Navigating Capital Structures Through COVID-19: Rescue Finance

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Prior to the onset of the COVID-19 outbreak, the credit market was riding a prolonged 11-year bull cycle. The loan market, in particular, had seen a pervasiveness of borrower friendly late cycle excesses that resulted in capital structures predicated on increasingly optimistic assumptions of future performance. The onset of COVID-19 may have provided a catalyst for a recession – abruptly shutting down economic activity, forcing self-isolation, and creating a very uncertain future outlook.

While the Federal Reserve put in place several trillion dollars of stimulus packages, it appears a number of the policies will not provide meaningful relief to many private equity-backed middle-market borrowers. In the coming months, these companies will need to address liquidity concerns and capital structures.

Rescue Finance Overview

Rescue finance ("Rescue Finance") is a pocket of lending between performing credit and pureplay distressed credit. Rescue Finance, particularly in private equity-backed deals, involves consensual cooperation between the lender and company owner. Unlike other distressed debt strategies that generally involve an adversarial workout or bankruptcy, the solution helps the equity owner retain control and buy time to restore equity value.

Exhibit 1: Rescue Finance Overview

STRATEGIES

PERFORMING ⟶ NON-PERFORMING

DIRECT LENDING	RESCUE FINANCE	PUREPLAY DISTRESSED
	Rescue Finance	**Pureplay Distressed**
Strategy Description	▪ Solutions provider to fundamentally sound businesses with unstable balance sheets due to cyclical pressures	▪ Businesses requiring significant restructuring, workout, or bankruptcy process
Sourcing	▪ Directly sourced through private equity sponsors	▪ Generally through secondary market
Attributes	▪ Moderate current income ▪ Consensual, non-control refinancing process	▪ Little to no current income ▪ Investors seeking ownership/control or shorter-term trading profits ▪ Interests typically not aligned with current equity holders

While a significant amount of capital has been raised in recent years for broader distressed investing strategies, Rescue Finance remains a relatively uncrowded niche – especially in the middle market, where reputation, sourcing capabilities, and access to information are critical for success.

Impact of Recent Events – The Catalyst

COVID-19 and its exponential rate of transmission has caused national, state, and local governments to take extreme actions to limit the spread of the disease and "flatten the curve." One of those extreme measures is to encourage or require people to self-isolate and "shelter in place," which has resulted in the temporary shutdown of non-essential businesses and industries across the country.

This has caused rapid, meaningful declines in economic activity and instability in the financial markets.

Monetary and fiscal response has taken on a "whatever it takes" posture, enacting multi-trillion-dollar stimulus packages to help companies through this transition period. While the policies are still being finalized, it appears many will not provide substantial liquidity to non-investment grade middle-market borrowers owned by private equity sponsors.

As a result, these companies have begun to actively look for ways to stabilize balance sheets and capital structures. As a first line of defense, many have started to utilize liquidity options currently available to them, such as fully drawing on revolving credit facilities or asking lenders and vendors for forgiveness on near-term payments.

However, short-term solutions may not be enough to address their ultimate liquidity needs.

Many companies are preparing for the worst-case scenario of a prolonged shutdown and slow economic recovery and have started to explore their financing options. Under the current environment, many borrowers are finding themselves with unsustainable capital structures.

Uncrowded Niche

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Rescue Finance Considerations in the Middle Market

While a significant amount of capital has been raised in recent years for broader distressed investing strategies, Rescue Finance remains a relatively uncrowded niche in the middle market, as a successful strategy for borrowers requires several key attributes:

- **Sourcing Capabilities & Relationships:** Relationships with private equity sponsors are essential to unlock opportunities for borrowers, as middle-market credits are opaque and illiquid and require access to private information to evaluate. Trust between the lender and the sponsor is also of utmost importance, as the lender needs to have confidence in the sponsor's ability to work through the cyclical downturn and the sponsor needs to have confidence in the lender as a valued partner.
- **Reputation:** Lender reputation is important for access – many firms with distressed funds are not viewed as ideal partners by sponsors.
- **Capital Base:** Patient and flexible capital is ideal – Rescue Finance transactions will likely involve some form of non-current income, which will cause certain potential lenders (i.e., those that require current income or dividends such as business development companies ("BDCs")) to avoid the market. Other factors, discussed below, may cause other lenders to avoid the market.
- **Underwriting Process:** Experienced leadership with sound underwriting process.

