CLIFFORD CHANCE

PRIVATE CREDIT – A GLOBAL PERSPECTIVE ON MARKET DEVELOPMENTS

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With the continued global expansion of the pool of private credit, what does the future hold? Will the boom times continue, or will enthusiasm be dampened by the resurgence of syndicated bank loans and the return of CLOs? The private credit market over the past few years has expanded exponentially but this has been against the backdrop of a very subdued syndicated loan market. In this paper, senior members of Clifford Chance's Global Private Credit Group look at the impact on private credit of the return of the Broadly Syndicated Loan (BSL) market, the options for private credit in the short term and what developments we expect to see happening in the future.

The return of the Broadly Syndicated Loan (BSL) market

In the first four months of 2024, more than US$13.2 billion of private credit owed by US companies has been refinanced in the BSL market (according to data prepared by PitchBook). It's a similar picture in Europe as Clifford Chance Partner, Katherine Sinclair, explains: "I have had a number of private credit transactions refinanced in the syndicated market with reduced pricing and more flexible terms. Cinven's group. ONE is an excellent example of this – we closed the acquisition of Dogado with a large club of private credit providers in early 2023 and, just over 12 months later, have completed a full EUR 800 million refinancing with oversubscribed books and a 275bps improvement on pricing. That said, group. ONE is a great credit that has performed well, so perhaps it is an asset that was always destined for the syndicated markets." She adds that private credit stepped in to fill a gap while the BSL markets were quiet in 2023 but, as soon as non-call periods come to an end, sponsors are looking for (and finding) cheaper debt.

To remain competitive, an increasing number of private credit providers are agreeing to repricing transactions in an attempt to avoid sponsors going out to the BSL market. "I expect, for the right credits, that trend will continue over the remainder of 2024," she says.

On new money deals, sponsors are often running "dual-track" processes where papers for both an underwritten TLB and a private credit club solution are being undertaken concurrently. "Throw in an infrastructure track for a cross-over asset and you can see the vast financing options that are currently available to sponsor capital markets teams – in stark contrast to 2022-2023," she adds.

What's the situation in APAC?

While international banks have pulled back from straight corporate lending, there remains a lot of appetite for sponsor-backed financings / senior syndicated deals in APAC. "It is difficult for credit funds to compete at that level of pricing, so a lot of credit funds here are more focused on bilateral direct lending opportunities. These bilateral deals can be attractive because they give the credit funds full control over the initial structuring and terms as well as decision-making throughout the life of the debt. These deals are often highly structured and they sometimes involve convertible instruments and warrants, rather than just straight debt," says Chin Seng Chew, a Clifford Chance Counsel based in Singapore.

The highly structured nature of some of these deals can make it difficult for them to be refinanced in the syndicated bank loan market, where arrangers typically expect more standardised terms to facilitate syndication. That said, sponsors and promoters in APAC are always keen to explore opportunities for transitioning their companies to cheaper bank debt in the right circumstances, so some of the borrowers will access private credit effectively for a 12- or an 18-month bridge before returning to cheaper bank funding. "This is certainly happening in India, where we are hearing of a number of large private credit deals which the market is generally expecting to transition to cheaper bank debt in the near to medium term as the underlying businesses improve. Refinancing in the syndicated bank loan market certainly remains an option for borrowers with strengthening credit profiles," he says.

How are private credit providers looking to compete?

"Based on activity in the US, I'm not sure we'll see a complete return to the "norm" – with larger deals done as broadly syndicated loans and more mid-market deals done in private credit – as many private credit providers will look to compete by continuing to offer borrower-friendly terms that will attract sponsors and large corporates," says Jason Ewart, a Clifford Chance Partner based in New York. "The reality is that the new normal is increasing competition amongst lenders, as evidenced by the flexibility of debt documents. Even during the competitive lending markets of the past couple of years, when we would expect tightening of covenants and improvements in lender protections, we noticed only a small movement away from borrower-favourable terms." He adds: "To retain market share, I think we can expect providers of private credit to maintain those terms and agree to items that can often be "flexed" out in the BSL market. In addition, private credit providers often have the advantage of being able to provide bespoke flexible financing solutions in the form of hybrid capital. I suspect this will be another option for them as they look to retain market share."

Meanwhile, the Benelux region has seen a steep increase in the number of private credit deals over recent years due to the low interest environment and the enhanced flexibility offered by private credit providers to sponsors with ambitious business plans and active bolt-on acquisition strategies. Given the size of the average deals in the Benelux market, larger syndicated TLB structures are generally quite limited.

