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# Private Credit Adapts to Uncertain Market Climate

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Private credit lenders may take market share from the banks once again. Coming into the current crisis, private credit lenders have raised large pools of untapped capital. As a result, their ability to provide certainty of funds, speed of execution, and an ability to deploy capital into special situations such as new capital injections, exchanges of debt for equity, or other time-buying measures, may provide an edge over banks in the private equity and leveraged finance markets in 2020-2021.

At the onset of the Covid-19 pandemic, a majority of private credit funds played defense, focusing on their own portfolio companies and spending time with their private equity sponsor relationships in an effort to minimize losses. These lenders also invested time working with counsel to scrub their legal documents to grant additional security interests in assets that may have been excluded from what lenders previously sought out due to costs or other inefficiencies. Lenders also sought to close loopholes that allow sponsors to divert value away from lenders or weaken their likelihood of recovery in a bankruptcy by diluting lenders' positions with additional debt.

For example, carve-outs from credit agreement provisions that would allow, in some cases, hundreds of millions of dollars worth of intellectual property or the entire value of a brand to be transferred to entities that do not guarantee a lender's loan are being eliminated or pared back. Similarly, "incremental" or "accordion" provisions in credit agreements which, depending on how they are drafted, could allow borrowers to incur large amounts of additional debt that potentially get paid off in advance of existing debt are viewed more skeptically and subjected to more explicit restrictions.

More recently, private credit lenders have demonstrated agility and a willingness to adjust with their clients to mitigate and get ahead of the economic impact. Many see significant opportunities to invest the vast sums of dry powder available in their funds and to raise new capital for the purpose of providing liquidity to companies during the pandemic. These private credit funds are capitalizing on their ability to act with swiftness and long-term commitment in ways that have traditionally proved more challenging for banks offering syndicated options.

According to Preqin Ltd., as of mid-May 2020, firms were looking to raise $67 billion across 59 funds to invest in special and distressed situations driven by dislocation resulting from the pandemic. In comparison, firms raised $44.7 billion to profit from the fallout of the 2008 financial crisis. In other words, just months into the pandemic, nearly 50% more capital has been committed to investing in special and distressed situations than in the entirety of the wake of the 2008 crisis. Investors are seeing meaningful opportunity in these types of investments, and private credit funds are gearing up to get more active in these spaces.

## Past Is Prologue

It is nearly impossible to think about the present state of the economy without drawing comparisons to the 2008 financial crisis. Certain industry leaders have noted that the economy as a whole was healthier going into this crisis than the 2008-2009 recession. In 2008, the sickness facing the market was a systemic one. Banks traded heavily in risky structured credit products and carried significant off-balance sheet liabilities that created illusory pictures of bank capital, which in turn, fueled more unchecked and risky trades.

Now, with greater regulation and oversight, the pandemic poses an extrinsic issue that the market needs to withstand. While we may see higher losses due to an increase in "covenant-lite" loans (i.e. loans that do not require consistent and formal testing of the financial strength of a borrower), the expectation is that there will be fewer defaults. In fact, private credit lenders have been actively reaching out to their borrowers to explore which strategies can best be used to ensure this outcome as much as possible. Whether it's considering holidays on amortization or interest payments, or discussing whether companies should be given some temporary credit for the impacts of the pandemic when reporting on their financial situations, private credit funds are not staying on the sidelines waiting to react.

The situation is, of course, fluid. But uncertainty creates significant opportunity for private credit funds in a way that echoes the circumstances behind the formation and capitalization of many of these funds during and after the 2008 financial crisis. During that period, when banks were under severe financial distress, private equity sponsors found an opening with private credit funds. Many well-capitalized private credit funds were able to provide 100% of the loan funding needs to private equity sponsors looking to consummate leveraged buyouts without the normal delays or "flex" of deal terms that sometimes resulted from syndicating a loan in the bank markets.

Typically, when a leveraged loan is being syndicated, the bank agents are given a period of months to line up other banks and financial institutions to participate in the transaction and commit to fund a portion of the loan. During the syndication process, the bank agents are given flexibility (or "flex" rights) to modify certain provisions of the deal to make them more attractive to lenders if they encounter difficulty enlisting enough institutions to sign up for the deal.

In contrast, private credit funds can often commit to 100% of a deal in a matter of weeks, not months, and do not need "flex" rights or the ability to negotiate the terms of a syndication process. In 2008, when private equity sponsors needed to be decisive and quick in order to transact in mergers and acquisitions, the speed and certainty offered by private credit funds was invaluable. The result was over 10 years of bull market growth for private credit funds, during which their share of the leveraged loan market increased significantly.

Unsurprisingly, in light of the current market, M&A activity (historically a big source of lending business for private credit funds and banks alike) has chilled. Even setting aside the economic impact of Covid-19 on a company, the lack of ability to spend face time with management and conduct thorough due diligence has played a meaningful role in the decrease in acquisitions. So far, existing capital has been primarily used to manage the needs of companies already owned by private equity firms. Without an ability to research a potential target company with boots on the ground, and with portfolios already saddled with companies that are stressed and struggling, many private equity firms are prioritizing protecting their existing investments over seeking out new opportunities.

Inevitably, transactions in the current environment have largely been special situation-type transactions that infuse new capital into or defer payments from borrowers who are unclear about their recovery prospects. Designed to create time and relieve pressure, many recent financing transactions have served as speed bumps keeping companies out of default and bankruptcy.

