KEY POINTS

- Private credit funds hold an ever-increasing portion of issued debt in the London market, and have significant institutional differences and drivers compared to banks which impact how they may behave in a distressed scenario.
- Credit funds have differing drivers in relation to regulatory cost of capital, investment mandate, and approach to publicity. In some cases, they also have divisions more able to hold and run large equity positions.
- In relation to a new money ask in an existing credit, this is most likely to be funded by investors in the form of a new fund, rather than by drawing on one of the fund's bank debt facilities.

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Direct Lending in a distressed world

In this article the authors consider what makes funds behave differently to banks in a distressed scenario and some specific issues faced by funds.

PRIVATE CREDIT IN 2022

During the early stages of the COVID 19 pandemic, the expectation in some quarters was that there would be a huge wave of corporate collapses and restructurings. Undoubtedly there were immediate term cashflow impacts and a liquidity pinch for many businesses in the first UK lockdown. Whilst there have been some subsequent restructuring transactions and the occasional insolvency, the mid and upper market have seen very low numbers of either relative to historic norms. In the wake of the pandemic there is high demand for private credit and a willingness from lenders to consider distressed credits and riskier sectors in order to deploy the cash they had raised.

This is partly due to the level of government support provided during the pandemic (including the furlough program, the moratorium on landlord action and certain tax deferrals) and partly because of record levels of liquidity struggling to find a home in a low yield environment (exacerbated in part by central banks printing yet more of it). Banks and credit funds alike offered waivers and fresh liquidity to help the economy limp through unchartered waters. Lenders were faced with varying degrees of scenarios – from waivers, covenant relaxation, interest and amortisation deferrals and PIK toggles to new liquidity requests (commonly in the form of super senior tranches, sometimes pari or even junior). It was felt by many to be a bad time in the cycle to pursue enforcements – crystallising values at a low point, and recovering existing capital where most were more concerned with trying to deploy it. Broadly speaking, all lenders, whether traditional bank lenders or private credit funds have managed their credits through the pandemic period without the level of default rate previously anticipated.

As we start to emerge from the pandemic, there are two key reasons why private credit has remained in such high demand.

- first, various companies (and in some cases entire sectors) still need shoring up in what remains a turbulent time, particularly as government rescue measures have been switched off – and private credit has been eager to step up to the plate; and
- second, the private equity markets have come back to life with record capital to invest, and all of these deals need financing.

In the same way that there is pent up demand in the private equity funds, many banks and credit funds are actively seeking opportunities to provide funding, whether for a new acquisition or a refinancing of old debt, in order to generate returns for their investors. In the current market it may feel as though there is too much money chasing too few deals, with lenders having to look at risker, more distressed positions in their need to generate that return. Private credit investor fee structures are increasingly based on money invested not committed, adding to the pressure to deploy.

Uncertainties in the global economy in 2022, not least from Russian actions in eastern Europe, mean that the growth of private credit as a funding source for both stressed and distressed companies (as well as acquisition finance) is set to continue apace for some time to come.

WHAT DO PRIVATE CREDIT FUNDS CARE ABOUT?

Broadly speaking, credit funds have a similar set of concerns to their bank lender counterparts where they are investing at the same level. However, a distinction must be drawn between lenders' concerns in the context of a broadly syndicated deal and the interests of private credit funds who typically hold risk to maturity.

In terms of product specialisms, private credit funds (in addition to underwriting increasingly substantial unitranche tickets in competition with traditional banks) will typically have a broader investment mandate and are able to invest in more junior tranches of debt than their banking counterparts in order to secure the return that they are looking for. A fund will not have the same regulatory capital constraints as a bank lender, and funds are expressly raised with a higher risk/return mandate. This can make higher leveraged situations, and junior positions, attractive for a fund whilst not being feasible for a bank.

It would be too simplistic to say that all lenders investing at a senior level within a capital stack share the same concerns, and that credit funds at more junior levels will have the same common points on their issues lists. The reality is that in the same way that no one bank lender will have the same priorities or the same risk appetite as another bank lender, no private credit fund will be exactly the same as another. There is a broad spectrum of funds in existence today – some small, some standalone, some part of broader private equity platforms. Funds which are part of a larger PE house will no doubt draw on the experience of their PE colleagues and industry sector experience; they may even have owned the asset in the past. This knowledge will play into how they approach both new money lending and restructurings.

