Katten

2021 PRIVATE CREDIT SURVEY REPORT

Despite Private Credit's Sunny Outlook, Questions Emerge About Lender/Investor Congeniality, LIBOR

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Like much of the world economy, private credit markets were sideswiped by COVID-19 in March 2020 before bouncing back by year's end. That strong finish has left dealmakers with a clear sense of optimism that private credit might fully rebound in 2021.

> ***55%** of lenders say there will be pressure from their side of the bargaining table to pull back on "sponsor-friendly" deal terms in 2021.*

That's according to a new survey of private credit industry professionals by Katten. Ninety-one percent of private equity investors (referred to as "investors" throughout this report) and 80 percent of lenders surveyed expect deal flow to increase this year and are optimistic about several deal categories and sectors. "There are targets on our radar that would have never previously come onto it," one private equity investor who was surveyed said, "and that sort of thing is driving a necessary diversification for many firms."

The demand for deals in the second half of 2020, especially after the faucet was momentarily turned off last spring, led to greater flexibility in deal terms and loan documents, as lenders and investors worked together to get deals done. But questions remain as to whether that spirit of cooperation will continue to increase as the economic recovery continues.

It's not that the two sides are in a pitched battle — only a handful of investors said they have a negative relationship with lenders, and a plurality said relationships are very positive — but 55 percent of lenders say there will be pressure from their side of the bargaining table to pull back on "sponsor-friendly" deal terms in 2021. Meanwhile, 50 percent of private equity investors, who sponsor the deals, say their teams will be even more aggressive in negotiating terms compared with the second half of 2020.

"There are important questions about how resolute lenders and investors are in these sentiments," said Michael A. Jacobson, partner and chair of Katten's Private Credit Department. "Will the two groups prioritize retrenching in their positions instead of completing deals — especially in an environment with so much optimism? That's really the big question for the rest of 2021."

> ***50%** of private equity investors say their teams will be even more aggressive in negotiating terms compared with the second half of 2020.*

Even as the industry hopes for some stability — one respondent described the last year as "chaotic for our organization and chaotic for deals" — another big disruption is on the horizon: the phaseout of LIBOR, with a majority of respondents admitting they are not very prepared. The recent extension of the deadline to 2023 has given organizations more time, but respondents won't be able to kick the can down the road forever.

Here is a breakdown of the survey's key findings:

- When it comes to deal flow, 91 percent of investors and 80 percent of lenders expect an increase in 2021 compared with 2020 levels. Further, 19 percent of investors and 21 percent of lenders expect deal flow to increase significantly by more than 30 percent.
- Nearly two-thirds of investors (65 percent) and a plurality of lenders (41 percent) said loan documents in early 2021 are more flexible than they were before the pandemic — and just 18 percent of the combined group said the documents were less flexible.
- But that might be changing — while most lenders expect their side of the table to put more pressure on negotiations to lessen sponsor-friendly deal terms, just 37 percent of investors expect to see that change. Similarly, 50 percent of investors expect sponsors to be more aggressive in negotiating terms, an opinion held by just 29 percent of lenders.
- Lenders expect the most growth in financial services, information technology, and health care whereas lenders had a broader view, also focusing on communications services and consumer discretionary. Lenders also expected to see growth in health care twice as much as investors.
- Fewer than half of survey respondents (40 percent) say they are very prepared to address the LIBOR phaseout, which will take effect in 2023. At the time of the survey, fewer than half were even including current language in loan documentation around the issue.

Section 1 — Will Increased Deal Flexibility Continue?

The appetite for private credit deals between lenders and private equity investors appears strong. But just as the dynamic between the two groups changed as a result of the pandemic, it appears poised to change again as the world begins to emerge from the worst epidemic in a century.

