Big fish, big pond

Private debt is an asset class that's risen meteorically – and looks set to grow further. But tough economic conditions and a flexible approach to covenants mean there may be challenges, too. With major flux in banking and lending markets, Andy Thomson looks at who will provide debt for mid-market deals

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Private debt funds had not landed on UK shores at the time of the global financial crisis in 2008. Mezzanine funds predated the crisis, but were generally considered part of the private equity industry and in the US, debt funds were a far more significant part of the leverage landscape. It might have been a trend waiting to happen, but the financial crisis was certainly a major catalyst for the asset class's development in the UK and Europe.

Banks, a significant number with crippled balance sheets, were about to be subjected to increased regulation, which would constrain all sorts of activities – including mid-market corporate lending. Debt funds spotted an opportunity, in a market that was not fully developed, and stepped into the gap. So-called 'direct lending' – a kind of bank lending equivalent – became private debt's most popular strategy among investors.

What goes around comes around. The events of the past two months, involving Silicon Valley Bank and Credit Suisse, maybe have faint echoes of the great financial crisis. However, systemic risk appears less likely because governments and regulators have reached for the safety nets that were simply not available to the likes of Lehman Brothers 15 years ago. But will pressure on the banks lead to further retrenchment? And will it create an opportunity for debt funds to increase their market share even further?

Marc Ciancimino, a co-founder of private debt fund manager All Seas Capital, says it's too early to tell how things will play out, but notes: "It could certainly put something of a dampener on bank appetite. Banking will only become more regulated and governments, which have taken the risk of bailing out some institutions, will require banks to do what they want them to do – which is more likely to be lending to the real economy, rather than funding leveraged buyouts. I do think credit committees within banks will be getting more nervous about deals right now. Funds, as always, will be ready to step in."

Private debt fundraising globally was worth just less than $248bn last year, according to *Private Debt Investor*. Direct lending alone accounted for more than half of that. But while there's a common view that funds could grab an even bigger share of the lending market from the banks, there is also a natural divide in terms of the type of loans provided. Even the debt funds themselves concede that if a borrower's leverage requirement is modest – up to around 3xEBITDA, say – the chances are they'd be best off with a bank, as the cost of their financing will be lower.

But if the borrower requires leverage of more than 3x and possibly up to 6xEBITDA, conservative and risk-averse banks are unlikely to oblige. The same applies if the borrower is operating in a sector perceived as risky, or is a business with a complicated trading story. In

Under scrutiny

Regulators are casting their gaze over the strategy, but there's little sign of it slowing.

The private equity buy-and-build strategy – frequently supported by direct lenders – is an easy one to describe. Private equity firms simply acquire businesses, build platforms through a number of acquisitions, buy at low multiples, extract synergies and sell a larger business at a higher multiple. It's a fairly standard private equity way of making money for investors and it's traditionally been very successful.

It's also not without controversy. Last year, various media outlets reported on the increasing interest being taken by Jonathan Kanter, head of the US Department of Justice's antitrust unit, in some buy-and-build deals. The focus appeared to be on deals supported by the larger lenders rather than lower mid-market players. Kanter told the *Financial Times* that the motive of a private equity firm was sometimes "to hollow out or roll up an industry and essentially cash out. That business model is often very much at odds with the competition we're trying to protect."

Many in the market are inclined to think the regulator's bark is worse than its bite and there are few signs of the buy-and-build diminishing in popularity. Beechbrook co-founder and managing partner Paul Shea estimates that around 40-50% of deals the firm does in the sponsored market are buy-and-builds, compared with around 30% in the non-sponsored arena.

One example was children's education provider ICP Nurseries, which Beechbrook provided a unitranche loan to in 2017 and from which it was refinanced in March 2019. In 2022, it merged with Cresswell Nurseries. The firm, which operated in London and the South East, made multiple acquisitions of other nursery providers during the period of Beechbrook's involvement.

"The nursery market is highly fragmented," Shea says. "If you can combine single nurseries together at low multiples then, when you get to 30-40 nurseries under management, you become attractive for the big groups."

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these cases, private debt funds are more likely to be receptive – in exchange for the higher cost of financing that provides their limited partner investors with a decent return.

Efficiency gains?

There's a bifurcation between so-called 'sponsored' and 'non-sponsored' markets. The former is any deal led by a private equity (PE) firm, normally a leveraged buyout. The latter is any lending transaction without a PE sponsor. According to Deloitte's Private Debt Deal Tracker, in Q2 2022 – the most recent quarter for which figures are currently available – 92% of private debt deals in the UK were sponsored and a paltry 8% non-sponsored. Across the rest of Europe, the respective figures were 85% and 15%.

