Trends in Special Situations & Private Credit

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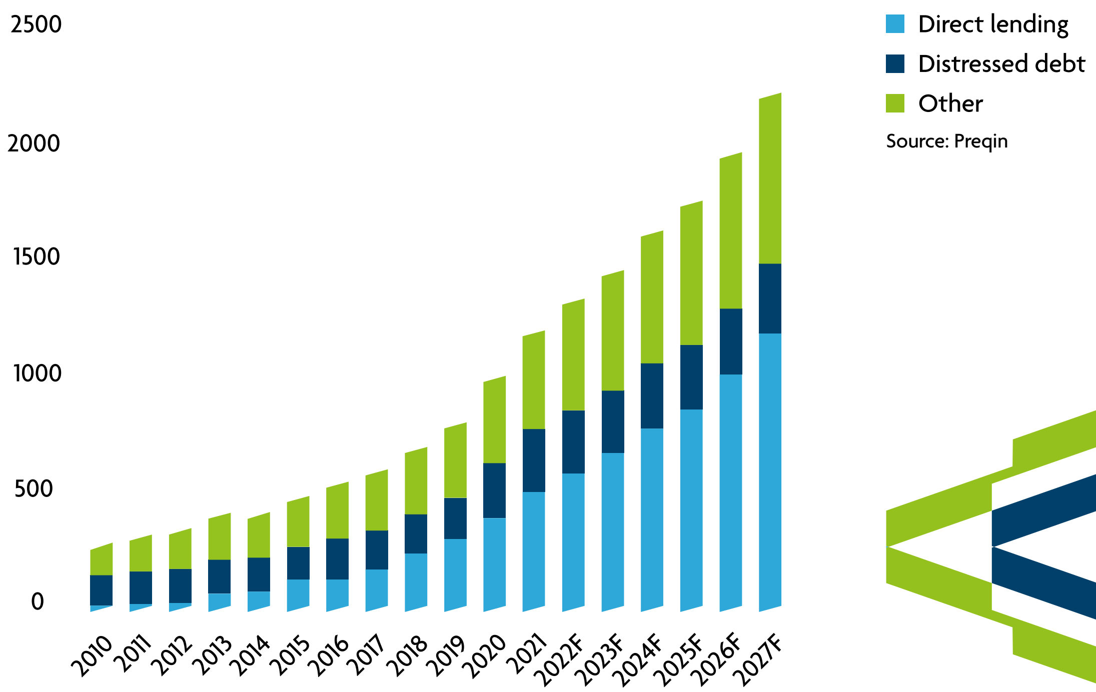
The year 2022 was a landmark one for private credit, which emerged from the pandemic in robust health having endured its first real test as an asset class.

Faced with new challenges from turbulent public markets, record inflation and rising interest rates, private credit once again proved its resilience as investors favored its timely characteristics of downside protection, floating rates, sizeable equity buffers and pragmatic credit selection.

From the current vantage point, as borrowers increasingly battle with rising prices, supply chain pressures, constraints in the syndicated lending markets and uncertainty in the stability of their relationship banks, private credit is proving an attractive option thanks to its ability to provide flexible, tailored and relationship-based financing at a time of growing liquidity constraints. With the threat of recession looming, and with so many leveraged buyouts having been financed with private debt in recent years, predictions of more widespread distress will put credit funds on the front lines of supporting businesses through the next challenging economic cycle.

Looking ahead, we expect companies facing a myriad of issues around liquidity needs, near term maturities and potential breaches of financial covenants to seek out more creative financing solutions from credit and special situations lenders. In this report, we explore four areas of focus, looking in depth at liability management transactions, opportunities for private debt in growth capital and renewable energy, and the importance of sanctions provisions in loan agreements.

Global private debt assets under management ($bn) by sub-strategy, 2010–2027F



Source: Preqin

Investors will continue to favor credit funds, and special sits-focused funds in particular, during turbulent times, giving them access to a wall of dry powder. As deal volumes remain stunted, direct lenders will face increased competition for new deals – particularly in popular and traditionally resilient sectors such as health care, business services and software – and we anticipate a diversification of market participants as the asset class grows in response to both investor appetite and sponsor demand.

As we explore in the following commentary, there is a growing appetite for opportunistic credit as borrowers seek to make room for additional debt in existing structures, including from third parties. Sponsors chasing fewer, more complex transactions will look for both senior and junior capital solutions, and will seek lenders able to bridge the gap between equity contributions and secured lending and leverage the benefits of multiple instruments.

