

***PE Pathways* — Debt and Lending Markets: Current Trends Impacting Private Equity Sponsors**

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Tricia McNeill:

Welcome to *PE Pathways*, our podcast series where experienced dealmakers share their thoughts on current private equity and M&A trends and developments. Today, we are going to discuss the current state and trends in the debt and lending markets, as it relates to and impacts private equity sponsors.

My name is Tricia McNeill. I am a partner in the finance group for Troutman Pepper Locke. And I'm happy to be joined today by my fellow partner and colleague, Jonathan Homer, who also resides in the firm's finance group.

We're going to kick off our discussion today with the current state of interest rates and the most recent Fed decision to pause rate cuts, which continues this higher-for-longer rate environment and sentiment into 2025. Jonathan, could you provide those recent trends of interest rates and the implications they may have on private equity and LBO activity?

Jonathan Homer:

Hi, yes, Tricia, thank you. And it's great to be here. It's great to see you again. I think the most important question that everyone's asking about in the market, of course, is interest rates. What have they done recently and where will they go? There's been some positive movement, of course, not as much positive movement as people would like, but we have seen in the last year, interest rates have come down. I think in our own deals that we're seeing come through Troutman, they've been anywhere from 100 basis points to 175 basis points lower than what we were seeing a year ago. That's about the same as what is being reported in the market generally.

How are the rates coming down or how is it being reflected? I think it's a mix of a decrease in SOFR. Right now, SOFR is around 4.35%, which is a full 100 basis points lower than it was a year ago. That decrease started somewhere around the beginning of the quarter four of 2024 and just continued until it leveled out around 4.35% over the last couple of weeks. Margins have also been coming down. A year ago, you'll recall that we were seeing a lot of margins that were 3% to 4%, even we were still seeing some low 5% margins in early 2024 for some of the more challenging credits.

Now, I think in the last quarter and even in the end of 2024, we were seeing a lot of deals that were SOFR plus two and a half, to SOFR plus three and a half, depending on the credit. So, that's all really positive. Similarly, in the same vein, OID and upfront fees came down. We're

seeing deals around a year 99.5% seems to be typical now, whereas a year ago, we were seeing a lot of deals that were 98.5% or even as low as 98% of par.

This is great, but it's still not quite enough compared to where we were five, six years ago. What's driving the decrease in rates? Of course, the Fed has been cautious, but they did announce that they are, though slowing rates, they did announce a couple weeks ago that they have a target rate of 4.25% to 4.5%, and there is a general expectation that there will be a couple more cuts in 2025 taking us down to a full percentage decrease by the end of the year.

That is all great. But on the flip side of that, there is a lot of uncertainty in the market that is going to impact the rates. Everyone knows that tariffs are on everyone's mind, and no one is exactly certain how tariffs will impact the market overall or the economy overall or specific borrowers or interest rates. There's just a lot of unknown. Additionally, there's some unknown around labor markets as there are some changes and adjustments in immigration measures. There is also some unknown expectations for whether or not there's going to be new tax breaks or deregulation. All of these different factors are just leading to the uncertainty, as well as uncertainty that there could be some recession risks coming up. We don't really know.

Aside from these more general broad uncertainty factors, one thing to think about too is that in the leverage market generally, we have a push-pull between the supply and demand of capital that continues. And that push-pull between the amount of capital that's available for debt and the small number of acquisitions that have been occurring lately should lead to more favorable interest rates. So, that's something to think about that could push against the more general market trend as well.

Tricia McNeill:

Yes, I think a lot of these same uncertainties is really what's driving deal activity. I know, especially in the deals we've seen, it's been really fueled by a lot of repricings and refinancings. Looking at some of those data points, refinancings actually accounted for 53% of year-to-day activity, with another 18% supporting refinancing. So, it's certainly what we have seen in our deal flows too, and really points to those uncertainty factors when we're thinking about new deal originations and getting PE firms to look at exits.

