FEATURE

US ROUNDTABLE

Roundtablers: (from left) John Finnerty, Randy Schwimmer, Bill Brady, Trevor Clark, Stuart Wood and Zia Uddin

More vehicles on the road

Competition is fiercer than ever as a growing number of industry veterans set up their own shops or private equity firms diversify with closed-end credit funds. **Andrew Hedlund** sat down with six US private debt experts to find out more

When US mid-market lenders gathered in the summer of 2016 for *PDI*'s annual US Roundtable, the world had just come through months of market turmoil and fundraising overall had started to slow. The top two strategies were mezzanine and distressed debt, which accounted for 35 percent and 33 percent, respectively, of targeted capital in the first half of 2016.

A year later, we find ourselves in a different world: deal terms have loosened considerably as we move further away from the last bout of market volatility and senior debt has now come to the forefront as a favoured strategy among LPs – at least for the moment.

Anecdotally, the rate at which private equity firms are launching their private credit practices has shown little sign of slowing. Meanwhile, dry powder keeps piling up, suggesting that there may be more capital than dealflow can sop up. All these themes play out against a an economic expansion now in its eighth year and with seemingly no end in sight. Even amid geopolitical turmoil, the stock market continues to reach new highs and corporate defaults remain low. Still, there seems to be little clarity as to when the cycle will turn, as Oaktree co-chairman and financial luminary Howard Marks wrote in a recent memo.

"We agree things can't go well forever – we agree the cycle is extended, prices are elevated and uncertainty is high – but we don't see anything that's likely to bring the bull market to a close anytime soon," he penned in a note released in late July.

No one can say with absolute certainty

where we are in this current cycle, but many seasoned private credit veterans think we are closer to the end than the beginning. Meanwhile, new private debt investors continue to enter the market, raising fears of oversaturation in the market.

Most can agree that more players in the market means fierce competition, and managers are having to differentiate themselves in a bid to raise capital from a finite pool.

Bill Brady

Partner, head of alternative lender and private credit practice, Paul Hastings

- *Paul Hastings works on deals spanning the capital structure from unitranche facilities to asset-based loans*
- *Provides counsel from structuring deals to workouts and restructurings*
- *Practices include operations in the US, Europe and Latin America*
- *Represents BDCs, mezzanine lenders and hedge funds*

On deal competition

"THE MARKET IS EXTREMELY COMPETITIVE RIGHT NOW, NOT ONLY FOR LENDERS BUT FOR THE PRIVATE EQUITY BUYERS THEY ARE SUPPORTING. FOR MANY OF THESE AUCTIONS, THE LINE OF BUYERS SEEMINGLY GOES OUT THE DOOR AND AROUND THE BLOCK"

Q What is your firm seeing as it hunts for transactions?

John Finnerty: At this point, we would say the demand for deals outstrips the supply of opportunities out there. Looking at the market from a high level, it's still very positive. The private equity firms continue to raise significant capital so they remain very active. The good news is while a lot of money has flowed into private credit, deal volume seems to be up. So, it's competitive; there is volume out there. I think we're just finding it's one of those markets you need to call more broadly and remain disciplined in your credit selection process.

Trevor Clark: With our focus on the lower middle market, we have historically experienced much less volatility regarding market clearing lending structures and terms when compared to the upper middle market and broadly syndicated loan markets. This trend continues today, with only a small minority of our recently closed transactions seeing any change in lending competition or lending terms. On isolated occasions, we will see volume-challenged upper middle market-focused lenders try to pursue mainstream middle market transactions, and offer large market terms.

Zia Uddin: Clearly, the sponsor market has been pretty active, and that's been the case for the last 12-18 months. The non-sponsor market is starting to pick up, but it's a competitive landscape. The last numbers I saw indicated that there are 175,000 companies that have revenue under $350 million in the US, that's where we tend to focus on. For us it's a numbers game.

Stuart Wood: We've seen funds that have gone through their raise and set their hurdle rate, but now they are sitting on a lot of dry powder. Many fund managers are not finding the deals out there that are going to meet their target yield requirements and so they are sitting on a lot of unused capital commitments – looking, waiting and continuing to hunt for deals that will meet their investment criteria and will attain higher yield thresholds.

Bill Brady: The market is extremely competitive right now, not only for lenders, but for the private equity buyers they are supporting. We have run trees on many auctions in 2017, in some cases up to six trees in a particular auction, and even in those deals we didn't necessarily support the winning buyer. For many of these auctions the line of buyers seemingly goes out the door and around the block.