In addition, several key middle-market stakeholder dynamics in this environment result in the need for Rescue Finance transactions:

- **Direct Lenders & BDCs:** Since the outbreak of COVID-19, several BDCs have seen significant trade-offs of share price to NAV and have concerns around portfolio liquidity and leverage. As a result, these funds would likely favor a paydown of their portfolio company loans to shore up their own balance sheets.
- **Banks:** While banks are no longer significant holders of middle-market debt, due to regulatory restrictions and capital ratios, banks will likely also invite a paydown in a credit in a cyclical downturn.
- **Private Equity & Company Management:** In addition to providing the private equity holder with a pathway to a full recovery and an enhanced return, Rescue Finance helps the private equity sponsor avoid further diluting the equity ownership of other important stakeholders such as company management who may not have additional dollars to invest.

Illustrative Rescue Finance Example

The below example is an illustrative transaction which has a 10.0x purchase price, initially capitalized with 6.0x leverage (all senior), and a 4.0x equity cushion.

PRE-DOWNTURN TO DOWNTURN

- From cyclical pressures, EBITDA declines by 25% (see Exhibit 2). Leverage increases to 8.0x EBITDA
- Valuation multiples compress by 2.0x, from the initial 10.0x EBITDA to 8.0x EBITDA. This is consistent with the prior downturn – per LCD, from 2007 – 2009, overall valuation multiples compressed by 2.0x, from 9.7x EBITDA to 7.7x EBITDA[1]

RECAPITALIZATION STAGE:

As a result of decreased financial performance and its initial leverage, this company may find itself in need of additional liquidity, and / or an existing lender is unwilling to provide additional capital due to outstanding covenants as well as other defaults and overall leverage.

Contrary to the broader liquid leveraged loan market, where many deals are covenant lite, deals in the private market generally contain maintenance-based financial covenants.[2] Companies in covenant default will be compelled to address their balance sheet needs.

At that stage the sponsor will be faced with three options:

- Make a significant equity infusion to delever and provide the company with additional liquidity
- Turn the company over to the lenders and incur a loss on their equity investment
- Work with a rescue finance provider to either take out the existing debt or layer in new capital to pay down existing debt, provide additional liquidity, and stabilize the balance sheet

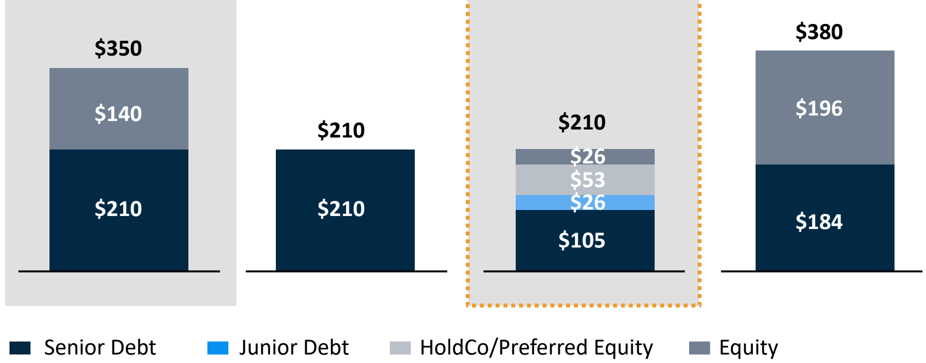
In this illustrative example, the Rescue Finance lender provides junior capital to pay down existing debt to a more normalized leverage level of 4.0x EBITDA.

POST-RECOVERY REFINANCING:

Post market recovery, the business refinances, taking out the more expensive rescue capital, resulting in a lower cost permanent capital structure and a recovery for the sponsor.

Exhibit 2: Anatomy of a Rescue Finance Deal
($ in millions)

		PRE-DOWNTOWN	DOWNTURN	RECAPITALIZATION	POST-RECOVERY REFINANCING
		Illustrative Example			
	EBITDA	**$35**	**$26**	**$26**	**$40**
	EBITDA Multiple				
	Senior Debt	**6.0x**	**8.0x**	**4.0x**	**4.6x**
Rescue Capital	Junior Debt	-	-	**1.0x**	-
Rescue Capital	HoldCo Debt / Preferred Equity	-	-	**2.0x**	-
	Common Equity	**4.0x**	-	**1.0x**	**4.9x**
	Enterprise Value	**10.0x**	**8.0x**	**8.0x**	**9.5x**



Conclusion

Contrary to prior market downturns, many of the challenges that today's businesses are facing have been forced upon them as a result of a COVID-19 related shutdown. The impact of the shutdown will undoubtedly linger on the economy for some time and the prospect of what a recovery looks like to many businesses remains uncertain. With a trusted lending partner, Rescue Finance can be an attractive option for equity owners and companies to bridge through the end of this cycle. ■

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1. Source: LCD LBO Purchase Multiples
2. Source: Refinitiv