KEY POINTS

- Direct lending structures have evolved to accommodate other creditors and stakeholders.
- Development of the capital structure in this way presents a number of legal and practical issues for practitioners and their clients to navigate.

Feature

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Current and anticipated trends in direct lending

Since 2008, and especially since 2013, direct lending has offered a new source of liquidity for European mid-market borrowers unable to access capital from the traditional lending community to refinance and grow in the aftermath of the financial crisis, and of insufficient size to access the debt capital markets. This article reflects on the present state of the direct lending market using data from Deloitte[1] and Preqin,[2] as well as the author's own observations of market activity and following discussions with a number of other market participants. It then considers some of the key issues – legal and practical – that arise where super-senior revolving credit facilities and asset-based lending facilities are introduced into direct lending capital structures, before concluding with the author's predictions for key themes that could shape the direct lending market in 2018 and beyond.

EUROPEAN MARKET UPDATE

Activity and size of market

2017 saw private debt, the principal contributor to direct lending, continue to reach record levels of activity. According to Preqin, dry-powder for European-focussed private debt funds rose to $56.1bn at the end of Q3 2017 on the back of record fund raising in 2017, with seven Europe-focused funds raising a total of $6.9bn in that quarter alone; and, according to Deloitte, there was a 15% increase during the twelve month period to and including Q3 2017 in deployment by volume. Demand for direct lending shows few signs of abating.

Market participants

The market continues to be driven by private debt funds owned, managed and/or advised by leading private equity funds, hedge funds and asset managers, as well as traditional financial institutions. Some of these were traditionally best known as junior or distressed debt specialists. Direct lending funds operate either on a standalone basis, or as part of a multi-asset approach, for example alongside senior, junior and special situations strategies.

Recently, the market has seen the advent of direct lending in the mid-market leveraged space directly by the private debt *investor* community (ie insurance, pension and similar funds that would generally have invested only through debt funds). Such investors have for many years participated directly in the origination of investment grade loans, but the migration to less liquid, higher risk/return assets marks an interesting development and is, perhaps, symptomatic of all investors' quest for yield in the current environment.

Purpose of credit

In 2017, we saw debt funds represent an ever growing proportion of financiers in mid-market acquisition financing. Lengthy drawdown periods are being surmounted through a combination of:

- debt funds having found a way of coming closer to matching the mainstream banks (for instance, utilising swingline or similar facilities, or drawing down funds from investors in advance); and
- sellers (and therefore bidders) becoming comfortable with the debt funds' slightly longer utilisation requirements in view of the benefits they can offer elsewhere.

Private equity houses' current willingness to all-equity fund more of their investments, allowing for partial debt refinancing post-acquisition, has also made this less of an obstacle. Debt funds' willingness, for the right credit, to allow greater levels of leverage, together with non-cash pay interest features, has continued to make them an attractive alternative for dividend recapitalisations. Committed acquisition and capital expenditure funding frequently sits alongside the main TLB (Term Loan B) loan to support the borrower's future development plans, as well as to finance permitted distributions to shareholders. This is complemented by increased flexibility seen in allowing uncommitted incremental debt capacity.

Jurisdictions

Deloitte's research makes plain the breadth of geographical activity witnessed in 2017. The UK continues to represent fertile ground for direct lenders, with activity even growing by 35% on 2016 levels. Areas of continental Europe – notably France (particularly through euro private placement) and Germany – are mature markets for the product, with the Netherlands and Sweden close behind.

Spain and Italy – traditionally markets dominated by local banks – are offering fresh opportunities, especially where credit funds can offer swift delivery. Regulatory constraints and withholding tax barriers in Italy continue to present an obstacle for non-domestic credit funds. "Double-Luxco" (or Dutchco) structures, once a pre-requisite for cross-border investment into a number of European jurisdictions to facilitate share enforcement and mitigate risk of COMI shift, would appear to have been less prevalent in 2017. Central and Eastern Europe has, to date, notably remained relatively under exploited by debt funds.

