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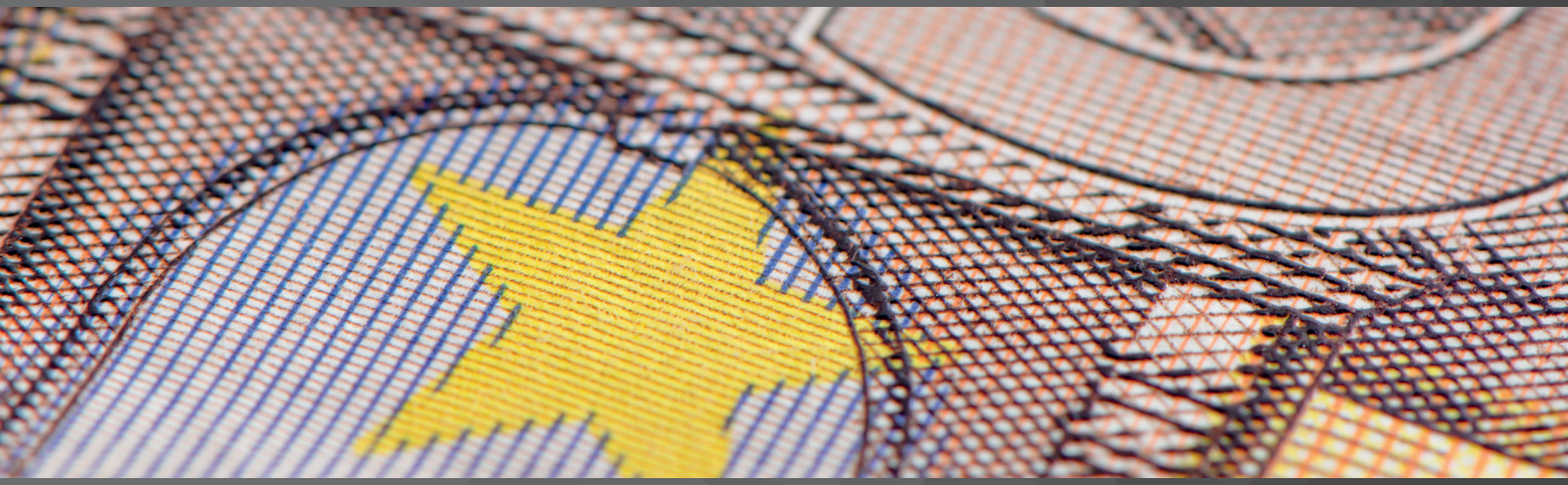

Lending & Secured Finance 2020

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Eighth Edition

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The Continuing Evolution of the Direct Lending Market


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The direct lending, or private credit, market has evolved dramatically over the past few years. While historically focused on middle-market borrowers with financing needs in amounts and with structures generally not available in the broadly syndicated leveraged term loan (or BSL) market, direct lenders have increasingly moved "up market" and now offer private equity sponsors and large corporate borrowers leveraged facilities that compete with syndicated loan financings in facility size, structure and terms. Private equity sponsors and borrowers increasingly compare and contrast the financing options available in the two markets in determining the most efficient option to finance leveraged buyouts and other acquisitions. This chapter discusses the distinguishing characteristics of direct loans that have allowed direct lenders to play an increasingly important role in the large cap loan market as well as certain challenges to the ability of direct lenders to provide answers for all of the financing needs of borrowers.

Characteristics of Direct Lending

Unique structure

The direct lender's fundamental model differs from that of BSL arrangers in the expectation that the direct lender will commit to, make and expect to hold through maturity, the loans with no (or only limited) expectation of syndicating to participating institutional investors. The ultimate lenders in a direct lending transaction will typically comprise the committing lender (and one or more of its affiliates) and, in appropriate circumstances (typically, with an unusually large loan), a small "club" of similarly situated private credit lenders, rather than the dozens or even hundreds of institutional investors that may hold a BSL.