We will continue to see structures and documentation become more lender friendly this year, as direct lenders get creative in their support for current deals and shift their role on new deals from providers of primarily growth capital into growing supporters of rescue financing. Such a transition will call on more tools in the capital provider's toolkit, driving the potential for another year of outsized returns.

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Liability management grows in prevalence

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As the macroeconomic climate shifted in 2022 and companies faced a myriad of issues including liquidity needs, near term maturities and potential breaches of financial covenants under their loan agreements, the need for many borrowers to seek out more creative financing techniques, and to look for flexibility in existing documents, became front of mind.

Liability management transactions, both through which companies transfer collateral away from creditors, and in which one set of creditors are given an advantage at the expense of other, previously similarly situated creditors, have become more common in the U.S. syndicated loan market over the past several years. These transactions enable participating creditors, and offer opportunities for new incoming creditors, to position themselves for any potential upside while reducing downside risk—as well as to deploy capital into the top of the capital structure.

One reason for the growth in these deals has been the increasingly borrower-friendly terms that have made their way into syndicated loan documentation during hotter financing markets of the past several years, and the failure of the syndicated loan market to effectively push back on those terms. In the three years of Covid, distressed sponsors and companies have begun to utilize these flexibilities to consummate transactions that benefit themselves by providing longer runway on their equity investments and certain selected lenders at the detriment of other lenders.

Liability management transactions broadly fall into two buckets: those that transfer assets and collateral away through an unrestricted subsidiary or other non-guarantor subsidiary, and those that see a company work with a subset of lenders to execute a priming financing transaction (often including both new money and a roll-up) that is senior in priority to the existing loans.

These transactions have not so far been widely seen in private credit for several reasons. First, private credit documentation has generally remained more lender friendly than the equivalent in the syndicated market. Further, private credit deals typically involve much smaller groups of lenders and are heavily relationship based.

2023

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As we step into the evolving market, the prevalence of liability management transactions by sponsors will inevitably impact private credit. In the last six to eight years, private debt has had exponential growth in the LBO market as private credit institutions have taken up increasingly more significant ticket sizes. Historically, liability management transactions have most often involved private equity-sponsored portfolio companies and a large portion of the debt we initially see moving into situations ripe for liability management will be acquisition financings. Private credit funds will need to become more attuned to covenant flexibility, voting rights and other minority lender protections as their credit investments may become distressed.

Glancing ahead, we expect to see deal dynamics evolving as lenders increasingly mobilize and get into groups much earlier on in transaction processes. Sponsors will continue to take a more active role in initiating the organization of lender groups and proposing liability management transactions, increasingly seeking their own solutions with lenders that may or may not already be in the credit. With the downturn impacting credits through rising interest rates, increasing inflation, supply chain issues and geopolitical instability, more direct lenders will be addressing borrowers facing liquidity issues and equity investors less willing to step up, driving a requirement for more creative financing solutions. Historically, liability transactions have been primarily utilized to address liquidity issues. However, in the upcoming year, we expect sponsors to explore using the tools of liability transactions to potentially address maturity and interest expense issues in a coercive manner.

In the year ahead, creative and opportunistic financing will be a growing feature of the market, as more direct lenders face up to the realization that their role may shift somewhat from growth capital providers to providers of rescue financing. That will drive a change in mindset for many with regards to how they get compensated for risk. Private credit funds will need to be more focused on the provisions in financing agreements that allow for liability management transactions and they should proceed with caution on these points.

Credit funds step up to provide growth capital to emerging companies

As the world recovers from the pandemic shutdowns, emerging companies with real recurring revenues and valuable intellectual property have proven to be one of the more resilient borrower groups during times of macroeconomic uncertainty and volatility. In 2022, an increasing number of private credit funds saw the value in focusing on stable revenues and IP as solid barometers when underwriting growth capital and, as more liquidity has flushed into the credit space, lenders are becoming more creative than ever in offering solutions to finance the entrepreneurial ecosystem. Debt funds are able to provide innovative structures capable of accommodating these borrowers' sensitivities around dilution and valuation, developing solutions that keep the right valuation of the business without requiring dilutive equity.

