What the Current Credit Market Means for Distressed M&A

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The availability of capital for private companies is at an all-time high. According to Preqin's Q3 2018 Fundraising Report, global private equity dry powder currently sits at approximately $1.1 trillion, while global private debt dry powder was at a record $281 billion as of September 30, 2018.

With the exception of 2014, private debt dry powder has increased each year since 2009, when it sat at just above $100 billion. Fundraising for U.S. middle market direct lending is also at record levels, with $61 billion raised in 2016 and $69 billion raised in 2017; 2018 is expected to be another strong year with fundraising on track to again exceed $60 billion (Thomson Reuters LPC).

The abundance of private capital and the desire to put dollars to work has resulted in a steady trend of rising purchase and leverage multiples. According to PitchBook's 3Q 2018 U.S. PE Breakdown, average purchase multiples have nearly doubled since 2009, increasing from 7.0x in 2009 to approximately 12.0x through Q3 2018. Leverage multiples have experienced a similar trend, increasing from an average of approximately 3.0x to more than 6.0x during the same comparative period (**Figure 1**). Increased competition and pressure to deploy capital have forced investors to "pay up," while lenders have needed to stretch outside their typical box of lending criteria to remain active.

Asset-based lenders, in particular, are dealing with a challenging environment. Traditional cash-flow lenders are stretching further and scooping up would-be asset-based lending borrowers, leading to limited deal volume for the abundance of firms and capital dedicated to asset-based lending. As a result, asset-based lenders have been forced to make material sacrifices to compete aggressively for deals. For many, this means compromising on collateral coverage to beat out competitors. Lenders are submitting term sheets with increased advance rates, unsecured/air ball advances, little or no covenants, limited to no personal guarantees, and limited to no borrowing base reserves. Current profitability or positive EBITDA may not even be required.

Lately, however, an aggressive borrowing base and willingness to lend to a currently unprofitable business is often not enough. Many lenders have been willing (and are forced) to compromise on yield as well as closing and monitoring fees to win deals. The risk-reward curve for many has flattened significantly as lenders have accepted depressed yields, despite increased exposure with reduced security.

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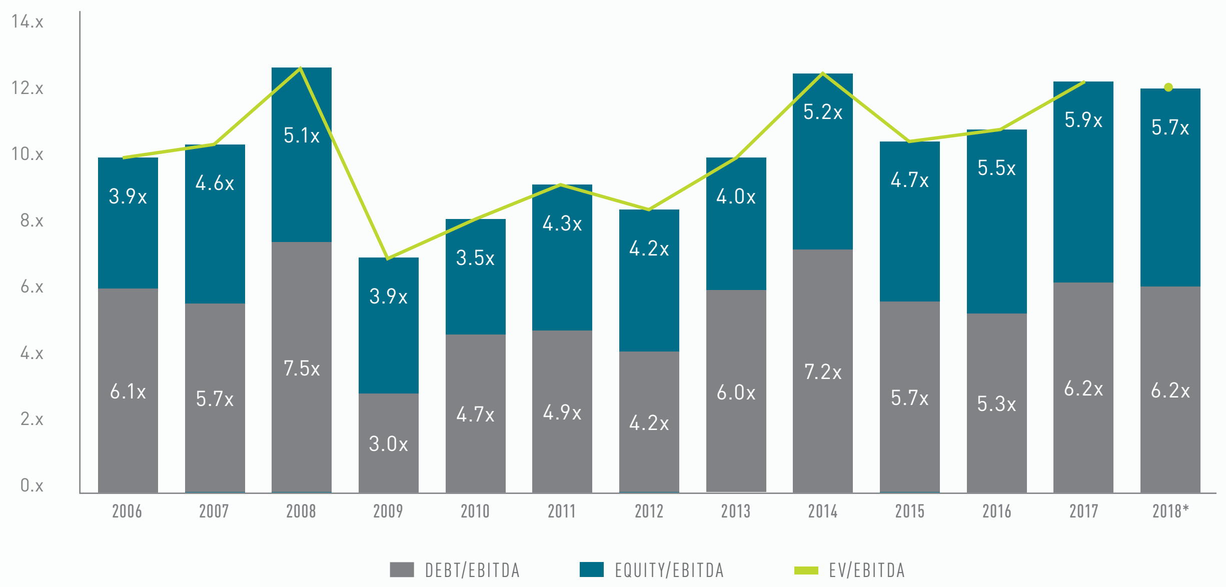
FIGURE 1: U.S. PE BUYOUT MULTIPLES



