PRIVATE DEBT – ALTERNATIVE SOURCES OF FINANCING

Private debt as an alternative form of financing sought by companies from institutional and financial investors.

INTRODUCTION

Private debt is a rapidly developing segment of debt financings granted by non-bank investors. Among direct lenders granting debt financing in the form of private debt those most often encountered are credit fund specialists, the debt arms of private equity houses, asset management firms, pension and insurance funds, and hedge funds and distressed lenders.

Private debt began appearing on a large scale on financial markets in the USA and Europe after the 2008 financial crisis. After the end of the financial crisis, the global economic landscape began to be characterised by low interest rates and increasingly onerous capital and regulatory requirements for banks, which largely led to banks' scaling down their lending business. Consequently, many businesses, including not only mid-market enterprises but also large enterprises without investment grade ratings or in industries the banking sector considered 'risky', found themselves in a situation where access to bank financing was closed to them or severely limited. At the same time, lower rates of return on investments on capital markets combined with a surplus of cash pushed institutional investors to look for alternative investment opportunities and prompted them to enter the leveraged and corporate financing market. This process led to the formation of a new financial product – private debt. Since then, private debt has been developing dynamically globally, and direct lenders are making debt financing offers available on more European markets. Private debt has indisputably become one of the hottest investment topics of recent years.

TYPES OF PRIVATE DEBT AVAILABLE

Private debt is predominantly provided in the form of loans and bonds, but CLO transactions are also encountered. Direct lenders are most willing to finance acquisitions, corporate refinancing, capital growth and provide distressed/special purpose financing.

A broad spectrum of debt instruments can be distinguished in the products offered, such as senior financing (including senior leveraged financing), structurally or contractually subordinated financing – second lien financing, mezzanine (PIK) and holdco financing, and also unitranche hybrid financing.

Acquisition finance / Corporate refinancing	Capital growth	Distressed / Special purpose financing)
• Senior • Second Lien • Mezzanine (w tym PIK) • Unitranche	• Holdco • Senior • Second Lien • Mezzanine (w tym PIK) • Unitranche	• Holdco • Mezzanine (w tym PIK)

MAIN FEATURES OF PRIVATE DEBT

Private debt transactions are becoming increasingly popular on European markets, not just thanks to the availability of capital outside the banking and capital markets but also because of the many features of the product itself, which many borrowers find attractive. Private debt is becoming increasingly popular with private equity houses, which use private debt to finance their acquisitions. This is mostly because private debt customarily enables private equity houses to be more flexible when conducting their investments than would be possible if the acquisition financing had been granted by banks. The main features distinguishing private debt are:

- Speed and efficiency of the credit/investment process: process of obtaining investment consent from the lender and access to decision-makers is relatively fast when compared with bank financing (in particular syndicated financing);
- Flexibility: possibility of individually negotiating the conditions of the transaction, usually with one investor, the result of which is a tailored deal;
- Innovative solutions: financing through unitranche hybrid financing, holdco financing or convertible financing (e.g. through the use of subscription warrants);
- Greater freedom and less restriction in running the business: often includes only incurrence covenants and no maintenance covenants, with other conditions usually also being more flexible than in bank financing; at the same time, it should be noted that flexibility has its price and private debt financing is usually more expensive than bank financing.

Direct lenders and borrowers alike also point out the availability of private debt for entities for which, for various reasons (e.g. too-small scale of the business – the mid-market), it is more difficult to gain access to bank financing or which have not achieved the scale required to obtain access to debt capital markets in order to, for example, issue high-yield bonds.

PRIVATE DEBT IN POLAND AND THE LEGAL FRAMEWORK

As an attractive product, private debt transactions are also becoming increasingly popular on the Polish market. Not only Polish investors but also experienced European private debt investors are becoming increasingly active on the Polish private debt market.

As private debt is a relatively new product, in the case of financings of this type material legal issues arise in every jurisdiction, which need to be analysed and regulated accordingly when the transaction is being structured. The situation is no different in the case of private debt financing in Poland. The primary legal issues which should be analysed in transactions of this type in Poland include:

- **Regulatory issues**: The private debt market is a young and dynamically developing market not only in Poland, but also in many other European countries, therefore regulatory issues must to be considered before a transaction is implemented. A more in-depth analysis will be required concerning, in particular, issues related to the admissibility and possible terms of the granting of the financing by domestic or foreign non-banks wishing to operate on a cross-border basis.
- **Tax issues**: The issue of potential withholding tax will also be crucial for foreign investors; the beneficial owner and the new pay&refund mechanism requirements closely related to withholding tax will need to be taken into consideration in the case of any cross-border financing.
- **Maximum interest**: the provisions of the Polish Civil Code on maximum interest rates must absolutely be taken into consideration when agreeing the financial terms of a transaction – if a finance contract stipulates an interest rate that exceeds the maximum interest rate permitted by law, the lender will be entitled only to the maximum interest permitted by law, even if the parties agree to have the financing documentation governed by a foreign law. It is also worth noting that the regulations concerning maximum interest rates will not apply to financing in the form of bonds or financing granted in the form of a loan to a parent company with its registered office outside Poland (in such a case, a debt pushdown solution analysis, namely of the mechanisms enabling the transfer of funds to operating companies in Poland and the subsequent service of the debt at the level of the parent company, will be required).
- **Capitalisation of interest**: In the case of subordinated financings, which frequently contain terms concerning PIK interest (i.e. capitalisation of interest) or a PIK toggle (the borrower's right to make a change between a cash payment and the capitalisation of interest during the term of the loan/credit agreement), it will be necessary to take into consideration the restrictions on capitalisation of interest that are specific to Polish law.
- **Security for the transaction**: The issue of the security package for the transaction available to the borrower will also need to be considered at the term sheet stage. For example, only an entity that is among the group of institutions exhaustively listed in the Act on Certain Financial Collateral Arrangements of 2 April 2004 may be a beneficiary of a financial pledge.

SUMMARY

We expect that private debt transactions will become increasingly popular on the Polish financial market. This is evidenced by both the growing number of Polish investors entering the direct lending market and the growing interest we have observed on the part of European investors granting alternative forms of financing on foreign markets in entering the Polish market. The growing awareness of Polish companies and capital groups of the availability of financing outside the banking market in the form of private debt will also be important for the future rapid development of the direct lending market in Poland.

At the same time, because private debt is a new, continuously developing product, a careful analysis of legal (in particular regulatory and tax) issues, which in many areas may prove inadequate for the market's requirements and the new private debt products, will be required in each case.

AUTHORS

Andrzej Stosio
Partner

T +48 22 627 11 77
E andrzej.stosio@cliffordchance.com

Anna Biała
Counsel

T +48 22 627 11 77
E anna.biala@cliffordchance.com

Kacper Bardan
Legal Adviser

T +48 22 627 11 77
E kacper.bardan@cliffordchance.com