ACCESS Insights

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Navigating Challenging Debt Capital Markets to Enable Growth

BY TOM GREGORY

Access Holdings Senior Advisor Tom Gregory shares his view of current debt capital markets, the challenges faced by midmarket private equity-backed companies and small business owners, and the opportunity or need for creative capital solutions.

Growing and scaling a business is exciting, though fraught with challenges that are further magnified by disruption and uncertainty in today's markets. In particular, the ability to finance sustainable, profitable growth is a critical competency that can define the difference between success or failure. To be successful, business owners and investors need to understand the current state of debt capital markets and the financing options that are available to support growth in this "new normal."

State of Play

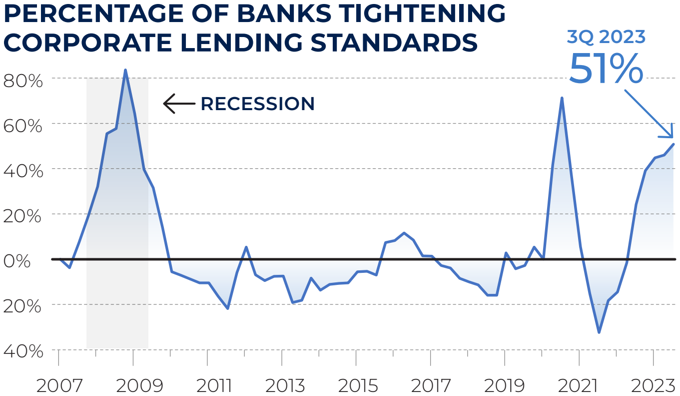
Debt capital markets have calmed from mid-2022 yet remain challenged. Current uncertainty is the result of a decade plus of low-cost capital, increased risk-taking, an erosion of credit fundamentals, and inflation spurred on by profligate government spending. The forward looking rate forecast is beginning to firm around "higher for longer." What if the recent decade of low rates was the aberration and rates end up being higher for much longer?

As a result, middle market private credit firms are seeking to drive a 1.0x to 2.0x+ turns of first lien leverage reduction, causing borrowers to scramble for solutions. The underlying issue is that fixed charge coverage ratios ("FCCR") no longer work with higher interest rates. First lien leverage must decrease, allowing borrowers to meet debt service requirements. This "perfect storm" has the potential to generate serious dislocation in the middle market and creates opportunity for innovative firms to fill the gap between traditional financing solutions for smaller companies and the needs of middle market private equity funds.

After Federal Reserve Chairman Paul Volcker did the unthinkable in the early 1980s, raising interest rates to over 20 percent, interest rates have steadily fallen, declining some 2,000 basis points in the last 40 years. After the Great Recession, interest rates approached 0%, and the Federal Reserve further eased monetary policy with significant rounds of Quantitative Easing, growing its balance sheet from $2T in 2009 to nearly $10T in 2022. This multi-year period of interest rates declining to near-zero propelled risk-taking, particularly by private equity, venture capital, public equities, and private credit, in pursuit of yield. Meanwhile, credit fundamentals have severely deteriorated.

COVID-19 lockdowns forced an unprecedent government response that injected trillions of dollars of fiscal stimulus into the American economy. High consumer demand for commodities and goods in limited supply, as well as increased government fiscal spending and loose monetary policy, drove the most severe increase in prices in over 20 years. Inflation increased from 0.1% in May 2020 to a peak of 9.1% in June 2022. Inflation was reported as of August 2023 at 3.7%, still meaningfully above the Federal Reserve's stated 2.0% annual target.

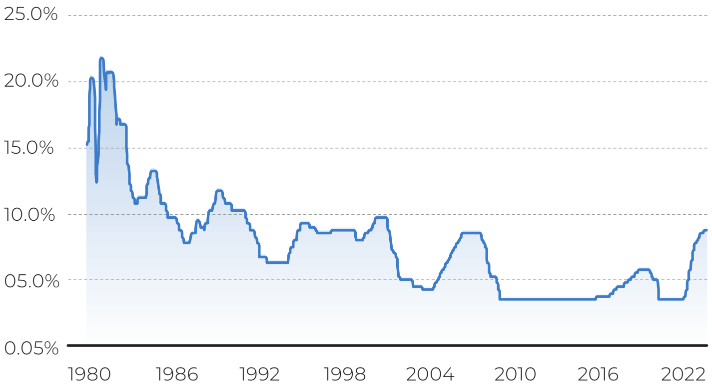
PERCENTAGE OF BANKS TIGHTENING CORPORATE LENDING STANDARDS



CONCERNED LOANS AS A PERCENTAGE OF OVERALL MARKET, MONTHLY (THROUGH 8/23)

Sources: Federal Reserve (tightening corporate lending); Fitch U.S. Leveraged Loan Index (concerned loans); FactSet (interest expense)

