PRIVATE EQUITY
PERSPECTIVES
PODCAST

EPISODE 21: DISTRESSED M&A AND MEZZANINE FINANCING: PE'S LATEST STRATEGIES

INSIGHTS FROM THE BDO PRIVATE EQUITY PRACTICE

Todd: Hello, and welcome to another episode of BDO's Private Equity PErspectives Podcast. I'm Todd Kinney, National Relationship Director in BDO's Private Equity practice based in New York City. I'm really excited that our podcast series is back on after a few months of hiatus. We hope all of our listeners are continuing to stay safe and healthy. As for today, I'm delighted to welcome two very special guests to talk about private equity. First off, I'd like to introduce Engin Okaya, who's a managing director at Prudential Private Capital. Next, I'd like to welcome David Felts.

INTRODUCTORY QUESTIONS

Todd: So, let's jump right into things. David, as a Managing Director at TM Capital, your career spans nearly three decades and encompasses a range of transaction types. Maybe you could tell our listeners about your role and the focus of your firm.

David: Sure, Todd. Thanks. Appreciate being on the podcast. First, the firm, TM Capital, has been around for 30 plus years, private partnership owned, so one of the oldest, still private players in the middle market space. We're about 40 professionals in three offices, Boston, New York, and Atlanta. We cover the US and Canada directly. We're a founding member of one of the largest international M&A alliances, Oaklins, where we're also one of the largest members there. About 50% of our work is working for private equity firms on exits. In almost every case, we have private equity firms involved in our sale processes. We are mostly a sell-side M&A advisor. For probably the last 12 years of a bull market, we've been working on a lot of healthy growing companies. But as we'll talk about here, we have a distressed experience base that's being called upon as we speak as this time period evolves.

Todd: All right, David. Appreciate the brief background there. Turning to you, Engin, as a Managing Director with Prudential Private Capital's NYC Corporate Finance office, I believe you're celebrating more than 22 years at the firm, if our fact-checkers have it

TOPICS DISCUSSED INCLUDE:

right. Can you describe for our listeners your role and how the company has evolved during your time there?

Engin: Yes. Your fact-checkers do have it right, Todd. I will be celebrating 22 years next month. And thanks for including me on this podcast. Prudential Private Capital is basically the private investing arm of the broader Prudential Financial, the insurance company. We work through PGM, which is the investment management arm of the insurance company. Simplistically, we're taking money that comes from the insurance side of the business and then loaning it/investing it in middle-market companies. We're investing up and down the capital spectrum, so everything from a couple hundred million dollar senior investment grade, term loans alongside banks down the capital spectrum through minority equity. We have a $1.8 billion mezzanine fund that we are investing. Out of that fund, we have the ability to invest junior capital and minority equity as well. So, we're industry agnostic. I like to call our portfolio a pie slice of the American economy. It's about a $90 billion portfolio, about $6.5 billion of which sits in the Northeast portion of the United States, which is the territory that I manage. We are out in the marketplace calling directly on companies, intermediaries, accounting firms, lawyers, investment banks, etc., looking for companies that need our type of capital. In terms of the development over the 22 years that I've been at the firm is really our international expansion. We used to be almost exclusively US focused although we did spend some time in Canada. But now we have 14 offices around the world including four offices in Europe, an office in Mexico City and Sydney as well. So, we're basically a worldwide organization and continue to expand our global reach and our product set across the world.

DISTRESSED M&A AND ADD-ONS

Todd: All right. Thanks for the background, Engin. I think I did a good job here picking guests for this podcast because you both certainly bring a lot of experience that should make for an interesting discussion. So, thanks again. So, David, first to you. It certainly appears as if we're starting to get distressed, lender-driven, sale assignments. Can you comment perhaps about what you're seeing from your angle of the world?

David: Yes. Absolutely. If we had chosen this topic even six months ago, it might not have been as rich a discussion as I think it's becoming right now. We're really starting to see the heat map light up on both ends of the deal barbell. We are seeing—and we'll talk about this later—regular kind of deal flow looking forward for companies that have done well. But we're also now starting to see lender driven distressed situations. There are certain companies that may have been impacted already during 2019 for other reasons. COVID is just an additional weight on the scale. The situations that we're seeing right now, we think, are situations that are really tailored where larger strategic buyers who have their own resources, their own pre-existing lending, and their own long-term strategies are the likely buyers. We are getting certain phone calls in sectors where we're acknowledged industry experts. I'm sure other bankers are getting phone calls where they're the acknowledged industry sector. So, we do see it starting to light up actually in real time.