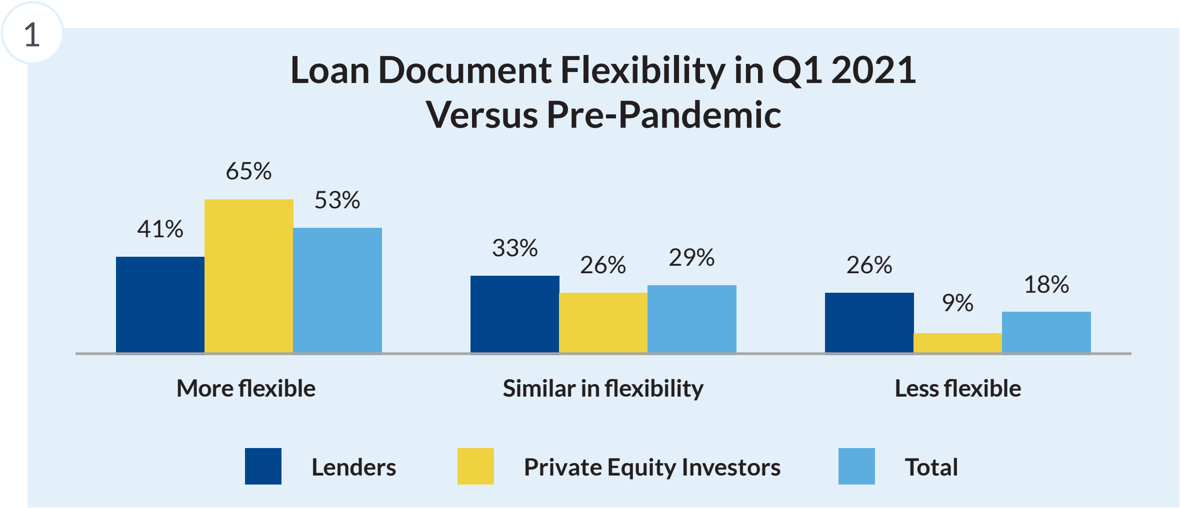
Fifty-three percent of all respondents said loan documents are more flexible compared with what they looked like in early 2020, led by nearly two-thirds of investors surveyed and a plurality of lenders. As one investor put it, "There is greater flexibility, all around, and it's welcome." Not everyone is convinced — 28 percent of lenders said they were less flexible — but even one respondent who was ambivalent explained that there was increased flexibility in procedures, if not the documents themselves.

Goodwill, or at least cooperative relationships, between the two groups is clear — 77 percent of investors said they had at least a somewhat positive relationship with lenders — but it is important to consider what might have spurred the current flexibility. One lender, speaking about the pandemic environment, suggested that "short-term and easy deals in various fields to keep the economy afloat" were the drivers of increased deal activity in 2020. That was especially true after the pandemic's early days when a desire to make up for lost time prompted a surge of deals — and a corresponding increase in flexibility.

"In March, April and May of 2020, we definitely saw tighter terms and more rigid negotiations," Jacobson said. "Eventually, everyone had to come to the table and settle on terms to get deals done. But the expected divergence when comparing lenders and sponsors on future deal terms indicates that changes might be in store again, and that the flexibility might be temporary."

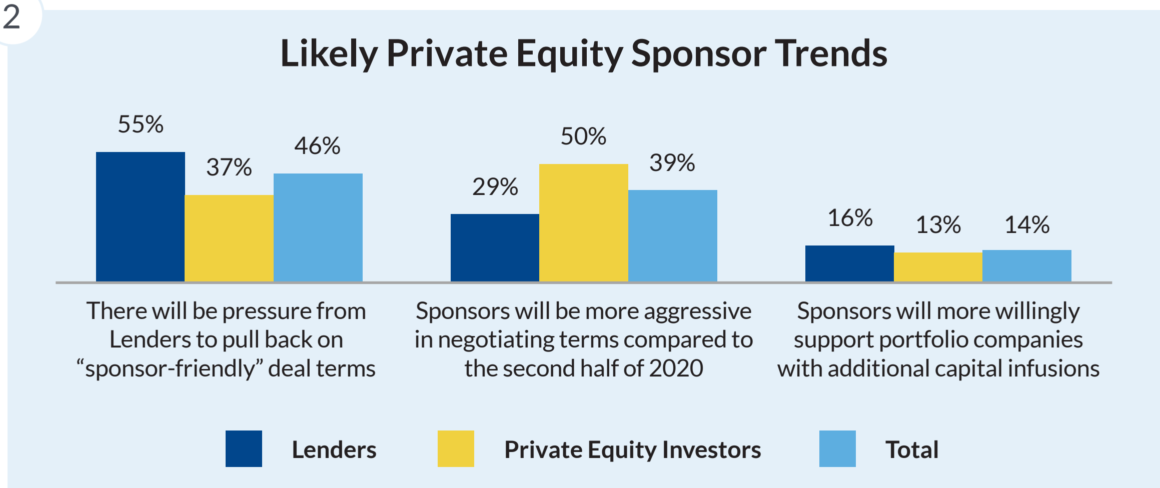
As lenders and investors rethink how they approach deals, both sides are increasingly focused on loan document protections. In one of the survey's key findings, 55 percent of lenders said they expect pressure from their side of the table to pull back on "sponsor-friendly" deal terms — and 50 percent of investors said they plan on being more aggressive negotiating terms compared with the second half of 2020. It's telling to review what each side thinks the other will do. Just 37 percent of investors expect lenders to be less friendly to sponsors and just 29 percent of lenders think sponsors will be more aggressive.