Is this what we should expect? To a large extent, yes it is. Private debt firms appreciate the regular deal flow that PE firms can supply them with and the due diligence they undertake on the borrowers before they put equity in. They are relying on the fact that an experienced PE house has its skin in the game. In a nutshell, it's a relatively cheap and efficient process. PE sponsors, for their part, appreciate private debt funds' speed of execution and the flexibility of their financing, when compared with the typically more bureaucratic and 'plain vanilla' approach of the banks.

In the non-sponsored market, it's a different story. This is still largely the domain of the banks – often small, growing businesses with modest leverage requirements. "It's a world where a lot of funds would like to do more, but often find it difficult to originate transactions because they are trying to unearth opportunities that aren't already in the hands of private equity," says Matthew Ayre, partner and head of leveraged finance at law firm Travers Smith. This might be because PE has missed the opportunity, or the borrower is not interested in a PE-sponsored deal. Or it could be because PE has looked at the business and passed up the opportunity to invest. "This is where many businesses see the banks as the ones they traditionally borrow from," adds Ayre.

It's also expensive for private debt firms to build the operational infrastructure. Setting up regional offices and scanning thousands of business opportunities located far and wide in the hope of unearthing a few jewels requires a lot of resource and investment – although big data and AI techniques have made some of the legwork easier.

However, in the new world of inflation and rising interest rates, a spanner has been thrown in the works, raising the possibility that change may be afoot. Fazed by economic turbulence, private equity firms have applied the brakes. According to Debtwire Par, European buyout deal value dropped from $124.3bn in the second quarter of last year to $25.8bn in the fourth quarter – dragging the market back to stunted activity levels last seen during the first COVID-19 lockdowns in 2020. And according to Refinitiv, M&A with any UK involvement in the first quarter of 2023 totalled $47bn – 60% down on Q1 2022.

Given the dearth of deal flow in the sponsored market, fund managers with dry powder to deploy are being forced to look beyond their traditional hunting grounds. On top of this, there's another possible twist. Counterintuitive it may be, when all the talk for many years has been of private debt's irresistible advance at the expense of the banks, but might current economic conditions favour a shift in the opposite direction?

Ayre thinks it's possible: "Attitude to risk is changing with interest rates going up and borrowers being more circumspect about being prepared to take on board more expensive debt. So some borrowers would previously have had appetite for as much leverage as possible and were prepared to pay for it. As debt is now more expensive, the banks become more attractive

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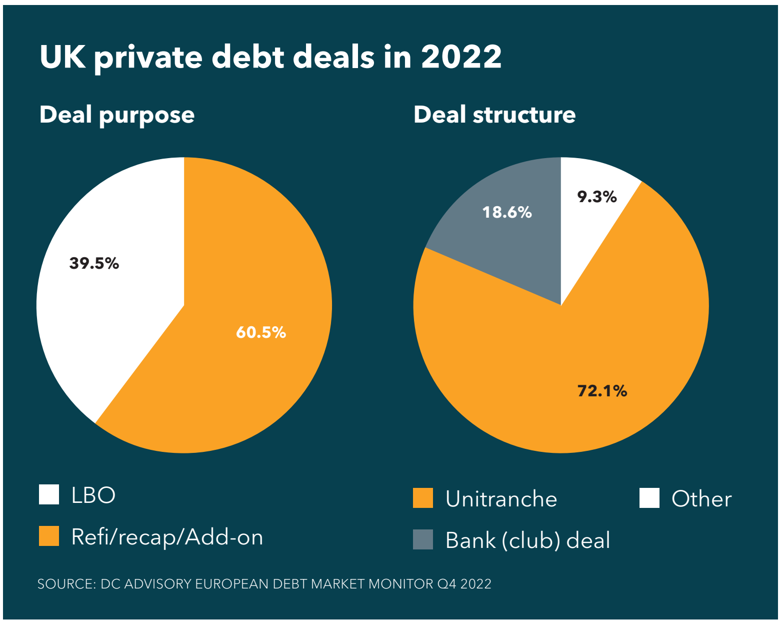


