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In Search of Financing: Sponsors Willing to Seek Debt

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Inflation and rising interest rates are filtering down to leveraged finance markets and impacting the terms and pricing for acquisition finance. Private equity (PE) sponsors are adapting to changing debt dynamics by exploring new financing structures and leaning on lender relationships.

Less than a year ago, abundant liquidity allowed sponsors to secure debt for deals at attractive multiples on loose terms, but through the course of 2022, the acquisition finance landscape has shifted dramatically.

According to *Dealogic,* high yield bond and leveraged loan issuance for U.S. buyouts and M&A has contracted steadily during 2022, making it tougher for PE sponsors to fund deals on the same terms and leverage levels as were available last year. U.S. buyout financing totaled US$20.4 billion in Q3 2022, down from US$23.1 billion in Q2 2022 and less than half the US$50.9 billion secured in Q1 2022.[1] U.S. M&A financing has faced similar pressures, reaching just US$7.9 billion in Q3 2022, down almost 70% from the previous quarter.[2]

Private debt has not been immune to the effects of tightening liquidity either. According to *PitchBook,* private debt fundraising for the 12 months ending June 30, 2022, came in at US$211.3 billion, down from the US$228.1 billion raised in the 12 months ending December 31, 2021.[3]

Volatile stock markets (the Dow Jones has shed close to one-fifth of its value thus far in 2022[4]) and climbing inflation, which is running at the highest levels observed since the early 1980s,[5] have contributed to the slowdown, with lenders and investors resetting risk thresholds and pulling back from leveraged finance deals.

"It has become much harder for sponsors to raise the same quantum of leverage and find the lenders to provide it. PE sponsors are having to go out to a much broader range of providers to pull a lending consortium together," says **Stefanie Birkmann**, a finance partner at Ropes & Gray and co-head of the firm's global finance practice group. "Syndicated loan and high yield markets are noticeably quieter, and even direct lenders that had strong appetite to underwrite debt packages in the hundreds of millions are taking a more cautious approach."

Rising interest rates, meanwhile, have also seen borrowing costs spike. The U.S. Federal Reserve has been increasing interest rates throughout 2022 to keep a lid on inflation—in September, the Fed upped rates to the highest level observed since early 2008.[6]

As benchmark rates have increased, so have financing costs. In Q3 2022, the average margin on U.S. loans climbed to 4.73% versus just 4.34% in Q2 2022.[7] In addition, borrowers have also had to offer lenders steeper original issue discounts, which have driven the weighted average yields on U.S. leveraged loans up from 6% to 8.9%.[8]

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Analysis from Oaktree Capital, meanwhile, shows that coupons for senior mid-market loans provided by private debt players have increased between 0.5% and 1% since the middle of June 2022.[9]

Rising debt costs and skittish investor sentiment have deterred many PE borrowers from braving the market with new deals, while deals that have proceeded have encountered challenging syndication processes.

For example, banks underwriting debt for the US$16.5 billion leveraged buyout of software company Citrix Systems, led by Vista Equity Partners and Elliott Management, had to offer steep discounts on the US$8.55 billion in bonds and loans funding the deal to secure buyers for the paper. Banks have also been holding a larger proportion of the debt on their own balance sheets than planned. Many banks are now putting LBO financing activity on hold until markets stabilize.[10]

"It has been a tough period for the syndicated loan market, and several banks are pretty much wound down for this year. Even if there is a huge amount of flex on new deals, I don't sense that there is much appetite from investment banks to provide underwritten commitments," says Birkmann.

PE adapts as direct lenders step in

While the headwinds facing PE borrowers have intensified this year, sponsors have adjusted to shifting market dynamics by working with direct lenders and exploring new financing structures and products. Sponsors focused on smaller mid-market deals, meanwhile, have found acquisition finance to be more resilient than for jumbo leveraged buyouts thanks to long-term relationships with lenders.

For both mid-market and mega-market buyouts, private debt funds have become an increasingly important source of funding for deals in a period of uncertainty.

