The Business Funding Landscape

MACFARLANES

Contents Page

1 The Current Business Funding Landscape 1

2 The Outlook for PE Sponsors and Corporate Borrowers 3

3 The Outlook for Private Credit Funds 7

4 The Outlook for Real Estate Debt 9

5 The Outlook of Private Credit Fund Lenders on Borrowers in Financial Distress 12

The Current Business Funding Landscape

The business funding landscape in the UK is unique: spanning start-ups to multinationals, it is hardy and innovative in equal measure, capable of both holding fast to weather the storm and rapidly evolving. That endurance was put to the test by the continued instability of the credit markets in 2023 – characterised by high rates of interest and inflation, and further economic shockwaves triggered by the Russian invasion of Ukraine – which persisted in driving high financing costs in what was undoubtedly one of the toughest fundraising environments in recent times.

> *Whilst for many businesses the narrative of 2023 might best be described as one of treading water in an effort to keep afloat amid the wave after wave of crises to hit UK plc, one good news story was the increased availability of direct lending from private credit funds as a viable alternative to bank debt.*

Having grown substantially since the 2008 economic crisis, recent economic stresses - in particular the “higher for longer” interest rate environment which has had a negative impact upon the cost of traditional bank lending, coupled with the retrenchment of banks from mid-cap and corporate lending - have driven businesses in the direction of the private markets in greater number, as their higher pricing becomes relatively more competitive and the flexibility offered by private credit fund lenders affords them an edge on their heavily regulated bank competitors. Indeed, today the private credit sector is a significant source of finance for businesses across the UK, having contributed over £425 billion in lending to UK businesses since 2008.

Fortunately, when compared to 2023, the outlook for 2024 appears better, and has the potential to be a story of some rejuvenation with the emergence of green shoots across parts of the economy. Whilst the current macroeconomic landscape is anything but calm, as interest rates and UK inflation remain high and half of the world’s adult population gears up to head to the polls, the Bank of England reported in its assessment of the economy in early February 2024 that inflation had fallen faster than previously

expected, and generally forecast a continued fall, albeit at a more gradual pace than that set at the end of 2023 and with a few expected bumps on the road.[1]

With this apparent resettling of inflation comes the expectation of a downward trajectory in interest rates, and investors are readying themselves for expected interest rate reductions in 2024 from each of the US Federal Bank, the European Central Bank (ECB) and the Bank of England – albeit perhaps from some earlier than others. As interest rates fall, they bring with them the prospect of the increased availability of affordable credit, something that has been a key challenge to source in recent times, particularly for stressed but viable businesses. Indeed, falling interest rates in Q4 2023 coincided with renewed signs of optimism in the European private debt markets as deal volumes increased by 34% when compared to activity in Q3 2023.[2]

Aside from falling interest rates, activity in the remainder of 2024 may be bolstered by the significant amounts of dry powder awaiting deployment by private credit funds. For the most part, private credit funds have been holding fire on investment, waiting for markets to stabilise. As the potential for that stability comes into sight and the remaining investment windows for both private equity (PE) and private credit funds become shorter, General Partners will soon have to decide when to pull the trigger on investing the cash currently languishing on their balance sheets.

The improving economic signals over Q4 2023 and Q1 2024 have created optimism for what might be expected of 2024. However, only time will tell if this current optimism is founded and if some areas of the funding landscape will fare better than others. Until then, in this chapter we consider what the 2024 outlook might be like if the current tail winds continue, in particular for PE sponsors and corporate borrowers; private credit funds; real estate debt; and private credit fund lender attitudes to borrower financial distress.

The Outlook for PE Sponsors and Corporate Borrowers

2023 saw a continued significant slowdown in PE M&A activity, with UK M&A activity generally declining by 17% year-on year compared to an aggregate global decline of deal volumes of just 6%.[3] As across other sectors of the economy, this slowdown was driven by the persistence of geopolitical and economic instability and inflationary pressures, which manifested for M&A as:

- an increased cost of debt and lower returns as higher interest rates impacted the price of the debt that is fundamental to the PE leveraged finance thesis;
- a reluctance on the part of selling PE sponsors to transact at depressed valuations; and on the part of potential buyers, to rely on more expensive leveraged finance;
- the withdrawal of investment banks from the syndicated loan market and of high yield bond investors; and
- the increased presence of private credit fund clubs in the upper market, which whilst successful in plugging the liquidity gap in the upper markets did so at the cost of debt availability in the mid-market, from which much of that liquidity was diverted.

