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Direct lending – market trends

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1. The rise and strength of private credit

The rise of private debt has been well publicised in recent years. It is a growing asset class that has increased market share in the leveraged finance space year on year since its inception. In 2021 and 2022, we saw more leveraged buyouts financed in the private credit markets than ever before, and direct lenders were involved in providing financing for larger, high-quality businesses and not just small and medium-sized enterprises, which is where the product was originally pitched. Recent unprecedented volatility from macroeconomic and geopolitical factors has created adverse market conditions which have left the debt markets dealing with strong headwinds. Rising energy prices, supply chain disruption and labour shortages have resulted in inflationary pressures which in turn have led to rising interest rates. These factors have resulted in one of the lowest levels of issuance of leveraged loans since 2016. Institutional investors have spent past quarters selling debt that was underwritten in the first two quarters of 2022 rather than underwriting new deals. Issuance of leveraged loans in January 2023 left much to be desired, with only August 2022 registering lower volumes over the last three years. Where the public markets have faltered and bank lending is scarce, the private debt market has continued to show its strength and flexibility, as it has grown from being a solely mid-market product into something available on the largest transactions for the highest-quality companies. It has been able to step in and help underwriters to build books on syndicated financings or provide a compelling alternative capital structure to financial sponsors and borrowers.

We expect conditions to remain challenging through at least the first half of 2023. These challenges could result in the continued strength and growth of the private credit market as borrowers look for certainty on their financings.

As an asset class to invest in, European loans are well placed to offer attractive yields, provided that credits are selected carefully. While traditional sources of finance remain constrained, private credit is still a reliable source to finance new transactions and refinancings. Direct lenders are continuing to deploy and have used the dislocation in the traditional financing markets as an opportunity to participate in larger transactions and put more capital to work

than has previously been seen. However, this does not mean there is a '*carte blanche*' approach – direct lenders have always been and remain highly focused on the quality of the credit. Given the 'take and hold' approach, there is a high level of scrutiny of their underwriting. As fewer new money deals are available given the continued gap in the bid–ask spread, credit selection is of paramount importance. In today's market, direct lenders' focus on documentation has increased and direct lenders are pushing back on some of the more aggressive terms that started to creep into private deals in 2021 and the first half of 2022.

While we are not yet seeing huge waves of restructurings, we are seeing short-term stress in certain sectors. We expect new money M&A deal flow to remain subdued, but there is still a considerable amount of debt which needs to be refinanced before the end of 2025. We expect private credit to be a big winner of that.

2. Structural trends

The private debt offering has developed over the years to become a sophisticated financing option. What started as a blended rate for senior and junior financing with one lender has morphed into a variety of options for borrowers. Debt quantums, leverage levels and pricing have all evolved in order to offer a viable option for borrowers versus the public markets.

Debt quantum has been a major development over the years. What started out as a mid-market concept whereby a single lender would provide a small unitranche facility has grown exponentially over time. Lending millions increased to tens and hundreds of millions; now we see 'jumbo' unitranches where well in excess of $1 billion of capital can be provided. In parallel, the ability for direct lenders to write larger cheques has grown to the extent where an individual lender (prior to the current market deterioration) would lend hundreds of millions of dollars and in some cases even more.

In current market conditions, there is greater desire among direct lenders to club on larger deals, which helps them to conserve some dry powder and spread their risk and concentration hurdles. Clubbing the deal also allows the sponsors some flexibility when they want to raise additional capital, which was a lot harder with a sole direct lender. Prior to these club deals, direct lenders were becoming increasingly sophisticated with quasi-syndication of the large cheque sizes they had underwritten, whether to third-party lenders or to affiliates and co-investors. If this market returns, we can expect to see a continued evolution of this, including:

- the conversion of structures into 'first out, last out' structures, which helpfully (for borrowers) reduces overall blended costs of capital; and
- the negotiation about the pass-through of fees to incoming lenders.

Such structures had fallen away a little over the last couple of years as traditional banks retrenched from this market.

As a related point, the super senior revolving credit facility (RCF) sitting alongside the unitranche has become a regular structural feature of the market. As above, one of the key advantages of private debt is the certainty of financing and the ability, in a competitive auction process, to show vendors that the full capital structure, including working capital needs, has been underwritten; this can be a differentiator when it comes to selecting a credit fund to provide the financing. There are differing approaches to funds underwriting the RCF, but most funds recognise the importance of doing this and will try to provide it at the bid stage through an agreement with the borrower that the parties will seek a more traditional bank to fulfil this role prior to closing. Needless to say, a lot of the ancillary lines capable of being used under an RCF cannot be provided by a credit fund. Where credit funds are holding the RCF post-closing, they may impose various restrictions on utilisation (basically limiting this to single-currency cash loans) and seek additional economics as a result of being on risk.

One of the main attractions of private debt concerns flexible leverage multiples. With the introduction of leveraged lending guidelines, banks shied away from providing financing to highly levered structures. Credit funds were not impacted by the same guidelines, and the ability to offer additional leverage (especially in times of cheap money) was a highly attractive feature. Where sponsors pursue buy and build strategies – a common investment thesis in recent years – the ability to lever up beyond opening leverage sets the direct lenders apart. This additional leverage comes at a price and direct lenders have been successful in getting a step-up in the margin ratchet to mitigate the increased risk profile. Higher margins (on top of a reference rate) from credit funds primarily reflect the more expensive cost of capital, but are also a result of the additional flexibility that can be provided. As in the public markets, as deal volume grew over 2021 and the first half of 2022 and the demand to provide financings increased, pricing was pushed down. It is not surprising to see that with recent market troubles, pricing has increased again on new money deals as credit funds readjust for market risk. Equally, because private debt pricing is usually based on a floating rate, the increase in base rates has resulted in a significant yield increase for lenders for existing portfolio companies. On new deals, because of rate rises, leverage levels have reduced significantly to ensure that debt service capabilities are not impacted.