The year 2022 was an interesting one for many emerging companies, particularly in the technology sector, as prior explosive growth trends in fundraises and valuations appeared to continue for much of the first half of the year. However, against the backdrop of rising interest rates and declining market liquidity, the venture capital world became increasingly wary of funding profitless futures indefinitely. Many borrowers that had prioritized growth over all else and had been burning through cash to realize that mandate suddenly found there were no longer additional rounds of equity capital available to extend the runway. For much of 2022, we saw private credit funds starting to step up to provide creative ways of injecting capital to support existing investments and to provide opportunistic financings.

837

Number of private debt funds in market as of Q3 2022, collectively targeting $297bn.

One prominent theme last year was the growth of annual recurring revenue financings, and we expect those structures to be employed more widely in the coming year as traditional loans based on EBITDA covenants struggle to provide the right tools to evaluate companies that prioritize growth over profitability. For companies that are not yet generating profit but do have strong and growing revenues, discerning lenders are now increasingly willing to structure models based on such recurring revenues (which may toggle to a more traditional EBITDA-based covenant after the initial test periods) and allow these companies to borrow against the value of its innovative IP, something historically overlooked by debt funds.

We have also started to see a number of insurance companies step into the private credit market to “wrap” these loans, which essentially provides the lenders with downside risk protection in the event the lenders are unable to recover on their investment. Substantial amounts of diligence, particularly in IP valuation, and coordination with the insurers and their advisors are required on the front-end, and all, or substantially all, of the insurance premiums are paid by the borrower at closing. In the event the lenders are unable to recover after an event of default, the insurers will pay up to 100% of the outstanding principal to the lenders and the insurers will seek to monetize the borrower’s collateral, primarily focused on its IP. This is but one of many interesting corners of the growth capital space that saw explosive growth in 2022 and we expect this trend of creative structures to continue to emerge in the next 12 months and in coming years.

Through 2023, lenders are likely to be more selective than ever in challenging market conditions and competition will intensify, giving funds with an appetite to take aggressive bets on high-growth businesses the potential to achieve attractive returns.

We expect private credit investors to continue to deliver more flexible growth capital solutions, including demanding more prominent equity kickers and developing new and more creative structures. What is clear is that more niche areas are emerging for debt funds in the growth space and there will undoubtedly be more innovation in the year ahead. These companies need lenders to offer bespoke terms that address their unique situations, and private credit looks ready to step in and fill the gap being left by venture capital and public equity markets.

2023

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More room for private credit in energy transition

