KEYNOTE INTERVIEW

Debt markets volatility hits PE deals

With lending terms shifting and syndicated loan markets largely closed, private equity buyers are turning to direct lenders and preparing for deal activity to pick up, says Mike Fieweger at Baker McKenzie

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Q What are lending terms currently looking like? And what is happening with distressed borrowers?

In general, leveraged loan pricing is trending higher by about 25 to 50 basis points compared to previous quarters, there are tighter structures, and leverage has tightened by around half a turn. The percentage of M&A deals that were getting done at six times leverage or greater has probably dropped from around half 12 months ago to closer to a third today. It is definitely a more challenging environment.

It is important to draw a distinction between the syndicated market, where new leveraged loan issuance is at its lowest since the second quarter of 2020, and the direct lending market, which has remained relatively robust, attracting private equity sponsors to dive into that part of the market for debt financing. Mid-market and upper mid-market sponsors have found the direct lending market to be predictable and functional from a deal certainty and execution standpoint.

For distressed borrowers, the challenges from the secondary market in syndicated lending are significant for facilitating workout activity. In the direct lending market, the lack of a secondary market means direct lenders will play a more active leading role in workouts.

Right now there is a particularly interesting dynamic for businesses in those non-defensive sectors that were able to kick the can down the road during the pandemic and have not yet fully recovered. Their profitability picture is unclear, and many are suffering supply chain issues and other challenges that will last for the foreseeable future, so that is going to drive a real increase in workout activity through the end of the calendar year.

Q Given the current volatility in lending markets, how are PE firms viewing and working with syndicated loans and direct lenders? What is the role of the direct lender in this market?

There has been a proliferation of direct lending capital providers and that has driven robust competition for deals, which leads to an environment where we as counsel can play a value-added role in the lender selection process. Our leveraged finance team is helping borrowers to make that process as competitive as possible and as a result we can help them to achieve greater operating headroom and to partner with lenders that will provide deal certainty in an acquisition context moving forward.

We have seen direct lending hold sizes reduced and that means more club arrangements rather than bilateral loans held by a single lender. That, combined with some of the antitrust challenges we are seeing under this administration, has required financing structures to be adapted to facilitate larger deals with longer commitment periods.

That said, direct lenders benefit from having capital locked up in long-term commitments from limited partners, so they have been able to credibly commit to buy and build strategies in a way that contrasts to the syndicated loan market, which has struggled. All of that has led to a real movement by sponsors into the direct lending market, and that looks set to continue.

Q Do you see PE deals getting pulled as a result of financing options and terms? What are the key challenges?

We have not really seen private equity deals getting pulled, but then deals don't really get signed unless the financing is

Q How are sponsors dealing with market volatility? What are you seeing in terms of deal volumes, and what is the outlook?

There are certainly some sectors that never fully recovered from the pandemic and are now struggling with supply chain issues, rising input costs and margin compression. A lot of people are struggling to work their way through those issues and that is demanding a lot of attention from the private equity owners of those businesses. That is one driver behind a significant drop-off in deal activity in Q2 that looks unlikely to bounce back in Q3.

We are also in one of those periods where there is a supply-demand market valuation gap, because sellers haven't yet adjusted their pricing expectations and buyers are waiting for that to happen. Buyers are also reassessing their financial models in light of increasing interest rates and inflationary pressures. In the current market, where it is unclear as to the impact of supply chain deficiencies and money supply is contributing to inflation, that is a particularly difficult task. As such, we are seeing an impact not so much reflected in a reduction in valuations but instead in a drop in deal activity.

We have, however, continued to see sponsors in the mid-market complete add-on strategies that lower the sponsor's overall multiple in a portfolio company – helping mitigate the higher valuations that may have been paid for the platform acquisition. We have seen significant buy and build strategies coming to fruition in recent months and we expect that to continue.

Eventually, valuations will drop and then deal activity will kick back in, because there is still a lot of dry powder out there. The money is there and it will get invested – it is just taking a bit of time for people to get to the point where inflation can be priced in and assets can come back into the market. For now, people are focusing on their portfolios and trying to figure out when there is going to be sufficient stability to push forward.

in place. In parts of the market where there are acquisition financings that have a junior debt or second lien component, or some credit-risk challenging structuring aspect, then underwriting is certainly more difficult than it was a year ago. Some of the riskier structures and some of the antitrust issues have resulted in scepticism of acquisitions that require commitment periods in excess of six months. So those are more complex and, where they are yet to get off the ground, there is generally a desire to wait.

We are seeing private equity firms bidding lower and perhaps missing out on some opportunities because they know they cannot put as much leverage into a deal as they would like. But even then, that is not really impacting competitiveness in auction situations because there just aren't that many deals out there.

As deal activity picks up, what is going to be interesting is whether sponsors' ability to incur leverage in light of higher interest rates and reassessed financial models impacts the competitiveness of sponsors in auctions. I do not really see that being the case, in part because you have to think about who you are competing with, and strategics are not particularly bullish on M&A in this environment. Rather than looking at growth via M&A, they are looking to address their own operational and profitability issues.

"There has been a proliferation of direct lending capital providers and that has driven robust competition for deals"

Q Which are the hottest sectors and geographies for PE sponsors right now? Where do you expect to see the most deal activity through the remainder of this year?

In some sectors where the public markets have been really beaten up, like the tech sector for example, private equity funds are excited about the prospect of acquiring tech businesses at more realistic valuations.

In other sectors, like industrials, we are still seeing a fair amount of activity. Those businesses have been impacted by supply chain issues, but they are still quite attractive compared to other opportunities globally – especially those with a large US footprint. There are some discounted valuations there and that is an interesting area for private equity, in the US in particular.

Europe has some unique challenges from a demographic, regulatory and geopolitical standpoint that are particularly impacting industrial businesses. In time, these challenges may also create some interesting buying opportunities. We do have clients looking to the slightly longer term and planning for some bargain hunting in Europe in the industrials space in 2023.

For those service-orientated businesses that bounced back pretty well from the pandemic, there is a focus among private equity firms on picking up opportunities and getting back into those markets. Traditional brick-and-mortar retail is an exception to that, as sponsors are still wary of the real estate exposure associated with the sector.

We are a premier global law firm in terms of our transactional breadth and depth, and an example of that is what we are seeing in terms of representing non-US clients seeking to access US deals. One of the few positive stories has been inbound US M&A activity, and we have seen our fair share of that in computer electronics and other sectors.

We have otherwise been supporting non-US clients doing their first US acquisitions and that is because, globally, people still see the US as a much stronger economy than elsewhere to put money to work. From a private equity perspective, even non-US based managers are still often investing dollar-denominated funds, which is important given how strong the US dollar is right now.

Broadly, we expect activity to stay off until at least the fourth quarter of 2022, but transactions should then start to pick up again going into 2023. ■

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Mike Fieweger is chair of the North America PE practice at Baker McKenzie