

# The growing role of private debt investors in Spain

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Until 2008, banks and saving banks (“cajas de ahorro”) controlled the Spanish debt market. Spain was historically a bank-driven economy with a limited presence of alternative lenders and a small debt capital market, in comparison to the US or England.

The 2008 financial crisis and the subsequent collapse of several Spanish financial institutions, coupled with the contraction in loan supply, proved fertile ground for alternative lenders – and the gap in bank lending was seized by direct lenders.

Between 2010 and 2014, direct lending experienced slower growth than expected, owing to, among other things, the quantitative easing (QE) and associated monetary policy and cheap(er) bank financing.

However, alongside the wider global growth, direct lending experienced steady development in the Spanish market from 2014 onwards – and it is certainly booming today, with collaboration between banks and debt funds in the direct lending space, mezzanine and holdco debt, growth, special situations and rescue finance giving direct lending a strong (and growing) market share.

International debt funds initially queried whether direct lending triggers banking licensing requirements in Spain.

In essence, there is no Spanish regulatory framework for direct alternative financing. Lending money is not a regulated activity in Spain, and direct lenders do not require a licence, making Spain an easily accessible market.

However, direct lenders may not be able to avail themselves of certain security instruments (such as financial collateral and floating mortgages (“hipotecas de máximo”) which has called for sophisticated lending counsel to provide creative workarounds, that are used by direct lenders frequently today.

## Spanish and English law

International lenders can use English law and English courts as the governing law and forum applicable to loan agreements for Spanish borrowers. So strong is the English influence that financing documentation based on the LMA forms have also become a cornerstone in financing transactions subject to Spanish law. This convergence has allowed sponsors and direct lenders to easily translate commonly understood provisions and driven significant transactional efficiency, also helping to increase and diversify the nature of direct lenders in the Spanish market.

Strong and enforceable collateral is a major concern for any financier. As Spanish practice has shown, Spanish borrowers will often grant

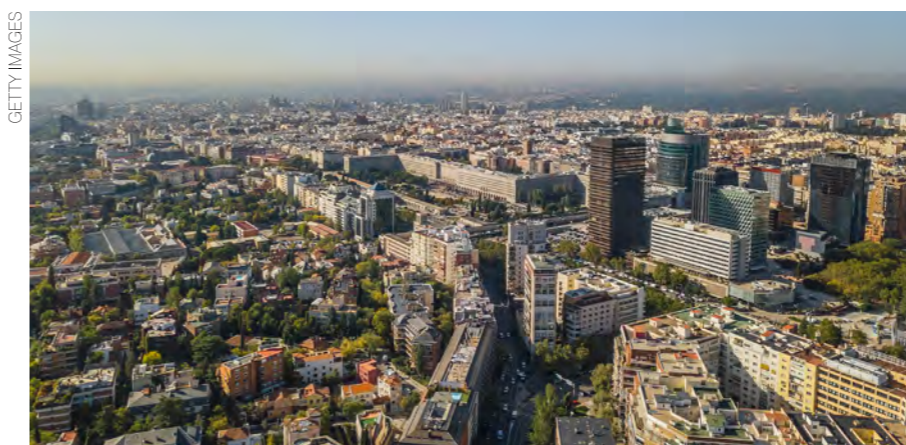
full security packages in favour of their lenders and Spain represents a safe jurisdiction for direct lenders.

Creditors’ interests will be sufficiently covered by extensive Spanish collateral whose enforceability through judicial and out-of-court procedures is widely recognised in law and use of LMA documentation will bolster lender protections further, particularly through access to the English law restructuring toolkit.

In case of limitations of the Spanish framework and to accelerate lenders’ recovery in the case of borrower default, lenders can also choose to implement complementary structures. Well-known double Luxcos allowing a single point of enforcement in a similarly well-known forum can enhance the overall security package; this approach is not uncommon in Spanish law direct lending transactions, giving access to the appropriation of shares as financial collateral. There are also other security enhancement structures utilised, such as dematerialisation of Spanish shares, call options and warrants.

In all cases, security improvement mechanisms do not generally operate as a replacement for Spanish security interests. Even if a double Luxcos security setup provides the lenders with a potentially more expedient route to enforcement and a well-known forum, strong Spanish security interests are

# debt investors in Spain



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still advisable to effectively capture key assets and ensure priority secured status over such assets.

## Insolvency issues

The formal insolvency of a Spanish borrower triggers certain legal risks, such as the stay of enforcement actions and the potential claw-back of the security interests granted by the insolvent debtor.

However, these dynamics have led to a surge of legal engineering and creativity in the

search for strategies and workarounds. For example, the double Luxcos structure referenced above has proven to be a good workaround to ensure a more predictable outcome around insolvency, facilitating early step-in rights and, as the new controlling shareholder, management of the debtor’s turnaround without any time-driven diminution in value.

