Private Debt Investor

By: Guest Writer
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FUND MANAGEMENT

How is the private debt market scaling up to back bigger transactions?

The size of private debt deals is growing. Latham & Watkins partners take a look at how the industry is scaling up to meet the needs of sponsors. Guest comment by Stelios Saffos, Peter Sluka and Alf Xue.

In a challenging year for global credit markets, private debt played a major role in the acquisition financing and leveraged lending market, with private equity sponsors increasingly turning to direct lenders and private debt funds.

While the broadly syndicated market was challenged in 2022, private debt deal size continues to scale up, with funds delivering on committed financing to support some of the largest take-privates on tight timelines. Average deal sizes have risen based on reported deals, which in our experience tends to underreport the lower mid-market, with Preqin reporting an average deal value of more than $1 billion for private debt deals in 2022. We expect that 2023 will be no different.

To meet these increasing deal sizes, sponsors have been building larger clubs rather than expecting individual funds to provide sole underwrites. In turn, we see a trend towards selectivity from private debt funds in 2023.

In the largest acquisition financings, sponsors have also resorted to creative hybrid financing packages in a bid to maximise the leverage options available to them. The combination of traditional term loan A debt held by relationship bank lenders alongside tranches of pari term loan B debt placed with direct lenders has evolved into an option. This was the financing playbook used by Blackstone in the highly publicised $14 billion buyout of the HVAC division of Emerson Electric that was announced in the fourth quarter of 2022. We expect to see this hybrid structure continue to be employed for the largest underwrites at least in the first quarter of 2023.

Peter Sluka

Alfred Xue

Despite the deployment of significant capital in Q4 2021 through 2022, the amount of dry powder available to direct lenders increased 5 percent from December 2021 to December 2022 and now stands at a record $201 billion, according to Preqin data. In 2022, the average fund size was nearing $1 billion for the first time, according to Private Debt Investor. Given some funds are facing redemptions and others are finding capital is not recycling fast enough, the fact that private credit continues to fund raise and build dry powder when the broader broadly syndicated market has been contracting does show a resilience of the product that bodes well for private debt deal activity in 2023.

Junior financing scale up

Private capital providers continue to develop and deploy new junior capital solutions to provide additional liquidity and achieve higher leverage levels. Sponsors are increasingly turning to debt-like, non-convertible preferred equity to supplement their operating company-level financings in leverage transactions, with preferred equity allowing them to place additional leverage on a portfolio company without increasing the cash interest burden as a result of the favourable payment-in-kind feature. In addition, we've seen some private debt providers offer junior capital solutions including mezzanine, holdco and second lien debt, including to restructure the capital structure on some of the most challenged syndicated deals in 2022.

Preferred equity is designed to receive full or partial equity credit from the rating agencies and senior lenders, delivering additional financing firepower for larger investments, add-on portfolio company acquisitions, dividend recapitalisations, and other situations in which the sponsor may not want to fill the gap with common equity.

In addition to the direct lenders that previously focused on the senior portion of the capital structure, the other providers of junior financing include traditional mezzanine and opportunistic credit funds that customarily supply junior capital. In 2023, we expect to see providers offer the market a number of capital solutions for junior debt, ranging from the evolving preferred equity product and the more traditional second lien and mezzanine products.

Stelios Saffos

Looking ahead

We see a possible inflection point in the leveraged lending market, with investment banks and arranger banks pausing to re-evaluate their positions and consider their risk appetite in the face of regulatory pressure and losses on long dated underwrites. While the absolute losses by the banks in 2022 are still unclear, they appear far less acute than the write-downs faced by the banks in the 2008 financial crisis, when the hung forward calendar was much larger and the soundness of the banks was tested. We continue to hear that investment banks and lead arrangers will want to make an aggressive return to the market in 2023, but even if they do we continue to forecast another year of selective expansion by private debt providers.

Stelios Saffos, Peter Sluka and Alf Xue are partners at Latham & Watkins