Direct lenders look to snatch deals from levfin market in next LBO wave

By Silas Brown September 09, 2021 09:33 PM

With heavy financial firepower, private credit funds want to take advantage of the LBO pipeline

Private credit funds in Europe are aiming to pluck larger LBOs from the banks over the next few months, following successful high profile attempts to do the same in the US earlier in the year.

In June, private equity firm Thomas Bravo managed to sign $2.6bn of debt financing for its buyout of Stamps.com, as well as a $2.3bn unitranche loan for the acquisition of Calypso Technology all through private credit funds.

There is in excess of €40bn worth of visible transactions in the European leveraged finance pipeline for the remainder of the year, according to JP Morgan. Direct lenders hope to take some of that flow to the private side.

“Following the trend in the US, we are expecting to see more large LBOs being financed by larger direct lenders in Europe in the future,” said Andrew McCullagh, a managing director at Hayfin. “Some of the frictional areas in more traditional syndication processes are the cost of underwriting, the risk of upward flex, the time required of management teams, certainty of execution and the challenges around confidentiality when providing data. That’s where we’ll see direct lenders stepping in to make sponsors more comfortable. Ultimately, sponsors can reduce hassle and risk without materially increasing cost by speaking to one private lender instead of a syndicate.”

Conventional forms of leveraged finance have very clear advantages to private debt instruments. Typical financing for leveraged buyouts can be priced as tightly as 350bp over Euribor, which is almost impossible for direct lenders — which can stoop to the mid-500s — to match. Also, at least historically, private credit funds expect tougher covenant packages than traditional leveraged lenders.

But where traditional LBO financing competes on price and fewer covenant protections, direct lending can offer more bespoke packages with speed, privacy and certainty of execution.

“Many syndicated deals are ‘cov-lite’ or ‘cov-loose’ or utilise incurrence-based covenants rather than maintenance-based ones,” said Aymen Mahmoud, a partner at McDermott Will & Emery. “Whilst some private credit deals do feature cov-lite or cov-loose, the vast majority do not. Direct lenders instead offer other documentary flexibility that bank lenders do not, such as more sponsor-friendly transfer restrictions. They also offer, by virtue of type of capital they deploy, more flexibility on leverage multiples, speed of deployment and they have no need to syndicate (meaning no need for pricing or terms flex).”

While a large crop of direct lenders have the capacity to push into large cap LBOs, there are a few including Blackstone, Goldman Sachs AM, HPS, KKR and ICG that have a more explicit intention.

These firms have shown more flexibility when it comes to covenants, according to Richard Meehan, executive director within Pemberton’s origination team. “The guys that are more geared up in that large cap space have a more relaxed approach to documentation, whereas the guys that will dip in and out will probably have certain restrictions where they actually do need a covenant or there will be a pricing premium,” he said.

One market source knew of two prospective LBO deals — one for an insurance business and another in leisure — where a decision has yet to be made whether to go public or private.

The most likely LBOs to go down the private route in the next few months are still somewhat left-of-centre, according to Floris Hovingh, a managing director at Alvarez & Marsal. “Where I’ve seen unitranche successful is for instance with companies that have high pro forma Ebitda, where there have been multiple acquisitions and synergies but the actual Ebitda numbers are significantly lower, which is much harder for rating agencies to give benefit for.

“The other way is when the debt stack will go deep in the capital structure, which would mean taking the traditional syndicated route for first and second lien and a PIK note structure," he added. "With direct lenders, you can just print a unitranche in a very short time frame without a roadshow and associated syndication risk.”

Direct lending in Europe has grown close to $200bn in assets under management, according to market sources. Due primarily to the sheer volume of cash being raised in direct lending, many expect further encroachment into public markets. “We will see more high profile LBOs,” said Hovingh. “There’s so much money being raised and the only way to deploy it is with ever larger LBOs.”

The standout European trade so far to have side-stepped traditional LBO debt financing was from Irish insurer Ardonagh. Last year, it raised a £1.575bn unitranche loan alongside a £300m committed capital expenditure facility to refinance its capital structure and buy insurance brokers Arachas and Bravo. Direct lenders involved in the deal included Ares, HPS and KKR.

However, there have been a few hiccups. Advent was offered a €1.5bn unitranche loan from GSO (now called Blackstone Credit) in 2019, to finance the leveraged buyout of German chemicals firm Evonik. However, the private equity firm instead opted for traditional leveraged finance.

Covenant protections

While many on the leveraged finance buy-side grumble about the disintegration of investor protections, companies still manage to get deals through. This is partly because of an active secondary market, which allows investors a quick option to shed exposure if a credit turns sour.

For private credit funds, that option does not yet exist. “We don’t have a secondary market to sell into so our options are more restricted,” said Pemberton’s Meehan. “That’s why firms like ours maintain discipline on docs and require a covenant in our unitranche funding.”

In essence, direct lenders must be prepared to take the keys of a business if the going gets tough, which may be an impediment to large cap lending. "You have so much money at stake, that barrier of certainty is much higher without the comfort of a secondary market to sell (admittedly at a discount) into," said one fund manager.

But some leveraged finance bankers are still worried. “You can sell out of leveraged loans but it's by no means perfect,” said the head of high yield at a European bank. "Investors can still lose a lot of money in the trade. If you just look at the sheer firepower of the direct lenders now, when compared with even two or three years ago, it's enormous. You can't deny that they are growing in stature — and have been particularly during the coronavirus."

“Once upon a time, direct lenders were subject to the perception from certain corners of the markets that they were akin to distressed or vulture investors that wanted to break a business apart and/or own it for themselves,” said Mahmoud. “But the growth, track record and patience of direct lenders during difficult times, in particular throughout the pandemic, has helped to dispel this perception in the private equity space specifically."

Many people in both leveraged finance and private credit have told *GlobalCapital* that they expect private credit to grow into a competitive alternative for large and mainstream LBOs in the coming years. In the future, a sponsor will decide whether to concede on margins for certainty, speed and privacy, or do the reverse.

"There will be that differential pitch which will come down to a decision on pricing flexibility versus certainty and simplicity," said Meehan.

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Last updated on September 10, 2021 11:45 AM