

Trends in Special Situations & Private Credit

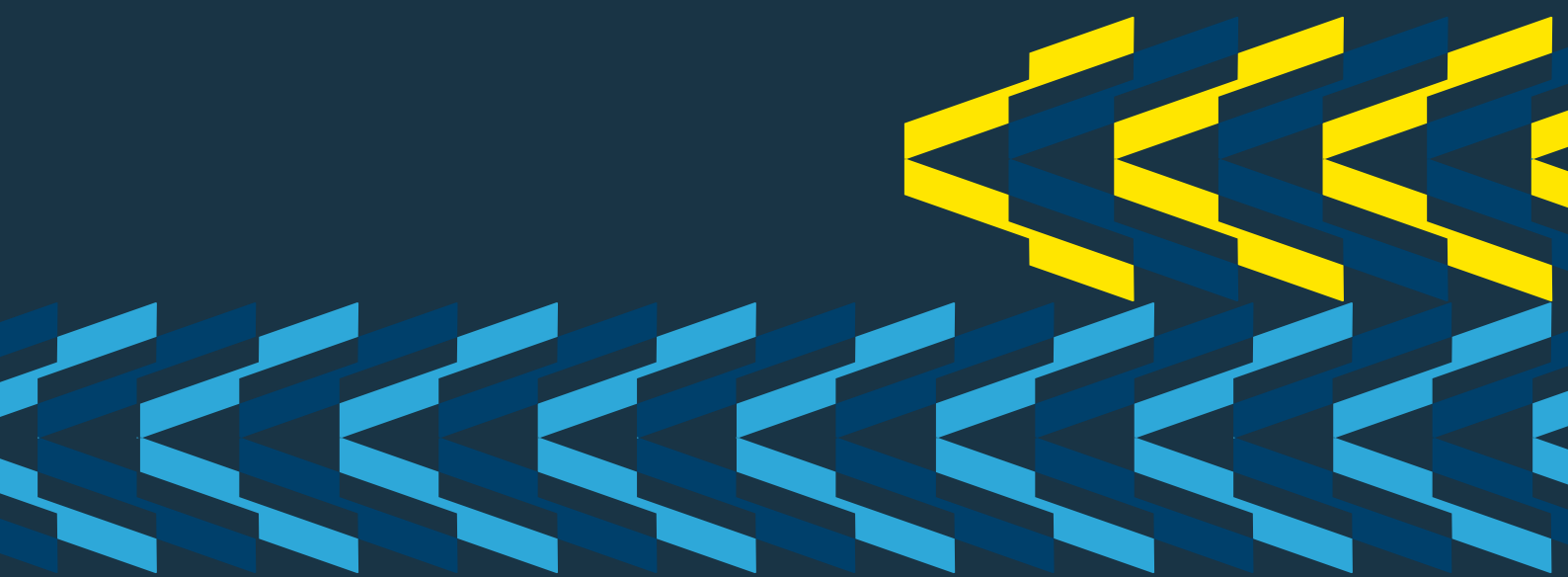
2024



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Introduction

Welcome to this second edition of *Akin's Trends in Special Situations & Private Credit*, in which we reflect on another active year for the global private credit market in the face of turbulent public markets and geopolitical challenges.

With 2023 characterized by record inflation, constraints in the syndicated lending environment and rising interest rates, credit funds were able to step in to provide flexible, tailored and relationship-based financing to address widespread liquidity challenges. With predictions of extensive distress failing to materialize, the asset class proved particularly attractive to investors able to benefit from a floating-rate product offering outsized returns.



2024

As we progress into 2024, we expect credit funds to continue to grow market share as a viable alternative to the broadly syndicated loan market.

As we progress into 2024, we expect credit funds to continue to grow market share as a viable alternative to the broadly syndicated loan market, financing ever-larger transactions and expanding into more esoteric and non-

sponsored lending channels, especially asset-based and asset-backed finance. While the U.S. remains by far the dominant private credit market, we are now witnessing rapid adoption and scaling of the asset class across Europe and Asia Pacific, and increased interest from Middle East investors.

Meanwhile, as a new period of sustained high interest rates makes refinancings challenging, borrowers facing upcoming maturity walls are increasingly engaging in liability management exercises (LMEs) to preserve and increase equity value and extend runway. The so-called lender-on-lender violence that had characterized these transactions in the past cooled somewhat in 2023, with an evolution of structures aimed at broader lender engagement. We explore these themes in more depth below, looking at LME developments in the U.S., Europe and Asia, as well as the outlook for their continued advancement in 2024.

Trends in the Lending Market

Effect of Heightened Interest Rates

After a prolonged period of low interest rates and relatively benign lending conditions, the rate hikes that began in spring 2022 and continued through most of 2023 meant that the last 12 months have been challenging for the loan markets and borrowers alike.

