

PEACEFUL COEXISTENCE

Evolving Private Credit Market Shows Similarities to BSL Market

Despite the reopening of the broadly syndicated loan market this year, private credit continues to stand its ground and even expand. While competition intensified between direct and traditional lending — leading to dual tracking of transactions and tighter spreads in both markets — the dynamic between banks and non-bank lenders is one of peaceful coexistence. This article explores the lending landscape anchored by two viable sources of financing.

The team at SRS Acquiom examines the current state of the two markets, including the competition between banks and non-bank lenders, to win new deals and the mounting pressures that may lead to an increase in restructuring activity of both traditional and direct-lending deals.

BSL Snap-back

The resuscitation of the broadly syndicated loan market this year showed that the ebb and flow of activity among banks and non-bank lenders in the loan market will likely be a recurring theme.

The continued lack of M&A activity due to the high-base rate in conjunction with an increase in investor appetite for risk as well as subdued new-issue loan supply resulted in spread compression. The convergence of spreads on private-credit and syndicated-loan deals highlighted the competition between the two lending groups.

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Indeed, with direct lenders and banks in hot pursuit of limited deal activity, the pricing premium on private-credit loans declined significantly. Private-credit lenders, after losing some share to banks earlier this year, opted to forego some of the traditional spread premium commonly associated with the direct-lending market and acquiesced to borrowers' requests to slash interest costs and loosen covenants, too.

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Risk-reward Premium

Part of the allure of direct lending has always been the illiquidity premium. Private-credit lenders have historically been paid 100 basis points to 150 basis points more to lend to a company than if the same company borrowed from banks.

There are several additional reasons why direct lenders are paid more than banks. Sponsors and corporate borrowers value the speed and certainty to close a transaction. When dealing with one or a few lenders, it is easier to execute a deal and close

a transaction in a timely manner because closing is not contingent upon a successful syndication, and loan terms are not subject to flexing. Expecting to hold loans to maturity, private-credit lenders perform extensive due diligence, but their fund structures often eliminate the time and cost required to obtain debt ratings.

Private-credit lenders are subject to significantly less regulatory oversight than their traditional bank competitors. As a result, these firms can structure customized financing packages based upon the specific needs of a borrower. Borrowers are willing to pay wider spreads for the flexibility offered by delayed-draw term loan, portability, PIK (payment-in-kind) interest payment options and other provisions that are less readily available in the bank market.

The spread compression experienced this year may have reduced the premiums paid to direct lenders for now, but cyclicalities of the syndicated loan market is a certainty and dispersion between the two markets will likely return.

Attractive Attributes Remain

Despite higher pricing, borrowers seeking creative financing terms and structures may still opt for the private-credit market. Syndicated loans are typically structured with first- and second-lien tranches designed to attract a wide range of investors. Private-credit loans frequently use

a unitranche construction that pays a blended rate. This simplifies the capital structure for the borrower, and the lender benefits from a single class of creditors if debt relief or a workout is required.

Private credit lenders are also more likely to offer PIK interest payment options to be switched on when interest rates are high and borrowers need to conserve cash. Synthetic PIK — which functions as a capital reserve for PIK interest — emerged this year as a workaround to help private-credit managers comply with fund-level limits on the amount of PIK interest. The synthetic PIK facilities work essentially as delayed-draw term loans. A borrower may use PIK interest to conserve cash and a corresponding amount will be drawn and paid in cash from the synthetic PIK facility.

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What’s more, direct lenders take a deep interest in the businesses they are backing and may even put some equity into the company.

To that end, the relationships forged between private lenders and borrowers are closer than in the syndicated loan market. Lenders and borrowers expect to work together during times of distress and may modify covenants and amend loan documents well before a borrower is in default. The dynamic is more win-win oriented.

Still, while much of the syndicated loan market has turned to “covenant-lite” documentation, covenants typically remain in private-credit contracts. Maintenance covenants position the lender to negotiate with borrowers during periods of financial underperformance, or to encourage deleveraging to preserve value in the debt.

Private-credit Growth Has Further to Go

Direct lending remains a popular investment strategy, accounting for 88% of the total fundraising of the \$44.5bn raised during the second quarter, according to Preqin data. Yet, the growth of the market extends beyond directly originated loans.

Plenty of new entrants, joint ventures, and partnerships have been proliferating to reach a broader audience and to bring alternative investments to retail investors.

In July, Marathon Asset Management teamed up with Webster Bank to originate directly sourced senior secured loans across an array of industries.

The joint venture followed the formation of similar alliances between Stifel Financial and Lord Abbett in June and between PNC Financial Services and TCW Group in May. These partnerships help banks diversify their revenue streams while funds benefit from introductions to corporate borrowers seeking the flexibility provided by private-credit financing.

