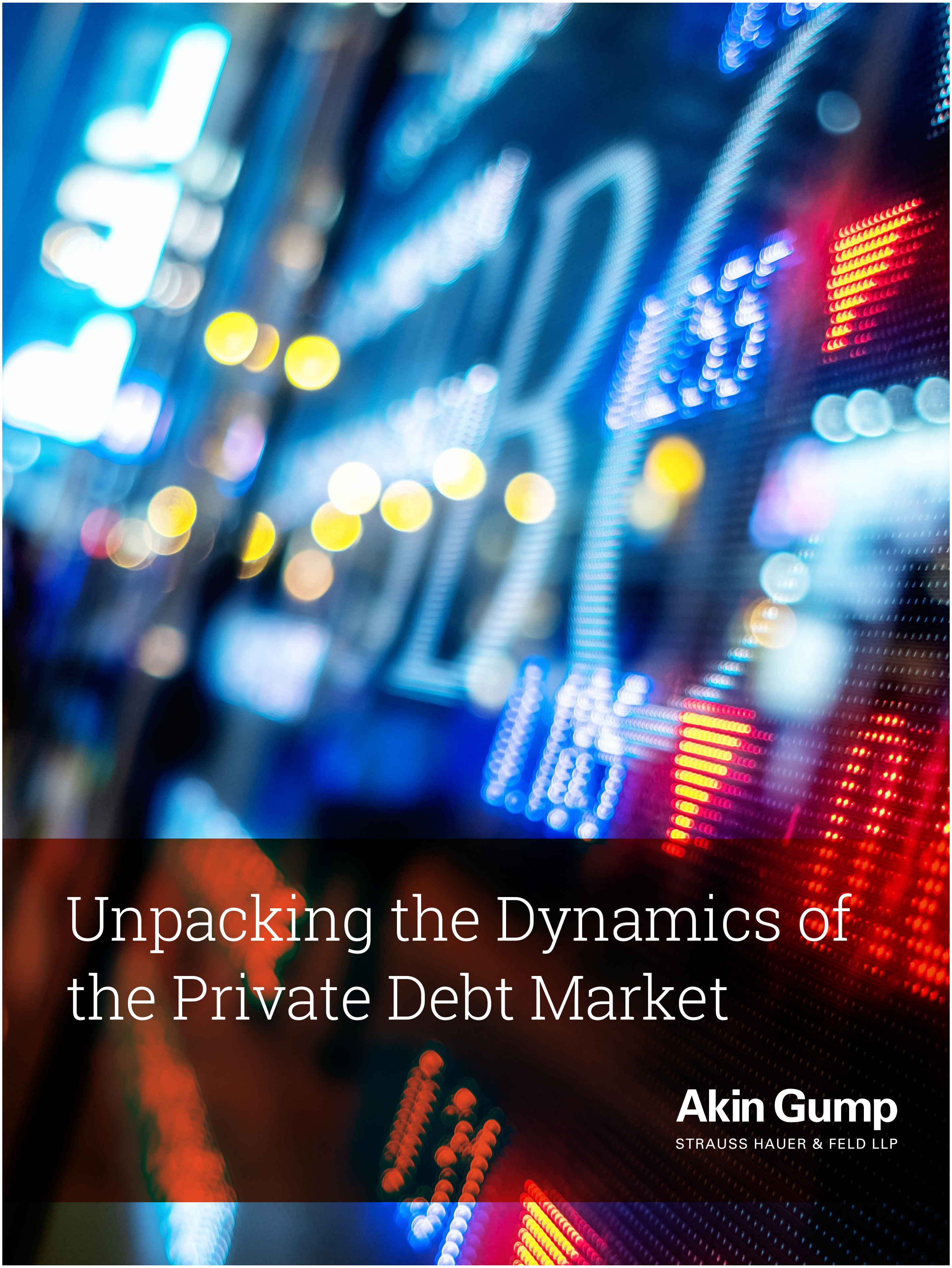


Unpacking the Dynamics of the Private Debt Market

Akin Gump
STRAUSS HAUER & FELD LLP

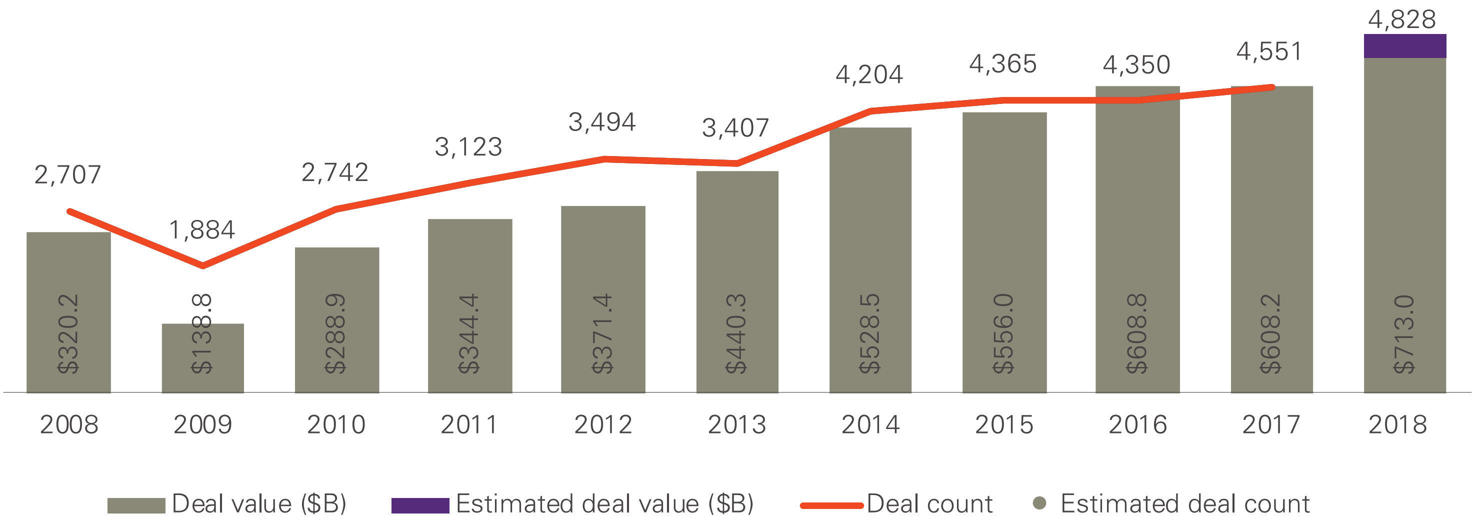
Contents

Executive summary

- Following the financial crisis, nonbank lenders looking to carve out new, profitable niches—especially within the leveraged loan universe—quickly filled the lending gap created by the exit of banks.
- The relatively swift recovery of the private equity (PE) industry from the nadir of the financial crisis also helped reinforce demand for private debt solutions. As dry powder levels inflated to record levels, competition for choice assets intensified, producing new strategies across PE and private debt in turn.
- Private debt fundraising within the U.S. consequently hit a record in terms of capital raised in 2017, at nearly $80 billion. However, the volume of private debt fundraising started slowing a few years earlier, as the environment grew heated and as early movers absorbed market share. For example, direct lending, one of the faster-growing segments post-crisis, reached its decade apex with 33 funds closed in 2015.