Boudewijn Vermeer, a Clifford Chance Partner based in Amsterdam, says that, towards the end of 2022 and during the first half of 2023, the appetite for larger sized bank (club) deals slightly revived as a result of the changed interest environment. The sizes of those deals were comparable to deals that would otherwise have been done by a single PC fund (supported by a limited amount of super senior debt). Banks, both local and international players, were more active during that period in The Netherlands and sponsors and borrowers have accepted tighter terms, a trend which has continued on a number of deals throughout 2023 and early 2024. "We also see some PC funds focus on larger deals and some PC funds focus on mid-market deals. The growth of the asset class will likely continue to push certain PC funds to do larger deals," he says.

What does the immediate future look like?

"Given the rise of interest rates in the London market, we have not seen the wave of restructurings which we might have expected because of "amend and extend" transactions, covenant waivers, additional equity injections, etc," says Jim MacHale, a Clifford Chance partner based in London. By contrast, it is a mixed picture in Germany where, generally, sponsors and private credit lenders have been required (over the last two years or so) to look more closely at their existing portfolios. While, in many cases, a covenant holiday combined with some form of PIK interest and, potentially, a smaller equity injection was considered sufficient to stabilise the borrower group, this has not been universally successful, with some borrowers struggling with the increased debt burden arising from the PIK which can no longer be dealt with by a simple waiver process. "This included, for example, substantial equity contributions or debt hive-ups, but there were also several cases where the shares were fully or partially handed over to the lenders on a consensual basis and, in rare cases, borrowers even ended up in insolvency," says Christoph Nensa, a Clifford Chance Counsel based in Frankfurt. He adds that, in the more severe cases, this was mostly due to a combination of factors, including – in addition to the higher interest rates – high inflation (leading to higher costs without the ability to pass them on immediately) and financial problems amongst the supplier or customer base due to the delayed effects of COVID or weakening demand. "It remains to be seen how the 'wait and pray' approach will play out in the majority of the affected transactions, and the recent slight decrease in EURIBOR might be beneficial or lead to a return of inflation," he says.

Shaun Langhorne, a Clifford Chance Partner based in Singapore, says that, from a distress and restructuring point of view, "the past 18 months has been probably the strangest period that we have seen here for a long, long time as, despite the various economic indicators, there has not been the level of distress or restructuring activity that might be expected outside of mainland China real estate. What we are seeing instead is two main trends: the first is the increased use of insolvency and enforcement processes which is presenting opportunities for credit funds, particularly in the Hong Kong and mainland China real estate space, to buy out existing bank debt and look to execute credit bids or debt for equity plays for key assets in receivership or liquidation; and the other is second or third rounds of restructurings. Deals that we did throughout COVID and in the year or two after are now starting to come back for another round, given the changing landscape for businesses post-COVID."

With a subdued M&A market, how are funds looking to capitalise on their "dry powder"?

In the London market there have been examples of a convergence of senior and junior debt, with an opco financing provided by banks sitting alongside a Holdco PIK provided by private credit lenders. "Australia is also seeing bespoke transactions where sponsors are looking for an extra bit of leverage. Perhaps they're reluctant to exit on lower dollar valuations and see value in doubling down on their investment and unlocking that last bit of value. They're funding this further capex spend through Holdco PIKs or additional pieces of subordinated debt that sit behind a senior financing (whether it be a syndicated unitranche or senior bank debt)," explains Elizabeth Hundt Russell, a Clifford Chance Partner based in Sydney.

How are PE funds getting money back to their investors?

In a subdued M&A market (preventing sponsors from returning cash to their investors via the traditional route), we might have expected to see (but haven't) an increase in dividend recaps, perhaps reflecting the unwillingness of sponsors to engage given the current cost of debt. This is certainly the position in Germany, where Christoph Nensa says: "We don't expect significant activity in the German market for recaps and the focus generally seems to be on stabilising the portfolio and building or maintaining reserves against the background of a volatile, uncertain economic perspective, including a potential return of inflation. Some lenders recently learnt the painful lesson that negotiating a financial restructuring on an asset where the sponsor has already done one or more dividend recaps may be more challenging than with an asset where there has been no return on capital. This also may affect the current subdued appetite for recaps."

