EXPERT Q&A

*Dislocation is creating opportunities for lenders and driving changes to fund structures, say Luke McDougall, co-chair of the global finance practice, and Diala Minott, private funds partner, at Paul Hastings*

# Direct lending: The healthy European outlook

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**Q How has direct lending in Europe changed as a result of dislocation in syndicated and high-yield markets in 2022?**

**Luke McDougall:** The syndicated loan market and the high-yield market are both effectively shut in Europe right now. There are some limited circumstances in which someone would go to market, but generally speaking, as of early September, it is not a feasible option for leveraged buyouts. We saw underwriting done over the summer but very little was launched and quite a lot either aborted or switched from an underwriter to a direct lender.

The problem is that the level that the banks will underwrite in the current market is so punitive for the borrower in an LBO that it is better to go for the certainty of a direct lending solution. There is an inversion going on where direct lenders will now do deals at a cheaper price than a syndication.

After the application of market flex, the cost of capital represented by a bank underwrite could be in the 10-12 percent range for debt that would have been priced in the 5-6 percent range just nine months ago. So there has been a significant switch.

There are some circumstances where we have seen banks do a long bridge, but it is a bridge to a better market 12 or 18 months away, hoping for a term loan B take out when things improve. We see people propose that but it is not seen as very attractive.

As a result, direct lenders have had this enormous space to walk into over the last six months, and a number have stepped up really effectively.

While the terms often start from a relatively aggressive position from the sponsor perspective, there are signs direct lenders are chipping away pretty heavily at pricing, terms have got tighter, and lots of documentary flexibility that had crept into the senior loan market over the last two years has reversed out again.

> *"Tech and software businesses are regarded as more resilient and a bit less cyclical"*
>
> **LUKE MCDOUGALL**

**Q What has been the response of direct lenders to these new opportunities?**

**Diala Minott:** What I'm seeing is an influx of direct lenders wanting to set up fund vehicles really quickly to take advantage of price dislocation in the loan market and looking at bonds, turning to more liquid asset classes and mixing liquid assets with illiquid assets. They are responding to what they are seeing, which is lots of opportunity, and that is being matched by investors looking for liquidity.

We have seen quite a lot of pressure on some of the closed-end funds to offer some liquidity, plus managers changing their strategies to take advantage of the opportunity in credit while staying within core direct lending, which they know will come back.

Smaller managers are putting in some opportunistic buckets quickly, while larger funds are finding it a bit slower to get the money from investors to match the credit opportunities. They are having difficulties getting money from nervous LPs, some of whom have shut up shop and put funds on hold as they wait to see how markets react. Managers are aware of the new opportunities to fund loans left by the banks but risk losing out on those opportunities because they don't have the requisite funds from LPs.

**Q How are regulators reacting to these changed market dynamics?**

**DM:** We hear good noises from the regulators, in that all of them are allowing new structures. They were starting to do that before the macroeconomic challenges hit, so we are waiting for new regulations to be published. Certainly, they are much more comfortable with the current regulation of direct lenders and have started to look at other ways to allow more liquidity into these products. We see them looking at allowing direct lenders to expand their investor bases, potentially allowing open-end funds to do direct lending, and becoming more amenable to retail investors coming into funds.

Because it is so difficult to find the LP base, a lot of managers are turning their attention to retail, starting with high-net-worth individuals but also looking at new fund structures like the UK's Long-Term Asset Funds. There is a real drive now for managers to have one platform that can bring in all these different investors, and regulators are providing that framework to ensure retail investors understand what they are getting into.

**Q How are managers adapting to the macroeconomic environment?**

**LM:** From a deployment perspective, the inflationary expectations and recessionary expectations in the macroeconomic outlook naturally cause managers to exercise a degree of caution. We have also seen quite specific problems that have broad application, such as the supply chain problems caused by the pandemic that have affected a great range of businesses and drawn lenders into difficulties with existing credits.

The environment is certainly impacting behaviour. While there is appetite to do deals and lots of value being seen in the market, there are also headwinds that are causing lenders to decline opportunities because of the stresses they see coming. Investment committees face a difficult time right now in selecting where to deploy. Tech and software businesses are regarded as more resilient and a bit less cyclical, and, of course, credit funds tend to have much healthier and less cyclical portfolios too.

**DM:** On the funds side, managers are realising that potentially they don't have the expertise to deal with some of the credits that have gone into distress. They are hiring whole teams of distressed credit specialists.

In addition, a lot of funds are drawing on their cornerstone investors – either setting up new funds with cornerstone money or calling it down from their group parent because it is so difficult to bring in a diverse LP base at the moment. We are seeing a lot of joint ventures between cornerstones and managers, often with deals in mind that they are warehousing.

Finally, we see some broadening out of strategies and European managers partnering with US managers or US pension plans, allowing them to set up funds quickly and look at opportunistic credit that they might not otherwise be able to do without that financial support. We expect to see a bit more asset manager consolidation as a result and especially as it gets harder for managers to grow their own businesses.

## Q How have recent market conditions affected direct lenders raising capital?

**DM:** There are a lot of delays; fundraising is now taking a minimum of 18 months when it used to be 12 months, and investment periods are shrinking to two or three years. We have seen specialist funds set up really to acquire an asset, turn it around, sell it and then move onto the next vehicle quickly.

We see more evergreen funds, including several small evergreen funds being set up for different assets within the same fund, to save on the cost base. And we are seeing some investors looking for exposure to higher risk assets than straight direct lending, causing funds to set up as a master fund with different classes to track different assets for different returns. Fund administrators are now trying to segment those cashflows, as market conditions are leading this structural change to funds.

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>
> **DIALA MINOTT**

Inflation has also changed the return expectations of LP investors in credit funds. The divergence of incentives between managers and LPs has become a bit more acute and is driving investors to really force managers to monitor portfolios and push returns on investments. Some LPs are asking managers to benchmark returns to inflation, and it will be interesting to see if any agree to that.

## Q What structural trends in funds are we seeing, particularly new fund structures?

**DM**: There is more appetite for evergreen funds, including some closed-end funds that are half open and half closed, with a mixture of liquid and illiquid assets, and allowing investors to be exposed to different risks and returns according to their appetite.

Those funds are not fully open-end because many managers don't have the expertise to manage open-end funds and the liquidity needs associated with those. However, LPs are asking for that liquidity premium, so we are seeing these closed-end funds that essentially offer the ability for investors to be bought out at a certain point in time.

These structures are proving to be of interest to some of the UK pension plans, who are actively asking to be bought out of their current investments as they seek to pause and see what happens next within the current market. I noticed that big US state plans are suggesting that they are expecting to see valuations start to drop and so will only look at tier one managers, which creates tensions around the definition of a tier one manager and makes conditions even more challenging for new managers with their new strategies.

## Q Should we expect further tightening of lending conditions as a result of scarcity of debt capital?

**LM:** The trendline has definitely been tightening over the last few months and we have seen sponsors frustrated by processes where terms have worsened between when they started to negotiate and the point where diligence is done, and they are going to investment committee.

That is in part market driven, but there has also been a degree of market finding recently that large sponsors are less used to. The syndicated market and the high-yield market give them so much data, and the banks were so much more confident of where a credit would price and what terms would be achievable, they are not used to this level of uncertainty.

So, there is a bit of frustration, but credit funds are being asked to deploy significant amounts of money on single name exposures because they are looking opportunistically at larger deals, so their investment committees are, perhaps understandably, back on the terms the investment teams would like to do. ■