- Private debt dry powder has hit an all-time high, pressuring players to develop new strategies in an attempt to differentiate further, whether in approach or in target areas such as less-popular sectors and smaller segments of the U.S. middle market.

Background

U.S. PE deal activity

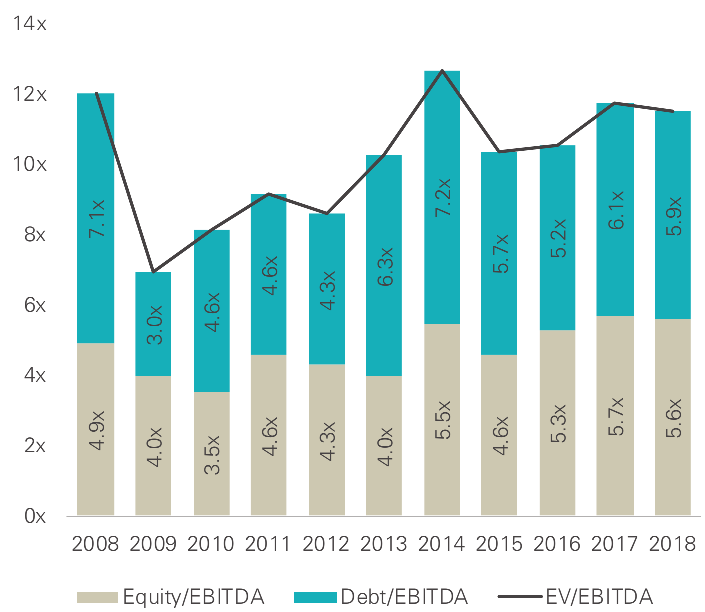


Source: PitchBook

As the volume of financial assets exploded following the 2008-2009 financial crisis, public markets consolidated even further, rendering outperformance even more elusive beyond the scope and reign of indices. Investors of all kinds, from institutional to high net worth, turned to private capital strategies, including private debt. Over $1.6 trillion flowed into private fund coffers in the U.S. between 2015 and 2018, even as the volume of funds closed diminished. As a consequence, competition heightened to the extent that new strategies proliferated into novel arenas, most notoriously producing the unicorn phenomenon as well as a remarkable degree of institutionalization in one of the major areas of private capital: PE. This has reinforced demand for private debt even more.