When a company is suddenly thrust into a zero-revenue scenario without warning, which is exactly what is occurring now across a myriad of industries (e.g. restaurants, gyms, hotels, casinos and events to name a few), the ability to borrow additional money or hold off on making an interest payment can end up being the difference between filing for bankruptcy and funding payroll for employees. It remains to be seen whether these amendments will be viewed, in retrospect, as vital business and portfolio protection, or mere branches grabbed on the way down to an eventual bottoming out before the economy recovers in earnest. The truth will likely land somewhere in the middle, but in the meantime the partnership between private equity sponsors and private credit lenders has given some cushion to many impacted companies.

## Changes in Deal Terms

As more clarity emerges regarding how the pandemic will play out, private credit lenders are finding ways to factor in the effects of the new normal. For example, amendments have already focused on correcting the underpriced cost of the large amount of revolver draws, the use of delayed draws on general use and capital expenditures (as opposed to just permitted acquisitions), and the general lack of anti-cash hoarding covenants in deals.

Documentation terms recently considered "market" features designed to offer sponsors flexibility (e.g. the ability to move certain assets out of reach from secured lenders to "unrestricted subsidiaries" that do not need to comply with credit agreement requirements, broad capacity to incur additional incremental debt that can dilute the ranking and likelihood of recovery of existing lenders, and terms that allow sponsors to pull money out of companies to pay dividends and even spin out business lines and divisions, all subject to limited restrictions) are starting to be either cleaned up or priced in. Because of the uniqueness of the existing situation, these legal and business risks were underpriced going into the market. At a base level, even accounting for a recession, no lender was prepared to underwrite a zero-revenue scenario for any business.

## Options for Downgraded Ratings

Beyond amendments to existing financings, distress-focused and special situations teams within private credit funds are demonstrating preparedness to step in where public markets or more traditional lending institutions are unable to participate if ratings downgrades occur. Private credit funds can offer suites of options not typically on the menu at a bank or broad syndicate.

These solutions can involve anything from lending against company assets that can be designated as unencumbered, using sale-leaseback transactions, securitization facilities and allowing certain interest payments to be deferred and/or paid-in-kind (added to principal), and balance sheet assistance through taking some types of equity interests in exchange for forgiveness of a portion of existing debt and de-levering. Banks are subject to regulatory requirements and capital constraints that make these types of bespoke solutions a challenge. Moreover, in a syndicate with a large number of participants, each with their own distinct risk appetites, internal guidelines and constraints, getting the requisite lenders to agree on these types of terms can be a logistical and substantive challenge.

As was the case in 2008, these types of quick maneuvers are more easily achieved when a company can call on a single lender for collaboration rather than navigate the process of managing numerous constituents in a syndicate through the solicitation and consent process. These efficiencies feel even more critical now where the conversation is anchored by a virus that is not fully understood. Variables and unknowns threaten transactions; at a certain point, too many uncertainties can cause a deal to die and a business left without a solution to a liquidity issue. With such a massive unknown now present in Covid-19, private equity sponsors may seek to cut out some of the other typical uncertainties that come from dealing with multiple constituents in a syndicated deal. Indeed, the challenges are different than they were in 2008, but the unique ability of private credit funds to serve as a place of refuge remains the same.

## Industry Impacts

Predicting the path forward is a tremendous challenge. Until there is a deeper understanding of the texture and contours of the medical crisis and how we learn to either eradicate or live with this disease, new deals will largely appear in non-impacted industries such as technology, software, and certain life sciences.

Even setting aside the economic changes, the potential for a total transformation of certain industries is a real factor that private credit firms are considering for future deals. Developments in e-commerce for retail, transformations in traditionally face-to-face interactions, and a large portion of the work force (including in professional services) working remotely, as well as the great innovation and invention that we expect to see going forward are all areas of focus for lenders.

As the economy reopens, expect to see essential businesses, certain healthcare and infrastructure businesses, and technology as the likely initial hot spots for investment activity. The travel, leisure, and certain food and beverage industries may see a slower return as, even when the economy bounces back, additional transformation may be needed for them to reopen in a way that makes sense, from both a public health and financial standpoint.

## Special Situations Ahead

Too easily lost in the conversation is the tough reality that a business reopening does not guarantee its survival. It is alluring to think that a reopening of businesses will mean a bounce back of the economy and that opening a business's doors, even with significantly diminished capacity, is better than nothing from an economic perspective. Unfortunately, however, this isn't always the case if the revenue generated from reopening remains insufficient to fund payroll, rent, and overhead.

There are significant unknowns, and some rational consolidation within industries may need to occur. Two things are clear though: It will take time to figure it all out, and time comes at a cost. Businesses will continue to need liquidity and the ability to communicate in real time with their leverage providers to be able to chart the path forward or make difficult decisions with regard to right-sizing.

The deals that will need to get done will be time-sensitive, sophisticated, and require certainty of funding. They will also require thorough analysis of corporate structure, sector fundamentals and macro issues to craft bespoke and creative financing arrangements involving everything from amendments and new capital infusions, refinancing transactions and dispositions to, where necessary, in or out-of-court restructurings.

These will be special-situation deals with complex companies and capital structures, where a syndicate participant may not be able to complete diligence fast enough to fill-or-kill within 48 hours of documents being posted by a bank agent. But they will be the types of deals that private credit funds are poised to execute with certainty on the right terms.