EXPERT Q&A

A growing wave of innovative fund structures and strategies is a boon to private credit managers looking to attract new investors and maximise returns, say Latham & Watkins' Dan Seale, Alfred Xue, Stelios Saffos and Peter Sluka

Flexibility and complexity drive private credit expansion

With private credit continuing to grow on the back of its ability to deliver borrowers flexibility amid an increasingly complex market, funds are exploring new opportunities to generate value. Here, we ask four partners at Latham & Watkins – which won this year's *Private Debt Investor* award for Law Firm of the Year for Transactions in the Americas – about the trends and developments shaping the industry.

Q Do you expect the market consolidation and strategic partnerships that we saw in 2024 to continue?

Dan Seale: Private credit continues to grow exponentially. The big firms are only going to get bigger, new funds are going to enter, and banks and other asset managers that are not currently active are going to find ways to join in through partnerships and acquisitions.

Alfred Xue: The market stands at $2 trillion today, 10 times the size of the same market in 2009, according to McKinsey & Company data. The data suggests that the addressable market will reach $30 trillion, and that only happens with consolidation, strategic partnerships and a shift of other financing activity towards private credit providers.

SPONSOR
LATHAM & WATKINS

Dan Seale
Global chair, Latham's Banking and Private Credit practices

Alfred Xue
Global vice-chair, Latham's Banking and Private Credit practices

Stelios Saffos
Global vice-chair, Latham's Capital Markets and Public Company Representation practices; global co-chair, Hybrid Capital practice

Peter Sluka
Global co-chair, Latham's Hybrid Capital practice

Stelios Saffos: Larger scale gives asset managers more stability, because doing more deals reduces risk across portfolios. The more dollars raised by funds, and the more strategies they explore with different return hurdles, the more flexibility they have to interface with borrowers, be they PE funds or corporations. Flexibility is the origin story of private credit and differentiates private markets from syndicated lending.

Peter Sluka: We now see a broad base of asset type structures and strategies emerging, which appeals to LPs. The race to secure insurance capital underpins a lot of recent consolidation, and the move to increase and diversify sources of capital (including retail) will keep driving deals.

Q What innovative financing structures are you seeing?

SS: The go-forward picture is going to be one of growing complexity and increased flexibility, driven by larger funds competing to partner with borrowers and issuers.

At the same time, the convergence of some private equity-type investments with more high-yielding hybrid capital, mezzanine and opportunistic fund investments continues apace. We also see innovation at the senior end of the capital structure, driven by the demands of the market and the sources of funding.

PS: One example of this kind of innovation we can point to is our recent work with Blackstone Credit & Insurance on a $2 billion secured credit agreement for Dropbox, a large publicly-listed technology company with many other financing options.

They found the flexibility of the structure being offered by private credit, through a first-out, last-out structure, could deliver competitive pricing, while Blackstone was still able to earn a really attractive return. By employing structures like that at greater scale to reduce the cost of capital, debt funds can open up a wider borrower market.

AX: As the prudentially-managed banks are forced by regulation to retrench, private credit has stepped up, first in leveraged buyouts and now on both the more junior and more highly rated sides of the capital structure. Funds are giving banks a run for their money in asset-based finance and with hybrid products like mezzanine and preferred equity.

DS: There are many other markets into which private capital can grow, from real estate and infrastructure to fund finance and beyond. We have recently been through a distressed cycle during which the partnerships between credit funds and borrowers proved to be constructive. The flexible solutions that private credit can provide will be attractive to borrowers across new markets.

Q What trends are you seeing with respect to terms, covenants and documentation?

AX: There has always been a lot of pressure from sponsors in the traditional mainstream space towards terms that look to be competitive with the broadly syndicated market. Conversely, private credit LPs increasingly demand tighter terms, and the best asset managers continue to want to drive terms they like. They are willing to provide capital to sponsors but are equally prepared to walk away if the terms do not suit them.

While there has been some covenant loosening in the market, private credit managers remain highly focused on maintaining covenant quality. The best managers are very focused on underwriting cashflow, their EBITDA definitions are tighter, and their focus is on leakage because they typically hold the whole deal.

