EXPERT Q&A

Covid-19 has presented the private debt market with both challenges and opportunities. William Brady, Mei Lian, Luke McDougall, Diala Minott and Jennifer Yount of Paul Hastings assess some of the major developments

How a crisis-hit market is taking shape

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Q How are European and US markets coping with the economic turbulence?

Luke McDougall: The overall impression is that this year has been generally positive given the economic background. The private debt market is in much better health than people expected it to be in when the pandemic originally hit and a lot of countries went into lockdown. Even though the UK and other countries in Europe are bracing themselves for another lockdown for a period of time, there isn't quite the same pessimism this time around regarding the ability to do good deals.

We spoke to the European head of credit for a fund manager who said that in March they were predicting 30 percent of their European portfolio would be in default within six months. As it turned out, it was less than 10 percent. One of the key factors, which seems to have been underestimated, is the degree to which government intervention was able to prop up the market.

In addition, private equity funds in Europe have scaled their own expectations up since March. Back then, they were recalibrating their portfolios for an exit timetable 18 months to two years later than originally anticipated and for much lower multiples. They were preparing their own investors for bad news and putting huge amounts of effort into establishing where the covid-19 exposure was for their portfolio companies and how they would mitigate it and, on the whole, they've been more successful than expected.

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>
> **JENNIFER YOUNT**
> **Paul Hastings**

William Brady: You have a tale of two worlds – where you've got technology on one side and on the other side you've got travel, entertainment, restaurants and retail – and I think it's pretty clear there are winners and losers based on that. But there's another distinction. In terms of heavy restructurings that I've been involved in – and by heavy I mean not just re-setting covenants but taking the keys to the company or forcing a sale of the company – they have been limited to companies which were wobbly heading into covid-19. With companies that were performing well outside of disastrous industries, the lenders have been pretty accommodating in giving covenant relief and minimising fees and helping with liquidity solutions.

The short-term liquidity fix was everyone maxing out revolvers and the mid-term fix was hitting incrementals either within the lender group or, in some cases, new money coming in, maybe without the lender's consent.

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Mei Lian, is a partner in the finance and restructuring practice, London

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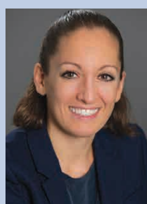

Diala Minott, is a partner and private funds lawyer in the credit funds practice, London

Jennifer Yount, is a partner and chairwoman of the global finance and restructuring practice, New York

We've helped some private debt funds find opportunities to invest in companies which need that additional liquidity. Today, we also have a bunch of deals that are competitive, front-end LBO auctions with multiple lenders chasing the deal and with terms that don't look too different from pre-covid-19.

Q How has the pandemic impacted cross-border transactions?

Jennifer Yount: To echo William's statement about a tale of two worlds, during the first six months of covid-19 we focused on a number of cross-border restructurings particularly in industries that were negatively impacted by the pandemic – travel, entertainment, and retail. The public French digital media company Technicolor is one example. At the same time, we also were focused intently on new financings in industries that were propelled by the pandemic, namely technology.

New financings in global technology companies have been abundant for years. The pandemic intensified the essential nature of this industry to global businesses and the private debt market's interest in the opportunities presented by technology. As technology companies expanded their digital solutions to solve problems never seen before – social distancing, crowd control, entire work forces remotely working from home, retooling supply chains – the private debt market stepped up to provide these companies with financing solutions to meet their needs. Interestingly, some technology companies that pre-covid were focused solely on passive software solutions have expanded their offerings to a much more customised digital solution for their customers. This has, in turn, resulted in the private credit market structuring and underwriting loans to these businesses a bit differently.

Q What opportunities are you seeing arise in the distressed and special situations space?

Diala Minott: We've launched a few credit opportunities funds – quite a few in October and another few in November. In the European market, because pricing has been quite volatile, especially with the second lockdown in Europe, managers have taken the opportunity to set up funds quickly to take advantage of that pricing mismatch. A lot of the underlying assets have been mispriced in their view, are in potentially healthy industries and a lot of them have capital from organisations like the European Investment Fund or the British Business Bank, which are providing financing to help these struggling industries.

