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How Europe's Private Debt Funds Are Approaching the Leveraged Finance Market

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Paul Mullen is a partner in the Hogan Lovells London office. Acting for both lenders and borrowers at the top end of mid-market sponsor-backed financings, he has been particularly closely involved with the development of the direct lending market in Europe.

In this hoganlovells.com interview, Mullen talks about how the deal structures vary between the private debt funds and the banks, the differences in the financial covenants, and the flexibility of the private debt funds' unitranche's structure.

Why are the private debt funds rising in prominence in the leveraged finance market?

Mullen: The evolution of direct lending within leveraged finance is at different stages in different jurisdictions. In the U.S., this is quite a developed market — it has been going for a number of years. Whereas in Europe, I would say it is probably post-financial crisis that private debt funds started to emerge as lenders on deals backed by private equity sponsors, in particular. Looking to Asia and Australia, the direct lending market is at an earlier stage but there is a lot of potential in those regions.

In Europe, the combination of increased regulation of the banks post-financial crisis — particularly in the area of leveraged finance — and the fact that we have been living in a low interest rate environment for some time now, with investors looking for alternative sources of investment in order to generate yield, has created the perfect opportunity for the private debt funds to step forward, raise capital from these investors, and — to some extent —take the place of the banks. The banks are still active but not on the scale that they were before. We are seeing the introduction of leveraged lending guidelines for banks in Europe that are regulated by the European Central Bank. That's certainly causing the banks to think carefully about the leveraged finance deals that they are financing.

How do deal terms differ when a private debt fund is the lender as opposed to a bank?

Mullen: We now regularly advise these funds on financing transactions and, of course, we have to think about how the terms of those deals should differ because it is a fund that's lending rather than a bank. For example, if a bank was approaching one of these deals, they would be looking for their debt to amortize over the term of the facility — meaning there is a repayment profile throughout the life of the facility. In fact, that's not what the funds want. The funds want to put their capital to work and have their money invested for the full seven or eight year term of

the loan. This approach may also have some other knock-on effects on the terms of the credit documents, for example there may be an incentive on the borrower not to repay the funds because they want to keep their investors’ money working — this leads to the inclusion of terms like non-call provisions, where the borrower is actually penalized if they pay the facility back in the early years.

How do the private debt funds differ in their approach to financial covenants compared to the banks?

Mullen: Another interesting difference is in relation to the part of the deal that lenders focus on more than anything else — the financial covenants — which are tested throughout the life of the deal to check the financial health of the borrower. The funds have been prepared to give more headroom on these covenants — meaning that the borrower has a bit more flexibility and additional room for maneuver than they’d have with the banks.

The funds have also been prepared to look at the particular circumstances of a borrower and perhaps adapt the traditional financial covenants to something that works in that particular situation. What we have seen and what’s been quite interesting is the funds being prepared to take a more bespoke approach to designing financial covenants.

As these deals have grown larger in size, how have the private debt funds approached them?

Mullen: One of the most popular structures adopted by the funds has been "unitranche," which is a single loan with a blended interest rate that reflects the fact that the fund is providing the whole of the term debt rather than separate senior and mezzanine tranches being provided by different lending groups. The size of these deals started off quite small but they are continually increasing in size and are now competing at the lower end of the large cap syndicated loan market and the high yield bond market. Another development has been that several institutions may participate in the unitranche — either through it being shared upfront or behind the scenes — so that one institution is taking the senior part of the unitranche and another is taking a junior tranche. These are often referred to as first loss/ second loss structures. This is still done within a unitranche wrapper, which tends to be more efficient in terms of execution for the borrower.

One of the funds' selling points is that there is quite a lot of flexibility around these products. So although unitranche is the basic product, we’ve seen quite a lot of variation in structures so that they meet the requirements of a particular deal.

For More Information

For more information about the work Hogan Lovells does in the area of alternative lending for funds and institutions, visit the alternative lending page on our website. Hogan Lovells has been advising private debt funds since the market was established in Europe. The firm also has a strong debt fund practice in the U.S. and throughout other parts of its network.

In March 2017, Hogan Lovells hosted a panel discussion in its London office to explore the recent regulatory changes in Italy that have opened up the market for direct lending. Combined with the current challenges and changes in the Italian banking sector, Hogan Lovells believes this development potentially creates a wealth of opportunity.

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