PLEASE SELECT THE PHRASE THAT MOST ACCURATELY COMPLETES THIS SENTENCE, FROM YOUR POINT OF VIEW: LOAN DOCUMENTS ARE NOW ________ THAN THEY WERE IN PRE-PANDEMIC TIMES.



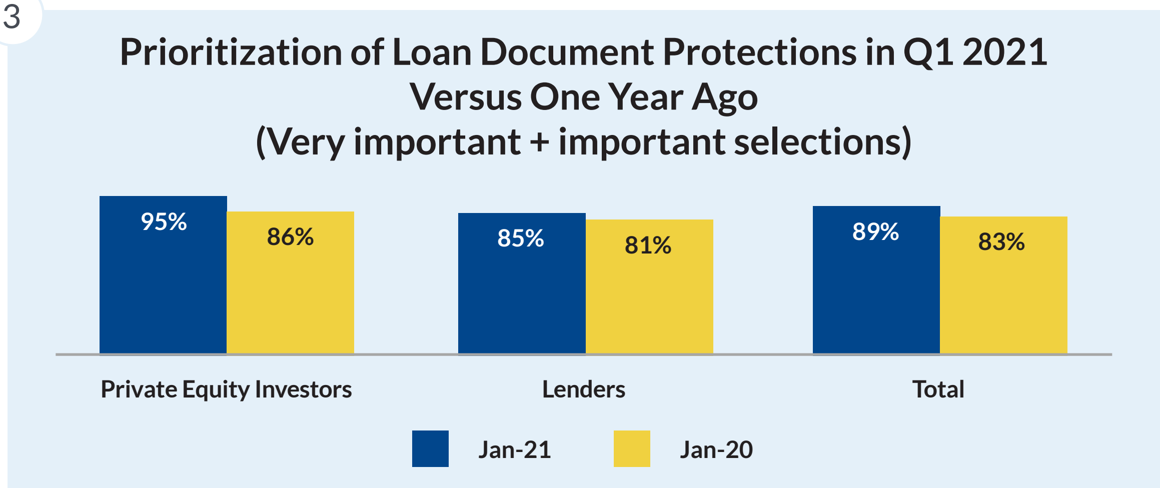
WHICH OF THE FOLLOWING DO YOU EXPECT TO BE TRUE IN 2021 WHEN IT COMES TO PRIVATE EQUITY SPONSORS?

2



CONSIDER THE LOAN DOCUMENTATION PROTECTIONS AS A FOCUS BEFORE CLOSING A DEAL. HOW DOES YOUR PRIORITIZATION OF LOAN DOCUMENT PROTECTIONS IN JANUARY 2021 COMPARE TO YOUR PRIORITIZATION ONE YEAR AGO (JANUARY 2020), PRE-PANDEMIC?

3



Section 2 — Strong Deal Flow Expected, But Disagreement on Sector Potential

As noted above, 91 percent of investors and 80 percent of lenders expect deal flow to increase in 2021, but the high level of optimism might be even more noteworthy. When provided with possible deal flow ranges, 46 percent of respondents said they expect growth of more than 15 percent — and one in five expects more than 30 percent. Lenders and investors said growth will be most pronounced for deals with an EBITDA in the $50 million to $75 million range.

