THE STATE OF THE DEAL MARKET

SHAKE UP

HOW TERMS ARE CHANGING

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EDITORIAL COMMENT

Getting the right deal

At Private Debt Investor, much of our coverage is focused on the fundraising environment and the evolving relationship between fund manager and investor. The story has broadly been upbeat. The past few years have displayed record levels of investment amid favourable markets conditions and a better informed, more sophisticated LP base. Yet capital-raising is just part of the story. The $135 billion gathered in 2018, according to PDI data, adds to a growing pot of dry powder now looking for a home.

Even in a favourable market, putting that capital to work can be every bit as complex and challenging as the fundraising process. In a borrower-friendly market, managers are under increasing pressure to deploy, credits standards are being relaxed and documentation requirements are fewer. Facing competition from other lenders, managers are now agreeing more generous deal terms.

A recent report titled Private Credit Insights – put out by our partner sponsor for this issue, law firm Proskauer – offers insight on this deal activity, the state it is in now and where it is heading. One thing that is apparent is there are more deals with fewer covenants. On p. 4, Steve Ellis, partner and co-head of Proskauer’s private credit group, describes the choice that managers face: staying in the market or offering the flex-uous deal terms.

On the other hand, the debt deal market has been buoyed by several sector themes, ranging from demographics to data and technology, that have displayed record levels of investment amid favourable markets conditions and a better informed, more sophisticated LP base. Yet capital-raising is just part of the story. The $135 billion gathered in 2018, according to PDI data, adds to a growing pot of dry powder now looking for a home.

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The industry has seen some pushback, however. This is explored on p. 8 by Proskauer partners Stephen Boyko and Faisal Ramzan who reflect on the trends in their respective markets in the US and Europe. In the US, managers who are acutely aware that we are now in the later stages of the current economic cycle, are exercising more caution. Meanwhile, in Europe, concerns about Brexit have affected sentiment for UK deals as lenders play it safe in anticipation of a eurozone downturn. As explained on our analysis on p. 12, private debt investors are focusing on their red lines and how they are enforced. This is also becoming a chief area of concern for investors who worry, given an environment of loosening covenants, whether there are any lines left at all.

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Dealing with the numbers

A look at some of the highlight deal figures from Proskauer’s *Private Credit Insights 2018* report and *PDI*’s own data

**203**
Number of US deals closed by Proskauer, 2017

**188**
Number of US deals closed by Proskauer, 2018

**68**
Number of European deals closed by Proskauer, 2018

**$135bn**
Global private debt fundraising 2018*

**$42.1bn**
Value of US deals closed by Proskauer, 2018

**$24.6bn**
Value of European deals closed by Proskauer, 2018

**$20.1bn**
Value of US deals closed by Proskauer, 2017

**US DEALS: AVERAGE EQUITY CONTRIBUTION 2018**

- **41%**
- **17%**

**PERCENTAGE OF US DEALS IN MANUFACTURING IN 2018**

- **61%**

**PERCENTAGE OF US DEALS THAT WERE 1ST LIEN/UNITRANCHE**

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*Source: Proskauer Private Credit Insights 2018; *PDI*
State of the market

Private credit has come a long way in a short space of time. But how are increasing fund sizes, more flexible terms and the prospect of a more difficult economic environment shaping the way managers are approaching the market? By Steven Ellis

The past five years have seen the private credit market develop at an astonishing pace as institutional investors have shifted increasing amounts of capital towards direct lending strategies. With nearly $135 billion raised globally in 2018, according to Private Debt Investor data, private credit funds are now an established part of the deal financing landscape, with the capacity to offer borrowers flexibility and an increasing array of sophisticated products that enable them to pursue their strategies.

The record sums now managed by private credit firms has led to a marked increase in the size of deal many players target. Much of the $36 billion Ares Management Corp attracted during 2018, for example, was raised for its credit strategies, while ICG raised €6 billion last year to bring its total AUM to over €33 billion, and GSO Capital Partners’ third Capital Solutions Fund raised $7 billion in 2018.

And these firms are far from alone in being able to raise multi-billion-dollar funds. While just a few years ago, private credit was largely a mid-market strategy, funds are increasingly looking at larger deals and are holding ever larger ticket sizes in a bid to deploy capital. Yet this trend also reflects the fact that direct lenders have become far more selective in the companies they back at a time when many believe we are reaching the top of the credit cycle. Larger companies offer lenders greater stability and lower risk and they are often run by better quality management teams.

Given how competitive the credit market has now become, firms are faced with the choice of either staying out of the market – a strategy that would not be welcomed by their investors, which have committed capital on the basis that it will be deployed within the investment period – or offering the flexible terms that borrowers and their sponsors now expect.

Yet to do this, direct lenders are taking a more conservative approach to the businesses they lend to, with an eye on a potential softening of the economy at some point over the next two to three years. This is perfectly in step with the way sponsors also see the market – what we’re seeing from both direct lenders and private equity firms (which also have record amounts of capital to deploy) is portfolio construction designed to deliver returns across all companies rather than home runs. Bolt-on acquisitions are a clear feature of the market today and over the coming year or two, we may well see direct lenders increasingly finance dividend recaps — which accounted for just 12 percent of the 188 completed deals we analysed in 2018 for our latest Private Credit Insights publication — in a bid to deliver the returns their investors expect. This trend may accelerate as sponsors seek ways of returning capital to investors in the event that the exit market slows.
A HANDS-ON APPROACH

A potential shift away from the benign economic environment we’ve seen over the past few years is also concentrating minds at the helm of many direct lending funds. Over the past 18-24 months, we’ve seen an increasing focus in the industry on portfolio management capability. Firms may have different models – some houses have a preference for origination teams to retain portfolio management responsibilities post-transaction, while others keep the two functions separate – but there has been a clear move towards bringing in more portfolio management expertise to ensure their positions are protected in the event of underperformance.

This latter point is especially pertinent in today’s market, given the looser terms on which many lenders have advanced capital. Cov-lite and cov-loose terms in particular have become increasingly prevalent: only 60 percent of deals in our Private Credit Insights report featured traditional financial covenants in their documentation. Credit funds are therefore highly cognisant of the fact that companies will be able to trade for far longer than has historically been the case before any loan covenant is triggered. As a result, funds are monitoring their portfolios closely to ensure they can work with companies effectively and flexibly in the event of a downturn.

Yet while documentation has enabled greater flexibility for borrowers, the past few months has seen something of a pull-back on the part of lenders to close loopholes and prevent companies from exploiting certain provisions in ways that were unintended when agreements were initially negotiated.

The case of J Crew, in which the company created an unrestricted subsidiary to hold its intellectual property for use as collateral against which it subsequently increased its borrowing, and similar instances involving other businesses, have focused minds on areas of sensitivity. In particular, we’ve seen far more careful consideration of incurrence test and leakage terms by credit funds. For their part, sponsors have also been largely supportive of loopholes being closed, so that, as we move through 2019, the market as a whole is attending to documentation in a more robust manner while still offering the flexibility that borrowers need to grow and navigate a potentially more difficult market.

Overall, the stage is set for continued direct lending activity as both credit funds and private equity sponsors need to deploy the capital they have raised. Yet the focus is on larger, stable businesses with strong management teams and in areas of the economy most likely to trade well through any economic downturn. There is an element of caution to the market as funds take into account headwinds such as the effect of trade tariffs, Brexit and volatile stock markets, but we are not seeing hesitancy. For the right deal, with the right management backed by the right sponsors, direct lenders continue to put their money where their mouths are.
The past decade has seen technology become one of the most important drivers of economic growth in many markets worldwide. In the US, as an example, various parts of the technology landscape – from hardware, software and telecoms through to support services and e-commerce – are now key components of the national economy. And the significance of technology is only increasing. According to Forrester figures, the US technology market grew by over 6 percent in 2018, approximately three times the growth rate of US GDP. The technology industry now employs roughly six million Americans, representing nearly 4 percent of the US workforce and often at salaries that are meaningfully higher than those in other segments of the economy.