Todd: Interesting. So, Engin, let's take a look at it from the lender's side. Can you share your perspective?

Engin: Sure. Unfortunately, in a COVID-19 environment like we're in or any other downturn in the economy, we've done our fair share of breeding our own internally distressed opportunities of types of businesses that we've invested in that have been impacted from the virtual shutdown of the economy, everything from trade show businesses to companies that rent cars to Uber drivers, etc. So we have our fair share of opportunities that we're working through internally, but we do have plenty of capacity for new opportunities as well, both specifically on the distressed debt side but then also just good company, bad balance sheet-type situations. So that's one of the opportunities that we have, having a junior capital fund, is the ability to participate in new transactions in an environment like this and try and find companies who need some junior capital or refinancing opportunities. On the senior debt side, if they have unhappy banks, we're able to come in and try and derisk the banks, the senior lenders, and provide the company liquidity from the junior capital side. One of the biggest challenges that we're facing right now is just how to due diligence some of those opportunities given restrictions on travel, but we are actively engaged in a number of new opportunities and using virtual networks and Zoom meetings and trying to figure out how we can due diligence new opportunities because our source of capital certainly hasn't dried up, so we see this as an interesting opportunity in which to continue to invest.

CROSS-BORDER TRANSACTIONS

Todd: Sure. As both of you know, you've been guests on our BDO virtual networking series, so we're all trying to be creative during these times and I appreciate that intel, Engin. Next, I'm curious to hear from both of you on the topic of cross-border transactions. Are you seeing anything unique? Maybe David, you could weigh in first and then we'll hear from Engin.

David: Sure, happy to. We as a firm had had a few cross-border deals in process as COVID-19 started to have its impact, certainly by the middle of March. I have two projects myself. And cross-border deals are challenging in the very best of times. You've got time delays, you've got deal styles that are different between countries, you've got different legal and regulatory frameworks that you have to operate in. So, those are oftentimes some of the most challenging. But with this current environment, we add just a variety of other practical implications. We have a situation where our management team over in the UK in a situation where they may be speaking to a new lender. If they were to come to the US, they'd have to self-quarantine back in the UK for 14 straight days. And we have another situation where a large international company, the patriarch there has been stranded in his European country for the same reason. If he tries to come over, see that facility—which he needs to—and go back, again, there's quite a quarantine. On the lender side, we're seeing some of the similar lender stresses across economies. Obviously, COVID has hit many countries similarly and so you're seeing lending in Europe and lending in the UK and lending in the US all facing extremely similar challenges. For cross-border deals, that just adds a new wrinkle. Lastly, I will say we're starting to see a little bit of the COVID impact lightening up, and we're starting to see buyers more and more comfortable in going very, very far down the path using Zoom, and their advisors as feet on the ground in order to try to get deals done.

Todd: Yeah, makes a lot of sense. I think we're seeing a lot of the same trends. Engin, care to share your thoughts?

Engin: Sure, Todd. As I alluded to at the beginning of the discussion, we have five offices in Europe and then an office in Mexico City and Australia as well, which has led to growth over the years, but in an environment like this, also the diversification from a geographic perspective also works to our advantage, just as different countries and regions re-emerge from COVID at different paces. For example, my colleagues in our Frankfurt office are actually back in the office at this point in time, which allows them to continue to due diligence transactions, move forward on new transactions. Part of the biggest challenge in the environment that we're in is the fact that we're whittling through our existing pipeline, and as David mentioned, activity level is picking up but it's still a challenge to get in front of people and try and assess good situations when you're doing everything virtually. But the fact that we have expanded internationally and have the capability of investing cross-borders out of all of our platforms of capital has really allowed us to diversify, grow across the world, but then also in a situation like this, be able to take advantage of different restrictions in different geographies and continue normal business activities where we can, for example, in Germany, when we can't quite get there in the United States yet.

COFFEE BREAK WITH BDO'S BETH GARNER

Todd: All right, Engin. Good stuff there – I know we're certainly getting a lot of useful insights between the two of you. Next, I'd like to turn it over to our Coffee Break guest, Beth Garner. She is the National Practice Leader of BDO's Employee Benefit Plan Audit practice and she is based in BDO's Atlanta office. Let's hear what she has to say.

Beth Garner: Thanks, Todd. I'm Beth Garner and I am the National Practice Leader for BDO's Employee Benefit Plan audit practice. Today I'm going to give a short presentation on an interesting new regulatory development—private equity becoming available to the 401(k) market and similar defined contribution plans for the first time ever.