Last year saw leveraged loan and M&A volumes way down from 2021 and early 2022 levels. Q3 2023 saw an uptick in M&A activity, and the end of 2023 saw a limited reemergence of dividend recapitalizations transactions, but neither approached pre-rate hike levels. Amend-and-extend (A&E) transactions in 2023 were up from 2022 levels.

With interest rates expected to remain high until at least the latter part of 2024, we have seen a markedly different impact in the floating rate leveraged loan market versus fixed rate high-yield and investment grade bonds on both sides of the Atlantic.

As the interest rate being paid by loan market participants has effectively doubled, there are signs of default rates creeping up even as companies continue to perform better than expected. The much anticipated recession did not happen in 2023 and looks avoidable in 2024, though several economic and geopolitical headwinds remain that continue to drive macro uncertainty.

Maturity Walls



In Europe, in particular, there are fears that expensive refinancings and sluggish economies will combine to push up levels of distress.

While elevated interest rates continue to make refinancings difficult in 2024, borrowers are facing significant upcoming maturity walls, particularly in 2025 and 2026. Companies and their private equity sponsors are having to be more creative when weighing refinancing options, with sponsors having to write bigger checks to get refinancings over the line and borrowers often taking on more preferred equity and higher rate junior debt to facilitate maturity extensions.



2X

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In Europe, in particular, there are fears that expensive refinancings and sluggish economies will combine to push up levels of distress. The restructuring market is expected to be more active as a result, such that not only are we likely to see more distressed A&Es and increased LMEs, there may also be more debt-for-equity swaps and sponsors handing control of troubled companies to creditors.

Borrower-Friendly Documents

During years of low interest rates and competitive financing markets, borrowers and their sponsors enjoyed significant negotiating power when agreeing to terms with current and potential creditors. With capital widely available, protective covenants eroded and we have seen an expansion of debt document flexibility over the past decade.

Even in the tougher lending markets of 2022 and 2023, we witnessed only a small movement away from these borrower-favorable terms. While far fewer loans were issued, the deals that transacted typically involved higher quality companies that could still generate competition among lenders, so borrowers did not have to concede much on terms.

Now, with interest rates set to remain high and many maturities approaching, we expect to see private companies in the U.S. continue to enter into LMEs at a high level to address liquidity issues or financial distress utilizing this document flexibility.

In Europe, we have yet to see the same velocity of LMEs as opposed to in the U.S. as a result of differences in directors' duties regimes, intercreditor agreement terms, restructuring processes and market practice and culture. Still, we expect European companies to be increasingly mindful of these tools in their toolboxes, even if the primary consequences may be to shift dynamics, encouraging lender groups to mobilize more quickly and providing additional leverage to certain parties in negotiations.

In Asia, there are fewer examples of borrowers engaging in LMEs, though a notable example in late 2023 saw Vedanta Resources launch an exercise to restructure repayments of about \$3.8 billion on bonds after it secured new funds from a bank and private credit funds.

Evolution of LMEs

In the last couple of years, borrowers and their sponsors have begun to take advantage of the flexibility afforded by their loan documents to engage in LMEs that preserve or increase equity value to the detriment of some or all of their existing creditors.

While LMEs have previously taken one of two forms—involving either (i) drop-downs of assets with unrestricted subsidiaries or non-guarantor restricted subsidiaries incurring structurally senior financing or (ii) up-tiering certain debt into priming debt—the latest evolution of “double dips,” “pari plus” and related hybrid transactions raises new concerns—and opportunities—for lenders in 2024.



In the past year in the U.S., we saw more up-tiering transactions offered broadly to all lenders rather than up-tier debt available only to a closed group of lenders.