It is therefore unsurprising that 87 percent of lending institutions included in Proskauer’s Trends in Private Credit survey for 2018 indicated they were considering investing in software and technology businesses over the next 12 months, just behind healthcare and business services. We sit down with Jim Miller, co-head of US direct lending at Ares Management, a leading global alternative asset manager with $131 billion in assets under management and $96 billion in various credit strategies, to discuss how technology has shaped the US economy and what sector expertise is needed to effectively lend to companies in this space.

“At Ares, we view the technology sector as a core component within our US direct lending strategy,” Miller notes. “Ares has been successfully lending to technology-related businesses for more than a decade and such transactions now account for about 15 percent of our total dealflow. A good example of a recent transaction is the funding we provided to support the acquisition of Avetta, a leading supply chain risk management SaaS platform that electronically connects global enterprise customers to contractors and suppliers, by Welsh, Carson, Anderson and Stowe.”

Yet Ares Management’s view is that
technology is not a discrete sector — it is unique in this regard. There is significant overlap with other sectors, with applications transforming industrial, healthcare, business services and transport and logistics companies, to name just a few.

“As a result, we tend to view technology as an enabler in a variety of sectors. For us, that means lending to technology-enabled businesses requires a dual evaluation. We have specialists with the knowledge and capability to evaluate the technology being employed in a business, complemented by another layer of detailed and expert analysis on the sector in which the company operates,” Miller says.

While the due diligence can vary considerably when looking at technology-enabled businesses, there are some consistent factors that will determine whether to provide financing, according to Miller. “Clearly, as a lender, our overarching aim is to avoid loss. As a result, we look for high-growth businesses with strong free cashflow that can demonstrate long-term stability and sustainability.”

He points out that these last two factors are particularly important. There are many high-growth businesses that are driven by technological developments, and they often attract a lot of capital. Yet high growth in and of itself does not necessarily make a good credit as there can often also be a high risk of disruption.

“Companies that look attractive early on can become far less so as competitors enter the market — and this is especially true in technology, where developments happen at a rapid pace. Businesses we lend to need to have clear differentiation, high switching costs and significant barriers to entry to ensure we have downside protection.”

Miller emphasises that the market for lending into technology-enabled businesses has become more robust over the past few years as lenders have increasingly gained comfort from strong historical performance and credible growth projections. As with the broader credit markets, default rates remain low and the performance of technology-enabled business lending is, in Ares’ experience, better than average.

“The strong performance and growth of technology companies has certainly deepened the pool of lending opportunity in the space,” adds Miller. “Yet, there is another related factor that is making technology-enabled businesses an increasingly attractive area for direct lending strategies. A decade ago, private equity sponsors were largely circumspect about investing in companies that relied on technology for growth. Now, firms actively seek out such opportunities.”

Highlighting this trend, Preqin figures indicate that IT accounted for the highest proportion of the value of private equity buyouts globally in 2018, at 15 percent, and the second highest by number, at 21 percent. And because these figures fail to capture the raft of technology-enabled businesses across other sectors, the real proportion of technology investment by sponsors is likely far higher.

Miller says: “This trend is accelerating as many companies are now choosing to remain private rather than list on the public markets.”

IPO data support this assessment with a marked decrease in the number of private equity and venture capital-backed technology IPOs in recent years. By way of example, in 1997 there were 173 private equity and venture capital-backed technology IPOs, yet by 2017 that number had fallen to a mere 30. Also of note is that the median age of US venture capital and private equity-backed technology IPO companies rose to a record 13 years in 2017, more than double the median age of seven years seen in 1997, according to research carried out by Jay R Ritter of the University of Florida.

Miller concludes: “Companies are eschewing the costs associated with being public and are instead seeking private capital to invest in their growth. With continued healthy appetite from strategic buyers, the technology exit market remains robust. We are therefore highly optimistic about the growth in lending opportunity across the spectrum of technology-enabled businesses. The private credit market is well positioned to capture a sizeable share of the lending market for these companies as they become an ever larger and more mature component of the economy in the US and beyond.”
**FEATURE**

**US AND EUROPE**

Pushing back on both sides

Deal terms have been loosening on both sides of the Atlantic, but lenders are pushing back. Stephen Boyko, partner and co-head of the private credit and finance groups with Proskauer in New York, and Faisal Ramzan, partner and member of the private credit and finance groups in London, look at the sectors and geographies holding promise.

**Q** With so much debt fund capital available, what has happened to deal terms in the US?

**Stephen Boyko:** In the US a tremendous amount of capital is available. There are literally hundreds of funds seeking deals, so there is an enormous amount of supply. This makes the markets incredibly competitive, so for the right management team, or the right private equity sponsor, terms are very attractive.

**Q** How about Europe?

**Faisal Ramzan:** Sentiment in Europe has many similarities with the US, as there is also a lot of liquidity in Europe on the supply side. But there are some nuances, because Europe consists of distinct regional markets. To an extent, it is possible to divide Europe into certain categories. In the UK, France, Benelux and the Nordics, private debt is now a well-established product – something that sponsors are very comfortable with. Consequently, in these jurisdictions there is an immense amount of supply.

**Q** How has supply in Europe affected deals?

**FR:** Leverage levels have crept up a little, so deals that might have had leverage of 4.5x EBITDA might now have up to 5.5x. When it comes to pricing, spreads above LIBOR might have fallen for some deals, but only by 25 basis points or so — certainly not to the point where lenders start thinking that it will threaten the hurdle rate for their funds.

**Q** What has happened to financial covenants in Europe?

**FR:** Since the financial crisis, large-cap deals have had fewer covenants, but historically, documents in the middle market would have a full suite of financial covenants: the standard four of leverage, cashflow cover, interest cover and maximum capital expenditure. That has largely fallen by the wayside. In our experience, almost all middle market European deals are now down to one covenant: usually leverage, though it might instead be cashflow cover, and, more rarely, interest cover. However, I think we have only seen one debt fund in Europe that has done deals on a cov-lite basis.

**Q** How about financial covenants in the US?

**SB:** We are seeing a similar weakening in financial covenants in the US, but just as in Europe, this depends on the size of deal. In the lower middle market, covenant packages tend to be more robust, and even EBITDA definitions tend to be stricter. But once EBITDA rises into the teens — $15 million of EBITDA or so — covenants tend to be looser. For example, there are more
addbacks, and addbacks may be uncapped. The flexibility gets more pronounced as EBITDA increases to $50 million or more. If it is a very competitive situation the covenant package and greater strictness on addback terms get swept out with the tide of the market.

**Q** When it comes to the important details of documentation, what is up for negotiation?

**SB:** In the US, a primary focus for borrowers has been the ability to incur additional debt, after the deal closes – often all the way back to closing leverage, and sometimes even above closing leverage. There is also a lot of negotiation around free-and-clear baskets, that might allow three-quarters or even a full turn of additional leverage without any leverage governors.

We are also seeing lenders commit to delayed draw loans right up front to fund acquisitions and capital spending – we saw this last year for about one-third of the transactions we did in the US. Another focus of negotiation is flexibility around restricted payments: borrowers are seeking to lessen restrictions on their ability to take dividends.

**FR:** In Europe too, the ability to take on additional debt has been a primary focus for sponsors. There has been a gradual erosion of protections for lenders in this area.

**Q** Which market has looser documentation terms these days: Europe or the US?

**FR:** There is no doubt in my mind that documentation terms in the US are looser. This is not altogether surprising, because innovations in private credit usually start in the US, then make their way across to the UK, next spill out across mainland Europe, and finally may pass into the rest of the world. This means that the US is ahead in the trend towards looser documentation. The trend in the US is transmitted to Europe by big US fund managers that have significant operations in Europe too. They are familiar with US terms, so are prepared to do deals on these terms in Europe as well in order to compete.