Another trend that we've seen, definitely, in our deals has been debt to fund dividends, which was up in 2024. As of course, our PE sponsors are looking to get realize those profits, get capital back to investors, and get deals moving. It's significantly up dividends from 2023 and 2022. And it actually marks the highest issuance of that debt for this purpose.

These reports are highlighting, again, this uncertainty for new originations and exits that you spoke about earlier. Of course, tariffs are pausing some deals that have entered LOI and now hit pause. The volatility across capital markets and uncertain growth for borrowers as we look towards the future. All of that said, there has not been a stop in deal activity, especially in the middle to upper-middle markets. Reports are showing that still while we are behind long-term averages, the totals for LBO activity last year were encouraging to the market with Q4 being the busiest since 2021.

Looking a little bit at multiples until then we'll shift over to deal terms and trends, deal multiples have tracked in the broadly syndicated market, showing on average pro-forma debt multiples of 5.2 times, which is up from a 13-year low of 4.9 times in 2021, while still significantly more conservative in the peak we saw of 6 times in 2019, and the 10-year average of 5.7 times.

Jonathan, what are you seeing by way of deal terms and trends on our deals and in the market generally?

Jonathan Homer:

I think one interesting point that correlates with a slight uptick in leverage ratios is a decrease in equity contributions. You'll recall that for the last couple of years, we have seen a lot of deals where the equity contributions are 50% or even higher, and that is of course not consistent with historical equity contributions for sponsored buyouts. I think that we should expect this to come down. I think what will be interesting to see is whether they're coming down because the sponsors are just proactively avoiding putting in as much equity as they were, or if it's going to be more of a negotiated point.

In the last couple of years, I haven't done a lot of deals where equity contributions were an issue, and that was because the sponsors were voluntarily putting in more equity. That was just too expensive to finance as much as they'd like. I am curious to see when will we get to the point where the lenders are actually setting the terms for the equity contribution minimums. I think that's still a ways off, but it will be interesting to see when that happens.

Something that is not necessarily the middle market, in fact, probably a very large cap deal that unlike some that we've seen in a long time, but is the Walgreens deal that's coming up. An interesting data point is that they're expected to put in 83% debt. That is a really quite the large multiple of debt that we just haven't seen. So, that'll be interesting to see how the market reacts to that.

Some other interesting deal trends. I don't know that there's been a lot of dramatic movement in covenant both financial covenants and just general and negative covenants. I would say it's been more subtle. I personally think that we've seen some more borrower-friendly terms towards the end of 2024 and into Q1 of 2025. But again, it's subtle. I don't think it's anything that has been drastic. I do think though, it is something still I would want private equity sponsors to take note of to say, even in these uncertain times, there's always still flexibility to push for more favorable terms.

On the financial covenants, I think where we're still seeing subtle improvements, especially in the middle market, is EBITDA definitions are still getting better and more borrower-friendly, and we are seeing larger cushions on the financial covenants. I don't know that we have seen as many flips to true cut light deals as we would like, but we have seen some, and I think we will continue to see them as the markets improve. The other subtle shift, which is just a continuation of what we've seen for a while, is that the private lender market is becoming more and more accepting of some softer financial covenants.

I think that the market trends that we should expect coming are a lot of trends are just going to depend on where the market goes. I do wonder if tariffs, especially tariffs that are placed on

industries that are sensitive to tariffs, if they're going to result in a significant backslide in financial covenants and covenant flexibility, something to watch for?

Tricia McNeill:

Yes. One point I read about recently was really focusing on the lower middle market. Some positioning for borrowers, especially as hopefully deal activity picks up in the second half, is traditionally we see a fixed charge covenant as well as a leverage covenant, but looking towards dropping that fixed charge and only having a leverage covenant. Like you said, having that wider cushion, really giving that loose covenant to good borrowers.

Jonathan Homer:

Yes. I think that's a really good point. Something that I agree, I would hope to see more of that, less of the fixed charge coverage ratio and more of just relying on the leverage ratio. I think something else that will also continue to be a play in the market is going to be this never-ending tug-of-war between the private market and the syndicated market, which influences a lot of factors, not only does that the competition between the two markets is good for borrowers and some subtle improvements in pricing, but also in covenants.