BANK PRIME LOAN RATE



Source: Federal Reserve Bank of St. Louis

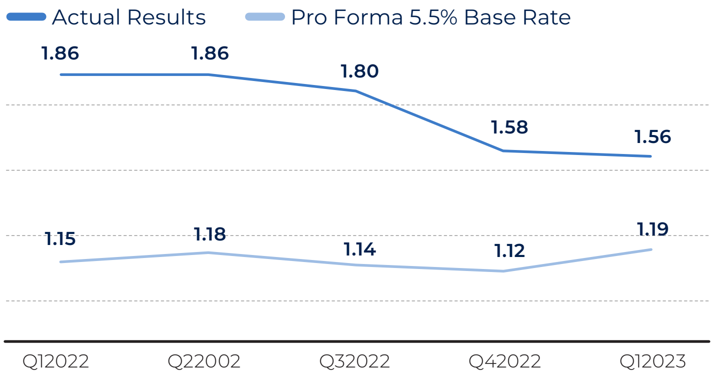
As a result, since March 2022, the Fed has increased interest rates 11 times. In the past few months alone, the Federal Funds rate has increased to 5.33%, last seen in 2007 and not exceeded since 2001. Modest additional rate increases may occur to tame inflation in an economy that is still exhibiting stronger than expected growth and particularly strong employment and job creation.

The impact of higher interest rates on debt capital and the potential insolvency of many mid-market businesses is pronounced. Environmental factors like geopolitical pressures and the ongoing risk of a recession have further distorted the global economic outlook. Simply put, the cost of capital has risen dramatically while access to capital has been constrained. As a result, leverage multiples are under pressure. Many companies have seen their all-in interest expense double since early 2022 for the same amount of debt. For many companies that over-levered when capital was cheap, this is unsustainable. Incremental capital needs and scheduled debt maturities may pose challenges.

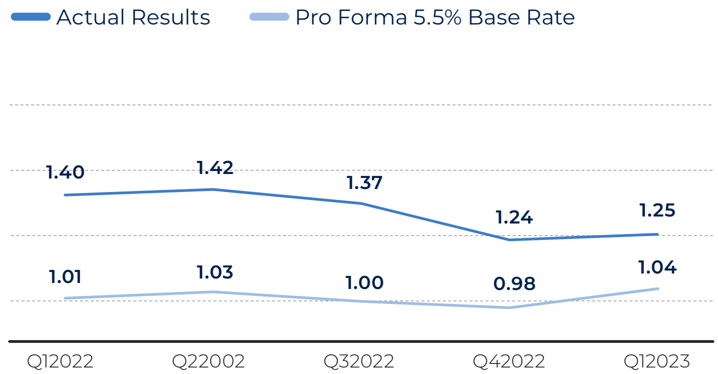
Numerous credible forecasts suggest that as many as half of the private equity-backed leveraged borrowers will have a FCCR of less than 1 for 2023 and perhaps into 2024. This means that many borrowers will not be able to cover their debt service requirements going forward and will be required to raise capital, primarily to deleverage first lien debt.

"Actual EBITDA" noted above represents Pro Forma Adjusted EBITDA, which includes adjustments to earnings (typically ranging from 20% to 30% of reported Adjusted EBITDA) that are permitted in the definition of EBITDA by credit agreements governing middle market credit facilities. It is important to consider that these adjustments erode the quality of earnings. When evaluating the complex nuance of these adjustments, one is likely to discern that the borrower's true cash flow results in a FCCR of less than 1.0x.

INTEREST COVERAGE RATIO

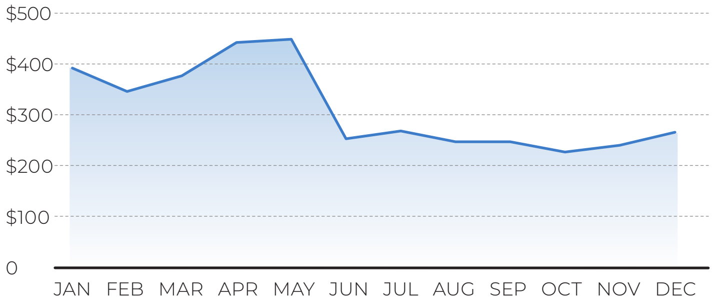


FIXED CHARGE COVERAGE RATIO



Source: Lincoln International Perspectives: Capital Market Observations (June 2023)

M&A DEAL VALUE DROPPED OFF IN THE SECOND HALF OF 2023 (IN BILLIONS)



Source: Dealogic

What's Happening in the Middle Market

While the shift in the market has led to a drop in M&A activity, opportunities still exist. Private equity firms are using less debt to finance new platforms and add-on investment activity, seeking financing alternatives to supplement constrained access to first lien loans, as well as reexamining enterprise valuations. Careful due diligence is becoming even more essential to ensure successful partnerships and investments.

Firms are increasingly funding such acquisitions with a larger proportion of equity in lieu of first lien debt because first lien lenders are now seeking to reduce their leverage exposure by at least 1x to 2x turns of EBITDA. Borrowers are actively searching for ways to augment access to alternative debt capital to enhance equity returns. Private equity leaders are holding investments longer to yield greater value when stability returns to capital markets.