As you may have already heard, on June 3, 2020, the United States Department of Labor approved the use of private equity investments in 401(k) plan allocations, lifting the traditional barriers between retail investors and private market funds.

The initial purpose of this guidance was to assure companies that offer certain types of target-date funds that they have legal protection for those and other investments, including private equity. This was also meant to give plan sponsors some runway to innovate from their traditional structures. In the words of Labor Secretary Eugene Scalia, the new guidance "helps level the playing field for ordinary investors and is another step by the department to ensure that ordinary people investing for retirement have the opportunities they need for a secure retirement."

In the spirit of expanding opportunity, this development is the latest in the trend of "retailization" of private equity. Retail investors are increasingly seeing more transparency into the private market that was historically reserved for institutional investors and other wealthy entities due to income requirements set by the government.

This significant regulatory change has attracted the attention of numerous private equity investors but has left them holding off on any action before seeing if capitalizing on this trend catches on amongst their peers. So, for those curious about PE firms getting into the 401(k) market, I'd like to provide an overview of some of the pros and cons to pursuing these alternative investments.

The private equity market is expecting a windfall of capital infusion on the back of this new regulation, reportedly to the tune of $6.2 trillion, according to PitchBook. Proponents of this guidance believe it will result in higher returns for small investors, too. Despite being subject to the winds of the economy, the potential of what some predict could generate robust financial returns even in a volatile market and a recession is appealing. Another positive implication of this announcement is the added ability to increase portfolio diversification to hedge against investment risk. Generally accepted wisdom is that diversification of assets within an investment portfolio can help lower expected losses and reduce the volatility of a portfolio over time.

Now, on the flip side, those who might be less enthusiastic about the idea of PE in 401(k) plan allocations may have this sentiment due to the potential liquidity concerns. Private equity capital is traditionally invested for long hold periods and there's uncertainty as to whether retail investors will be able to cash out as easily as they can with public equities and other types of securities. Not understanding the intricacies of how PE funds operate may sway the average retail investor. For example, if someone should decide to retire earlier than initially expected or sooner than the typical 8-10 years that private money is usually held for, that person would rightfully want to know if they can feasibly exit the investment and access cash. The question as to whether 401(k) plan participants' investment horizons will match the PE investment horizons will likely need to be more closely examined before anyone takes advantage of this opportunity in any significant capacity.

Adversaries to the Labor Department's announcement also cite concerns around these alternative investments being too risky and fee intensive for some consumers, depending on their risk appetite. The sensitivity around administrative fees may be enough to deter smaller investors from participating, which explains why lower-risk mutual funds are more commonly known to be associated with the 401(k) market.

It remains to be seen whether or not this regulatory change takes hold. Companies will have to decide if they want to include this asset class as an option for retirement plan participants, though what we're more likely to see is individually tailored plans set up by boutique financial advisors, rather than 401(k) managers offering this up on a wide scale. However, even without access to this untapped pool of capital, private equity managers have been able to raise record amounts in recent years. Fund managers in the United States had access to $914 billion as of mid-May 2020, according to the investment data firm, Preqin.

While there's no hard and fast answer, it'll surely be interesting to keep ears peeled as to whether private equity investments in 401(k) plan allocations becomes part of the new norm. With that, I'll turn it back over to you, Todd.

Todd: Thanks, Beth. Now, let's return to our conversation with Engin Okaya and David Felts.

MEZZANINE FINANCING

Todd: Let's switch gears to mezzanine financing. Understanding that mezzanine investors have the option to convert debt to equity in the event of a bankruptcy, it would be great if both of you could talk about what you're seeing or expect to see in the middle market, certainly given the rate of bankruptcies today. Engin, this time we'll start with you. Can you tell us what the coronavirus's economic impact generally has been or will be on financing in the mez area?