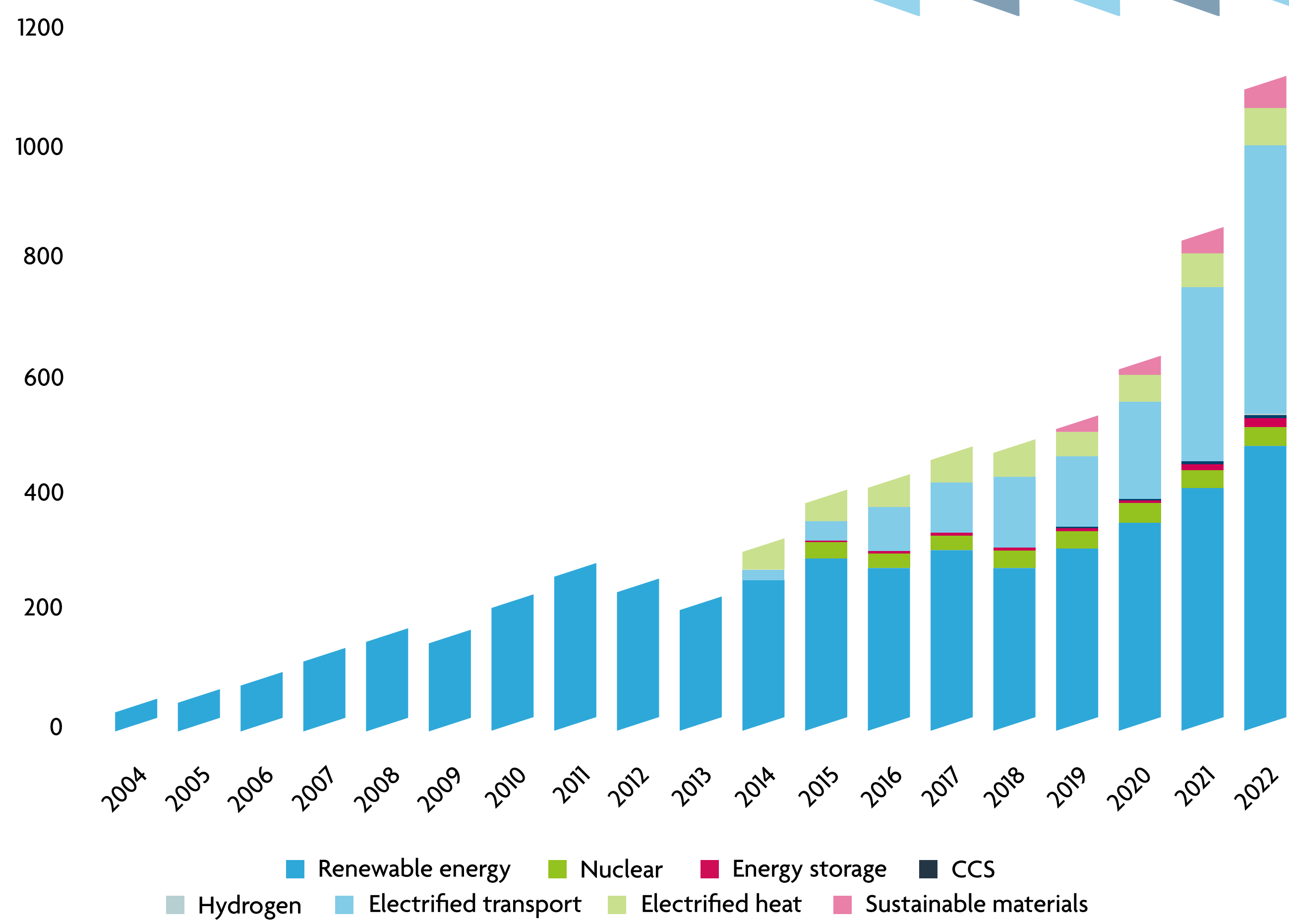
With the signing of the Inflation Reduction Act in August 2022, the U.S. government committed to the largest investment in climate and energy in the country's history.

Russia's invasion of Ukraine in February 2022, and the global macroeconomic fallout that resulted, put energy security, energy independence and the transition to net zero greenhouse gas emissions at the top of the political agenda worldwide. With the signing of the Inflation Reduction Act in August 2022, the U.S. government committed to the largest investment in climate and energy in American history, stepping up to tackle the climate crisis, advance environmental justice and position the U.S. as a world leader in domestic clean energy manufacturing.

Bloomberg New Energy Finance has forecast that global investment levels, at a high of $755 billion in 2021, will need to rocket to $4.2 trillion a year by 2026 if the world is to achieve net zero by 2050, and it is increasingly clear that private capital, both debt and equity, will have a critical role to play in meeting that funding requirement. On the debt side, traditional bank markets do not have the scale, capacity or risk appetite to deliver all of what is needed, so the opportunity for private credit is increasingly stark.

What became clear in 2022 is that there are countless ways in which private credit can be deployed in energy, infrastructure and natural resource assets, from senior debt through to special situations and distressed lending, and on a planned, opportunistic or event-driven basis. Private credit strategies can be tailored to marry desired returns with investment prospects, while the opportunities in the space can meet credit funds' desire for higher yields, decorrelated performance, inbuilt inflation and forex protection and exposure to assets with long-term intrinsic value.

Global energy transition investment ($bn) , by sector



Source: BloombergNEF

These assets offer a different risk profile to traditional project finance and can therefore generate more attractive returns, often including elements of technology risk, construction risk, feedstock and offtake price and route to market risks and/or regulatory and change in law risks associated with less mature sectors or more merchant revenue risk profiles.

Meanwhile, private credit funds are answerable to their own institutional investors with ever more demanding ESG mandates and have begun hiring experienced project finance bankers to push further into energy transition. Provided the risks are fully understood, private credit funds are well positioned to capitalize on the opportunities on offer thanks to their ability to assess risk on a more nuanced basis and develop bespoke structures; to tap into a huge pool of dry powder; to bring flexibility to deal execution and hold periods; and to understand and work with less traditional contractual structures.

Unlike commercial banks, private credit offers an alternative to traditional equity raises. Borrowers faced with a choice between raising equity to develop energy transition platforms, which will dilute their ownership, or pursuing debt with equity-style components that can be paid off without dilution once the business becomes profitable, are likely to respond favorably to credit funds embracing the market.

