quickly from 1.9 percent in January to 1 percent in March. The broadly syndicated loan market had been issuing without LIBOR floors and the mid-market had been issuing with a 1 percent LIBOR floor for this period. Unlevered all-in yields in legacy portfolios will decline sharply in 2020 as a result. Tree Line benefited from the

lower mid-market where we were able to negotiate LIBOR floors of 1.5-2.25 percent during this period.

#### 5 How much leverage is at the asset level and what is the definition of EBITDA used to calculate leverage?

We've seen record levels of 6x and 7x loans from the BSL market, with the mid-market following suit with leverage averaging between 5.5x and 6.0x. The calculation to derive these levels typically uses an adjusted EBITDA figure, which can often include synergy add-backs and other speculative one-time adjustments. This will overstate EBITDA and understate leverage. Tree Line does not have any exposure to synergy add-backs, which is a benefit of the lower mid-market. Our weighted average leverage across our portfolio is 3.5x.

#### 6 What percent of the portfolio has covenants and what are they?

Over 80 percent of new issuances in the BSL market have been cov-lite. Many managers have tried to explain away what they can't have by saying covenants aren't very important. Covid-19's impact on the economy may be a textbook example of why they are so important to a lender as they provide the opportunity to act sooner and effect change. The difference between having a fixed charge coverage covenant at 1.25x, enabling a lender to act, versus waiting for a payment default where the next step is likely to be insolvency will have a dramatic impact on recovery rates.

The portfolio construction and planning to deal successfully with covid-19 would need to have started long ago. So once again it is likely that a 'foreseen unforeseen' event will impact portfolios and returns. The volatility, uncertainty and decline are likely to be followed by a period of investment opportunity, but there is much work to be done before we get there. For now, LPs across all markets seem to collectively have said, 'If you don't know, don't go.' ■