**SB:** The US is ahead in looser documentation probably because of the volume: it is a very large market, with a tremendous number of private equity sponsors.

**Q** But which market has higher headline leverage these days: Europe or the US?

**SB:** In direct lending, data for Proskauer deals shows that last year average leverage in the US and Europe was identical, at 5.2x EBITDA. While this may seem surprising at first, it makes sense to us, because members of the investment committee of a big global fund will usually take a house view on what leverage they are willing to accept, whether in the US or Europe.

**Q** Returning to documentation, is there not any pushback against these more liberal terms?

**SB:** In the US, our clients are becoming more cautious, and pushing back in some areas. It may be because they believe that we are late in the cycle. The US recovery has gone on for more than 10 years, so there are some concerns.

**FR:** In Europe, the picture is complex. Lenders’ willingness to accept loose terms depends partly on their assessment of the economic backdrop. Concern about Brexit has affected sentiment for UK deals, and lenders are aware that in the eurozone the downturn will come sooner or later, but it is hard to generalise: lender behaviour depends on differing microeconomic and macroeconomic factors in different pockets.

**Q** What kind of pushback are you tending to see, and what is it actually achieving?

**SB:** In the US, a key area of focus is leakage. For example, there has been increased
attention to terms allowing the transfer of assets to an unrestricted subsidiary – a subsidiary that is not restricted by the covenants in the loan agreement and can therefore borrow as much as it likes from other lenders. This might well be a company owned by the borrower, or a foreign subsidiary. The flexibility that borrowers have to move assets around is causing concern with lenders in the US, particularly after the media attention high stakes asset transfers have attracted.

We can contrast this lack of protection with some of the protections in the European markets. European deals generally have a guarantor coverage test, which throws a net over 80-85 percent or so of the earnings of the entire enterprise. We do not have a similar concept yet in the United States, and this lack of structural protection is causing some of the leakage.

While lenders are focused on limiting leakage, it is a very competitive market. Lenders are often chasing a deal with three to five of their toughest competitors nipping at their heels, so although there is a progressively louder chorus among lenders calling for greater restrictions on leakage, in other respects documentation remains very flexible.

FR: In Europe, it is hard to say whether documentation terms have reached their peak of looseness. One loan document with loose terms often serves as a precedent for the next one. However, there has certainly been a little bit more pushback among banks and private debt investors in large-cap deals.

Q How is Brexit affecting dealflow?
FR: Historically, when we look at deals done by Proskauer in London, between two-thirds and three-quarters of deals have involved UK businesses, with the rest covering businesses elsewhere in Europe. However, last year that balance shifted to about 50-50. The uncertainty around Brexit has impacted the number of deals in the UK.

“IN EUROPE, IT IS HARD TO SAY WHETHER DOCUMENTATION TERMS HAVE REACHED THEIR PEAK OF LOOSENESS. ONE LOAN DOCUMENT WITH LOOSE TERMS OFTEN SERVES AS A PRECEDENT FOR THE NEXT ONE”
Faisal Ramzan

Q On the other side of the coin, have any developments made doing deals more attractive in other European countries?
FR: In the past, private debt funds were unable to provide loans in certain countries where these restrictions have now been amended or lifted altogether. Germany is a classic example. In 2015 the German regulator decided to loosen the prohibition on lending by private debt funds, and since then direct lending has taken off like a rocket. Debt funds now account for about 30 or 40 percent of deals in the middle market, filling a gap left by the banks, which are pretty short of capital.

There are other jurisdictions where there is no regulatory restriction on lending, but the bankruptcy regime has not been attractive for lenders. This is changing: certain debtor-friendly jurisdictions are updating their bankruptcy legislation to create greater balance. These jurisdictions include Spain, the Netherlands and Italy. In Italy we have seen a bit of an uptick in deal activity in a market that was previously a no-go area for debt funds, with Proskauer advising on three or four deals last year.

Q Which business sectors are seeing the greatest private debt fund deal activity?
SB: In the US, last year manufacturing became the biggest sector for Proskauer deals involving private debt funds, for the first time since we started adding up the numbers in 2012. The sector has benefited from a big push on the regulatory and tax sides by the Trump administration to encourage domestic output. Moreover, manufacturing clients have been prudently diversifying their sources for input materials bought outside the US, in response to trade tensions. In addition, their ability to sell within the US might actually increase if tariffs make goods produced outside the US more expensive.

Aside from manufacturing, software and technology was the second most popular sector last year, with reasonable interest in healthcare, business services, and retail.

Q Are there any sectors in Europe which lenders are tending to avoid?
FR: In the UK, debt funds are being more cautious about retail and casual dining, which has been hit by Brexit and by rises in business rates and the minimum wage. Some household name retailers, such as House of Fraser, have gone into administration. They are cautious elsewhere in Europe too about bricks and mortar retail, which has been hit by e-commerce.

When it comes to sectors they like, anything that tends to have a lot of recurring revenue, such as large parts of software and technology, is tremendously attractive to a lender. However, this tends to make them hotly contested assets, which brings us round again to sharp competition and the resulting problem of loose documentation.
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Rich Robben, Interim CIO, Director of Fixed Income, Kentucky Retirement Systems

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Politicians, business people and even, on occasion, harassed parents talk about red lines beyond which they are not prepared to negotiate. But in the world of direct lending, most observers say that these red lines have been pushed back progressively by borrowers in recent years – to the point where terms that, at the height of the credit crunch would have been considered unacceptable, have become almost standard for certain types of sponsored deal.

It is often over terms where the negotiation is toughest, and where lenders have been forced to make the most generous concessions. "The biggest changes have been in the documentation terms, then leverage and then pricing, in that order," says Faisal Ramzan, a London-based partner at law firm Proskauer. In other words, because funds have target internal rates of return to meet, they choose to make pricing their red line rather than documentation.

Sponsors and their lawyers are, of course, trying to push the red lines even further. Judah Frogel, partner in the New York office of Allen & Overy, the law firm, offers a useful historical perspective. "In the two years before the beginning of the credit crisis in 2007, everyone thought that the terms being sought were super-aggressive, because that was when covenant-lite deals began permeating the market. At the time people thought the terms couldn’t get more aggressive, but now they are more borrower-friendly than in 2007."

A fall in the number of financial covenants is the aspect of loosening most commonly quoted in the media. However, the trend goes beyond this, to include important issues such as flexibility within covenants, addbacks, starter baskets, and the ability to make payments to sponsors and transfer assets.

Ramzan gives an example of how key these finer details of loan documentation can be: "Borrowers often push for an increase in the percentage of headroom between the covenant numbers set out by the sponsor, based on the sponsor’s expected trajectory for the business, and
the levels in the credit agreement, so if the business underperforms there isn’t a breach of the covenant. In Europe, historically that headroom has tended to be around 30 or 35 percent, but in recent years headroom has been as high as 40 percent, and we see 45 percent as well from time to time.”

**SETTING LIMITS**

To return to the general market trend, worried limited partners might wonder whether, given the progressive market loosening, there are any red lines left at all. When asked if she is ever surprised by what particular term borrowers try to push forward on, Annette Kurdian, partner at law firm Linklaters, in London, replies: “No. Nothing surprises me at this stage.”

But there is ground on which she will recommend that lenders not give way. “My red line is that you have to have your single point of enforcement security that works, because the best covenants in the world won’t protect you if somebody breaches those covenants and you need to take control of the borrowing group by enforcing that”, says Kurdian.

A single point of enforcement is the ability of lenders to take control of the borrowing group, by enforcing share and receivables security at the top of the borrowing group in the event of a covenant breach.

Kurdian notes that even the effectiveness of the single point of enforcement security “is up for grabs” in the market, though she personally will heavily recommend to lenders that they hold firm. “There are some transactions where the covenant flexibility is such that we have to say to people, ‘There is a possibility that your single point of enforcement may be prejudiced in certain situations.’ We advise lenders to push back quite heavily on anything that could potentially impact that.”