> *When compared to the picture painted in 2023, the outlook for 2024 is improved: syndicated bank and high yield bond financing have re-appeared and indeed are displacing, and in some cases refinancing the more expensive 2024 vintage, upper market credit fund loans; inflation is slowing (albeit not as rapidly as central bankers would hope, particularly in the US); economists anticipate interest rate cuts at some point over the remainder of the year (albeit not as many or as much as hoped); and although geopolitical instability and the risk of its further increase continues, concerted diplomatic effort continues to be expended in the hope of containing it.*

Some cautious optimism for an increase in deal activity has emerged for these and a number of other reasons, including:

- very significant liquidity is waiting to be deployed. Deployment is a necessary part of the investment thesis, for both PE and private credit funds. PE funds have huge reserves of dry powder, even more so as capital has been flowing into private credit funds in the current high interest rate environment;

- investors need to see returns on capital. This has been addressed (in part) by the injection of fund level leverage at cheaper pricing due to the inherent risk diversification across operating portfolios, and by re-leveraging operating companies to pay a distribution to shareholders (so-called dividend recapitalisations, of which there has been a surge in number, in the US at least, in Q1 2024);

- the market outlook is more stable. We expect to start seeing more exits coming through as more stability of economic expectations steadies projections and valuations;

- the number of companies waiting to be exited as part of the typical investment cycle is growing. Bain & Company[4] report that buyout funds are currently sitting on 28,000 of unsold companies with a record value of US$3.2 trillion, and that 46% of those companies have been held for 4 years or longer. Whilst funds may have been comfortable to play a longer game for the short term at least, their own obligations to provide investor returns will not accommodate this indefinitely;

- debt is becoming cheaper. Debt availability and competition to lend to “good” assets (in a limited range of sectors less exposed to consumer pressures, including healthcare, tech and business and financial services) had, in 2023, already started to improve pricing for borrowers. That trajectory is expected to continue with the resumption of bank and high yield debt financing alongside direct lending from private credit funds, coupled (eventually, it is hoped) with long-anticipated interest rate cuts. In turn this should enable lower equity deployment and more favourable returns for PE sponsors; and

- an increase in new M&A, as well as transactions other than new M&A, is expected as debt liquidity and lower cost of funds drive:

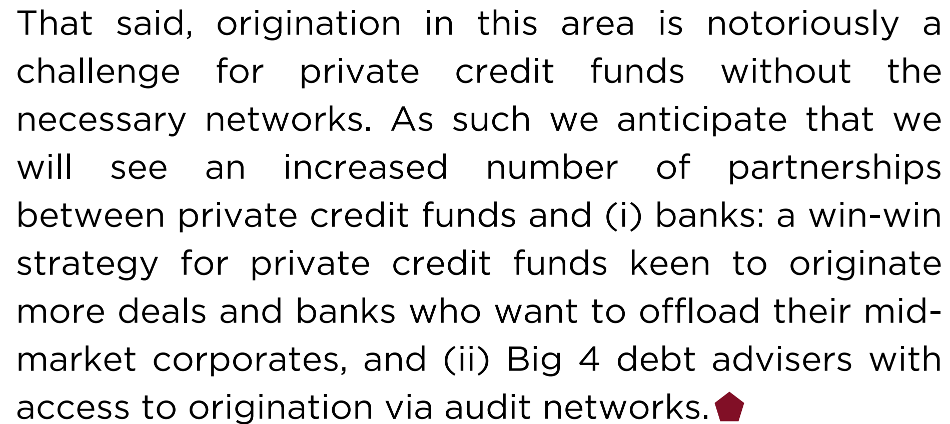
> *activity in less favoured industries, where refinancings and dividend recapitalisations will continue;*
>
> *bolt-on acquisitions, which require the commitment of new incremental debt if existing committed acquisition lines have been used; and*
>
> *refinancings of equity bridge-funded acquisitions undertaken by PE sponsors in preference to the debt terms available in 2023.*