One of the more mature private asset classes, the U.S. PE market has only further institutionalized and become even more popular in the past decade. PE's portion of that $1.6 trillion+ stands at no less than $693.4 billion. PE fund managers have become key players in not only the general mergers and acquisitions (M&A) cycle but also the vast universe of U.S. companies, penetrating deeper into the U.S. middle market than ever before. Yet competition has ratcheted up within the PE domain as well, resulting in a variety of trends, from the surging popularity of add-ons

Median U.S. PE buyout multiples

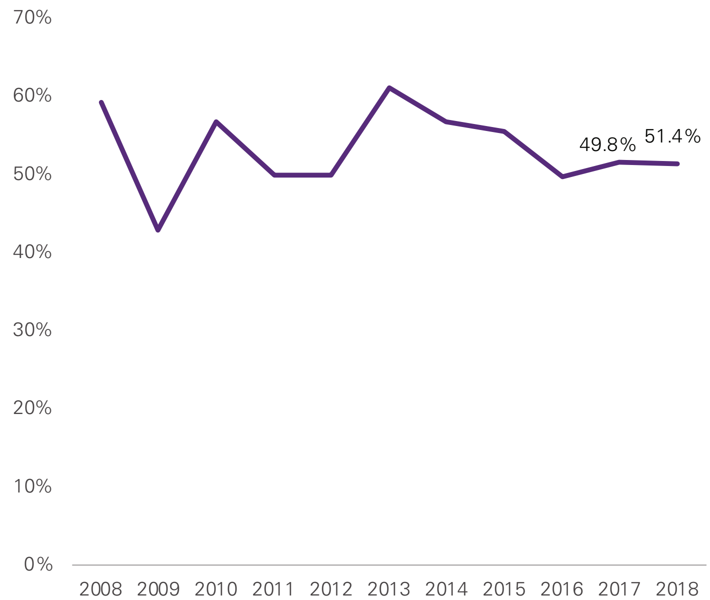


Source: PitchBook

to intensified focus on the lower reaches of the middle market. Multiples surged as well, with buyouts maintaining a median EV/EBITDA multiple above 11x in both 2017 and 2018, higher than all but two other years since 2006. Debt percentages also have held steady, handily exceeding 50 percent of deal value for the past two years. Concurrent expansion of the leveraged loan universe has proceeded apace, exceeding a trillion dollars according to most estimates.

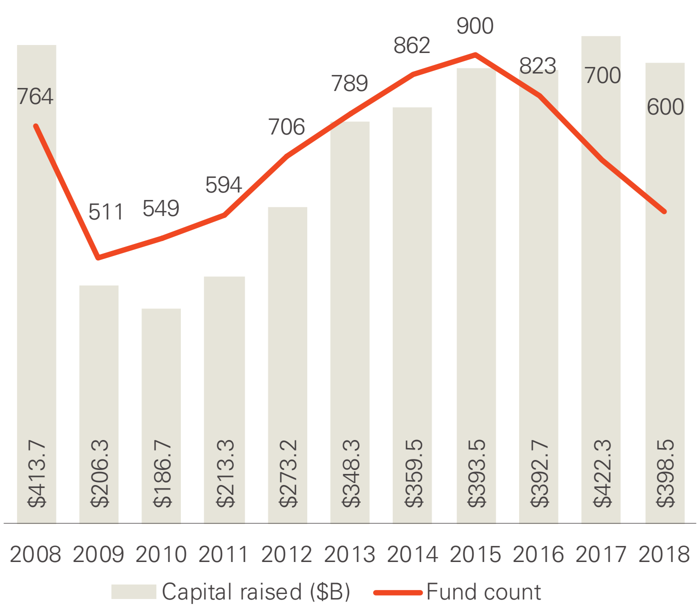
To little surprise, this diversified demand has contributed significantly to a rise in private debt fundraising, particularly within the U.S. 112 completed fundraises in 2015 may stand as the high-water mark of volume for the decade, but 2017 saw nearly $80 billion alone committed to private debt strategies. In fact, that $80 billion accounted for nearly 19 percent of all private capital raised that year. But even beyond demand aided and abetted by PE's popularity, there was one last key factor not yet enumerated within the regulatory realm. As traditional lenders pulled back in the wake of the financial crisis, smarting from their losses, private debt funds enterprisingly stepped in, seizing market share. With that last key driver in place, private debt's growth was ensured, and now it has warranted its status as a newly established asset class. That said, any established asset class that has rapidly grown faces its own unique quirks and characteristics, with which players in private debt are currently contending.