Engin: Sure, Todd. As you can imagine, in situations where we're providing mezzanine capital, those companies went into the coronavirus environment with pretty significant leverage on the balance sheet already. A number of those companies have limited flexibility going forward, just in terms of decreases in revenue and profitability and flexibility within their covenant levels. Luckily, we haven't seen any true bankruptcies result from this environment, but we have certainly seen a number of situations where we've been faced with and are still faced with payment blocks. The percentage of the portfolio that's experiencing that trend today is actually about the same percentage as we experienced in 2008 and '09. So, not too much different, which I find interesting just given the difference in the economic impact today versus 12 years ago. But as a lender we're trying to be as supportive as possible, realizing that really no company could see this on the horizon and that there really wasn't anything that they could do to prevent this. So, again, companies with less leverage going into this situation certainly have more flexibility, but I've seen pretty good responses and pretty good support levels from the lender groups that we're party to as well. I think most lenders' balance sheets are in pretty good positions so it allows them to be more supportive of portfolio companies. But I think it goes without saying that we're going to see a number of bankruptcies. We've seen the likes of J.Crew and a number of other retailers declare bankruptcy thus far and unfortunately, I think that there's probably going to be more that are going to reach that state as well. But hopefully, with the support of lenders and DIP [debtor-in-possession] financing and alternative sources of capital, those companies will be able to survive and come out the back end.

Todd: Certainly a lot of good market intel there, Engin, thank you. David, you care to add some thoughts on the same topic?

David: I would, and maybe from just a slightly different angle. When we go back to the Great Recession, as you alluded to, Todd, in your introduction of this section, in a lot of cases certain mezzanine funds ended up with the keys to the companies. As Engin mentioned, we saw during that time period many of those actually, be very good stewards of the businesses once they were in control. And when you talk about lender-driven transactions, sometimes those are negative, as in, "We need to force a sale," but sometimes they are the unwitting owner of the business. In roughly 2012, '13, given four or five years after the true impact of the Great Recession, we actually saw the mez funds starting to exit those businesses. One of the observations we've seen there is that as owners, it appears to us that the mez funds are looking for those time periods when they can get a full recovery and/or full recovery plus additional compensation for the hold period. They're not necessarily a seller that's trying to hold for a few more years and maximize. So, we tend to see sellers, mezzanine players, once they become an owner, supporting the business, getting it back to that level, but looking for the earliest opportunity to get out of the business ownership business and return to more of a traditional lending status.

INDUSTRY SECTOR OUTLOOK

Todd: All right, thanks to both of you. Let's switch gears and talk about the industry sector lookout. David, I'll go to you first. Because of COVID-19, to what extent have your new business or advisory strategies shifted for the sectors you focus on? Maybe touch on the few that you highlighted in your earlier commentary.

David: Sure. As you watch the world freeze up from COVID-19, those areas that don't freeze up stand out in a very positive way and you take notice. Through March, April, May, you start to see those companies that have survived better than others. From our standpoint, we have been grateful that we actually have a very robust healthcare products practice and we've had a couple of deals in that space that have been moving right through the COVID period with very little impact. We have watched, and Todd, you alluded to one of your video of BDO virtual networking events, you will hear private equity groups in those same venues talking about that they're starting to look at—business services, outsource business services, things that reduce cost for the customer, activities that include a human being on the other side, and so, therefore hard to disintermediate that person with an IT service. We have seen the IT practice area in cybersecurity, identity access management, and other mid-sized enterprise activity—we've seen good, solid activity and continued focus there, so, we're turning our attention. On the consumer side, the clients of ours that have built over the last few years a true, direct consumer platform, be it their business, direct-to-consumer, or supporting let's say, a HomeDepot.com or selling through an Amazon marketplace, we've seen many of those reporting 200–300% increases in April in their direct to consumer sales. I think the consumer is learning to use their computer, and coming out of this, we think those consumer sectors that have developed those D2C platforms are going to be real beneficiaries.

Todd: Some very important points there, David. Appreciate that insight. Engin, over to you. In these COVID-19 times, are there certain industry sectors you are going after or avoiding, for that matter?

Engin: Yes, as I mentioned, we are industry generalists, so we have a pretty wide variety of types of businesses in our portfolio. That being said, just given the historical volatility within the broader retail industry, for example, that's never been a sector that we focused on, and certainly, one that we're avoiding today given the challenges that the sector is focused with today. In terms of other industries, the one that we're watching the closest is the REITs sector. We have a fairly large exposure to REITs. All kinds of REITs—retail REITs, office REITs, multifamily, industrial, and that industry has been experiencing some challenges just with rent payments, etc. Still a pretty defensible industry, but again, given the specific industry focus that different REITs have, some of those have had challenges in terms of collecting rent payments. Then, we've seen "problem children" in our portfolio that actually have experienced pretty remarkable rebounds during COVID. There's definitely been a focus on 'Made in America' and not focus on businesses that don't have to deal with shipping challenges and cross-border activities. We've had some companies that have gotten some windfalls because of that. We've also had a couple of companies that have been involved tangentially in face mask production or other PPE type equipment. So, to be honest, from our perspective, the best defense is having a diversified portfolio because sometimes, you just never know where you're going to take the hits and where you're going to get the upside in. I think this COVID environment is certainly an indicator of exactly that.