That said, notwithstanding the general optimism for an improved outlook, 2024 will not approach the heady dealmaking days of 2020-2021. It is unlikely that PE sponsors will rush head long into the race, rather it is expected that they will start from a more prudent and measured standpoint, keen to differentiate themselves from the pack not with cheap debt but by their strategic execution and operational excellence. In 2024, PE sponsor enthusiasm is likely to be tempered by:

- careful sale processes, as PE sponsors seek to avoid risking their asset or reputation with the tarnish of an unsuccessful process;
- more discernment, notwithstanding greater liquidity;
- less focus on absolute debt quantum; and
- lower opening leverage levels.

2024 does however have the potential to be a year in which private credit wins more ground from banks in non-sponsored and/or mid-market corporate territory. Traditionally financed by equity, venture debt or bilateral banking relationships, private credit fund solutions can be an option for 'non-sponsored' or 'sponsor-less' businesses, and mid-market or 'special situations' corporate lending, where a founder does not want to take venture debt or IPO, or a corporate may have outgrown bilateral relationship banks, been de-banked or simply be unable to find suitable bank lending. Increased competition amongst private credit funds,

differentiation of fund strategies and relaxation in pricing driven by expected interest rate cuts and overall economics for private credit fund lenders reducing margin pricing at the borrower level may grow their reach into this area.



That said, origination in this area is notoriously a challenge for private credit funds without the necessary networks. As such we anticipate that we will see an increased number of partnerships between private credit funds and (i) banks: a win-win strategy for private credit funds keen to originate more deals and banks who want to offload their mid-market corporates, and (ii) Big 4 debt advisers with access to origination via audit networks.

The Outlook for Private Credit Funds

For private credit funds, the anticipated uptick in M&A activity in 2024 (see also section 1 (The outlook for PE sponsors and corporate borrowers) above) will be well received as they look to satisfy their strong appetite for deployment with the provision of buy-out financing.

Nonetheless private credit funds, like PE sponsors, will not be rushing to return to the frenzy of 2020-2021, which for private credit funds saw a relaxation on terms and tightening on pricing. Indeed, recent macroeconomic pressures on portfolio companies (primarily high interest costs and inflation), geopolitical instability and ever-increasing Limited Partner scrutiny have driven a level of conservatism amongst private credit funds and a focus on re-tightening documentation to close any loopholes agreed in more buoyant times: notwithstanding any indications that the outlook looks optimistic, this conservatism is likely to remain.

Add to that an environment where asset realisations are slower and fund-raising harder - with the consequence that fund managers may more often look to stretch a fund for longer - and private credit funds do not feel a need to chase more speculative credits and are willing to drop out of processes that they are not comfortable in.

> *It is not likely that the raised bar for credit approval that we saw in 2023 will lower in the short term in any meaningful way. As such, any uptick in deployment will likely be deliberate and measured, with activity fuelled by more deals coming to market rather than relaxed credit processes.*

That said, a challenge to this conservative approach to deployment persists in the form of financing to borrowers which are attractive investment propositions to lenders as a whole. Courting this group of borrowers is highly competitive and often sees multiple private credit fund lenders pitched against one another. Albeit dependant on the particular business and strategy, lender selection is today largely driven by pricing, growth capacity, flexibility for acquisitions and an ability to return cash to a sponsor or management. We have seen private

credit fund lenders willing to offer efficiencies in these areas in order to win a mandate.

Whilst private credit funds are likely to value prudence over pace, their eagerness "to do deals" - coupled with an almost persistent desire to increase their assets under management - has led to the launch of new strategies across the market designed to accommodate the current stretch and dislocation within the markets, and we expect to see more of this in 2024. Recent new strategies launched include:

- strategic opportunities/credit solutions. These are broad mandate strategies seeking a higher return and are often instrument and sector agnostic. They have the potential to blur the lines between debt and equity with decision making driven purely by credit and the relevant risk/return profile. Deals from these strategies are not always subject to the same sponsor market dynamics as direct lending or senior loan fund deals– many of the liquidity solutions are creative or designed to contend with particular challenges in the portfolio company (cashflow constraints, bridging to a liquidity event, etc.) and fewer funds are able to take any particular deal all the way through credit processes, so they tend to be less competitive;