However, achieving the right level of return is characteristically a universal consideration for all credit funds. Typically credit funds will be looking for returns with a yield of at least 7% or 8%, and therefore the credits and sectors where private credit has focussed have often had a higher risk profile. The fierce competition in the lending markets has meant that stressed and distressed credits are commonly of interest as a conduit to those greater ROIs. Needless to say, those credits and sectors are often more prone to economic shocks, meaning that restructurings where direct lending forms part of the capital structure are becoming more commonplace.

One area where credit funds are often focused is deals where they can take advantage of priming opportunities (which have become a common feature of borrower-friendly documentation in the last few years) and entering into transactions where traditional bank lenders may be loathe to go. The recent US cases of *TriMark*, *Serta*, *Chewy* and *J Crew* have brought into focus a number of particular "loopholes" arising from borrower-friendly (and so perhaps "looser") debt documentation. Credit funds have sought both to protect themselves in the documentation from the outset, and exploit the potential priming opportunities presented within a restructuring scenario. Not just seen as the dark arts explored in a restructuring context, these types of gaps are now deliberately plumbed into origination documents by sponsors and borrowers that have been burned by tight documents in the past.

Aside from these now familiar trip-hazards from the likes of *TriMark*, *Serta*, *Chewy* and *J Crew*, there are two documentation issues particular to credit funds which have become a focus at the restructuring stage. First, whether the intercreditor agreement includes an option to close-out hedging or the ability to transfer hedging liabilities to third parties. This is important for credit funds seeking to avoid having to acquire hedging liabilities which may not be permitted under their fund documents. Second, indemnities given to various stakeholders in a restructuring (for example the indemnity to the Security Agent before taking enforcement action) can be hotly negotiated, and funds may have policy issues associated with giving such indemnities.

A DIFFERENT APPROACH TO DISTRESSED SITUATIONS?

The question of how the approach of credit funds, in a distressed scenario, differs from that of syndicated bank lenders has been discussed before. The standard response is usually that credit funds may be more willing to take the keys on a restructuring than their banking counterparts. This may be correct for a number of reasons, it is true that from a PR perspective a bank lender may be more averse to taking enforcement action, than a relatively unknown credit fund might be. But this answer oversimplifies the position. To understand the different approaches, we need to consider what makes credit funds behave differently to banks.

What makes funds behave differently?

- Funds will typically hold the debt (unlike banks in syndicated deals) so their exposures to any one credit is often bigger, and this will impact their behaviour in a restructuring scenario. Generally, capital requirement regulations apply to banks but not credit funds. The regulations dictate how much capital a bank must hold against a particular lending and will be a major factor in its willingness to hold the debt. The riskier and more stressed the credit, the greater the capital requirement and the more expensive it is for a bank to hold the credit. For bank lenders this often means that in relation to risky credits they are more likely to sell the debt on in the secondary market, sometimes at the very start of the transaction if a sector is particularly risky, or more often later on when a credit becomes at greater risk of default. Conversely funds do not have to grapple with these restrictions. This is not to do with differing views of credit quality between the banks and the funds, but it is purely a function of the regulations which bite on banks and not on credit funds that make it the right economic choice for one party to hold the debt yet still the right economic choice for another entity to buy at that same price.
- It is problematic for funds to be repaid early. Funds make their investments based on returns over a specified period, so if repaid they would then need to redeploy that capital elsewhere in order to ensure they hit their necessary returns for a particular fund or investment period (exacerbated in particular in the last year or two of a particular fund, where there is unlikely to be an obvious opportunity to deploy and receive repayment prior to fund maturity). This often leads to large prepayment fees in the facility agreements together with/or make whole provisions. This consideration is likely to impact how a credit fund might approach a restructuring: it may want to continue the lending and support the distressed borrower whereas a traditional bank lender may be more focussed on getting paid out as close to par as soon as possible, through an enforcement if necessary.
- The larger credit funds have both the operational and financial ability to help their portfolio companies navigate choppy waters. The smaller credit funds are not set up to deal with a significant number of restructurings. They may have only one or two people in the team tasked with managing all special situations across the portfolio and that may well affect their approach to any restructuring – but this varies enormously from fund to fund and depends on the specific set-up of each institution. Banks in contrast have tended to maintain very large teams, and some say can scale it quickly. Both are ultimately doing the same thing however – which is to leverage their restructuring expertise by bolstering the team with origination personnel if and when the market gets busy.

