Direct Lending Deals
Terms & Trends for Originators, Investors

DLD follows up with Art Penn of PennantPark: "There is a general belief that we've seen the worst"

*DLD recently reconnected with **Art Penn**, founder of **PennantPark Investment Advisers**. Our conversation followed up a chat back in March just as the pandemic was beginning to unfold in the U.S. This time around the 34-year credit veteran shared his views on navigating Covid 19 and a better outlook for 2021.*

DLD: The last time we talked was in March when the pandemic was just getting started here in the U.S. We thought capital markets would be toast the rest of the year. Thankfully, we were dead wrong. What do you make of the turnaround?

AP: When we talked 6 months ago, there was pervasive uncertainty about people's health, the economy, and individual companies. The mood was really concerning. We never would have thought we'd be where we are today.

DLD: And where is that?

AP: We're in a K-shaped recovery— there's been big losers and big winners throughout all of this. Nobody has made it through unscathed, but direct *lenders avoided most of the industries that were heavily impacted— airlines, hotels, travel. Many of us didn't have a lot of exposure to those businesses.*

DLD: How did portfolio companies handle the immediate impacts?

AP: One of the takeaway lessons from the Great Recession was: Make your moves — make 'em big and make 'em quick. And that's what teams did this time around. They took speedy action, cut costs, and managed their way through.

DLD: How did lenders react?

AP: It was case by case and many layers to it. You had to consider how to construct it. Waivers were common and given to very temporary situations, where numbers were expected to look better after getting through June, July. Longer term issues became amendments. Credit agreements were reopened for a year or more of relief. We've seen a lot less of all of these measures over the past few months.

DLD: What about sponsors?

AP: In many cases, sponsors put in equity or delayed management fees.

DLD: A lot of uncertainty has been eliminated, but Covid surges could lead to another round of business closures...

AP: There is a general belief that we've seen the worst. That's not to say we're done. The virus continues, but we understand it now and how to get through it. We know a lot more than we did six months ago. There are vaccines in the works. The big difference now is that there is a light at the end of the tunnel.

DLD: Is that driving the heavy flow of deals heading into the holidays?

AP: Usually there’s a blizzard of activity to close by year end, and then it slows up in the first quarter until about March or April. But this December is very busy, and we expect an unusually active start to 2021 since the market was on hold for so long. A lot of processes were started ahead of the election in anticipation of the ‘blue wave’ and a change in taxes. Sellers can find good prices, and many have decided they should take the opportunity to cash out.

DLD: Where do you see structures and pricing headed?

AP: A lot of people are trying to figure out where the market is. It really depends on where you play. Mega funds —those with $10 billion to $40 billion to invest— need to write big checks to big companies. A $25 million EBITDA deal doesn’t make sense for them. They are forced to go upmarket where your biggest competition is the broadly syndicated loan market. You can get a very efficient financing there with more aggressive terms: Cov-lite, lots of leverage. If you compare a February deal to terms now across the biggest direct lenders, they’d look very similar.

DLD: What about the smaller end of the middle market?

AP: We tend to focus on 'classic' or 'core' middle market: about $25 million of EBITDA. We’re not competing with BSL, and therefore it’s a better overall package. Covenants are tighter, leverage is lower, yields are higher. EBITDA adjustments are thoroughly diligenced. We’re not forced to deploy capital. There is less competition in this space. Investors will look back and see this was one of the best vintages for direct lending.

DLD: So you’re bullish on 2021?

AP: We are optimistic that it will be better than 2020. There’s even the prospect for some normalcy by mid-year. Hopefully, we’ll be grappling with the tail end of the pandemic by then.

DLD: Biggest challenges for 2021?

AP: I think the biggest challenge will be how to bring companies back that haven't come back yet. A secondary concern is returns amid low interest rates. One upside is that low rates could end up driving more capital to direct lending.

DLD: Speaking of fundraising, what's that like right now?

AP: It's a mixed bag. Many investors are still very cautious —we are in the middle of a pandemic— but others have been more opportunistic and optimistic. Existing relationships are already there. It's much harder to develop new relationships. Investors would rather be in a room with somebody.

—Kelly Thompson

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