- NAV. Private credit fund lending to PE funds on a net asset value (NAV) basis – whether as a means to satisfy additional funding needs to enhance a mid to late-stage portfolio or as a distribution to paid-in capital accelerator – became more mainstream and well-utilised in 2023. In an area increasingly challenging for bank lenders, private credit funds are deploying heavily into this space, either out of those credit solutions strategies noted above or, in some cases, specific pots of capital being raised under an umbrella of "fund liquidity solutions"; and

- Specific asset-class strategies. Certain private credit funds are also setting up specific asset-class strategies, often targeted at tangible asset classes as such real estate and shipping.

> *These new and innovative strategies offer much needed liquidity solutions for businesses and investors which might otherwise struggle to find a cash injection in the current market and PE funds that have hit a liquidity roadblock. Private credit fund lenders, more so than bank lenders, can be creative in managing cashflow restrictions, operational impingements and bridging to liquidity events.*

The Outlook for Real Estate Debt

> *It would be fair to say that the shockwaves triggered by the covid-19 pandemic - which in certain cases changed traditional demand for real estate assets, particularly in the new age of hybrid working - along with high inflation and the end of the era of "lower for longer" interest rates hit the real estate sector with the full veracity of their force.*

Credit providers in the space, typically shielded from much market volatility by the nature of real estate as an underlying asset, have not been able to evade the impact of the numerous macroeconomic events that have had an impact on all aspects of the economy: among other things falling property prices caused loan-to-value (LTV) ratios to increase to a level which banks were uncomfortable lending at, leading borrowers in the sector, as elsewhere, to look towards more flexible lenders, particularly on refinancing.

On a practical level credit providers were also troubled by increased project costs and longer than anticipated routes to commercial operation date as construction firms have also battled to weather the storm.[5] Even so, notwithstanding, and perhaps as a result of, the stresses in the sector, private credit activity in real estate debt grew in 2023 as the number of real estate debt funds launched tripled from the previous year and at least ten fund managers launched their debut real estate debt fund.

This migration of commercial real estate lending activity away from bank lenders and towards private credit fund lenders is not new but has been an increasing trend for a number of reasons:

- for such private credit fund lenders, the sector is a growing source of funding opportunities with bank lenders, cautious due to the current market environment, retrenching from it, and higher interest rates improving the return profile. Indeed, 84% of respondents to the Investment Intentions Survey 2024 by INREV – the European Association for Investors in non-listed real estate vehicles – indicated that they expect to increase

allocations to debt vehicles, which would make debt the preferred route into European real estate for investors; and

- for borrowers, private credit fund lenders offering real estate lending are regarded as having a greater appetite than most banks to invest and hold and are more comfortable with higher LTV ratios, providing borrowers with some flexibility to ride out the current valuation storm. This is attractive to those borrowers whose loans would otherwise be underwater from an LTV perspective given the impact of falling property prices on their ability to satisfy valuation-based covenants. Fundamentally also, borrowers and other market participants have begun to adapt to a higher financing cost: private credit fund financing that may have been considered inherently pricey five years ago, is no longer regarded as such, when the increased interest rates payable on floating rate loans to banks are taken into account.

Whilst the borrowing market has adapted to "higher for longer" as a new status quo and falling valuations have increased yield for lenders, it is likely that the much-heralded promise that interest rates will start to decline in the near term will open the door further for real estate transactions, fuelling an improved sentiment on market conditions which ought to signal the "bottom of the market" from a valuation perspective across a number of Real Estate asset classes.[6]

> *In real estate, as in other asset classes, significant liquidity is waiting to be unlocked and falling interest rates are likely to be the key. Q1 2024 has seen a number of transactions start to move forward and signs suggest that this momentum will grow. That said, 2024 marks the point when financing taken out in 2019, for most sectors the valuation peak, will come to the end of its typical five-year maturity.*

Refinancing of these loans with existing bank lenders may be challenging and may lead to:

- an increased appetite for enforcement by existing bank lenders;