Cross-border direct lending requires careful analysis to help debt funds approach and price debt service and downside risk appropriately. A non-exhaustive list of issues to consider with local law experts in the context of direct lending are:

- regulatory requirements to lend, to take deposits, to sell and/or market debt or securities (as applicable);
- tax (withholding tax, interest deductibility, capital gains tax, recharacterisation risk);
- security (availability of types of security to debt funds, use of a security trust, costs/taxes);

- financial assistance;
- usury laws (caps, restrictions on PIK (payment in kind));
- corporate benefit and maintenance of capital;
- equitable subordination;
- shadow directorship; and
- enforcement and insolvency (process, timing, triggers, moratoria).

Many of these are clearly not issues exclusively facing debt funds involved in direct lending. However, the illiquid nature of the product, and some of the "bells and whistles" more frequently encountered – such as high levels of, or PIK, interest, call protection, directors and board observers, warrants or other equity – can make them particularly acute. Most such issues are beyond the assumed scope of English law Loan Market Association (LMA) leveraged finance template documentation and therefore will need to be addressed on a case-by-case basis.

DEVELOPING THE CAPITAL STRUCTURE

Background

Private debt still typically forms the majority, if not all, of the overall capital structure in which it is invested. Notwithstanding this, other creditors frequently co-exist alongside the main term debt provider(s); either as part of an inherited structure, or by being brought in (or permitted to be brought in) during the life of the facilities to respond to a further financing need.

The impact of additional financial indebtedness on debt service and downside planning needs to be carefully considered by the debt fund with its advisers, with facilities priced accordingly. In some cases, satisfactory intercreditor and subordination arrangements will be required.

In this context we encounter structures that do not conform to the customary "large cap", private equity acquisition structure (on the basis of which the LMA leveraged documentation was drafted). Examples we have encountered include:

- no holding company structure;
- minority interests and joint ventures within the recourse group (including those which prohibit credit support from material entities);
- insolvent and/or negative EBITDA group companies;
- ring-fenced assets outside of security net (impacting qualifying floating charge holder analysis);
- deferred consideration arising through executed buy-and-build strategies;
- natural person (subordinated) creditors;
- related-party creditors or stakeholders (such as landlords or contract counterparties);
- potentially valuable assets, such as IP, being owned outside the group;
- warrants and equity kickers;
- defined benefit pension schemes; and
- public limited companies (raising potential English law financial assistance concerns).

Such features, from my experience and with the exception of pensions issues, tend to be found disproportionately in non-sponsored credits, or in lower value transactions. Borrowers and sponsors invariably approach such deals expecting structuring requirements and legal advisor involvement (and therefore cost) to be lower given the lower deal size or in contrast to corporate facilities provided at lower leverage levels on banks' standard terms. These cost constraints, accentuated by the widespread use of capped estimates for lenders' counsel agreed by sponsors and debt advisors, make it particularly difficult for credit funds and their legal advisors to analyse and navigate effectively the issues which in many cases only become apparent once work on a transaction has commenced. The consequence is that a future restructuring of the credit is likely to be less straightforward, with recoveries being jeopardised.

A note on leverage

Deloitte's recent data (citing S&P) indicates that leverage levels in sub-£200m debt structures have risen to 4.8x, almost a turn of leverage higher than a year earlier (but still some way short of highs in the region of 6.0x seen prior to the global crash). Credit funds have contributed to this, through their willingness to provide unitranche or stretched-senior financing for businesses for whom a traditional senior-junior capital structure or high yield notes issuance would otherwise be unattainable, prohibitively expensive or too administratively burdensome.

Increased leverage is not only a point for debt funds: a number of traditional bank lenders providing working capital facilities alongside debt funds on a super-senior basis have voiced reputational concerns at rising debt levels. This is especially the case where the super-senior working capital debt, although forming only a limited part of the overall capital structure, will recover first on an enforcement which may also result in an elimination of the equity and subordinated indebtedness.