But even in these looser times, most observers are reluctant to say that the market has passed ‘peak looseness’, when it comes to acceptable terms. On the one hand, Frogel of Allen & Overy has noticed “some tightening of some terms”, because of the recent volatility across financial markets, which has triggered outflows from debt funds. On the other, he thinks that not too much should be read into this.

“The last two or three years have shown that the minute markets come back, and the minute the supply-demand dynamic turns in favour of the borrowers, there is a push for more borrower-friendly terms. And then the trajectory towards looser terms starts again,” he says.

An important aspect of this trend is the size dimension. In Europe, “as lenders swim downstream to deals with a debt value of less than £25 million or €30 million, or a similar value in sterling, they tend to get progressively stronger covenant protection”, says Ramzan.

“There are many reasons for this. There are fewer private debt fund lenders, the paper is highly illiquid, and the sponsor tends to be less well-known.”

If the lender has never previously dealt with the sponsor, they are more reluctant to take matters on trust. Stephen Boyko, Ramzan’s colleague in New York, sees much the same in the US market. “In the lower mid-market, the packages tend to be more robust, the conditions tend to be more restrictive, and EBITDA definitions tend to be stricter.” Pierre Maugüé, a partner at Debevoise & Plimpton, the law firm, notes that in Europe, where terms always used to be tighter than the US, in certain respects they can now be more flexible. Maugüé is involved in deals on both sides of the Atlantic. He gives the example of ‘most-favoured-nation’ (MFN) status, which can sometimes favour the borrower more in Europe these days.

According to this concept, if a borrower takes a loan from Lender A at a higher interest rate within a specified period after closing its original deal with Lender B, Lender A can hike its interest rate to bring it to within a certain number of basis points of Lender B’s level. Negotiations often take place, when inking the original deal, over how long Lender A will enjoy its MFN protection, and what the maximum differential can be between the rates of the original and the new loan.

Observers also note that in the non-sponsored market, where competitive bidding among lenders is much less fierce, one is less likely to see loose terms. However, borrowers are not universally winning their battle over red lines, or even finding it progressively easier to do so with every passing month. The situation is more complex than that.

**ADDBACK COMPLEXITIES**

David Leland, who as head of capital markets at BC Partners, the private equity firm, in New York, raises debt for acquisitions, differs from the consensus by describing the long-term trend of looser documentation as “minor”, and limited to specific areas. He lists these as the ability to take on incremental debt, EBITDA definitions and addbacks, restrictions on permitted payments, and restrictions on investments.

“These terms loosen or tighten based on conditions in the market”, with negotiations favouring the lender more “during
periods of volatility in the marketplace”. Asked whether he has more negotiating power over these specific issues than he would have three or four years ago, he replies: “No. Substantially similar.”

Leland also makes a point mentioned almost universally by interviewees, including those who act for lenders: that the interests of lender and borrower are usually aligned, and that flexibility can serve the interests of both. In other words, if well-crafted, terms can be not only acceptable but desirable for both parties.

Leland gives the example of addbacks: “There are times when we might take a strategic action that has a very long-term benefit for a company in perpetuity, such as consolidating manufacturing capacity in a smaller number of factories to reduce inefficient spare capacity. A company wouldn’t want to be prevented from taking an action that positively impacts the credit in the long term for the benefit of lenders and equity investors, just because it would create negative covenant implications for you.”

It might, for example, entail redundancy costs that would hit EBITDA. If addback provisions prevented the sponsor from adding back to EBITDA to counteract this, it might not be able to take the action without breaching its leverage covenant.

But although lenders agree that they do not want to create perverse disincentives to make businesses more profitable for the long term, many are also starting to express qualms about the acceptability of particular document terms. “A favourite subject of pushback at the moment is addbacks to EBITDA”, says Alan Davies, partner at Debevoise & Plimpton.

He says the historical practice of adding back projected earnings from acquisitions to existing EBITDA “has morphed into something even more flexible. You don’t even have to make an acquisition – sometimes you can just make an operational change to the business”.

An example: “You make widgets on one type of machine and say, ‘I’m going to make widgets on another type of machine, and realise cost savings from that, that I want to add back into EBITDA now, even though I haven’t actually made those savings yet.”

**PUSHING FOR CAPS**

Lenders are prepared to accept such reasoning up to a point, he says, but “the thing that lenders particularly don’t like is for addbacks to be uncapped in amount or percentage terms. Lenders are therefore pushing for caps, and we are increasingly seeing them”. Lenders are also tending, he says, to demand third-party verification that addback estimates above a certain amount, such as 10 percent of existing EBITDA, are reasonable.

Another current area of pushback is over the transfer of assets to unrestricted subsidiaries: subsidiaries of the company that are not covered by the credit agreement, and are therefore not constrained by the credit agreement from borrowing as much as they can, or paying as much in dividends as their owners want. Such transfers also reduce the value of assets that can be seized if the borrower goes bust, as usually the creditors of relevant unrestricted subsidiaries will have first call on these assets.

The issue of unrestricted subsidiaries has been catapulted to the forefront of lenders’ minds by the cases of the US retailers Neiman Marcus and J Crew. “Once something goes wrong with a particular practice, such as the transfer to unrestricted subsidiaries by Neiman Marcus and J Crew, then every lender is focused on it in initial loan negotiations,” says Kurdian of Linklaters.

It is instructive, however, that both cases have produced extensive legal arguments about who had the right to do what, with what, and to whom (J Crew won its legal battle, while the newer case of Neiman Marcus is unresolved). This is itself a symptom of the trend for looser documentation, which has produced less clarity about lenders’ rights. For this reason, lenders can end up ceding more ground than they know, by giving way on what appear to be unimportant technical details, but prove to be vitally important when something goes wrong.

Jeffrey Griffiths, principal at Campbell Lutyens, the placement agent, in London, notes: “Most direct lenders for sponsor-backed, mid-market deals will say, ‘We’re very selective, and disciplined on covenants.’ Private equity sponsors will say, ‘It’s an amazing private debt market: we can get what terms we want, and we can remove covenants. So there’s a disconnect.’

Which side, ultimately, is nearer the truth? “More often, the private equity guys,” replies Griffiths. “I’m not saying the private debt guys are being dishonest, because there’s so much ambiguity, and the terminology can be used to obfuscate.” In other words, there may still be red lines, but there is also an increasing number of grey areas.”
Where once European private credit may have been viewed as the poor relation when compared with its US cousin, the past five years has consigned that perception to history. Europe’s private credit market has grown exponentially as funds seize the opportunity to attract capital from institutional investors struggling to find yield in more traditional asset classes.

They have also capitalised on bank constraints driven by tighter post-crisis regulation, taking significant market share in the lower and mid-market leveraged lending space. The flexible, borrower-friendly and often bespoke terms offered by funds have found favour among sponsors and debt advisors, which are now highly familiar with direct lending, having built strong relationships with fund teams.

With significant capital to deploy, direct lenders are refining and diversifying their offerings to appeal to sponsors and borrowers. Today’s funds can offer companies and their private equity backers a menu of options, from preferred equity, revolving facilities, ABL lines and follow-on capex or acquisition facilities or uncommitted facilities, which can be called on as the business grows. Some offer equity co-investment to help sponsors make up a potential equity shortfall in a deal, in a structure that also helps direct lenders benefit from upside and mitigate potentially lower pricing in debt products. Increasingly, funds are hiring specialist teams from banks and other debt providers to grow their product offering and expand their market reach.

Bigger fund sizes are also leading to much larger debt packages being underwritten by the private credit market. The recent £1 billion ($1.3 billion; €1.15 billion) refinancing of UK telecoms and IT business Daisy Group by Ares is an example of how the size of deals being completed by private credit funds in Europe now almost rivals those in the US.