- increased sales, encouraged by existing bank

lenders; and/or

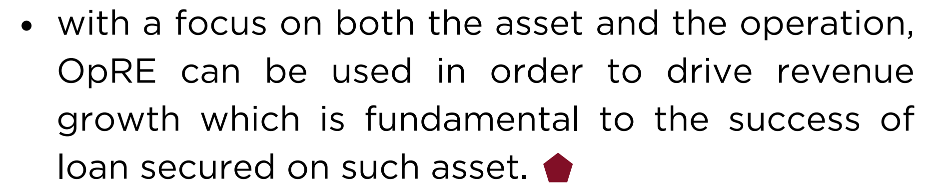
- as preliminary signs suggest, a continued and growing demand for the more flexible debt financing solutions offered by private credit fund lenders.

The increased presence of private credit funds in the real estate debt space is expected to be further bolstered by the rise in fortunes of operational real estate (OpRE). A recent area of growth, OpRE is distinguished from traditional real estate by its shift away from asset classes such as offices to operational models such as hotels, build to rent, purpose-built student housing and student campuses: a real estate asset is considered "operational" when income and values attributed to it are linked to the performance of the underlying operator. OpRE is considered increasingly favourably by lenders and often suits the risk-appetite of private credit rather than bank lenders, for a number of factors:

- performance of an OpRE loan is not necessarily linked to a defined cash flow, which can appear risky from a lender's perspective;

- income derived from OpRE is regarded as more resilient in a rising interest rate environment with the ability to manage operating costs coupled with the granular, short-term nature of the income streams; and

- with a focus on both the asset and the operation, OpRE can be used in order to drive revenue growth which is fundamental to the success of loan secured on such asset.



The Outlook of Private Credit Fund Lenders on Borrowers in Financial Distress

There is a general market expectation that 2024 will be a year of rising default numbers - with some in the industry having forecast a 5% default rate in private credit – and an increased number of insolvencies.

Indeed, statistics indicate that insolvencies are currently at their highest levels since 2009, and 2023 saw an increased number of voluntary small business liquidations as rising costs and the current high interest rate environment impacted on the ability of certain SMEs, notably those which took on debt during the covid-19 pandemic, to service that debt.

In the mid-market, where administrations and company voluntary arrangements currently remain at or slightly below pre-pandemic levels, we expect 2024 to see an uptick in these processes as the merits of mid-market companies that are over leveraged but operationally viable are recognised by relevant stakeholders.

> *It is also anticipated that 2024 will see an increased use of restructuring plans - introduced into English law pursuant to the 2020 UK Corporate Insolvency and Governance Act - by mid-market companies.*

The question is what this might mean for borrowers and their private credit fund lenders in the year ahead.

When assessing the outlook for private credit fund lenders and their attitudes to borrowers in financial distress in a rising default environment, it is important to recognise that:

- each situation is bespoke and that there is a huge amount of nuance driven by the specific circumstances affecting a given business;

- a key difference between private credit funds and PE is that the return on loans advanced by private credit funds is typically fixed, or a fixed margin above a floating rate like SONIA, and consequently there will be very limited scope for sharing in the upside that PE investors enjoy when they make a significant return on a particular investment. Therefore, whilst PE investors might be able to afford to get a zero return on two to three out of ten investments because they catch up via very significant returns on other deals, that dynamic does not apply in the private credit space where the aim of the game is not to lose money on any loans; and
- resourcing and expertise in dealing with situations of financial distress differs from institution to institution. In particular:
  - larger private credit funds in the market are typically well resourced with portfolio managers who have a lot of restructuring experience and are therefore well placed to manage situations carefully and help to ensure that value is preserved;
  - a number of private credit funds have a "special situations" strategy alongside direct lending and so those individuals will also have the required expertise should a loan investment get into difficulty (subject to the management of conflicts, given their primary role will be sourcing new distressed investments); and
  - certain private credit funds have less restructuring experience and rely more on their financial and legal advisors to navigate a process, resulting in higher professional costs, potentially longer timelines and consequentially a greater risk to business and value.