Asset-backed Finance Expansion

Asset-backed financing (ABL) has moved farther to the fore as a private-credit strategy. Firms from Apollo Global Management to Värde Partners have identified asset-backed finance as a key theme for the year and beyond.

One of the biggest commitments to the strategy came from Blue Owl, which purchased Atalaya Capital Management for \$800mn in July, deepening its ABL footprint. At the other end of the spectrum, SG Credit in June launched a commercial finance unit and hired bankers for its push into asset-backed loans. The firm plans to originate ABLs ranging in size from \$5mn to \$20mn.

Firms such as KKR and Carlyle — who acquired a \$10.1bn portfolio of prime student loans — have also demonstrated their commitment to the asset-backed arena. In fact, Bruce Richards, CEO of Marathon Asset Management, claims asset-backed lending will grow to \$4 trillion to \$5 trillion in the next 10 years, from \$1 trillion currently.

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Across the Pond

U.S. private lenders have cast their sights across the pond to tap the lucrative European sector and are targeting borrowers seeking sterling funds in particular. It is typically easier and cheaper to raise debt in euros or dollars rather than cross-hedge to create synthetic sterling debt.

Margins and fees are primarily driving U.S. interest in Europe. Even if spreads converge, a U.S. deal may have a 1% origination fee while fees in Europe hover near 1.75%-2%.

What's more, a study commissioned in April by fund services provider Ocorian shows that North American fund managers are looking to raise more funds in Europe to broaden their investor base. The study — surveying private equity, private debt, real estate, venture capital, and infrastructure fund management executives in the U.S. and Canada — revealed that more than one third of professionals polled have not yet raised capital in Europe but expect to do so in the next 12–24 months.

Private-credit Trilogy

As direct lending becomes more ubiquitous, it has evolved. It is no longer synonymous with middle-market lending as it once was. In fact, many market participants see it as a three-tiered market.

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The first level is the lower-middle market, which typically comprises companies that generate less than \$25 million of EBITDA. Such businesses may be viewed as riskier than companies that generate higher levels of cash flow.

Core-middle-market companies fall into the EBITDA range of \$25 million to \$100 million. Historically, these businesses may have been considered “middle market.”

The final category is termed upper-middle market as these businesses often generate \$100 million EBITDA or more. Financings for these companies are generally larger and may be provided by a “club” of lenders rather than just one or two. Loans to upper-middle-market companies may share similarities with the broadly syndicated loan market, including looser documentation and risk spreads across multiple lenders.

Loan Agency Services and Administrative Agents

Among the similarities in both markets is the need for an administrative agent and loan-agency services. Whether an issuer finances via private credit or a syndicated loan, an experienced administrative agent is essential to streamline deal mechanics and execute the credit agreement. Appointing a loan agent can help control costs, maximize operational efficiency, coordinate interest and collateral payments, and generally make for a smoother transaction while enabling lenders to focus on new business opportunities.

What’s more, given the “higher-for-longer” interest-rate environment, an increase in PIK interest, and potential for market volatility or a “hard” landing, a distressed market is not off the table. In such a scenario, there will likely be a rise in liability-management transactions, and the administrative agent will play an even more integral role going forward. A unified point of contact is essential with an administrative agent who understands these nuanced market dynamics.

While the lines between private-credit and broadly syndicated loans may be blurring, there is clearly room for the two viable markets to sate the needs of borrowers.

“The markets are merging between private credit and liquid credit,” Marathon’s Richards said. “It’s one big credit market.”

The team at SRS Acquiom is available to discuss loan agency services as they pertain to the direct-lending and syndicated-loan markets and what the ongoing growth of the asset class means for your portfolio and business needs.

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About the Author



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Renee is the managing director of the SRS Acquiom Loan Agency Group. With more than 15 years of experience as administrative and collateral agent on loan transactions and more than ten years managing teams in loan agency and restructuring products, she is an accomplished financial industry professional, and leads the loan agency business globally.

Before joining SRS Acquiom, Renee served as an administrative vice president at Wilmington Trust, N.A., most recently leading the loan agency and restructuring products. In addition to her ten years at Wilmington Trust, she also worked for Wells Fargo Bank, N.A. in the corporate trust and shareholder services departments.

Renee has a J.D. from Mitchell Hamline School of Law in Minnesota, and a B.A. in political science and history from Azusa Pacific University in Azusa, California.

About the SRS Acquiom Loan Agency

True to our heritage of bringing simplicity, efficiency and expertise to complex financial transactions, the SRS Acquiom Loan Agency Team brings decades of combined experience in providing unbiased, independent, third-party loan agency services for thousands of complex credit agreements. Our team of respected industry veterans provides Administrative Agent, Collateral Agent, Sub-Agent, and Successor Agent services on syndicated and bilateral loans, new originations and successor appointments, first and second lien facilities, distressed and restructuring facilities, and DIP Loans.