Legal 500
Country Comparative Guides
Hot Topic |

Cross-Border Financing Trends in Middle Market Transactions

Contributor

McDermott Will & Emery LLP

Aymen Mahmoud

Partner | amahmoud@mwe.com

Stephanie S. McCann

Partner | smccann@mwe.com

Cross-Border Financing Trends in Middle Market Transactions

INTRODUCTION

At the start of 2020, the world could not have foreseen the impact of a global pandemic. The financing markets were as strong as ever, with robust liquidity within both the private equity and credit markets and well-positioned public markets on both sides of the Atlantic.

Economic indicators such as commodity and oil prices, interest rates and mainstay currencies had remained broadly stable. Now, two years into the post-COVID world, having endured multiple global lockdowns, massive government spending and intense political instability, we look back on a 2021 which broke all imaginable deal activity metrics.

With even more uncertainty on the horizon in 2022, with stimulus reduction, exploding inflation and interest rate hikes, war in Eastern Europe and a wave of recent restructurings, the middle market outlook is still surprisingly optimistic and, some would argue, more competitive than ever.

Trends and deal dynamics continue to reflect a very liquid market and even during periods where the syndicated market is a little more reluctant to paper deals, the huge strides being taken by private credit have kept even the large-cap space ticking over with rumours of the biggest unitranche in European history being papered at above £3 billion.

Borrowers continue to leverage markets to achieve market-leading terms (and "firsts") across a range of industries and sectors, particularly with respect to cross-border matters, and even to push the market to even more ameliorated terms for A+ credits. It will of course be interesting to see if any market slowdown will tighten terms, or if the increased competition for a smaller number of deals will widen terms even further. As we investigate some of these trends, it is clear that uncertainty no longer drives a wholesale slowdown of markets owing to the prevalence of direct lenders and the magnitude of their offerings, whether by reference to size (both large and small), complexity, willingness to underwrite sector-specific credits such as recurring revenue transactions, or by the absence of any deal flex. Here we explore what other trends have proliferated the market and where we can expect even more stretching.

A LOOK AT INCREASING LEVELS OF LEVERAGE

It is no secret that leverage levels have slowly been increasing. As lenders have deployed larger loans and certain types of businesses have sustained increasing levels of leverage, the stars somewhat have become aligned. Increasing leverage levels have also led to a resurgence in "holdco" financings done by way of payment in kind ("PIK") or preferred equity – the latter in particular providing comfort for credits which need a rating. While historically these vehicles have been more prevalent in the U.S. market, it is interesting that European credit institutions also are taking their funds to the U.S.to deploy in preferred equity transactions.

For borrowers, having lenders sitting in the capital structure at a level aligned with that borrower provides obvious advantages in a restructuring scenario, not least of which is the likelihood that there will be a consensual workout, which will help to preserve value and the going-concern status of the company. This raises a very pertinent dynamic, in that LP investors have invested across a multitude of strategies, which may well now include both private credit and private equity, and this may mean that some LPs may find themselves in a restructuring on both sides of the capital structure.

This may lead larger LPs to make directions to the fund managers in which they have invested, but it will most likely drive a very consensual type of workout for the more affected structures. In either event, workouts will require very careful consideration and analysis, particularly as the European restructuring toolkit moves closer to that of Chapter 11, with its use of cross-class crackdown features, and a harmonization of restructuring approaches takes place. With those more levered deals, one also can anticipate continued growth in deal size, as well as the use of private credit "clubs" for the jumbo and ultra-jumbo transactions which come to market. One also must consider that, for existing deals, leverage levels may seem to rise by default, to the extent there is any EBITDA slowdown, and that this may skew figures that consider more than new-to-market deals.

As those leverage levels have increased, the middle market space has seen an increasing level of covenant-lite activity on both sides of the Atlantic. While some commentators have viewed this development with alarm, others consider it a more appropriate method for pricing risk. It is an age-old tenet of leveraged finance that the financial covenant is intended to provide a sort of canary in the coal mine protection and give stakeholders an early warning mechanism for identifying problems. However, the normalization of EBITDA and other metric adjustments, coupled with the non-amortizing nature of most middle market indebtedness, means that breaching a financial covenant with 25 or more percent headroom likely also will trigger a debt service issue and lead to payment or other defaults.