> *With that in mind a, perhaps "the", key driver behind the attitudes of, and actions taken by, private credit funds in any fundraising environment is that of reputation. Lending by private credit funds, more so than bank lending, is fuelled by good relationships.*

The core business of private credit funds is the making of loans and so faced with a distressed borrower, private credit funds will more likely than not be particularly concerned about the potential negative impact on their reputation if they are too aggressive towards their borrowers and related sponsors when financial difficulty first starts to be seen. There will of course always be a number of exceptions to that rule, such as where a particular private credit fund takes the view that their duties to their investors mean that they must maximise the economic return from any situation where a right to enforce has arisen, but by and large private credit funds will take a "relationship driven" approach and seek to work collaboratively together with a PE sponsor and its investee company in order to find a solution to a given problem facing a business.

These attitudes are likely to drive behaviour in a number of ways. When faced with a distressed company private credit funds are in the first instance likely to call for the provision of additional equity capital by the sponsor, as a key indicator of "good behaviour". Alarm bells are likely to ring if such sponsor financial support is not readily on the table, particularly in the event of a projected liquidity need. In such cases it is likely that private credit fund lenders will look to ramp up the pressure – such as pushing a board to take on external capital or make a sale – in order to avoid a situation where a company runs out of cash. We should expect to see more of this activity as default rates rise, albeit that one of the problems in the current market is that documentary controls which have weakened over recent years, particularly on the larger transactions, may put a private credit fund lender in a position where its bark is worse than its bite until the point where a company is on the verge of cashflow insolvency.

Should there be no alternative source of funds, a private credit fund lender may well step up to provide additional liquidity themselves, either in the form of a new loan, or converting interest from cash pay to payment-in-kind (PIK). However, if the private credit fund lender considers that it is having to step into the shoes of an equity sponsor and provide support, then they will not be keen for such equity sponsor to get a "free ride" off the back of the additional risk that it is taking and therefore may demand that the business is transferred to the private credit fund lender as a condition to the provision of funding. That said, liquidity isn't always the problem and so a takeover by a private credit fund lender won't always be the answer.

Over 2024-2025 a good number of financing deals are coming to maturity, particularly as a result of sale processes - which would have otherwise been completed by now and which would have caused a refinancing to occur - being put off due to floundering valuations, low prices and the hope of lower interest rates to come. These sellers are starting to bump up against financing maturity dates and difficult conversations with their lenders. What remains to be seen is whether private credit funds continue to be collaborative and agree simply to "amend and extend" deals or require borrowers to sign up to a series of steps which will ultimately culminate in a change of control and related refinancing which gets the private credit fund their money back. One thing is for certain, we can certainly expect to see M&A deal volumes increasing as a result of current conditions: sponsors will not be permitted to extend indefinitely by their private credit fund lender (see also section 1 (*The outlook for PE sponsors and corporate borrowers*) above).

Thanks

The IFT would like to extend our thanks to Macfarlanes for this piece of expert commentary which provides a comprehensive and detailed overview of recent and future trends in the business funding landscape.In particular we would like to thank the author Katherine Hensby, Jat Bains and Brooke Grainger. Contact details if you would like further information are included below.

This piece represents part of a series of work The IFT is carrying out on funding, including our Funding Conference earlier this year with Macfarlanes. This document will be followed by an overview report later in the year based on interviews with various lenders and funds. This will cover a broad range of funding types, looking at how approaches and considerations can differ as well as the role of turnaround professionals in relation to funding.

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Footnotes

[1] In their February 2024 Monetary Policy Report, the Bank of England forecast inflation forecast to fall to 2.0% on average in Q2 2024, before rising again to 2.8% in Q1 2025 as a result to persistent domestic inflationary pressures, and from there falling gradually to its 2% target in Q4 2026.

[2] Deloitte Private Debt Deal Tracker Spring 2024 Update.

[3] Global M&A Industry Trends 2024 Outlook, PwC.

[4] Bain & Company, Global Private Equity Report 2024.

[5] In the year to January 2024, the total number of construction firms becoming insolvent was 4,383, an increase of 5.9% on the insolvencies recorded in England and Wales in the year to January 2023, and a 36.2% increase on 2019 (Figures from The Insolvency Service).

[6] CREFC Europe Market Sentiment Survey Q1 2024 results

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