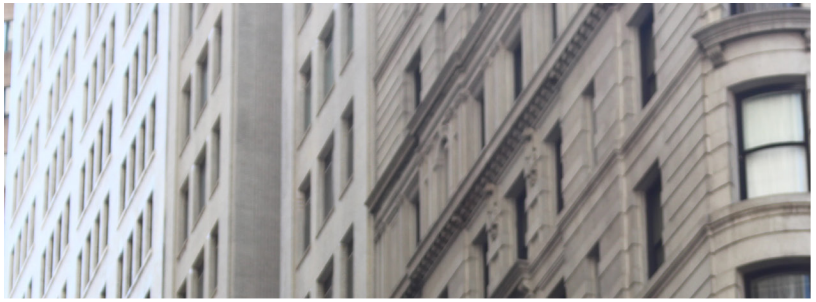
INSIGHTS

NOVEMBER 2022







PRIVATE EQUITY WIRE



CREDIT DUE

HOW BUYOUT FUNDS ARE BYPASSING A TIGHTER BANK MARKET

EXECUTIVE SUMMARY

A decade of cheap money is over and buyout funds are facing a significant change in the way they do business. The lifeblood of the leveraged buyout market – bank syndications – has slowed to a trickle and debt is either hard to come by here, or too expensive at the levels required. In normal times, the adjustment would be slow but the simultaneous threat of a deep downturn in the US and Europe has focused minds. The situation has massive ramifications for deal volumes into 2023: just $10.6 billion of leveraged loans were raised to fund buyouts by US companies in Q3 – the lowest reading in almost seven years. In a survey by Private Equity Wire, over 70% of private equity GPs said they expect a decrease in deal volumes during H1 2023 due to new borrowing conditions. The same number said increased debt pricing was their greatest concern. Ructions in the debt markets are throwing a spotlight on a group once known as alternative lenders: credit funds. The ability of direct lending credit funds to fully replace large,syndicated loans is in question though and they will have to mature quickly. A growth in allocations from institutional investors is in their favour. In the meantime, private equity sponsors may need to structure some of their buyouts differently, focus on incremental financing and look for leverage in other places.

COLIN LEOPOLD
HEAD OF RESEARCH & INSIGHT

CONTENTS

KEY FINDINGS 3

CHAPTER 1 - LEVERAGED FINANCE 4

CHAPTER 2 - CREDIT FUNDRAISING 13

CHAPTER 3 - FUND FINANCE 21

CHAPTER 4 - DEBT RESTRUCTURING 29

METHODOLOGY

Approximately 50 private equity fund GPs were surveyed by Private Equity Wire during September and October 2022 for their views on debt financing, credit funds and fund finance. Of those surveyed, 76% said they were involved in a debt process either at fund or asset level at the time of their response.

KEY FINDINGS

1

Hung banks will limit LBO volumes

Overstretched syndicated banks are limiting the amount of debt that is available for buyout fund sponsors. The situation is expected to impact the size and type of buyouts over the coming months. In a survey by Private Equity Wire, around 70% of private equity GPs said they expect a decrease in deal volumes during H1 2023 due to new borrowing conditions. The same number said increased debt pricing was their greatest concern. Direct lending credit funds with dry powder will shape the market.

2

Credit fund allocations swell

Institutional investors, particularly pension funds, have been willing to assume greater credit and illiquidity risk in exchange for higher returns in private credit. Credit fundraising this year is on par with 2021: managers raised $82billion across 66 funds in the first half of this year and direct lending – which tends to benefit from rising interest rates by using floating rate instruments and has comparatively lower volatility – continues to be the standout strategy.

3

GPs look for leverage elsewhere

With the cost of acquisition debt rising and a more uncertain dealmaking environment emerging, NAV-based loan requests are picking up with many of the top tier private equity firms investigating how they can use the structure to boost liquidity. A survey by Private Equity Wire found that more than 60% of GPs will continue or increase their use of fund finance in the current macro environment. The interest of larger private equity funds in NAV-based loans will test the capacity of lenders.

4

Loan restructuring wave builds

Although loan defaults are expected to remain below levels seen in previous recessions, a wave of debt restructuring among private equity-backed companies is expected to build during 2023. Sponsors with excessive leverage which operate in cyclical industries will be the most vulnerable. The prevalence of covenant-lite loan structures may give them an upper hand over bank lenders in any debt restructuring though.



WITH BANKS HUNG ON LBOs, DIRECT LENDERS CONTROL THE FLOOR

The carnage in the syndicated bank market looks set to continue and the near-term liquidity of direct lenders is being squeezed. Private equity sponsors are looking for other levers to pull on their buyout financing

There is a problem in the bank market.The leveraged buyouts, or LBOs, which have characterised private equity over the past decade have left banks on the hook for more than $50 billion in financing commitments, which they underwrote in more stable times.

Loans that haven't been pulled by sponsors or offloaded by banks at a steep discount are expected to be "puked into the market" by early next year, says one New York-based banker.

"The downside is that in 2023, as banks figure out how they're going to deal with this, you then have a real economic slowdown, which creates an even bigger problem," says the banker.

For now, the situation has left banks acting "flaky" on buyout transactions, says a second banker in Europe, and private equity dealmakers without a major source of funding.

"There is no sugar-coating it," says a partner at a European private equity fund with over €10 billion AUM, "the public debt market for LBOs is virtually shut and that has a lot of ramifications for investment in that zip code, but also for the entire industry. If you are large cap fund, and that is historically the way you finance yourself, you are facing a significant change in the way you operate."

Just $10.6 billion of leveraged loans were raised to fund buyouts by US companies in Q3 – the lowest reading in almost seven years, according to Leveraged Commentary & Data.

In Europe, it's possible for GPs to "piece some debt together if it's below €200 million but it's super expensive and getting above €200 million is virtually impossible", says a managing director at a well-known global private equity firm.

In a survey by Private Equity Wire during October, over 70% of private equity GPs said they expect a decrease in deal volumes during H1 2023 due to new borrowing conditions. The same number said increased debt pricing was their greatest concern.

The crisis has presented an opportunity for others in the lending market, however.

In a second advance since the Global Financial Crisis and the stricter bank regulations that followed, private credit has a solution.

"In 10 years, [direct lenders] have gone from being a backwater to now, they're like the Pacific Ocean," says Jonathan Bray, partner and fund specialist at law firm Clifford Chance.

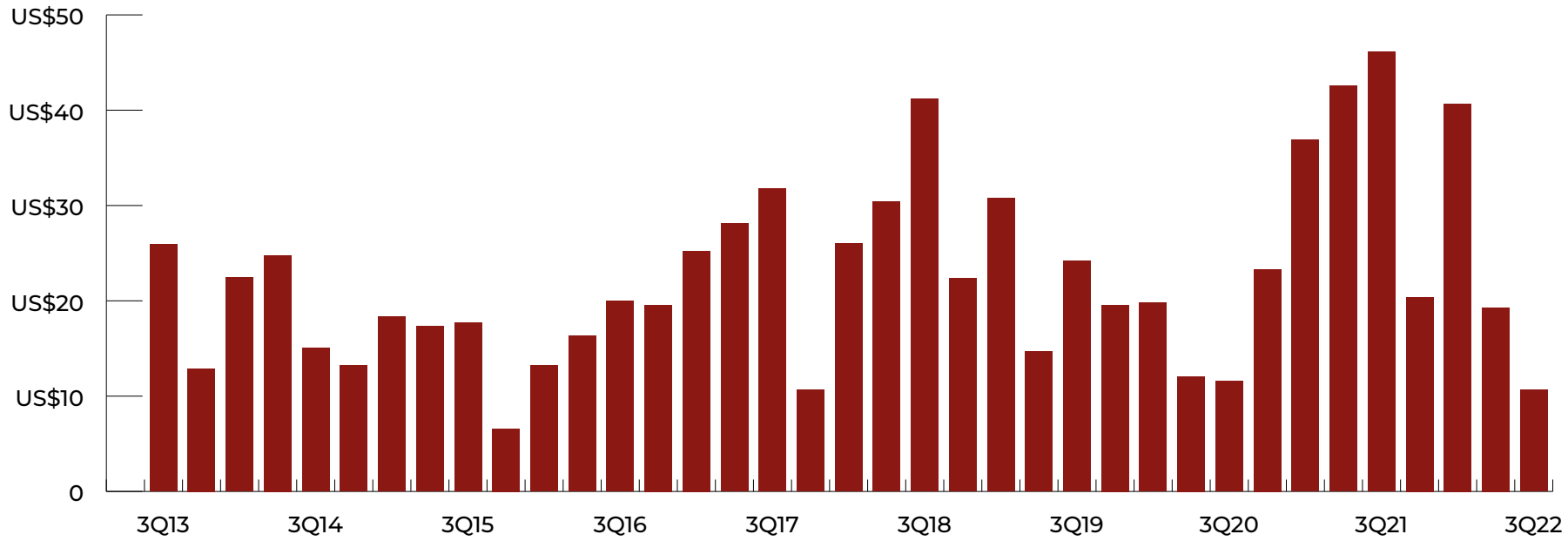
Yet, at the same time, concerns are growing about the depth of their near-term liquidity, their selection bias towards certain sponsors and sectors and whether, in a deep recession, they may face some problems of their own.

Bank bellwether

One of the largest LBOs of the year was also a bellwether for banks and their private equity clients. The take-private of software company Citrix, announced before Russia's invasion of Ukraine, saw banks in September selling $4 billion of bonds at a discount of around 83.6 cents to yield 10% and one of the co-sponsors stepping in to rescue $1 billion of the debt. Speaking to the Financial Times, one banker involved described it as a "bloodbath".