Hiring trends emerging among private credit firms will continue as they scale up with experienced project finance professionals to do renewables and broader energy transition deals.

The hiring trends emerging among private credit firms will continue as they scale up with experienced project finance professionals to do renewables and broader energy transition deals. There is already growing interest from private debt in supporting platform deals in this market, with funds coming in at corporate level to finance the roll-out of new technologies and projects; last year was a seminal year for such deals in the U.S. and we expect to see many more transactions of that nature on both sides of the Atlantic in the next year.

Emerging energy sectors, including carbon capture and storage, clean hydrogen, EV charging and the production of sustainable aviation fuels represent a pressing opportunity for private credit to deploy capital and benefit from more attractive rates of return. The mining of rare earth minerals that support energy transition (such as lithium and cobalt) is another space ripe for more private debt activity. There is a noticeable softening of the willingness of large contractors to do EPC wraps (committing to deliver a project's construction on time and on budget) with new technologies in the current high inflation environment, and if that continues it will push deals up the risk spectrum towards other sources of credit. The expectation of possible recession will also play into the hands of private debt funds better accustomed to investing in special or distressed situations or more complex credits than other lenders.

Another theme for 2023 is blended finance, making use of public or multilateral funds to catalyze or de-risk private investments in climate action. The European Bank for Reconstruction and Development has plans to accelerate its work in blended finance this year, while first-mover private credit funds are already developing platforms to enable big pension funds to co-invest with the leading multilateral development banks in emerging market green credits.

Investors will eagerly await the publication of the implementation guidelines for the Inflation Reduction Act in the U.S., which will provide clarity on issues such as the transferability of tax credits. If the rules permit the formation of pools of capital to acquire credits and sell them in the secondary market, that will open up the market to even more interested participants.

In Europe, policymakers will continue to take actions in response to the situation in Ukraine and tensions with China, with the potential for further exploration in the North Sea and elsewhere as part of a push for energy independence and security. The European Union (EU) will also need to craft its own policy response to the Inflation Reduction Act if it is to remain competitive in the race for global capital flows.

The scale of the investment opportunity around energy, infrastructure and natural resources is unprecedented in 2023, allowing debt funds with the requisite knowledge of the underlying political and regulatory landscape to tailor solutions to individual sectors and projects and reap the rewards.

Sanctions provisions are becoming more important in private credit

Sanctions were in the spotlight in 2022 following the outbreak of the war in Ukraine, which saw the EU, UK, U.S. and other allied countries impose sanctions on a broad range of entities and individuals, as well as new, unprecedented restrictions, including on new investment in Russia, certain services critical to business and the energy sector. Sanctions provisions in debt agreements have long been overlooked and often treated as “boiler plate,” and are therefore frequently outdated and deficient in their ability to protect lenders in the face of rapidly evolving sanctions and enforcement risk. The events of 2022 have made it increasingly clear to lenders that there is a need to focus on sanctions provisions.

Map of countries facing EU sanctions

Source: Sanctions map

Historically, there are three main types of sanctions programs of which lenders need to be aware:

- Comprehensive sanctions against countries and territories, such as those currently in place against Cuba, Iran, North Korea, Syria, Crimea and certain other regions of Ukraine;
- U.S. blocking sanctions prohibiting transactions, activities and dealings with, and EU or UK freezing sanctions prohibiting the transfer of funds to, named entities or individuals or entities that owned or controlled by named entities; and,
- Sectoral sanctions, beginning less than a decade ago, which prohibit or restrict certain types of activities with named entities (or entities that they own or control) in certain sectors (such as finance, energy or mining).

Sanctions imposed in 2022 as a result of the war in Ukraine have gone further, however, and included a ban on new investment in Russia, restrictions on the provision of trustee, accounting, corporate formation and certain other services, and restrictions relating to the sale of Russian energy.

In the U.S. and certain other jurisdictions, sanctions violations are strict liability offenses, potentially putting lenders on the hook if borrowers engage in unlawful activities, irrespective of whether the lenders knew of those activities or the materiality of those activities were to the business. For this reason, the current sanctions environment warrants a heightened level of due diligence on borrowers that simply would not have been needed five years ago.

Lenders can best protect themselves by first putting sanctions risk at the heart of their due diligence process and asking more questions.