Because direct loans are not broadly syndicated, their execution and closing timelines are often significantly condensed. In particular, due to the absence of any need for a syndication process prior to closing – which typically entails preparing marketing materials and term sheets, hosting lender meetings and calls, obtaining both public facility and corporate family ratings and providing lenders with a period to review definitive loan documentation – direct lenders are often able to close financings within weeks of providing the related commitment, rather than the minimum one- to three-month period typically required for a BSL. Where an M&A process requires an expedited closing, this ability to forego the marketing process may be a highly attractive option and competitive advantage for the buyer/borrower. In response to this perceived advantage, we have seen an increase in arrangers of syndicated financings willing (often in exchange for an increased fee) to accept an "inside date" instead of a formal marketing period[1] or even fund loans directly at closing with the syndication process commencing only on a post-closing basis.

A second outgrowth of the lack of participating institutional investors in direct loans is that direct lenders are not constrained by the leverage-based expectations of investors in the BSL market: most typically, a first lien facility sized up to 4.0–4.5× leverage; and a second lien facility sized up to 6.5× leverage. For example, direct lenders often provide "stretch" first lien (also referred to as "unitranche"[2]) facilities up to 5.5× (or higher) leverage and are willing to consider lending to borrowers with leverage profiles of 7.0× (or higher). In contrast, arranging investment banks may be reluctant to commit to financings at these levels, whether because of regulatory concerns or uncertainty around the ability to successfully syndicate loans that do not meet customary lender expectations to a broad syndicate of institutional investors. In exchange for permitting initially higher leverage levels, direct lenders will often seek to ensure material deleveraging over time through the use of (i) bespoke financial maintenance covenants,[3] (ii) material amortisation requirements (potentially after a relatively lengthy post-closing "holiday"), and/or (iii) a "payment in kind" (PIK) feature providing that all or a portion of interest accrual shall (or, at the option of the borrower, may) be capitalised for a specified period following closing, all of which would be atypical in BSL transactions.

Under certain circumstances, direct lenders may also have greater flexibility to provide financing to companies with complex or atypical assets or liabilities, organisational structures or historical financial reporting. While direct lenders – willing to commit to and hold the entire financing – may be incentivised to engage in the extensive diligence required to understand, analyse and appropriately price such complexity, arranging investment banks may be challenged to find participating institutional lenders, who typically only hold a small portion of the financing and invest in a large number of loan transactions across the primary and secondary markets, willing to invest the time and effort necessary to analyse the novel issues and resulting novel structuring solutions to address them.

It is important to note, however, that direct lenders are not best suited to execute financing transactions under all structures. In particular, financings in connection with large LBOs and other acquisitions that require a significant high yield bond or post-closing working capital component will require the engagement of a traditional investment bank and registered broker-dealer to act as underwriter of the bonds and syndicate of commercial banks to provide the short-term liquidity needs.

Unique terms

Because of the breadth of the direct lending market (ranging from middle market corporate borrowers to portfolio companies

of top-tier private equity fund sponsors) and the increasing number of direct lender participants with different structures and investment strategies, it is difficult to provide broad generalisations regarding direct lending "market terms". Still, it is fair to say that direct lenders, when looking at conventional covenant packages, tend to focus on terms governing additional leverage and preventing "leakage".