Median U.S. PE debt percentages



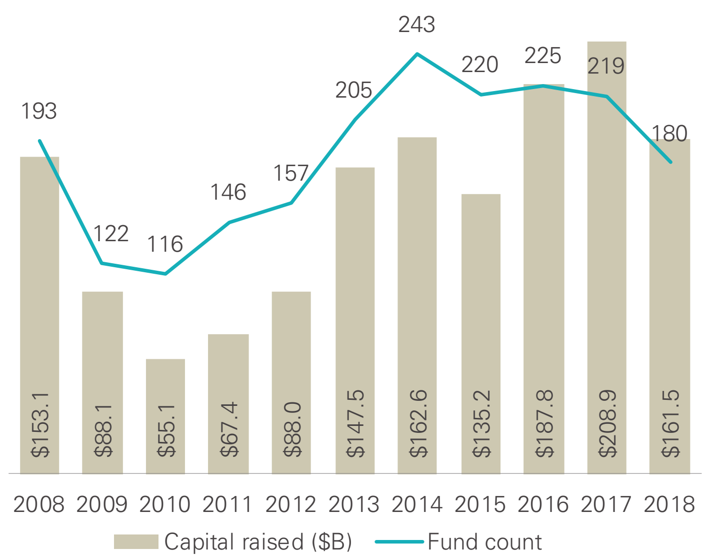
Source: PitchBook

U.S. private capital fundraising activity



Source: PitchBook

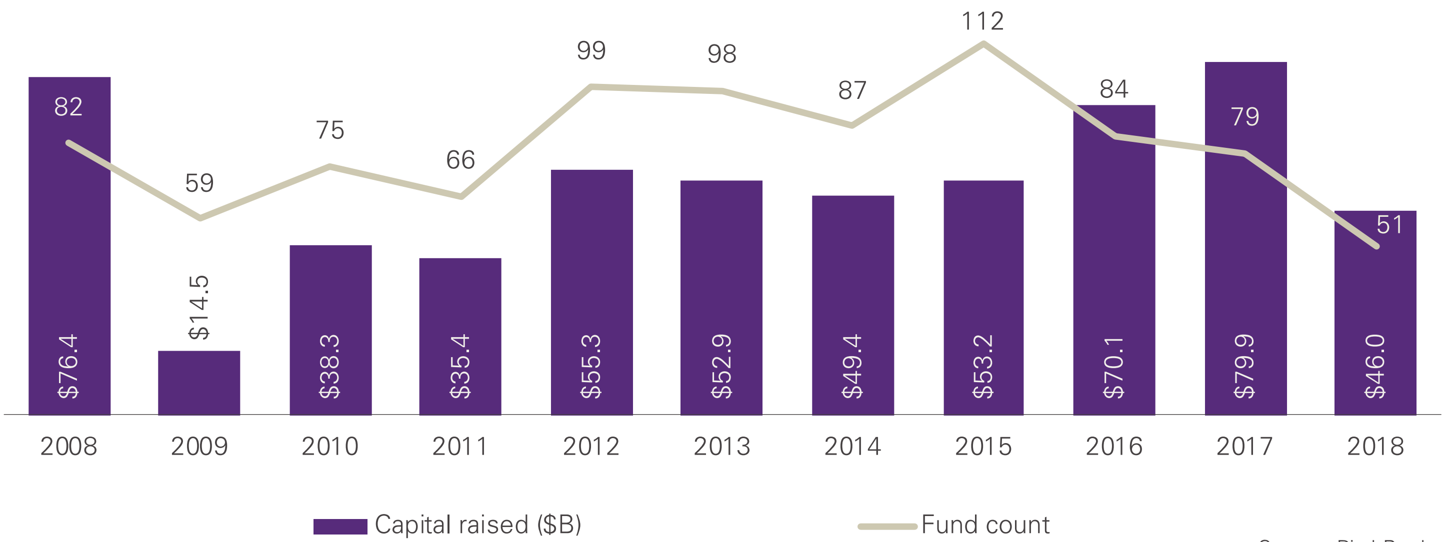
U.S. PE fundraising activity



Source: PitchBook

Current trends

U.S. private debt fundraising activity

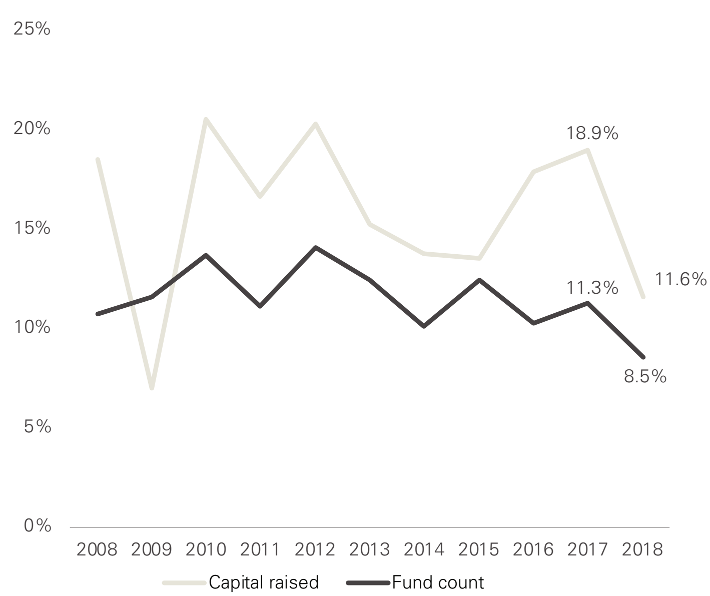


Source: PitchBook

A slump in private debt's proportion of all private capital in 2018 already hints at a combination of both timing and saturation within the market, although 2018 figures remain well within historical norms. The private debt space has clearly become quite competitive, intensifying even further since 2015. However, the competition is likely most concentrated in the more popular types of private debt vehicles. Throughout the past decade, the popularity of distressed debt waned even as that of direct lending waxed, reaching its