RECENT TRENDS IN PRIVATE EQUITY ACQUISITION FINANCING: GROWTH OF PRIVATE CREDIT

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One of the most significant changes over the past three years in acquisition financing has been the growth in the role of private credit providers, particularly as part of the financial sponsor leveraged buyout process. According to the 2016 Preqin Global Private Debt Report, direct lending funds—key participants in the private credit market—have seen robust growth in assets under management, increasing from $10.1 billion in 2006 to $115 billion in 2015. The recent expansion of private credit in private equity acquisitions can be traced back to the issuance by the Federal Reserve, the OCC and the FDIC of updated leveraged lending guidance in March 2013, which limited the ability of financial institutions under their supervision to underwrite or arrange certain highly levered loans, in particular those with a debt to EBITDA ratio above six times. As a result, financial sponsors looking to engage in highly-levered acquisitions have turned to private credit providers to provide acquisition financing as these providers are not subject to the leveraged lending guidance.

What Are Private Credit Providers?

Private credit providers consist of a broad group of non-bank debt investors, such as business development companies (BDCs), private debt funds and pension funds. Well-known private credit providers include, among others, Ares Capital, CPPIB, Crescent, Golub, Guggenheim, Oak Tree, Owl Rock, and PSP. In acquisition financing contexts, private credit providers often seek to provide debt financing commitments directly to financial sponsors and borrowers rather than buying debt that is syndicated by arranging banks after the commitment letter stage. These providers typically plan to "buy and hold" the debt for the long term, unlike traditional arranger banks that look to syndicate the debt as quickly as possible. As a result, private credit providers are generally less focused on arrangement fees and more focused on yield.

While private credit providers have always been around, the asset class had been significantly smaller and had fewer participants. For instance, some of the most significant providers have only entered the market in the past two years. Private credit providers historically had participated in middle market transactions or provided mezzanine finance. The combination of the growth of the asset class and the leveraged lending guidance have resulted in private credit providers becoming a significant part of the financial sponsor acquisition process and participating in larger deals than historically, including providing in certain cases commitments above $1 billion.

Participation in the Acquisition Financing Process

Given the recent growth of the private credit provider asset class and the ability of these lenders to provide debt financing in highly levered acquisitions, it has become increasingly common for financial sponsors to run parallel processes with financial institutions (regulated and unregulated) and private credit providers at both the grid and commitment paper stages of an acquisition financing (*i.e.*, the stages at which the banks and private credit providers compete to provide the acquisition financing). This is a significant change from five years ago, when private credit providers rarely participated in these processes, particularly in the context of large financial sponsor acquisitions.

Private credit providers typically participate in the

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acquisition financing process in two ways: (i) by providing an alternative to the banks for the full debt financing and (ii) by underwriting a portion of the debt financing alongside the banks (*e.g.*, the banks would underwrite the first lien debt, while the private credit providers would underwrite the second lien and/or mezzanine debt). It is not uncommon for financial sponsors to ask private credit providers to offer proposals for both types of structure to maximize flexibility.

Additionally, in acquisitions where financial sponsors have to move quickly and there may not be time to explore multiple financing options prior to signing, it is becoming increasingly common for financial sponsors to include a "private credit provider" option in the commitment papers they execute with banks. Such an option permits the financial sponsor to replace all or a portion of the second lien commitment with financing provided by private credit providers, typically within ten to twenty business days of signing the commitment letter.

In 2016, private credit providers were key providers of debt financing in a number of financial sponsor led acquisitions. Most notably, the sizes of the facilities underwritten by private credit providers have increased. For example, in 2016, Ares Capital led a $1.075 billion unitranche credit facility to finance Thoma Bravo's acquisition of Qlik, and a group of private credit providers provided $715 million of first lien and second lien term facilities for KKR's acquisition of Mills Fleet Farm.

Benefits of Private Credit Providers to Financial Sponsors

In addition to being able to underwrite acquisitions with higher leverage, private credit providers provide other key benefits. Given their intention to hold the debt, there is typically no "flex" (*i.e.*, ability to modify certain terms to facilitate syndication) in a private credit solution. While the yield in a private credit solution may be higher than the "best case" scenario in an underwritten solution, private credit pricing terms are often well inside of the "fully-flexed" pricing (*i.e.*, "worst case" scenario) for a traditional bank commitment. In more difficult market conditions or with challenged credits, private credit providers can allow sponsors to limit downside on pricing by avoiding syndication risk.

Also, given that private credit providers have varying yield targets and different pockets of capital to access, private credit providers are often willing to provide the more difficult portions of a capital structure, including second lien, mezzanine and "PIK" preferred instruments, which may often be difficult to syndicate and can only be underwritten with significant "flex."

Other Key Considerations

There are a number of key considerations in pursuing a private credit solution. First, as private credit providers are typically "buy and hold" investors, they tend to push for tighter terms than those of broadly syndicated deals. For instance, private credit providers often push to include more meaningful financial maintenance covenants, increased limits on restricted payments and acquisitions (*e.g.*, requiring more deleveraging before certain baskets are available), and caps on EBITDA addbacks. Additionally, private credit providers often will want enhanced reporting (including monthly financials) and, in certain cases, may request board observer rights.

Second, private credit providers may also want the ability to participate in the upside of the business and may also want warrants or the opportunity to make a small equity investment as part of their debt investment. Whether a co-investment or warrant option is requested often depends on the deal size, the private credit provider and the overall yield.

Third, certain private credit providers may not be able to provide letters of credit and revolving credit facilities. It is important to understand early in the

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financing process whether the involvement of a bank will be required to provide these financing components and if the private credit provider has any arrangements with banks to provide any of these products in transactions in which they lead.

Finally, unlike a broadly syndicated deal, in many private credit solutions there may be only one or a handful of lenders. In a workout scenario, this limits the sponsors' ability to put together different groups of lenders for amendments and waivers. The private credit providers will have significant leverage in these situations.

Future of Private Credit

While there has been speculation in the market that enforcement of the leveraged lending guidance may be relaxed under the new administration, private credit is expected to continue to play an important role in future sponsor-backed buyouts. Going forward, it is likely that private credit providers will continue to compete with traditional banks to provide financing in the financial sponsor leveraged buyout process. Private credit providers are expected to continue to increase the size of the transactions that they are able to fund by participating in club deals with other such providers. To the extent there is market volatility in 2017, private credit providers will be able to take advantage of such market conditions

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