Analysis

Five direct lending trends for 2022

  

Guest comment by **Karan Chopra, Dan Seale and Alfred Xue**

It's a part of the market that keeps on finding ways to grow further. Three partners of Latham & Watkins explore what the year ahead holds for direct lending

Direct lending activity was extremely hectic in 2021 as the number and size of unitranche transactions continued to escalate and billion-dollar deals became a more common feature of the market, particularly in the US.

Despite an unprecedented period of turbulence in recent times due to covid-19, the direct lending market has rebounded to pre-pandemic levels of activity, if not exceeding it. Direct lending has proved to be nimble, flexible and creative not only in the face of significant market disruption caused by the pandemic, but also when the markets recovered in 2021.

The ability of private capital to provide higher leverage solutions for the right credit, in addition to fixed terms and execution without syndication, proved attractive to many borrowers in the volatile environment that persisted throughout last year, and that looks set to continue this year in light of recent world events and ongoing uncertainty in the markets.

We expect the following five trends to be dominant throughout what is likely to be another busy time for direct lending activity. ■

Terms will converge between direct and syndicated loans

Alongside escalating deal sizes, there is an increasing convergence of terms between direct and syndicated loans – a trend that we expect to continue in 2022 as long as benign market conditions persist. Historically, direct lenders have been more sensitive to certain deal points, accepting less covenant flexibility and in particular insisting on tighter terms around restricted payments, debt incurrence, financial maintenance covenants and EBITDA adjustments than the syndicated market, but direct lenders have shown increasing flexibility on such terms on a deal-by-deal basis. In addition, covenant-lite unitranche transactions have also appeared for a limited number of particularly strong credits, driven by competition among lenders and vast amounts of liquidity. This feature may continue to grow in 2022.

With heightened competition in the direct lending space in the past few years, we have seen greater willingness to negotiate around many of these differentiated terms, though certain key features of direct lending documentation will certainly remain. In the lower end of the market, direct lenders are still pushing for tighter restrictions. But for the biggest deals and strongest credits, which are most attractive to many of the largest credit funds, we expect that gap to continue to close.

Deal sizes will continue to increase

The amount of fundraising achieved by direct lenders in recent years has driven ever-larger deal sizes.

Private equity sponsors are increasingly confident in the direct lending product, and borrowers now regularly run dual-track processes, or they take the direct lending route from the outset.

As both the volume of dry powder and the scale of lending continue to rise, direct lenders will continue to compete for a growing share of the market. As competition intensifies, we will also likely see credit funds taking on larger deals, either on their own or as part of a club with other funds or co-investors, or with the intention of effectively syndicating deals themselves. Europe has shown early signs of following the lead of US funds in this practice.

New entrants will fuel competition

New entrants were a particular feature of the direct lending market in 2021 and we expect that to remain the case in 2022, with fund sizes growing apace. Traditional direct lenders have been rapidly raising funds as investors continue to search for yield, and large players in the private capital space are increasingly turning to credit funds to boost assets under management and in turn bolster stock valuations.

Debt is an attractive asset class to private equity firms that are looking at the same assets and are able to move quickly to compete for deals. Direct lending has proved its durability as an asset class throughout the pandemic – its first real test after a decade of rapid growth – and there are opportunities for this market to support more complex credits as government stimulus packages wind down. A number of investment banks have reorganised their balance sheet lending entities to compete in the direct lending market, kicking off another wave of new entrants that will continue to grow in significance this year.

Funds will dig deeper into junior level capital

The direct lending solution continues to expand its penetration of the market, with private credit now appearing in second lien, preferred equity, and/or PIK on many syndicated first lien deals. In addition, credit funds have begun to regularly offer a full capital structure solution for a private equity sponsor by providing both a unitranche loan and preferred equity, and we expect direct lenders to dig deeper into the junior level capital in 2022, adding a new layer of capital through products like preferred equity, holdco debt and second lien loans. Direct lenders are responding both to borrower demand for a "one-stop shop" solution and investors' appetite for greater yield than that available in traditional credit markets, much in the same way lead arrangers provide an array of products to the same sponsors.

Increased cross-border direct lending

The direct lending solution remains less common on large cross-border deals, particularly in the fragmented European regulatory landscape, but we expect that to change. Investor appetite clearly supports these funds backing more cross-border lending, which has historically been hindered by the inability to track a clear path to enforcement across multiple jurisdictions and the existence of local lending rules.

Some European jurisdictions have long placed restrictions on the ability of investment funds to carry out direct lending to businesses without a local banking licence, for example, creating a challenge for lenders looking to support multi-jurisdictional facilities. In 2022, we expect to see direct lenders pushing the boundaries to overcome such complexities as they navigate another year of extreme growth.

Driven by appetite from institutional investors for broader geographical exposure via a smaller group of top-tier GP relationships, the largest direct lenders are achieving transatlantic market penetration. In the past few years we have seen a growing number of predominantly European transactions backed by US lenders, and the pre-eminent European debt funds are succeeding in taking a slice of the larger American opportunity.

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