Specifics of LME Developments

Double Dips and Pari Plus Transactions

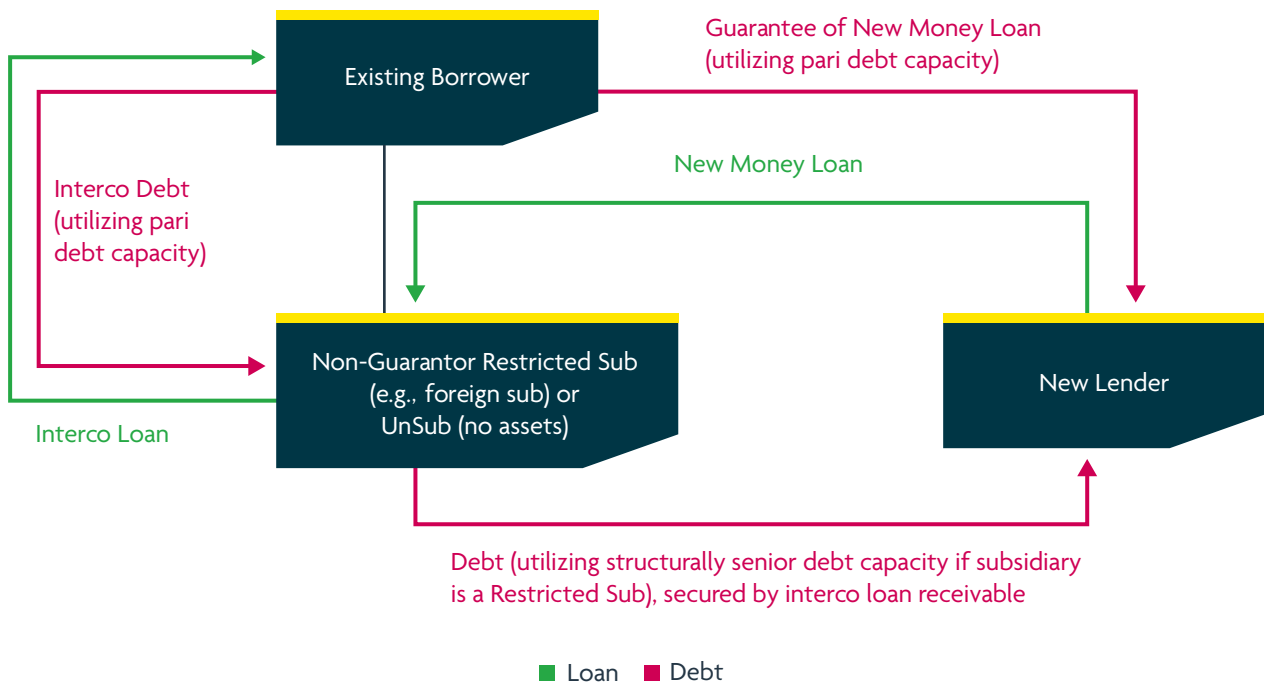
Double dips and pari plus deals represent the next generation of LMEs, arguably taking a less aggressive stance toward existing lenders. Both became more common through 2023.

Double Dips

In a double dip transaction, one loan effectively establishes two new claims on the existing debtor, as seen in the financings of both At Home Group and Wheel Pros last year:

- Given sufficient debt capacity under existing loan documents, a new lender may be able to dilute existing lenders by obtaining both a direct claim against existing loan parties, and a second indirect claim against those entities via an intercompany loan.
- The subsidiary then on-lends the proceeds to the existing borrower in an intercompany loan (utilizing pari debt capacity), creating a claim against the existing loan parties that is also pari with existing lenders.
- A new lender might do this by lending to a non-guarantor (utilizing structurally senior debt capacity) or unrestricted subsidiary of the company, with existing loan parties guaranteeing, and existing collateral securing, the loan, resulting in a direct pari claim against the existing loan parties.
- The subsidiary's interest in the pari intercompany loan can then secure the loan to the subsidiary, giving the new lender the indirect benefit of the second pari claim.

Simplified “Double Dip” Transaction Structure



Pari Plus

In a pari plus transaction, seen in the financings of Sabre and Trinseo last year, a variation establishes an indirect claim on the existing debtors and a structurally senior claim on certain other entities:

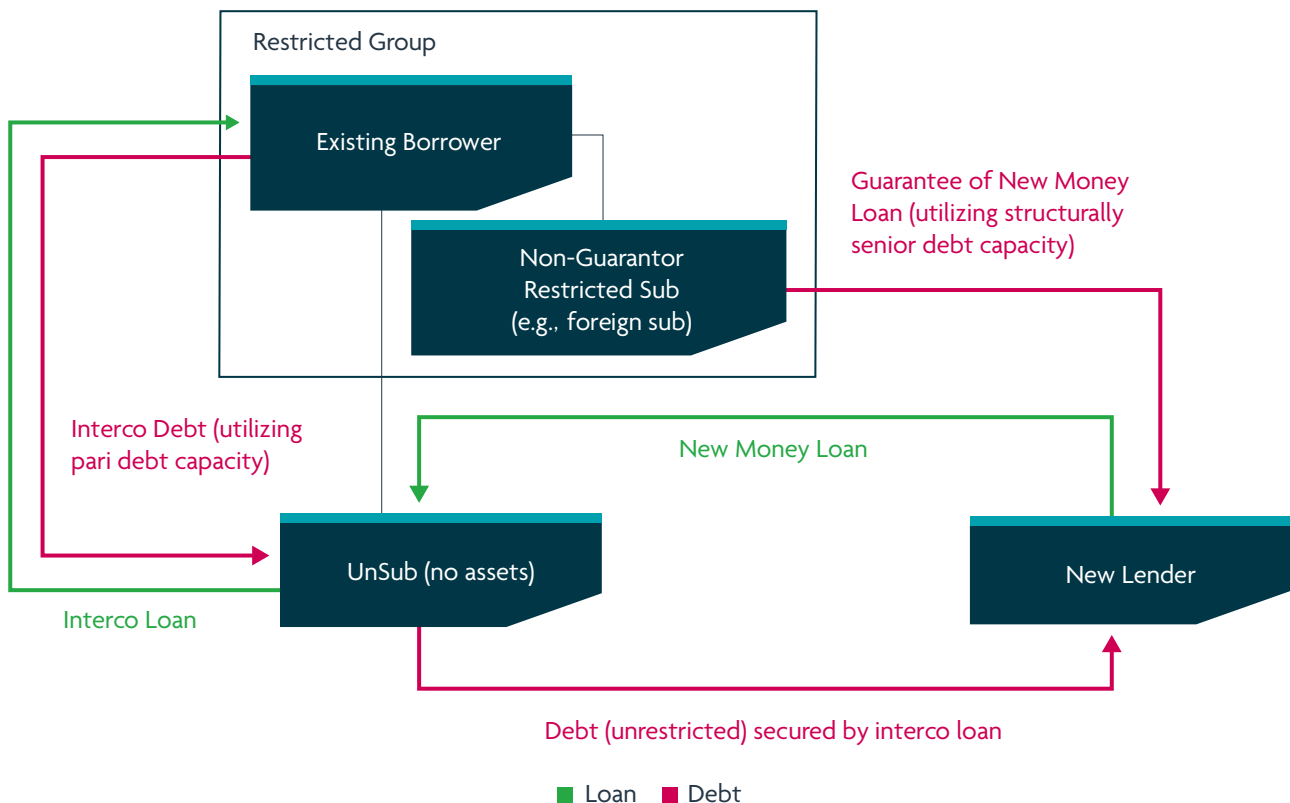
- A new lender may be willing to lend to a borrower with existing debt if it can obtain both a pari claim on existing guarantors and collateral, and additional guarantees/collateral that do not support the existing debt, i.e., pari plus.
- A common roadblock to a pari plus is a requirement in existing debt documents that certain permitted pari debt cannot be supported by non-guarantors or non-collateral. A new lender may be able to circumvent this requirement through use of an intercompany loan.
- A new lender may lend to an unrestricted subsidiary, with proceeds on-lent to the existing borrower on a pari basis with existing debt (utilizing pari debt capacity).



The loan to the subsidiary may be supported by:

- The unrestricted subsidiary's intercompany claim against the existing borrower (giving the new lender an indirect claim pari with existing debtors), and
- Guarantees from non-guarantors and/or security interest in non-collateral (utilizing structurally senior debt capacity).

Simplified “Pari Plus” Transaction Structure



Related Hybrid Transactions

Borrowers and new lenders can combine the more familiar drop-down maneuver with either the double dip or pari plus structure to further enhance the position of the new lenders with respect to the existing lenders.