For the lead sponsor Vista Equity Partners, it was a turning point. A second and third LBO, for Avalara and then KnowBe4, continued but the billions of dollars in combined loans required went to a group of private lenders.

Figure 1.1 LBO volume sinks in Q3



Analyst note: Data correct up to Sept. 30, 2022
Source: Leveraged Commentary & Data

“What I believe is happening is private credit today is going through a phase that private equity went through 30 or 40 years ago”

Thierry Aoun, partner, IK Partners

In a recent interview, Vista's CEO and Founder Robert F. Smith described it as a dynamic he is now seeing across the marketplace. "[Private lending market has gone] from 10 or so lenders to now about 30 or 40, and so you may have to go to a few more, but we still see the ability to get deals like KnowBe4 done, Avalara done in these private markets as opposed to relying on syndicated debt markets".

Others agree. The first banker quoted says he has handled 80 direct lending transactions since the Ukraine war began – twice last year's total. Earlier this year, Hg and TA Associates concluded the largest private debt financing transaction ever undertaken in Europe, with 16 funds competing.

Direct lending's roots lie in smaller, mid-market transactions, typically with higher pricing and tighter covenants. But in the current market they represent certainty of funding. The typically smaller lender groups involved can also move quickly on transactions, price loans that don't 'flex' upwards during syndication and take a longer-term view on more risky private equity buyouts, say people working in the market. It's a situation where in some cases, as with Elliot Investment Management on Citrix, the same company is providing debt and equity on the transaction.

"Often, direct lenders are clearly aligned with the strategy of the companies," says Thierry Aoun, a partner who leads acquisition financing at private equity firm IK Partners, "and they allow you to grow there notably by putting at the disposal of the borrower incremental indebtedness swiftly, so we have been embracing that technology."

With banks launching their own debt funds and direct lenders opening the door to co-investment from their LPs, lender groups are becoming increasingly blurred. But as more private equity borrowers are forced to open up to these new lenders, there are fears that short-term private credit liquidity may be running dry and borrowers without strong relationships in the space may struggle to raise debt at all.

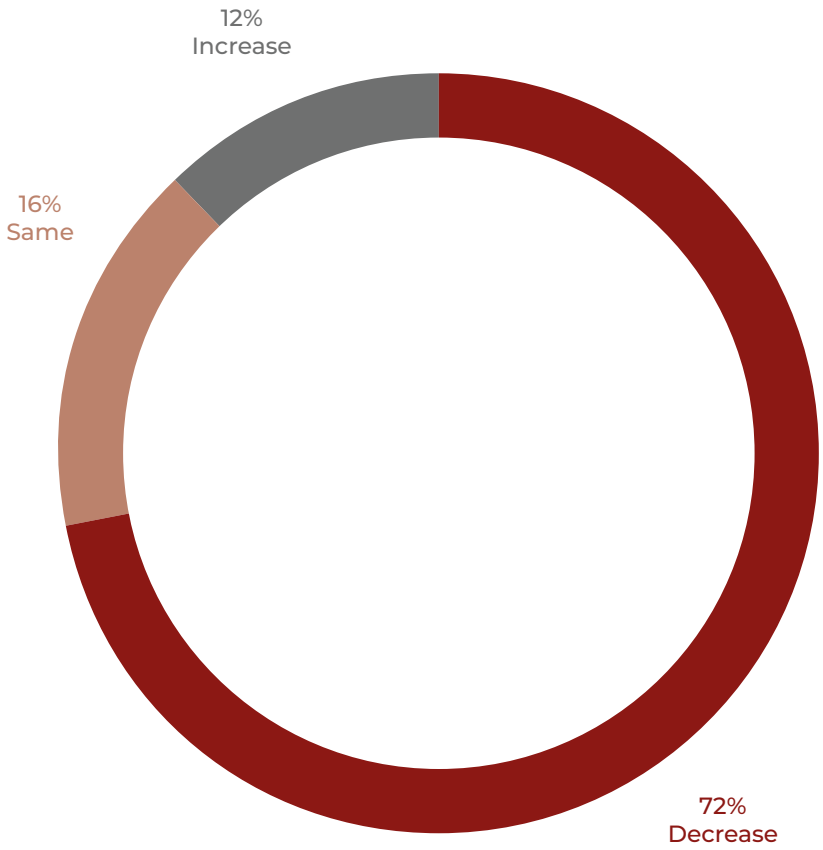
Plumbing liquidity

As of Q2 this year, direct lending dry powder stood at $68.7 billion globally, according to PitchBook. The figure has grown only 6.8% since 2018 amid rapid deployment. With single asset concentration limits, even large credit funds can struggle to provide the debt tickets needed on a leveraged buyout. According to Bloomberg, Thoma Bravo needed six direct lenders to provide $1 billion for the Ping buyout it completed in October.

"The depths of [direct lender] liquidity may have been plumbed in the last couple of months," says Richard Day, a partner who works on LBOs at Clifford Chance. "The market has been tested and it seems like direct lenders are becoming more selective, deploying a little bit more slowly and if they feel they have done enough for the year that's going to really complicate the picture for a sponsor looking to raise debt."

This selection bias may disadvantage capex-intensive industries with excessive customer concentration and sectors which don't align with the ESG mandate of their LPs,

Figure 1.1b Survey asked 'How will increasing interest rates impact private equity deal volumes in the first half of 2023?'



Source: Private Equity Wire survey, September 2022

as well as specific private equity sponsors.

"A lot of these funds now are saying 'look, actually, even though I have a lot of dry powder, it is reducing very quickly but I also need to be loyal to the [private equity] funds that I have always transacted with'," says the European private equity fund partner. "There are some [private equity] funds who are struggling much more to get the love they need from the private credit funds… and it has become more expensive."

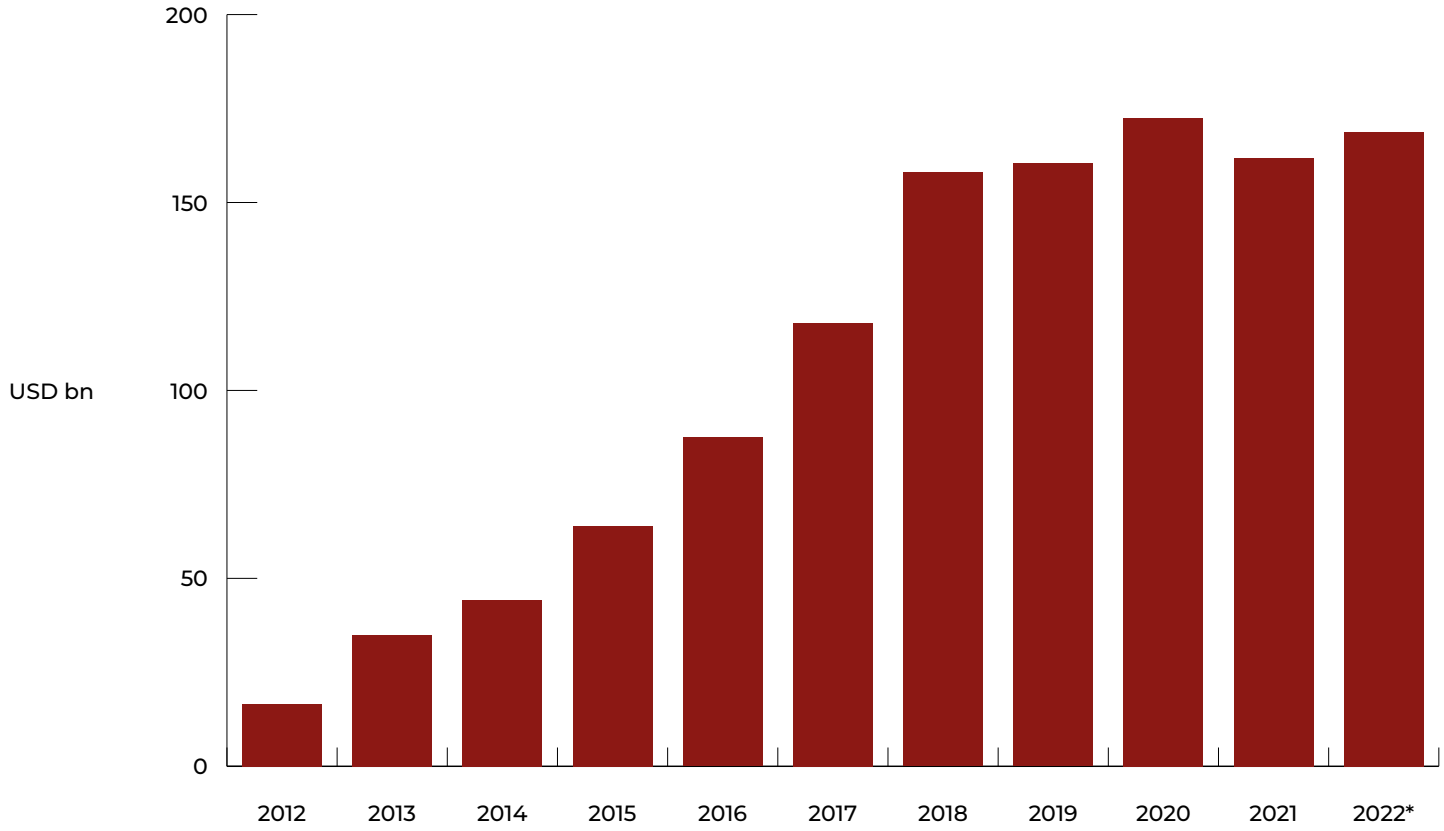
"[Direct lenders] have to be compelled by either a strong situation, good returns on the underlying position, or strong relationship with the sponsor to extend credit," says James Blastland, a partner in Deloitte's debt advisory practice. "The more resilient sectors, the more predictable sectors that have lower standard deviation of outcomes, will likely be those that get support."