At the same time, we have seen a massive expansion in the private debt space. In 2017, we have supported private debt providers in signing deals with borrowers whose EBITDA ranges from $5 million on the low end to almost $500 million on the high end. Those larger deals are "hybrid" in nature, in that they include a large, widely syndicated first lien bank facility and a private, second lien facility provided by one private debt provider or a small club of private debt providers.

Q What is happening to deal terms, including pricing and covenants?

Randy Schwimmer: We do see deal terms for some middle-market issuers more appropriate for larger borrowers. That's particularly the case around the $50 million EBITDA level. Cov-lite is

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appearing in some deals lower than that benchmark, but pricing has retained its premium to the large-cap market. If sponsors choose the syndication route, they may get cheaper capital. But most of our clients want relationship lenders. They want to know who they're dealing with.

BB: Fierce competition has facilitated, in many auction processes, the introduction of more and more borrower-friendly large cap terms in the middle market. The front line in this battle has moved further down market. The large-cap concepts have historically trickled down into deals where EBITDA is $50 million, but that has changed.

What was once $50 million of EBITDA became $40 million, $30 million and most recently $20 million or less. This year I am also seeing more and more creative structures to get deals done. I am structuring some deals with up to four tranches of debt that require three or four different inter-creditor or inter-lender agreements which govern the relative rights of each tranche of lenders.

Q What are the negotiations like in private equity sponsor-backed deals?

RS: It's very much an issuer's market today. Sponsors have a variety of financing options being thrown at them. For the better credits, arrangers are compelled to offer increasingly loose terms. It's somewhat better in the club market we play in than for the syndicated middle market. But sponsors do have a strong hand at the moment. We try to be constructive, but stay focused on the risks.

JF: In the mid- to upper-middle market you are seeing a higher use of grids to negotiate deals whereby the sponsor has taken terms from multiple term sheets and is asking lenders to respond back. You have to reply back via the grid with your response on each term. It is situational, and dependent on the competitive landscape. In some cases, if you don't accept the terms as is, you are out. In others, there is more give and take.

TC: The answer to this question is largely dependent on the private equity group in question and the lender's history of closing transactions with the private equity group. Past deals can set a precedent for future negotiations. This precedent streamlines the negotiating process from initial

John Finnerty

Senior managing director, corporate finance group head, NXT Capital

- *NXT Capital targets businesses with $5 million-$75 million of EBITDA*
- *Lends senior debt and does equity co-investments*
- *Finances transactions including leveraged buyouts and refinancings*
- *Has a specific healthcare lending team*

On investors

"LPs ARE MUCH MORE EDUCATED AND ARE PURSUING THE ASSET CLASS, BUT I STILL THINK IT IS CHALLENGING TO CONTINUE TO EDUCATE AND EXPLAIN DIFFERENTIATION AMONG MANAGERS"

MAKING THEIR DEBUT

Managers with a first-time senior debt fund

All managers – 27%

US managers – 21%

European managers – 38%

Source: bfinance (five searches from November 2016 to February 2017)

transaction structuring through closing. A private equity group's choice of legal counsel can impact the amount of negotiation on a transaction, especially when the lender and private equity group have not worked together in the past.

ZU: We are not exclusively a shop doing PE-backed deals. Approximately 35-40 percent of our business is non-sponsored. So, a lot of what's being talked about in terms of PE shops driving pricing down and leverage up is for sure happening in the sponsor market – particularly in the larger end. So, we are not trying to compete with 10 other lenders. It's not what we're doing.

Q Where does all this put us in the credit cycle?

RS: Somebody recently described what we have today as a "cycle-free market". Certainly, some firms are acting as if the good times will last forever. In terms of a business cycle, we're either in an extra innings or a very long seventh inning. We approach each credit as if there will be a downturn next year. Then we ask, how will they perform? All this because we've been through cycles as a management team.

BB: There is so much dry powder out there that, just like last year, I think we have a way to go. Our practice encompasses front-end deals as well as restructurings, and I can't recall, other than pre-financial crisis, when I had a smaller pile of defaults on my desk. We currently have some restructurings in-house in the retail and restaurant space, but outside of those our client's borrowers are performing well.

SW: There is still a lot of first-time credit fund managers jumping into the space that still believe there are opportunities out there despite the fact that many experienced credit lenders believe we are in the later stages of the game.