greatest proportionate expanse at 33 funds closed in 2015. Since then, direct lending has remained one of the mainstays of private debt fundraising, although pure debt has surged in proportion in the past two years. The bulk of all dollars raised, however, still goes to distressed debt and direct lending. The two combined for nearly 70 percent of all dollars raised for private debt vehicles last year.

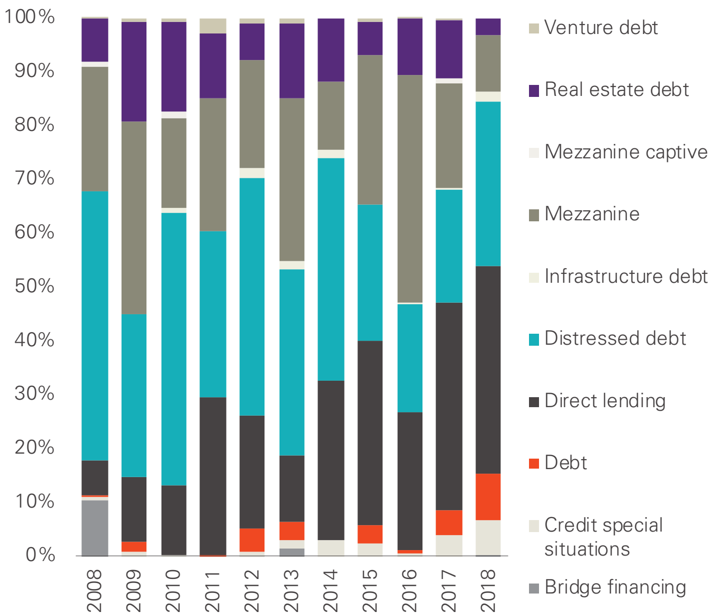
These concurrent trends suggest that, given direct lending's positive reputation, decent returns boasting low volatility, and low correlation to other asset classes, the lending type is no less popular but rather more competitive. The larger, most sophisticated players are still able to raise significant sums, such as Kayne Senior Credit Fund III closing $3 billion in August 2018 or Ares Private Credit Solutions closing $3.4 billion toward the end