Debt fund liquidity could also be squeezed further during a severe downturn in 2023 if fund redemptions spike and cracks appear in credit portfolios.

"The smaller, less-established companies that disproportionately comprise private credit portfolios are likely to be less resilient to business stresses from inflationary cost pressures and higher interest rates than larger, higher-rated companies," said credit agency Moody's in May. In a report, it claimed that a broad deterioration in borrower credit quality in private credit has the potential to cause "cascading disruptions across the capital markets and the broader economy".

"As private lending is largely opaque,"

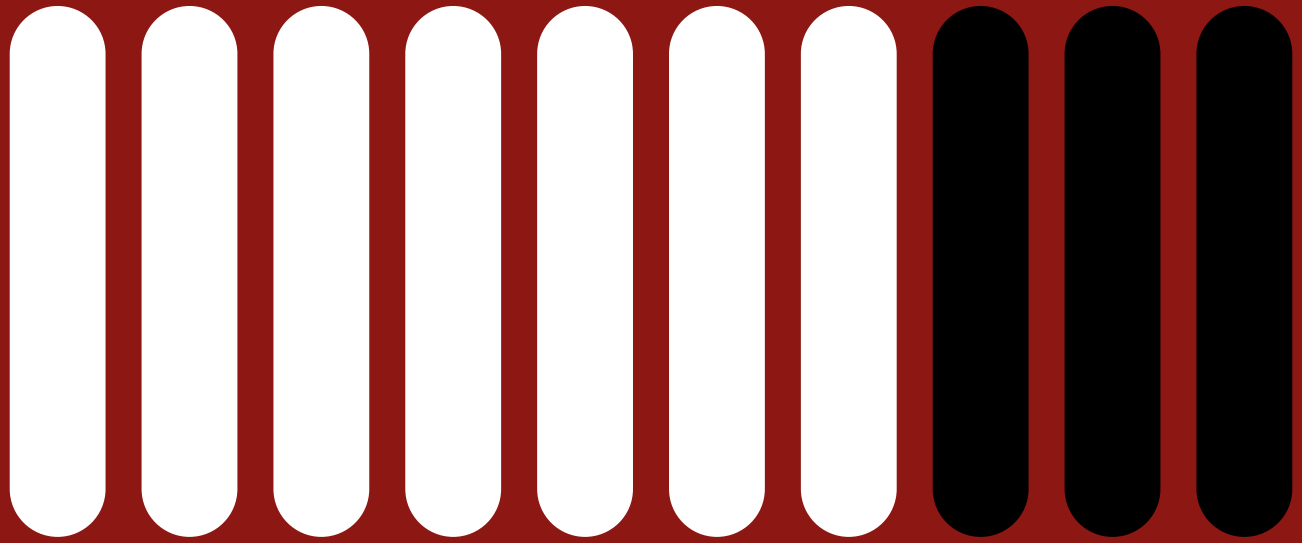
Figure 1.2 Direct lending dry powder



Analyst note: Cumulative dry powder up to 30 June 2022.*
Source: PitchBook

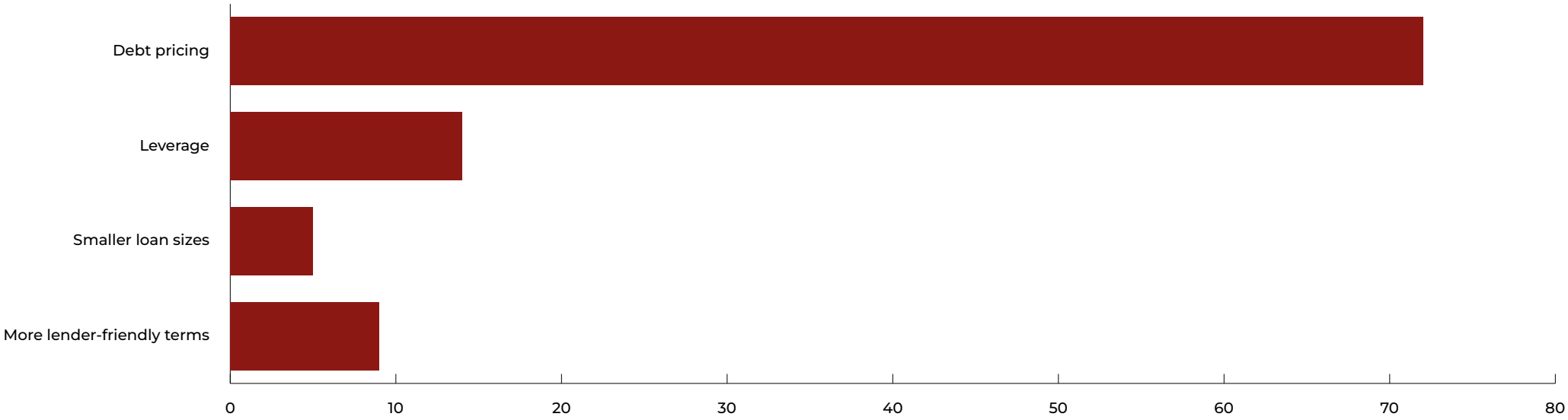
KEY FINDINGS

Increased debt pricing is the greatest concern for seven out of 10 private equity sponsors



INSIGHTS

Figure 1.3 Survey asked 'In the current macroeconomic environment, which one factor is most concerning to you?'



Source: Private Equity Wire survey, September 2022

it wrote in June, "asset quality risks are growing, which may be hard for market participants and regulators to discern until it is too late to counteract."

With banks gummed up and direct lenders being squeezed, private equity dealmaking may slump, but it won't die completely. Sponsors are already turning to smaller bolt-on acquisitions that require less debt and, in many cases, they have borrower provisions to incur debt at higher multiples even when EBITDA is deteriorating so long as they can find a less levered target. Others are using all-equity structures to get larger deals away and a stronger dollar is giving US sponsors more purchasing power overseas. But in many cases, a higher cost of debt, or its absence completely, will be reflected in lower valuations, delayed exit plans and fewer sellers. According to a recent analysis by Schroders Capital, if only 50% debt financing was available pre-acquisition, entry prices would have to fall by 12% for investors to still earn an 18.5% return. At 40% debt, the purchase price was have to drop by 18.6%

"Buying sponsors will be even more focused on the valuation they are paying in an environment where lower debt is available. They will have to work hard to ensure they deliver the IRR for their clients," says Blastland.

This may be less of a problem for corporate buyers or strategics using their own balance-sheet funding in an auction process. The situation is forcing private equity funds to consider 'off-market' transactions and pre-empting sales. And, for others, the answer to 'no debt' could actually be 'more debt'.

Mezzanine financing or junior debt and other, more risky debt instruments are becoming a necessity to meet private equity fund returns, says the second banker. Here sponsors can secure an extra turn of leverage, typically on an all-PIK basis without needing to consider debt service cover ratio. In a note to credit investors in August, KKR predicted 2022 could be a "golden vintage" for junior debt. Back-leverage, or NAV-based lending, is also being investigated by many of the major funds as a way to inject equity into portfolio companies and deals.

"If you can't access the capital markets as easily on the terms you would want, then getting the financing at the fund level and injecting it down into the individual businesses can allow you to refinance existing positions and continue to raise additional financing for bolt-on M&A," says David Wilson, a partner at 17Capital, which provides NAV-based loans to

> "There are some private equity funds struggling much more to get the love they need from private credit funds

“Buying sponsors will be even more focused on the valuation they are paying in an environment where lower debt is available”

James Blastland, partner, Deloitte

top tier private equity firms. “We’ve seen a little bit of that already and are working on a couple of deals like that. If a sponsor is going to hold on to an asset for one or two years longer than originally anticipated, then some additional fire power at the fund level can be very helpful to allow them to keep growing the business and protect the returns.”

The solution will vary depending on the situation and is contingent on the bank syndication market being stuck right into 2023. In certain parts of Europe such as the Nordics, and to a lesser extent France and Germany, traditional bank clubs are still active, says Aoun. “Whoever is saying that the syndicated market is dead, and it’s over and that’s it, it’s private credit and private credit only, is in my view mistaken. The syndicated market could go back to completely functioning status in the next couple of years,” he says. “What I believe is happening is private credit today is going through a phase that private equity went through 30 or 40 years ago and these two sources of capital will co-exist.”

In this period private equity has transformed the corporate landscape with ever larger buyouts across the entire economy. As private credit matures, it is likely to redefine again the size and type of companies being bought and the people who are doing it.

KEY TAKEAWAY

GPs – Credit funds are becoming more selective in their deployment as bank syndications stall. Sponsors and sectors which may be out of favour in a recession will struggle to get debt funding

> “In 10 years, [direct lenders] have gone from being a backwater to now, they’re like the Pacific Ocean



MEGA-TREND STATUS DRIVES CREDIT FUNDRAISING

Large pension fund investors have increased their allocations to private credit in memory of how the asset class performed post-global financial crisis.

Last year, private credit assets under management exceeded $1 trillion for the first time. Over the next five years that figure is expected to more than double.

On an earnings call at the end of October, Blackstone's COO Jon Gray described private credit as a "long-term mega trend" within alternatives, which has been experiencing mega-trend status itself for almost a decade. Gray has reason to be positive: Blackstone's Q3 earnings showed private equity shedding 0.3% in value during Q3, compared to a 2.1% increase net returns for private credit. "I don't see any of sort of large-scale movement away from this very attractive asset class," he said.