Europe-focused private credit funds are now competing with the European high-yield bond and large-cap Term Loan B markets – something unheard of a few years ago. While almost all funds still require a financial covenant (unlike high-yield and TLB), the certainty of finance and the ease of dealing with a small club of funds are proving highly attractive to sponsors and borrowers.

Yet even with their increased firepower, private credit funds haven’t quite reached the stage where they can hold £1 billion in debt. As a result, we’ve seen funds collaborate on deals to form lending clubs, much as the banks have done in the past, although with significantly higher hold limits than the £20 million to £25 million the clearing banks can currently offer. We’ve also seen, as with the Daisy Group deal, funds underwriting the entire amount and then, again like the banks, sell on parts of the debt to other market participants immediately following closing, in a process similar to syndication.

The penetration of credit funds in the European market has been rapid but more is to come. Until recently, the UK accounted for most direct lending in Europe. Now, jurisdictions like Italy, Spain and Germany are welcoming private credit and we are starting to see more direct lending coming from outside of the UK. In the last 12 months included in Deloitte’s Alternative Lender Deal Tracker, 269 out of 425 deals were non-UK.

There is also scope for growth in the non-sponsored private credit market. While there are barriers to overcome, the competitive nature of the sponsored private credit market is leading some houses to ramp up efforts to build relationships with corporate finance directors. If this gains traction, the private credit market could be set for further significant growth.

Private credit has been an exciting market to be involved with during recent times, and the signs are that it could become yet more so over the coming period.
Q The healthcare sector is one of the most popular areas of private debt investment—why do you think this is?

Gary Creem: Private equity funds and finance sources have to be able to understand the regulations to evaluate risk; the area is constantly evolving and general investors may shy away if they don’t have a firm grasp of what is happening in the industry. It’s also non-cyclical and non-discretionary: whether there’s a recession or economic times are good, people still need healthcare.

There is also a lot of change going on in the industry: new services and delivery modes are entering the market. That creates opportunity for investors, for M&A and financing. Much like the shift from mainframes to the cloud that has happened in the technology industry, there’s a similar shift taking place in healthcare. Hospitals had traditionally been the site of healthcare delivery. That distribution now has moved to outpatient care, to urgent care and surgery centres; there’s an ongoing shift to a more distribution-focused model. There’s also a lot of innovation taking place. That creates opportunities to invest. This requires capital and that creates opportunities for our clients.

Q Is there a pattern in the type of financing that healthcare companies need? For example, the need for expansion capital, industry consolidation or distressed opportunities?

GC: There is a lot of industry consolidation taking place: insurance companies are buying doctor groups, insurance companies are getting into pharmacy services; there’s lots of vertical integration. There is also growth-stage demand, given the innovation taking place. That creates opportunities for our clients.
and disruption that leads to financing needs. Technology is increasingly driving the development of new services and that creates enormous opportunities for private equity funds and the sources of capital that help support them. The other driver is demographics. For instance, the US population is aging. An ageing population means greater healthcare needs, leading to expansion of services and growth opportunities for private equity and investors.

**Q** Do you typically find investors in the healthcare area have specialisation? How important is this to be able to invest in the sector?

**GC:** This industry has heavy regulation and lots of specialisation. Clients that engage in this area tend to have specialised knowledge in the space. They need to be able to evaluate risks like reimbursement rates and appreciate the ever-evolving nature of the industry, which does create more risk. While our clients may not be a speciality firm, they will have that speciality at the firm. We have seen a growth in speciality finance sources but I think we've also seen growth in team depth: if firms are interested in doing deals in healthcare they add depth to their healthcare team.

**Q** Are there particular regions where healthcare deals are focused?

**Richard Zall:** The US and Europe are two parts of the world in which there's a lot of activity, but we have also seen deals in places like South America and Asia. There hasn’t been a pronounced difference in concentration by location. Healthcare is a global need and deals are taking place globally.

**Q** What macroeconomic factors have supported the development of the healthcare market? Has increased privatisation or deregulation of the healthcare sector driven more dealflow?

**RZ:** The government sector has over the past half a dozen years increased in its regulatory activity; there’s more coverage being funded by the government. The health of the country is also a factor. Primarily though, market development is being driven by the constant innovation in the market, whether that’s the use of AI in drug development, fundamental rethinking of service delivery, or the rise of wearables with a healthcare focus; there’s a lot happening.

**Q** In those countries where there is more government involvement in the healthcare sector, can reliance on state contracts create additional political risk for investors?

**RZ:** Government involvement has by and large created positive investment considerations in our experience, as it protects incumbents to a high degree and there tend not to be major shifts in government programmes and priorities. It is important that investors understand the regulatory trends as those can lead to differences in the ability to generate revenues and earnings, but if you’re in the game it provides a level of protection. There’s always the extreme case of someone violating the law and losing their licence, and some don’t like anything where there’s a government role as it alters market forces, but for those who become expert in the sector it provides some insulation too.

**Q** Are there other regulatory hurdles when investing in this sector?

**RZ:** In just about every jurisdiction inside and outside the US, physicians and clinicians are credentialed to provide service to the public. So, businesses can’t just go out there on a whim and employ the doctors. It does require some creative structures. From a lending perspective, the collateral and the ability to have remedies can be limited by that factor.

**Q** Your report highlights a notable fall in mezzanine deals in recent years. Why?

**GC:** We did not see a dramatic rise in interest rates in 2017 and so floating rate loans were still more attractive to borrowers. I also think that for a lot of our clients, as we get towards the end of a cycle, they may be shying away from junior debt and looking to go up the capital stack to senior debt and so I think that may just reflect a choice of investors to shy away from riskier assets. We are continuing to see more opportunities in senior debt. But we are also seeing some clients go out on the risk curve for really attractive assets that have strong cashflows. So, for those types of deals, they may look at recurring revenue deals; they may look at preferred stock opportunities — for strong companies in the technology and healthcare space.
The growth of private credit funds in Europe has already transformed the lending landscape in some markets, with others evolving rapidly as the regulatory environment in countries such as Italy, Spain and Germany became more accommodating of alternative debt finance options. Alternative lending was up 9 percent by number of deals across Europe in 2018 versus the previous year, according to Deloitte’s latest Alternative Lender Deal Tracker. European private credit firms have also grown in scale as they have raised larger funds, inviting some comparisons with the larger, more mature US market, where direct lending has long been an established alternative to the bank loans more traditionally employed by European companies.

Indeed, the arrival of US-based private credit firms on European soil has created a degree of consistency between the two regions. “We don’t approach the two markets differently,” says Daniel Pietrzak, KKR member and portfolio manager for the firm’s private credit funds. “We have dedicated coverage of financial sponsors and intermediaries in both the US and across Europe to ensure our sourcing funnel is as large as possible.”

While, in some respects, the two regions are converging when it comes to the use of private credit, there are key distinctions. Part of this is because of the variety in European states that doesn’t exist in the US. “The US market can at times be easier to cover than the European market, even though the former is much larger, as the different jurisdictions and languages across Europe mean we have to sculpt our teams with a great deal of care,” adds Pietrzak.

Yet the differences between the US and European credit markets also extend to the type of structure on offer to borrowers. In the US, around one-third of direct lending deals are unitranche, according to Proskauer’s 2018 Private Credit Insights report, which analyses terms and features across the transactions the firms have worked on during the year. By contrast, 82 percent of private credit deals in Europe were unitranche in 2018.

Lost in Translation
Part of this divergence can be explained by a difference in terminology. “When talking about unitranche loans in the US and European markets, we should define what we mean,” says Peter Antoszyk, partner in Proskauer’s Private Credit Group.

“The term unitranche in Europe generally means a stretched senior loan with a super senior revolver, all governed by a single document; in the US, the term unitranche can mean any number of structures, including the European style unitranche. However, it is most often used to refer to a bifurcated or first out-last out structure.”