Private debt as proportion of U.S. private capital fundraising



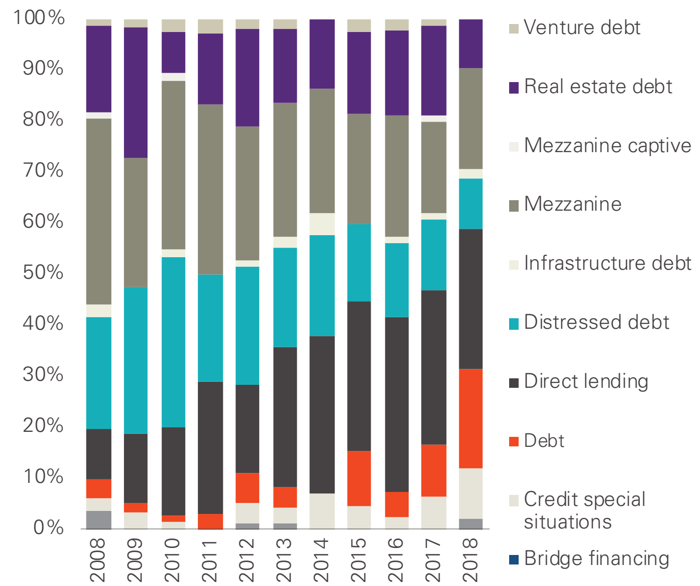
Source: PitchBook

U.S. private debt funds ($) by type



Source: PitchBook

U.S. private debt funds (#) by type

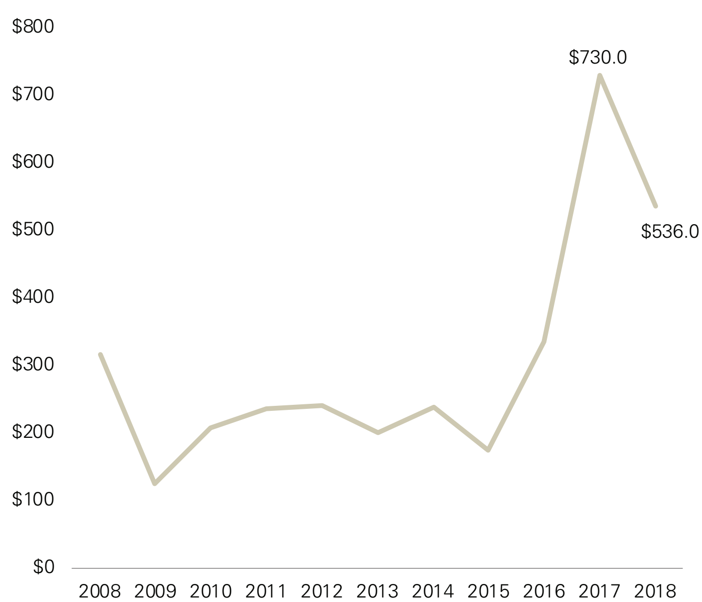


Source: PitchBook

of December 2017. 2018's median private debt fund size further reinforces this finding, staying resolutely high at $536 million, the second-highest tally of the decade.

As the direct lending space grows more crowded and competitive, however, niche strategies will likely gain in popularity as players look to gain exposure to middle-market loans and develop expertise within a particular arena. Senior-secured debt is already cropping up as a preferred haven, especially as heightened competition has led to concerns around eroding covenants and thinner spreads. That could also be driving the swelling proportion of general debt vehicles, as investors embrace a broader strategy that may have recourse to other debt types and situations. Distressed debt's numbers, on the other hand, align in narrative given the uptick in pressures exerted on some companies due to trade disputes as well as more systemic factors, such as persistently low oil prices and shale production combining to make an even more dire future for coal miners.

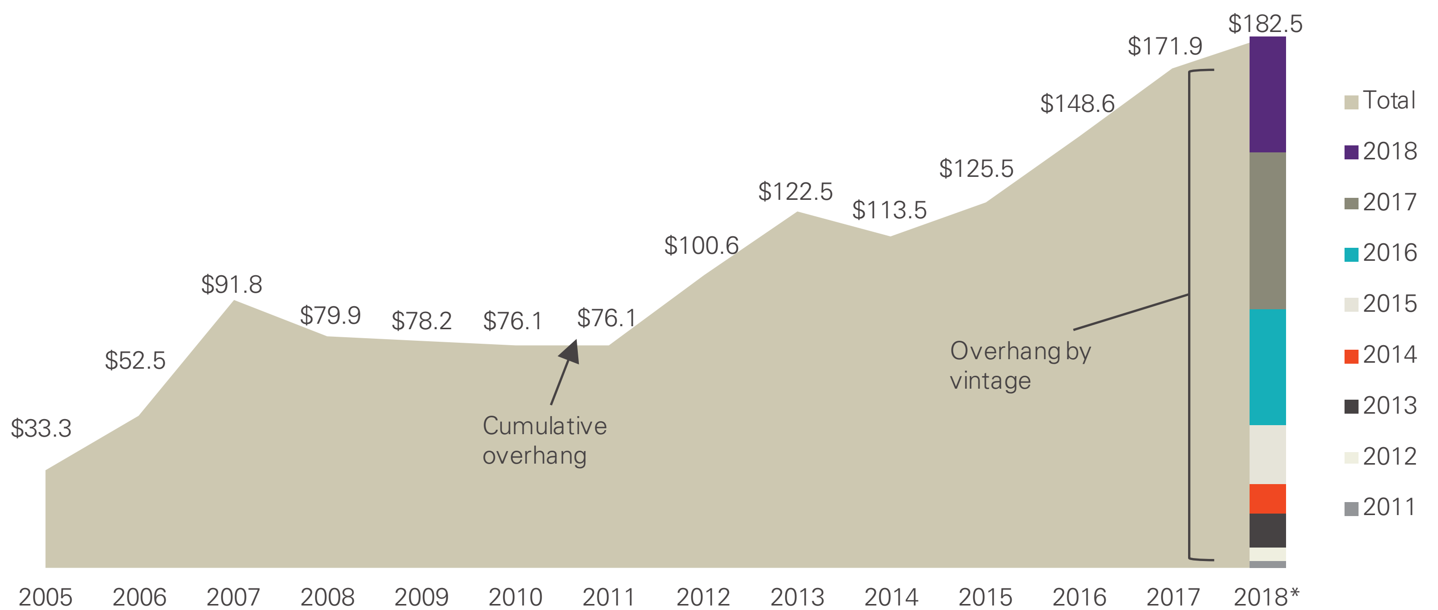
Median U.S. private debt fund size ($M)