He might be right. Pension funds, insurance companies, and endowments have been willing to assume greater credit and illiquidity risk in exchange for higher returns, said Moody's earlier this year. In a more

volatile economy, they are expected to show even more interest in the asset class, rather than less. Fifty-seven percent of institutional investors plan to increase their allocations to private debt over the next three years, according to a survey by SS&C Intralinks at the start of this year. The figure is likely to be much higher now.

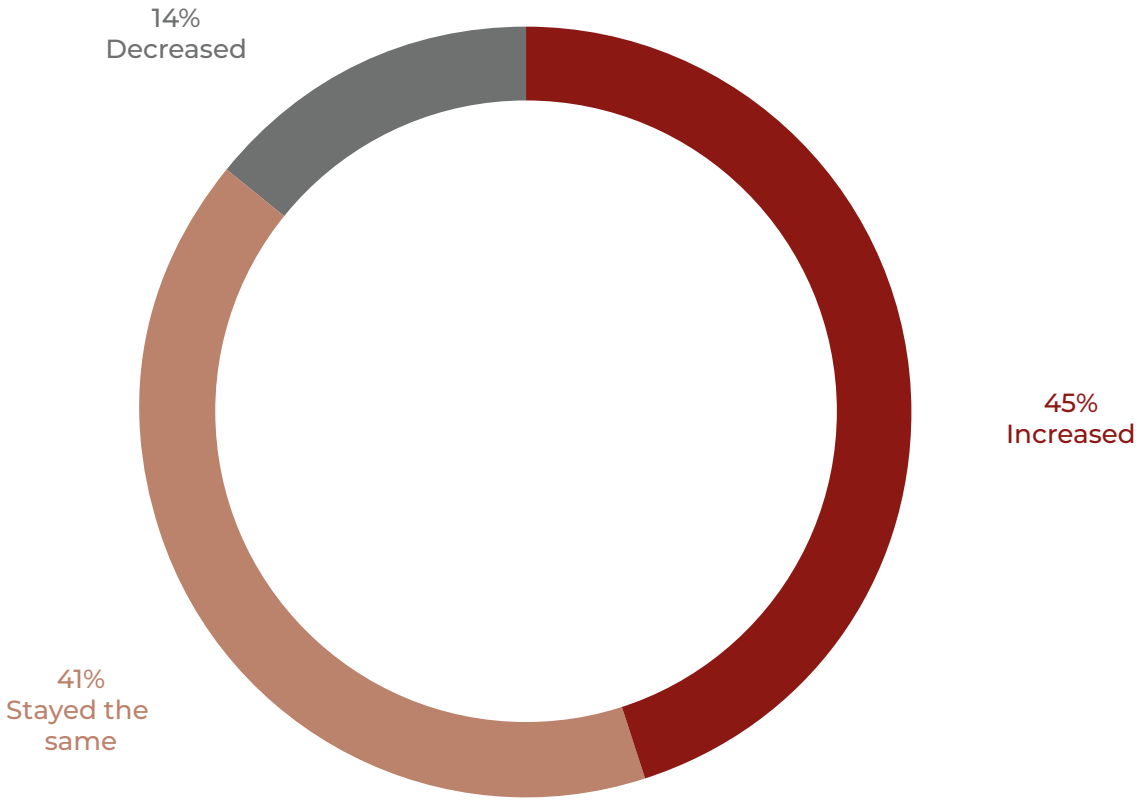
"Investors also have long memories, and they remember that the [private credit] vintages raised in the aftermath of the GFC performed incredibly well," says Jonathan Bray, partner at Clifford Chance, who works with some of the world's largest credit funds.

Pensions push up

Pensions have been the largest allocators to private credit by dollars invested and hold an average allocation of around 3%, but some allocations are now much higher. This year the largest public pension fund in the US, the California Public Employees' Retirement System, increased its asset allocation target for private debt to 5%, from 0%. The Arizona Public Safety Personnel Retirement System has a 20% target asset allocation for private credit. Insurers are also expected to add private credit to their portfolios, though at a more gradual pace, and high-net-worth investors are also allocating a higher percentage of investment capital to private credit.

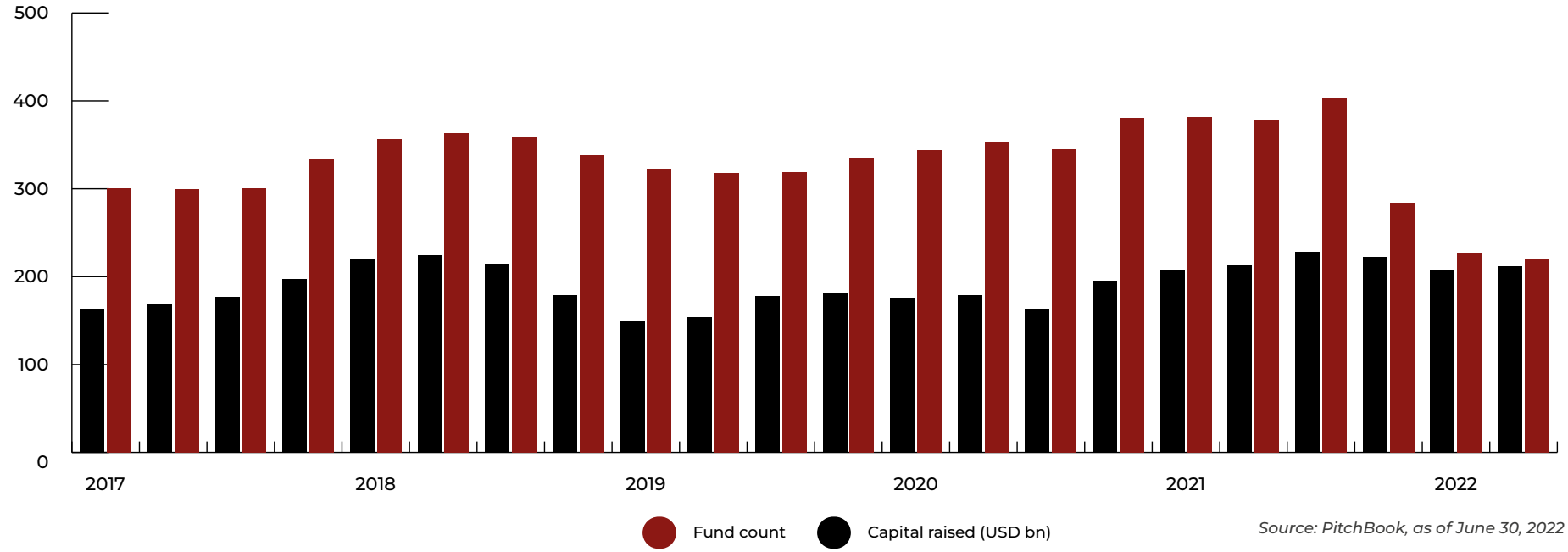
Fundraising is currently on par with its peak

Figure 2.1 Survey asked 'How has private credit been used in your buyout financing over the past three years?'



Source: Dechert Global Private Equity 2022, Mergermarket

Figure 2.2 Global private debt fundraising activity, quarterly (12-month rolling basis)



Source: PitchBook, as of June 30, 2022

in 2021, according to PitchBook. Managers raised $82bn across 66 funds in the first half of this year.

Direct lending – which tends to benefit from rising interest rates by using floating rate instruments and has comparatively lower volatility – continues to be the standout strategy, accounting for more than a third of capital raised in the first half of the year, but special situations funds and real estate debt funds also received plenty of attention.

"We're seeing investors come down the risk curve a bit and shifting some of their equity allocation into mezzanine funds and some of the people who have been heavily into mezzanine funds move down to direct lending funds so there's a bit of movement within the asset allocation," says Bray.

While it is now rare to see a private credit fund below $1bn in target size – Blackstone's credit vehicle focused on renewable energy and the energy transition is targeting $7 billion next year – many in the market see the potential for smaller niche strategies within the asset class as banks retreat. Debt funds providing revolving credit facilities could be the next trend here, following distressed or sector-specific vehicles, says one debt fund source. A scarcity of private credit solutions in the 250-500 bps range could also create an additional opportunity set for direct lenders, according to Deloitte's Private Debt Deal Tracker.

Stafford Capital Partners launched the Private Credit Income Opportunities Fund in October, a new open-ended fund split equally between direct lending and speciality finance. The direct lending arm will focus on senior secured debt in the lower middle market, while the speciality financing will target assets with

DEBT FUNDS GOING GREEN

Private equity sponsors are embracing sustainable loans and green bonds and helped to drive issuance here to record levels last year.