Bifurcated unitranche is a structure that synthetically recreates, in a single document, a first-lien/second lien structure. The US market tends to feature more bespoke credit deals, adds Pietrzak. “We can do more highly structured unitranche in the US, with between 2.5 and 10 percent mandatory amortisation rather than just using cash sweeps, for example, plus a term loan with covenants for when the capital is allowed to be drawn. You wouldn’t see this kind of structuring in Europe.”

Some of this is due to the difference in maturity between the two markets and the higher prevalence of bank lending in Europe. “In our view, Europe is two to three years behind the US in terms of development,” says Fenton Burgin, head of Deloitte’s UK advisory corporate finance team. “In the US, it’s an accepted feature that direct lenders provide working capital in a deal, rather than the banks, while in Europe, the banks still largely provide the working capital lines in private capital transactions.”

Pietrzak agrees. “The US market is more mature,” he says. “You also have quite a few companies in continental Europe that are lower levered and have banks as an alternative. This can make for simpler unitranche deal structures than you’d see in the US.”

However, part of the reason the two regions show a divergence is the type of documentation used. Bifurcation is a case
Going straight
Once a dominant feature of the US deal market, bifurcated unitranche is becoming increasingly rare.

Bifurcated unitranche – a structure that synthetically recreates first and second lien debt to provide what looks like a single credit facility – used to be a prevalent type of unitranche debt in the US. Yet over the past few years, the market has swung in favour of traditional first lien/second lien structures. “It was perceived in the past that bifurcated unitranche allowed lenders to offer better terms with less execution time and cost and fewer points of friction as the facility was governed by one document,” says Proskauer’s Antoszyk. “However, there is now much less of a distinction between unitranche and traditional first lien/second lien structures. These more traditional document structures are tried and tested.”

The move towards straight deals is also a result of the greater amount of capital held by private credit funds today. “We are seeing fewer bifurcated unitranche deals in the US mainly for practical reasons,” says KKR’s Pietrzak. “Funds are now more sophisticated and have deeper pools of capital – they can provide funding at shorter notice than previously and more frequently.”

BIFURCATED vs STRAIGHT
The US deal landscape has gone through a dramatic change in the past four years.

The proportion of bifurcated unitranche deals in the US has decreased significantly over the past four years. In 2014, 61 percent of US unitranche deals were bifurcated, according to the Proskauer report, yet this proportion has fallen to 4% in 2018. In contrast, the proportion of straight deals has increased from 39% in 2014 to 96% in 2018.

Comparing the two structures, bifurcated unitranche is seen as more complex and less transparent, whereas straight deals are perceived as simpler and more straightforward. The shift towards straight deals is likely due to a combination of factors, including the greater sophistication of private credit funds and the increased preference for traditional documentation structures.

Source: Proskauer Private Credit Insights 2018
US DEAL ACTIVITY

Snapshot of the deal market

Data from Proskauer’s Private Credit Insights 2018 report, which tracks deals advised by the firm, offer a glimpse into an evolving private debt deal landscape in the US.

**STEADY DEALFLOW**
Deal volume was slightly lower in 2018 compared with the previous year, when much of the activity was concentrated in Q2 and Q4.

**MID-MARKET OPPORTUNITIES**
More than half the dealflow involved companies with less than $30m in EBITDA.

**FLEXIBLE CAPITAL**
Transactions ranged from less than $50m to more than $1bn.

**NON-SPONSORED NICHE**
Sponsored deals made up the vast majority of deals.

**BACKING BUYOUTS**
Acquisition financings accounted for nearly two-thirds of deal activity.
GROWTH SECTORS
Manufacturing saw the biggest growth in activity from the previous year.

LEADING INDUSTRIES
Manufacturing, healthcare and business services accounted for nearly half of all deal activity.

TOP STRUCTURES
First lien and unitranche deals accounted for nearly two-thirds of volume.

FIRST LIEN LEAD
Second lien deals fell out of favour while first lien deals soared.

MEZZANINE DECLINE
Mezzanine deals have taken up a smaller proportion of the market over the years.

188
Number of deals tracked by Proskauer

86
Number of private equity sponsors

$42.1bn
Total transaction volume

5.2x
Average closing leverage

41%
Average equity contribution

83%
Share of deals either 1st lien, Unitranche or 2nd lien

Source: Proskauer Private Credit Insights 2018
EUROPEAN DEAL ACTIVITY

Continent in focus

Insights from Proskauer’s Private Credit Insights 2018 report paint a portrait of a maturing private debt market

BEYOND BRITAIN
Around half of Proskauer’s deals were continental, with the highest concentration of non-UK transactions coming from Germany, Benelux and France

Proskauer deals in 2018: 68
Total European transaction value: €21.8bn+
Private equity sponsors: 42
Average closing leverage: 5.18x
EUROPEAN DEAL ACTIVITY

LIEN MACHINE
The vast majority of European activity in 2018 involved unitranche deals

EYES ON THE FUTURE
Technology was the dominant sector for private debt deals in 2018

NASCENT SPECIALISM
Non-sponsored deals are even more of a minority in Europe when compared with the more mature US market

LOOSE AND LIGHT
Full covenant packages account for just under a quarter of European deals

FINANCIAL COVENANTS
Cashflow cover test covenants decreased from over half of all deals in 2017 to just under a quarter of deals in 2018

FEWER TERMS
The number of covenants per deal decreased in 2018

THERE CAN BE ONLY ONE
Deals with only one covenant increased by one-third
European deals to look out for in 2019

With record amounts of capital to deploy, managers are eyeing opportunities on the continent. Aaron Woolner examines some of the potential areas of focus and how the market differs across the Atlantic.

When examining manager appetites across sectors and regions common themes emerge, but there are also key differences. This is what Proskauer discovered when it polled US private credit managers on their preferred sectors as part of its annual Trends in Private Credit report last year. When asked which industries they considered investing in over the following 12 months, 95 percent of managers cited business services as an attractive sector, followed by healthcare (89 percent), software and technology (87 percent), manufacturing (79 percent), and transport and logistics (76 percent).

European respondents offered similar responses, but they were significantly more likely to consider investing in software and technology than their US counterparts – 95 percent included it among their target sectors. They were also far more likely to consider investing in education – 88 percent compared with 51 percent in the US.

We spoke to industry participants to get deeper insights on what trends they are focusing on and why.

**EVOLVING CONSUMER SECTORS**

According to Alexander Griffith, partner at Proskauer, roughly 10 percent of European survey respondents saw consumer retail as a sector to watch in 2019. This is despite the previous 12 months seeing a lull in activity in this sector. The London-based lawyer says some investors in Europe are taking a long-term view of the consumer retail sector despite its current travails.

“You would wonder why there is still interest in the sector given the number of distressed areas in retail last year, such as casual dining and high street retail,” he says. “But deals are still being done by private credit institutions in that space. That’s something to remark on – while there are challenges in that sector there are still some opportunities. People are still able to see through the short-term pain and see the long-term potential and are therefore able to back them.”

Not everyone agrees. Stephan Caron, head of European private debt at BlackRock, says that while opportunities may exist in retail, they are from the equity side, not debt. “The amount of destruction going on in retail makes it a difficult sector to invest in,” he says. “Even the technology disruption in those sectors means there is a lot of risk in consumer retail and fashion from a credit perspective.”

Instead Caron says there needs to be a distinction between retail investment and consumer services, with the latter proving to be more attractive for debt investors. Although it is a broad category, there is greater potential in this area, provided businesses meet a set number of criteria. He adds: “The firms that we prefer in the consumer sector are ones with contractual revenues and regular cashflows where essential services are being provided to companies that are resilient to economic cycles.”
INNOVATIONS IN TRANSPORT AND AVIATION

Germany has seen its private debt market share increase rapidly both in terms of deal activity and volume over the last two years, explains Daniel Heine, a managing partner at Zurich-based Patrimonium. Heine sees several opportunities forming in the country’s automotive market in 2019. Much of this change will come as car manufacturers require capital to fund the switch from combustion engines to electric vehicles in the coming years. This trend has in part been driven by strict emissions targets and clean air rules brought in by the European Parliament.