Additional term debt

Debt funds' investment models are often well-suited to deploying as much of the capital structure as possible. We therefore continue to see them:

- offer to provide increased up-front committed term debt (available either on a delayed-draw basis or at signing to be held in a secured account – from the lender's perspective, ideally a blocked account to bolster the fixed/floating charge analysis – pending release and application for agreed purposes, such as capital expenditure); and/or
- require control over the incurrence of future term debt to take advantage of future opportunities to provide additional capital, either through a traditional consent right or a right to match where incremental debt capacity is permitted.

In relation to this latter permission, debt baskets, in the lower mid-market in particular, tend to be subject to an absolute cap (as per the LMA drafting) which might grow in line with acquisitions or EBITDA growth. Larger businesses may achieve a leverage based-cap. At the very top end of activity, a leverage-based cap *plus* an absolute cap (which might itself grow with EBITDA) *plus* certain further add-backs are the norm, in line with the non-private credit leveraged finance market.

Debt funds continue to seek and achieve call protection (which protects against the risk of being repaid early from the proceeds of a cheaper financing) for their term debt in the deals we have seen. Notwithstanding this, faced with re-pricing opportunities, owners keen to extract value before the macro-economic landscape changes, and a

relatively buoyant M&A landscape, we have seen a number of credits refinanced relatively early within the life of a facility, including on occasion prior to the expiry of call-protection periods. This may allow capital to be recycled by credit funds within re-investment periods.

Working capital: some general observations

Generally, debt funds have limited ability or appetite to provide revolving working capital lines; less still ancillary facilities and operational debt lines. However, we are now seeing a small number of funds willing to make available a revolving credit facility (RCF), albeit invariably only alongside the provision of term debt and not on a standalone basis. And we are aware that at least one credit fund has recently invested in specialist asset-based lending (ABL) capabilities to complement its direct lending offering. That said, in the main these credit lines continue to be provided by third party financiers.

Where there is an identified need for such facilities, debt funds are usually asked at the outset to provide flexibility for a working capital provider to be brought into the capital structure. This often takes the form of an RCF provided on a super-senior basis. Increasingly where the cash flows or other assets permit, this may take the form of an invoice discounting or other ABL line where the recourse and credit support package available to each creditor will invariably differ.

The common issue this presents (in contrast to a bank-led financing offering a *pari passu* RCF on substantially LMA terms) is the need to involve a third-party creditor and (if appointed) their legal counsel in the principal term financing discussions. In principle, working capital facilities can be – and indeed we do see them – put in place at the outset of the deal alongside the term facilities. This requires a lender to be identified to negotiate relevant rights. However, the execution risk of failure to put in place a working capital facility at the outset, in the absence of market standard documentation, means this approach is comparatively rare in the context of competitive acquisition processes.

Beyond this, we have advised on a range of options available to sponsors/borrowers and credit funds looking to introduce a working capital provider. These options span incorporating as much of the "plumbing" as possible into the unitranche financing documents, to an outline permission which may contain only certain key terms which would, in principle, be acceptable to the unitranche provider. In between, relatively detailed intercreditor principles (agreed as between sponsor/borrower and debt fund only) are being seen. In assessing which solution is optimal, the following factors might be considered:

- **Execution risk**: Can the arrangements be negotiated and documented within the timetable for the term financing need? If, there is a risk to this, what can be achieved without jeopardising that?
- **Cost and cost-cover**: What are the relative up-front costs? If not all up-front, what are the anticipated subsequent/overall costs taking into account additional negotiations, amendments, credit support? Are there efficiencies that can be achieved by doing or approving more up-front? What cost-cover does the term debt provider have?
- **Certainty of availability**: How important is the working capital facility – or related ancillary facilities, such as operational debt lines – and what is the timing for that? What risks are there to achieving this? And what alternatives are there?
- **Key terms and construct**: Has a proposed provider been identified? Will the facility sit within or outside the existing finance documents? Is there a market position for terms that will require third party approval? Will the new provider be separately advised?
- **Negotiating power**: Sponsors and borrowers can leverage competition from other providers for the provision of the term debt to achieve optimal working capital flexibility. After closing, term debt providers' willingness to accommodate this will wane.
- **Credit support**: Has the security package for, and ranking of, the new facility been agreed? Can credit support be effectively taken for all debt (including new working capital) up front? Does the agreed mechanism: allow for a robust and timely analysis of the impact of its introduction, include a flexible security trust and work from a local law perspective?