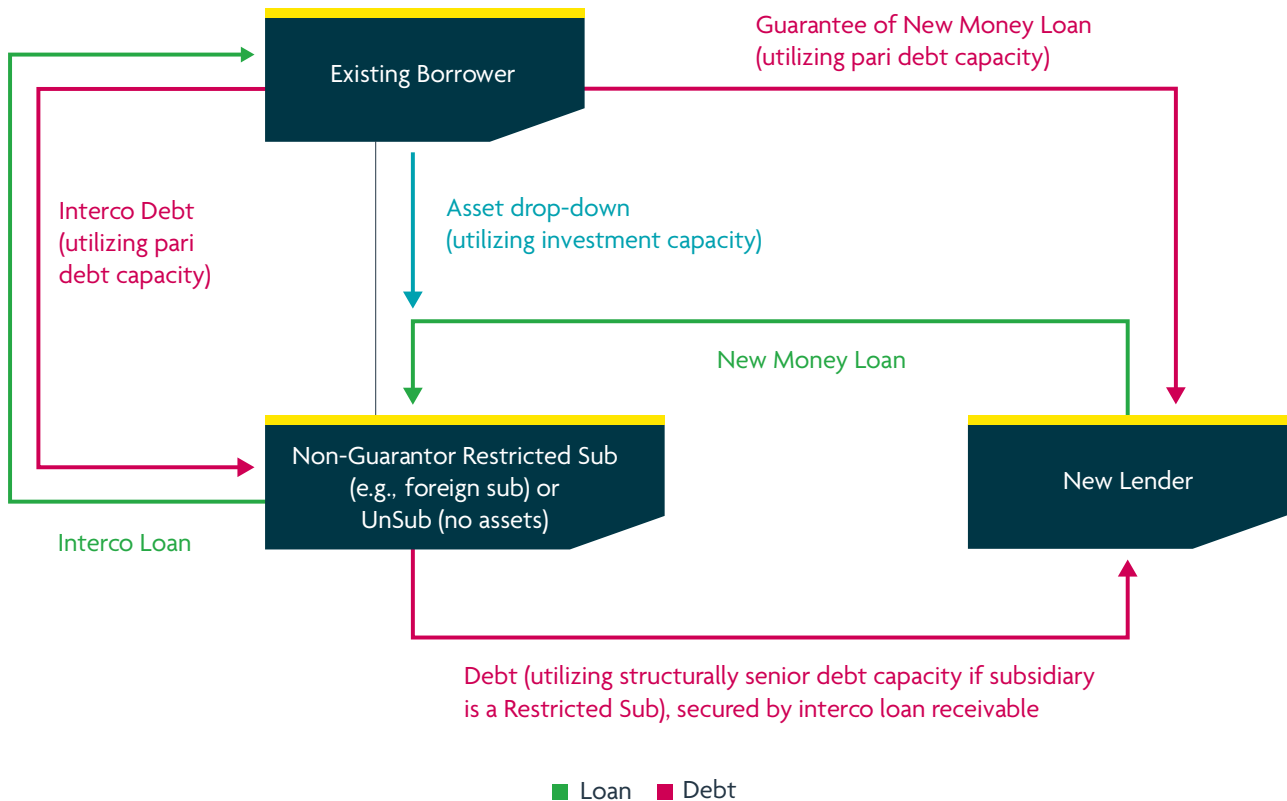


Borrowing through a sister company increases flexibility by avoiding certain subsidiary-related credit restrictions.

In Sabre, the “plus” component received by new lenders came from foreign guarantors that did not guarantee the existing debt. However, in Trinseo, the company moved equity that had been pledged to the existing debt to an unrestricted subsidiary, using that equity to support the new money loan. In other words, new lenders did not simply get something that existing lenders did not have, they got something that was moved away from existing lenders.

Further, in Trinseo, the drop-down of equity to an unrestricted subsidiary required more investment capacity than was available. Instead of on-lending all of the new money to the existing borrower, some was on-lent to a holding company above the restricted group, which contributed it down to the existing borrower, building up additional investment capacity that was used for the drop-down component. Finally, Trinseo also introduced the use of a sister company (in addition to unrestricted subsidiaries and non-guarantor restricted subsidiaries). Using a sister company as the borrower of the new money loan has the benefit of increased flexibility, because conditions in credit agreements applying to unrestricted subsidiaries and covenants restricting non-guarantor restricted subsidiaries do not apply to sister companies that are not subsidiaries of any loan party.

Simplified “Double Dip” + Drop-Down Transaction Structure



Up-Tiering and the Evolution of Lender-On-Lender Violence

Up-tiering transactions typically involve the insertion of priority tranches of senior debt and/or the up-tiering of selected existing debt. In the past year in the U.S., we saw more up-tiering transactions offered broadly to all lenders rather than up-tier debt available only to a closed group of lenders, suggesting something of a trend away from the lender-on-lender violence that was more typical in 2022. However, the question that will arise in these broadly offered transactions will be the amount of fees and other enhancements given to the backstop group or steering committee.

While some new loan documents prevent subordination to future debt, others allow subordination if participation in the new priming debt is offered pro rata to all lenders.

One reason to offer up-tier participation to all lenders rather than only an exclusive group of lenders is to reduce litigation risk. One recent positive indication for excluded, non-participating lenders came in December 2023 in Mitel. In litigation challenging the company's October 2022 up-tier exchange transaction, the court allowed contractual claims to proceed (which is usually some indication of the strength of the claim), while dismissing the covenant of good faith and fair dealing, fraudulent transfer and tortious interference claims. However, by contrast, in the Serta bankruptcy, similar claims brought by non-participating lenders were dismissed, and the issue remains unresolved.



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Up-Tier Priming Transaction Structure (with majority lender consent)

Existing First Lien Loans

First Out - new money from participating lenders

Second Lien or Second Out - Exchanged 1L (with participation in new money, which may or may not need to be offered pro rata to all lenders). In many documents 51% participation is sufficient to subordinate liens or obligations.

Third Lien or Third Out- non-participating 1L

Defaults and Recoveries Post-LME

Some initial studies suggest that many LME transactions end up in bankruptcy in any event, and on the way negatively impact various parties involved. While borrowers and their sponsors may see the appeal of additional liquidity as new money lines up against old money, in most cases the result may only be a short-term reprieve.

