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TRANSACTION ADVISORY SERVICES

DEALING WITH DEFAULTS

Do's and Don'ts for Private Debt Managers

For over a decade, Navigant Consulting, Inc. has provided third-party valuation, investment banking, and consulting services to a wide variety of private debt fund managers, including direct lenders, distressed debt funds, interval funds, and BDCs. During that time, we've had a front-row seat for the good and the bad of lender strategies for events of default. We've watched the performance of borrowers through economic cycles, commodity cycles, real estate cycles, and the financial crisis. Based on our independent perspective of numerous managers' strategies and actions, and the results that have followed, we've developed key observations regarding the critical do's and don'ts for events of default.

DO be proactive, not reactive.

Monitor collateral frequently and substantively, looking out for what has changed since underwriting. Whether a loan is backed by equipment, real estate, or simply the business, lenders should monitor the collateral frequently, based on conservative assumptions. Deterioration of collateral value can provide an early warning signal long before there are covenant breaches or payment defaults. Sensitivity analysis using worst-case scenarios helps define the probability and likely severity of a possible default. Changes in financial condition and performance should be compared to industry benchmarks, and monitoring should accelerate during industry downturns.

DON'T ignore covenant breaches.

True, covenant defaults can sometimes be temporary setbacks, resulting from cyclical or seasonal downturns. But resist the temptation to rationalize underperformance. These triggers were designed precisely to warn both lenders and borrowers of potential problems before an interest or principal default, as well as to trigger pre-emptive actions to avoid defaults, re-evaluating changes in the risk/reward profile compared to initial underwriting.

DO plan for defaults before they happen.

Fully develop your firm's restructuring expertise before defaults happen, and agree at senior levels what triggers escalation. Developing internal restructuring capabilities takes far too much time when events of default have already occurred. Outsourcing to external restructuring firms can be faster and may be cost-effective, particularly for younger, smaller firms. But whether you chose a primarily internal or outsourced model, having that infrastructure in place will enable you to be much more proactive and responsive when defaults occur.

DO lawyer up in advance — internally and externally.

Legal expertise is often the most important component of resolving debt issues, and the most successful firms use a combination of excellent internal and external counsel.

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About Navigant

Navigant Consulting, Inc. (NYSE: NCI) is a specialized, global professional services firm that helps clients take control of their future. Navigant's professionals apply deep industry knowledge, substantive technical expertise, and an enterprising approach to help clients build, manage, and/or protect their business interests. With a focus on markets and clients facing transformational change and significant regulatory or legal pressures, the firm primarily serves clients in the healthcare, energy, and financial services industries. Across a range of advisory, consulting, outsourcing, and technology/analytics services, Navigant's practitioners bring sharp insight that pinpoints opportunities and delivers powerful results. More information about Navigant can be found at navigant.com.

Navigant's alternative investment valuation group is composed of experts in diverse financial markets and investment instruments, as well as valuation and financial reporting requirements. Our clients include some of the largest private debt and hedge funds in the world.

DON'T compromise the integrity of your firm by hiding the valuation implications.

Be honest and transparent with all stakeholders — including yourself. Don't engage in denial — with yourself or others — when you see signs of deterioration. Some managers are reluctant to admit to themselves, their valuation firms, their auditors, and their investors when events of default have occurred. Sometimes, this even extends to manipulation of the valuation process, at worst leading to a failure to disclose material facts or to misrepresent them. Sophisticated investors understand that risk and reward are correlated, and even the best managers will occasionally have events turn against them. The integrity — or lack thereof — that managers demonstrate when things go wrong reveals a great deal about the character and credibility of the firm.

DON'T be lulled into a false sense of security by PIK interest.

It may be more difficult to detect deteriorating conditions for PIK instruments, as they won't miss cash interest payments. But the compounding accumulation of interest often makes PIK instruments more difficult to repay. As a result, PIK instruments require more monitoring than cash interest loans, not less.

DON'T fall into the lender liability trap.

Even though you may be simply acting in the best interests of your investors, an enterprising trial lawyer may try to spin those actions into something that looks to a judge or jury more like predatory lending practices, such as loan-to-own. Know the risks before you act.

DO insist on compensation for most waivers, amendments, and modifications.

Notwithstanding lender liability, whenever you waive a covenant or draft an amendment, there should be adequate consideration of the economic interests of both sides. Default interest and/or restructuring fees are entirely justified when a borrower receives more generous terms than they originally agreed to. There may be times when this isn't possible or advisable. But the best advisors get compensated for changes in terms more often than not.

DO look for win-win solutions.

Lending is not a zero-sum game. When events of default occur, some managers may instinctively go on defense, negotiating as if on a team opposing the borrower. But often the best solution for the lender may also be the best solution for the borrower. The healthier the borrower is, the more likely your investors will be repaid.

DON'T try to lend your way out of the problem.

Win-win doesn't always mean lending more. While it's fine to lend additional funds to a creditworthy borrower, throwing good money after bad only delays and compounds the inevitable losses. Never make a follow-on loan you wouldn't initiate fresh today. Re-underwriting is required for each new tranche without decision bias.

DO learn from your mistakes.

Every event of default, large or small, is unique. Therefore, it should result in a post-mortem investigation of what could have been done differently to avoid that outcome. We see the best managers continually evolving their underwriting standards and their terms and conditions, so as not to repeat past mistakes. Your success results from your lending acumen, and learning from mistakes is valuable, albeit very expensive. Better yet, hire managers who have seen all the mistakes at their predecessor firms. That experience can be invaluable in avoiding future traps.

DON'T ever forget that your fiduciary duty is to your investors.

The world is much smaller and more transparent than any of us care to admit. Investment management is an industry based on trust. Reputation and integrity are everything.

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