Expert Q&A on Direct Lending

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An expert Q&A with Brandon R. Anderson, Paul L. Bonewitz, Jason R. Bosworth, Andrew A. Fayé, I. Scott Gottdiener, Daniel C. Seale, Jesse K. Sheff, Jane Summers and Alfred Y. Xue of Latham & Watkins LLP on the increasing role of direct lending in the US loan market.

DIRECT LENDING IS PLAYING AN EVER-GROWING ROLE IN THE US CORPORATE LOAN MARKET. WHAT IS DIRECT LENDING?

Direct lenders raise capital from investors to make leveraged loans directly to borrowers in deals sourced by the direct lenders themselves. Direct lenders use the capital raised from investors to fund a large portion, or the entirety, of a loan without syndicating it out to the institutional loan market.

Direct lenders have evolved from working primarily on simple club deals executed on a best efforts basis, serving family offices and middle market sponsors in sub-$50 million EBITDA companies, into influential market players that handle leading committed deals for top-tier sponsors and public companies.

The unitranche deal size record has been broken again and again, and in 2017 direct lenders made committed financings as large as $1.45 billion available to borrowers. Similar to balance sheet banks, direct lenders focus on achieving a return on actual lending as opposed to distribution. However, because direct lenders are unregulated non-banks, they do not need to adhere to the Leveraged Lending Guidelines and can provide financing for the more difficult parts of the capital structure.

IN WHAT WAYS DO DIRECT LENDING DEALS DIFFER FROM TRADITIONAL BANK DEALS?

Direct lending deals differ from traditional bank deals in the following key ways:

- There is limited or no syndication. If syndication does occur in a direct lending deal, it is often limited to a targeted strategy of pre-identified lenders. Committed club deals often do not require preparation of a confidential information memoranda or other marketing materials.
- The marketing period receives little or no emphasis in direct lending deals, leading to speedier execution.
- Unlike committed syndicated deals where much of the focus is on flex in syndication, committed direct lending deals feature limited or no flex and no concept of "Successful Syndication." This results in certainty of pricing and of terms in contrast to traditional lending deals that include the risk of pricing at the caps.
- Smaller direct lending deals often have no ratings or use private or shadow ratings that provide cost savings to the borrower. In smaller deals, the sponsor relies almost exclusively on shadow ratings. Larger deals (greater than $300 million) often include some form of syndication, and therefore private (or sometimes public) ratings are obtained.
- Direct lending deals place a stronger emphasis on underwriting at the commitment stage. Accordingly, lenders provide sponsors with certainty that terms will be executed on. There is rarely, if ever, flex to tighten terms to more lender-friendly features.

WHY DO SPONSORS USE DIRECT LENDERS?

Sponsors often gain unique advantages by using direct lenders, including:

- Certainty on pricing through limited or no pricing flex rather than taking the risk of pricing at the caps. Although this approach is less competitive than indicative pricing, it is very competitive compared to fully flexed pricing on a blended basis. Including OID and upfront fees leads to certainty of proceeds.
- No flex on terms in most instances, as explained earlier.
- Limited conditionality, which is a shift away from traditional club deal constructs that direct lenders have made consciously in order to better compete with arrangers. Limited conditionality transaction "testing," providing certainty of funds for tack-on

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acquisitions, only became acceptable to direct lenders when they found themselves competing with large cap terms.

- The ability to take advantage of higher leverage by those direct lenders for whom the Leveraged Lending Guidelines do not apply. Unitranche lenders can go deeper into the capital structure than first lien/second lien deals, and the unitranche structure, as mentioned below, has less onerous call protection than the second lien.
- The ability in many instances of direct lenders to take on the most difficult piece of the capital structure (for example, the second lien), frequently on a bought basis. Taking the risk of syndicating the most difficult piece of the capital structure off the table means the syndication of the first lien or senior piece is often far easier and less likely to be subject to contagion from a difficult second lien or junior syndication.
- Call protection terms in unitranche deals that typically are less onerous than the call protection in a second lien or bond deal. Non-call is rare and hard call often runs for shorter periods than even the indicative on a second lien.
- The potential for lower all-in fees and costs versus disintermediation by arranger banks. Simplification of the lending process through working with a direct lender provides further cost savings to the sponsor.

WHAT KEY TERMS ARE DIRECT LENDERS FOCUSED ON?

Direct lenders expect, and often receive, better terms than borrowers are required to provide in the institutional market. In general, direct lenders are still reluctant to forgo the financial covenants or adopt more bond-like covenant packages and basket structures. Direct lenders typically get higher indicative pricing. Additionally, because no market check is performed, direct lenders do not need to, and will not have the opportunity to, sell syndicated paper at the best possible market clearing price. The price is agreed to at signing, and the sponsor does not benefit if the market improves during the interim period. Conversely, there is no price flex to adjust if the market deteriorates.

As sponsors have become more sophisticated and the need to compete with other arrangers in auction situations has increased, direct lenders have had to agree to terms that converge with large-cap deals, such as run rate EBITDA cost savings adjustments, cutting edge and extremely sponsor-friendly revenue side adjustments (adjustments that include projected new revenues as opposed to cost savings or synergies), incurrence-based covenants, reclassification rights (in some deals), and underwriting the terms contained in precedent credit agreements. Nonetheless, direct lenders continue to exhibit their middle market attributes, including through:

- Disqualified lender list fall-aways in default.
- Delivery of fourth quarter and monthly financials.
- Quarterly lender calls and/or MD&A (management's discussion and analysis of financial condition and results of operations).
- Deposit account control agreements (DACAs) and other collateral perfection steps typically not required in large cap deals.
- Specific positions on earnouts.

WHAT DO YOU SEE AS THE FUTURE OF DIRECT LENDING?

Almost every balance sheet lending bank and arranger investment bank has a middle market team focused on smaller corporates and mid-tier sponsors. Direct lenders capitalized on the opportunity to show that they could, and would, play when credit markets closed in the first quarter of 2016. In particular, direct lenders wrote big tickets on economically competitive terms and offered certainty of execution and pricing, attracting the attention of top-tier and large-cap sponsors.

The role of direct lenders will continue to grow. Direct lending fundraising accounted for a quarter of the capital raising in 2016, and while the syndicated markets have rebounded in a big way from the first quarter of 2016, this is a resilient space with many new entrants making a big splash in the marketplace.

Direct lending platforms are expanding to cover larger deals with top tier sponsors, as direct lenders become more sophisticated and more aggressive in their marketing. Direct lenders are now developing effective syndications and capital markets teams that have growing track records of syndicating upper middle market first lien/second lien deals. The ability to effectively execute on a syndicated option and also show willingness to hold an anchor order on terms within the caps (often by pivoting to a unitranche offering of similar size) if the market turns during syndication makes their offerings particularly attractive to sponsors looking at marginal credits that could go either way in volatile credit conditions.

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