Biog box
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How will a credit fund behave differently?

- **More willing to take the keys:** Yes – credit funds are sometimes more inclined than a traditional bank lender to take the keys to a distressed credit, to the extent they have the platform to run a portfolio company. It is an inescapable fact that banks, as typically well-known house names, sometimes have reputational risk issues connected with the enforcement processes often needed to gain control of the distressed company. A credit fund which is part of a larger PE platform may have the operational, as well as financial, experience needed to run the business, and they may be free from regulatory and institutional policy restrictions associated with owning certain businesses which bank lenders can sometimes face. Practically, it is also often easier to take the keys in a unitranche/direct lending deal because there are a smaller number of lenders who have to take the relevant decisions leading up to enforcement, as opposed to a widely syndicated deal where the capital structure may be more fractured and will often require creditor committees to be formed to represent the wider classes of lenders in the restructuring negotiations. Regulatory costs of capital, audit consolidation, and anti-trust clearances can also hamper a bank in taking equity. Club deals, with each lender taking a small stake, can mitigate this but without effective decision-making corporate governance then tends to suffer. But, as mentioned, smaller players may not be so keen to take the keys because they are not set up to run the company, so will look for a more consensual route to working through the issues, eg through a waiver process or consensual resizing of the capital structure. It is big drain on a lender's resources to go through a full restructuring and take ownership of a portfolio company and many funds are simply not set up to do so. Even where a fund is so minded, finding willing management and expertise is not always straightforward where those resources are not available in house or from the wider PE platform.
- **More flexibility:** In a restructuring scenario, credit funds can arguably be nimbler as they do not have the same level of credit committee and approval processes to go through before they can agree a deal. They might also be more willing to participate in a new money ask for the struggling credit where they are likely to get a higher coupon and benefit from super seniority. In relation to a new money ask in an existing credit, this is most likely to be funded by investors in the form of a new fund, rather than by drawing on one of the fund's bank debt facilities. Where incremental debt is advanced by a new fund, this will be dealt with under the fund formation documents which typically cater for this scenario by allowing cross holdings in different parts of the capital structure even if those funds are advised by the same fund manager. Credit funds are debatably hungrier for return and so can be willing to make riskier investment, such as providing a new money ask in a distressed credit where the return is attractive. They can also take positions across different levels of a capital structure (whether a super senior tranche or holdco PIK debt) which makes them more flexible in distressed cases, and they can increase their leverage by having multiple holdings across the debt stack.
- **Sponsor relationships:** Some might argue that the strong sponsor-credit fund relationships will also have an impact on the stance that a credit fund will take in a distressed credit situation. Clearly taking enforcement action against a sponsor has its own reputational risks for the fund and may endanger future mandates from that sponsor. However, this is likely to be a consideration to a varying degree for all lenders and will depend very much on the circumstances of and relationships involved in each individual deal. There may well be instances of funds acting in multiple capacities within a particular credit, for example in cases where a credit fund with a PE arm is invested both in the equity and the debt. Where an institution is acting as both shareholder and lender, it is likely to have a bearing on how a credit fund might behave on a restructuring, albeit those credit funds will want to ensure they are not conflicted, falling on the wrong side of internal conflict management regulations, or risk becoming disenfranchised from any relevant lending decisions under the intercreditor agreement.

CONCLUSION

There are natural differences between how traditional bank lenders and private credit lenders may see distressed situations, but it depends largely on a private credit fund's unique circumstance which are broad ranging.

Inevitably, given the increasing number of private credit deals, we are likely to see more instances of credit funds taking the keys to distressed credits over the coming twelve months, and it is likely that those transactions will happen more readily in cases where credit funds are well set up to operate businesses going forwards. Having said that, the vast majority of outcomes of distressed situations with private credit funds are likely to be dominated by consensual restructurings, in the same way that they are in bank-led transactions. But in terms of the options available to credit funds to find a solution to a distressed situation, there may be more on the table. ■