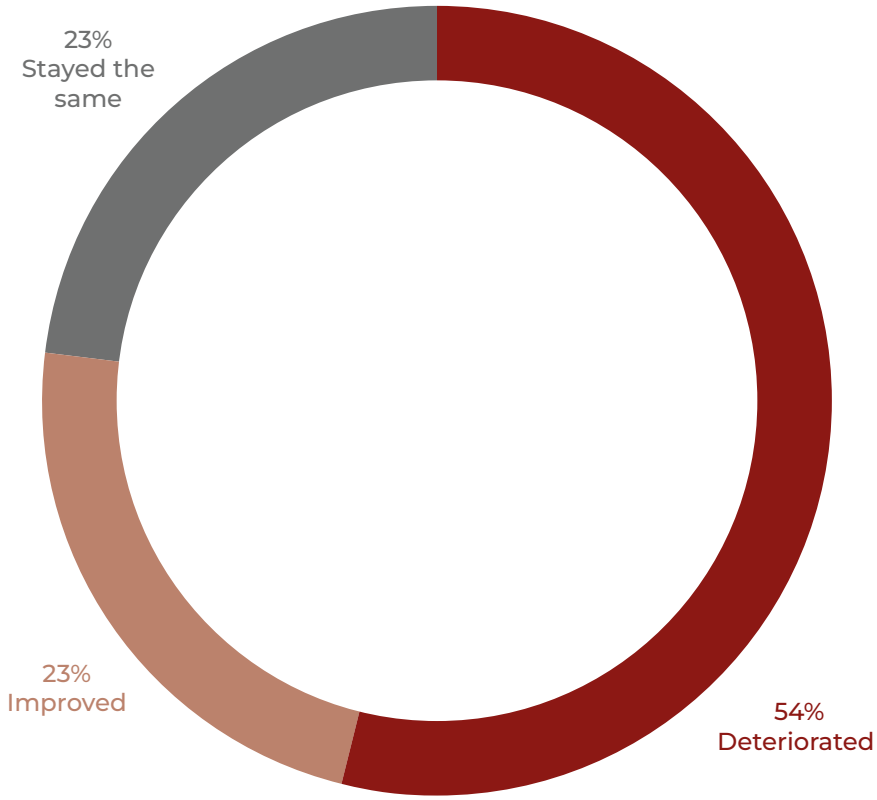
In the first half of this year, sustainable finance bonds raised $422bn, but fell 23% compared with the first half of 2021, according to Refinitiv. It is the first decline since records began in 2015 and means as a proportion of the overall debt capital markets, sustainable finance slipped one percentage point to 9%. Private credit has been slower to expand its presence here but this is changing, even as overall debt issuance declines through 2022.

KKR is preparing to launch its first two credit funds dedicated to investing based on ESG principles later this year, Reuters reported in July, targeting high-single-digit returns on a net basis. More will follow, mirroring the growth of ESG and impact funds in private equity. In an interview published on its website last month, Partners Group senior portfolio manager Aurélie Madé said the firm has deployed EUR 750 million in sustainability-linked loans across European lending over the past 12 months, adding: “Our aim is for these loans to be an integral part of our direct lending strategy going forward”.

low market correlation, which could include music royalties, says managing partner Rick Fratus. He sees an opportunity for increased deployment from co-investing LPs, particularly from well-funded Australian pension funds, but acknowledges there is a risk where they might be invested on the equity of a transaction already.

In terms of traditional fundraising, more growth is expected to come from Europe in the coming years than North America, which is considered to be the more mature private credit market. Between 2013 and 2020, Europe represented 43% of direct lender fundraising,

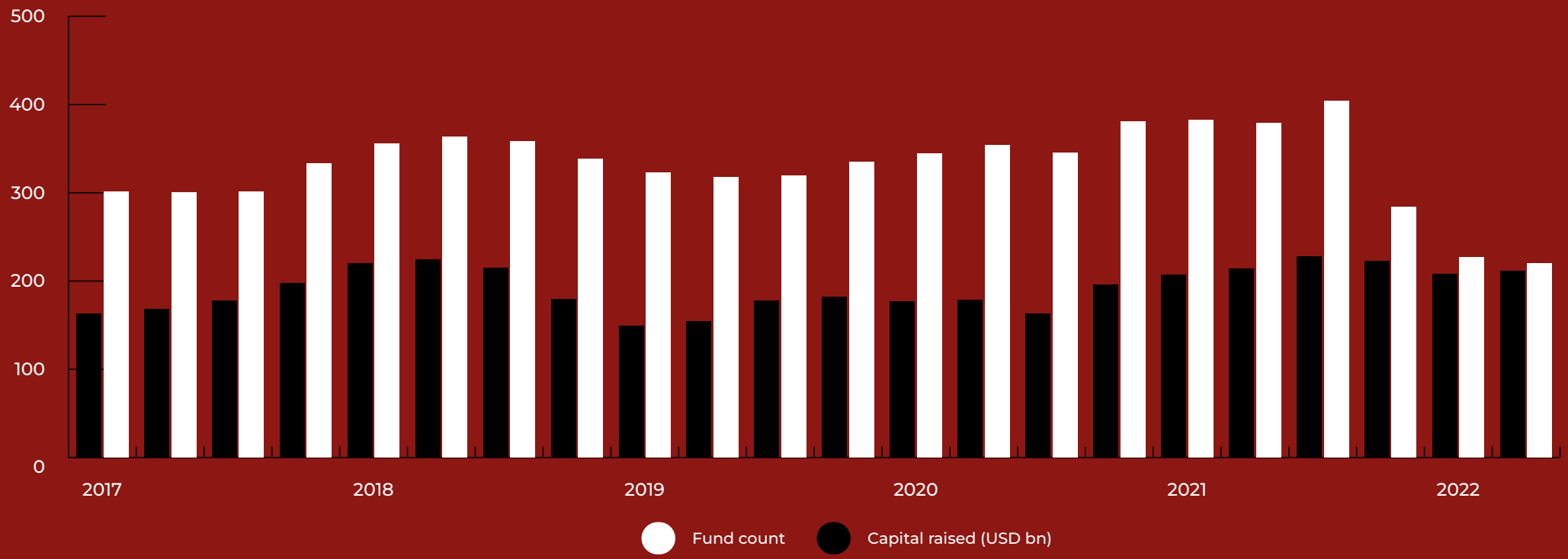
Figure 2.3 Survey asked ‘During 2022, how has the ability of private equity firms and their portfolio companies to raise debt changed?’



Source: PEW survey, Sept 2022

KEY FINDINGS

Credit fundraising in H1 this year holds up but fund count has fallen



INSIGHTS

compared to 51% from North America, according to Deloitte.

And much like the fund consolidation that has taken place across private equity, larger credit funds are already dominating: almost half of all the capital raised by private credit managers last year was taken in by the ten largest funds, according to Preqin, with the number fundraising dropping from 255 to 202.

The largest direct lending fundraise in Europe last year was Ares Capital Europe V at over EUR 11 billion which included institutional investors California Public Employees' Retirement System, Virginia Retirement System and Maine Public Employees Retirement System, according to Bloomberg. Next year Ares should go further when it launches Ares Capital Europe VI at the beginning of the year.

As a result, the average credit fund size grew from $663 million in 2020 to $958 billion in 2021. Direct lending funds tend to be even larger. This growth in fund size is a positive fundraising signal but it is also significant because it allows direct lending funds to compete more easily with syndicating banks on larger buyout transactions, where ticket size is an important consideration for sponsors. Indeed, traditionally, the challenge for private debt funds has deployment rather than fundraising. With banks in retreat from leveraged buyouts for now, many direct lenders sense opportunity to deploy at a faster rate.

"Direct lenders in Europe had become more comfortable earlier this year with providing financing on looser, more flexible terms tailored to borrower requirements for bigger deals," says Colin Harley, a London-based partner in the White & Case Global Debt Finance Practice, adding that the current market volatility, and accompanying lack of competition from the syndicated loan market on larger deals, has brought those looser terms under greater scrutiny once again.

In Europe, it is the UK which leads as the main source of deal volume for direct lenders, followed by France and Germany. Deal volume here is trending down year-on-year but a flurry of activity is expected from overseas buyers following a weakened pound and depressed valuations. The current generation of direct lenders in fundraising will be watching closely.

KEY TAKEAWAY

LPs – Vintage years during or just after a recessionary period have historically outperformed. Among credit fundraising, direct lending is the standout strategy for now

"Direct lenders in Europe had become more comfortable earlier this year with providing financing on looser, more flexible terms tailored to borrower requirements for bigger deals

LARGER GPs TO TEST LIMITS OF NAV-BASED LENDING

Fund financing – which includes subscription lines of credit and NAV-based loans – is set to grow even as capital markets slow. A measured approach is advised



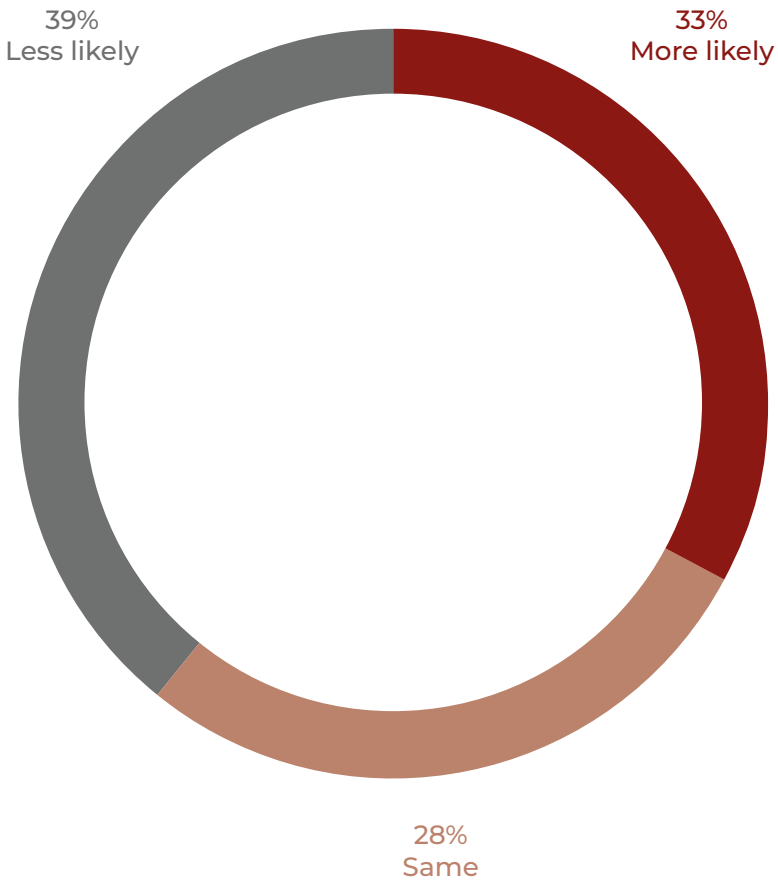
In a slower credit market, there is one form of debt financing that tends to accelerate among private equity funds.