The use of hybrid equity instruments

Private credit providers have the ability to provide flexible, bespoke financing solutions and, for the right businesses, the use of hybrid capital in resized capital structures is key. "In the US, we continue to see the use of products ranging from traditional HoldCo debt packages to hybrid equity instruments, such as convertibles notes, vanilla preferred equity and convertible preferred equity investments," says Jason Ewart. "These instruments are attractive to investors, as they provide sizeable risk-adjusted returns along with protection against downside scenarios. Use of these junior capital instruments tends to be most common in situations where a borrower/issuer is looking to reduce leverage at an operating company level, minimise cash interest payments or address immediate liquidity concerns. Outside of these scenarios, special situations dynamics, requiring more tailored solutions unique to a specific capital structure, are where we're also seeing increasing use of such instruments."

Boudewijn Vermeer adds that this is happening on one of the deals he is currently working on, where private debt is being deployed at the top level. "While there is sufficient appetite at senior bank syndicate level to increase the financing arrangements to fund a substantive add-on acquisition, a PC fund has expressed an interest to provide the necessary additional funds on PIK terms to fill the gap in the capital structure as a result of senior lender leverage limitations," he says. "Many PC funds already have special opportunity strategies to allow them to fund higher up in the structure or to allow them to fund into potentially more volatile businesses and/or provide a combination of debt and equity. I would not be surprised to see these kinds of structures more and more in the near future in an attempt to put the dry powder to work."

In APAC, hybrid equity instruments are typically used in circumstances where the corporate cannot take on more debt (either due to existing restrictions in their debt documents or regulatory or jurisdiction-specific issues) and is looking for liquidity. "Structuring these can be challenging depending on the jurisdiction – ensuring that it is not treated as debt but having debt-like protections is a key aspect of any investment using this structure," says Shaun Langhorne. "This is typically only done for the larger players where confidence can be taken from the various underlying businesses and where other investors have done something similar and funds can get comfortable with the regulatory risk."

The current approach to deployment by funds in APAC

The private credit market is buoyant in Australia. Financing by credit funds is a critical option in any sponsor (and more recently, corporate) financing toolkit. Credit funds regularly deploy on a direct lend, club or syndicated basis. They participate in a variety of commoditised-type products – for example, stretch senior debt, unitranche, Holdco PIKs and then more structured / bespoke instruments such as convertibles / hybrids, and of course, in asset-based lends and real estate financings. In the rest of APAC, some challenges around deployment have been observed, but this partly arises from the fact that credit funds have been very successful with fundraising and getting capital allocations for APAC in recent years.

"We see a lot of credit funds taking a very broad and opportunistic approach to deployment. Besides doing more direct lending deals, some credit funds are also seeking to deploy capital through secondary loan acquisitions and investments in securitisation structures. Many credit funds also have strategies targeting special situations and distressed opportunities," Chin Seng Chew says. Another interesting trend in recent years is the increased use of back leverage and synthetic structures to push returns upwards, which can help make a deal more attractive for a fund to deploy into.

Credit funds are also increasingly going into APAC markets that are new to them. For example, Australian funds which have traditionally focused on their domestic market are now investing into India as well. "There is of course a bit of a learning curve to overcome when credit funds are going into jurisdictions that are unfamiliar to them and that is when credit funds tend to see a lot of value in having a strong team of advisors to help them navigate the jurisdiction," Chin Seng Chew adds.

The longer-term future

While historically a mid-market instrument, private credit is increasingly being viewed as an alternative to the public markets and it no longer just operates in that mid-market space in Europe. There has been an increasing convergence of terms between direct lending and syndicated loans, with a number of covenant-light club-style unitranche transactions emerging for strong credits and/or strong sponsors. This has been largely driven by competition among direct lenders, sponsor precedent and the vast amounts of liquidity in the market during 2021-22. “We will see more of this as private credit providers try to compete with the broadly syndicated loan markets and deploy the mega funds that have been raised over the past couple of years. Retail investment into private credit funds is also driving additional pressure on deployment and we are seeing funds like Goldman Sachs and Blackstone being more willing to invest in that large cap space than some of their competitors,” says Katherine Sinclair.

It is a similar position in Australia, with perhaps more convergence of terms between TLBs and unitranches in the large cap space. Credit funds who invest in Australian credit will do so interchangeably via a unitranche or an Australian TLB (unlike the US TLB market dominated by CLOs, the Australian TLB market regularly sees just credit funds participating). Because of this, there is more willingness to consider covenant-light terms on unitranche products (especially when an alternative Australian TLB (covenant light) option is also being run in a dual-track process).

