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Title:

A review of private credit in the immediate wake of COVID-19

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Key Points:

- Private credit has evolved to offer financing at all levels of the capital structure in any phase of the cycle.

- The intense fund-raising exercises of recent years evidence real focus on opportunistic lending which is seemingly well-timed in the wake of COVID-19.

- The hallmarks of flexible structuring, bespoke solutions and quick execution remain critical to the success of private credit.

Summary/Abstract

In the aftermath of the global financial crisis, private credit institutions emerged as being able to offer flexible financing solutions on short time frames when compared to more heavily regulated banks. Traditional bank lending inevitably had slower processes and more limited scope to support nuanced credits. The strengths of the private credit model may well permit those institutions to advance their position further in the post-pandemic landscape. Whilst all private credits funds have as their objective a strong economic return, the context of each investment will determine the optimal approach each institution will employ to achieve that result.

Main Article

Introduction

The economy is opening up again following the turbulent times and pressures imposed by COVID-19. Emergence, in particular as government support measures tail-off or are refocussed on other immediate issues (e.g. supply chain pressures, energy supplies), will allow for a more accurate assessment of the impact of the pandemic to be conducted.

Perhaps what is already clear is that private credit providers have to date stewarded their investments through the immediate issues without suffering the default rate many predicted at the outset. The steps taken in the early part of the pandemic by these investors to stabilise companies and avoid unnecessary losses, e.g. covenant waivers and interest deferrals, may now have to be reviewed and adjusted.

It is particularly notable that this realignment comes at a time when the debt markets are particularly liquid and significant private credit funds have been raised. This combination of factors seems to present an unique opportunity for direct lending across the spectrum, even if current distress levels are not those anticipated at the onset of the pandemic.

Evolution

It has long been a selling point of private credit that its providers can move quickly, structure investments flexibly and invest in credits that present challenges to mainstream banks.

Credit funds have also worked to eradicate what were once material limitations to their ambition, for example by offering ever-increasing cheque sizes or by tweaking their constitutional documents to provide new options in work-out situations, e.g. enhanced powers to provide follow-on financing. As a result, there are now very few levels of the capital structure, instruments or situations that direct lenders cannot compete in.

All of the above needs to be understood in the context of the extensive fund raising that private debt funds have conducted in recent times. It is apparent from market commentary that private debt funds have raised a significant amount of capital in recent times, and as a result there is a substantial amount of dry powder that will need to be invested. This increased liquidity will lead to increased competition and a broadening of scope and application for private credit, as investors are required to explore new terrain to generate returns.

The Spectrum

The willingness to formulate innovative and bespoke structures means that the spectrum of opportunity for private credit institutions is expansive and covers all phases of the investment cycle, including both primary and secondary investment and all parts of the capital structure.

In an attempt to better understand the approach private credit investors take, we will look first at the issues that these institutions consider when investing in the secondary market. We will then address how an analogous approach has developed in the context of a new primary investment. Finally we will review the behaviours we have seen these financiers adopt in the wake of COVID-19 and a run of potential defaults.

Secondary Investments

Secondary investments can have many objectives, which may adapt as situations develop. Such objectives range from the desire to better understand a credit through the acquisition of debt such that the financial institution is immediately in receipt of otherwise private information – a transaction which may be executed with minimal preparation - through to a more expansive objective to stake-build in a credit or even launch a loan-to-own strategy. These latter goals will require significant diligence and preparation in order to determine the optimal implementation route.

More intricate investments will require private credit funds to pay attention not just to the longer-term strategy to maximise returns from the investment, but also to the immediate steps that need to be taken to achieve that end. This means undertaking a detailed analysis of the mechanics and terms of control in the relevant debt instrument, and identifying the legal and practical ways in which those levers can be pulled to deliver the objective. Typically this requires not only a deep understanding of the covenants, voting thresholds and mechanics and intercreditor issues, including enforcement options, but also a thorough appreciation of the applicable legal and regulatory frameworks. The ability and willingness of a private credit fund to work quickly through these fundamental issues and develop creative and bespoke solutions to manage risk allow them to pursue secondary investment strategies across the spectrum.

