Debt and the M&A Markets Amid COVID-19

Meridian's Recent Conversations with Debt Providers

MERIDIAN CAPITAL
INVESTMENT BANKERS

April 2020

Introduction

The emergence and rapid global spread of COVID-19 has triggered swift, widespread disruption to the economy and financial markets. From our ongoing discussions with business owners, management teams, and financial sponsors, we know that businesses across all industries are working around the clock to address the challenges posed by the pandemic and adapt to a new environment. In the middle market, several factors are currently at play that will impact the finance landscape in 2020. To better understand the current state of the private debt markets and implications for middle-market deal activity, we caught up with several commercial banks as well as non-bank lenders in our network to ask how they're navigating the current situation and what they're seeing in the market. From our conversations covering a core set of five questions, we identified the following key themes in the current lending environment:

- Continued commitment to current clients
- Sufficient on-hand liquidity to originate new loans
- Pipeline of acquisition financing opportunities drying up as M&A processes put on hold
- Tightening lending standards and increasing cost of debt across the board

Questions

1. How are lenders currently thinking about their approach to COVID-19 and current markets?
2. What are they doing with existing opportunities in the pipeline?
3. Are they looking at new opportunities? If so, is it industry specific and how are they underwriting?
4. How are they thinking about underwriting in the near- to mid-term?
5. How are they seeing investment banks / sponsors adjust their transaction processes?

1. How are lenders currently thinking about their approach to COVID-19 and current markets?

Lenders' top and primary priority right now is supporting their existing borrowers – helping their clients navigate Coronavirus-related challenges by offering some flexibility and additional liquidity where possible.

Non-bank lenders are seeing an influx of financing opportunities from midsize companies in various sectors – borrowers that traditionally would qualify for bank financing but, given the current situation, are now outside of banks' tolerable risk profiles – and view this as an opportunity to add solid, high-quality businesses to their loan portfolios.

Larger private credit funds with excess capital to deploy have started opportunistically buying public notes and bonds on the secondary market amid a significant yield increase across all grades of public debt, even that of the most high-quality borrowers.

Generally, lenders are continuing to originate new loans and currently have ample liquidity to do so – though pricing has increased, and standards have tightened.

2. What are lenders doing with existing opportunities in the pipeline?

Lenders are continuing move forward with opportunities in the pipeline, although they noted that nearly all acquisition financings in their pipeline have been pulled (more details on this later). Much of the current pipeline is comprised of refinancings and other general business lending.

For high-quality opportunities already in the pipeline, lenders are still providing term sheets for potential borrowers that fit within their risk tolerances, at pricing and terms commensurate with the current environment. Lenders continue to honor the term sheets that they have outstanding, but generally are not allowing additional room for negotiation at this point.

On occasion, lenders have opted not to move forward with opportunities in the pipeline; this has generally occurred where the long-term prospects of the borrower are unclear because of a probable long-term adverse impact from COVID-19.

3. Are lenders looking at new opportunities? If so, is it industry specific and how are they underwriting?

All lenders we spoke with continue to evaluate new opportunities. While none of the lenders we spoke with take a strictly industry-specific approach to determining which new opportunities to evaluate, lenders are weighing their risk assessment in the current environment vs. how they view the long-term prospects of each business post-Coronavirus.

A few specific examples we heard:

- Lenders are shying away from businesses such as fitness gyms that are currently completely closed and therefore don't currently have revenue
- Businesses that aren't expected to see any short- or long-term negative impact from the pandemic, such as lab businesses, are viewed favorably as new opportunities
- Subscription-based/SaaS businesses continue to be viable lending opportunities, particularly when they have contractually-set revenue for the next year or so

While the commercial banks we spoke with continue to evaluate new opportunities, the uncertainty of the current situation combined with conservative risk tolerances means that the portion of opportunities that are actually viable in the current environment has decreased. As noted above, many of the opportunities not eligible for traditional bank financing in the current environment have moved to non-bank lenders.

With private debt funds currently sitting on record levels of uninvested capital, non-bank lenders are upholding their targets for capital deployed and number of new deals this year.

4. How are lenders thinking about underwriting in the near- to mid-term?

In the current environment, lenders are making the following changes:

- Increasing pricing – generally lenders indicated that debt is becoming 2-3% more expensive for businesses across the board
- Decreasing maximum leverage availability for borrowers
- Heightening level of diligence and vetting of projections as part of the underwriting process
- Stronger preference for collateral/security on loans – unsecured loans are becoming less common
- Tighter, more thorough documentation requirements for new loans
- More stringent loan covenants such as tighter restrictions on use of cash for dividends
- Specific to Asset Based Loans (“ABL”), generally used to meet routine cash flow demands related to working capital, we noted the following changes:
    - Lowering capacity of lines of credit; no more unnecessarily large revolvers
    - Increasing level of diligence on assets
    - Tightening the calculation of borrowing base – the maximum amount of lending against a specific set of assets – by lowering the percentage of eligible assets that can be borrowed against or by disallowing certain assets.

In the mid-to-long term, lenders expect debt costs will come back down post-Coronavirus and as the economy recovers.

5. How are lenders seeing investment banks / sponsors adjust their transaction processes?

All lenders we spoke with have seen a significant decrease in their acquisition financing pipeline as most processes have been put on hold for several reasons including:

- Distraction among potential buyers – both financial and strategic – makes it difficult to create the competitive process needed to maximize transaction value for the seller
  - Most buyers that are still evaluating opportunities tend to be doing so opportunistically (i.e., looking for a good deal given the current environment)
- Process-related challenges such as the inability to conduct in-person management presentations
- Many financial buyers are not willing to pay the extra points on new debt when they believe the cost of debt will decrease soon
- More difficult / higher administrative burden to obtain debt financing currently
- General environment of uncertainty

The level to which transaction processes have been affected has also depended heavily on which phase they are currently in.

5. How are lenders seeing investment banks / sponsors adjust their transaction processes? (Cont.)

For deals under LOI and in the confirmatory diligence phase, buyers and sellers are generally still trying to get the deals across the finish line if they can. Sometimes these deals have been put on hold or cancelled due to reasons such as a material adverse effect of COVID-19 on the target or buyer.

For deals just now coming to market, virtually all of them have been put on hold. One lender noted that they'd seen a couple of exceptions to this for assets that already have inbound strategic interest.

Lenders also noted that they're seeing an uptick in debt recap opportunities from would-be sellers looking for an alternate path to shareholder liquidity while waiting for the M&A market to regain stability.

Meridian Capital is closely monitoring the impact of COVID-19 on the finance environment and will continue to share essential real-time insights as the situation evolves. If you have any questions related to the above information, including what it may mean for your business, please don't hesitate to contact us.

MERIDIAN CAPITAL

INVESTMENT BANKERS

ABOUT MERIDIAN CAPITAL

Meridian Capital (www.meridianllc.com), a Seattle-based capital sourcing and M&A advisory firm, has served as a trusted advisor to business owners on complex corporate finance, M&A and strategic challenges for 25 years. The firm differentiates itself through its deep industry insights, highly customized service approach, and end-to-end commitment to execution with exceptional results. Meridian also offers clients unparalleled cross-border capabilities through its Global M&A Partners network.

LEADERSHIP

Brian Murphy | Patrick Ringland
Michael Barber | Chuck Wilke
Bruce Pym | Tony Richardson

EXPERTISE

Aerospace | Technology
Consumer | Diversified Industrials
Food & Beverage | Telecom
Family Business