NEGOTIATING LOAN MODIFICATIONS

Todd: True. All right. Well, our audience is going to have to agree. We're definitely getting some good insider knowledge here. Again, thanks to both of you. We do have one last topic and Engin, I'm going to go to you first. It certainly looks like you've been recently digging into current dynamics in the loan market as well as the surge in volume of loan modifications ahead. Perhaps you could talk about some of the processes for a successful loan modification, and what lenders and borrowers should look for in an effective proposal.

Engin: Sure, Todd. Yes, I'd say we played defense for at least the first two months of the current environment and really focused on our portfolio and challenges within, which in most cases, end up in some type of modification. Again, there are certain companies that have done very well in this environment. But there are others that are pretty challenged that they're seen close to an 80-90% drop off in revenue that, of course, need some help and some assistance on meeting their covenants and their liquidity needs. In terms of the best process to follow for a loan modification, I think transparency is the number one thing that everyone should be focused on, and communication. The situations that I have been involved with that have gone well have been ones where sponsors, the management team, financial advisors, to the extent that they've gotten involved, have been very forthcoming. Usually, we'll have weekly calls in those situations with the management team and the sponsors. There'll be development of 13-week cash flow forecasts. That heightened level of communication really allows everyone to figure out the next best step forward. Oftentimes, that means the suspension of covenants or a significant reduction in the number of covenants. Maybe it's just simply a liquidity covenant. Then, sometimes, we're having to move interest and principal payments, too. But again, if we feel like companies, management teams, sponsors are doing the right thing, we're trying to be as flexible as we can in these situations, recognizing the fact that no one really saw this environment coming. It also depends on who's in the capital structure and the composition thereof. Oftentimes, we may be the only lender in the capital structure or maybe the only term lender alongside a bank facility, which makes things a little easier. Sometimes, you may have a capital stack that includes two, three, four layers of capital. In those situations, sometimes, it feels like herding cats and trying to get everyone on the same page in terms of what needs to be done. In some of those instances, we'll get an investment banker, someone like David involved in those situations, because that can really help navigate the situation and come up with solutions that are amenable to everyone in the capital stack, as opposed to having one-off conversations which oftentimes doesn't really accomplish anyone's goals and just draws out the time period in which it takes to come to into an amicable solution.

Todd: Well, certainly a lot of moving pieces. I really appreciate that insight. And you set up David, here. So, David, I really think it might be helpful for our listeners to hear the approach for more of these complicated structures.

David: Well, absolutely. Engin really, I think, gave an insider's view of what it's like from her side. I've got a couple of partners who had been around investment banking as long as I've had. So, we've been through '87 and '89 and '94 and 2001, etc. In each of those cases, you end up in these circumstances where covenants and company performance come into contact. In particular, two of my partners did a really good thought piece back in February—we thought a little bit early, it turned out it was probably right on time—talking to companies about, as they entered this, what should they be focused on. Really to Engin's point—what we were advising is, be the company that is the easiest to deal with, because they're going to have other portfolio companies that are going to be really hard. So, self-select yourself into the fast lane. Have your 13-week proposals. Have your revised projections. Have your mitigation strategies well laid out. Communicate, communicate, communicate, and be open. Reinforce that level of trust, because at the end of the day, that lender is going to need to trust what they're hearing. It sounds like many of Engin's portfolio companies stepped right into that. On the flip side, we also advocate that those discussions if they work out, that's perfect. But if they don't, you could have burned a fair amount of time, possibly additional liquidity, and they'll be in a worse place. There are certain circumstances where we also recommend, absolutely, let's pursue those loan modifications as the primary objective. But at the same time, let's light up some dialogue with some other players who may be able to play on a different risk pricing curve. So, if for some reason we just can't get resolution that the company can end up with a financing partner that can help them get through this process.

Todd: All right. Well, it's really been a pleasure having both of you on the podcast. Engin Okaya with Prudential Private Capital, and David Felts with TM Capital Corp. I really appreciate your time and your friendships in the market and all the insight you shared with our listeners today. Thanks on behalf of the team at BDO.

To our listeners, thanks so much for tuning in. If you haven't already, we'd love for you to subscribe, rate, and leave a review of the show on iTunes. Until next time, this is BDO's Private Equity PErspectives.

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