KEYNOTE INTERVIEW

Banks versus private credit

Banks and direct lending funds will continue to battle it out in the bid to finance sponsor-backed deals as M&A markets at last open up, says Ropes & Gray partner Michael Lee

Q How do you see the lending landscape playing out over the next few years, in terms of the interplay between banks and private credit?
Wall Street banks are raising billions of dollars to regain ground after private credit platforms have muscled in on their business over the past two years. Looking forward, I expect there will continue to be competition between banks and private credit solutions as a financing source for private equity investors.

Indeed, there have been some sizeable transactions over the past 12 months where there was considerable speculation as to whether the sponsors involved would turn to the direct lending market or the broadly syndicated loan market. What we have seen is that the ability of the private credit market to deliver increasingly large amounts of debt capital – often at higher leverage ratios than that which is available in the broadly syndicated loan market – has proved compelling for private equity buyers.

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In addition, private credit funds can offer greater certainty around timing, given that no syndication process is required, and are proving willing to offer creative structures including the ability to offer PIK (paid-in-kind) portions of the interest expense, enabling portfolio companies to better manage their debt service costs.

These attributes have made private credit a strong contender relative to the broadly syndicated loan market, particularly over the past couple of years. Having said that, banks continue to provide competitive pricing and term flexibility. In short, I think we will continue to see demand for both sources of capital as they compete to provide finance in M&A transactions over the coming years.

Q What other developments do you expect to see in terms of how deals get financed?
We are continuing to see the build out of preferred equity solutions for those sponsors looking for an extra turn or two of leverage on top of what can be provided by the banks or private credit funds. These solutions are being offered by a number of different sources

of financing, including larger institutional investors and private credit funds that are looking to diversify their platforms.

Meanwhile, in addition to preferred equity being used as a mechanism for providing additional leverage in new buyout transactions, we have also seen growing interest in sponsors looking at preferred equity in relation to some of their mid- and late-hold portfolio companies, either to provide additional leverage or to help execute a buy-and-build strategy as hold periods increase relative to the original business case.

> *"We have seen growing interest in sponsors looking at preferred equity in relation to some of their mid- and late-hold portfolio companies"*

Q How would you describe the financing environment for buy-and-build plays?

It has traditionally been possible to acquire smaller bolt-on businesses at lower multiples and with lower leverage profiles than is the case for larger platform assets. Multiple arbitrage has therefore been one way in which private equity firms have looked to add value to the companies they buy.

These buy-and-build strategies have historically been debt financed, however. As the cost of finance and therefore the cost associated with these acquisitions has gone up, that has increasingly eaten into that multiple arbitrage opportunity. As a result, private equity firms have had to become more disciplined in terms of which add-ons they are choosing to move forward with. While buy-and-builds still represent one of the most compelling forms of value creation for investors, and many have continued to implement their add-on pipeline, the cost of debt in this new interest rate environment has certainly created challenges for many firms.

Q How do you expect the exit environment to evolve and how are private equity firms responding?

There are a number of different forces that should drive an improvement in the exit environment. First, the interest rate environment has stabilised, albeit at a higher level than we have seen in recent history. Furthermore, pressure is mounting on GPs to provide liquidity to their investors, particularly if they are fundraising or are planning to raise a new fund in the near term.

The increased scrutiny on distributions to paid-in capital (DPI), when combined with the substantial amount of dry powder that is available to deploy, all point to a pickup in M&A and therefore exits. We are already beginning to see that play out in the number of sales processes being kicked off.

There is still a clear bifurcation in the market between the highest quality assets where owners can command the prices they expect, and less stellar businesses where a meaningful bid/ask spread remains. However, that bid/ask spread should ease as pressure grows on sellers to realise older investments.

Meanwhile, we are also seeing an increase in financing structures that include a portability provision that allows the buyer to assume the target's existing debt. All these trends point to a rally in traditional exit routes.

At the same time, we expect to see more sales of minority stakes as GPs look to generate liquidity for their investors, as well as strong appetite for continuation vehicles, which generate liquidity for those investors that want it, while also allowing GPs to retain ownership of their strongest assets.

Q How is ESG influencing the investor lens and how do you see that evolving?

We continue to see allocations grow around impact and ESG-focused funds. Despite what is undoubtedly a very challenging fundraising environment, investors still have dollars to allocate to these strategies and I don't think that is going to change any time soon. Energy transition, in particular, is one of the fastest growing segments within private asset management and many investors still feel underallocated to what is one of the most powerful mega-trends in the world today. All of this points to the continued growth of this segment.

Q What do you see as the biggest cause for concern for PE, and what do you see as the biggest cause for optimism?

Generally speaking, I am sensing significant optimism, both from investment banks and investment managers. We believe the deal environment will become increasingly robust over the course of this year and heading into 2025. If there is one area of concern on the horizon, it would have to be the political uncertainty that surrounds the upcoming presidential election in the US. That may be the biggest unknown that could potentially impact a deal economy that is otherwise ripe for recovery. ■