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Four for ’24 (Last of a Series)

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4. ***Next Gen Private Capital: Financing technologies, the next phase of applications.***

In the absence of fully functioning public markets during the Fed’s intense anti-inflation campaign, liquidity was drained, not just from the economy but from bank reserves, trading desks, CLO formation and retail fund flows. Of course, this was in addition to the decades-long effort by regulators to discourage banks from holding leveraged loans on their balance sheets.

The result was the steady disintermediation of buyout financings away from broadly syndicated loan and high-yield bond markets to private credit managers. There issuers had the benefit of quick execution without relying on a syndication process and price certainty with managers holding (not distributing) debt. Simultaneously investors enjoyed the higher premiums, better protections, tighter terms, and consistent returns afforded by less correlated assets.

Lower interest rates will likely create better conditions for liquid loans as the improved equity arbitrage for CLOs supports more vehicle formation. It’s a fairly typical feature of the cycle to then have banks invade the higher end of the middle market, borrowers with Ebitda below $100 million, with higher leverage, unitranche, cov-lite structures, and tighter pricing.

The difference is that in the intervening years the largest private debt managers have armed themselves with hold levels above $1 billion for cov-lite term loans. They are also creating expertise and capacity in specialized industries, such as retail, software and technology. For traditional middle market borrowers, with Ebitda between $25-100 million, direct lenders have benefited from a wildly skewed ratio of private versus public financings. A healthy new crop of private lead agencies will produce refinancings and new LBOs for years to come.

Top middle market arrangers have also built powerful one-stop platforms, allowing private equity sponsors to select from a wide range of sophisticated options, up and down the balance sheet, to accommodate their capital solution needs.

Take PIK coupon structures. Prevalent since the rise in interest rates and resulting pressure on borrowers’ cash flows, securities can be structured as holdco subordinated notes, or preferred equity with the entire contractual return in the form of an accrued return. They can also appear as traditional operating company mezzanine debt investments with more PIK flexibility, allowing borrowers to still pay a cash interest component, but with a higher PIK mix.

An example of next gen capabilities among private capital leaders is equity secondaries. Born out of purchases and sales of LP interests in PE funds to free up investor liquidity, secondaries are now a tool for GPs and LPs to manage portfolio issues such as navigating concentrated exposures, extending the duration of top-performing assets, and wind-down tail-end positions.

Most notable has been the recent proliferation of continuation vehicles. CVs refinance the equity stack of one or more businesses in a sponsor’s portfolio, without a change of control. They can also extend the duration of existing holds and provide follow-on capital for accretive M&A and platform investments. As one PE partner put it, “In the past CVs were used because you couldn’t sell the business. Now we use them because we don’t want to sell the business.”