# (LON) EUROLOANMARKETPULSE: PRESSURE ON TERMS PROMPTS DEBT FUNDS TO GET CREATIVE - REUTERS LOAN PRICING CORP

08-Feb-2019 01:12:12 PM

To view this story on Eikon, click here

A deal reached 12 times leverage in the private credit market last year as lenders are pushed to up multiples and decrease pricing in an effort to win deals in an increasingly competitive market.

Average closing leverage in the market was 5.18, up from 4.79 in 2017, while a large chunk of unitranche deals fell below the 7% margin, according to a report from law firm Proskauer.

The private credit market has the same liquidity mismatch evident in the syndicated market. Funds raised a total of €110bn last year, Preqin found, the second highest fundraising year since the global financial crisis.

Because market dynamics continues to favour sponsors, many managers are expecting pricing to continue to erode in 2019. Some 46% of respondents to Proskauer's survey say pricing will come down, compared with 12% who believe it will go up.

Private credit funds market themselves on their ability to provide more bespoke financing solutions compared with their banking counterparts, but unlike the syndicated market are unable to offer covenant-lite terms.

"Given strong investor preference, most middle market direct lending funds require at least one covenant," said Eric Capp, partner at Pemberton.

Sponsors pushing for greater flexibility on documentation are finding funds willing to bend to their demands. The average number of covenants dropped to 1.33 in 2018 from 1.82 recorded by Proskauer in 2017. 62% of deals contain single covenant, Proskauer said.

"Sponsors and their advisers will often push for documentation that is typical in the public syndicated loan market, which includes looser restricted payment provisions and the ability to move security outside the obligor group," said Capp.

"We believe most direct lenders are maintaining their discipline on terms and conditions," he added.

BATTLE LINES

Covenants have become a key focus for investors and regulators over the last 12 months, but some in the market are concerned the discussion is focused on the quantity, rather than the substance.

"There are covenants and then there are covenants. It's good that mid-market deals still include a single covenant, but it it's set at 40%-45% to the sponsor's base case model and there is a bunch of crazy add-backs then that covenant rapidly loses teeth," said Faisal Ramzan, partner at law firm Proskauer.

“If it is super loose then it is tantamount to covenant-lite, direct lenders are fully aware of this and are trying to push back to maintain discipline,” he added.

The middle market has stronger restrictions on add-backs with pro forma adjustments typically at 12 months and in some cases 18 months, tighter than those seen in the leveraged market.

Restrictions on builder baskets are also stricter in comparison and exceptional items factored into in the Ebitda is capped at 15% in the middle market.

However, it is under the uncapped exceptional items, which cover non-recurring items adding to the Ebtida total, where private equity firms gain a negotiating advantage.

“One hole is in the uncapped exceptional items provision. Our data shows it’s a losing battle. On the larger deals we don’t capped exceptional items add-backs, but in the middle market we push for it and sometimes get it. Now, often we don’t,” Ramzan said.

NEW FRONTIERS

The downward pressure on terms saw many private debt funds look to the higher end of the buyout market as well as with corporates without private equity backing, with mixed results.

In July, Ares supported the recapitalisation of UK-based VetPartners by acquiring a 40% minimum stake, in addition to providing a unitranche and preferred equity instruments of around £500m.

Following the sale of VetPartners to buyout firm BC Partners, Ares provided a debt package of £595m, maintaining its position in the capital stack even as the owners changed.

Funds have successfully lured borrowers from the high-yield market. Hearing aid maker Sivantos turned to the direct lending market for a €500m subordinated debt package and UK private school operator Cognita pulled its bond offering and placed a £255m second-lien facility with EQT Credit.

Where funds have struggled to find lift off is in the sponsorless market. According to Proskauer, only 3% of the loans the firm worked on did not involve a private equity sponsor. Research from GCA Altium also show it’s still a tiny segment of the European private debt market.

“When we launched private debt strategy, we anticipated us doing more sponsorless deals by now,” said one fund manager.

(( david.brooke@thomsonreuters.com; +44 207 542 7489; Reuters Messaging: david.brooke.thomsonreuters.com@reuters.net ))



nRLP84104a