MV|Credit

MV Credit's View on Cov-Lite Loans

INTRODUCTION

The main focus of a private debt manager should be capital preservation. MV Credit believes that even the best documentation and structure cannot make up for a bad credit. A fund's investment strategy (such as a focus on non-cyclical industries) and loan documentation should consistently be reviewed in anticipation of economic cyclicality, whether in an up or down market, not in reaction to ongoing events. MV Credit believes the right approach to investing is strong origination, active monitoring and partnering with the right private equity sponsor.

DEFINING COV-LITE

Cov-lite does not mean an absence of any financial covenants. There are different types of covenants:

- Maintenance covenants (e.g. leverage, interest coverage ratios) which are normally tested on a quarterly basis. Cov-lite investments do not have these other than a leverage covenant for the benefit of RCF lenders which is only tested after a "springing" condition (drawing RCF above an agreed level) is triggered.
- Incurrence covenants which only apply when an agreed event (e.g. the "incurrence" of additional debt) occurs. In cov-lite these covenants are generally combined with a "springing" leverage covenant as above.

In both cases, given how widely covenants are set, the borrower is likely to have a cash shortfall before breaching leverage tests. Therefore, too much reliance on and comfort from maintenance covenants can lull managers into a false sense of security

IMPORTANCE OF INVESTMENT STRATEGY

MV Credit believes that financial covenants, even in the exceptional context of a crisis such as the current one, do not "give back control to lenders". Those lenders, like us, who experienced previous economic cycles did not lose money on businesses which suffered a performance dip, even a medium-term one. Money was typically lost when:

- The company experienced a fundamental change in market demand (resulting for example, from the emergence of a new technology).
- The company experienced capex cycles (particularly in the manufacturing industry) with a significant cash requirement to upgrade the production tool
- The company had weak credit fundamentals.

It is a misconception that lenders can force private equity sponsors to inject new money into a company as a result of covenants. This is unlikely to be the case. Firstly, there can be a lack of visibility on the part of the lender if there is no liquidity issue and secondly, sponsors may feel that the lenders could take the business away (after all, they also have investors and an Investment Committee). As seen in previous cycles, sponsors and/or shareholders typically request "covenant holidays" for time to assess the situation where there are no strong liquidity pressures.

MV Credit's 2006 vintage fund invested through the Great Financial Crisis ("GFC") and is as an excellent example of what can happen during a period of severe stress. The fund invested in 63 companies, of which 24 companies experienced enough stress to request a covenant waiver and/or reset from their lenders.

For some of these companies, the waiver/reset was sufficient to allow them breathing room through the GFC and to eventual recovery.

The remaining companies required further restructuring. There was no standard template for restructurings as they depend on the specific needs of each business. Restructurings included a broad range of options, from a sponsor injecting new money in exchange for limited concessions from the group of lenders (e.g. capitalisation of the subordinated interest to PIK and no particular amendment to the senior facilities), to more severe restructurings requiring rearranging the waterfall of the debt facilities in order to accommodate new money. Only one restructuring resulted in a court-led process, where documentation played a part in the result in the short-term. Notably, the underlying credit's partial recovery post-recession may not have in any case made a material difference, from the perspective of the junior creditors.

MV Credit's experience in the GFC underlined that credit selection is key to minimising the risk of default in case of a downturn. MV Credit focusses on investing in businesses in less cyclical industries such as healthcare, software as a service and subscription-based businesses and conducts thorough due diligence before investing. Please refer to the below graph showing that healthcare and technology have experienced below average default rates across the market[1].

1 Source: Moody's Global Corporates Annual Default study 2019. Food, Beverage & Tobacco is Moody's classification. However, MV Credit does not invest in Tobacco. Default rates shown represent historical data and are no guarantee of, and not necessarily indicative of, future results.

