Analysis

Private debt expands toolkit in Germany

Guest comment by **Thomas Weitkamp**, **Rainer Adlhart** and **Anna-Maria Kuckerz**

The German market is branching out from unitranche to other types of financing, as well as seeing innovations in documentation

Germany is Europe's largest economy and one of the continent's most significant markets for leveraged finance, including for private debt. Despite stagnating M&A activity and fluctuating credit markets, new opportunities have emerged for private debt to extend its reach into the German finance market.

While year-to-date leveraged buyout volumes in Europe are down by more than 50 percent from last year, private debt in Germany remains strong due to continued refinancing needs and sponsors looking for alternative sources of finance to support add-on acquisitions and buy-and-build strategies.

In recent years, and for German buyouts in particular, the balance between syndicated financings and direct lending has shifted significantly in favour of direct lending. A sustained period of market volatility driven by covid, the war in Ukraine and now rising inflation and tightening of monetary policies has amplified this trend towards the growth of private debt (relative to commercial bank debt).

The challenging economic environment has prompted many borrowers in need of liquidity and flexible financing to turn to credit funds. Over the past 10 years, direct lending assets under management in Europe and across all transactions (senior and unitranche) rose from zero in 2012 to more than €200 billion by 2022.

In terms of deal size and type of capital, we see private debt financing a wide variety of transactions in Europe. As smaller deals have increasingly moved from commercial banks to direct lenders, the slowdown and volatility across institutional debt markets has enabled private debt to increase market share in larger credits normally backed by broadly syndicated loans and high-yield capital markets.

Moreover, while market participants in Germany previously associated private debt primarily with unitranche, direct lenders now increasingly provide new instruments, including junior-level capital such as PIK instruments, traditional equity co-investments and debt-like preferred equity instruments.

As private debt providers continue to extend their reach through the German market, particularly into larger deals and deeper into subordinated asset classes of capital structures, we also see an evolution of deal terms and intercreditor relationships driven by both short- and long-term market dynamics.

A cyclical tightening of terms

The long-term trend towards convergence of deal terms will likely continue in the mid- and large-cap markets, as in other markets, with direct lenders willing to accept higher leverage and allowing more flexibility in capital structures to balance higher debt costs compared with financing provided by commercial banks and institutional investors. However, so far in 2023, we are seeing a cyclical tightening of terms in Germany, in favour of bank lenders, institutional investors and private debt providers.

While documentation for loans is not shifting as far back as the lender-friendly documentation seen years ago, the current interest rate environment and credit markets have clearly reduced German borrowers' negotiation leverage. Lenders increasingly request tighter terms around financial covenants, additional debt incurrence and leakage of cash and material assets outside the financing group, including (but not limited to) by way of dividends.

Similarly, EBITDA adjustments, exceptional items and pro forma synergies have moved into the centre of negotiations, and we see German borrowers accept tighter terms to obtain credit. Equally, terms are also tightening around security packages and credit support from affiliated companies of German borrowing groups.

These recent developments interplay with the tentative reopening of the high-yield bond market in Europe, which is offering comparatively loose features without financial maintenance covenants. A possible resurgence in the bond market starting in late 2023 or during 2024 could indeed reverse the trend of contracting loan terms,

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allowing the market to quickly shift back towards the long-term trend of more borrower-friendly documentation.

Large-cap features

Filling the void of the still relatively slow public markets in Germany, private debt increasingly penetrates into large-cap deals – often as part of a club of lenders in a complex capital structure. In the German large-cap space in particular, direct lenders will likely allow the long-term trend of more borrower-friendly documentation, since certain private debt providers will be prepared to invest in covenant-lite structures and accept terms under which they have fewer protections in order to compete with institutional investors. Moreover, as direct lenders participate in bank syndication processes, there might be a further drive towards convergence of terms in the large-cap space.

Consistent with other markets, private debt providers in Germany have historically insisted on being able to steer enforcement processes or loan amendments. Direct lenders have regularly requested full control over the main voting processes and have offered to participate only if they could be assured that they would hold the required majority of votes. If retaining such a majority proved impossible, private debt providers – at a minimum – sought to obtain a blocking minority (ie a veto right in any majority votes).

Filling the gap in Europe's largest economy

In an environment of rising cost of capital resulting from recent interest rate hikes in Europe and elsewhere, company valuations continue to be suppressed.

Nevertheless, sellers will not necessarily lower their price expectations in a bid process, leaving buyers struggling to raise the required debt quantum to finance the acquisition. This presents an opportunity for private debt providers as they step in and 'fill the gap' by providing the necessary leverage.

In the past, direct lenders may have offered up to six times leverage on German deals. Today, the more restrictive environment and, in particular, the increasing debt costs, is bringing leverage levels below five times, in line with more traditional bank financings in the German market. To fill this gap of at least one turn of EBITDA (and to meet price expectations in sales processes) private debt providers are offering – especially in the mid-market – evolving products such as term loan Cs.

In the German large-cap market, direct lenders are similarly finding creative solutions in addressing valuation gaps, typically responding with co-equity cushions or by offering more PIK junior-level debt if cashflows are insufficient to meet cash pay requirements, all of which significantly contributes to converging terms between the private and public markets.

However, with private debt branching out further, intercreditor relations are also evolving. Credit funds sitting alongside more diverse groups of other lenders increasingly accept structures under which they have neither a majority voting power nor a blocking minority. In the German market, private debt providers are often willing to provide PIK instruments at a junior level in the capital structure and accept structural subordination in lieu of rights under an intercreditor agreement.

In recent transactions, to provide credit support for such instruments, PIK lenders have also sought 'good behaviour letters' from borrowers, giving them the same (or similar) information rights as senior lenders (especially with regard to insolvency procedures and formal restructuring processes).

In addition, some direct lenders providing such junior debt instruments now prohibit shareholders from purchasing the asset in a liquidation scenario and offer them participation rights in the event of a purchase out of insolvency. However, the ability to secure those rights depends in large part on the leverage of the negotiating parties.

Outlook for direct lending

In Germany, the classic unitranche financing remains the mainstay of the direct lending market. Still, private debt's expanding market share suggests the documentation rights demanded by credit funds will continue to evolve as they work to deliver a wider array of financing solutions to borrowers across the capital structure.

A key question will be how intercreditor relationships change as private debt providers continue to invest next to commercial banks and institutional investors. We have not yet seen capital structures combine private debt and high-yield bonds in Germany, but the possibility remains open. ■

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