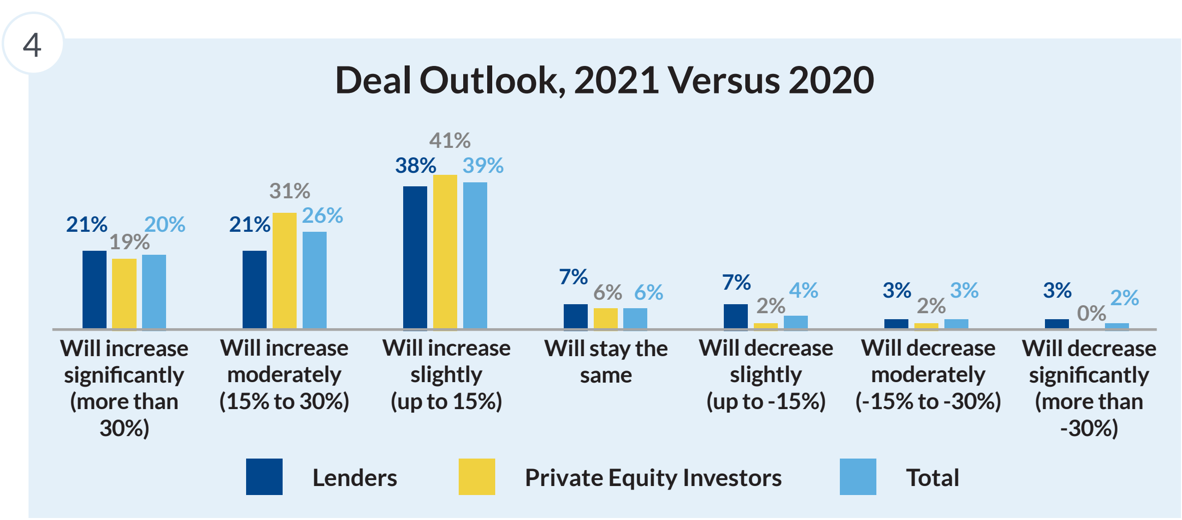
While investors and lenders were somewhat aligned when it comes to which sectors to watch — notably financial services and information technology — investors had higher levels of enthusiasm, with 57 percent expecting growth in financial services and 52 percent expecting growth in information technology (compared to 45 percent and 34 percent for lenders respectively). Lenders expressed more distributed enthusiasm across sectors, also registering high interest for opportunities in health care and communications services.

The shared interest in the financial services and technology sectors may not be surprising, as they have long been hot sectors for investment. One of the most curious splits between lenders and investors was in health care, as lenders are more bullish on the growth of deal flow than investors by a margin of almost 2:1. Health care's strong deal flow even before the pandemic might make investors who are watching closely think there's less room left to run and not that many targets.

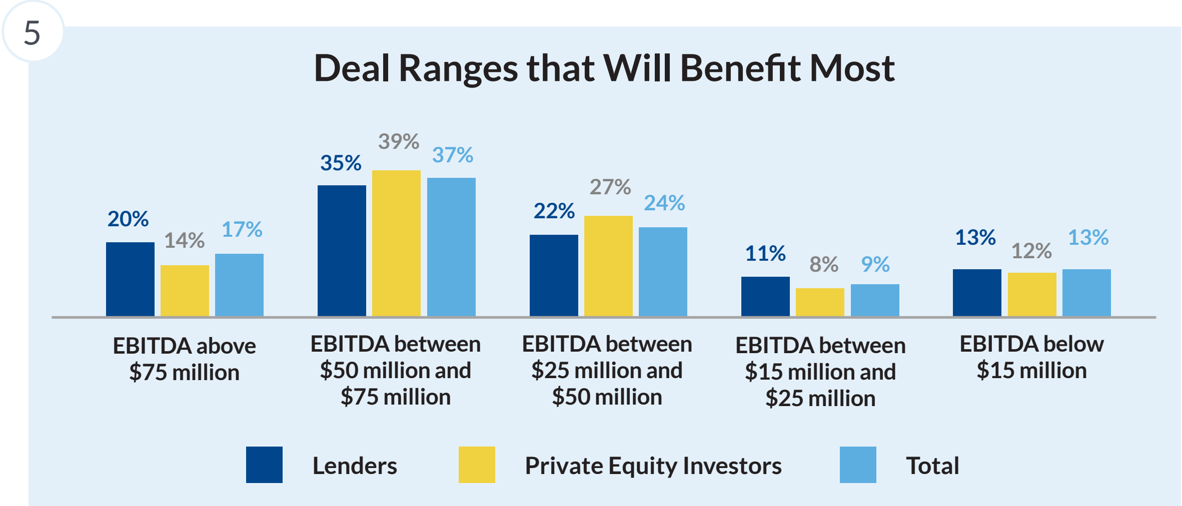
"Health care has experienced inordinate market activity over the last 10 years," said Katten Private Credit partner Derek F. Ladgenski. "From the private equity perspective, it's likely they are seeing the field narrow in terms of available deals. Lenders might be trailing the trend a bit."

Interestingly, some of the industries that respondents think will be most challenged are also those with strong perceived opportunities — notably financial services and information technology. This is likely a result of intense competition in such hot sectors, whereas others that are viewed as challenging (restaurants, health clubs) are struggling to materialize as the world emerges from the pandemic.

