Taking on the underwriting challenge

With due diligence having been made tougher by travel restrictions, parties to deals are asking more questions than ever before

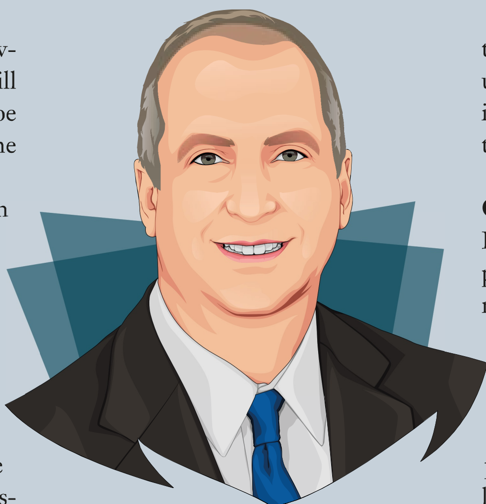
The short answer, when observers ask how underwriting will change, is that there should be no discernible differences between the standards pre- and post-covid.

At Monroe, every deal on which we perform due diligence has been underwritten on the premise that the borrower will have to operate through some type of downturn. And regardless of whether a V- or W-shaped recovery takes hold, or the economy continues to experience fits and starts, lenders will have to view prospective credits under the assumption that output will remain below peak levels for the foreseeable future.

The biggest differences in underwriting relate to how lenders perform due diligence, their anticipated returns and the risk they are willing to accept.

The most obvious change to the diligence process stems from restrictions on travel. Lenders are relying on video-conferencing to conduct management meetings and facility visits and to produce quality-of-earnings reports. Video calls are used to conduct facility tours and, in some cases, there has been talk about using drones for larger site visits. But even without travel, the diligence process will take longer and require multiple rounds of questions and answers to ensure all parties access the required information.

As it relates to investment returns, covid-19 has resulted in a need for increased pricing to account for the greater uncertainty associated with lending. Leverage multiples are a turn to a turn-and-a-half lower than before the pandemic. There has been a tightening of covenants and credit documentation to protect against leakage in the form of dividends or assets being transferred out of lenders' control.



"The backdrop created by covid-19 has resulted in a need for increased pricing to account for the greater uncertainty associated with lending"

TED KOENIG
President and chief executive
Monroe Capital

Opportunity set unchanged

Lenders and sponsors have a clear preference for companies operating in recession-resistant industries. At Monroe, even before covid, our largest concentrations were in software/technology, healthcare and business services, all of which are generally performing well this year. We have largely avoided borrowers operating in traditionally cyclical end markets in recent years. The opportunity set for us is largely unchanged.

What has changed, however, is the mix of non-sponsored dealflow. These family-owned, management- and entrepreneur-led companies have been crowded out of the market over the past few years due to high valuations and intense competition from private equity firms. It has been Monroe's experience that periods of volatility in the economy result in more actionable dealflow from non-sponsored companies as private equity sponsors focus on playing defence with their existing portfolio companies and valuations are less elevated.

Taken together, the dynamics in the direct lending market brought about by covid present new challenges in underwriting. However, they also present interesting opportunities that should amplify returns in current fund vintages, assuming that lenders remain disciplined in their underwriting and vigilant in their portfolio management. ■