Proskauer

Talking Trends with Ares

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In **Women in Private Credit: Talking Trends**, we dive into the world of private credit through the lens of eminent women in the field — from professionals at the forefront of industry leadership to our own lawyers. Together, we navigate the trends and topics influencing private credit against the backdrop of today's ever-evolving geopolitical landscape.

In our latest edition, Proskauer private credit partner Harriet West engages with Ares principal, Laura Berguig, focusing on private credit lending in Italy, including navigating complexities, recent developments and trends and the potential opportunities for private credit within this geography.

What is the current landscape like for private credit funds lending into Italy?

Laura Berguig, *Ares:* Direct lending is a relatively nascent market in Italy and penetration of private credit has accelerated considerably in the last 2-3 years. Yet, it is still well behind other European geographies, and I think there is still a lot of untapped potential for private credit. We usually see a larger number of players in the small to midcap market, which has been most active in Italy lately, and where local private equity ("**PE**") and private credit funds have a strong presence. In the mid to large cap market, which tends to be covered by Pan-European sponsors, the landscape is very similar as to what we'd see in other jurisdictions, with an increasing number of players having a dedicated coverage team on the ground.

Harriet West, *Proskauer:* The Italian market has been slower to develop for direct lending compared with the evolution in the UK, French and German markets. It was traditionally dominated by banks and when the banks retreated midway through 2022, in the wake of geopolitical uncertainty, private credit funds stepped in, to finance investments. Whilst local bank lending has bounced back somewhat, this has not displaced the relationships built between sponsors and borrowers and private credit providers and most mid-market deals utilise or explore private credit lending as a viable option. Italy has evolved into a dynamic and active market for private credit funds.

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Laura Berguig, Principal, Ares

What makes lending in Italy unique and how do direct lenders find ways to work around any challenges?

Laura, *Ares:* The market is very attractive to PE and direct lending players because of the opportunities it presents in terms of primary LBOs, and market consolidation. SMEs account for over half of the Italian economy and there is an impressive reservoir of sizeable family-owned businesses, sometimes with no succession plans, which make great candidates for primary LBOs. If you look at the industries which have seen a lot of consolidation plays across Europe, Italy is still lagging behind – for example in the education space, or insurance brokerage, the players are still very fragmented.

On the structuring side, the market does have a few specificities which makes it unique when compared to other European jurisdictions. For instance, most direct lending deals are structured as bonds rather than loans. Italian law also prohibits a company assisting with the acquisition of shares in itself or in any controlling company so a push down of debt is achieved with a “merger-based” structure where the newly incorporated Italian company acquires the shares in the target, and following the acquisition, merges with the target. It can be difficult for a credit manager who has never been active in Italy to navigate these rules, and to put in place an appropriate fund structure and local accounts to be able to lend into their first transaction.

Harriet, *Proskauer:* As you mention, international direct lenders entering into the market face a myriad of unique structuring and legal complexities. Whilst regulatory steps were implemented in 2016 to permit EU alternative investment funds to apply for a licence to grant direct credit in Italy and lend through loan documentation, the practical adoption of such practices by international credit funds has been somewhat limited. Instead we still see a majority of international private credit providers continue to structure their financing as bonds, which has become a well-trodden path for debt funds, sponsors and borrowers (and their respective advisors) alike, active in the Italian market.

There are points to navigate: some of which are unique to Italy; some of which are complexities which also typically arise in other European markets; and some of which are just part and parcel of the debt being structured as bonds. These can include:

- the analysis and self-declarations of lending vehicles as qualified investors;
- complexities around tap and incremental issuances, which are more involved than simply drawing on a committed loan line or delivering an incremental facility notice under similar loan documents;
- ongoing amendment and/or consent processes, especially if decisions are required to be taken at a bondholders’ meeting with an Italian notary;
- corporate benefit restrictions and financial assistance restrictions on the guarantee and security package (with workarounds including the merger approach you mention Laura);
- dealings with clearing systems and custodian banks;
- operational considerations such as bond settlement and ISIN applications; and
- execution procedures (e.g. exchange of correspondence or notary meetings and co-ordination of powers of attorney as applicable).

All the above have become a common part of the transactional advice we would give to funds both operating or intending to operate within this market. One point to emphasise is that despite the novelties of the legal documentation, the terms from commercially negotiated term grids and "precedent" deals from other European markets can be easily replicated through the bond style documents.

How do direct lenders deal with the competition from traditional bank lenders within the Italian market?

Laura, *Ares:* Banks have considerably retreated from LBO financing since Covid-19 and even more so since the start of the Ukraine war, with some even freezing their lending activities for a few months at the end of 2022. Today we rarely see them underwriting large transactions and they typically hold smaller tickets, with leverage hardly ever exceeding 3-4x. This makes it difficult for a borrower to find enough liquidity in the Italian banking market for transactions above €300m and has helped with increasing the penetration of direct lending in the past couple of years. The anticipated decrease in interest rates will likely translate to an even wider gap between leverage offered by direct lenders and banks, with the cost of debt coming down.

Another factor is the opening of local offices from a large number of PE funds in the last 12-18 months given the attractiveness of the Italian market. As these international funds typically use direct lending in other geographies, they are more inclined to use private debt for their Italian transactions too, whereas local PE funds are still mostly bank financed. There are also situations where the need for speed and certainty of execution naturally makes direct lending the chosen route. Another good example of such situation is consolidation plays, where direct lenders can be more relevant than banks, given the need for PE funds to dispose of follow-on capital to support their buy and build strategy within a short timeframe.