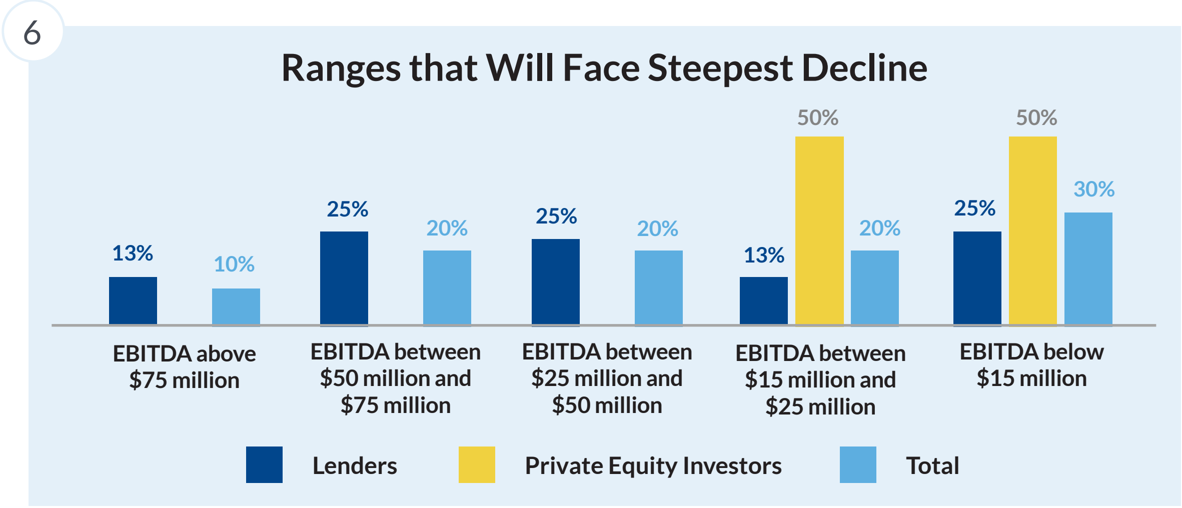
WHAT IS YOUR OUTLOOK FOR 2021 DEAL FLOW COMPARED TO 2020?



SPECIFICALLY, WHICH DEAL RANGES DO YOU EXPECT TO BENEFIT MOST?