Some interesting reporting that's come out in the last few weeks is about the number of private deals that are being refinanced into the syndicated market. The reason this is notable is three years ago when we were having this conversation, all of the news was about the private debt market taking deals away from the syndicated market. I think that was a factor of a few things. There was a lot of new private capital in the private debt market that needed to be deployed. And also, the syndicated markets were just very risk averse. The private markets were willing to take on some of those riskier deals at some higher interest rates, of course, but they were due to the deals.

So, we saw that trend of borrowers that typically would have been in a syndicated market going to the private market. Well, now some of those exact same deals that were issued in 2020 and 2021 are now at the point where they're ready to be refinanced or repriced, and the syndicated market is taking back some of that share.

I think that is a couple of things, a couple of factors leading to that. One is the syndicated market is not as risk averse as it was a few years ago, so it's willing to take on some of these more challenging credits. But also, some of those deals that were in the private market two or three years ago have also improved and have some higher ratings and can afford to go into the syndicated market.

I mentioned this only because it's interesting, but I also think it's really important for borrowers and private equity sponsors, especially in the middle market, to always look wide between the syndicated market and the direct market. Some private equity sponsors sometimes get comfortable working with the same private lender over and over again. I just think it's always worth casting a wide net to get the best terms that you can.

One other point is that, I mentioned Walgreens has this incredibly high leverage. Another interesting thing about it is that they are seeking debt from all avenues. They are getting private debt, privately placed term loans. They are getting private preferred equity from some of your traditional private lenders. They are getting cash flow revolvers from private lenders, then they are also getting widely syndicated term loans and ABLs and revolvers that are being underwritten by the typical banks that are underwriting these widely syndicated deals.

Additionally, they are getting some committed bridge facilities to backstop some high yield debt. So, it's a very interesting mix of capital that's financing the Walgreens deal.

Tricia McNeill:

Yes. I think it's such a great point, the Walgreens deal and the combined debt sources, because we talk about this competition where we have talked about a lot of the competition between the broadly syndicated and private credit markets, but really, we should be looking at it as a partnership. We see a lot of new banks coming up with their own private credit arm or joining in with a private credit fund, and it allows for the large banks to leverage their existing relationships, keep those bank cash management with the borrowers, really leveraging their geographic coverage and footprint, whereas the private credit side can use that bank's network, as well as partnership with those dealer originations and sourcing. So, it's not really about competition.

Hopefully, of course, on the borrower side, that drives some really good terms for the borrowers that are in good credit positions. But it's really how are we all going to come to the table and be a part of the action? So, I think that Walgreens deal is so interesting to see. And another data point we have seen in our deals is that Q1 has seen a really big uptick in the high-yield primary markets, coming back with this last week seeing it seven-week high a performer volume of 10 billion in for the week. So, definitely seeing activity there. Some of that slowing as well, but all of that sort of mixed up in that news of the Walgreens debt sourcing. Very interesting.

Jonathan Homer:

Yes, I really like that. I think that I'm glad you mentioned the high yield debt that we've been seeing specifically. I know that you did a very large transaction that closed in Q1. It was multi, I believe, four or five billion dollars for a public company that included a high-yield piece. And I think that's a good thing to highlight what we're seeing in the very sophisticated market in our own team.

Tricia McNeill:

Yes, that's right. Shifting a little bit, gears, here. I want to talk a little bit about portfolio management and the default rates and then this optionality for pick that we're hearing about and also seeing. We are on default rates just kind of looking at data points a little bit. Default rates have been modest, but we're seeing a little bit in the market a recent increase. The private credit default rate rose to 5.7% for the 12-month period ending last month, February 2025, which was just up slightly from January, which was at 5%. Of course, the elevated interest rates are going to be impacting cash flow and liquidity, which is leading to these defaults.

