EXPERT Q&A

Credit funds proved to be supportive partners to sponsors during the pandemic, and their ability to offer creative solutions is paying off as the economy recovers, say Kfir Abutbul, Bill Brady, Yousuf Dhamee and Jennifer Yount, partners at Paul Hastings

'The private debt market is white hot'

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Q How would you describe the state of the private credit markets today?

Jennifer Yount: 2020 was a year of disruption. In 2021, companies have adapted by creating new business models and systems that generate opportunities for investors, including the private credit funds we represent.

On an industry basis, we are seeing significant investment in technology, healthcare, renewable energy, retail and consumer goods, infrastructure and transportation. On a product basis, we are seeing private credit funds diversifying their investments between debt and equity, starting at the operational subsidiaries all the way up to the fund and holding company level and every level in between.

Bill Brady: The private debt market is white hot and hotter than it was pre-covid. Many private debt funds stepped up for borrowers through the pandemic, either providing new liquidity or being supportive in finding other solutions as sponsors weathered the storm. That has strengthened relationships and, with competition so high, put a premium on digging deep on underwriting, because the margin of error is smaller than ever.

Unitranche is still a big theme as debt funds have moved up the capital structure, and the ability of the funds to be creative and flexible is benefiting them in the competitive landscape.

Kfir Abutbul: The M&A market is extremely active and people are looking for sources of capital to do deals. Those private credit funds that are offering preferred equity structures to help sponsors create acquisition capacity are really being welcomed by borrowers.

Yousuf Dhamee: The debt funds have been able to both increase returns and show investors how well they can perform through a challenging market. The competition for deals now means people can put money to work quickly and investors are agreeing to support next-generation funds quickly too. We expect to see more capital raised this year, with bigger funds raised and capital put to work more quickly as new and more diversified products come to market.

Q Private equity borrowers can currently take advantage of an abundance of investment products in the market. What are you observing when it comes to investments and products?

JY: Because of the disruption that occurred during 2020, not just from covid but also as a result of the change in administration in the US, new

regulations, the social justice movement and a focus on ESG, several micro markets have emerged.

At one end, we see highly competitive micro markets like technology and software, where some investors have now opted out because of the intensity of the competition. Tech was already a highly developed market for private credit and covid accelerated growth.

Structures that continue to be popular include unitranche as well as maintenance covenant toggle and PIK toggle structures, covenant-lite and super-senior revolvers. There is now less emphasis on IP as many of these businesses are succeeding and growing based less on IP and more on expertise and consulting know-how, meeting the needs of businesses leveraging the disruption to create growth.

At the other end, there are more bespoke micro markets like healthcare and energy. Healthcare and life sciences in the US present a significant opportunity. However, because it is diverse, specialised, and highly regulated, it requires experienced subject matter specialists in diligence, structure and documentation.

KA: We are seeing a lot more use of preferred equity as rate pressure has hit other products. For some private debt investors, this is a good opportunity to enhance some risk and some return – there's a fair amount of competition and these deals often get syndicated. Preferred equity gives the sponsor a chance to get more acquisition capacity to their platform without increasing leverage.

The other market that is busy is renewable energy, where there's a lot of focus at government level with well over $1 trillion committed to sustainable new infrastructure. There is also interest from LPs in sustainable investment and energy transition, with investors looking to deploy capital in a way that meets those goals.

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> **KFIR ABUTBUL**

BB: Borrowers are leveraging the state of the world today. A few years ago, delayed draw term loans were not common, but we are seeing more of them as sponsors not only want certainty to close front-end acquisitions but also that lenders will be there again 18 months down the line for follow-on deals. They're asking for delayed draw term loans so that the lender agrees upfront to provide additional capital down the road.

Lenders are responding and are very nimble, not only in structuring the deals but also in terms of the industries where they are deploying capital – we see traditional debt funds looking more into infrastructure, for example.

YD: At the fund level, sponsors are making sure their structures allow them to capture all the different innovations occurring at the financing level and they are having conversations with LPs about those. Funds are responding to investor concerns about ESG matters.

Q What are the latest developments around SPV and holdco investments and products?

BB: When it comes to holdco, it's really an opportunity to add another turn or turn-and-a-half of leverage between the equity and the senior debt to give that added return and a bit more buying power. We were doing a lot of those deals some time ago but they fell away; now they are a creative way to stay competitive and offer a private equity firm additional buying power so they can win deals.

KA: Many SPV investments are structured as preferred equity or quasi debt, to give the sponsor acquisition capacity without more leverage. That is particularly helpful for a highly acquisitive platform, and the terms around it

continue to evolve. Basically, you are telling a sponsor to go ahead and invest that money, make a return and then on exit you come out first.

Q What are you seeing in the context of private credit fund investments, and what trends are you anticipating going into next year?

BB: There are many trends similar to 2008, in that purchase price multiples are extraordinarily high, leverage is up, and covenants are being watered down. But the main difference is the amount of dry powder sitting on the side lines with non-bank lenders. Many of our clients have raised very flexible money, not just in terms of where it sits in the capital structure, but also to invest in special situations, distressed opportunities and the like.

Even though there are many yellow flags, the market is going to be supported by that capital and clients that can provide that money. If things go sideways, the private debt funds have the ability to provide some kind of distressed new money deals and rescue financing, whether at opco, through cash to the holdco, or through preferred equity. Whichever way the wind blows over the next year, asset managers will be ready to provide solutions.

YD: Private debt funds are maturing and accelerating in terms of popularity. A few years ago, credit funds were spinning out of institutions, but now they are spinning out of fairly institutionalised private debt funds, managers are merging and acquiring, and joint ventures are being created to capitalise on new opportunities.

Deal volumes continue to be strong and, in terms of distressed, people are waiting to see when the break will happen. There is dry powder to deploy, so if something breaks, our clients will respond. At some point, managers of private debt funds are going to have to focus on some of the conflicts that exist, whether between different parties in the capital structure or between different sponsors. We are helping clients think that through as their businesses get so much more complex.

KA: In energy, there is a tremendous need for capital and we expect huge flows into the space in the next few years. We see it in the ambitious carbon targets and infrastructure spending plans; there's a lot of momentum and it is going to require significant investment. ■

Q Currently, what trends are you seeing in deal terms?

JY: The industry is pretty well informed about the challenges presented by cases like J Crew and PetSmart. One relatively new area of focus is change of control flexibility, including portability features which has occurred, in part, because of the emergence of SPACs.

BB: Obviously, deal terms have continued to erode based in large part on the competition that exists on deals, with sponsors typically going to five to 10 lenders and asking them to compete. The real goal for the private debt fund is to thread the needle between being commercially competitive and being responsible, which puts a premium on due diligence, the underwriting process and focusing on the deal terms that matter most as they relate to credit risk and recovery.

While being accommodating on financial covenants where they have them, and providing the flexibility sponsors are demanding, lenders are balancing that against more important points like leakage and paying close attention to downside scenarios.

"Private debt funds are maturing and accelerating in terms of popularity"

YOUSUF DHAMEE