We've also seen a convergence of the US and Europe in these funds because there are a lot of US managers taking advantage of the pricing mismatch in Europe and seeing some interesting pricing in the US as well but wanting to have one platform that can do both things by catering for an interest in both European and US assets. That sort of platform is particularly challenging given the current tax environment so having one platform for which investors can come in and take advantage of those price mismatches has been challenging, but we have managed to structure that.

Q What are some of the challenges in turning around struggling companies?

LM: There's no shortage of capital available for companies that have a viable story but I think we're increasingly finding it binary, ie, there is zero capital available for a business that is old economy and was probably due to struggle anyway, and it's becoming so binary that equity values quickly go to zero. I don't think anyone was surprised about the 'sick man' retailers that are based on bricks and mortar falling to pieces over the summer and, while it's sad for communities when the businesses are of a regional nature, it's also not surprising. But if you have a viable business there's no shortage of rescue capital and distressed debt that's been raised. There's a lot of money out there for companies that have got a story and a viable business model post-covid.

DM: The other thing I've seen, which is quite interesting, is a rise in products that have integrated a lot of ESG and sustainability measures into their business plans because they know that will attract a lot of investor inflow if they have that, especially with the new

disclosure regulation that's coming into force next year. We've seen more companies putting in place sustainability and ESG measures and it will attract a lot of capital because investors are very highly focused on that during this covid environment.

Q Are EU interventions, such as forced payment holidays, likely to cause problems for lenders in these jurisdictions?

Mei Lian: The scope of EU interventions such as forced payment holidays varies by jurisdiction, eg, by type of borrowers, lenders or loans, but the impact has been significant.

As at August 2020, more than €360 billion of loans at Europe's biggest banks were subject to payment holidays. For some of them, the value of outstanding loans subject to payment holidays was estimated at around 15x the size of the total provisions set aside for loan losses. According to the *Financial Times*, the estimated loan loss from bad debts could rise to $880 billion by 2022. So, it would seem that the outlook isn't that great, and the banks need to be prepared to deal with these losses, notwithstanding their own exposures as a result of covid-19.

However, the banks are in a much stronger capital and liquidity position than they were in the wake of Lehman. Overall, I think governments and central banks are much more likely to be accommodating towards the banks, and likely to provide more support in terms of bearing the cost of shifting the risk from the high street to the banks. You can already see this in the encouragement of the use of capital and liquidity buffers, extensions in time periods for restoring buffers, the extension of consultation periods, delays in new consultations, and other measures. My view is that there will be more support for the lenders in unwinding the implications of these intervention measures over time.

Q Will private debt funds be better able to cope with the turbulence than the banks?

WB: I think the key is flexible capital and the appetite and willingness to take the keys if the private equity fund is way out of the money and just wants to walk away. In that scenario we've got clients who have the capacity and the expertise to run the business for a couple of years and turn it around. We've seen a lot of that. Other clients, based on market conditions, aren't really looking to hold the company for a couple of years and they're running a sale process. In some cases, you take the keys, you run the sale process, the new private equity fund comes in to run the company and guess who provides the financing? The same debt fund. So, there is a bit of an annuity model and it comes back to the appetite to own – and we're not necessarily just talking about sharp-elbowed distressed funds.

Q How have loan terms and documentation changed and does this benefit lenders or borrowers?

