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What's Market: 2022 Year-End Trends in Large Cap and Middle Market Loan Terms

by Practical Law Finance

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An Expert's View: Developments in Direct Lending and Private Credit

Christopher Nairn-Kim of Davis Polk & Wardwell LLP discusses developments in private credit.

What were the key trends in loan documentation and overall deal structures that occurred in the private credit market in 2022?

Much like the other sectors of the credit market in 2022, private credit faced a tale of two halves last year, but with a particularly distinct Q3 as compared to the syndicated market.

Early in the year, let's not forget we were seeing some of the largest leveraged buyouts in history being signed up, often supported by committed financing from a mix of lenders looking to syndicate their position and direct lenders. This raised incredibly interesting technical questions around how these financing sources should interact during the commitment and (partial) syndication phases of a given transaction. As you might expect, this also had an impact on documentation terms, as sponsors continued to push lenders for more covenant flexibility, and the convergence of terms between the syndicated and direct lending markets we saw in 2021 continued.

But as interest rates continued to rise and uncertainty in the market became more pronounced, Q3 saw syndicated financing structures largely fall away, giving way in many cases to private credit solutions. The core direct lending model of underwriting terms based on what lenders are willing to hold in the long term, combined with the certainty of terms direct lenders are able to provide up front (for example, the absence of any market flex, particularly with respect to pricing terms), offered an attractive financing solution to prospective borrowers. On the other hand, there was also increased strictness around negative covenants during this time, in part as a reaction to the prior convergence with syndicated terms. This movement continued through the end of the year, and we expect it to continue deep into 2023.

Moving into Q4 of 2022, with slowed M&A activity as a backdrop, new issuance activity levels were down across the board. The results of this lower activity were two-fold:

- Relationship-based portfolio management, including amendments, tack-on incremental facilities, and LIBOR transition amendments, all became more of a focus for both borrowers and lenders, highlighting once more the importance of the relationship aspects of private credit.
- A newer set of private credit providers sought to step in and fill a gap in new issue supply, seeking to establish stronger relationships with borrowers in the process. As a result, we saw an increasingly diverse list of institutions become part of (and take leading roles in) the club deals that were assembled to finance a generally smaller number of select M&A processes.

As additional debt/leverage of borrowers remains one of the chief concerns of lenders, how have direct lenders addressed this concern in loan negotiations during 2022?

One of the themes in the loan market that has contributed to permissibility around additional leverage is "reallocation." It comes in many shapes and sizes, such as the reallocation of the general debt basket to the incremental free and clear prong, and reallocation of restricted

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payment or investment capacity to incur additional (sometimes secured) debt, all of which contributes to a higher potential leverage profile. Although provisions like these are historically more common in the syndicated lending space, given the convergence of terms in late 2021 and early 2022, and the commitment many borrowers have to their preferred precedent, we expect this to continue to be a real concern in the direct lending market.

To address this concern, we have seen private credit providers seek to limit any reallocation proposed in new underwriting terms, and also be particularly mindful of the precedent document being proposed by prospective borrowers. Taking the time to dig into the terms of any proposed precedent before agreeing to its appropriateness has always been a critical part of the underwriting process for direct lenders, but given the factors described above, it has recently taken on a new level of importance. Although this process can be time-consuming, we find these conversations are most effective when employed early in the negotiation process, at which point lenders will be able to negotiate appropriate modifications to the proposed precedent or put forward a different agreement entirely.

How do you expect the direct lending market to continue to develop? Are there particular issues in direct lending transactions that may garner increased attention in 2023?

It has become increasingly clear that private credit providers will continue to play a crucial role in the largest and most complex leveraged finance transactions going forward. An uncertain economic environment will not only continue to highlight the importance of non-syndicated financing options as a source of liquidity, but will also continue to drive the industry's recent recommitment to discipline around terms.

This is particularly the case with respect to the potential for credit leakage, for example, resulting from guarantee and collateral releases, distributions and investments outside of the credit group, and restricted debt payments. Similarly, as the popularity of liability management transactions grows, so too will the resolve of direct lenders (and other credit providers) to shut off the ability for borrowers to both incur priming debt in so-called up-tiering transactions and shift assets into non-guarantor and unrestricted subsidiaries.

Setting aside future underwriting activity, it is worth noting that many direct lenders currently find themselves with a much larger active portfolio than ever before, spanning a wide range of industries and geographies. Depending on macroeconomic conditions, with default rates increasing, we may well see the relationship model of private credit come under stress as borrowers seek an increasing number of covenant relief amendments and ultimately engage in restructuring negotiations with their respective lender groups.

And of course, there will be new opportunities for many market participants in 2023. For example, we have already seen certain lenders traditionally in the business of providing syndicated financing solutions now allocating capital to private credit functions of their own, with a view to offering borrowers a one-stop-shop for all their financing needs. Combined with the increased participation rate of other new private credit providers, this is likely to result in a healthy level of competition within the market for leading roles in new transactions, as well as a heightened level of support from lenders clubbing together to fill borrower financing needs.

We also expect to see strong activity levels in energy, infrastructure, and related assets over the coming year. The flexibility offered by direct lenders, combined with their ability to lend into structures and circumstances that may be more challenging in a syndicated environment, may well prove to be an opportunity for willing private capital providers to deploy resources in an industry traditionally dominated by other financial institutions.

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