Source: PitchBook *As of September 30, 2018

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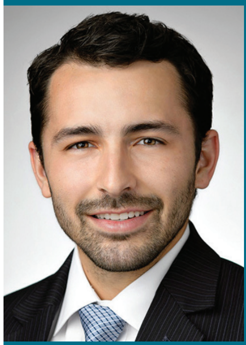

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The capital markets for lower middle market companies today are the strongest ever. Many refinancing mandates seek to replace traditional banks with alternative financing sources to provide additional liquidity. In a recent transaction, a client received more than 10 term sheets from a variety of lending sources, most of which met the client's aggressive ask or were at least superior to the incumbent credit facility. For businesses that historically may have been forced into change-of-control transactions, transactions such as these and the opportunity to refinance has thrown existing ownership groups a lifeline to retain control. However, it is important for these businesses to understand that when lenders are already overextended at the time of closing, there is likely a limited willingness or ability to work with the company during periods of default.

For many, these lifelines, coupled with the implementation of a sound turnaround plan (often with the assistance of the proper advisors), have resulted in the stabilization and revitalization of the company's operations. For others, these opportunities have been taken for granted and the necessary, company-saving decisions are postponed. For those that choose inaction, any dip in performance can lead to an unexpected cash crunch. When the underwritten projections are not met and liquidity is constrained, the exposed lenders typically want out. Fortunately for lenders and owners, the current abundance of capital readily available to serve the middle market has allowed existing owners who otherwise would be required to pursue a sale transaction to retain control and swap one lender for another, often being able to increase liquidity—and at times pull capital out of the business—in the process.

Near-historic low interest rates and aggressive credit markets have enabled many struggling companies to continue to operate despite stagnant performance. However, rising interest rates will drive increases in debt service requirements on already burdensome debt loads. As an increasing percentage of free cash flow is required to service principal and interest, businesses may be forced to defer necessary investments in their operations—a short-term move that can materially impact the long-term success and viability of a business.

Filings can be expected to increase significantly as businesses look to shed overlevered capital structures and effectuate transactions that force creditors to accept recoveries below outstanding principal amounts.

Without continuous reinvestment, many businesses will struggle to grow, let alone maintain historical performance, and when all other financing alternatives have been exhausted, these businesses will be left with no other choice but to pursue a change-of-control transaction.

The availability of quality distressed investment opportunities has been limited in recent years due to the loose credit markets. U.S. commercial bankruptcy filings declined more than 50 percent from 2009 through 2017 according to data from the American Bankruptcy Institute. However, in March 2018 monthly bankruptcy filings increased 63 percent compared to the prior year and reached the highest level of filings per month since April 2011. Filings can be expected to increase significantly as businesses look to shed overlevered capital structures and effectuate transactions that force creditors to accept recoveries below outstanding principal amounts.

For advisors, attorneys, and consultants, this will mean an increase in opportunities to provide services to businesses in need of guidance through these challenging periods of transition. For investors targeting turnaround opportunities, businesses that have survived solely due to the frothy credit market will start to appear on the auction block.

Before the Tide Turns

For companies that need to or are looking to refinance, now is the time. The likelihood of generating incremental availability at a reasonable or even reduced cost of borrowing is at an all-time high. However, this trend cannot be expected to continue indefinitely, and a refinancing should not be used as an opportunity to continue the status quo.

The proactive and timely implementation of a viable turnaround strategy prior to or in conjunction with the closing of a new debt facility is crucial to the long-term success of a company fortunate enough to receive another chance. Management teams must identify and, more importantly, execute initiatives to control costs and drive profitability to meet the current and future debt service of their new capital structure.

It is also imperative that owners and management teams be aware of their position on the credit spectrum. For those that have drifted to the bottom, at some point, likely in the not-too-distant future, there will no longer be a more aggressive lender waiting in the shadows to provide a fourth or fifth chance at survival. J