Harriet, *Proskauer:* We have also seen pricing decrease in 2024, meaning the price difference between the banks and direct lenders is less pronounced. This smaller pricing differential, along with the other benefits direct lenders can provide, is making it hard for borrowers and sponsors within the Italian market to ignore the appeal of private credit. As banks have become more risk adverse, borrowers and sponsors have looked to private credit for liquidity, and its take and hold model allows a deeper relationship to develop. Certainty of execution and provision of flexible products, such as delayed draw lines, are also perfectly suited to buy and build strategies.

Whilst we have seen increased collaboration between debt funds and Italian banks, for example, the debt funds providing unitranche financing via bond issuance and local banks providing revolving credit lines or super senior term debt, we may also see increased partnering up between the debt funds and Italian banks to provide more unique hybrid structures.

What part of the Italian market is of key interest to Ares at the moment?

Laura, *Ares:* It's generally a geography where we are keen to expand, so we've taken interest in a broad range of opportunities. Most of the transactions we've reviewed in the last twelve months have been in the small to mid-cap space, which we see as particularly active given it represents over half of the economic landscape in Italy. One of the most active sectors this year has been healthcare, where we've seen a lot of interesting opportunities, in particular in sectors which are being consolidated (for instance CDMOs, Labs, Vets, Dental, which are all sectors where Ares has extensive experience). As such we've been spending time on both small-mid and large opportunities, across a broad range of sectors. We remain focused on situations where Ares can be sole lender, which is a very compelling proposition when competing with a pool of several banks or a club of direct lenders as we can speak for 100% of the ticket and have a strong track-record of deploying more capital to support our portfolio companies.

Recent years have seen a modernization or development of certain Italian legal principles and market practices; have these had an impact on direct lending in this area?

Laura, *Ares:* I've definitely noticed a professionalization of the market in the last 5 years, where counsels such as Proskauer have done a number of deals in Italy, and are able to work through specific local issues on a transaction in a very efficient and seamless manner. We've also seen creative structures whereby banks team up with direct lenders, and even have seen banks stepping in to provide super senior term loan alongside direct lending funds' unitranche lending. The standardization of market practices has certainly helped us in our most recent transactions.

Harriet, *Proskauer:* We have seen great steps forward recently to increase the availability of non-traditional debt to Italian companies. For example, earlier this year, the changes to Italian capital market laws, amongst other things, removed the requirement for bonds held by debt funds to be listed (thereby also doing away with the related applicability of market abuse regulations) if issued by Italian joint stock companies (typically newco "issuers" on debt fund transactions) where the quantum exceeded twice the share capital and reserves of such company.

The security package for direct lending deals may now also include a non-possessory pledge, which showcases many features of a "floating charge" concept - familiar to private credit funds on English transactions.

One other market practice we have seen adopted, whilst not new in the Italian regime, but new in its reinvented application to private credit transactions, especially on those more competitive deals, is the use of a Luxembourg law governed demateralised account pledge. Its practical application avoids the lenders needing to rely on enforcement of an Italian share pledge as a single point of enforcement or amending the structure to include a new Lux Holdco structure if not commercially on the table.

"The increase of funds with dedicated Italian coverage, the number of attractive opportunities for primary LBOs and buy-and-build strategies and the professionalization of the market are all contributing to the momentum towards more direct lending."

Laura Berguig, Principal, Ares

How do you anticipate the Italian debt market to continue to evolve over the coming years?

Laura, *Ares:* Italy has been the fastest growing market for direct lending in the last few years and I think it will likely continue on that trend. Advisors and local players are now a lot more aware of the advantages of direct lending vs. banks and now almost systematically launch dual track processes or even processes exclusively with direct lenders when appropriate. As mentioned previously, the increase of funds with dedicated Italian coverage, the number of attractive opportunities for primary LBOs and buy-and-build strategies, and the professionalization of the market are all contributing to the momentum towards more direct lending. The macroeconomic and political environment has also been stable, with all key indicators benchmarking well against other European economies. Recent data shows that Italian Direct Lending deals represent about 10% of the European deal count in FY24 to date, up from 6% in FY23, and I wouldn't be surprised if the number of transactions surpasses other large European markets in the next few years.

Harriet, *Proskauer:* I agree - other European jurisdictions, with their own complexities such as France and Germany, have shown how direct lending can establish a strong market position and I'd expect Italy to follow this trend. Whilst there are unique factors to take into account when considering Italian investments and lending as discussed, we'd expect a number of the commercial terms and trends which we have seen take hold in the direct lending market in the UK, France, Benelux and the Nordics to migrate into Italy. Debt funds should look to advisors and counsels with expertise of working with direct lenders, as well as a track record of deal experience in Italy, to help navigate these market trends efficiently alongside the Italian legal complexities.

For more than 20 years, the Private Credit Group at Proskauer has been intrinsically involved in the evolution of the industry, working on pioneering structures and products. Our technical strength, combined with our expansive experience, makes us the Firm of choice for first-in-kind transactions. Acting as strategic partners to our clients across industries and jurisdictions, our team of lawyers has expertise in U.S. and Europe-centric transactions, as well as North American and European cross-border transactions.

Proskauer Women in Private Credit offers a knowledge sharing and peer network platform for females active in the private credit market. **Click here to register your interest in receiving future updates**.

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