“There is a certain element of increased demand for healthcare as the population ages,” he says. “But it’s also a case of more and more acceptance of privately owned businesses supporting healthcare. The spin-offs from the National Health Service, parts of what would have been publicly owned businesses or services, are now being provided to the NHS. So, we are seeing opportunities for private credit to come in and support new business in this area.”

SENIORS DEBT

Europe’s ageing population is creating opportunities, and problems, in various areas of the economy. However, Proskauer’s Griffith believes private debt providers are well placed to capitalise on this development. He points to increased activity in the care home sector and specifically cites the UK, where the health service is increasingly looking towards the private sector to provide certain services.

“We can continue to expect further penetration in the Benelux in 2019,” says Caron. “Southern Europe is also very underrepresented in terms of private debt but we are starting to see an increased recognition of its value from both corporates and financial sponsors in Spain and Italy than we have seen previously. However, I wouldn’t expect the shift that we saw in Germany, which was really quite dramatic.”

NEW FRONTIERS IN THE OLD WORLD

According to BlackRock’s Caron, while Germany may have been the European private debt success story of the last two years, the next frontier for the asset class is in the Mediterranean — regardless of sector. Data from the Deloitte Alternative Lender Deal Tracker shows that there were 110 deals in Europe – outside the major markets of the UK, France and Germany – for the year leading up to September 2018, more than in any other 12-month period.

Consensus was reached across both European and US private debt managers polled in the Proskauer survey, and by everyone spoken to for this feature, that software and technology will continue to be a major driver for private debt managers in 2019. According to Griffith, the drivers of this growth are software-as-a-service (SaaS) providers, which have all the characteristics that Caron outlines as making consumer services attractive: repeat revenues and resilience to the business cycle.

“OPPORTUNITIES IN TECHNOLOGY AND COMMUNICATIONS

Consensus was reached across both European and US private debt managers polled in the Proskauer survey, and by everyone spoken to for this feature, that software and technology will continue to be a major driver for private debt managers in 2019. According to Griffith, the drivers of this growth are software-as-a-service (SaaS) providers, which have all the characteristics that Caron outlines as making consumer services attractive: repeat revenues and resilience to the business cycle.

“There seem to be particular funds out there that like software and technology and that can get their heads around the recurring revenues and the risks involved,” says Griffith. “They will really go all out to do those kinds of deals. Most funds are more generalist and look at all the different sectors and, providing the credit stacks up, they will go for it. There are certainly a lot of SaaS deals being done in Europe at the moment.” Examples of specialists include TPG, which concluded a number of deals in Europe last year, and more generalist firms such as Ares which provided a £1 billion ($1.3 billion; €1.2 billion) loan at the end of February to UK telecoms and IT firm Daisy.
DEAL HIGHLIGHTS

A year in deals

Some of the standout private debt transactions covered by PDI over the past 12 months

- **Guitar maker Gibson gets bankruptcy financing from KKR, others**
  Gibson Brands received the final go-ahead for its bankruptcy financing after a deal was reached among the lenders on the $135 million loan. Tennessee-based Gibson and its financiers came to an agreement on the debtor-in-possession loan that resolved disagreements over the refinancing of Gibson’s pre-Chapter 11 asset-based loans. Among lenders on the DIP are KKR, Melody Capital Partners, Silver Point Capital and Grantham, Mayo, Van Otterloo & Company, according to federal bankruptcy court papers. Blackstone’s GSO was a prepetition lender, as it extended a $135 million term loan to the company.

- **Ares, HPS and GSO back purchase of licensing business**
  Three private debt managers financed Differential Brands Group’s acquisition of Global Brands Group’s licensing business, which includes a diverse set of brands such as Disney, Under Armour and Michael Kors. Ares Capital Management, HPS Investment Partners and GSO Capital Partners were slated to back the purchase with a $1.3 billion financing, according to an announcement. The lenders are also providing equity co-investments alongside the GBG existing management team and other co-investors. Tengram Capital Partners, a Connecticut-based private equity firm that specialises in the consumer sector with $591 million of assets under management, is a shareholder.

- **CVC and EQT back second sponsorless Paymentsense round**
  CVC Credit Partners and EQT Credit arranged a £218 million ($289 million; €255 million) refinancing for Paymentsense. The funding consists of a mix of senior and subordinated financing for the non-sponsored firm. The deal was the second round of funding for Paymentsense, a merchant services provider. EQT and CVC both backed a £110 million unitranche facility for the firm in November 2016. UK-based Paymentsense provides card processing services for 65,000 small and medium-sized businesses.

- **LCM snaps up €300m of Spanish loans**
  London-based fund manager LCM Partners acquired a portfolio of approximately 1,200 loans from Grupo Cooperativo Cajamar, the Spanish credit co-operative. The portfolio is valued at around €300 million and comprises secured, non-performing SME loans predominantly secured against residential real estate assets on Spain’s southern and eastern coasts. The deal represented LCM’s fourth purchase in Spain in 2018.

- **MaxCap backs A$400m deal as Australian banks withdraw**
  MaxCap Group, a Melbourne-headquartered commercial real estate investment firm, backed a project worth over A$400 million ($284 million; €250 million). Eddie Law, a Sydney-based investment director at the firm told PDI the investment firm had structured a senior secured debt facility to provide flexible loans to a borrower, alongside an industrial superfund in Australia. The borrower is Golden Age Group, a Melbourne-based real estate developer.
Alcentra to buy $1bn of US business loans from Funding Circle
Bank of New York Mellon private credit arm Alcentra and small business financing startup Funding Circle, both based in London, entered into a partnership to fund US small and mid-sized enterprises. Alcentra was set to buy up to $1 billion of loans originated by Funding Circle’s US platform over a three-year period, the two firms announced on Friday. The loans could fund up to 8,000 companies. Financing for the loan purchases would come from Credit Suisse.

FS, Bain, KKR BDCs hold first lien debt in bankrupt American Tire
Ares Management- and TPG Capital-backed American Tire Distributors filed for Chapter 11 bankruptcy, affecting the portfolios of some of the largest business development companies. The North Carolina-based tyre distributor sought court protection after the loss of several key customers and online shopping took their toll. Goodyear Tire & Rubber Company and Bridgestone Americas both severed ties with American Tire, while a partnership between Amazon and Sears further cut into the debtor’s business, according to bankruptcy court papers. The company counts six BDCs - American Capital Floating Senior, Corporate Capital Trust, Corporate Capital Trust II, Bain Capital Specialty Finance, FS Investment Corporation and FS Investment Corporation II - among its lenders.

AXA makes further strides into the US market with $9.4bn Quadrant deal
AXA Investment Managers - Real Assets has made a significant push into the US market through the acquisition of a dedicated investment team and a $9.4 billion portfolio of US commercial mortgage loans from Quadrant Real Estate Advisors. As part of the deal, which is pending regulatory approval, the £77 billion asset manager will take over one of Quadrant’s US business lines focused on commercial property mortgage loan mandates. Additionally, 24 members of Quadrant, including five of the founding partners, will join the real estate investment management arm of French insurance firm AXA.

Ares agrees £1bn loan for UK IT company
Ares Management made a more than £1 billion ($1.3 billion; €1.2 billion) loan to UK-based technology services specialist Daisy Group to back a management buyout. The loan is thought to be one of the largest private credit transactions in Europe and will see Ares become the sole lender to the company, which provides telecoms, IT and cloud services.

