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What's Market: 2021 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

David Hahn of Davis Polk & Wardwell LLP discusses developments in direct lending in 2021.

Private credit surged in 2021, underlining the attractiveness of direct lending as a source of capital for sponsors and borrowers. Why has direct lending become so popular?

The popularity of direct lending can be traced to a number of factors, including:

- **Speed of execution.** Direct lenders are able to close transactions on more compressed timeframes as compared to syndicated transactions. There is no need to market the debt facilities, which can be a time-consuming process that involves presentations to third parties such as rating agencies and marketing to prospective lenders. Since the terms agreed by a direct lender are usually not subject to any "market flex" (negotiated flexibility to adjust specific terms based on market response) and do not require any review period by a potential lending syndicate, deal timelines are typically shorter for direct lending transactions. This is especially attractive in an M&A process that requires an accelerated closing based on the negotiated terms.
- **Certainty of terms.** Most direct lending matters are not subject to market conditions since direct lenders underwrite terms based on what they are willing to hold and the level of risk that is acceptable to them. This aspect of direct lending, coupled with an absence of marketing and market flex, provides greater certainty on the terms of a financing. This is particularly important, especially as it relates to economic terms.
- **Flexibility.** Direct lenders are not limited by restrictions, such as prudential leverage limits, applicable to regulated banks that syndicate loans or by potential constraints among a syndicate of institutional investors that may have their own standards to be satisfied. Furthermore, direct lenders can lend into structures and circumstances that might be more challenging in a syndicated environment, including where:
  - borrowers lack customary financials for syndicated deals;
  - EBITDA may not be an available or useful metric; or
  - there is a more complex capitalization or organizational structure.

  Direct lenders are able to offer products that are tailored to a borrower and that simply may not be available through the syndicated market.
- **Partnership.** Direct lenders foster strong relationships with their borrowers and generally view the arrangement as a long-term partnership. Individual direct lenders or small groups or clubs of direct lenders can more quickly provide capital to finance growth and acquisitions in good times. In more challenging times they can act more efficiently if the need for an amendment or other difficulties arise.

What were some of the most important negotiating points in direct lending transactions in 2021?

Some of the most important negotiating points for direct lenders are negative covenant exceptions (especially with respect to the ability of borrowers to increase leverage and baskets that could permit leakage, or deterioration of the initial collateral and guarantee configuration), EBITDA addbacks, financial covenants, borrowers’ ability to effect lien or payment subordination and collateral, and guarantees. Leakage is commonly the most highly negotiated point or at least one that draws the most attention in direct lending. This is because direct lenders are motivated not only to ensure both a sufficient collateral and guarantee package at the initial closing of a transaction but also to protect against dilution or adverse changes to that package in the future. Leakage may result from any number of factors, including:

- Exceptions and exclusions that lead to releases of existing guarantees or collateral or the failure to obtain future guarantees or collateral.
- Distributions or investments outside of the credit group.
- Acquisitions of assets that do not become collateral and entities that do not become guarantors.
- Prepayments of junior lien or subordinated debt.

How do you expect the direct lending market to continue to develop and are there particular issues in direct lending transactions that may garner increased attention in 2022?

The direct lending market has experienced extraordinary growth and maturity over the last several years and we expect its upward trajectory to continue in 2022. One especially noteworthy trend is the growing number of jumbo or megatranche direct lender financings in excess of $1 billion. We have seen a proliferation of these deals in the private credit market recently, with new issuances of this type becoming more common as direct lenders increasingly demonstrate the capability to successfully execute them and hold ever-larger positions. This happens to coincide with a period of immense fundraising by private equity sponsors (paired with correspondingly significant dry powder among direct lenders) and heightened interest in pursuing M&A “mega-deals” requiring multibillion dollar financings, all of which presents favorable conditions for private credit megatranche transactions to flourish.

Another potential area of attention is cross-border deals, where we expect to see increasing activity in the coming year. Cross-border financings often warrant a particular emphasis on transaction structuring. Issues such as the scope of guarantees and collateral (and related local law limitations), structurally senior debt, investments outside of the credit group, and protections regarding transferring material assets to parties outside of the credit group may be pronounced and receive more attention. Capacity to lend in multiple currencies may also take on increased importance. Industry participants will need to be prepared to evaluate the specifics of each potential transaction and find creative solutions to what will likely be individualized issues.

Direct lenders are well-positioned to capitalize on a greater prevalence of cross-border financings because of their flexibility to address complex capital structures and offer financing solutions to borrowers with unorthodox organizational configurations or non-standard asset types or financial information. The fact that direct lending institutions are already accustomed to analyzing these types of issues and structures bodes well for their cross-border prospects.

With the growth of direct lending, the loan market has seen an increase in the size of direct lending deals. How has this impacted direct loan transactions?

Probably the most notable impact has been an increasing convergence of terms between the direct lending and broadly syndicated markets in larger transactions as an outcome of amplified competition for these matters. Direct lenders are frequently providing multiple financing options to private equity sponsors and corporate borrowers. These may include both syndicated and direct possibilities depending on the direct lending institution.

Even direct lenders offering strictly private credit optionality will often take anchor positions in syndicated loans or commit to an entire facility that is part of a broader syndicated financing, such as junior capital (for example, second lien facilities) or a delayed-draw facility. As a result, direct lenders have deep institutional knowledge of current market terms for broadly syndicated deals and have been willing to harmonize certain terms under the right circumstances. However, despite this mounting convergence within larger deal profiles, direct lenders have generally sustained their assiduous attention on overall leverage, the integrity of collateral and guarantee packages (and potential dilution or leakage) and maintaining seniority in the capital structure.

Interestingly, it is not just direct lending debt deals that have been increasing in magnitude. In recent private equity-backed leveraged buy-outs, we have seen direct lenders commit to purchase preferred equity issued at a parent level above the credit group for a concurrent debt financing (in which case the direct lenders are often providing all or significant portions of the debt financing as well) on a more frequent basis. The sizes of these preferred equity financings continue to climb. Additionally, direct lenders may seek common equity co-investments in connection with an acquisition for which they are providing debt financing.