In the absence of a true "market" position, there is a competitive advantage for credit funds that can demonstrate to corporates, sponsors and intermediaries, a recent track record of or protocol for agreeing terms with a number of potential working capital facility providers to mitigate risk and reduce the costs involved in putting such arrangements in place.

If an anticipated working capital need post-closing cannot be addressed short term through an increased equity contribution or retained cash, we have seen term facilities offered by private debt providers as a bridge to introducing an RCF post-closing. In this scenario, borrowers will be mindful of being asked to pay up-front fees on the working capital financing twice (once to the debt fund, and then to the incoming RCF provider) and of the risk of failure to agree terms for the take-out.

The bridge solution also does not wholly address any requirement for letters of credit or bank guarantees (for instance in businesses relying on cross-border trade or tendering). Over-funded equity, retained cash or term debt can be used to cash collateralise letters of credit or guarantees. However, that still requires the original issuer (often an out-going lender with limited incentive to co-operate) to agree to accept that cash collateral within the parameters of its existing facility arrangements or to negotiate new facilities documentation that can accommodate that cash collateral.

Revolving credit facilities (RCF)

RCFs, once constituted, usually participate in the common transaction security package on a *pari passu* or super-senior basis and will benefit from the same guarantees as those provided to the debt fund. Most of the RCFs we have recently seen introduced have been provided on a super-senior basis, as part of the unitranche facility agreement, representing between 5 and 15% of the size of the day-one committed term debt.

A detailed discussion of the key areas for negotiation in these structures can be found at (2016) 4 JIBFL 216: *Intercreditor considerations for super senior lenders in unitranche financings*. These now tend to fall within a much narrower range of positions than was seen even 18 months ago, although control of enforcement in particular remains negotiable. As the size of the RCF relative to the term debt increases, the bargaining position of term and RCF provider

and therefore the expected outcome will start to shift in favour of the RCF provider.

Unless the RCF terms are sufficiently clear at the outset and a mechanism has been included for constituting the RCF, supplemental security will typically be sought as a result of the increase in secured obligations. Local law advice should always be taken (or the potential consequences of failure to take such advice discussed with clients) where overseas credit support is concerned. For further discussion of the issues at stake when introducing the revolving credit facility, see (2012) 6 JIBFL 334: *Debt restructuring: Putting the security at risk*. Care should also be taken not to destroy the existing trust mechanism, if that was constituted to benefit only those persons who were "original lenders" or those becoming lenders through the prescribed transfer mechanism.

As an alternative or interim solution, specific working capital facilities, or baskets for such facilities, could simply be permitted – without agreeing intercreditor terms – in much the same way that local credit line permissions have long been customary in LBO facilities. There are clear risks for the term debt provider in doing so, although from a debt fund's perspective these may be acceptable where these are relatively immaterial and capped; ideally, they would also not benefit from any credit support, although this is primarily a question of risk allocation between the debt funds and the RCF provider. In any event, borrowings and credit support should be resisted in "clean" holding companies to preserve the integrity and priority of the term lenders' enforcement rights as far as possible.

Asset-based lending lines

In contrast to the relative ease with which a small super-senior RCF with limited enforcement rights can be incorporated and priorities modelled, introducing an ABL line where the recourse and credit support package available to each creditor will invariably differ is less straightforward. This is accentuated where the ABL line will represent a material proportion of the capital structure.

In the context of an invoice discounting line, the traditional security package would comprise (in addition to the assignment of the receivables themselves) only security over the receivables seller's collection account proceeds (which will itself typically be a trust account), including any non-vesting debts. In addition, one also now sees ABL providers seeking a wide range of other credit support from the "borrower" and its affiliates: cross-guarantees from affiliates and holding companies, all-asset debentures from borrowers and others, waivers of liens, directors' indemnities, etc. Some of these rights and remedies are capable of materially cutting across the unitranche provider's downside enforcement and recovery strategy. Fundamentally, the unitranche provider is being asked to release, or at least share recourse to, assets it has lent against and to concede flexibility over how it enforces against what it retains.

