dialogues

PUBLIC VOICES IN
PRIVATE EQUITY

DynamicDuo
The convergence of public and private markets

As the private credit market continues to expand, it is becoming increasingly attractive to a range of companies – including those that would historically have sought funding from public markets. So how are funds evolving to tap these opportunities? And what is their role in a post-COVID environment?

As banks find themselves retrenching in the current market, how can this convergence create opportunities for private lenders and credit providers?

"During the second quarter of 2020, the public markets were essentially closed, private credit was the only option."

Michael Dennis, Partner & Co-Head of European Credit at Ares

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>
> Faisal Ramzan, Partner at Proskauer

The past decade has been something of a perfect storm for private credit funds. "There have been very strong secular growth trends driving the rise of private credit," says Michael Dennis, Partner and Co-Head of European Credit at Ares. Indeed, private credit funds have seen tremendous growth in the years since the global financial crisis (GFC): assets under management reached a record US$812 billion by June 2019 globally, according to Preqin figures.

The retrenchment of banks from middle-market lending in the face of regulatory pressure has been one of the strongest tailwinds behind the industry as private credit funds have stepped in to fill a growing funding gap. In 1999, 52% of U.S. leveraged loans were provided by banks, according to S&P LCD figures, yet by 2019, this had fallen to 16%; in Europe, the shift has been even more rapid, with the banks' share of leveraged loans declining from 68% in 2010 to just 24% in 2019.

At the same time, banks have had to reduce lending ticket sizes, resulting in the need to syndicate or seek club deals. "Pre-GFC, banks could lend up to £50 million or even £100 million," says Eric Capp, Partner responsible for origination at Pemberton. "Regulators and internal bank risk departments have sought to reduce single name concentrations, so typical mid-market bank loan exposure would be £15 million to £25 million, depending on jurisdiction." →

In dialogue - More about our contributors

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Michael Dennis, Partner & Co-Head of European Credit at Ares Michael is a Partner and Co-Head of European Credit, in the Ares Credit Group. He serves on the Ares Executive Management Committee. Additionally, Michael serves as a member of the Ares Credit Group's European Direct Lending and European Liquid Credit Investment Committees.

Alexander Griffith, Partner at Proskauer Alex is a Partner in the Corporate Department at the international law firm Proskauer. He is a member of the Firm's Private Credit and Finance Groups. His practice focuses on leveraged finance and general debt finance work, advising senior, mezzanine, second lien, unitranche and other private capital providers. Alex is recognized by Chambers UK, Legal 500 and recently been named as a notable banking lawyer by IFLR 1000.

Faisal Ramzan, Partner at Proskauer Faisal is a Partner in the Corporate Department at the international law firm Proskauer. He is a member of the Firm's Private Credit, Finance and Distressed Debt Groups. Faisal's practice focuses on complex cross-border and domestic finance transactions and credit arrangements, particularly those financings that involve private sources of capital. He has written debt finance articles for various publications and is a frequent contributor to industry and legal articles on European debt finance as well as a regular speaker at industry conferences.

With the vast majority of private credit deals currently backed by sponsors, the rise of private equity at the expense of public markets has also driven the industry's expansion. While the number of public companies has fallen – in the U.S. by 46% from 1996 to 2017, according to McKinsey & Co private equity-backed company numbers have swelled, doubling to 8,000 in the U.S. between 2006 and 2017. And private equity will continue to provide significant deal opportunities for private credit funds, given its significant dry powder, which reached US$1.48 trillion at the end of Q2 2020, according to Preqin. "We can provide large amounts of capital on a bilateral basis and we can execute transactions in a fast and convenient way – private equity houses really appreciate this," says Capp. →

Demand from yield-seeking institutional investors is the third leg underpinning private credit's substantial growth. "Private credit investments offer institutional investors attractive yields and they tend to have lower correlations with traditional fixed income and public equities," says Dennis. "Private credit is typically less volatile and has an illiquidity premium built in."

This demand has led to significant growth in fund sizes among some key private credit funds, with capital consolidating at the larger end. In 2019, 36% of all capital raised by private credit went to the 10 largest funds, Preqin data shows.

With larger sums of capital to deploy, private credit funds are increasingly eyeing larger opportunities – both sponsored and sponsorless investments – that would previously have been financed through the public markets. "Private equity sponsored deals remain the lion's share of private credit opportunities," says Faisal Ramzan, Private Credit Partner at Proskauer. "Yet there is a huge non-sponsored market and private credit is now starting to play here. We're already seeing some large corporates being funded with private credit deals." He points to the recent US$1 billion financing of Airbnb provided by a group of private credit funds.

It's a scale Dennis is very familiar with. "We started out investing in businesses with between US$5 million and US$25 million EBITDA, but as our funds have grown, so has our addressable market," says Dennis. "We have a number of US$1 billion commitments in our European Direct Lending portfolio today."

