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Skadden

Private Capital Remains an Attractive Alternative for Many Companies

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If you have any questions regarding the matters discussed in this memorandum, please contact the following attorneys or call your regular Skadden contact.

P. Michelle Gasaway
Partner / Los Angeles
213.687.5122
michelle.gasaway@skadden.com

Leila B. Sayegh
Partner / Los Angeles
213.687.5294
leila.sayegh@skadden.com

Andrianna M. Frinzi
Associate / Los Angeles
213.687.5123
andrianna.frinzi@skadden.com

Key Points

- Private capital became an important option for companies when the conventional financing markets were disrupted by rising interest rates, inflation, bank failures and other factors.
- While conventional financial markets are stabilizing and syndicated loans are once again proving more attractive to some than private borrowing, other companies may prefer private capital for the flexibility, creativity, certainty and speed of execution it offers.
- Large amounts of capital have flowed into the private capital asset class over the past decade, resulting in a continued source of funds and the ability to provide larger fundings.

Private credit and other forms of private capital have emerged as attractive alternatives to traditional bank loans and capital market offerings for many companies. These sources of funds were critical in recent years when the markets for broadly syndicated bank loans and traditional securities offerings were uncertain and volatile due to rising interest rates, inflation, tightening standards for traditional credit, bank failures, and economic and geopolitical events.

Private capital was able to fill this void and moved into a mainstream role, funding larger companies with more substantial amounts of financing. It offered a solution to companies in need of funds and provided structural features, strategic support and other benefits that may not be as available in typical commercial bank loans or capital market financings.

With traditional markets improving, conventional providers of funding are working to regain market share. But we expect private credit and other forms of private capital to continue to be attractive options for companies because of the flexibility, creativity, certainty and speed of execution they offer.

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The Growth of Private Capital

"Private capital" is a broad category that encompasses numerous types of direct funding from private sources, including:

- institutional investors;
- family offices;
- private equity, venture capital and hedge funds;
- dedicated private credit or private capital funds; and
- high-net-worth individuals.

Depending on the company's and the lender's or investor's objectives, a private loan or investment can be structured in any number of ways:

- regular equity such as a private investment in public equity (PIPE);
- a convertible or derivative security;
- a mezzanine or other debt-like instrument;
- direct lending; or
- any combination of these.

In the last decade, private capital assets under management (AUM) of all types have shown sustained growth, more than doubling from less than $10 trillion globally in 2012 to more than $24 trillion by the end of 2022, driven by strong returns for investors, according to an August 21, 2023, EY report.

Some of that increase reflects the significant growth in family offices, which now have $6.1 trillion in AUM, according to EY, and are now the single largest source of private capital, outranking private equity, venture capital and hedge funds.

Within the private debt subcategory of private capital, private lending has become the largest component, according to a December 4, 2023, fundraising report by the market analytics firm PitchBook. Private lending AUM exceeded $500 billion globally by late 2023 — up ninefold in 10 years — and the number of fund managers raising direct lending funds increased 20% over the past three years.

That, in turn, was reflected in a growing number of direct lending transactions. According to Bloomberg, in 2023 U.S. companies raised over $72 billion in direct loans across nearly 150 transactions (not including the nearly 1,300 direct loans where the amount loaned was not available).

Conventional Financing Options Are Competitive Again

As traditional financing markets have rebounded in 2024, we have seen investment banks and traditional lenders seek to become sources of private capital or to compete more directly against private capital.

A growing number of investment banks are making the push into the direct lending space. According to a January 16, 2024, PitchBook article, in the last few months, numerous commercial and investment banks have all announced private credit and/or private capital initiatives — on their own or in collaboration with other investors in the space.

In reaction to the significant private capital financings over the last few years, we have recently seen the traditional syndicated loan market seek to take back some of its lost market share, and other traditional financings are rebounding. For example, in some recent M&A-related transactions, major commercial lenders won the mandates for the financing over private capital competitors, leading some commentators to view this as a possible turning point in the market in favor of commercial lenders.