While private debt funds have felt the effects of a tough macroeconomic backdrop, the fact that private lenders amassed a record US$1.2 trillion of dry powder by the end of 2021 (according to *Preqin*[11]) has enabled them to remain active despite strengthening headwinds.

Private debt managers have been able to expand market share and win more deals that would otherwise have gone directly to syndicated loan or high yield bond markets. A group of direct lenders led by Blackstone, for example, provided a US$5 billion debt package to fund the US$9.5 billion buyout of San Francisco-based software maker Zendesk by Hellman & Friedman and Permira.[12] Blue Owl Group, meanwhile, laid on a US$2.5 billion loan to fund Vista Equity Partners' US$8.4 billion purchase of tax software group Avalara.[13]

In some cases, private debt funds have taken out bridge loans that would normally be replaced by leveraged loans and high yield bonds sold to institutional investors. Ares Management, for example, led a consortium providing a US$2.15 billion second-lien loan to replace a bridge facility raised to finance the take private of Nielsen by Elliott Investment Management and Brookfield Asset Management.[14]

By working with private debt managers on larger deals, sponsors have been able to reduce syndication risk and ensure certainty of execution, as private debt managers hold debt on their own balance sheets until loans mature.

"Even before the market dislocation observed this year, direct lending was already taking a huge share of the syndicated market," says **Michael Lee**, a finance partner at Ropes & Gray and co-head of the firm's global finance practice group. "With the syndicated loan market slowing, that market share has probably increased even further in 2022, and, with a few exceptions, direct lending is pretty much the only game in town at this point."

For direct lenders, the current situation has allowed them to win more deals at attractive prices while also mitigating risk. Direct lenders have generally become more selective and have reduced the size of the commitment they are willing to provide for a single transaction. For sponsors, this means that they have to assemble a club of direct lenders for any meaningful commitment amount versus being able to rely on one or two providers to underwrite the entire deal.

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"Direct lenders have been able to compete for market share with syndicated loans without having to loosen their terms," says Lee. "This is an ideal time for them to be even more prominent in larger financings for high-quality businesses at the same time as pushing up prices and spreading the risk by clubbing up with other direct lenders."

Private debt managers have also remained open for business in the mid-market, focusing on lending to sponsors that have long-term lender relationships. The flexibility of the private debt offer has also come to the fore, with lenders in the space able to put together bespoke structures tailored to the specific requirements of individual deals.

"Lenders in the mid-market have not faced the same pushback on terms observed in bigger transactions," says Lee. "There are still maintenance covenants, and grower baskets have never been as wide. This is a market where deals have been able to proceed."

"Although we have seen pricing go up and call protection increase, sponsors have generally been able to draw a line in the sand and avoid terms going backward relative to what we were seeing in 2021. This is not a market where sponsors are advancing new terms, nor has there been much movement to erase the borrower-friendly terms that have become embedded in the market in the past few years," says Lee.

Even for larger deals in the more volatile leveraged finance capital markets, sponsors that have been able to push deals through have been able to do so without giving too much ground on terms. According to *Debtwire Par,* 84% of U.S. institutional loan issuance for the year to the end of September 2022 included covenant-lite terms. This matches 2020 levels and is only marginally down on the bull-market thresholds achieved in 2021.[15]

In both the mid-market and mega-market, however, the terms and documentation on offer will vary from credit to credit.

Company size, for example, has become a key point for lenders when considering debt provision on borrower-friendly terms.

One area where it has become more difficult to secure cov-lite terms is in the smaller company space, according to Birkmann: "It used to be possible to raise cov-lite debt for companies with EBITDA as low as US$15–20 million, but these days, lenders may request a financial maintenance covenant for companies with EBITDA as high as in the US$100 million to US$150 million range."

Sponsor track record and the quality of an asset are also benchmarks being applied by lenders to triage credits and decide when to lean in and advance favorable terms to borrowers.