New Investments

Whilst the original focus was on middle market transactions, private credit funds have deliberately and strategically evolved to be in a position to provide financing in virtually any context. This strategy is clear in the proliferation of distressed and opportunistic funds raised in recent times, and the interesting changes made to those funds' constitutional documents giving them increasing scope to invest in different instruments on flexible terms. This breadth of scope means that private credit investments can sit alongside traditional financing in the same structure, as well as constituting the only indebtedness in a structure.

Whilst the fundamental aspects of any new financing, regardless of the institution providing it, are the same – return, control and downside protection – the ability of private credits to tailor their approach on each of these factors means that the terms they can offer debtors are not static and can flex to meet commercial objectives in any given context. An obvious example of such creativity is the well-reported financings involving the use of unrestricted subsidiaries. In this situation, all aspects of the structure present a degree of complexity and risk to be assessed and managed – the transfer of assets to the unrestricted subsidiary, the valuation of those assets, an assessment of the anticipated response of incumbent creditors in the structure, and whether the structure ultimately satisfies the overall objective of the intended transaction. These issues must be judged in parallel with, and in addition to, the usual issues of diligence, e.g. assessing the financial case, and agreeing commercial terms and covenants.

Similarly, there is a burgeoning market in Europe for third-party financed rescue or bridging loans in the context of a restructuring process. Without the "debtor-in-possession" regime seen in the United States, it has traditionally been difficult for creditors not already in a capital structure to provide short-term financing in a work-out. However, there have been notable cases where private credit funds have been able to structure rescue financings with structural and/or contractual protections as well as strong economic terms whether that is coupon, OID (original issue discount), day-one fees, non-call premia or a mixture of all of the above. Offering such financing requires an understanding of the nature and extent of distress the debtor is facing and the options available to solve for those underlying issues, as well as structuring new money with maximum protections and reward.

Even within the niche of such financing structures it is clear that the weight each of the factors will be assigned, and the optimal way to address any issues, will be different from transaction to transaction. It is this intellectual and practical flexibility that debtors look to private credit for. Debtors ask private credit funds to distinguish perceived risk from actual risk, and implement strategies to mitigate actual risk to the extent possible.

Reaction to COVID-19

There was some speculation early in the pandemic that private credit institutions may have less appetite or ability to direct significant work-outs, and that the limited liquidity in private credit investments would make shifting exposure too difficult. It was therefore assumed that such investors would move quickly to foreclosure when faced with the wave of defaults it was first thought the stifling of the economy would prompt.

Whilst it remains too early to fully appreciate what the real impact of COVID-19 may be on the financial markets more generally, it is possible to say that private credit funds, like their more traditional counterparts, worked hard in the pandemic to stave-off defaults and provide their portfolio investments with interim support to bridge the worst of the immediate impacts of the economic shutdown. Although data is not available to determine whether that support took the form of new money investment or simply interest and covenant waivers and deferrals, private credit clearly played a huge role in stabilising borrowers.

Certainly COVID-19 did nothing to slow down fund raising efforts by private credit institutions, and some funds have taken the opportunity to extend further the scope of their potential investments and therefore be even better placed to compete for investment when the opportunistic markets heat up.

Conclusions

Despite private credit originally having been viewed only as an alternative to traditional bank-debt for mid-market “plain vanilla” transactions it has arguably now become the most innovative, flexible and competitive part of the finance market.

What the lasting impact of the ascendancy of private credit will be is hard to predict. Some believe that traditional creditors will try and cage private credit by pushing for structures and terms that make direct lending opportunities harder to come by and riskier to pursue. However, this does not seem to be the direction of travel when one looks at documents and structures advanced in the last twelve months. Others take the opposing view that the need for private credit funds to invest the huge amounts of capital raised and the comparative advantages of private credit as against traditional banks, will drive a race to discover and develop new structures and to exploit existing opportunities, both commercial and structural, on increasingly competitive and favourable terms.

Certainly, as it becomes possible to build a clearer picture of the lasting effects of COVID-19, private credit funds seem extremely well positioned to move quickly and decisively.

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