E X P E R T Q & A

Direct lenders need to be strategic about higher default rates, according to William Brady, Kris Hansen and Jennifer Yount, partners at global law firm Paul Hastings

Direct lenders are navigating rough seas

Q What challenges are facing direct lenders in the current environment?

William Brady: Direct lenders are facing challenges on two fronts: they are under enormous pressure to deploy capital in a market that is still highly competitive, and at the same time, they must protect themselves against the downside to maximise value and returns. They need to remain commercial and competitive while also protecting their LPs' investment in times of incredible uncertainty. This requires a delicate balancing act.

Kris Hansen: Given the global macro environment, direct lenders should prepare for a higher default rate. We work with clients to draft their documents on new deals in a way that remains competitive but also protects them in the event of a recession. In the event of defaults, both issuers and sponsors want maximum flexibility, which comes at a price on both sides.

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Jennifer Yount: With the increase in portfolio diversification – across geographies, industries, products and asset classes – direct lenders need diversification of expertise for their investments. The typical analysis of "how does a lender get out of a credit before a lender gets into a credit" often requires a spectrum of specialists across asset classes, products, industries and geographies.

Q How can managers maximise opportunities on front-end deals to tighten certain credit terms?

JY: Many direct lenders keep a wish list for tightening terms. But in this market – which is still competitive – it's not realistic to get every item on one's wish list. One must prioritise. For those priority items, direct lenders are flagging them earlier in the process to avoid surprises later in negotiations.

WB: The focus is on threading the

Q Where are the opportunities to go on the offensive in existing deals?

KH: It always starts with a covenant analysis to determine what opportunities exist throughout the document – what leverage the lenders have and what leverage the sponsors have. It's about finding a capital solution and that can be tricky when some lenders have a very different cost basis than others and some own the loans through vehicles that may not be able to operate as flexibly as others. Being able to see the full playing field and understanding who can play where on that field is critical.

The market in recent years has caused lenders to evaluate their ability to jump the line and exchange their debt into a different category to get ahead of other lenders. That is a strong offensive strategy but people need to be careful to consider the responses to those actions and their place in the broader market.

When on the offensive, lenders need to determine whether there are open market purchases available, whether there is a any absence of protections from a pro rata sharing perspective, or whether there is ringfencing around significant assets. However, lenders also have to be mindful that, in this market, they are frequently dealing with the same people around the table so they need to be careful about focusing only on what is best for their LPs in a single investment.

Finally, lenders should always look at purchasing or refinancing the asset-backed loan in a troubled situation in order to take charge of the more favourable inter-creditor position that ABLs often have and to make use of the more liquid collateral associated with ABLs. Doing so often allows lenders with a greater willingness to deploy flexible capital to do so in a faster and more efficient way.

WB: All of this points to the importance of understanding existing documentation and, again, the cause for distress. Good companies with bad balance sheets are prime targets for opportunistic lending. With the vast amounts of dry powder on the sidelines that didn't exist during the Great Recession, our current economic environment is unlike anything we've seen before. Opportunities will surely follow.

needle between remaining competitive and protecting the downside – primarily leakage and leverage. This applies on both fronts to credit provisions vis-à-vis the borrower (J Crew, Chewy, Envision, etc) and other lenders (Serta, Revlon, etc). It's essential to focus on the most critical "must have" underwriting protections while remaining commercial on other less critical terms.

KH: We are doing a lot of bridge lending into distressed situations and rescue financing into more significantly distressed scenarios. It's critical that people negotiating the documents in these situations have deep experience with transactions in which sponsors and lenders have taken advantage of loopholes in documents so that areas for exploitation can be addressed in ways that are most advantageous to the lenders.

For example, it's typical for a sponsor to have a non-wholly-owned subsidiary carve out, which has been exploited in the past. However, it remains hard to negotiate that out of credit agreements because sponsors are still in control of dealflow and so lenders need to protect themselves in other ways.

Many of these exceptions in documents were used to keep lenders at bay and favour some lenders over others. In private credit, there are typically fewer lenders and they tend to know each other, so there is a higher trust factor, but it's not a substitute for relying on experience with documents and the knowledge of where to look for potential issues.

Q What can direct lenders do to protect existing deals and maximise value?

WB: It's critical to be proactive and get out in front of things while also communicating strategically with other parties of interest, including certain lenders. The people you speak with or don't speak with, and what you say or don't say, will matter. Navigating to a consensus among certain constituents to maximise value is no easy task but it's achievable with a proactive plan. It is also critical to understand the cause for distress, as every deal is different and there is no 'one-size-fits-all' solution.

JY: We keep a list of our distressed credits and review the list frequently to determine if there are any trends emerging and, if so, whether those trends match up to available data, geo-political events or court cases. When a trend or theme emerges, we connect with our direct lending clients. As just two examples, we have seen some themes around labour shortages and data privacy.

To protect value, direct lenders often are in frequent communication with the company or the private equity sponsor to ensure that everyone is on the same page as to the issues, the plan and next steps. Situations with this approach are where we see the most success in terms of stabilising credits.

KH: It's very important to be able to have an agency relationship that favours the lenders, especially in troubled situations. We have noticed that, if we inherit a deal, it can be very difficult to remove the agent, and many sponsor-friendly provisions rely on agent consent. As a result, it's very important to have an agent that is prepared to communicate with and take direction from lenders and to appoint that kind of an agent initially or get to work early to replace the incumbent agent.

Playing defence is also about knowing your rights and making sure that you have the right partners. All of that advance communication will allow managers to react early and that is absolutely critical. The relationship between the lenders and the issuer doesn't have to be adversarial and, in fact, should be about working together to bring additional flexibility to a company.

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WILLIAM BRADY

Q What new opportunities might be available in these rough seas?

JY: Choppy markets offer plenty of opportunities but the opportunities in this recessionary environment differ from those in previous downturns. Three stand out to me:

First, as for products, we are seeing private credit lenders focusing on asset-based lending or hybrid asset-based lending, which historically was a product that only the banks provided. Private credit lenders are also focusing more on structured finance products, real estate and infrastructure. Second, in terms of industries, we are seeing private credit lenders focusing more on sports and entertainment, financial services, and industries that are seeing a resurgence due to federal and state legislation, such as clean energy and healthcare. Third, structures have become more bespoke and are specifically tailored to business and yield goals of the investors.

KH: We are seeing a move on our side towards a more structured hybrid debt and equity opportunity in an effort to blend returns up and deal with the potential for increased market risk. Capital providers who are able to blend both private equity and private credit see that as a way of reaching for returns. Obviously, there are issues of enforceability of covenants and the trick is always in the drafting.

WB: Every situation is different. Business and legal diligence will be critical to understanding if, and where, opportunities can be found on each particular deal. Liquidity and debt service will be a driving factor for many borrowers who are facing a shrinking GDP, higher labour costs, inflation and rapidly rising interest rates. Liquidity solutions can come in many forms and possibly in many parts of the capital structure.

Strategies for finding permitted liquidity solutions while protecting the downside risk will be different in each transaction. With respect to leakage, governors on RPs, RDPs, investments and affiliate transactions are at a premium. As for leverage, managers should focus on limiting all indebtedness with a premium on locking down priming debt and preserving MFN protection on all pari debt, regardless of how it's classified (incremental, incremental equivalent, ratio debt or otherwise). ■

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