Debt incurrence

Direct lenders, consistent with lenders and arrangers in the BSL market, rely on various leverage ratios (calculated as the ratio of specified categories of debt to EBITDA) as the key metric for measuring the leverage profile of a borrower. While the same points of negotiation as to the definitions of debt and EBITDA typically arise in syndicated and direct lending deals, direct loans tend to (i) include all debt (including capital leases and that of foreign subsidiaries) secured by any assets of the borrower and its subsidiaries in the numerator of secured leverage ratios (*versus* limiting such debt to that secured by the collateral package agreed in the loan documents themselves), and (ii) contain more company-specific limitations on the "addbacks" increasing EBITDA. In particular, a direct lender will often cap the EBITDA addbacks relating to run-rate cost savings and other synergies for any period at 20–25% of EBITDA for such period. In contrast, a similar addback in a BSL facility – especially for larger and stronger credits – may be uncapped. A second difference between the markets is that direct loans most typically contain a leverage ratio-based financial *maintenance* covenant applicable to the borrower at all times, in contrast to the "covenant-lite" term loans – that have no such maintenance covenant – that are one of the hallmarks of the BSL market. In part due to the increased competition referred to above, we note a recent trend, especially in large cap and private equity-related transactions, for direct lenders to accept either "covenant loose" (*i.e.*, term loans that benefit from a maintenance covenant, but one that is set with significant cushion to closing date leverage) or even true covenant-lite term loan structures. Both direct and syndicated loans to large cap borrowers generally permit the incurrence of an unlimited amount of debt subject to compliance with various leverage ratios, based on the form of the debt incurred. However, direct loans generally do not permit such incurrence based on compliance with an interest coverage ratio, which is a more permissive test in lower interest rate environments. Similarly, direct loans are less likely than syndicated financings to permit borrowers to incur debt in connection with an acquisition that is, in aggregate, accretive or non-dilutive: *i.e.*, if the applicable leverage ratio after giving effect to such debt and related transaction is "no worse than" such leverage ratio immediately prior to such incurrence.

While direct lenders are particularly sensitive to the terms under which additional debt may be incurred, they are, especially for borrowers with an acquisitive investment thesis, often willing to provide significant committed post-closing incremental financing in the form of delayed draw term loan commitments. While this feature is available in the BSL market, the conditions are typically more restrictive – for example, limited to funding specifically identified acquisitions that are scheduled to close within a relatively short period (typically six to 12 months following the initial funding) – and it is still generally disfavoured by institutional lenders seeking the yield certainty of fully funded investments.

Leakage

When referring to "leakage", direct and syndicated lenders focus on both the initial composition of the borrower and guarantor group and related collateral package as well as the ways in which the integrity of such initial structure may be compromised over time. In looking at the initial guarantor group, direct lenders tend to focus on limiting exclusions and exceptions that might "clear" the market in a BSL facility. For example, recent changes in U.S. tax regulations have made it easier in certain cases to include foreign subsidiaries of a U.S. borrower as guarantors. While the BSL market has generally not insisted on including those entities (even after the change in regulations), many recent direct lending transactions do, where feasible, include foreign subsidiary guarantees, relying on diligence and discussions with the borrower to minimise the risk that such structure will create tax issues for the borrower.

After closing, leakage from the borrower and guarantor group comes in a number of forms, including making investments in (or acquiring) non-guarantor entities, paying dividends to the private equity sponsor or other shareholders and prepaying or repurchasing junior debt (collectively referred to, consistent with the nomenclature of high yield bonds, as restricted payments). While the focus on basket sizes, ratio levels and guarantee release mechanics is consistent across markets, direct lenders tend to insist on tighter conditionality around restricted payments, including more robust default "blockers" and protective leverage ratio governors.

This difference in terms is also, in part, a function of the varying processes by which the lenders commit to, syndicate (in the case of arranging investment banks) and make the loans. In particular, the "indicative" committed terms of BSL are subject to "market flex" rights, which permit the arrangers to increase pricing, reduce basket sizes and leverage ratios and make other lender-favourable changes to ensure or promote successful syndication. As such, arranging investment banks are often willing to market more borrower-favourable terms, so long as they maintain the contractual right – via the market flex provisions – to unilaterally revert to more conservative formulations where required by the lender syndicate. With a combination of the right conditions – a strong credit, top-tier private equity sponsor and/or frothy market – participating syndicated lenders may be willing to accept more borrower-friendly terms, which then become precedent for subsequent transactions. In contrast, direct lending commitments are rarely subject to any such flex rights (and, where included, are very narrowly tailored in scope). While this structure provides borrowers with certainty as to the final terms of the loan documentation, it also requires that direct lenders exercise greater discipline in negotiating the terms of the commitment, rather than subjecting them to a subsequent "market" test.