As such, lenders may lose a traditional early warning sign and lose a default lever, but the nature of the warning may not have been very helpful, and the lever will likely arise elsewhere, so those lenders can choose to deliver a covenant-lite structure where they achieve a more appropriate financial return for the risk profile being examined without a disproportionate downside. In a market where the search for yield has been very challenging, this could prove to be a very useful tool for lenders to deliver increased returns to investors. While covenant-lite middle market transactions have been more prevalent in the U.S. than in Europe, there has been a clear increase in European middle market covenant-lite transactions in 2021, and again in 2022. With geopolitics being where they are at the time of writing, and the syndicated markets being somewhat less accessible than the private credit markets, we can likely expect this trend to continue.

To date, 2022 has seen a continuance in attention toward pre-EBITDA financings, and in particular recurring revenue deals. For these growth-stage companies, profitability can have a varied time horizon. Investors across the capital structure are increasingly looking to get involved at varying points of that time horizon, with some credit investors prepared to wait several years and invest smaller amounts, potentially also with some equity upside or co-invest, while others look for more developed companies with sustained revenue, reducing expense volume and a more near-term move to profitability. The second category tends to lead to larger amounts of deployed capital for creditors, given the relative stage of growth. These growth-stage companies previously struggled to access the debt markets and were instead reliant on dilutive equity financing; so the availability of non-dilutive credit can be very attractive at the right terms.

Technology and/or software as a service ("SaaS") business can be particularly attractive to private equity buyers, as they represent potentially massive growth, but even founder-based businesses are increasingly looking to the debt markets to raise their capital. For lenders, the credit analysis is paramount, of course, and the resilience of revenue (and its growth) will be critical to future repayment. But this type of financing provides a huge additional potential revenue stream for those lenders and allows them to build relationships directly with borrowers even before the involvement of private equity sponsors, thereby increasing their relationship base to a wider pool of investors. The U.S. market has largely settled on terms for these types of financings, while Europe sees much more variance across terms. The more nascent and competitive nature of these types of financings in Europe may be responsible for driving more competition and therefore an increased willingness to offer greater flexibility to borrowers around items such as PIK interest, basket flexibility (even pre-conversion) and powerful variations on conversion itself to align with the company's requirements over the period of the loan.

As companies delay their foray into the public markets during difficult geo-political times or periods of significant inflation, the direct lending markets look set to provide a strong basis for increased investment in the pre-EBITDA sphere, and this seems to be matched by an increasing number of credit funds setting up specific strategies, or pockets within strategies, for undertaking these financings. It is possible to imagine that the coming months and years will continue to provide significant entry points for pre-EBITDA borrowers into the private debt markets, and that terms will continue to improve as the success stories of these borrowers continue. As with all relatively nascent financing types, there tends to be a period of consolidation (which may now have passed) before there is then a period of borrowers negotiating improvements to terms.

Within this theme of bridging the topics of both the flexibility of capital, but also the growing toolkit available to borrowers of different backgrounds to achieve their financings, is the growth in preferred equity financing provided by third-party credit institutions. Preferred equity structures have been brought to the fore recently by the advent of European and U.S. leveraged lending guidelines, the latter being neutered throughout the Trump administration, and the former never really gaining momentum.

This financing tool then started to present itself increasingly throughout 2017 to 2019; not only to achieve favourable ratings on public deals, but also to nullify any issues that might arise under bank regulatory regimes or even subscription lines "in-place" facilities. These "perpetual" instruments, taxed and carrying the protections of equity and not debt, but without the upside of common equity, were at first somewhat alien to the more mainstream private credit providers. Nowadays, even having seen unfavourable U.S. case law around "efficient breach," creditors are using their more tactical or "special opportunities" funds to seek PIK-like returns and even to supplement those with the upside participation of a convertible preferred instrument.

Unsurprisingly, these facilities can be quite large and support the themes in this article around greater size, increased leverage and a willingness to price risk at levels where investors can accept a corresponding reduction in protections.

For the last decade, the improvement in terms (for borrowers) or the increase in documentary flexibility has been commented on from a variety of standpoints, ranging from the alarmist to the analytical, and every inch between the two. Commentators have heralded what they argued was the absence of any fiscal responsibility, while borrowers broadly maintained that such flexibility was an operational efficiency of busy markets and avoided the need for complex consents and waivers. Whichever view an individual is inclined to take, it is clear that global insolvencies are far from being at an all-time high. During periods of global volatility, we have seen the capital markets take a more conservative approach and “push back” on certain terms that once were deemed to be inappropriate for a particular credit. Overall, however, the direction of travel has been forward, even if sometimes the footsteps have shuffled. Within the private credit markets, external economic and geopolitical drivers have not been impactful.

