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US direct lenders hope for helping hand from private equity lobbying

Direct lenders have had to meet unprecedented funding requests from their borrowers in recent weeks. Could a tweak to the coronavirus stimulus bill take some of the pressure off?

James Harvey April 2, 2020, 8:57 pm

When the US government passed a $2trn stimulus bill to mitigate the economic impact of the coronavirus pandemic, most private equity-sponsored companies were left out.

But the **Institutional Limited Partners Association** (ILPA) – a lobby group representing about 550 institutional investors – wants to change that.

The group is calling for private equity-sponsored companies to be made eligible for coronavirus relief loans, in a move which could, in turn, take a lot of pressure of direct lenders, who have had to meet unprecedented funding requests in the past few weeks.

In a letter to Treasury Secretary Steven Mnuchin earlier this week, Steve Nelson, ILPA's CEO, called for the Treasury and Small Business Administration (SBA) to issue guidance allowing PE-sponsored firms to access emergency relief funds made available by the Coronavirus Aid, Relief, and Economic Security (Cares) Act.

The Cares Act commits an additional $349bn to the SBA's emergency loan program, allowing businesses with fewer than 500 employees to borrow up to $10m in low-interest loans to retain employees during the Covid-19 crisis.

However, many small businesses held by private equity funds will fall foul of the 500-employee threshold, under the SBA's affiliation rules.

"Under existing SBA affiliation rules, portfolio companies of private equity funds could be considered to be affiliated, which would likely make them ineligible for relief under the 500-employee threshold test," says John Mahon, partner at **Schulte, Roth & Zabel** in Washington DC.

In his letter to Mnuchin, Nelson wrote that the affiliation rules put a "significant limitation" on the ability of small businesses to access "critical capital" in the wake of the coronavirus crisis.

"These regulations effectively prevent the small business portfolio companies owned by venture capital or private equity funds from accessing the Paycheck Protection Program, just because they are owned within a private fund structure," wrote Nelson.

The SBA rules present a problem for direct lenders and business development companies, most of whom lend primarily to PE-sponsored firms.

For example, in a recent investor letter, BDC **Ares Capital** (NYSE: ARCC) revealed that 85% of its portfolio companies were backed by PE sponsors. For **Owl Rock Capital** (NYSE: ORCC), the proportion was even higher, at approximately 90%.

However, the Cares Act does provide for some exceptions to the affiliation rules, meaning direct lenders may see some of their portfolio companies benefit from SBA loans.

Firms with financing from a small business investment company (SBIC) are specifically exempted from the 500-employe threshold, while for firms in the accommodation or food service businesses, the threshold is applied on a per-physical location basis.

Art Penn, founder and managing partner of **PennantPark Capital**, says that these exemptions will allow some of the firm's borrowers to access SBA loans – but only a small minority.

"We're still figuring everything out, but from or preliminary assessment, we think that about 15-25% of our portfolio companies will be eligible to apply," he says.

ILPA's letter calls on the Treasury and SBA to issue guidance either extending the SBIC exemption to all private fund structures, or to consider PE portfolio companies to be unaffiliated for the purpose of the 500-employee test.

"At a minimum, if this extension is not possible, the SBA should provide an expedited process for these funds with these investments to convert to non-levered SBICs to access the existing exemption under the regulations," the letter adds.

A change to the affiliation rules – even if only temporary – could provide significant relief to direct lenders, many of whom have had to field significant liquidity requests in recent weeks as portfolio companies look to stockpile cash to cover expenses including payroll, rent and utilities.

For example, in a letter to investors on 30 March, BDC **Bain Capital Specialty Finance** (NYSE: BCSF) said that it had received "unprecedented draw requests on revolving credit and delayed draw facilities" during the month of March, as its portfolio companies looked to "husband excess cash as a defensive measure".

A day later, Ares Capital announced that it had upsized and extended its own revolvers, in a move to "[enhance] our deep sources of liquidity and our flexibility," following a string of drawdown requests earlier in the month.

But with "first come, first served" applications for relief loans set to begin on Friday, 3 April, time is of the essence. So, how likely is it that regulators will budge?

According to Mahon at SRZ, it's possible.

"Given the current crisis, it is possible that the SBA might update their guidelines to make private equity portfolio companies eligible for assistance, if only on a temporary basis," he says. "Other regulatory agencies like the SEC have, for example, been quick to make adjustments in view of the crisis."

However, Mahon adds that any relief for PE-backed companies will need to be handled sensitively.

"Any revision to the guidelines will likely be carefully structured to focus on the underlying portfolio companies, to avoid the appearance of aiding private equity funds directly."

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