Taking security over all the borrower's assets as an example, this will clearly be contentious where the borrower has material assets beside the receivables and their proceeds. Furthermore, the ability as a qualifying floating charge holder to appoint or veto the appointment of an administrator is evidently valuable. These issues need to be navigated.

The consequence has typically been lengthy negotiation of intercreditor principles that either gives the ABL a synthetic super-senior position or (more frequently from our perspective) gives the ABL priority in relation to recoveries from only certain assets over which each party will have security, regulated by a deed of priority supplemented by traditional intercreditor terms. Occasionally, it may be feasible to isolate only the key ABL assets in one entity to mitigate the risk to the unitranche provider. Transferring the ABL assets to a clean entity (rather than transferring the material non-ABL assets and contracts to another group member) would be ideal, but, in the case of an *undisclosed* invoice discounting facility, this may not be commercially acceptable.

Over the course of the past year we have nonetheless observed an increased desire from both the ABL community and debt funds (spurred on by strong sponsors and borrowers agitating for solutions at the outset of the term financing) to overcome these issues. This has resulted in arrangements being agreed, albeit with some bespoke outcomes.

Owing to the wide range of potential outcomes and even structures encountered that will influence downside modelling, it is often difficult to agree a middle ground before those negotiations have begun to take shape. As such, for a non-event driven financing, it may be feasible for all parties to agree the requisite terms at the outset – although parties motivated to ensure that the primary term financing is not jeopardised may still seek to postpone this. The debt adviser's mandate may influence this. Barring that, soft comfort around a term debt provider's willingness to consider the introduction of an ABL of a certain size, possibly based on criteria favourable to the unitranche provider, will occasionally be all it is willing to offer and for which it can obtain credit sanction.

Some further considerations

Further discussion of ABL structures and the key areas for intercreditor negotiation in these structures can be found at (2017) 9 JIBFL 563 – *Developments in intercreditor agreements with asset-based lenders*.

A note of caution: "recourse", "non-recourse" and "limited recourse", being brief designations, are capable of being construed in different ways. It remains to be seen whether a court, in applying contractual interpretation techniques as they presently stand under English law, would interpret the phrasing:

- in the financial reporting sense;
- in line with ABL industry norms; or
- by giving the term its plain and ordinary meaning – which is ambiguous.

For instance, does "non-recourse" mean the receivables seller takes no underlying risk on the receivable being paid; does it mean the receivables financier has no recourse to the seller (or any credit support provider) whatsoever; or does it mean that the receivable financier's liability is non-recourse to the seller over and beyond the receivable sold and any security provided? Strong sponsor precedent documents are widely drafted and may offer flexibility for such permissions; sponsors may also feel that any ambiguity would work in their favour. But if a specific type of facility is to be permitted, all parties will wish to ensure that what is contemplated is captured, which would point the draftsperson towards including further clarification.

Similarly, financial accounting and covenant treatment of any particular ABL line should be carefully considered on a case-by-case basis with the client, the ABL provider and any

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debt advisers to ensure it accurately reflects the parties' intentions. As regards financial covenants, the starting point tends to be that this will follow the financial reporting treatment – the current form of LMA leveraged finance document requires both that a receivables line must be "non-recourse" and that the accounting requirements for de-recognition be met, in order for it not to constitute "Borrowings".[3] Many of the lines encountered in mid-cap structures are recourse facilities, and as such should often be treated as debt under the covenants.