These might include, for example:

- Who is owning or controlling the borrower (including the shareholders and ultimate beneficial owners);
- The countries and territories where the borrower currently and previously has engaged in activities or transactions (including location of operations, supply chain and distribution chain);
- Whether the type of business is high risk from a sanctions perspective (including if there is specific guidance issued by the sanctions authorities for, and/or enforcement actions related to such industries, eg, shipping, ecommerce and crypto);
- Whether a borrower has sanctions policies and procedures in place and conducts sanctions screening; and,
- Whether the borrower has been the subject of an internal investigation or communicated with a governmental entity regarding potential or apparent sanctions violations.

Asking these questions will often smoke out issues that need further scrutiny and, where issues arise, enable the lenders to address those as part of negotiations. For example, it is now not uncommon for lenders to include post-closing covenants that call for proper policies and procedures to be put in place within a defined time post-closing if the borrower does not have such policies and procedures in place at signing.

Second, as we saw during 2022, a number of lenders are protecting themselves by taking a risk-based but more conservative approach in documentation. Firstly, lenders are increasingly focused on sanctions covenants with respect to the borrower's use of proceeds and source of funds for repayment of the debt given the increased risk of liability for lenders. Secondly, lenders are increasingly seeking to restrict borrowers from engaging in any activities or transactions directly or indirectly involving Russia or Belarus (in addition to comprehensively sanctioned territories and countries whose governments are sanctioned, such as Venezuela) or sanctioned individuals or entities.

Provisions that require borrowers to seek a waiver for doing business with such territories or sanctioned persons, even if such activity is not unlawful (whether due to a general license or other authorization, or because the sanctioned person is subject to only limited sanctions), are becoming more widespread. Further, when negotiating sanctions provisions, lenders need to, and do, think not only about the current sanctions environment but also how that might evolve over the life of the loan given the risk profile of the borrower, including in terms of geographic footprint (for operations, distribution and supply chain) and sector.

The imposition of wide-reaching sanctions in 2022 has also resulted in unexpected structural challenges in debt transactions.

Certain geographies and sectors are or are becoming increasingly risky to do business in, whether because of supply chains, distribution or manufacturing, or their relevance to national security. From a sector perspective, more focus should be placed on deals in shipping, finance, energy, ecommerce and crypto, for example. From a geographical perspective, in addition to the jurisdictions referenced above, more careful consideration should be place on deals involving Venezuela, China and/or Taiwan.

The imposition of wide-reaching sanctions in 2022 has also resulted in unexpected structural challenges in debt transactions. The U.S., EU and UK sanctions prohibitions are intentionally drafted broadly, and therefore may cover situations that one would not initially expect to be implicated. For example, where a non-Russian parent company seeks to amend and extend a transaction with its debt holders, but the underlying assets or operations of the group include significant Russian assets or operations, such a transaction may be prohibited by the new investment bans under U.S. and/or UK sanctions, respectively, and, if so, cannot proceed without appropriate licensing.

Likewise, we have seen challenges for debt service where either borrowers or lenders have been themselves impacted by sanctions, and in some instances the implementation of service bans has impacted the ability of trustee companies to be able to continue (or be willing to continue) to act as trustees.

The evolving sanctions landscape has meant that the private credit markets have had to adapt to a number of unique and unprecedented challenges, and arising out of that have been a number of creative solutions. For example, in Europe, a borrower successfully constructed a reverse Dutch auction and conducted a tender offer of its privately held loan debt, facilitating a timely exit out of the market for the lender group comprised of certain EU-sanctioned persons. It is transactions such as these that we expect to appear in the year ahead as borrowers and lenders continually look for creative solutions to address and mitigate sanctions problems and risks and bring new ideas into the private debt markets.

Sanctions were rarely front of mind when looking at debt agreements a decade ago, but today need to be looked at in every transaction, even those whose activities appear, on the surface at least, not to raise sanctions concerns. The tools typically used in conjunction with problems relating to borrowers, including assignment/transfers, amendments/waivers and debt purchase transactions, must be subjected to scrutiny given the complexity of certain sanctions restrictions.

With sanctions now widely used in the toolbox of foreign policymakers, and with enforcement action expected to ramp up through 2023 and beyond, making sure representations, warranties and covenants in debt agreements are up-to-date and appropriate based on the sanctions risks identified during due diligence will be key for private credit funds, and having one eye on creative solutions, whether reactive or proactive, will be crucial for all market constituents.

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