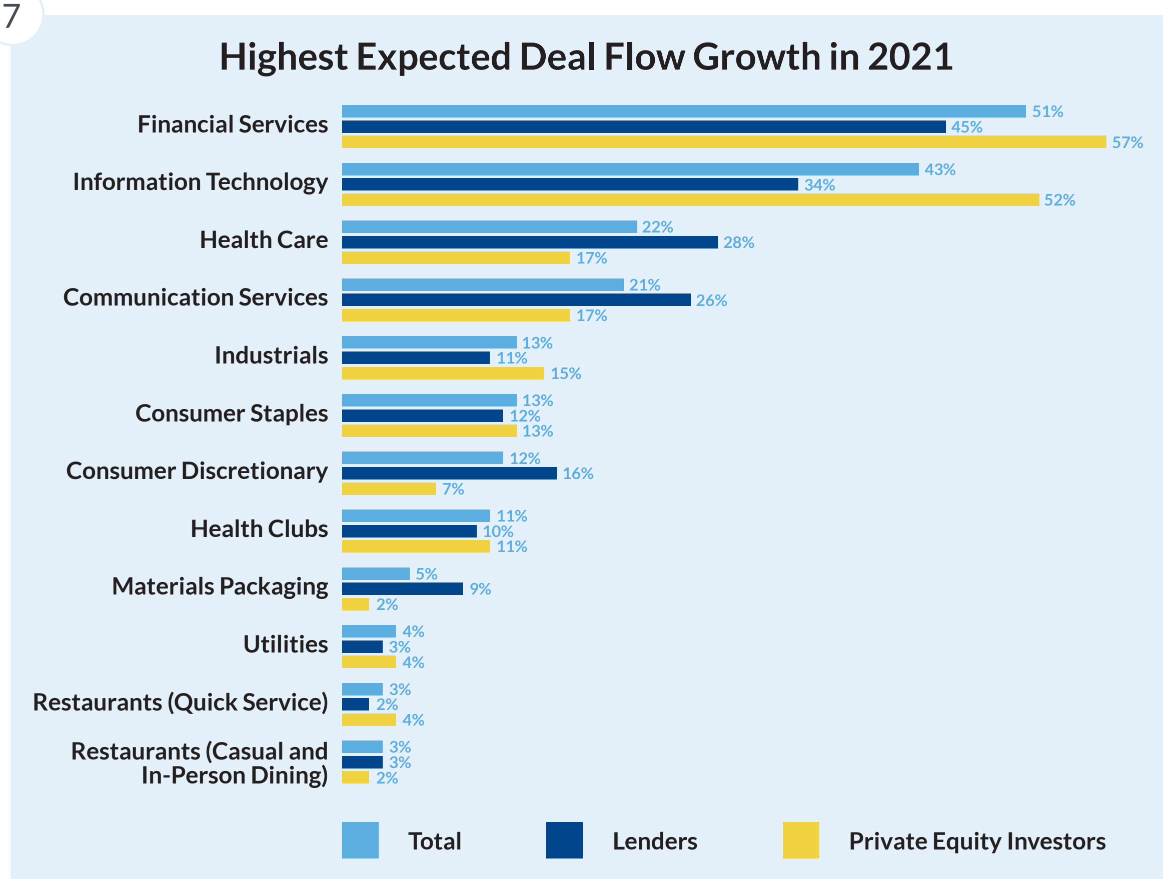


SPECIFICALLY, WHICH DEAL RANGES DO YOU EXPECT TO FACE THE STEEPEST DECLINE?



IN WHICH SECTORS DO YOU EXPECT TO SEE THE HIGHEST GROWTH IN DEAL FLOW IN 2021 COMPARED TO 2020?

7



Section 3 — Running Behind on LIBOR Phaseout

The London Interbank Offered Rate, commonly referred to as LIBOR, has historically been the standard interest rate for short-term lending. A plan had been in place to transition from LIBOR to the Secured Overnight Financing Rate (SOFR) by the end of 2021. In late 2020, however, it was announced by the US Federal Reserve and its UK counterpart that LIBOR would instead be phased out by 2023.

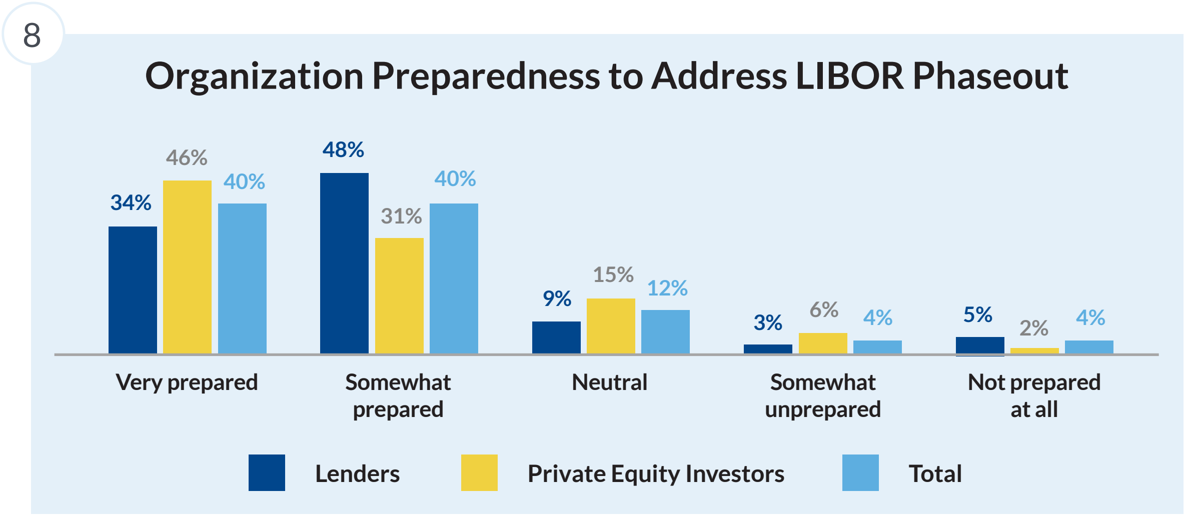
The additional time is necessary for many organizations to prepare. At the time of our survey, fewer than half of our respondents (40 percent) said they were ready for the phaseout. Nearly half said they were or would include the alternative rate (in this case, SOFR) in their operative documentation, though an additional third planned to do so in the next six months.

"We can expect the biggest banks and the largest institutions to move on this the fastest," Jacobson said. "But there are some real fears out there for moving first. You certainly wouldn't want to hardwire something into loan documentation that turns out to be anything than the market approach."

But he also advises, "A smart approach means observing closely, but you also want to make sure you have the right amendment provisions for coverage as the dust settles."