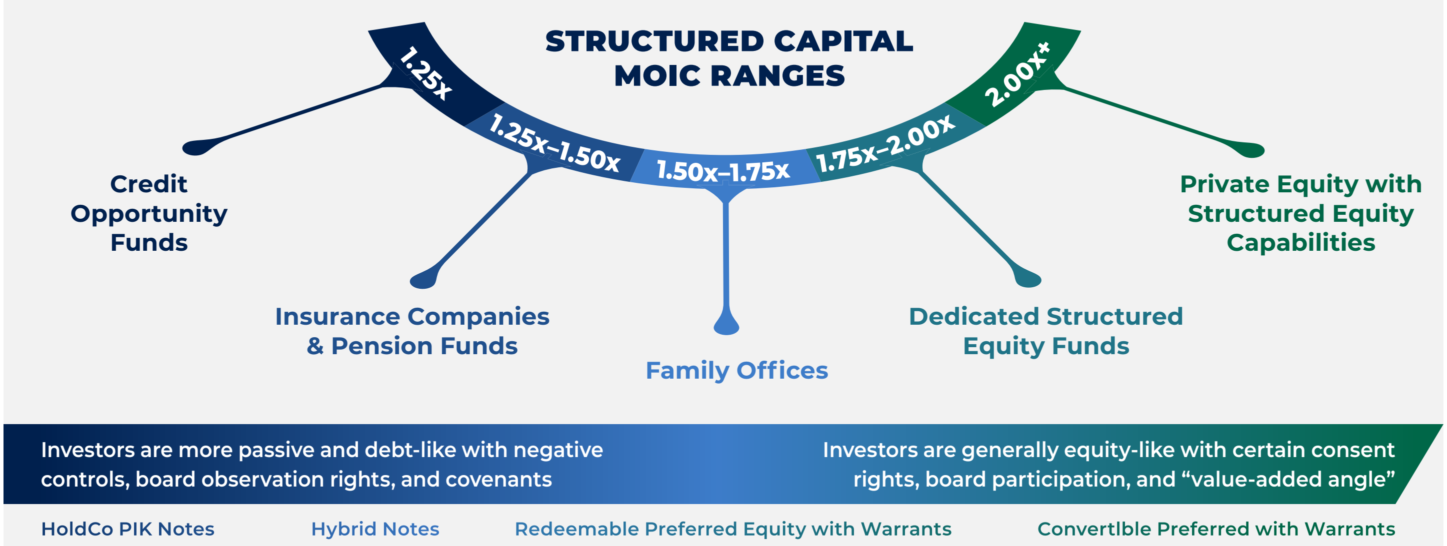
New Opportunities for Innovative Business Owners and Investors

In the face of increased challenges, buyers and sellers still want to get deals done, and business owners want to grow and scale. The way capital markets are evolving, solutions are emerging to address this changing market context. To do this, more creative deal terms and financing are being considered:

- **JUNIOR CAPITAL** Junior capital has emerged as a more attractive funding option as it can help avoid triggering Most Favored Nation ("MFN") protections on senior debt, a provision that automatically increases the interest rate on a borrower's existing loans if the all-

STRUCTURED CAPITAL FUNDS ARE FILLING THE GAPS

With interest rates and input costs continuing to rise, structured capital is an attractive capital solution that is typically structured without cash interest payments



in yield of a new loan is higher than the all-in yield of the existing loans. In the place of lower first lien leverage, junior debt can be utilized as "patient capital," a long-term investment to provide a cushion to senior lenders and enhance overall shareholder returns.

We have seen the success of this alternative approach before. In 2021, private equity buyers sought patient capital in the face of supply-chain disruptions and volatile commodity costs. Credit conditions improved as this nontraditional approach offered greater liquidity to buyers.

- **FLEXIBLE LOAN STRUCTURES** The need for liquidity can also be addressed through flexible loan structures. Instead of paying interest payments in cash, some refinancing options allow borrowers to make a portion of interest payments in-kind ("PIK") by being capitalized and added to the principal amount.

Conclusion

As businesses, investors, and private equity firms adapt to these new conditions, we believe there will be more opportunities to utilize creative and flexible capital solutions to grow businesses effectively, despite continuing market uncertainty and disruption. Proactive leaders should consider the following to chart a successful path forward:

- Focus intently on the business strategy and operational changes necessary to optimize enterprise value creation;
- Ensure best practices are employed in all aspects of business operations to ensure competitive viability;
- Communicate openly and on a regular cadence with lenders and other capital providers to keep these constituencies apprised of business performance and expectations;
- Prioritize and spend recurring time on capital planning vs. waiting for a need or issue to emerge;
- Define and evaluate potential growth scenarios (vs. a single path), capital implications, and financing solutions; and
- Seek internal and external financing expertise to exhaust consideration of potential financing solutions that can meet the needs of a business given its stage of maturity, scale, and best path forward.

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