Select Challenges of Direct Lending

Commercial banking affiliates of arranging investment banks have deep experience in the operational and administrative aspects of the various agency roles in a BSL financing. Direct lenders, in contrast, are much more recent entrants to this space and a primary challenge of direct lending is ensuring that borrowers are comfortable with direct lenders' ability to execute these traditional roles after making a direct loan.

One of the most basic functions of an administrative agent in a syndicated loan agreement is to exercise the unilateral discretion granted to it to extend certain delivery and notice periods and approve other matters on behalf of the syndicate.

Providing this level of discretion may be inappropriate in a clubbed direct loan, as each of the lenders, holding a substantial portion of the facility, may expect a voice in such matters. Rather than relying exclusively on the administrative agent, direct lenders will frequently insist that such items are subject to majority lender approval (which, in clubbed deals, with only a few lenders, may include a minimum number of unaffiliated lenders). Borrowers may be concerned that the requirement to obtain approvals for such "regular way" amendments, waivers and consents from multiple direct lenders (rather than just the administrative agent) is overly burdensome. In practice, however, the approval process in direct loans may not differ that dramatically, as (i) straightforward approvals should be routinely and promptly granted by the lenders, and (ii) with respect to any (even potentially) controversial amendment, administrative agents in BSL facilities most typically consult with the lender syndicate and, absent a consensus view, seek approval from the requisite lenders.

A second challenge for direct lenders is a borrower's desire for flexible and readily accessible revolving credit and letters of credit. This ability has long been a mainstay and competitive strength of commercial banks, and while many direct lenders have made strides in providing this critical function, it still represents a challenge to their ability to compete in this part of the financing market. In particular, direct lenders historically – and, in certain cases, still – fund borrowings by calling capital from their investors and/or borrowing under fund-level credit facilities. The time it takes for lenders to do so, however, may be inconsistent with a borrower's desire for funding on short notice. More recently, direct lenders have attempted to mitigate this disadvantage by restructuring their balance sheets to ensure that cash is available in order to make revolving loans on short notice and finding creative ways to issue letters of credit, either directly or through an arrangement with an acceptable third-party provider.

Conclusion

On account of its size, liquidity and, as noted above, potential to offer borrowers greater flexibility on terms, the BSL market will continue to remain a "first call" for private equity sponsors and large corporate borrowers on a wide range of financing transactions. In addition, commercial and investment banks will remain critical providers of cash management, working capital, hedging, underwriting and advisory services. That said, direct lenders are increasingly challenging the BSL model in ever larger and more complex financings. The combination of the direct lender's ability to provide larger facilities, willingness to consider atypical or complex corporate and financing structures and speed of execution has made direct lending an attractive option for borrowers in a range of financing transactions. As a result, they are increasingly competing directly with arranging investment banks to lead large financings transactions for top-tier private equity sponsors and corporate borrowers. As this competition continues to increase, it is certainly plausible that direct lenders will be pushed to accept certain of the more flexible terms included in BSL financings, while arranging investment banks are, in turn, increasingly asked, where required by the dynamics of the acquisition or other underlying transaction, to forego a conventional marketing process as a condition to funding.

Endnotes

1. More specifically, direct lenders and arranging investment banks may provide financing commitments on the basis that the closing date not occur prior to a specified "inside date" (typically not less than 30–45 days following signing of the acquisition agreement) – rather than only following the expiration of a customary 15–20 day marketing period – which is perceived to provide buyers with a competitive advantage in the M&A process by giving certainty of closing timing to sellers.
2. Historically, "unitranche" facilities were a middle-market financing product structured as a single class of loans (from the perspective of the borrower) that were bifurcated into a senior loan tranche and junior loan tranche pursuant to an "agreement among lenders" governing, solely as between the lenders (and completely invisible to the borrower), the respective priorities and rights of the tranches. While such financings continue to exist, the term has become synonymous in the large cap direct lending market with "stretch" first lien loans, not subject to any tranching or intercreditor arrangements.
3. An example of this may be a leverage ratio-based maintenance covenant subject to a six-month to one-year "holiday" during which the covenant is not tested. Once testing commences, the maximum testing level may be subject to material "step-downs" over time.

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