The timing for any security release of receivables or bank accounts should be considered, especially by the security agent. The LMA form of intercreditor agreement, in essence, permits qualifying releases to become effective only on the making of the relevant non-distressed disposal. A deferred release mechanism that dovetails with the timing for any "sale" under the receivables purchase agreement and any conditions to sale or disposal set out in the facilities agreement may therefore be required. The LMA provision also only allows releases in relation to disposals to a person which is not a "Debtor" – which, in the case of a release back to the relevant debtor, may not be satisfied. It is arguable that the subsequent disposal of receivables to the ABL provider will be cause to fall within the scope of the release mechanism; similarly, one might conclude the declaration of trust in favour of an ABL provider over a collection account amounts to a qualifying disposal. Either way, it merits considering appropriate amendments to the standard provision at the outset of the deal. Failing that, the parties could agree to vary this.

The receivables release should reflect the commercial agreement as to whether all receivables are being funded, or only certain receivables. Even where certain receivables will not be financed against, it is not unusual for the receivables financier to seek security (on a first-ranking basis *vis-à-vis* the term debt provider) over all receivables not being assigned.

Finally, the term debt lender will want to ensure that there is a mechanism for released assets to fall back within its security net, and any priority arrangements to fall away, once the ABL line terminates. The ABL financier here will wish to ensure it is clear from the drafting that any such mechanism does not cut across any receivables sold (ie financed against) but not yet repaid.

THE OUTLOOK FOR 2018

2017 was, for the most part, a healthy one for credit funds: a relatively benign macroeconomic landscape, with only modest tightening of central government monetary policies towards the end of the year; low default rates; buoyant M&A activity and aggressive fundraising, all fuelled an active deployment schedule. So, what might the next twelve months hold in store?

- **Re-financings galore**: a combination of early direct lending deals approaching the traditional refinancing window, event-driven opportunities (such as to extract value before any perceived bubble bursts), coupled with record amounts of dry-powder, point to a flurry of refinancing activity in 2018. With typical margins still hovering well above the 2007 lows, and call protection periods from 2014-2016 vintage credit fund loans expiring, re-pricings appear attractive to borrowers.
- **Erosion of lower mid-market terms**: the scope for upper-mid market deal terms to loosen further is limited. But for deals in the £15m to £50m range, where the incumbent competition includes clearing banks benefitting from close-to standard terms, there remains ample room for terms to deteriorate from a lender's perspective – but also creating opportunities for credit funds to demonstrate flexibility.
- **Co-investments**: will anchor investors start to exert more pressure on funds to participate directly alongside them?
- **Increased deal leverage**: credit funds able to deploy in the large-cap market space – several of whom closed new, even larger funds in 2016 and 2017 – may seek to target potential investments where traditional lenders are hamstrung by the application of the US leveraged lending guidelines and the more recent ECB guidance on leveraged transactions.
- **Increased leverage at fund level**: in comparison with US debt funds, we understand European fund-level leverage remains low. Additional leverage would swell the capital available for deployment further still.
- **Consolidation**: absent a flurry of new investment assets coming to market, consolidation may represent the best way for debt funds to increase their assets under management and access refinancing opportunities.
- **ABL in unitranche structures**: as discussed above, the path to including ABL lines appears smoother than it has in the recent past.
- **Increase in default rates**: few economists are predicting a material spike in European loan default rates this year. However, with many businesses exposed, indirectly if not directly, to under-pressure sectors and with the consequences of Brexit beginning to be play out, financial covenants in 2013 to 2015 vintage documents that contained greater investor protections may start to be tested. The absence of interest rate hedging in many private debt deals will also leave borrowers exposed to further increases in base rates.
- **Gearing up for more intensive asset management**: rapid growth in fund raising and consequently assets under management have led to credit funds expanding in origination and credit expertise. What is less clear is the extent to which asset management and work out functions have kept apace, areas of particular importance given the higher levels of risk and the illiquid nature of the product. Equally, stressed and special opportunities may present attractive opportunities for funds whose investment parameters allow them to invest. ■

1 Deloitte Alternative Lender Deal Tracker Q3 2017.
2 Preqin Quarterly Private Debt Update, Q3 2017
3 "receivables sold or discounted (other than any receivables to the extent they are sold on a non-recourse basis and meet any requirements for de-recognition under the Accounting Principles)".