Dec 17, 2020 9:19:58 AM EST

Busy Q4 in middle market lending adds to optimism for 2021

By: Abby Latour

A year-end surge in activity involving midsized companies is expected to continue into 2021, adding to optimism for next year, market participants say.

Dealmakers are trying to make up for lost time after M&A activity came to a screeching halt earlier this year due to the COVID-19 pandemic. In the second and third quarters of 2020, many lenders and private equity sponsors largely turned away from new transactions to focus on existing portfolios.

“We're expecting 2021 to return to close to 2019 activity levels. There is a level of cautious optimism in credit markets due to the vaccine and government stimulus, so that 2021, particularly the second half, should be a more 'normal' time,” said Dave Brackett, Antares Capital CEO.

“Our pipeline is up 30% compared to this time a year ago. The recovery in activity has been significant,” Brackett said.

One impetus to close deals this quarter is to 'salvage' 2020 volumes, hurt when activity stopped as the pandemic unfolded. Some owners of midsized companies are anticipating changes to the tax code that may make a sale this year more attractive than in the future, sources say.

“With a COVID vaccine on the near-term horizon, additional fiscal stimulus expected, and a significant amount of dry powder controlled by private equity sponsors, 2021 should be a very robust environment for M&A activity,” said Chris Wright, head of Private Markets at Crescent Capital Group.

If originations in Crescent Capital's BDC are indicative of broader trends in the debt market, it's worth noting that the lender had closed at least six new investments and one add-on, totaling $60 million of funded capital, so far in the fourth quarter, counted at the time of the quarterly earnings call last month.

The majority of these debt investments were first-lien or unitranche loans backed by private equity sponsors, and spreads were comparable to Q3 levels, which were roughly L+600-700, 1% Libor floor, offered with a discount of 2%-3%, management said on a Nov. 5 earnings call.

“We continue to see an attractive pipeline of new opportunities,” Crescent Capital BDC CEO Jason Breaux said on the call.

Many borrowers have been able to obtain pricing and documentation terms in line with pre-pandemic levels, particularly in sectors that have so far withstood shutdowns such as software, business services, food staples, some healthcare and insurance. Competition has been strong for these deals.

In contrast, the outlook continues to be negative for businesses exposed to entertainment, sports, live events and conferences, fitness operators, and restaurants, even ones that received new loans, capital injections or new owners, sources say.

“From a very high level, the 2020-21 vintage of deals in private credit is going to be very strong. Deals done since September are similar to those after the financial crisis. That should continue for the next 12 months or so,” said Ted Koenig, CEO of Monroe Capital.

“The fourth quarter will be our largest quarter ever for fundings. There are a lot of deals coming today that will get done now, or in the first quarter,” Koenig said.

Ahead in 2021

There is some talk of a second wave of credit amendments next year. In the second and third quarters of 2020, it was all hands on deck at private credit firms as they worked with borrowers and private equity sponsors to bridge low-to-no revenue resulting from pandemic-related shutdowns.

It’s likely that there will be more lenders taking ownership of portfolio companies, market sources say. This year, there were several instances of private credit providers becoming owners when private equity sponsors chose not to commit to businesses at the levels lenders wanted, sources say.

In terms of product, the unitranche loan continues to have a lot of momentum in the market, a trend likely to continue into 2021.

“The unitranche is by far the most popular product, with a single loan provided by one lender, or a small club, and leverage of about 5.5x-7x. It’s more attractive than a first-lien, second-lien structure because some lenders are concerned about where we are in the cycle,” said Bill Brady, head of the alternative lender and private debt group, and member of the special situations group, at Paul Hastings.

“Nonbanks have gravitated toward the product because they are the first dollar in, as opposed to second-lien loans that attach behind a few turns of first-lien debt.”

Looking ahead, lenders will take into account new factors in underwriting processes to better manage expectations during an event like a pandemic. There are already ongoing re-assessments of what “resilient” and “recession resistant” businesses are.

Among deals expected in the first quarter is an acquisition of a controlling interest in Truck Hero Inc., a provider of aftermarket accessories for pickup trucks and Jeep vehicles, by an L Catterton-led consortium. CCMP Capital, among other shareholders, and Truck Hero's founding CEO Bill Reminder, will remain meaningful investors. Jefferies and BofA Securities are providing financing.