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Private Credit Insights

Hybrid Capital: downside protections for private credit funds in an opportunistic market

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As a result of a combination of well documented macro-economic factors, new money financings backing traditional private equity (PE) activity has stalled so far in 2023. With a vast amount of PE capital at the ready, estimated to be in the region of $1 trillion, when inflationary pressures ease and the market stabilises, sponsors will inevitably refocus their attention on deal-doing. What will the new landscape look like when the market re-opens? Given the retrenchment of traditional bank lenders in the face of on-going instability, along with the stuttering nature of the collateralized loan obligations (CLO) market, it is probably fair to say that private credit is the only show in town. A key arrow in the private credit quiver is the ability to provide flexible, bespoke financing solutions. For the right businesses in robust sectors, flexible capital will be a highly sought-after commodity.

For sponsors and portfolio companies in these sectors, the impact of rising interest rates on their ability to comfortably service floating rate liabilities will give some CFOs food for thought, and is likely to lead to an increased focus on the use of junior debt in re-sized capital structures. It is therefore no surprise that a number of sophisticated credit fund clients in the market have been spending time raising junior capital to service this need. These funds will typically have a flexible mandate from investors to provide sponsors with a broad range of options, ranging from more traditional holdco debt packages to hybrid instruments, including convertibles notes and preferred equity investments.

These instruments, if structured correctly, can provide investors with attractive risk-adjusted returns, especially if placed ahead of a substantial equity cushion, however we reiterate the importance of focussing investors' minds on protections against potential downside scenarios.

The following are just some examples of typical protections that well-advised investors often seek to document to minimise downside risk:

- **Single Point of Enforcement (SPE)**: obviously of more relevance to a holdco debt deal versus a preferred equity type of investment, the creditors' single point of enforcement should be in a creditor-friendly jurisdiction with a single share pledge and an assignment of receivables (or equivalent) from the grantor

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of the pledge. As the creditors key downside protection, lenders should beware of interference with the SPE, especially through operation of the permitted reorganisation carve-out from the mergers covenant and potential release of security by operation of the non-distressed disposals provisions in any subordination agreement.

- **Anti-Short Circuit**: to protect the integrity of any enforcement procedure, creditors should ensure that documentation is adequately drafted to provide that new shareholder equity injections, e.g. by way of shareholder loans, is not permitted to be structurally senior to the holdco instrument. In addition, the anti-short circuit provisions should ideally also ensure that all return of value to the shareholders, including by way of limiting indirect restricted payments, passes through the holdco borrower to prevent side-stepping the effect of the holdco covenant package.
- **Anti-layering**: critical to both debt and equity investments, investors should make sure that, with the exception of a pre-agreed senior financing package or a future replacement financing, no competing debt or equity instrument should rank structurally senior to the junior debt but junior to the senior instrument. This should not restrict sponsors from incurring permitted junior debt under the terms of their senior financing package, but the insertion of additional entities, or use of existing intermediary holding companies to incur competing liabilities, should be carefully controlled.
- **Covenant look-through**: applicable to both debt and equity investments, to maximise the chances of the holdco lenders having a proper trigger either to enforce or in the case of preferred equity investments, either ratchet up the economics, exercise a put right or initiate a sales process, the negative covenants set out in the junior instrument should "bite" on key members of the operating group, and not just on the junior issuer itself. Investors should note that there is an extremely wide degree of market variance on this form of protection.
- **Events of Default**: related to the point above, ideally key events of default should trigger off not only the actions or omissions of the junior issuer, but also material subsidiaries. Cross-acceleration is a given, however cross-default varies depending on the size of the deal, the nature of the private equity sponsor and precedent considerations. Ideally investors would obtain a cross-payment event of default above a realistic monetary threshold, however there are many deals out there which only trigger if the payment default happens at scheduled maturity of the senior instrument, obviously too late in the day.
- **Enhanced Information rights**: subject to respecting usual confidentiality obligations, sponsors and junior issuers should be comfortable granting holdco level investors with some form of enhanced information rights. While board observer representation is still often seen in the mid-market, access to group commissioned information and reports along with business up-dates from management on how the group is managing any actual or potential defaults which may negatively impact the group is critical. Ideally, junior lenders would have the right to cure senior breaches.

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As with all forms of hybrid instrument advanced at a holdco level in a given structure, investor recourse is rarely against the assets of the underlying business itself. Instead, creditor protection measures very much look upwards towards the equity. While some of the protections above seem relatively weak on a stand-alone basis, together they provide lenders with some useful tools, even if only to facilitate participation in, or to slow down, a senior led process.

The ability of private credit providers to fund into existing and new structures using such flexible instruments is likely to be of real value to sponsors in the next phase of transactions about to hit when the market recovers. In cases where sponsors are looking to reduce leverage at an operating company level, minimise cash pay debt service obligations to mitigate against the effect of rising interest rates and allow portfolio companies space to grow into a particular capital structure, junior capital is an obvious solution and we expect to see much more of it in the months ahead.

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