We have seen more amendments, and waivers, and covenant holidays, and now recently seeing the optionality to pick interest, which of course allows for interest to be paid in kind, freeing up cash and liquidity to the borrowers. This is a benefit for borrowers that are in the private credit-based as this optionality for pick flexibility, waiving that cash interest is really good for lenders that see a long-term prospect for borrowers that just need this relief in the short term. Private credit lenders are able to provide that flexibility, whereas the broadly syndicated market may not be able to do so.

Jonathan Homer:

Tricia, I like that you pointed that out because I think the pick interest option is really important in our current market where we have so many private equity sponsors that at the outset of their investment put in a huge amount of equity, which means if there is a liquidity problem or there is a financial covenant breach that may be coming down the pike, private equity sponsors are not as excited to put in more equity as they once were. It was once upon a time where if they only put in 15% to 20% equity in the beginning, they were happy to use their equity cure flexibility if there was a financial covenant breach down the road.

I think that that's less appealing now where they've already invested so much on the equity side. So, that's a really good point. And I think it's something that, again, I think the sponsor should think about when they are thinking between the two markets and which lenders to work with. There is some more flexibility in the private market for those pick options.

Tricia McNeill:

Yes. As we see, again, hopefully the uptick, I keep saying this uptick in M&A activity as my optimism for the last half of the year, but even in underwriting, there's been reports saying really strong, great credit borrowers can start asking for that optionality, even in underwriting, hopefully, in the broadly syndicated market too, really pushing for having that pick, not now, but having the option to have it in the future.

Jonathan Homer:

Yes, I really think that's a great point.

Tricia McNeill:

Just a little tip point, I think, especially on the private credit side, for borrowers to really be engaged with those lenders. It's great on the private credit side because when we've seen borrowers that need these covenant holidays or some cushioning, or they're going to be breaching leverage, they can sort of pick up the phone and call those lenders that they have those relationships a lot easier on the private credit side than they can on the broadly syndicated side. And that really just provides that option to get that flexibility quicker as they did those holidays and cushions moving forward.

So, really maintaining that relationship with lenders, making sure they understand your business so that you're not having to explain this complicated situation. They're already at tune for it. And when you think maybe a breach is coming, you're already having those conversations early on.

Jonathan Homer:

Just one thing I want to add to that, Tricia, is that for any of our existing clients, we're listening to this, or even not our existing clients, but other private equity sponsors that are out there: if there are questions about how best to manage that relationship or how best to approach it. As you know, you and I are both always available and people can reach out to us either by email or find our information online. It's a topic we're always happy to discuss, and especially, to discuss where the market trends may be going and how best to approach that with clients.

Tricia McNeill:

Yes, absolutely. All right, so shifting towards our sort of closing thoughts, Jonathan looking into the eight ball, everyone's favorite question. What do you think we'll see or maybe be talking about the next time we do this?

Jonathan Homer:

Unfortunately, I think we're going to be talking about a lot of the same things we're talking about right now, and that is a lot of uncertainty and some slow improvements in pricing, some slow improvements in covenants, and some slow improvements in deal flow. But I think there will still be uncertainty in general market terms and where things go.

Tricia McNeill:

Yes. I think saying uncertainty is sort of our key term throughout this podcast. But also, I want to say optimism, I think remains really high throughout the market with, of course, pent-up dry powder from the private equity side, as well as private credit funds that have raised over the last couple of years. This all really needs to be put to work. And we hope that private equity firms are likely to be motivated to get deals moving, especially ones that were bought during the busy 2020-2021.

So, at some point, though, because these deals are going to be brought to market, regardless of this uncertainty that we speak about today, and we're seeing a lot more activity in the second half of the year.

Jonathan Homer:

I like that, and I really appreciate your optimism. I think I need that messaging as much as anybody.

Tricia McNeill:

I always bring optimism.

Jonathan Homer:

Good to see you, Tricia. I hope to be talking about this again next quarter.

Tricia McNeill:

Great. Thank you for joining us for *PE Pathways* today. Please like and subscribe wherever you normally get your podcast, and we hope you join us for the next one.

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