Further, according to PitchBook and BofA Global Research in a February 9, 2024, report, approximately $10 billion of direct lending deals have been refinanced in the syndicated loan market so far in 2024 as companies are finding better pricing, with savings of 200 basis points on average on first-lien financings.

LevFin Insights, which provides news and analysis on the global leveraged finance markets, reported on January 30, 2024, that it is now tracking "syndicated take-outs," a list of private credit issuers that have moved to replace their private debt in the broadly syndicated loan market. The publication forecasts that this list will grow as companies continue to look for less expensive capital.

The Staying Power of Private Capital

However, we still expect that private capital will remain a significant alternative and an influence on the broader financing market. A number of factors work in favor of private capital:

Faster executions. Private capital transactions can be executed on a shorter timeline because they do not require the marketing and syndication process of traditional commercial bank lending or marketed securities transactions. It can also be easier to negotiate directly with one financing source (or in a club deal, a handful), with no need to post documentation for a potential lending syndicate or market terms to capital market investors. Ratings also are typically not required in a private debt transaction.

Deal certainty. By removing the market risk of syndication or broad investor reaction, private capital transactions provide more deal certainty. For example, "market flex" provisions typical in a traditional syndicated bank process, which allow arrangers to modify certain terms (including pricing) depending on market response, are not required in a direct lending transaction. Similarly, negotiating directly with just one or a handful of investors removes the pricing and other market risk inherent in a marketed securities transaction, and provides more timing certainty.

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Deal creativity and flexibility. Private capital also can provide more bespoke, creative and flexible financing structures, allowing companies to better tailor the financing to achieve their specific business objectives and look beyond just their balance sheet and capital structure. The terms of the financing do not have to be structured for broad market acceptance or have typical market terms. For example, private debt transactions can have greater leverage because direct lenders are not limited by leveraged lending guidelines, and companies do not have to obtain or maintain a particular rating on the financing.

In addition, the financing sources in a private capital transaction are able to take a more in-depth, direct look at the company, its business plans and strategies than is possible in a syndicated or marketed process. With the benefit of direct conversations with management on the business story, private capital providers can offer more of a strategic focus in their financing. In seeking to build a longer-term relationship with a company, private capital providers may be more willing to agree to bespoke and flexible terms, and companies may be open to more expensive economics and other restrictions in return.

In addition, if circumstances change, it may be easier, and less expensive, to obtain lender or investor consensus for solutions, including to amend or waive covenants and modify other terms, as there is no need to seek the consent of the majority of a large loan syndicate or conduct a consent solicitation to amend the terms of debt securities.

Structural and strategic solutions. Companies can use the menu of private capital options, including in combination with traditional financing. For example, a company may seek private capital from a strategic partner to provide not just a source of funds but also the benefits of the broader collaborative relationship. A company funding an acquisition may look to a combination of traditional bank and bond financing, along with PIPEs, preferred equity or mezzanine-style funding from private capital.

Similarly, a company seeking to restructure its balance sheet may look to both traditional financing and private capital to help achieve reductions in leverage and/or debt service requirements and build relationships with key stakeholders. In addition, private companies contemplating later access the public markets can consider a mix of crossover options — for example, from traditional venture capital funding to convertible notes to preferred — to best prepare their capital structure for an initial public offering.

Available capital. Finally, the enormous sums now allocated to the private capital asset class, and the wide range of investors committed to the category, ensure that there are funds in search of private financings.

In Sum

As companies look strategically at what types of financing and capital will best achieve their goals and help them execute on their business plans, they have the flexibility to choose from a wide range of options, including to mix and match traditional financing with private capital.

How much market share traditional financing sources will reclaim is impossible to predict. But, given the advantages private capital can offer to the right companies and in the right transactions, and the significant amount of cash available through sources of private credit and other private capital, we expect private capital to continue to be an important part of the financial landscape.

One Manhattan West / New York, NY 10001 / 212.735.3000
300 S. Grand Ave. / Suite 3400 / Los Angeles, CA 90071 / 213.687.5000