Fund finance – which allows GPs to raise loans at fund rather than asset-level – has been around for years but spiked during the onset of the Covid-19 pandemic when sponsors were unable to raise debt for their portfolio companies and unwilling to make capital calls on their LPs.

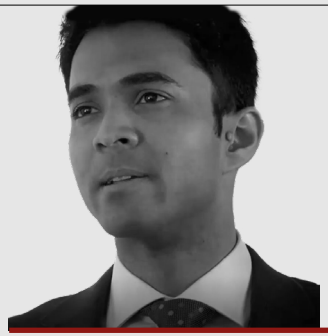
With the cost of acquisition debt rising and a more uncertain dealmaking environment emerging, NAV-based loan requests in particular are picking up again and, according to people with knowledge of plans, many of the top tier private equity firms are investigating how they can use the structure to boost liquidity.

"There's been a big increase generally over the last couple of years," says David

Figure 3.1 Survey asked 'Are you more or less likely to use fund finance (ie. NAV-based lending) in the current environment?'



Source: Private Equity Wire survey, September 2022



LETTING ROBOTS UNDERWRITE LOANS

Private equity investors are using AI as a key decision-making tool when evaluating investments and their lenders are no different. We call this Quantamental Private Capital and one such area is the precise underwriting of private credit or venture debt.

To make an informed credit decision, it is now of even greater importance to understand if the revenue will change significantly several years down the line. Hence, trustworthy, precise predictions of future revenue for private companies are important parameters.

Traditionally investment professionals would manually and empirically forecast revenue based on business model, competitor landscape, market trends and go-to-market efficiency. Data science-led diagnosis of customer value and its dynamics, such as customer acquisition cost and marketing ROI, are enabling deeper insight – especially where intangible assets have a bigger effect on earnings and book value.

AI-enabled financial due diligence is even more promising for apparent risky companies earlier in the life cycle with product-market fit and beyond technology risk. Such young companies can be offered competitive capital products to support faster growth, and business expansion, without expensive equity in the capital structure.

Private credit for middle market companies has attractive historic loss rates with lower long-term average and worst-case loss rates than leveraged loans. Combining that with data science and AI-enabled underwriting, can provide attractive yield while screening for asset quality even in the current interest rate environment. Such private credit arrangements can be structured as venture/growth debt transactions, or as merchant cash advance, revenue-based financing, receivables factoring, term loans and lines of credit.

Although predictive accuracy in estimating revenue growth is a key ingredient, data on private companies have traditionally been difficult to gather and share due to confidentiality or privacy. New technology will facilitate rapid innovation.

Adri Purkayastha
Head of AI Operational RIsk, BNP Paribas

Wilson at 17Capital. “As more managers are aware of it, we’ve seen an increase again over the last few weeks on the back of what’s happening in the world right now.”

17Capital announced final close of its 17Capital Credit Fund in April, raising EUR2.6 billion to provide NAV loans to high-performing private equity managers in Europe and North America and is planning to launch a second larger fund. Ares, Apollo and Pemberton are among a growing list of credit fund managers deploying NAV-based lending, either formally or informally, but they are yet to raise dedicated funds to do so, according to Mergermarket in October. A survey by Private Equity Wire in October found that more than 60% of GPs will continue or increase their use of fund finance in the current macro environment.

As fund finance is largely decoupled from pricing in the capital markets, lenders also remain bullish, according to US law firm Cadwalader, a leading adviser in the area which sees NAV-based lending as the “Swiss Army knife” of fund finance. It saw a 17% increase in fund finance originations during H1 this year and says that 86% of decision-makers are holding steady or increasing their exposure in 2023.

Banks have traditionally used another form of fund finance known as subscription lines of credit – raised by GPs on pledged commitments by LPs, rather than fund NAV – to build closer ties with private equity firms. Demand for capital call lending has increased due to the significant amount of dry powder at private equity and venture capital firms, wrote Moody’s in June. While short-term lending to these funds remains a small percentage of total US loan portfolios, some banks are rapidly growing their capital call commitments.

Citi pulls back

Despite a massive pullback here from one of the major providers Citigroup, reported by the Financial Times in September, sufficient appetite remains from lenders despite recent volatility. According to Moody’s, other US banks are growing capital call commitments and more are poised to enter the arena.

“I wouldn’t look too much into [Citi],” says a partner at a European private equity fund, “subscription lines are something that is practical, not harmful, and there is no systemic risk [from them being used or increasing].”

The same may not be true of NAV-loans as they grow in size and number, the partner adds.

“You need to be careful and sensible here. You need to stress test your cases. And you can’t just take whatever people are handing you – you need to do your homework before engaging in these products,” says the partner. “For NAV-based lending, you need a good [credit] cycle or two to really see how it’s going to react.”

Some LPs have also been less keen on NAV-based loans if they are not written into the Limited Partnership Agreement. With fund NAVs being revised downwards following this year’s fall in the public markets, the risk appetite here could shift quickly.

“We are very careful to negotiate upfront where the leverage is at the fund level, and we’re fine with that for six to 12 months,” says a senior level source at a large US-based private equity fund. “We’ve had situations with fund leverage where a deal went south and then you’re on the hook for a capital call.”

In their current form, the NAV-based loan structure makes sense for private equity funds and their increased use looks likely through 2023, by established top-tier managers at least. NAV-based loans are subordinated to the financing in the underlying fund assets but benefit from risk diversification across the whole portfolio. This means lenders are taking ‘manager risk’, rather than asset risk, says Wilson, meaning lenders will favour larger and more diverse managers as the structure evolves.

For now, the gearing of most NAV-based finance remains conservative, at between 10% and 20% loan-to-value, which makes it attractive to lenders, but the interest of larger private equity funds will test capacity further. Wilson says he has seen requests from private equity funds of $20bn in size seeking to raise 20% LTV, which would equate to a $4bn NAV-based loan. “Doing this in one transaction becomes a bit of stretch,” he says, “but there is good and increasing interest from co-investors, and capacity is growing all the time.”

KEY TAKEAWAY

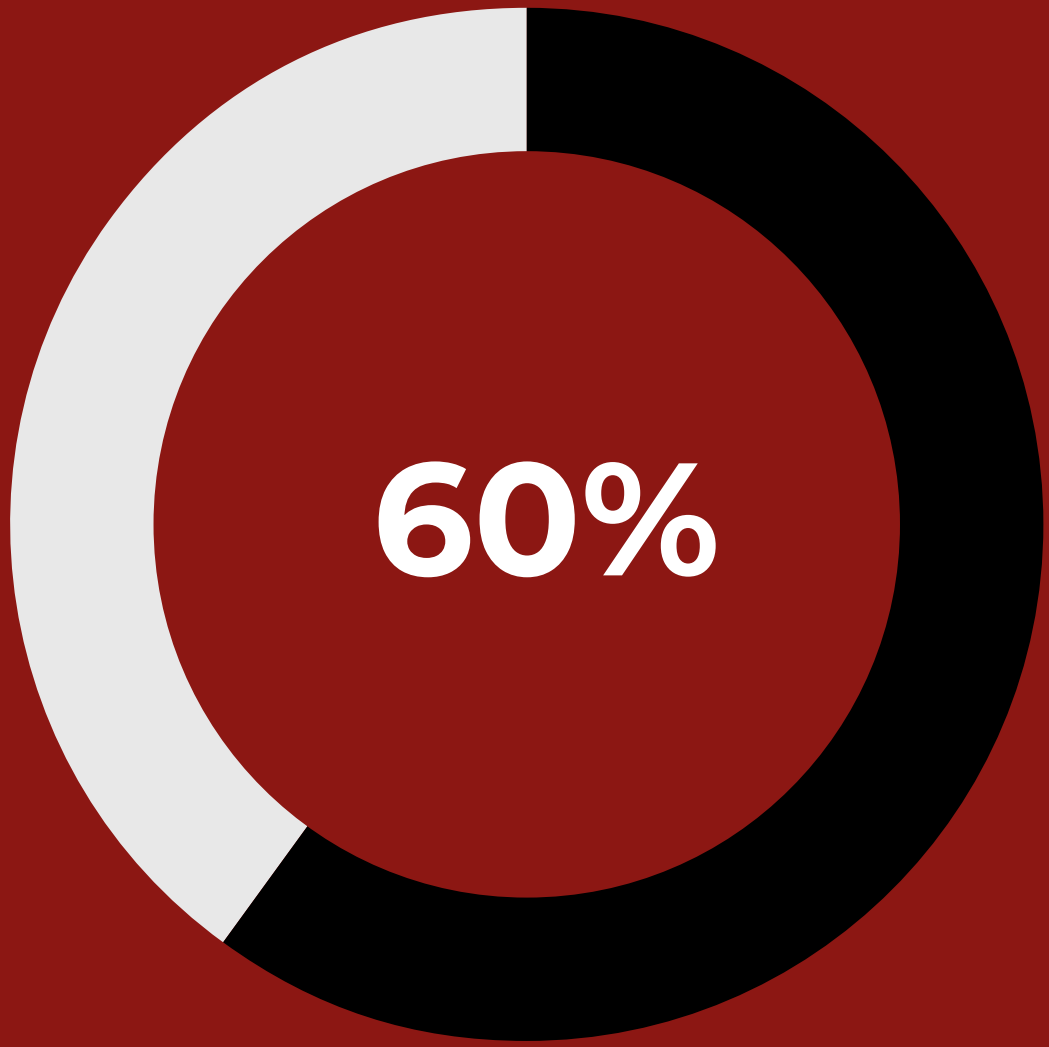
GPs – A growing number of large private equity funds will raise debt at fund level to inject into their portfolio companies, testing the market and the structure

“We’ve seen an increase again in NAV-based loans over the last few weeks on the back of what’s happening in the world right now”

David Wilson, partner, 17Capital

KEY FINDINGS

60% of GPs say they will continue or increase their use of fund finance in the current macro environment



INSIGHTS

DEBT RESTRUCTURING WAVE UNLIKELY TO DROWN SPONSORS

Loan defaults in 2023 are not predicted to match previous recessions, but a disproportionate amount will come from private equity-owned companies. Cov-lite structures should give them an upper hand in negotiations.