DS: Everyone talks about convergence in documentation between private credit and syndicated loans, but there will always be differences. Leakage issues and financial tests will continue to be a focus in the private credit space. Private credit financings bring unique privity between a borrower and its lenders – borrowers welcome that ongoing partnership in return for tighter terms and documentation.

Q What do private credit providers need to consider to navigate liability management transactions effectively?

AX: There was a lot of talk around liability management and private credit throughout 2024, which was a big focus for LPs. The truth is that liability management is a lot more limited in a market where you have lenders with bigger holds and smaller clubs, because the ability to form ad hoc groups is more limited.

That provides some in-built protection, but private credit has still had an interesting year in navigating these conditions and working with sponsor clients to avoid lender-on-lender situations. These situations also present opportunities for private credit funds to provide additional value to their clients and maximise outcomes for LPs. Many of the transactions we have worked on that could be classified as liability management have delivered an upside to private credit, who have been able to lend into distressed entities or deploy money at more moderate leverage, with a tighter structure, and make a great return.

PS: Another built-in protection comes from the repeat relationship dynamics. One lender will have a portfolio of loans to the same sponsor, which means if the sponsor takes an aggressive action against them on one deal, they know they have to work together on others.

Further, documentation is tighter in private credit deals, and we see a lot of crossover situations, where the first lien is syndicated and the second is private, for example. There, the private capital is the logical solutions provider for a sponsor, being the most likely to write a cheque or help reshape the capital structure. That gives them leverage.

Q Why has junior capital emerged as a crucial financing tool for private equity firms seeking to maximise returns?

SS: There was a period a few years ago when junior capital was almost the only market for borrowers that needed to continue to execute on business plans and needed cash to grow when they were capped out on senior leverage. Now, even just within private credit, there are endless variations of junior capital available, from second lien all the way through to deals that include significant minority equity pieces.

PS: Given the depressed dealflow of the past two years, many sponsors with solid businesses that would normally have sold for good returns turned instead to junior capital. That was used to finance a dividend, to bring in a minority equity partner or to return money to investors, setting a nice value for the business and holding on to the asset for longer.

On the other hand, those troubled businesses that struggled with increasing interest rates could replace senior debt with capital that would use payment-in-kind to avoid placing additional stress on cashflows.

Q What are you seeing with respect to the diversity of asset classes that private credit providers are financing?

AX: We are seeing private credit providers expanding their credit aperture in a range of directions, into asset-based lending, receivables financing and structured credit on the one hand, but also into commercial real estate, digital assets and longer-dated infrastructure debt.

"The more dollars raised by funds, and the more strategies they explore with different return hurdles, the more flexibility they have to interface with borrowers"

STELIOS SAFFOS

SS: There is a move into nearly any previously untouched asset in the market, and into providing additional leverage to investors and private equity funds. Basically, any asset class that is not yet infiltrated by private credit soon will be. In particular, we are seeing vast opportunity for private credit in the investment-grade landscape. Also, there is a drive for more power and infrastructure financing to match the continued development of artificial intelligence, so we see a lot of funds building out in that space.

PS: In terms of industries, sports and entertainment is increasingly opening up to lenders, as the regulatory frameworks around some of the major sports leagues (including college) change.

We also see hybrid capital opportunities around music and movie catalogues, as well as growing interest in new markets such as investment-grade credit.

Q What other growth drivers would you point to for private credit providers this year?

AX: Given the uncertainty we already see unfolding in 2025, the opportunities for private credit are immense. Private credit providers, unlike the broadly syndicated markets, can move quickly and step up to fulfil the financing needs of companies as those evolve.

In Europe, the majority of financing remains bank-driven, but the regulatory requirements for banks continue to shift in a direction that favours private funds. There is huge opportunity for growth there and the globalisation of private credit is a trend set to continue as Europe and Asia follow the same trajectory as the US.

SS: As in the US, there is an education process that goes into getting new regions comfortable with private credit, and then with more complex junior capital instruments. It takes time to build networks and have those conversations. Fund managers want to work with advisers that can help them navigate new geographies, strategies and products, and that are able to advise them on the full life cycle of their funds, from capital raising right through to exit. ■