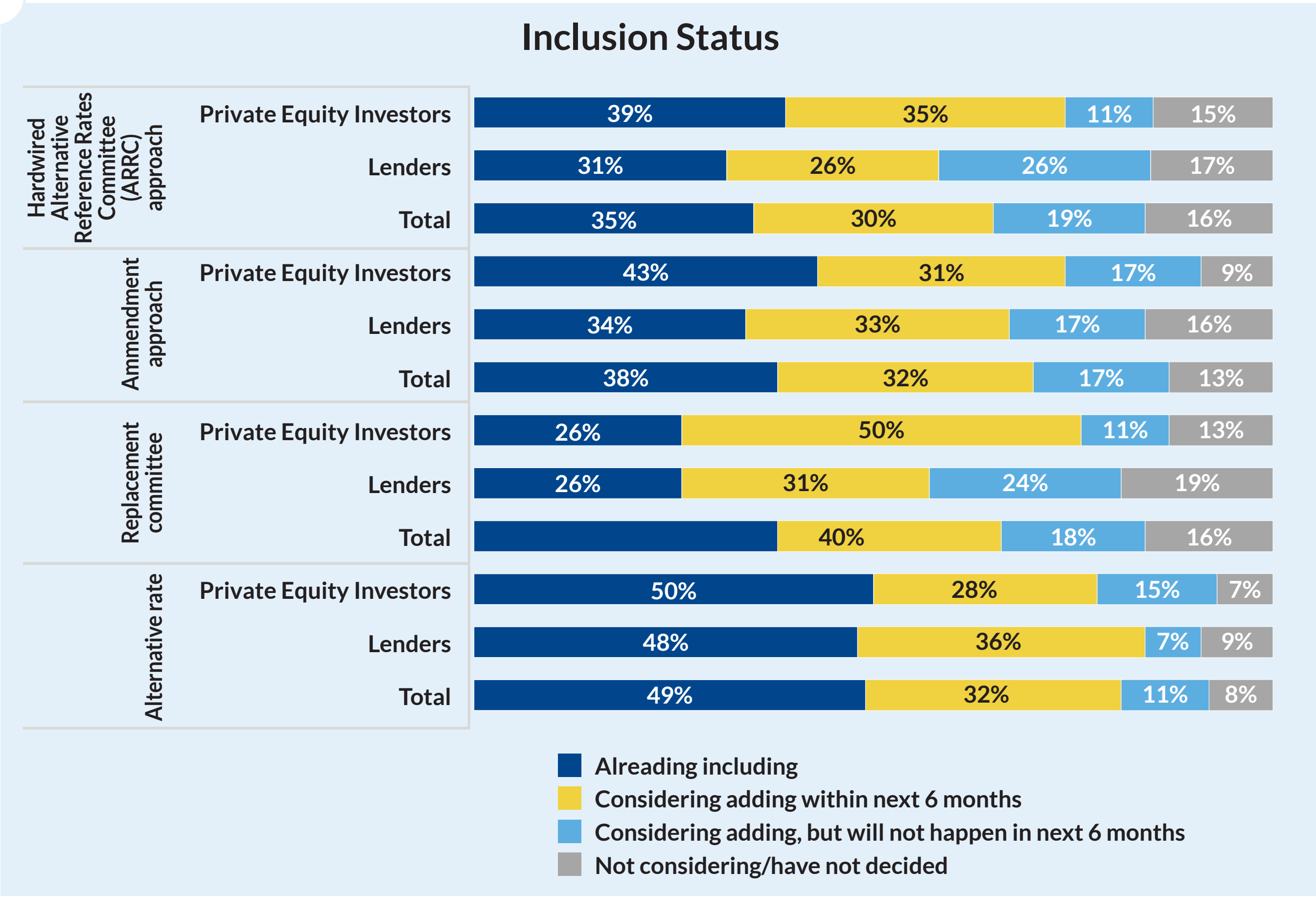
To gauge just how sweeping the LIBOR transition will likely be, we asked respondents about technical language they are including in operative documentation, and the responses spanned the gamut from effective dates of alternative rates, customized clauses (e.g., discontinuation and indemnification) and index fallbacks to retroactive liability and margin adjustments.

HOW PREPARED IS YOUR INSTITUTION TO ADDRESS THE LIBOR PHASEOUT?



PLEASE INDICATE THE EXTENT TO WHICH YOU ARE INCLUDING THE FOLLOWING:

9

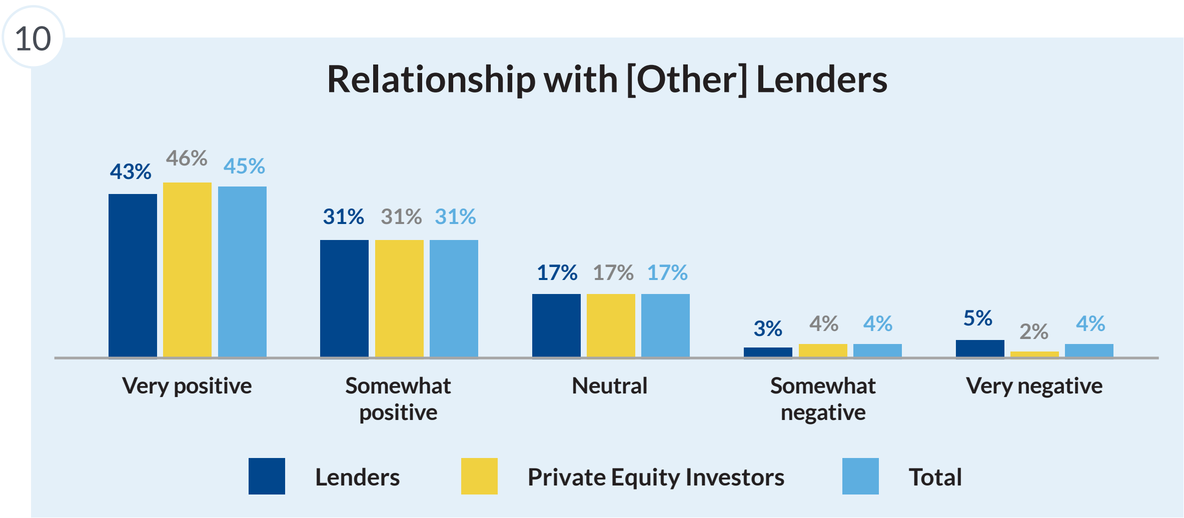


Section 4 — A Positive Outlook for Private Credit, Despite Lingering Questions on Deal Terms

Coming out of the pandemic and into an economy buoyed by the development and deployment of COVID-19 vaccines, the prospects for private credit deals are continuing to look up, even with lingering questions about deal terms.

Financial markets may not always come to mind when thinking of congeniality, but ultimately the cliché is true — good business is about good relationships. It bodes well for the industry moving forward that the vast majority of respondents (76 percent) felt they had positive relationships with the lenders they partnered with on deals.

PLEASE INDICATE THE WORD OR PHRASE THAT BEST DESCRIBES YOUR RELATIONSHIP WITH LENDERS [IN THE CASE OF LENDERS SURVEYED: OTHER LENDERS] ON DEALS THAT YOUR FIRM INITIATES.



In addition to recognizing positive lender relationships as a launching pad for future growth, hours worked and expectations to hire new staff in 2021 were up across the board.

Investors and lenders tempered any shared, post-2020 enthusiasm with questions about deal terms and the upcoming LIBOR transition, but it is clear their overall expectation is for deal flow to increase significantly.

IN WHICH BUSINESS OR OPERATIONAL AREAS, IF ANY, DOES YOUR ORGANIZATION ANTICIPATE ADDING STAFF IN 2021?

11

	Administrative					
Answer	**Total**	**Total**	**Lenders**	**Lenders**	**Private Equity Investors**	**Private Equity Investors**
In the process of hiring	49	44%	23	40%	26	48%
Considering hiring	37	33%	17	29%	20	37%
Not considering hiring at this time	26	23%	18	31%	8	15%
Total Responses	**112**					

Methodology and Demographics

In February 2021, 112 private credit industry professionals completed the 2021 Private Credit Survey conducted by Katten. These individuals were recruited through a leading global B2B online panel provider. Respondents were assessed first on whether they were a lender (52 percent) or a private equity investor (48 percent).

A large majority of respondents (84 percent) indicated they hold lead roles in decision-making.

Respondents in the sample represent firms that invest in a variety of sectors, with the largest being Financial Services, Information Technology and Consumer Staples — followed by Communications, Industrials and Health Care.

Firms surveyed included a wide range of sizes, with 62 percent reporting at least 500 employees and several in the 50,000+ category.

About Katten

With more than 700 attorneys serving public and private companies, Katten is the firm of choice for clients seeking sophisticated, high-value legal services in the United States and abroad. Our collaborative, entrepreneurial culture leads to true partnerships with our clients. We understand and focus on our clients' business objectives and address their legal needs in a manner consistent with their "big picture." We have a reputation for being trusted advisors, and we demonstrate our value every day in the successful results we deliver.

About Katten's Private Credit Practice

Our active Private Credit practice — which closes well over 500 transactions on average each year— has seen virtually every combination of deal variations, so our clients comfortably rely on our detailed, actionable counsel to help complete their transactions in all kinds of market environments.

Michael A. Jacobson
+1.312.902.5443
michael.jacobson@katten.com

Derek F. Ladgenski
+1.312.902.5485
dl@katten.com

Jennifer I. Wolfe
+1.312.902.5525
jennifer.wolfe@katten.com