> **"The quality and creditworthiness** of an asset, and the experience of the sponsor in the sector, are both being scrutinized with greater intensity. Sponsors are aware of the pivot in risk appetite from lenders, and they are more carefully evaluating how much an asset can expect to be financed in their underwriting."
>
> *—David Hutchins, Private Equity*

Blue-chip sponsor Blackstone, for example, locked in a US$5.5 billion debt financing package from a group of banks and direct lenders to fund its US$9.5 billion carve-out of Emerson Electric's climate technology business at the end of October. RBC, Wells Fargo and SMBC provided bank financing involving a US$700 million asset-based loan and a US$2.9 billion term loan A, while a consortium of direct lenders put up US$2.6 billion of lending.[16]

"The quality and creditworthiness of an asset, and the experience of the sponsor in the sector, are both being scrutinized with greater intensity," says **David Hutchins**, a private equity partner at Ropes & Gray. "Sponsors are aware of the pivot in risk appetite from lenders, and they are more carefully evaluating how much an asset can expect to be financed in their underwriting."

"I don't see sponsors bringing marginal deals forward when there is a risk of those deals not clearing syndication or not securing sufficient interest from lenders," says Hutchins.

Niche products and strategies emerge

In addition to working with private debt lenders across a wider range of scenarios to finance deals, PE managers are also considering increasingly niche products and strategies to secure debt in a tighter market and find a bridge until the markets normalize.

"Just because the syndicated loan market is quiet, it doesn't mean that financing is not available. We have seen direct lenders come in, certain banks are willing to provide term loan A commitments in reliance on their balance sheets, and we still see annual recurring revenue loans and preferred equity among other kinds of capital," says Birkmann.

To reduce buyout deal execution risk, some sponsors are providing equity underwrites to finance deals up front and then returning to market post-deal to raise debt financing outside of the pressures of an M&A auction process. EMK Capital, for example, has hired debt adviser Nielen Schuman to run a debt process to replace an equity bridge EMK provided to optical chain EyeCare Group.[17]

> **"We have high levels of activity** from lenders providing alternative sources of liquidity such as PIK loans and preferred equity to buffer the impact of tightening liquidity and buoy deal volume. In an uncertain period, with no one sure how high interest rates will go, much less the direction of the economy, I would expect PE dealmakers to continue to look for creative financing solutions."
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> —*Patrick Dorime, Capital Solutions*

Sponsors are also increasingly using preferred equity, payment-in-kind (PIK) loans and other junior capital options, as well as seller debt, to fill out deal structures that cannot be fully covered by "mainstream" lenders in a tougher market.

"We have high levels of activity from lenders providing alternative sources of liquidity such as PIK loans and preferred equity to buffer the impact of tightening liquidity and buoy deal volume," says Ropes & Gray capital solutions partner **Patrick Dorime**. "In an uncertain period, with no one sure how high interest rates will go, much less the direction of the economy, I would expect PE dealmakers to continue to look for creative financing solutions."

Portfolio management

Niche debt sources are also playing an increasingly prominent role when it comes to refinancing existing portfolio company debt structures. The change in market conditions has put some capital structures under pressure and made it more difficult for sponsors to refinance maturing debt facilities.

According to *Debtwire Par,* institutional loan and high yield bond defaults climbed to 1.6% and 1.3%, respectively, in September 2022, more than double the 0.6% and 0.3% levels recorded at the start of the year in January.[18] Refinancing issuance, meanwhile, has tailed off, coming in at just US$12.5 billion in Q3 2022, less than one-fifth of the US$66 billion secured in Q1 2022.[19]

With investors less likely to refinance credits when there is an option to buy up loans and bonds in the secondary market at significant discounts to par value, sponsors have not been able to count on refinancing debt that is either falling due or pressing up against covenants.

This has created opportunities for special situations investors to provide liquidity when vanilla refinancing is not an option.

"Companies that were able to comfortably service borrowings are now being squeezed as interest rates rise and inflation increases overhead," says Dorime. "It will be important to tackle warning signs early before problems escalate and find creative financing solutions to cope with these stressors."

Resetting expectations

With the U.S. Federal Reserve likely to continue raising interest rates this year (and potentially into next year[20]), debt markets are likely to remain tight.