For those private credit institutions that run dual track capital markets and direct lending solutions for their clients, it will be interesting to see whether there is any hold-back on the capital markets option during difficult times. “Can it continue” seems a trite question after a decade, and likely the answer is “yes it can.” Market participants, as usual, will seek creativity and growth, will find new ways to meet the challenges they are presented with, and will work with their markets to forge solutions.

If we compare the move of 2009 unsecured high yield covenant packages into the senior secured loan markets, which saw significant increases in flexibility but at far tighter pricing, it is clear how far that creativity can move in just over a decade. Where might there be increased pressure points on documentary terms in the near term? One would expect the growth to be around basket flexibility; the borrower looking to the market to be the most efficient arbiter of “how much” is OK. We can also envision a continued movement to reducing the impact of a holdout creditor seeking to damage a capital structure, and the maximisation of equity and going concern value, which would appear to be the hallmark of the cross-border modernization in restructuring toolkits.

In the end, we can be confident that while the markets continue to provide strong economic results, borrowers will continue to seek increased flexibility unless or until there is a change in the swing of power or some other market-driven reason. The move to covenant-lite is a great example of borrowers being willing to pay a premium for flexibility; and an equal example of lenders pricing what they consider to be their risk against a particular credit. For a profit-driven actor not to seek to maximize its profitability when it is in a position of strength is counter to its very design. The continued rise of direct lender prominence in the leveraged finance middle market appears to be without limit. While more traditional lenders struggled in the pandemic, wrestling with regulation and inundated by corporate treasury requests for liquidity advances, the direct lending community has made hay in a plethora of ways. While pricing has come down for a huge number of financing solutions, direct lenders also have continued to prove their marketing strategy by delivering patient capital which did not have a precipitant reaction, engaged with its borrowers and in many instances helped to provide a path to a mutually beneficial outcome where it was needed.

The growth in size set out above, the willingness to be flexible, and the ability to do these larger and more complex deals without syndication risk, has proven to be a key factor in direct lenders being selected as a viable alternative to the capital markets. The huge investor base which pays actors on called capital only means that the capacity and the desire to transact are in alignment and the sheer volume of liquidity creates a confidence which could almost be described as a fear of not lending and being left behind.

Even the “special situations” funds being set up by the direct lenders look set to be able to provide a nice gap-filler for any liquidity need which arises in a pre-distress scenario. With this in mind, it is difficult to conceive of how the abundance of liquidity can become meaningfully reduced, particularly for mid-market borrowers.

CONCLUSION

If we look back to even 2018 or 2019, we can identify thematic trends moving similarly, albeit at an earlier stage. Direct lenders seeing increased growth. Loan financings delivering bigger and more complex cross-border structures, whether in the private or syndicated markets. The growing ability to look to multiple money markets for cross-border borrowers or issuers that have a significant sterling, dollar or euro cash flow stream continues. Default rates continue to remain at historical lows, insolvency rates even more so. The modernization of restructuring regimes across Europe has been a very significant driver, whether pre-pandemic or precipitated to deal with some of the pandemic fall-out. It has put creditors and borrowers into a position where outcomes are more predictable and so, therefore, are behaviours.

The regulatory overlay for lending continues to become more facilitative, with previously more challenging lending jurisdictions becoming accessible. Even national security or protectionist legislation globally does not appear to be stifling M&A activity, rather simply ensuring that no current or future totalitarian governments take ownership of critical path businesses. With geopolitics and sanctions being where they are at the moment, it would seem to be a prudent move on behalf of governments to take a greater interest in M&A, albeit a light-touch one.

Predicting the market outlook during periods of uncertainty, inflation and interest rate hikes is always a challenge, especially following a period such as this, with such high levels of current deal activity. However, what we can in the near term is low default rates, exceptionally high levels of dry powder, supply-demand as it relates to cross-border financing need, and unusually healthy cash balances held by the corporate actors fuelling M&A activity.

We can even extrapolate from the rising interest rate environment that private equity sponsors and corporates may optimize their financings by going to market before the next set of interest rises to also profit from the flexible terms and low pricing available on both sides of the Atlantic. In the face of a pandemic, global lockdown, rampant inflation – and now war – M&A business-as-usual continues inexplicably to march on, and even thrive.

Contributors

Aymen Mahmoud
Partner

amahmoud@mwe.com

Stephanie S. McCann
Partner

smccann@mwe.com