Data from the U.S. Loan Syndications and Trading Association (LSTA) shows that in 2023, weighted average recoveries on first-lien claims against issuers who executed LMEs prior to bankruptcy were 47%, while no issuers with LMEs saw recoveries over 70% on first-lien claims. This trails behind recoveries for issuers without LMEs, which stood at 60% (or 73% if we take Avaya and Party City out of the equation).¹



47%

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Cooperation Agreements

While so-called J.Crew blockers, PetSmart blocks, Serta protections and other anti-LME provisions have now become increasingly common, particularly in private credit loans, one of the key tools available to groups of lenders looking to protect themselves against LMEs is cooperation agreements.

In the U.S., if a company is going to do a drop-down financing, it can generally do so without engaging with an ad hoc lender group—one or more individual new or existing lenders can provide financing which results in value leakage for the rest of the lenders.



In the past 12 months, co-op agreements have evolved from being short agreements between lenders into longer, more tailored and sophisticated arrangements.

For a company to complete an up-tiering transaction, it typically needs the consent of holders of 51% of the loans and commitments. With a cooperation (co-op) agreement, a group of lenders agree that none of them will support an LME—whether drop-down, up-tier or otherwise—unless all lenders who are cooperation agreement parties are provided equal opportunity to participate.

Co-op agreements are particularly effective if there is an amendment or consent threshold required in order to implement a transaction, allowing the aligned group of lenders to take a blocking position and shift the dynamics of negotiations.

In the past 12 months, co-op agreements have evolved from being short agreements (or even emails) between lenders into longer, more tailored and sophisticated arrangements. We are also seeing them more commonly on European-based and cross-border credits as lenders anticipate a threat and seek protection in numbers.

¹ LSTA, "Legal Perspectives on Loan Market Trends", October 12, 2023.

Lenders are advised to enter into these agreements thoughtfully, however, being mindful of the fact that their debt will essentially come under the control of the majority going forward. As co-op agreements become more commonplace, key considerations for those looking at them will include:



Disparate interests across classes



Protections for various parties' treatment, including backstop fees, work fees and allocations



Whether only original co-op parties should benefit from the agreement



Voting thresholds to approve actions and amendments



How transfers are handled



Any specified parties to whom debt cannot be transferred



Termination dates

Continued Expansion of Private Credit

Market Shift from Broadly Syndicated Lending

The sustained growth of the private credit asset class appears to continue unabated, with borrowers increasingly circumventing the broadly syndicated loan market and instead turning to debt funds for speed of execution and certainty of closing. Estimates suggest that 85% of leveraged buyouts are now funded by private credit versus 60% five years ago, with the syndicated lending market struggling to compete both on flexibility and terms.

Increased adoption of the unitranche structure has fueled the growth of private credit, with \$500 million-plus unitranche facilities now commonplace. Private equity firms have also increasingly turned to private credit to fund deals, while syndicated loan volumes have dropped significantly since 2021 as key players retreated in the face of rising interest rates and macroeconomic uncertainty.



85%

Estimates suggest that 85% of leveraged buyouts are now funded by private credit.

Private credit's market share may be at a cyclical high, with many describing a "golden age of private credit" in the current interest rate environment. Given today's high interest rates, investors in private credit are enjoying double-digit unlevered returns on senior secured debt, while also benefiting from the inflation rate hedge offered by floating rate instruments.

Dual Tracking and Larger Financings

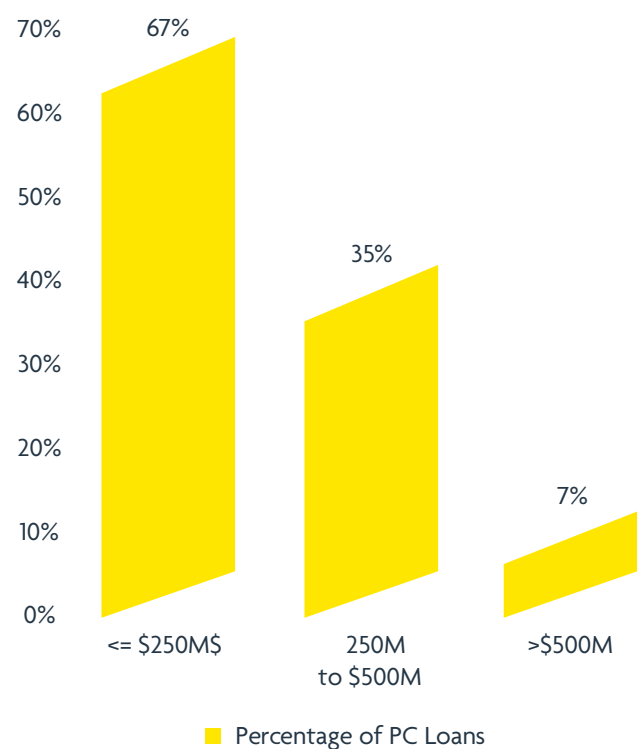
Despite the bullish strength of the private credit markets, the broadly syndicated loan markets remain competitive on pricing and showed signs of strengthening in the latter part of 2023. Many borrowers now run dual-track processes, and these have been a feature of most recent leveraged buyouts, with sponsors sometimes playing parties off against each other to the last minute.