“As for other terms more generally, Australia is still a borrower-friendly market (driven largely by the number of credit funds looking to deploy capital). Pricing continues to be the biggest hurdle with deployment. And, while terms on the whole have been largely borrower / sponsor-friendly, Australia is currently dealing with a greater focus on liability management activity and, as a result, credit funds have become particularly focused on Chewy, J. Crew, Serta and, more generally, lender-on-lender violence issues,” says Elizabeth Hundt Russell.

In the US, liability management is the main indication that there’s a convergence between the large deals in the BSL market and those being done by private credit providers. “I think the biggest thing that we are hearing on the street is that private credit, as we traditionally have understood it, should be in the middle market. Clients are less concerned about some of that lender-on-lender violence in the lower market largely because they will often club up with the same players and so nobody is going to engage in something that will have them hung out to dry.

However, clients in the upper market are hyper focused on liability management actions and are looking for new ways to tighten some of the customary lender protections, particularly in light of the recent discussions around Pluralsight” explains Jason Ewart.

Developments in APAC

Despite the current economic conditions, “there is still interest in China from select investors who are familiar with the market and specific sectors – for example, healthcare and tech – and we are also seeing some more opportunistic funds looking for distressed opportunities in mainland China and Hong Kong real estate,” says Shaun Langhorne. “India has become much more of a regional powerhouse perhaps given the pull back from China, but also because of various structural and legislative changes that have increased investor confidence in the market. One major change in India is the overhaul of its restructuring and insolvency laws. There is now a regime in place such that credit funds have got comfortable around enforcement and related risk when making investments in India. That said, it has already become a very competitive market for international private credit funds who have to compete with both banks and local private credit investors,” he adds.

“Liquidity and capital are needed to fuel growth in India for what it wants to achieve in terms of infrastructure and other fundamental sectors – and the same is true for Indonesia and Vietnam, which have favourable demographics and trends. There is simply no way that the domestic bank and funds markets can fill all of the liquidity that will be required for those markets to achieve their growth objectives in the next decade or so – there is going to be a funding gap, and that is where the opportunity lies. The markets are fundamentally different from the US and Europe and so there is an educational piece around structuring, risk assessment and mitigation and downside protections which is a key aspect of any investment in these markets,” he says.

The latest trends

(including partnerships between banks and funds and the rise of bank "in-house" private credit funds)

In terms of partnerships, Christoph Nensa says that, in Germany, "in small and mid-market transactions, there have been informal alliances or frequent combinations of certain debt funds and lenders which facilitated the agreement and finalisation of the credit documentation. However, some bank lenders have left the super senior lending market as quickly as they entered so the complexity and risk should not be underestimated, though generally the senior / super senior structures have been proven to work."

A (comparatively) recent development has been banks setting up their own debt funds. Across Europe generally, several banks have set up their own (off-balance sheet) debt funds which are operating successfully in the market, including, for example, Goldman Sachs, Deutsche Bank, Berenberg and Morgan Stanley, while in The Netherlands, a new private capital fund was formed by Colesco Capital, backed by Rabobank, specifically to target companies with a strong focus on realising sustainable growth.

Similar trends have been observed in APAC, with many banks now setting up their own private credit desks or investing directly into external credit funds. One prominent example in the region is DBS Bank's anchor investment in Muzinich's first private credit fund in Asia.

On a related note, Chin Seng Chew says that in recent years, international banks, who were historically very active in the region, have pulled back on their lending activities and focused on less risky areas. While some of the demand has been taken up by local and regional banks, it has also opened up significantly more space for private credit. "Private credit will continue to play an important part in the full range of capital solutions that sponsors and promoters in the region will look to tap into to help grow their companies," he says.

In Australia, the latest trend is credit funds moving into the non-sponsor / real estate space – i.e., more corporate-style financings which use other features such as back-leverage to achieve their return hurdles. "Credit funds are also more focused on the asset-based lends market and structured securitisation-style products which help slice return / risk," says Elizabeth Hundt Russell.

In conclusion, therefore, while the return of the BSL market may have led to an increase in competition, there remain significant opportunities for private credit across the globe as the funds adapt to the changes in the markets and the challenges represented by the different geographies and jurisdictions.

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