A Workout Team's Perspective:

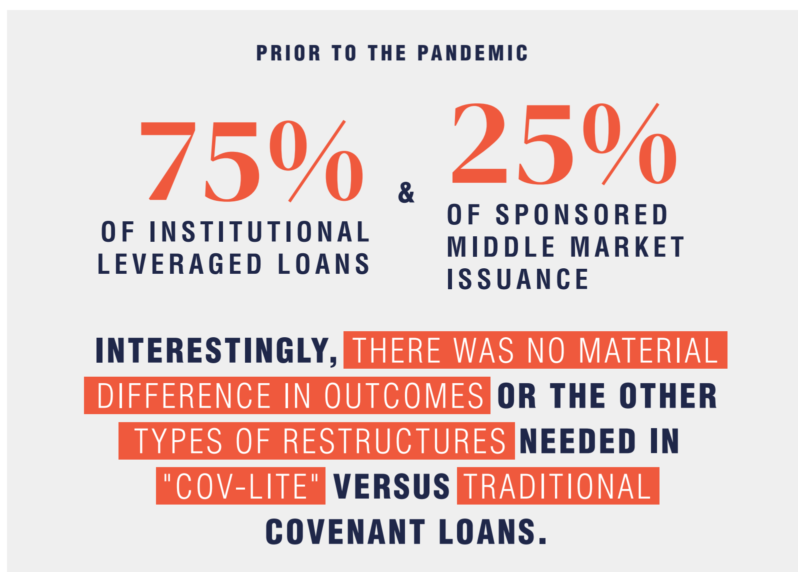
Five Key Factors at Play During the Covid-19 Downturn

The economic shockwaves of the pandemic were felt across industries and severely tested even the most seasoned executive teams. Thriving businesses were suddenly back on their heels, with some seeing their cash flow come to an abrupt halt. In this environment, the Antares credit advisory team worked around the clock to provide support to its most stressed borrowers across its portfolio of middle market private equity-backed companies.

Some key credit factors loomed large during this period – exacerbated by the rapid and far-reaching nature of the economic fallout – requiring creativity, commitment and ongoing communication among lenders, borrowers and PE sponsors to manage through to the other side.

EBITDA add-backs. Debt leverage always climbs late in a cycle, and that was certainly true leading up to the pandemic. The industry also was increasingly accepting EBITDA add-backs (the "adding back" of future expected benefits from synergies/cost savings and other adjustments to historical EBITDA) leading to understated true debt leverage. Once the impact of Covid hit, PE sponsors and borrowers quickly sought additional add-backs with some being well founded — such as the direct costs of Covid including the hiring of personnel to take temperatures at the factory door or purchasing of disposable masks to distribute to the workforce — while others were more aggressive and not acceptable to lenders, such as lost revenue. In supporting portfolio companies throughout these discussions, more sophisticated lenders were able to find a level of confidence through the active support of equity sponsors and covenant flexibility to help buoy these companies through the worst of the pandemic.

Covenant-lite loans and the scramble for liquidity. Prior to the pandemic, about three quarters of institutional leveraged loans and about a quarter of sponsored middle market issuance were "cov-lite" loans without financial maintenance covenants. One consequence of a "cov-lite" loan is that lenders had less advance notice when performance problems began to arise. Their popularity was another indication of how aggressive the market had become.



In the absence of financial covenants, the first sign of trouble during the pandemic was often a liquidity crunch as companies burned through cash. Because the scope of the economic disruption was so immediate, extreme, and widespread, and the duration unknown, experienced lenders proactively reached out to borrowers and sponsors across their portfolios to assess their near-term liquidity needs and gauge how they were coping. Interestingly, lenders did not see a material difference in outcomes or the types of restructures that were needed in "cov-lite" versus traditional covenant loans. While it was liquidity versus covenants that brought the parties to the table, all parties were needed to construct restructuring solutions.

For borrowers, working with well-capitalized lenders proved critical as many began to draw their revolvers to put cash on their balance sheets.

Overall, revolver utilization peaked at more than 65% - far beyond the ~40% level seen in the last cycle.

They also were quick to apply for funds under the Paycheck Protection Program (PPP), CARES Act and other government stimulus programs to build liquidity.

Loose credit terms. Loan document terms continued to loosen leading up to the pandemic. There were fewer restrictions on the use of credit party funds and more incremental debt capacity leading to less oversight and more opportunity for borrowers to attempt to fix issues independent of PE sponsors and lenders. For example, some companies began to use delayed draw term loans (DDTLs) for general operating needs instead of for acquisition financing, the traditional purpose of DDTLs. In some cases, credit terms were written so loosely that companies could transfer material assets into unrestricted subsidiaries, resulting in "collateral leakage."

However, even with loose credit terms at play, PE sponsors and lenders came together and ultimately played a key role in sustaining struggling companies when the cycle hit. Each party contributed in various ways, such as providing additional equity or agreeing to covenant relief.

Complex capital structures. Complexity creeping into capital structures over several years ahead of the pandemic made consensual workouts more difficult during the Covid downturn than during prior cycles. For example,

A **Leverage at different corporate levels** (i.e., holdco debt or separately financed divisions) resulted in disparate creditor groups. In this case, creditors may be less focused on consolidated valuation, but rather are primarily motivated to maximize value for the entity they have exposure to.

B **Lenders invested across the capital** structure of a borrower to diversify exposure.

As a result, restructurings became more challenging when investors were managing returns for investments at varying levels of a capital structure.

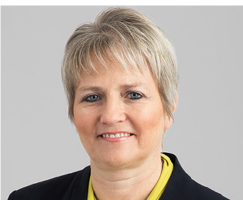
In addition, the process became inherently more complex with respect to information disclosure (e.g., reserving public investors status withholding confidential information related solely to the first lien from crossover lenders).

C **Distressed hedge funds sitting on investment dollars to deploy** can have materially different motivations from institutional or primary lenders. Some borrowers and sponsors tried to limit distressed investors from coming into their lending groups.

D **Highly engineered credit and intercreditor** documents created increased potential for disputes.

Choosing a lender for good times and bad

In many respects, today's market is back to pre-Covid borrower friendly terms and high debt leverage. Borrowers can be tempted to shop around for the lowest rate possible. But the downturn confirmed that companies need to take a broader view. Does the lender have the experience and capital strength to support the business in tough times and help the business grow during good times? Ultimately, companies and their PE sponsors should look for a lender that has a depth of operating knowledge informing a time-tested credit discipline in underwriting and portfolio management; a large, diverse portfolio across industries, sectors and borrowers; strong origination capabilities that allow the lender to be selective and lead the transaction; a solid "permanent" capital base; and, finally, a dedicated workout team with a track record of managing through down cycles.



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