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> **Paul Hastings**

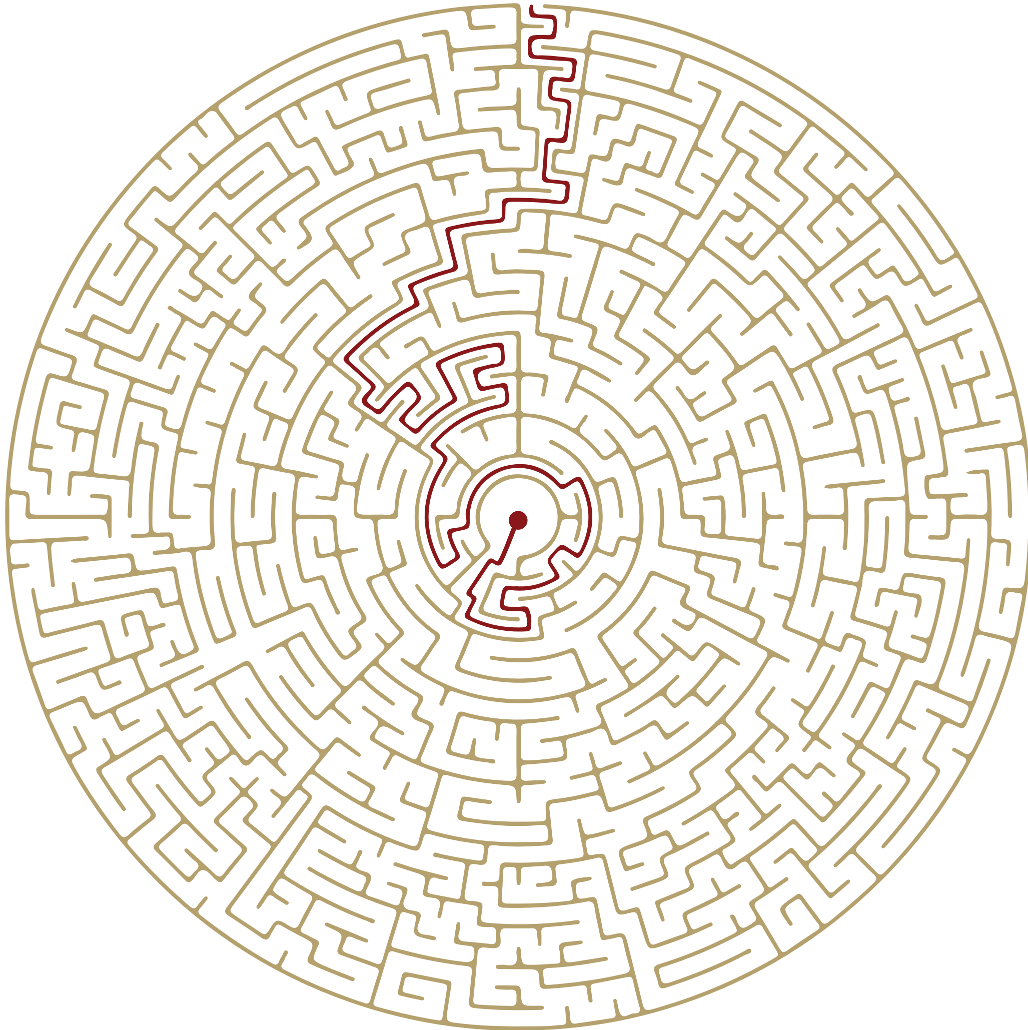
JY: There is disruption in the market. And with this disruption, we have seen some cases in which expectations of one or more parties have not been met. These have played out mainly in the bankruptcy courts – cases that the private debt market has studied and discussed, resulting in new approaches in the context of both restructurings and new financings. Of course, disruption can also create opportunities. And with opportunities comes the need for new structures, new terms and unique documentation. Private credit's flexibility and keen interest in understanding the need and how private credit can meet that need quickly has been enormously helpful to many businesses requiring these unique solutions post-covid.

ML: We've seen increased homogenisation, but this is not a new trend. This is across products (high-yield/leverage loans); across jurisdictions (US/Europe) and across sectors (large-cap/mid-cap).

Personally, I do not think that this is necessarily worse for borrowers or lenders. Homogenisation helps with liquidity which is always better for market participants – both for borrowers (as they have a wider pool of lenders to access) but also for lenders (as they can penetrate more markets). Over the years terms in general have become more borrower-friendly, as sponsors have used their leverage to drive the market and terms.

There are differences that remain notwithstanding the homogenisation – due to differences between the various legal regimes, insolvency rules, etc – so it will never be frictionless, but in practice it's allowing borrowers to take the lowest common denominator terms from different products. This is mainly because the low interest rate environment (for many years now) has meant that lenders are hungry for yield, and this is giving borrowers more flexibility to cherry-pick terms. ■

Navigating new paths to growth



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