Q Will the first-time credit funds generate enough deals and capital to fully invest through their life?

SW: I think that's where there's a little bit of a disconnect. The managers are not struggling to raise capital and are able to continue getting investors excited but when they go out and look for deals, it's more competitive than they expected or they are unable to find the right types of deals to fit their strategy. As a result, they are not necessarily deploying all the capital that they have access to as quickly as they had hoped.

TC: The sheer size of the middle market, in combination with the typical investment period – which is three years or longer – for middle-market debt funds, makes it likely that most first-time funds will be able to deploy their capital.

The more critical question is: "What is the quality of loans being booked by first-time, or non-cycle tested, fund managers?"

A concerning trend we have seen in the marketplace is the significant amount of capital that has been raised over the last five years by managers with experience outside of the middle market, or with track records that don't include a credit cycle.

Our biggest fear isn't that we can lend through a cycle. We've done that. Our biggest fear is you've got a lot of investors who've become aware of direct middle-market lending in the last five, six, seven years. They've put a lot of money into managers. So, when the new cycle does come, and people get burned, do LPs turn around and say: "I knew I didn't like this asset class"? Or are they going to look back and say: "I chose my managers poorly"?

Q What keeps you up at night as a private debt investor?

ZU: For me, it's the competitive landscape and people doing off-market things. It's not sustainable. It's easy to lend money – just lower your standards and lower your rate, and you can deploy a lot of capital. So, deploying money is not difficult. The more people aren't thinking straight, it's the greater fool theory, I think. That's what kind of keeps me up at night. Firms need

Trevor Clark

Founding partner, Twin Brook Capital Partners

- *Twin Brook targets companies of $3 million-$50 million of EBITDA*
- *Invests in senior debt*
- *Focuses on deals with a private equity sponsor*
- *Sector approach: generalist with specialties in aerospace, healthcare and financial services*

On the credit cycle

"WHEN THE NEW CYCLE COMES, AND PEOPLE GET BURNED, DO LPs TURN AROUND AND SAY, 'I KNEW I DIDN'T LIKE THIS ASSET CLASS'? OR ARE THEY GOING TO SAY, 'I CHOSE MY MANAGERS POORLY'?"

to stay disciplined from a strategy perspective. In my opinion, that is what will differentiate good managers from the rest of the pack.

Q What has fundraising been like and how is investor appetite for private debt?

JF: I would say from our perspective, we're seeing more investor appetite. There was a pretty big wave in 2013, 2014. A lot of those investors then turned away from the market in 2015 and 2016, at least in the US, and went overseas. They all seem to be back looking at the US market again, and those parties that were sitting on the sidelines seem to be coming into the space as well.

ZU: LPs are much more educated on what they want versus three, five or 10 years ago, when you needed to explain the asset class or they just really didn't understand the intricacies of it. And now they sure do. They know the players, they compare and contrast. You have to justify your existence on certain criteria.

JF: I think there are a lot more people in the market looking. LPs are much more educated and pursuing the asset class, but, as mentioned earlier, I still think it is challenging to continue to educate and explain differentiation among managers.

Randy Schwimmer

Senior managing director, head of originations and capital markets, Churchill Asset Management

- *Churchill provides senior debt and unitranche loans*
- *Focuses on deals with a private equity sponsor*
- *Part of Nuveen Asset Management (formerly TIAA)*
- *Closed debut mid-market CLO fund last autumn*

On sponsors

"IT'S VERY MUCH AN ISSUER'S MARKET TODAY. SPONSORS HAVE A VARIETY OF FINANCING OPTIONS BEING THROWN AT THEM. FOR THE BETTER CREDITS, ARRANGERS ARE COMPELLED TO OFFER INCREASINGLY LOOSE TERMS"

Q Have you seen an uptick in investor allocations to private debt due to the difficulties hedge funds have encountered?

RS: Middle-market loans as an asset class are increasingly attractive to investors who seek to diversify away from fixed income and public equities. Those asset categories are subject to high correlation relative to broader market moves. Loans are floating rate and have relatively low correlation.

Where it gets tricky – as you get more into private credit – is understanding there's a very different risk profile between a 7 percent-yielding senior secured credit and one that yields 10 percent.

Investors need to know that the 10 percent loan is a very different animal with more downside risk. In this benign credit environment, if you're a borrower paying 10 percent, there's a story behind that paper. And it's not where we play as an originator. Making that distinction with investors is an ongoing education issue.