One advantage of private debt, particularly in the current environment, is the structural certainty it can offer. Lenders can make commitments to borrowers without 'market flex' provisions, affording greater certainty of funding terms, pricing and structure to borrowers. Given that recently underwritten public deals have been heavily flexed, this represents a significant advantage to direct lending and sponsors and borrowers are willing to pay

additional rates to benefit from it. Deal execution times are shorter; and as direct lenders typically hold the facilities to their maturity, it is often viewed as a long-term relationship with the credit. As the public markets normalise, we may see more dual-track (syndicated and direct lending) processes being run by sponsors and competition is likely to heat up in the second half of 2023.

As a result of starting as a mid-market product, documentary terms have always been considered more lender friendly in the private debt space, with documents based on the English law Loan Market Association (LMA) standards as opposed to the New York-law incurrence-style covenant packages seen in term loan Bs and high yield. This makes sense, given direct lenders' 'take and hold' approach. Traditionally, direct lenders benefited from tighter restricted payments, debt incurrence, the inclusion of financial maintenance covenants and a cleaner definition of earnings before interest, taxes, depreciation and amortisation (EBITDA).

Naturally, as competition intensified, terms deteriorated and there was some convergence with the syndicated debt market. Some of those terms are discussed in more detail below. Direct lenders have shown increasing flexibility on terms on a deal-by-deal basis, with prize assets demanding more favourable terms. Covenant-lite structures have also appeared for the right credits. Increasingly, independent credit arms of private equity sponsors as lenders are more willing to negotiate the aggressive terms that the private equity side of the business is requiring.

This trend has been bucked by the recent troubles in the market and we have seen increased pushback from lenders on aggressive terms. Equally, sponsors are not pushing for flexibility they do not require. However, a good credit with a top-tier sponsor standing behind it will continue to receive the most favourable terms.

3. Documentary trends of note

3.1 Financial covenant

A big differentiator between private debt and the public market is the regular inclusion of at least one financial maintenance covenant. These 'cov-loose' structures usually include a leverage covenant that is tested on a quarterly basis after an agreed holiday testing period. The term lenders have the direct benefit of this covenant and when there is an event of default (subject to any cure rights), they can take action to accelerate their claims. This is different from the syndicated 'cov-lite' structures where the leverage covenant is tested only if a percentage of the revolving facility is drawn and such covenant only benefits the RCF lenders. As such, the term loan lenders are required to wait for RCF lenders to take action before they too can mobilise.

While the debate continues as to how effective a covenant really is, direct lenders enjoy the early warning trigger it provides and failure to include a

covenant is often a line in the sand for them. Naturally, the headroom and deleveraging profile go to the effectiveness of the covenant and are negotiated on a case-by-case basis.

Some unitranches have been completed with a cov-lite structure and we have seen an increasing number of these done over the past two years for larger companies that could alternatively tap the public markets.

3.2 EBITDA adjustments/synergies

A borrower's ability to adjust and inflate financial metrics continues to attract the most attention from lenders. These accounting adjustments can increase the value of EBITDA or reduce the reported debt/EBITDA multiple. While EBITDA addbacks for the deals remain high, they are usually more tightly governed in the private debt space.

It has become increasingly common for 'revenue synergies' to be added back to EBITDA. Due to their speculative nature and the fact that they are considered to be a core part of a company's operating performance, they were historically excluded from the scope of the EBITDA calculations. On mid-market transactions, direct lenders have generally been able to resist their inclusion or limit them to a small fixed-cap amount.

There is also increased focus on resisting unlimited synergy caps, with a return to a 25% cap fast becoming the norm on top-tier deals. In the mid-market, 20% is increasingly seen. To provide additional comfort on projected synergies, senior management certification or third-party diligence or verification by auditors is still seen on mid-market deals for direct lenders.

The timeframe for realising savings and synergies in order to benefit from their inclusion in EBITDA is generally subject to a time limit in the private debt space. The period can range from 18 to 24 months from the action on top-tier transactions, with realisation periods of 12 to 18 months being the mid-market norm.

Certain other covenants – such as debt incurrence, restricted payments and acquisitions – are also governed by the leverage test. Again, direct lenders are focused on the ability of inflated EBITDA to assist in meeting the required ratios to benefit more easily from these provisions.

3.3 Day one capped baskets

There have been general negotiations on the size of capped baskets. It is generally accepted that most baskets now are 'grower' (ie, increasing to the extent that (and in line with) EBITDA increases). Direct lenders have paid particular attention to:

- the day-one incremental 'freebie' basket;
- the general debt basket; and
- any general basket for restricted payments.

The freebie basket does not appear in all private debt deals; but where it is included, we are currently seeing it set at 25% to 75% of EBITDA. This is lower than from 2019 to 2022, when many deals set the basket at 100% EBITDA.

The incremental freebie debt basket and the general debt basket permit the borrower to borrow additional senior secured debt into the structure. It can incur debt under the incremental freebie basket without meeting any leverage ratio test – that is, debt can be incurred irrespective of the borrower's leverage ratio – so direct lenders give this careful consideration based on opening leverage levels. The general debt basket similarly can be incurred without meeting any leverage requirements, as has always been the case.

This is an extract from the chapter 'Direct lending – market trends' by Mark Fine in Investing in *Distressed Debt in Europe: The TMA Handbook for Practitioners, Second Edition*, published by Globe Law and Business.