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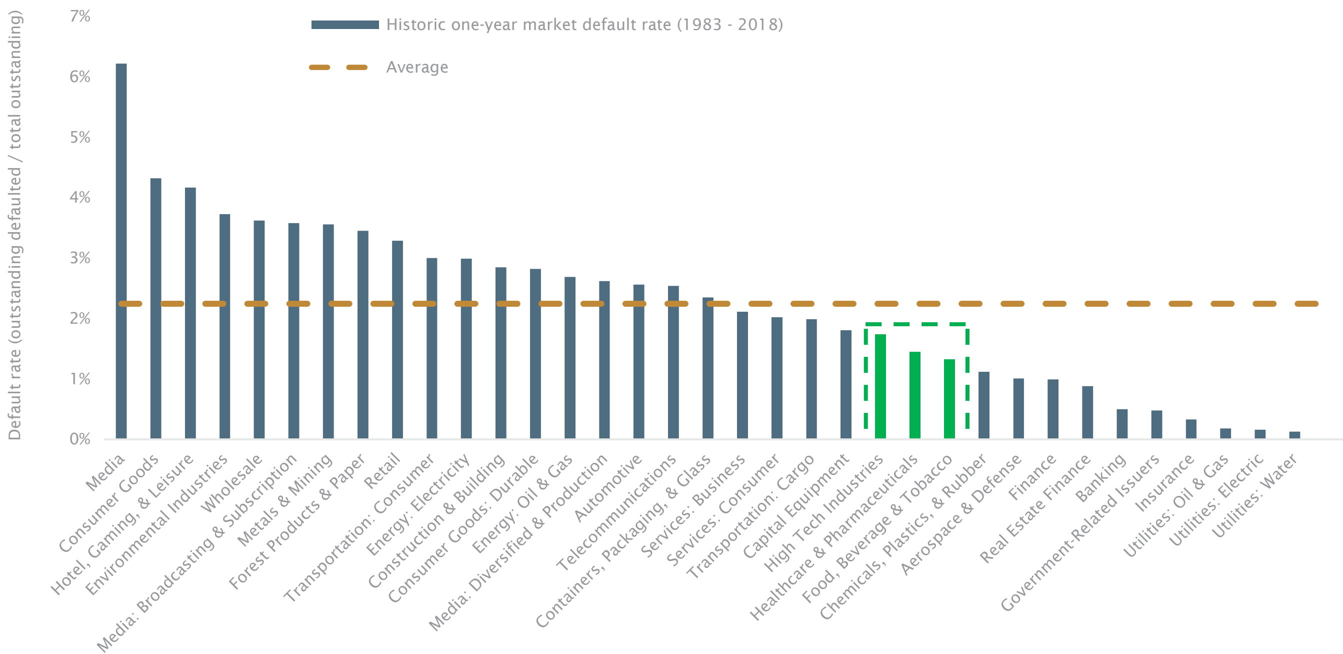

DOWNSIDE PROTECTION THROUGH ONGOING MONITORING

Covenants are not forward indicators of the performance of a credit and cannot predict a credit's significant deterioration. For example, the Financial Times has reported on S&P data which found that creditors recovered 78% of the money they originally lent to companies with weak covenants. In comparison, loans with traditional protection performed only marginally better[2]. The strength of a covenant does not necessarily correlate with credit risk and actively monitoring an investment throughout its life is crucial to anticipating issues.

McKinsey & Company suggested that loan-loss provisions can be reduced by 10-20% by improving the effectiveness of monitoring[3]. To this end, MV Credit has a dedicated Credit Monitoring Team ("CMT") which systematically reviews and monitors each investment on a monthly and quarterly basis (where appropriate), alongside monitoring conducted by the Deal Team.

INVESTING IN SPONSORED, UPPER MID-CAP COMPANIES

Another lesson of 2008 was that money can be lost where an investor does not partner with the right private equity sponsor (the "wrong" private equity sponsor being either uncollaborative or not up to the task). Working with the right private equity sponsor is key to originating good credits and for downside protection. MV Credit has built strong relationships with such sponsors since its inception in 2000. The benefit of investing in sponsored transactions is partnering with private equity firms who are also incentivised to support their investment companies, even in a downturn.

MV Credit targets sponsored upper mid-cap companies (EBITDA €30mn - €100mn). Small cap and lower-mid-cap companies, particularly sponsor-less ones, by nature need more restrictive covenants and undertakings, in addition to more conservative leverage, given their higher inherent credit risk. Please refer to the below graph[4] which shows default and recovery rates within global private debt during 2000-2018. Companies larger than €30mn EBITDA exhibit lower default rates and higher recovery rates than those with EBITDA €30mn and less. This could be because small-cap companies are likely more sensitive to external shocks given their regional nature, have less market share and face more competition and pricing pressure within their sector, amongst other things.

2 Source: Financial Times, 15th February 2019, "Why 'covenant lite' loans are not the menace they seem", Available at: https://www.ft.com/content/7f80d354-311b-11e9-8744-e7016697f225. Analysis quoted is based on loans issued before 2010. It is reported that the data set post-2010 is insufficient to draw firm conclusions.