The alternatives
Top 10 private debt lenders in the UK in 2022

1 **Ares**
LOANS MADE: 37

2 **Barings**
LOANS MADE: 16

3= **Pricoa**
LOANS MADE: 10

3= **Alcentra**
LOANS MADE: 10

5 **Pemberton**
LOANS MADE: 9

6 **CVC**
LOANS MADE: 8

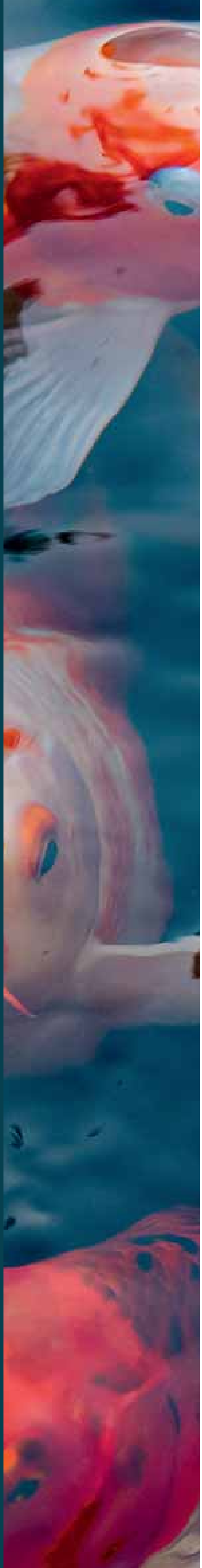
7= **Arcmont**
LOANS MADE: 7

7= **Kartesia**
LOANS MADE: 7

7= **Bridgepoint credit**
LOANS MADE: 7

10 **Hayfin**
LOANS MADE: 6

SOURCE: DC ADVISORY EUROPEAN DEBT MARKET MONITOR Q4 2022



According to *Private Debt Investor*, in the immediate post-global financial crisis world of 2009, global private debt fundraising totalled a modest

$46.9bn

Twelve years later, in the peak fundraising year of 2021, the total raised was

$289.4bn

because they are more competitive when a borrower is borrowing lower levels of debt."

Anyone taking on bank finance should bear in mind that they are likely to be signing up to tougher documentation. Banks will still insist on certain covenants, designed to enable them to take rapid action if a company looks like it's starting to struggle. The erosion of standard covenants has been most evident at the larger end of the private debt market, but it's a phenomenon that, to a lesser extent, has made its way into mid-market private debt as well.

Stay firm

A lack of covenants may mean alarm bells don't start ringing when a borrower first experiences difficulties. And even when they have insisted on covenants, private debt lenders have a reputation for being less willing to strictly enforce them.

This isn't necessarily a bad thing according to Claire Madden, managing partner at Connection Capital, which provides high-net-worth and family investors with access to alternative assets: "The behaviour of private debt lenders has been very supportive. Where there's been a technical breach, they've been flexible and given borrowers the opportunity to come out the other side."

However, this is likely to come under more scrutiny as economic conditions put pressure on borrowers. "There's definitely more strain in the market and an expectation of more still to come, but at the moment actual enforcement action is not really increasing that much," says Stephen Edwards, co-managing partner at fund manager Soho Square Capital. "There are some covenant breaches going on, but the covenants are generally being reset, so there's an opportunity to get some additional fees. Traditional lenders find that more attractive than crystalising debt write-offs."

Debt funds' approach to covenant breaches could be seen as too soft on borrowers, but some believe it's a welcome contrast to the 2008 financial crisis, when banks were accused of acting too harshly. "Often, troubled assets were transferred to specialist parts of the bank where some pretty brutal triage went on," says Madden. "By contrast, private debt providers have the flexibility to be more creative in support for companies that are fundamentally good businesses, but are experiencing temporary trading challenges or structural issues." Banks and funds may have learned an important lesson from the crisis: bad debts in unsustainable companies should probably be crystallised as bad debts, while viable companies should be supported. Debt funds showed a bit more flexibility to do just this during the crisis, in some cases with debt-for-equity swaps.

There's an argument that debt fund professionals would not be well placed to take remedial action, even if they were so inclined. "Debt funds tend not to have many specialist restructuring people ready to jump into the more difficult assets, in contrast to banks where there probably are more people with grey hair who worked on restructurings in previous downturns," says Ayre. "Many banks still have dedicated restructuring units." Some of those restructuring units came in for a lot of criticism during the global financial crisis, perhaps inevitably.

Edwards doesn't believe we can rely on smooth progress: "The untested bump in the road will be that a huge majority of assets under management has been raised post-global financial crisis, and some of that will have gone into deals with lighter covenants. They have not really been tested so we don't really know how they will behave in a downturn or higher interest rate environment."

Even if private debt professionals aren't necessarily the best equipped to deal with any problems that arise, no one is suggesting this will derail their train. Edward says there are three reasons he thinks the asset class will grow further: "Private debt funds have deployed capital pretty effectively, the banks can't answer the needs that all companies have and there is very strong demand among the LP community for the private debt product."

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Bust banks and bigger risks

In March, Silicon Valley Bank (SVB), a relatively young bank focused on the tech sector, went bust, with the UK arm being acquired by HSBC for the princely sum of £1.

Stephen Edwards, co-managing partner at Soho Square Capital, says: "In the UK, SVB is known best for its venture debt product, providing loan capital to tech sector businesses at the smaller end of the market. So it seems likely that this activity will be curtailed in the short term, but it will not have a material impact on the market overall.

"The bigger risk is if the problems evidenced at SVB and Credit Suisse emerge in other institutions. This seems unlikely to develop into a system-wide crisis, but bank lending may well contract, creating an opportunity for creative credit funds to increase their market share.

"We have seen an increase in activity levels and demand for our structured solutions at Soho Square, albeit confidence may keep M&A market activity in the first half of 2023 for traditional funders more subdued than it was in the more exuberant 2022."