CADWALADER

Rough Waters for Asset-Based Loans

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With the end of March came the close to a quarter that many investors will be eager to forget. Down more than 23%, the Dow Jones Industrial Average suffered its worst first quarter in 124 years and its worst quarter overall since the 1987 “Black Monday” stock market crash. The S&P 500 didn’t fare much better, declining 20% during the first quarter, its worst decline since the 2008 financial crisis. The price of a barrel of oil dropped to $20, energy, airline, and hotel stocks plummeted, and bitcoin fell by 10%. Other than gold and toilet paper, there were few places to hide. This overall decline was punctuated by bouts of extreme volatility, with equity markets whipsawed up or down on a near-daily basis. All of which contributed to an interesting few weeks in equities finance. Below are some observations as to what we have seen and what we expect to see in the near-to-medium term.

- Loans against securities generally held up. Overall, loan protections have worked as expected. Investment guidelines, concentration limits, financial covenants, LTV triggers and cure mechanics have generally provided sufficient cushion for parties to avoid outright default by renegotiating terms, supplementing collateral or liquidating assets to deleverage.
- Closings were delayed. There was a lot of focus around short-term spikes for interest rates in the commercial paper market, as well as on stale valuations on underlying assets. Parties are still looking to get deals done, but have delayed closings until funding costs stabilize and/or updated valuations have been received.
- LIBOR fluctuated. 3-month USD LIBOR touched a low of 0.74% on March 12 before recovering back to 1.45% by the end of the month. The fall in LIBOR presented additional challenges for lenders as their costs of funding in the commercial paper market diverged materially from the rates they are receiving on loans.
- Pricing was a hot topic. Discussions around pricing included firming up expectations as to utilization levels, raising zero floors on LIBOR and increasing spreads. Some lenders looked to reduce spreads by agreeing to shorter maturities or looked to improve liquidity coverage ratios by capping the term for which advances could remain outstanding, imposing longer notice periods for advances or adding a lender right to demand loan repayment with advance notice.
- Margin loans hit triggers. Margin loans breached price and LTV triggers almost daily, setting into motion frenzied efforts by both lenders and borrowers to react:
  - Lenders issued margin calls, carefully monitoring share price movements during the margin call period.
  - Forbearance agreements were hastily negotiated. Additional credit support was provided and took many forms, from guarantees to cash to less liquid collateral, including restricted share positions, stakes in private companies, real estate and works of art. Investment guidelines were relaxed, LTV triggers were revised, share price floors were reduced and payment amortization schedules were imposed.

  - Margin positions were liquidated. Lenders issued default notices, dusted off enforcement plans and refreshed on their Rule 144 analyses for restricted stock positions.
  - Block sales were arranged at discounts, and market makers sought to sell shares into markets quickly under threat from further price declines.
  - In some cases, lenders found themselves underwater on concentrated, illiquid positions. The mutual risk inherent in liquidating those positions has encouraged parties to work cooperatively to delay enforcement, supplement with alternative types of collateral and wait for market conditions to improve.

- NAV and fund of fund loans were not affected . . . yet. For funds of funds and private equity funds, recognition of March's market declines has been deferred:
  - Funds of hedge funds deliver monthly net asset value statements on a delayed basis, typically five weeks after the close of a month. End-of-March valuations won't be reflected until statements go out in early May. In the meantime, top-tier funds have been marketing the selloff as an investing opportunity to raise capital. We've seen actions to upsize credit facilities in order to increase available firepower or obtain bridge financing in anticipation of receipt of additional subscription proceeds from investors.
  - For private equity funds and secondaries funds, impaired asset values will not be reflected until first-quarter valuation statements start trickling in during the back half of the second quarter. How market events are reflected in valuations will vary, as valuations of privately held companies don't necessarily track short-term movements in the listed equities markets. While a lot of analysis has speculated that the secondaries market will slow overall until the effects of the coronavirus are fully reflected in valuations three-to-six months from now, there may be near-term opportunities as sponsors look to provide liquidity to LPs seeking to rebalance their portfolios, generate cash and/or avoid defaults. In the meantime, we are seeing strong interest in NAV loans, as private equity funds look to shore up liquidity to meet the needs of portfolio companies or to generate near-term liquidity for investors.
  - LTV triggers on fund of fund loans as well as secondaries and NAV facilities may be breached. Most such loan agreements include mechanics for flexible cure plans to be implemented over an extended period after valuation statements first reflect a breach. Borrowers and lenders should focus in advance on parameters for cure plans, including assessing access to more liquid assets, availability of uncalled capital from investors and the level of discounts being sought in the secondaries market.

We hope everyone stays safe and healthy. And avoids peeking at their retirement accounts. This too shall pass.