In the meantime, private credit continues to step up to finance larger and larger transactions, partly as a result of the advent of something approaching "broadly syndicated private credit," where we see club deals often involving groups of more than a dozen lenders. With so many players willing to participate in the right transactions, deals financed with up to \$10 billion of private debt are no longer inconceivable. As private credit transactions get larger, market terms in private credit more closely resemble broadly syndicated loan terms. Data shows maintenance covenants tend to diminish with size just as add-back cap sizes get larger and closer to the levels seen in the broadly syndicated loan market.

Banks are now moving to participate in private credit themselves, with a number of joint ventures announced in the past year. In practice, execution is challenging, and it remains to be seen whether the banks can compete on the speed and flexibility elements that have driven growth of the asset class.

We also expect to see a growing demand for hybrid capital in 2024, be that preferred equity or structured equity with debt-like features, which continues to play into the hands of private credit, offering more potential to increase yields.

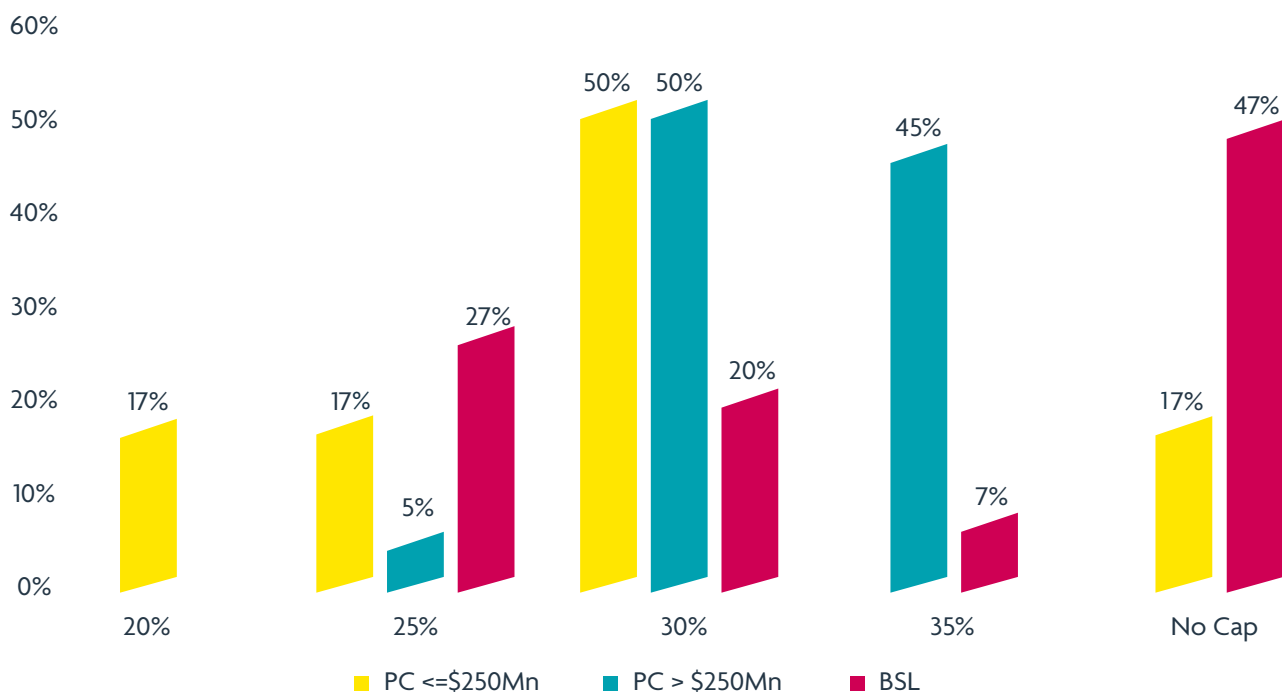
Percentage of PC Loans with Always-on (Not Springing) Term Loan Maintenance Covenant



Source: Moody's Investors Service



Cap Sizes on EBITDA Add-backs for Run Rate Cost Savings, Synergies, Business Optimizations



Source: Moody's Investors Service

Energy Transition and Private Credit

Recent data from McKinsey suggests the transformation of the global economy from fossil fuels to clean energy could require \$9 trillion of annual investment in physical assets from now until 2050, an increase of \$3.5 trillion a year on what we are spending today.² With a growing proportion of that set to come from the private sector as public finances struggle, private credit funds are increasingly seeking out opportunities to fund energy transition.

market. Private credit funds benefit from a flexibility of mandate that works well in energy transition, allowing them to contemplate deals that may involve sectors like oil & gas and mining where banks are now hindered by more restrictive mandates.

