Banking & Finance

How private debt funds are dealing with distress

Many private credit funds are steering portfolios through a downturn for the first time. Borrowers are keeping a close eye on how debt managers are reacting when company balance sheets come under pressure.

Various private debt managers are dealing with an increase in distress within their portfolios. In the direct lending space, for example, loan default rates hit 4.2% in Q2 2023, almost double the 2.2% rate observed in Q4 2021, according to the Lincoln Senior Debt Index.

New territory

The simultaneous drop in fundraising and uptick in default levels will present the first prolonged slowdown that some private debt managers have faced.

Private debt's expansion during the last decade came as commercial banks were concentrating on rebuilding balance sheets following the global financial crisis. This enabled private debt funds and other direct lenders to step in and fill the liquidity hole left by commercial banks and become a source of financing for borrowers who could not secure funding from commercial banks, allowing private debt funds to increase their market share and expand their assets under management.

Consequently, a number of debt funds are already moving to bolster their in-house workout and restructuring capabilities in anticipation of higher default rates and financial stress within their portfolios, according to Bloomberg.

Borrowers keep watch

Due to the deepening of the workout team benches by private credit lenders, borrowers are keeping a close eye on how debt funds are responding to an increasing number of borrowers encountering financial stress and distress.

To date, many private credit players have been open to supporting companies and PE sponsors by extending maturities and amending terms to help borrowers through market disruption.

Furthermore, private credit players often rely on sponsor relationships for most of their lending transaction flow. According to Deloitte, PE-backed companies have consistently accounted for more than two-thirds of European private debt deals in almost every quarter over the decade.

This is one of the reasons why private lenders have often taken a more conciliatory approach.

Sponsors and private lenders frequently also have aligned interests in distressed and restructuring situations.

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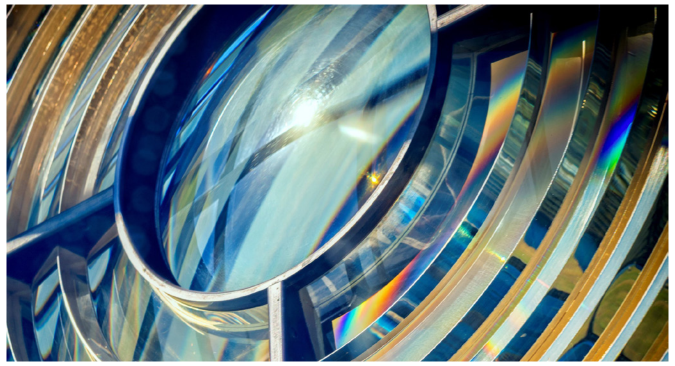
Sponsors will often want to buy time for companies with stretched balance sheets to stabilize themselves, while lenders may not want to take control of multiple assets under pressure at the same time.

As a result, private credit lenders prefer to use a variety of tools to protect value and maintain cooperative sponsor relationships rather than full-blown restructurings.

- Amendments to loan documents: Private debt default risks have mainly resulted from interest rate increases, allowing borrowers and lenders to proactively address potential problems early and amend loan documents. When undertaking amendments, lenders have in some cases negotiated equity injections from PE owners or increased interest rate spreads, including the use of payment-in-kind interest structures where interest due is added to the principal balance of a loan.
- Acquisitions of distressed portfolio companies: Currently, acquisitions of distressed portfolio companies by debt funds are becoming increasingly common due to difficulties of the companies to carry the increased interest rates. In the near past, for example, debt funds Ares, Ardian and Arcmont took over portfolio companies to rescue their outstanding debt capital by converting it to equity capital as a last resort effort.

Despite the difficult market situation, many private credit lenders are acting pragmatically and looking to support borrowers.



Practice Area News

New ESG-Reporting standards. ESG standards have already been heavily modified by the CSR and CSRD Directive. The relevance was reinforced by the draft delegated regulation of 31.07.2023, which, however, has already been adopted and will enter into force on 01.01.2024. Within the scope of the regulation, European standards for sustainability reporting (ESRS) will be defined. Various reporting and information requirements are intended to ensure a sustainable economy.

StaRUG in financing. In 2021, Germany implemented a new pre-insolvency restructuring proceeding under the German **StaRUG**. It enables debtors to restructure debt and processes on the basis of a restructuring plan with the consent of the majority of its creditor. Specifically, for multiple creditor scenarios the StaRUG is more flexible by separating different creditor branches of which the most senior ones are prioritized. Separation criteria can include groups of shareholders, same security interests or unsecured groups of creditors.

German implementation law for distressed loans. In October 2023 the German Government submitted a draft law to the German Bundestag on the promotion of orderly credit secondary markets and the implementation of the EU directive. The aim of this law is to reduce the stock of non-performing loans and to prevent the accumulation of non-performing loans in the future, as well as to ensure a high level of protection for borrowers.

Transparency register for real estate transactions. Due to the high susceptibility to money laundering in the real estate market, the notification obligations of foreign companies for newly acquired real estate in Germany have been extended to existing real estate since January 2023. The reporting requirement had to be met by 30.06.2023. Failure to meet the implementation deadline results in significant fines of up to EUR 1 million.

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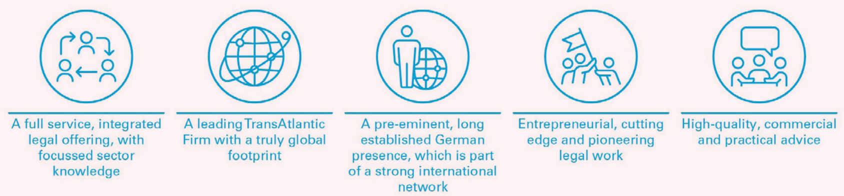
  - **Combining** highly qualified **German, English, and New York law finance** and respective language capabilities **in a single office**.
  - **Known** as **market leaders for complex cross-border finance transactions** in Germany.



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