Ares also recently arranged and was lead lender in the financing of Ardonagh, a leading insurance broker in the UK. Ares acted as the lead arranger and sole physical bookrunner for the deal, arranging a £1.875 billion total first lien debt package and a £191.5 million Revolving Credit Facility placed with relationship banks. Ardonagh also issued $500 million senior unsecured notes. The combined transaction represented the largest ever unitranche financing in the Direct Lending market. Given the quantum of the financing involved and the likely need for multiple currencies, the European team worked with the U.S. team to deliver a cross-platform solution, highlighting the benefits and power of the Ares global platform. "It was the right time in the cycle for the deal to be launched because private credit stepped in at a time of uncertainty," says Alex Griffith, Private Credit Partner at Proskauer. "It demonstrates that private credit is now a more focused competitor to high yield bonds." →

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Alex Griffith,
Partner at Proskauer

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Eric Capp,
Partner at Pemberton

And the COVID-19 crisis has only enhanced the attraction of private credit at the larger end of the deal spectrum. “During the second quarter of 2020, the public markets were largely closed,” says Dennis. “The deliverability and certainty offered by private credit solutions was a key differentiator given the market volatility, we believe this helped larger borrowers recognise the value of scaled direct lenders and their ability to compete with the capital markets.”

In addition to offering capital consistently through cycles, borrowers are increasingly seeing private credit as a tailored, one-stop-shop offering. “Private credit can offer substantial flexibility,” says Capp. “We can offer a range of senior secured loans, second lien loans, subordinated capital and so on, so we can tailor a bespoke financing solution. We also tend to work on a bilateral basis, so it’s much closer to old-fashioned relationship lending than public markets where it tends to be transactional and borrowers might not even know who the underlying loan counter-parties are.”

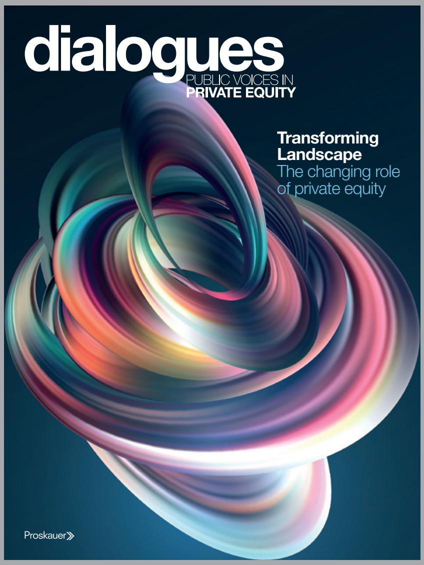
Further, private credit can provide certainty of execution and terms, adds Dennis. “In public markets, quantum and costs can shift if markets move during a fundraise,” he says. “This type of flex is not typically a characteristic of the private credit market and we are a holder of paper for the long term.”

As a result of these dynamics, the industry has a significant role to play in the post-COVID economy – a fact that is likely to assure private credit’s continued growth. “Private credit will be very important to the rebuilding and recovery of business as we move through the pandemic,” says Griffith. “Funds have firepower to provide solutions from day one, to which they can then add further lines as the business develops – in particular they have the capacity to upsize, even supersize their commitments and follow the growth of their borrowers when needed.”

This could mean that private credit funds can help lead a stronger and quicker economic recovery than might have been possible historically. “Banks are structured in a way that means they just want their money back if things don’t go according to plan,” says Capp. “In private credit, we can provide growth capital or a refinancing to offer an exit to existing lenders in a way that wasn’t possible 10 years ago. We have a long-term view and we have pools of patient capital that can help businesses recover more quickly.”

As Ramzan says: “Private credit will make up an increasingly important part of the funding requirement post-COVID. Many funds have been through the cycle in the post-GFC era and learnt a lot from that experience. And it’s always easier to have conversations with one or two lenders than and whole range of counterparties. Overall, I see potential for significant further growth in private credit.” •

[1] https://docs.preqin.com/samples/2020-Preqin-Global-Private_Debt-Report-Sample-Pages.pdf [2] LCD, Quarterly U.S. Leveraged Lending Review, Q4 2019 and LCD, Quarterly European Leveraged Lending Review, Q4 2019. [3] www.mckinsey.com/~/media/McKinsey/Industries/Private%20Equity%20and%20Principal%20Investors/Our%20Insights/Private%20markets%20come%20of%20age/Private-markets-come-of-age-McKinsey-Global-Private-Markets-Review-2019-vF.ashx [4] www.preqin.com/Portals/0/Documents/About/press-release/2020/July/PEVC-Q2-2020.pdf?ver=2020-07-08-154129-593 [5] https://docs.preqin.com/samples/2020-Preqin-Global-Private_Debt-Report-Sample-Pages.pdf



This article is taken from Dialogues - Public Voices in Private Equity. Issue 1 – Spring 2021

A publication by Proskauer.