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What's Market: 2023 Year-End Trends in Large Cap and Middle Market Loans

by Practical Law Finance

Status: **Published on 29 Feb 2024** | Jurisdiction: **United States**

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Expert's View: Sanders Witkow, Davis Polk & Wardwell LLP

Sanders discusses recent developments in large transactions in the private credit market. This Expert's View outlines the dynamics of jumbo direct lending deals and examines the process of dual track negotiations of broadly syndicated loan proposals and competing private credit solutions.

As the loan market has seen significant growth in the size of direct lending deals, how do jumbo direct loans with multiple lenders come together?

As private credit has grown in importance and availability as a financing option for larger enterprises and acquisitions, we see an increasing number of direct lending deals above $1billion. These deals are brought to the market, typically by private equity sponsors, for borrowers seeking refinancings and recapitalizations, as well as acquisition financing. The magnitude of these deals means that the commitments can in many cases be provided by a large group of direct lenders. Assembling large private credit "clubs" resembles a broad syndication. Typically, the deal is anchored by one to four direct lenders that make significant commitments, and they drive the negotiation of the deal terms with the borrower and sponsor. There may be a long list of potential syndicate members for the largest deals, usually including all the major market players, and the sponsor may also bring in associated entities and others with which it has connections to fill out the book. The "syndicate" for deals above $1billion may include more than ten lenders. In their biggest deals, sponsors have to manage the countervailing impulses of preferring to keep the group smaller and more manageable while also feeding as many of their relationship lenders as possible.

Sponsor's counsel circulates proposed deal terms and due diligence materials to potential lenders. There is often a great amount of detail in these grid terms. The sponsor asks for responses from potential lenders, encouraging them to evaluate the proposed terms in detail and to offer any other proposals, which the sponsor then considers. Typically, leading candidates emerge from lenders that are prepared to provide significant commitments and are ahead in their due diligence. The deal usually evolves collaboratively between the sponsor and the leading lender candidates, with pricing, structure and deal terms designed to appeal to a broad group of would-be lenders.

In the largest deals, which may involve groups of lenders growing as large as 20 or 30, the sponsor can often negotiate terms that are very borrower-favorable, close to what it might be able to achieve at the top end of the BSL market. A large private credit deal can also resemble a BSL deal in other ways. The lead lender selected by the sponsor usually expects "lead left" designation and a title of "joint lead arranger" or "joint bookrunner," similar to a BSL deal, though some direct lenders may have institutional limitations around certain titles. The loan agreement usually names an affiliate of the lead lender as the deal's administrative agent, though it is common for third-party service providers to carry out the administrative duties under a sub-agency arrangement.

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Complex structural issues can arise in these deals such as how to address multicurrency facilities, letters of credit, swingline loans, and other traditional "banking" needs. In many cases, direct lenders are not set up to operate in ways that can accommodate these aspects of lending arrangements in the ways that their banking competitors are. Large undrawn commitment tranches can also be uneconomical for direct lenders, and in some cases, direct lenders will bring a friendly bank to the group to provide a revolver if the borrower has a significant need.

Equally, there are features of private credit deals that you rarely see in BSL deals, such as payment-in-kind (PIK) interest. More creative structures may also be possible in the private credit space that banks could not underwrite in the BSL market, such as recurring revenue loans that convert into cash flow-based structures at some point during the term. The goal from the lenders' perspective is to try to provide the sponsor with the best of both worlds, including the underwriting flexibility and pricing certainty that are the hallmark of private credit along with the scale and negotiating efficiency that are traditionally associated with the BSL market.

Why do some borrowers and sponsors simultaneously negotiate financing proposals in the broadly syndicated market and the private credit market and how do the negotiations proceed?

Some sponsors frequently pursue a dual track loan negotiation process, simultaneously seeking financing proposals from private credit providers and underwriters in the BSL market. The economic considerations of these loans can differ, reflecting differences between the two parts of the market. In this scenario, the arranger in a BSL deal is asked to provide committed financing, subject always to market flex, while the direct lenders are asked to submit their best and final offers of terms.

Private credit, with its roots close to private equity, often involves a mindset among direct lenders that may differ from commercial banks. Private credit lenders tend to consider themselves as commercial partners in the borrower's business, rather than as financial service providers to business clients. This is also apparent in the varying risk profiles of lenders within the private credit space. Sometimes borrowers in private credit deals operate at leverage levels that would deter interest from lenders more accustomed to the BSL market. Private credit deals are often part of more complex capital structures, where the lenders or their related entities may also hold equity positions in the borrower or provide other junior capital. As such, direct lenders often share in the upside of the borrower's business performance, but they also demand more control over the borrower's underlying assets than CLOs or other investors in the BSL market.

The process of evaluating the different proposals is complicated because they cannot simply be compared on price, as they involve other contingencies and risk assessments. Although there is undoubtedly tremendous convergence between direct loans and BSL deals on legal terms in documentation, the deal structures and the fee structures can differ widely. Some sponsors may include a super-senior revolver that sits at the top of the borrower's capital structure, as a means of inducing a bank to provide the facility in the absence of the economic benefits of running a full syndication.

As far as deal terms are concerned, differences between large "syndicated" private credit deals and BSL deals can be pronounced. Direct lenders can underwrite deal structures that banks would generally avoid, such as deals with PIK interest features, or recurring revenue loans, which are well-suited to businesses earlier in their life-cycle. One also sees greater limits on liability management transactions in private deals, though terms are often more borrower-favorable in the larger private deals. Another key distinction between larger private credit deals and BSL transactions concerns call protection. Call protection is an important issue for many direct lenders, as they put a great deal of energy and effort into allocating capital to individual deals and may be more concerned about prepayment risk. Carve-outs to call protection that are common in BSL deals are often frowned upon by private credit

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providers. Ultimately, differences in deal terms reflect the different risk appetites of individual private credit lenders, which can be very different to CLOs and other lenders in the BSL market. The borrower in many private deals is a riskier credit and direct lenders typically want greater control over the borrower's capital structure as part of the economic rationale for providing the loans.

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