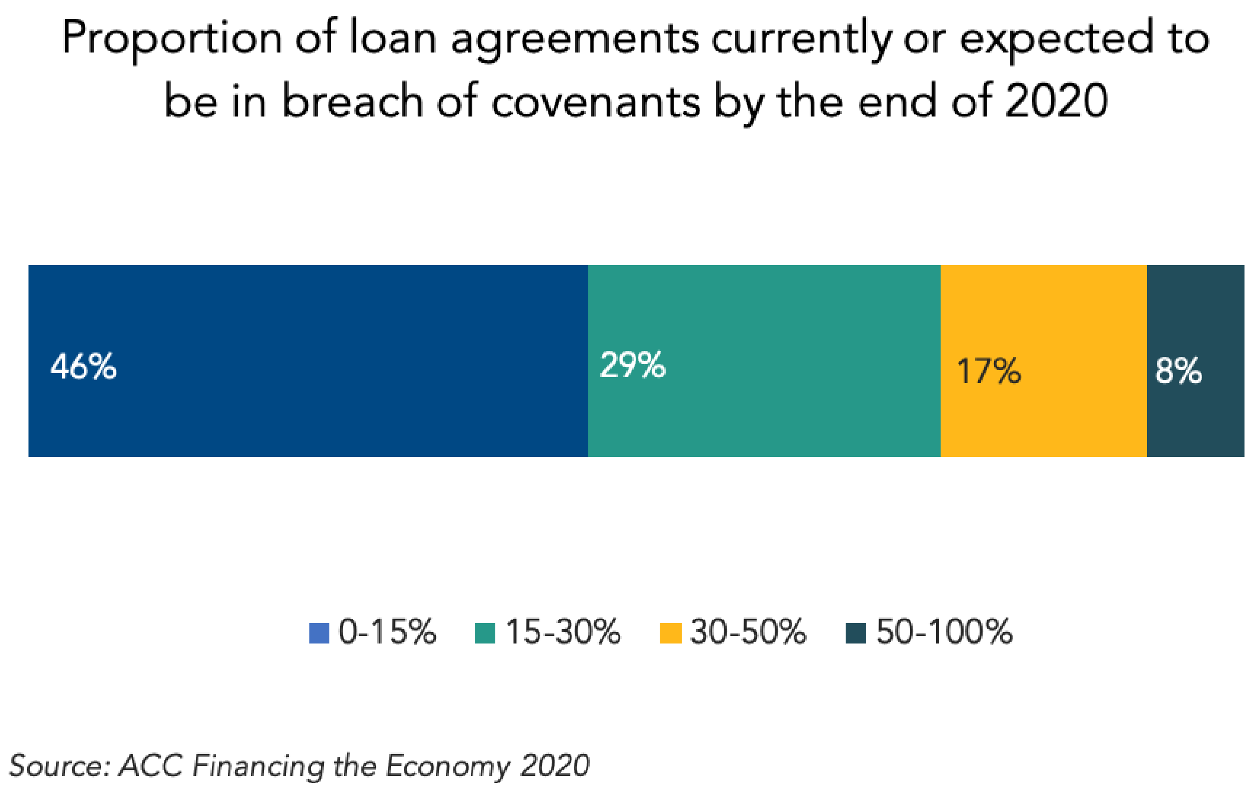
THE LEAD
https://theleadpc.com/pdi-picks-11-30-2020/

Breaking the covenant

PEI Private Credit | December 1, 2020



Two recent surveys have shed light on the issue of covenant breaches, and how managers are responding to them.

With the number of covenants in deals having declined markedly in recent years, there has been some doubt as to whether even a sharp downturn would be accompanied by a significant rise in breaches.

A survey from the Alternative Credit Council seems reasonably optimistic on the issue, with nearly half of respondents saying they expected between zero and 15 percent of their portfolio companies to have breached covenants by the end of the year (see chart).

In a separate survey from German consultancy Bluemont, one-third of participating debt fund managers said at least a quarter of their portfolio companies had seen covenant breaches due to covid-19 so far. The remaining two-thirds said that anywhere between none and a quarter of portfolio companies had seen breaches.

In terms of the measures taken in response to these breaches, more than three-quarters (76 percent) said they had "supported top management with guidance". This suggests that tough and radical measures are not normally used, at least initially. More than half (57 percent) said they had provided additional capital to soften the liquidity gap.

Some did opt for more drastic action, however. Ten percent said they had asked for an immediate return of the invested debt capital and another ten percent said they had sent in an operations team to improve profitability.

Among other key highlights from the Bluemont survey:

Nearly half of respondents (48 percent) thought that between 10 and 25 percent of debt funds would lose money with at least one portfolio company;

Forty-three percent said they thought it was “likely” or “very likely” that limited partners would accept changes to target return rates. One-third thought this was “unlikely”;

More than three-quarters (76 percent) were of the view that private debt funds would continue to gain market share over the next 12 months, with 19 percent predicting they would lose share during that period to the banks.