KKR spreads its wings with $1bn aircraft leasing investment
KKR’s infrastructure team has made its first foray into aircraft leasing with the acquisition of 50 percent of aircraft-asset manager Altavair, in a deal worth $1 billion. The deal was made alongside KKR’s credit unit on a 50-50 basis and will see KKR and Altavair seek to acquire commercial aircraft over the next several years. The pair’s initial investment is to go towards acquiring six cargo aircraft with a variety of airline counterparties, although KKR expects growth to be focused on passenger aircraft.

AnaCap buys Italian SME loans worth €4bn
AnaCap Financial Partners has bought a portfolio of Italian loans with a face value of €4 billion. The deal marks the first investment from its most recent fund, Credit Opportunities Fund IV, which held a first close on €600 million in November last year. The loans were purchased from an unnamed Italian bank with which AnaCap has a long-term relationship.
INTERVIEW

INDUSTRY OUTLOOK

Sizing up the market

From mid-market opportunities in the US to non-sponsor strategies in Europe, we ask managers on both sides of the Atlantic for their outlook on the deal market

OUR PANEL

Randy Schwimmer
New York-based senior managing director with Churchill Asset Management

Alfonso Erhardt
Madrid-based partner at Oquendo Capital

Dan Barry
Chicago-based senior managing director with Antares

Q: How has the deal market evolved since you first started investing this space?

RS: Expanded hold levels by direct lenders has disintermediated middle market bank syndication desks by allowing very small clubs to execute larger deals. Credit standards at the higher end of the middle market are being weakened by arrangers offering issuers broadly syndicated loan terms, meaning fewer and less enforceable covenants.

AE: The market looks nothing like when we started in 2007. At the time, the only private debt providers were mezzanine funds taking part in LBOs. The market has seen exponential growth with many other credit providers filling in the gaps left by the banks: unitranche, B-tranche, asset finance, real estate finance, sponsorless. The market is now huge, with many players and new funds and strategies being launched every year as new niche opportunities are discovered.

DB: Antares was one of the first non-bank lenders to enter the sponsored middle market about 25 years ago. Since then, the market has grown enormously in terms of lender volume, hold sizes and investor sophistication. It’s only been in the last decade or so that private debt has been recognised as a distinct asset class by most institutional investors.

Q: What strategies are you focused on and why?

RS: We focus on senior middle market credit in defensive sectors, such as healthcare, business services, software and tech, backed by top-tier private equity sponsors. Our team has invested successfully through several business cycles. We believe this is the best approach to ensure the best returns for our clients going into, and coming out of, the next downturn.

AE: We have evolved from being a provider of mezzanine finance to encompassing credit instruments across the capital structure. We have also launched a real estate activity through a JV with Azora, a leading real estate investor in Spain. We tend to focus on the lower-mid market, which is a segment of the market that is generally overlooked by the larger investors.

DB: Our strategy has always focused on the North American sponsored middle market, though the size of companies we service in the upper middle market has grown over the years to as high as the $175 million-$200 million EBITDA range. We like the sponsored middle market because it’s a very dynamic, faster growth segment and sponsors bring both management acumen and equity support.
Which regions are the most appealing to you in 2019?

**RS:** Churchill is exclusively US-centric, though our parent company, Nuveen, is a global asset manager. Our credit strategy is focused on middle market borrowers. These companies have been significantly disadvantaged in a financing environment in which US regulated banks are playing a much-reduced role. It seems clear as well that the US economy continues to be the best global performer a decade out from the Great Recession. We expect smaller companies, which represent 70 percent of GDP, will continue to be the beneficiary of that trend.

**AE:** Our focus remains Spain and Portugal because that’s our home market, which is where we believe we can generate more alpha for our investors.

**DB:** We only focus on the US and to a lesser degree Canada. Our most recent 3rd Annual Compass Survey suggests continued, if less robust, optimism for the US economic outlook in 2019 across sponsors, borrowers and investors. Of course, there will be a cycle at some point, but the long-term secular growth outlook for sponsored middle market growth remains quite bright.

What are the biggest challenges facing the deal market in the future?

**RS:** Private credit is generally non-correlated to volatility, but major market swings could chill M&A activity. While in the long-run, supply/demand fundamentals favour private credit investors, aggressive capital providers can weaken terms and increase leverage in the short-term.

**AE:** Educating the sponsorless market to use more private debt instruments. We have been working on this for some time, but it’s a slow and time-consuming process. Once private debt is embraced by family owned businesses, we believe it will significantly change the market.

**DB:** This depends on one’s perspective. Historically high valuation multiples are leaving little room for PE execution error to achieve targeted IRRs. As a lender, higher leverage, EBITDA add-backs and looser terms in a “late in cycle” economy suggests it’s ever more critical to be selective and maintain credit discipline.

What are the biggest tailwinds of dealmaking today?

**RS:** As public markets continue to be volatile, both investors and sponsors will seek the safety of private credit. Private equity sponsors are concentrating their relationships with direct lenders having large capacity ($150 million-plus) holds. Despite an environment in which terms and structures can be less-investor friendly, LP/GP relationships allow Churchill to remain extremely selective in building a strong credit portfolio.

**AE:** A lot of money has been raised very quickly. [However] there is pressure to deploy. This means we are seeing some situations where managers are relaxing their credit standards and documentation requirements, which could have an impact going forward.

**DB:** A healthy economy with favourable revenue and EBITDA growth prospects, abundant dry powder and access to capital. There are also several themes – demographics, data and technology – driving PE investment and consolidation across various industries.
Our group is a unique finance practice with a large team of lawyers based in key financial centers in New York, London, Los Angeles and Boston. Our breadth and diversity is unmatched in the industry. We have consistently closed approximately 200 deals a year, which provides us with a keen insight into market trends in deals of all sizes, structures and industries.

Our technical strength, combined with our expansive experience, makes us the Firm of choice for first-in-kind transactions. We have developed innovative structures such as upside-down unitranches and synthetic mezzanine, as well as migrated the bifurcated unitranche into the European market. We have been active in the market and participated in the evolution of a number of credit products, including senior-stretch loans, unitranche loans, second lien loans and secured mezzanine.

- Represent **75 of largest asset managers** globally
- Closed approximately **200 deals** a year
- Clients provided over **$42 billion+ in capital** last year
- Proprietary database includes **200+ deal terms**

**Changing the Landscape of Private Credit Deals**
We represented a number of prominent private credit funds in the development of a new template form of intercreditor agreement for unitranche financings with the Loan Market Association (LMA), the syndicated loan market authority in Europe. Proskauer was the only law firm to contribute to and attend all working party discussions on behalf of the private credit industry.

**Data Driven Insights**
We maintain two proprietary databases, giving us a market edge. With more than 200 searchable terms, our data provides our clients with real-time intelligence on the state of the credit markets.
The Private Credit Group

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- Bankruptcy & Restructuring
- Executive Compensation
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- Health Care
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- Life Sciences
- Public and Private BDCs
- Regulatory & Compliance
- Software & Technology
- Special Situations
- Sports

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Key Contacts

[Profiles of various partners with contact information]
Successfully completed the following financing

$520 million
Unitranche Credit Facility

$1.5 billion
Upsize of Existing Credit Facility

$420 million
Senior Secured Credit Facility

$130 million
Senior Secured Credit Facility

$325 million
Senior Secured Credit Facility

$1 billion
Senior Secured First Lien Facility

$305 million
Senior Secured Credit Facility

$535 million
Senior Secured 1L Credit Facility

$550 million
Series A Preferred Stock and Warrants

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Proskauer’s Private Credit Group is a unique finance practice with more than 50 lawyers based in key financial centers in London, New York, Los Angeles and Boston.

The team has consistently closed more than 200 deals a year and has been at the forefront of the development of the private credit market including working on the development of the new LMA Unitranche Intercreditor Agreement for use on private credit transactions.

In 2018, the Private Credit global team closed more than 190 deals with a combined transactional value of over $42.0 bn last year, of which approximately 120 were US / US cross border deals and 70 were Pan-European deals.

For further information, please visit: www.proskauer.com/practices/private-credit