Lenders and sponsors are still assessing what this means regarding debt pricing and leverage levels, but PE will have to adjust to putting together deals with less, more expensive debt, which in time could also reset expectations around asset valuations.

"Sponsors are rethinking debt structures in the current environment," says Hutchins. "Financing is still there, but, even for a quality asset, the amount of financing is lower, and PE firms are reconsidering underwriting and leverage multiples because of that. There will be some tweaks to capital structures, but the market will adjust and find ways to get transactions done."

Through the volatility of 2022, PE has shown that it is still possible to secure acquisition finance when lenders and sponsors can adapt capital structures, explore alternative funding sources and rely on relationships.

"We are not at a point where you can say that things are absolutely not financeable. It is just harder," says Birkmann. "Sponsors have to go out to bigger groups of lenders to pull together a consortium, pay a bit more for credit, be mindful of credit quality and lean on their relationships."

Debt markets may be very different from a year ago, but PE managers and lenders are still finding ways to get deals done. As leveraged loan and high yield bond markets have slowed, direct lenders have stepped in to finance large deals that would otherwise have been the preserve of capital markets. Buyout dealmakers have also been able to underwrite debt packages with equity to ensure deal execution and then secure financing post-deal. High quality credits, meanwhile, continue to attract lender financing on attractive terms.

Securing debt may be more difficult and expensive, but buyout investors still have options on the table.

ENDNOTES

[1] Dealogic data, U.S. Pricing Date by Quarter, 1Q22 through 3Q22 (LBO and M&A, ex-LBO); *see also* https://community.ionanalytics.com/levfin-highlights-3q22 - *See par 15*

[2] Dealogic data, U.S. Pricing Date by Quarter, 1Q22 through 3Q22 (LBO and M&A, ex-LBO); *see also* https://community.ionanalytics.com/levfin-highlights-3q22 - *See par 15*

[3] https://www.ai-cio.com/news/after-a-record-setting-2021-private-debt-fundraising-declines-in-first-half-of-2022/

[4] https://www.marketwatch.com/investing/index/djia - as of 14 October 2022

[5] https://www.cnbc.com/2022/09/21/fed-rate-hike-september-2022-.html

[6] https://www.cnbc.com/2022/09/21/fed-rate-hike-september-2022-.html

[7] Debtwire U.S. Leveraged Insights report, September 2022 - *See bottom row, page 10*

[8] https://community.ionanalytics.com/levfin-highlights-3q22 - *See par 9*

[9] https://www.oaktreecapital.com/insights/insight-commentary/market-commentary/the-roundup-top-takeaways-from-oaktrees-quarterly-letters-3q2022 - *See heading 6*

[10] https://on.ft.com/3CMNEn9

[11] https://www.ft.com/content/824a7fc3-a8a3-4a78-a565-bd663ba71520 - *See par 2*

[12] https://www.bloomberg.com/news/articles/2022-06-24/blackstone-led-group-provides-5-billion-of-debt-for-zendesk

[13] https://www.bloomberg.com/news/articles/2022-08-08/blue-owl-led-group-provides-2-5-billion-loan-for-avalara-buyout

[14] https://www.bloomberg.com/news/articles/2022-05-03/ares-led-group-snaps-up-2-billion-chunk-of-nielsen-buy-out-debt

[15] Debtwire U.S. Leveraged Insights report, September 2022 - *See page 27*

[16] https://www.ft.com/content/d92ee0ae-faeb-497d-a8a3-1cc165ef5db5; *see also* https://www.lcdcomps.com/lcd/n/article.html?rid=170&aid=12497317, https://www.lcdcomps.com/lcd/n/article.html?rid=170&aid=12497247

[17] https://community.ionanalytics.com/private-debt-crafts-new-solution-to-lever-up-private-equity-funds-bets - *See par 17*

[18] Debtwire U.S. Leveraged Insights report, September 2022 - *See bottom rows, pages 11 and 70*

[19] https://community.ionanalytics.com/levfin-highlights-3q22 - *See par 16*

[20] https://www.cnbc.com/2022/09/21/fed-rate-hike-september-2022-.html