Corporate loan defaults are slowly ticking up and are expected to rise to around 5% in the US and Europe during 2023 – still far below the peak of the global financial crisis.

Nevertheless, as growth slows and interest rates have increased, a wave of debt restructuring among private equity-backed companies is expected to build. Over the past 12 months, a growing number of private equity funds have been capping leverage on their portfolio companies and weighing up loan maturities. A record level of refinancing during 2021 and healthy revenues to date provides a liquidity cushion for many but those with excessive leverage or cyclical exposure will be more vulnerable.

"Some of our competitors have gone for what I believe is excessive leverage and were already faced with thin cash flow cover. Now they are facing top line volatility and a very real increase in interest rates," says a London-based partner at a private equity fund.

There has been a drift among private equity funds generally over the past three years to less cyclical sectors, a trend accelerated by the pandemic: almost half of the LBO issuance in the year to September 30 has been in the technology sector, according to Leveraged Commentary & Data (LCD). Financial services and business software investments are generally expected perform better in a recession than the consumer discretionary sector, for example, but private



JUMP TO CONTENTS

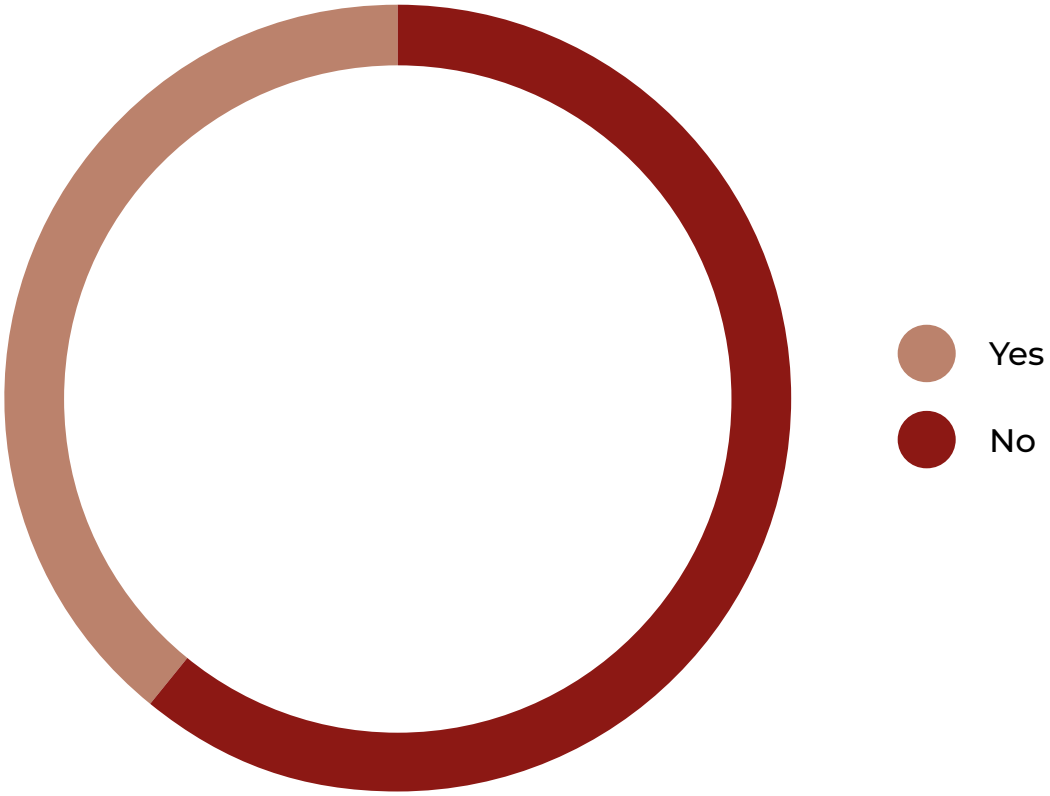
equity investments in food and agriculture, supply chain and logistics and energy face an added layer of volatility from the war in Ukraine. According to a recent survey by LCD, energy remains the debt market sector most likely to outperform, followed by healthcare and a jump by technology to third place.

Yet, given their presence in the B3 and below rating category, a disproportionate number of defaults are expected to come from private equity-owned companies. According to Moody's, 79% of North America companies at B3 or below are currently owned by private equity, compared to only 50% in Europe. Of the 177 companies on the credit agency's US B3 Negative and Lower List of distressed debt, around 70% are private equity-owned.

The three largest LBO term loans this year belong to borrowers rated B-minus on at least one side — athenahealth, McAfee, and Citrix Systems – representing almost a quarter of the overall LBO loan volume so far in 2022.

Though many private equity-backed companies have refinanced while borrowing was cheap, they also tend to be majority funded with floating-rate debt making them more vulnerable to base rate increases and macroeconomic shifts. Leverage has also been increasing: LBOs financed in the syndicated loan market in the last six months had an average debt/EBITDA ratio of 6.1x, the highest reading since 2007, and up from 5.8x in 2021, says LCD.

Figure 4.1: Survey asked 'Are you currently restructuring, or do you plan to restructure, the debt within one or more of your portfolio companies?'



Source: Private Equity Wire survey, September 2022

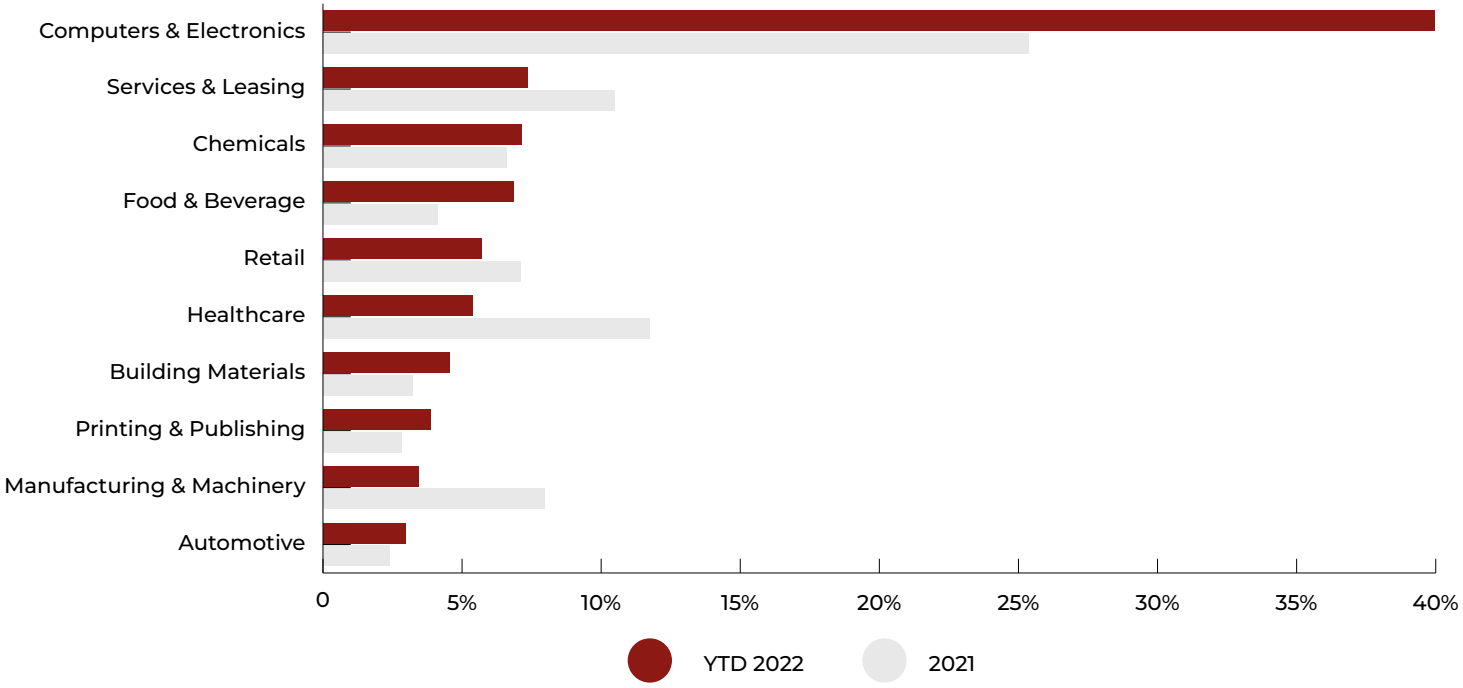
The stress point for private equity-backed B3-rated companies in the US comes when rates increase above 3%, according to Moody's. A senior source with a credit fund in the US likens the situation to a "slow-moving car crash" as GPs try to reposition companies in their portfolio.