Source: PitchBook

Looking ahead

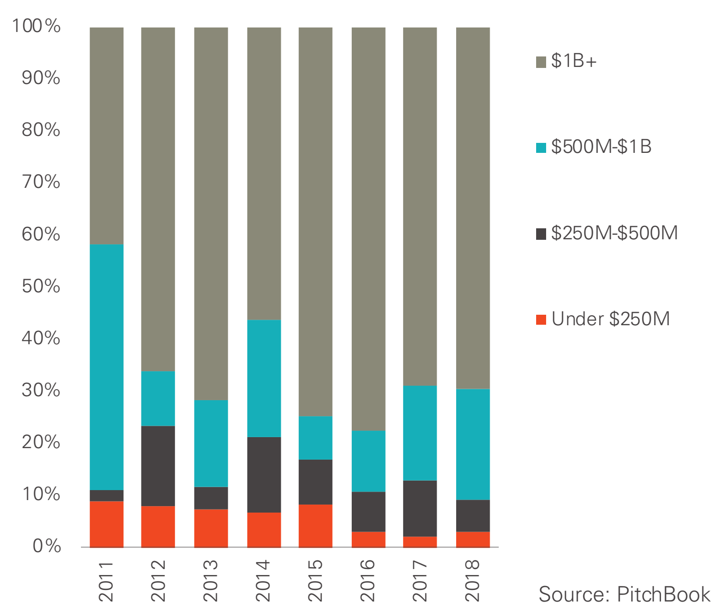
U.S. private debt capital overhang ($B)



Source: PitchBook
*As of June 30, 2018

Assessing the near future for private debt is easier when analyzing the current composition of capital committed to the array of strategies across the landscape. Through the middle of 2018, U.S. private debt capital overhang stood at $182.5 billion—a remarkable high—with the bulk concentrated in vintages from 2016 through last year. A surplus of recently committed capital, taking into account the typical lifecycle of funds, will support healthy or even exuberant competition for some years to come. In tandem with any such competition, however, will be compression of return margins and growing acceptance of greater risk, which is already occurring. No significant market downturn is in the offing yet, despite the tremors of December 2018, but players in private debt are already reshaping their plans and analyzing exposures. The strategy can prove resilient even in a downturn if lenders are savvy in adjusting portfolios. Areas of the U.S. middle market such as manufacturing or health care, in particular, should still prove fruitful arenas for direct lending, given the nation's relative economic outperformance and consequent reinvestment via global capital flows. That said, the private debt environment will prove more charged with caution and compression of performance in 2019 than it has in years, with investors opting for safer private credit scenarios and niches where demonstrated expertise can still outperform.

U.S. private debt capital overhang ($B) by size



Source: PitchBook

Q&A: Key trends in private debt fundraising

Dan Fisher
Partner

Dan Fisher, the co-leader of Akin Gump's integrated special situations group, practices at the nexus of M&A, restructuring, securities and finance and has market-leading experience in the unique issues raised by distressed and special situations.

Frederick Taehoon Lee
Partner

Fred Lee, the co-leader of Akin Gump's integrated special situations group, focuses on acquisition financing transactions, such as representing alternative capital sources in connection with loan originations and distressed debt.

Let's start off from a macro perspective: What is your take on the current private debt market within the U.S. and abroad?

Fisher: The private debt market has exploded in popularity and market significance within the past decade. Given the novel array of lending opportunities that emerged in the wake of the financial crisis, it was hard to predict that nonbank lenders and even traditional PE players would move into the space to the extent they did. As PitchBook data shows, direct lending has become the most popular sector in terms of volume growth across the entire U.S. private debt fundraising arena.

Simply put, the market has grown quite crowded within the U.S. The early entrants already boasting expertise were able to compete most successfully and, given the popularity of direct lending, have since looked to broaden into other niches and strategies. Overhang has exceeded $180 billion in the U.S., showing how competitive the space has become. Accordingly, terms and negotiations are prone to becoming overstretched, although there are the usual recurring headlines emphasizing caution. It isn't that there's clear evidence of a credit bubble due to competitiveness, so much as there is more potential than usual for one to develop given how avidly people are competing.

Lee: It'll be more difficult for fund managers to secure the best opportunities in the current market, although there are blue-water environments for firms that have the requisite expertise and enough capital to strike out into, namely, sector-specific special situations and larger market opportunities. Syndication and club deals at the top end are starting to emerge as the size of the opportunities grow larger. But all in all, as Dan indicated, the level of competition even for some of the most established players in the space could keep ratcheting up for the foreseeable future.

Given the current rate environment, as well as what has occurred in the lending market over the past decade, how do you think nonbank lenders will modify their strategies going forward?

Lee: Nonbank lenders will have to straddle a fine line between discipline and creativity, essentially. It's difficult when some competitors for whatever reason are able or willing to push the line a bit more in terms of covenants or structure. Growing interest in exposure to the middle market and large-cap competition are complicating matters. In the former, lenders often must work with businesses that are inherently riskier prospects due to their level of sophistication and resources. In the latter, competitors keep pushing the limits of covenants, disdaining protections and allowing flexible add-backs to EBITDA in order to secure business, as was also noted in a recent *Pensions & Investments* piece. If the cycle turns, some creditors won't have much recourse. Granted, until then, the conservative players will have to differentiate in some other fashion.

