

Direct lenders remain open to fund deals

Analysis 22 APR 2020

As banks become more hamstrung on making commitments to fund new acquisitions, direct lenders are playing an even bigger role providing debt financing for transactions, financial sponsor and advisor sources said.

Some direct lenders say they are still “open for business” even as much of the US remains on lockdown from the coronavirus pandemic and a severe recession is forecast for the second quarter, several sources said. This could provide an avenue for financial sponsors to continue to pursue M&A deals that require debt financing.

Credit markets have slowly started to thaw in recent weeks as the Federal Reserve has taken unprecedented actions to support markets. Publicly listed companies and well known high-yield issuers have been able to raise debt capital in deals backed by banks, but at much wider spreads than earlier in the year. There has hardly been any activity in syndicated markets for new issuers.

Unlike regulated banks and broker dealers that look to syndicate high-yield bonds and loans to other investors, direct lenders support financing from funds raised from limited partners or publicly-listed vehicles. This makes the direct lenders more flexible and less dependent on market sentiment, though the lenders typically offer borrowers more expensive terms than banks.

Some of the direct lending deals that were signed or closed in recent weeks were smaller in size than typical syndicate deals and would likely feature direct lending capital anyway. But advisor sources say this contrasts with banks pausing commitments for syndicated offerings.

Deals backed by direct lenders include **Pine Island Capital** and **Bain Capital Credit**'s acquisition of precision manufacturing company **Precinmac Precision Machining**, **Francisco Partners**' recent purchase of healthcare IT company **Smith Technologies** and **West Bridge Capital**'s purchase of floor care and landscape provider **Scopes Facility Services**.

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Fortress Investment Group and **Varagon Capital Partners** supported the Precinmac deal, while West Bridge's own mezzanine fund backed the Scopes acquisition, as reported. Francisco also used a direct lender for the Smith deal, said a source familiar with the matter.

The Blackstone Group [NYSE:BX] used a similar strategy as West Bridge to invest USD 2bn in **Alnylam Pharmaceuticals** [NASDAQ:ALNY], providing capital through its Blackstone Life Sciences fund to buy royalties on a treatment developed by Alnylam and a first lien loan from **GSO Capital Partners**, the sponsor's own credit fund.

Direct lenders are still cautious and are selecting investments that are safer in this environment or credits in industries that may benefit from the changes like government services, manufacturing and healthcare technology, sources said.

Art Penn, founder at **PennantPark**, a private credit firm that runs a duo of business development companies, said that while M&A remains muted for the time being, he expects more opportunity in defense and government service-related businesses going forward. BDCs are non-bank lenders that raise capital from institutional and retail sources. Many are publicly listed.

"We've become more interested in defense-related and government services businesses, they are seeing a lot of activity right now," Penn said. He added that he's seeing other "bright spots" among grocery and food businesses, while other portfolio companies have benefited from pivoting to take advantage in this environment. **Dermarite**, a New Jersey-based skin care company that PennantPark is invested in, for instance, has focused on making hand sanitizer.

Financial sponsors, in turn, are asking lenders for leads on companies that need equity capital investments rather than investment banks, the typical middle-men in transactions.

"Given what's going on with COVID-19, lender relationships play a bigger role with sourcing than they ever had," said an executive at a middle-market healthcare-focused sponsor, adding that his firm has been in talks with sponsor peers for opportunities as well.

"That's not our normal playbook," the executive said. Some of the opportunities currently on the table are sponsor and lender recapitalizations that do not involve an investment bank, he added.

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A managing director at a middle-market lender said multiple sponsors have contacted him, looking to inject capital into portfolio companies backed by sponsors reticent to put in new equity into existing portfolio companies.

If sponsors are unwilling to back portfolio companies in trouble, that may leave lenders exposed to losses. Advisors cautioned that many of the direct lenders only formed after the 2008 financial crisis in response to regulatory limits on banks, raising questions on how their lending models will perform through what is widely projected to be an extended economic downturn.

“When it comes to direct lenders, a lot of those institutions haven't been battle tested through this type of environment,” said Scott Selinger, a partner in the Finance and Private Equity groups at **Debevoise & Plimpton**. “Most of them weren't around during the last downturn.”

by Anastasia Donde and Claire Rychlewski

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