3 Source: McKinsey & Company, October 2012, McKinsey Working Papers on Risk, Number 37, "First-mover matters: Building credit monitoring for competitive advantage", Available at: https://www.mckinsey.com/~/media/mckinsey/business%20functions/risk/our%20insights/a%20better%20way%20for%20banks%20to%20monitor%20credit/credit_monitoring_for_competitive_advantage(1).ashx, page 2.

4 Source: Cepres. Default and recovery rates of global private debt from 2000-2018. Default rates shown represent historical data and are no guarantee of, and not necessarily indicative of, future results.

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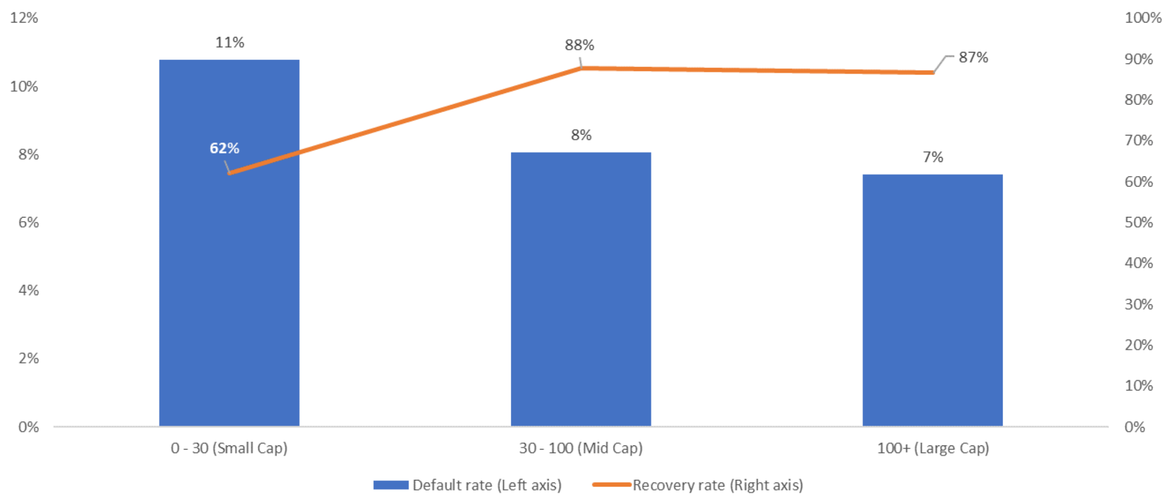

SHIFTING THE FOCUS FROM COVENANTS

Instead of the discussion on covenants, MV Credit believes in paying attention to conservative market standards. In terms of investments, investors should seek the strengthening of lenders' ability to monitor its portfolio investments as well as impose some limits on borrower companies after the investment is made. For example, monitoring can be further strengthened by more timely access to monthly financials from investment companies. Restrictions on new debt issuance and potential leakage to shareholders can strengthen an investment company's downside protection and greater limitations on EBITDA adjustments can assist lender transparency (after all, investors are meant to lend based on cash flows).

Aside from financial covenants, undertakings are important requirements negotiated by fund managers which, if they are not honoured as agreed, constitute a covenant breach. They include budgets, monthly/quarterly reporting, increased indebtedness and dividend restrictions. Given its excellent relationships with private equity sponsors, MV Credit can negotiate strong reporting packages and undertakings to strengthen its monitoring capabilities. Rather than requesting control through financial covenants, MV Credit believes investors' key focus should be an investment strategy rooted in strong due diligence and monitoring.

Finally, it is incumbent on fund managers to construct private debt portfolios with appropriate diversification to take into account the ability of the portfolio to self-heal through its performing investments, as well as service any debt within the fund. After all, no one can predict which portfolio companies are likely to under-perform, so outsized bets can lead to a disproportionately negative effect on the returns to investors.

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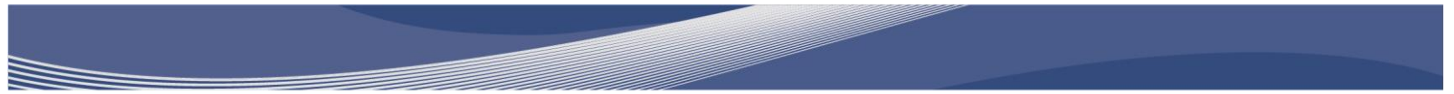

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RCS Paris 453 952 681 - Capital : €178 251 690
43, Avenue Pierre Mendès-France, 75013 Paris
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