Zia Uddin

Managing director, portfolio manager – private credit, Monroe Capital

- *Monroe invests in companies with at least $3 million of EBITDA*
- *Provides senior and junior debt along with equity co-investments and asset-based loans*
- *Multiple industry verticals, including healthcare and technology*
- *Operates a BDC, Monroe Capital Corporation, and a CLO platform*

On strategy

"THE COMPETITIVE LANDSCAPE AND PEOPLE DOING OFF-MARKET THINGS, IT'S NOT SUSTAINABLE. FIRMS NEED TO STAY DISCIPLINED FROM A STRATEGY PERSPECTIVE"

Q Has the due diligence process become more rigorous as the account investors became more sophisticated?

ZU: I don't know if it's gotten more rigorous. It's always been a financial equivalent to a proctology exam. It's pretty exhaustive. So, I haven't noticed a difference. I think LPs have picked certain areas they would like to focus on but, in general, it has been and continues to be an extensive process for us.

TC: I wouldn't say that the diligence

process has become more rigorous, but the focus of this due diligence has evolved. A few years ago, we would have spent a great deal of time with an account investor discussing the merits of the asset class, and why it was a good fit for their respective portfolios. Today there is a much greater focus on manager differentiation, and what makes one manager's value proposition more attractive than another manager.

In a really refreshing way, LPs really are educated enough to know the difference between some of the strategies and some of the groups. So, someone who is coming into the [mid-market] marketplace to do direct lending now is likely to have less success than four years ago when it was: "Just tell me why the middle-market's good, and I'll follow the brand." Now I definitely think LPs are thinking through it.

Q On the fund administration side, what is it like working with first-time funds?

SW: We see several emerging managers leveraging their relationships to line up a lot of institutional investors on the sideline, each one hesitant to be the first to invest. As soon as the manager can convince one institution or an investor with good name recognition then a lot of the other institutions will follow suit shortly thereafter.

Q Have you seen a lot of equity firms that start a credit arm parlay their equity investors into credit investors, or are they two disparate groups?

SW: It's interesting in that if you are a traditional private equity shop and now you are trying to offer something that's just a true credit play – although there's name recognition and brand recognition there – LPs know it's a little bit of a different product from an equity investment. They are keen to understand how managers are planning on handling the investment decisions and fund operations differently. The managers are also encountering a new level of operational due diligence that they may not have seen from their investor base previously which is leading many of them to hire third-party fund administrators.

ZU: Fundraising is very competitive generally right now; there are some nuances depending on what region of the world you're talking about. We spent some time fundraising in Asia, for example, and they are focused on big brand names, that's what appeals to them. In a couple of years, I think that will change, but right now it is easier to fundraise if you have a big name. Europe is a little bit different and the US is for sure different since they have had greater and longer exposure to the asset class.

Q Since Trump won the presidency, have you noticed a big change in the way private debt does business?

BB: Year-to-date the practice has been busier than ever before. I don't have a crystal ball, but I would anticipate more of the same in the latter part of 2017.

JF: With the Obama administration, it was clear where it was headed: more regulation. The business world adapted and managed business accordingly. When Trump came in I think there was a belief he'd bring material change, infrastructure spending would go up dramatically and healthcare would change. I think as we've gotten deeper into it, more and more people are questioning if there will be any real change coming out of Washington. ■

Stuart Wood

Managing director, Cortland fund administration business development, Cortland Capital Market Services

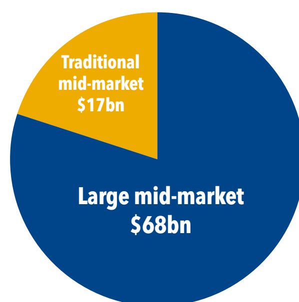
- *Cortland acts as an administrator for bank loan syndications*
- *Aids in origination for mid-market club deals*
- *Can act as administrative agent or appointee for the administrative agent*
- *Member of the Loan Syndication & Trading Association*

On dry powder

"MANY FUND MANAGERS ARE NOT FINDING THE DEALS OUT THERE THAT ARE GOING TO MEET THEIR TARGET YIELD REQUIREMENTS AND SO THEY ARE SITTING ON A LOT OF UNUSED CAPITAL COMMITMENTS"

SIZE MATTERS

Market lending volume Jan-Jul 2017



Source: Leveraged loan monthly July 2017, Thomson Reuters