"I wouldn't call this a crisis yet," he says, "companies are managing and I don't think they've been hit on the earnings side so what's happening is being taken on board. We know that some of the companies are in trouble right now. The [private equity] deals that were done in 2021 and at the beginning of 2022 are struggling with some of the debt that they've taken on with the rapid increase in the rates."

Unlike the global financial crisis however, credit funds – seeking distressed debt, special situations or direct lending – have a greater opportunity to steer this slow-moving car before impact.

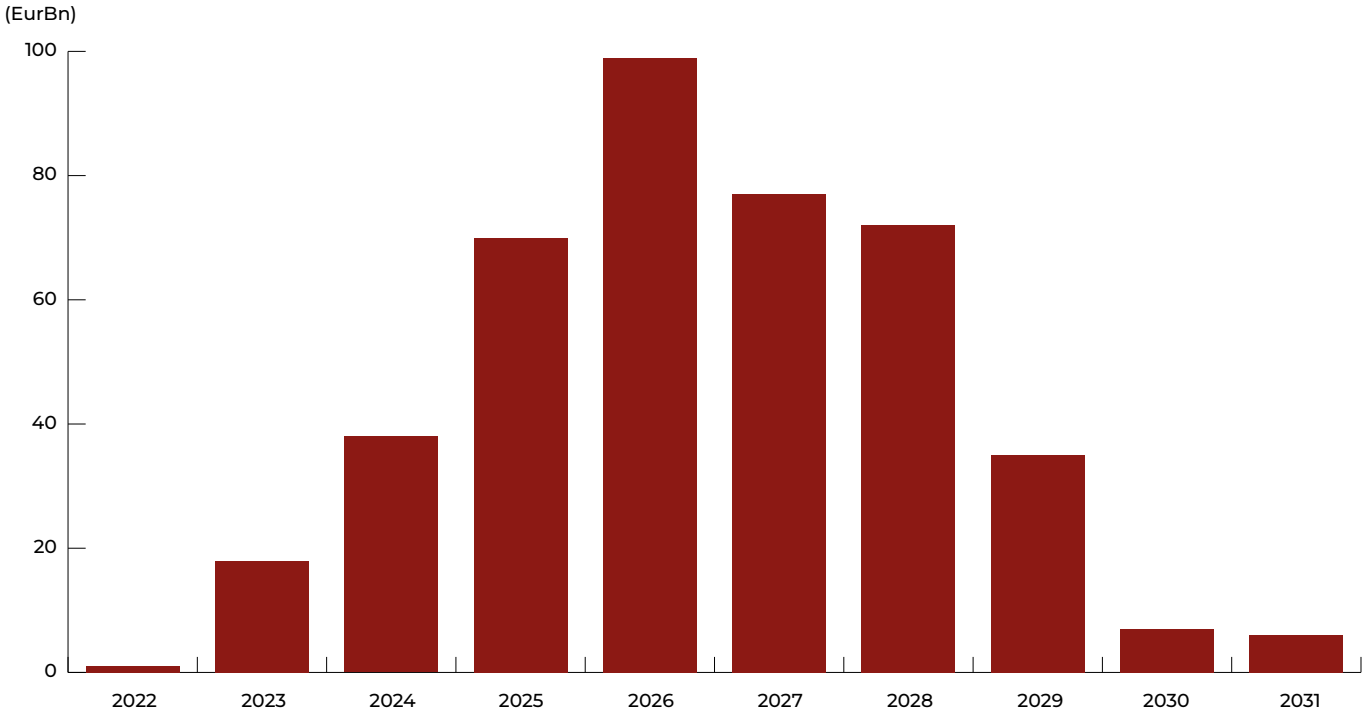
In a market commentary note at the end of September, Oaktree Capital – which raised $16 billion last year for its largest-ever opportunistic credit fund – said it believes the current expansion of the distressed credit universe could prove to be more long-lasting than during the pandemic in 2020. Private equity sponsors facing the risk of loan default

Figure 4.2: LBO loan volume by sector, 2022 vs. 2021



Analyst note: Data correct up to Sept. 30, 2022
Source: Leveraged Commentary & Data

Figure 4.3 European leveraged financing maturities



Source: Fitch

in their portfolio companies are likely to find themselves competing with distressed debt investors to retain control of these businesses, once cost-saving initiatives have been exhausted. They may have an advantage though in the sponsor-friendly covenant-lite documents that now dominate the market. These looser credit documents provide a greater opportunity for sponsors to restructure financing without full lender consent and to preserve their equity where possible.

"Sponsors now expect to have to do the thinking themselves," says a private equity lawyer based in London in relation to the syndicated loan market, "and correspondingly, they expect to be able to deploy the solution that they come up with without needing all their lenders' blessing."

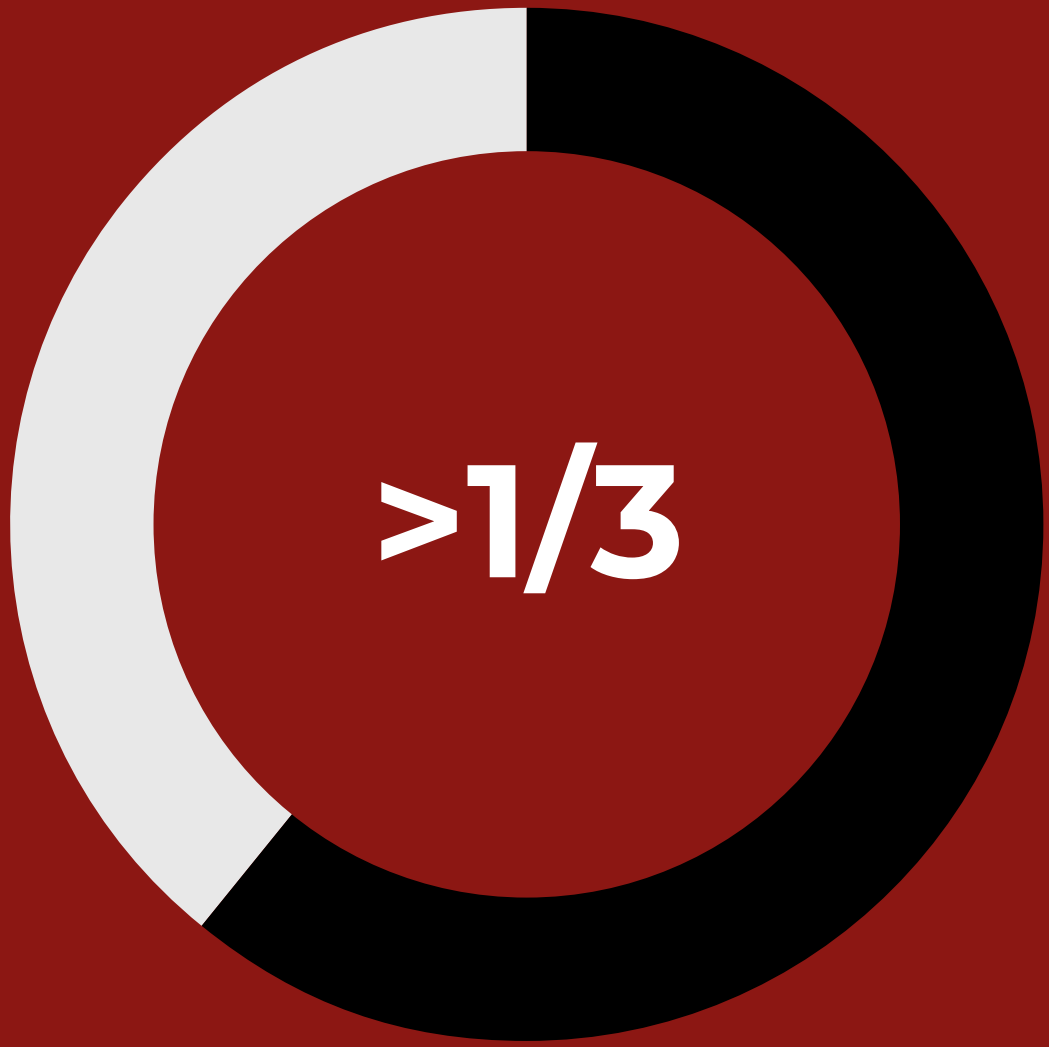
Where sponsors are working with credit funds – which traditionally avoid 'taking the keys' when a company gets into financial difficulties – even more thinking is likely to result, especially given some of those credit funds may have loan repayment problems in their own portfolios too.

KEY TAKEAWAY

GPs – Highly levered buyouts in certain sectors that were completed in 2021 may face increasing pressure to restructure their loans during 2023

KEY FINDINGS

More than a third of private equity GPs are planning a debt restructuring



INSIGHTS

“Sponsors now expect to have to do the thinking themselves and they expect to be able to deploy the solution that they come up with, without needing all their lenders’ blessing”

CONTRIBUTORS:

Colin Leopold
Head of Research & Insight
colin.leopold@globalfundmedia.com

FOR SPONSORSHIP & COMMERCIAL ENQUIRIES:

Jack Hassall
Senior Commercial Director
jack.hassall@globalfundmedia.com

Published by: Global Fund Media, Lion Court, 25 Procter St, London WC1V 6NY

© Copyright 2022 Global Fund Media Ltd. All rights reserved. No part of this publication may be reproduced, stored in a retrieval system, or transmitted, in any form or by any means, electronic, mechanical, photocopying, recording or otherwise, without the prior permission of the publisher.

Investment Warning: The information provided in this publication should not form the sole basis of any investment decision. No investment decision should be made in relation to any of the information provided other than on the advice of a professional financial advisor. Past performance is no guarantee of future results. The value and income derived from investments can go down as well as up.