In the U.S., the tax incentives offered by the Inflation Reduction Act (IRA) to encourage clean energy investing are having a clear impact, while Europe is also now moving to roll out its own subsidy packages in key sectors, taking a more piecemeal approach.



\$9 trillion

The transformation of the global economy from fossil fuels to clean energy could require \$9 trillion of annual investment in physical assets from now until 2050.

Structures are evolving from the traditional 20-year long-term project financing agreements of old, with debt funds looking at shorter term facilities and more complex, multitiered structures. We are also seeing greater use of junior debt and portfolio financings and expect those to feature more prominently moving forward.

We have seen a flurry of funds raised in the past 12 months to back green infrastructure and clean energy, in part driven by LP appetite and constraints in the bank lending

Sponsored Versus Non-Sponsored Deals

As the direct lending market becomes increasingly competitive, a growing number of credit funds are turning their attentions to non-sponsored deals in an effort to distinguish themselves, tap into new opportunities and receive enhanced economics. By creating unique sourcing channels to target both corporate lending and the more esoteric asset-based and asset-backed lending markets, funds can not only avoid pure term sheet competition but can also push up risk-adjusted returns.

For lenders, there are many advantages to having seasoned sponsors involved in deals, with non-sponsored corporates presenting greater risks when it comes to governance, raising future capital and recoveries in the event of restructuring.

Non-sponsored deals do tend to come with tighter documents, fewer covenant exceptions and tighter EBITDA definitions, however, as well as the potential for equity or equity-linked instruments and higher returns. There is also a greater likelihood that sponsor-backed companies will engage in aggressive LMEs, which remain rarer (but by no means unseen) among large unsponsored companies (e.g., Sabre and Trinseo) and uncommon among middle-market unsponsored companies.

Growth in Asia Pacific

The appetite for private credit continues to grow in the Asia Pacific region as a lack of domestic capital to support rapidly expanding economies creates an opportunity for alternative lenders. With many borrowers in Asia not yet at a level of maturity to tap international bond markets and experiencing constraints in bank lending, the demand for private debt is outstripping supply to create a borrower-friendly direct lending market.

As the Chinese economy struggles, opportunities for private credit funds have been particularly apparent in India and Indonesia as sponsors have prioritized those growth economies. Australia remains one of Asia's most active private debt markets, while the commercial real estate lending opportunity is also set to be a big feature for the region in 2024.



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Disqualified Lenders and Transferability

Since the global financial crisis, lenders have generally been relatively unrestricted in their ability to transfer loan positions without the consent of borrowers, to either:



Existing lenders



Entities included on “approved” lists (in U.K. and European documents), or



Where certain events of default were continuing, any other entities.

When consent is necessary (for example, in U.S. documents for transfers to non-lenders where there is no concept of a pre-approved list), borrowers have not typically withheld their consent to a transfer and under many documents, borrower consent, if not forthcoming, was deemed obtained after the lapse of a short period.

While these lender-friendly provisions made sense, the competitive financing market and general availability of capital over the last few years have driven an expansion in debt document flexibility and a shift to more borrower-friendly documentation.

As a result, borrowers and sponsors have been able to secure more control over the identity of the lender group, with the size and scope of approved lists (in U.K. and European documents) and the Disqualified Lender list (a concept in U.S. documents where certain lenders are not permitted to hold loans in any circumstance) evolving.

There has also been a move toward blanket restrictions on the transfer of loan interests to certain types of entities, such as industry competitors or distressed investors. The scope of transfer restrictions has also expanded,

in some cases now extending to voting sub-participations. In the U.S., borrowers more frequently seek to disqualify lenders or groups of lenders from buying loans or participations. There is also now an increased number of outstanding loan agreements that give borrowers the ability to force disqualified lenders to sell their loans, sometimes at the lesser of par, trading price and purchase price.

These restrictions have interesting implications for the credit markets going forward. Loan liquidity becomes limited as certain lenders are constrained from getting involved in certain situations and, as a result, existing lenders may struggle to exit stressed positions.

Looking forward, while enhanced restrictions on lender rights of transferability look likely to remain a feature for some time, lenders benefiting from stronger leverage during A&E processes may use the opportunity to remove approved list requirements (U.K. and Europe) or a borrower’s ability to designate Disqualified Lenders (U.S.).

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