Fisher: Ways in which they can differentiate likely include demonstrated expertise in niche situations and willingness to serve as sole party on the transaction. That said, it's important to note that it's not as if covenants are evaporating left and right. The market still sees plenty of what would be regarded as normal thresholds of protections. I'd expect more firms to

try to strike a balance between the two, stretching where they can to accommodate specific situations or industry trends yet trying to retain an overall sensible level of risk for their portfolio.

PitchBook data reveals an intriguing backdrop for private debt in general. Multiples have stayed persistently high, with debt/EBITDA components in U.S. PE buyouts at high, if not record, levels. How do you see that dynamic playing out in the 2019 dealmaking environment?

Fisher: The appetite for private debt is clear. PE buyers will take the best propositions they see in terms of financing, especially when it comes to refinancing portfolio companies to extract some liquidity as the state of the cycle remains affected by key macroeconomic factors, such as ripple effects of ongoing trade squabbles. PE buyers aren't going to become increasingly undisciplined; they'll just be even more laser-focused on what packages make the most sense for their situation and which firms can secure them the best deal.

Lee: PE firms are looking to get creative given regulatory constraints applicable to, and potentially high costs of, traditional underwritten deals. If they can convince private lenders to commit a portion of the required debt financing without having to pay underwriting fees, they'll do so. Given the repeat nature of PE-related financings, working with a trusted partner on a consistent basis for multiple acquisition and portfolio company financings is highly appealing to the PE firms. Lenders will strive to win that business; PE firms, in turn, will seek out whoever can maintain that level of trust and understanding of the strategy for said PE firm.

> "Nonbank lenders will have to balance discipline and creativity in order to differentiate in the current market."

Let's get more granular: Which private debt strategies in your opinion are set to fare the best? PitchBook data reveals a surge in direct lending and general debt as of late.

Lee: Direct lending can still work well but is fiercely competitive within the large-cap realm and likely to grow more competitive in the middle market as well, hence the shift to general debt and a moderate return to greater flexibility in strategy. Lenders are looking to keep their options as open as possible. I'd expect that direct lending fundraising evens out as practitioners in the space are able to carve out their niche or discover they need to rethink their strategies. As for general debt and mezzanine, I'd expect consistent fundraising and attendant steady success with their more flexible strategies.

Fisher: Often underrated is the impact creativity can have on a given market. The big macro drivers behind the surge

> "Lenders and borrowers overall could focus more thorough and detailed communication regarding underlying documentation, especially in the middle-market direct lending space."

How the $175M recapitalization of Meltwater exemplifies current credit markets

Closed recently in March 2019, the $175 million global recapitalization of Meltwater, a leader in media intelligence solutions that engages in media monitoring to provide datasets on behavior and interaction, exemplifies several interacting trends across the PE and private debt universes. As Vista Credit Partners, the credit investing arm of Vista Equity Partners, led the transaction, it's easy to note the now-established trend of flagship tech-focused PE firms engaging in every facet of gaining exposure to technology businesses, given Vista Equity Partners was and remains one of the most notable PE firms active within the enterprise software sector. What's also intriguing to note about this particular transaction, however, is the scale of the recapitalization and the segment of software of the recipient company. Meltwater's arena, to take the latter first, has seen heightened competition as tech incumbents invest in their own efforts within the space. Technical innovation is necessary but costly, driven by advances in machine learning and artificial intelligence which require significant investment in talent. Meltwater's desire to find a well-known and respected partner in its recapitalization was a major advantage to Vista in securing the deal as a sole-source lender.

This transaction illustrates a confluence of trends within the private debt market. Sector specialists are increasingly able to justify significantly sized deals in key niches, given their expertise and potential resources. On top of that, innovators in the blend of debt they can provide are able to be active in a variety of areas, bringing to bear a combination of both financing and fluency in sector or across verticals.

in private debt markets in general weren't just regulatory, but even more systemic in that investors in these private debt funds were looking for a lucrative arena in which they could subscribe their capital. As a result, the space quickly grew heated if not yet truly overheated, although the median private debt fund size hitting $730.0 million in 2017 and staying elevated at $536.0 million in 2018 does suggest the latter. If capital keeps pouring into this space, shifting in its diversity of strategies, some firms simply will be able to win out due to their greater creativity, capital hoard, disregard for constraints or judicious caution—or some combination of all the above.

Can you walk through some case studies in the course of your practice that you view as useful examples showcasing hurdles that private debt players—both investors and borrowers—should consider?

Fisher: Keeping matters general, the usual suspects often end up being not so much matters of covenants overall but rather those relating specifically to timing of expected recoveries in various default scenarios. Beyond that, increasingly troublesome issues are loosening standards around EBITDA calculations upon which leverage ratios are based.

Lee: Concurring with Dan, and staying general, I'd add that lenders and borrowers overall could focus on more thorough and detailed communication regarding the underlying documentation, especially in the middle-market direct lending space. Lenders in this space may need to provide some education to borrowers as to specific requirements and expectations in the underlying documentation given many of them may not have the sophistication to fully appreciate the requirements and obligations placed upon them pursuant to such documentation.

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