Direct lenders have a strong position in Spain given the attractiveness and accessibility of the Spanish market. Spanish law allows for solid and enforceable security interests which, coupled with instruments and struc-

tures (often involving English documentation and other creditor-friendly jurisdictional aspects), enhances lender protections and helps to maximise remoteness from Spanish insolvency risks.

Financings in Spain have been available to direct lenders for some time, but the market is seeing an increase in their prominence, matching the wider global landscape. As a jurisdiction that has not yet seen the growth seen in the US or the UK, it is only a matter of time before the Spanish direct lending market takes on increased investment. That investment will then likely drive even further improvements in the Spanish legal framework to facilitate the influx of capital and the growth of business.

While international investors seeking to enter the Spanish market should be aware of the legal issues that must be dealt with appropriately, they should similarly be aware that experienced advisers – particularly those familiar with cross-border financing matters – can effectively structure and document local Spanish direct lending transactions.

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# Dark clouds of recession build for private equity-owned businesses

Markus Lahrkamp

Just as it seemed that global supply chain disruptions were easing, Russia’s invasion of Ukraine has now destabilised conditions for private equity-owned companies around the globe. I’m sorry to say this, but the environment is likely going to take a turn for the worse before it gets better.

In addition to squeezing oil supplies, the war is impacting shipments of grains and fertilizers, critical metals, chemicals and gases, adding pressure to rising global inflation.

The timing is unfortunate. Clouds that were gathering in 2021, even as global buyout deal value and exits soared to record highs, are getting darker.

Together, Russia and Ukraine account for about 30% of the world’s barley exports, 25% of wheat exports and 16% of corn exports, a major feedstock for beef production.

Ukraine is a major supplier of roughly half the world’s semiconductor-grade neon, critical for computer-chip production, and is home to some significant uranium mines. It’s hard to underestimate how important Ukraine is for certain sectors of the global economy.

And that’s just the war. Other storm clouds are gathering.

## The pile-on effect

While we expected interest rates to rise globally, we didn’t necessarily expect the US Federal Reserve to project six additional rate hikes this year – including 50-basis-point increases. In the EU, European Central Bank governing council member Klaas Knot surprised markets when he said in May that possible worsening inflation could require a half-point interest rate hike. Also in May, the Bank of England boosted rates to a 13-year

high. Another surprise was China’s January rate cut to offset its slowing growth rate. These developments raise the possibility of an economic downturn, even a recession, this year or next.

Borrowing costs, which had been cheap for many years, are rising as interest rates increase. Lenders in the private equity market, now primarily hedge funds, will not let borrowers lock in current rates before they rise further. Borrowers will get adjustable rates no matter what, and private equity will have to adjust.

Until recently, companies have been able to pass on higher prices. But slowing

economic growth could make that more difficult. Additionally, it could cause a sudden decline in companies’ values.

I’m not convinced most PE firms have fully embraced or prepared for a likely slowdown. But I’m seeing some signs they’re starting to think about it. Deals have slowed. I suspect some dealmakers are starting to think twice about valuations as the prices of some transactions done over the past 12 months may start to look high.

## Risks and opportunities

Manufacturers of capital goods and commodity producers, including oil and gas and chemical manufacturers, could be especially hard hit if a downturn in 2022 or 2023 causes investments in capital-intensive industries to decline. But there could be more interest among private equity dealmakers and operating partners in service-oriented businesses. During the 2008-2009 financial crisis, deals in service-oriented businesses did well even as capital intensive industry deals were hammered.

Are PE firms and their portfolio company management teams ready for the coming

storm? Overall, I don’t think we’ll see a repeat of what happened during the Great Recession, but I do worry about the PE industry having enough capacity to deal with inflation or debt restructuring. A lot of PE deal teams have never experienced an entire business cycle with the volatility we are facing now. Running out of cash or breaking covenants (if they exist) is a hypothetical construct for a lot of deal teams. They’ve never managed through a period of rising inflation.

## Adjustments to make now

No matter their level of experience, PE deal partners, operating partners and officers of portfolio companies should take a step back. They should scrutinise every item on their P&L and balance sheets statements, as well as their products, channels and customers and cost positions. No expense is too small to examine, whether it’s materials, labour, overhead, transportation, or back office.

In many cases, immediate actions may be appropriate to prepare for a likely downturn. Consider tactical margin or price improvements, short-term sourcing opportunities, general cost take-out in

specific non-value add areas.

In general, stay away from growth initiatives now unless there is a clear short-term payback.

Balance sheets need to be shored up as quickly as possible, collect account receivables and dispose of excess inventory. Jettison anything that’s not profitable.

The most important topic is that PE and their portfolio companies need to understand the amount of cash/ liquidity they have on hand, and their cash flows going forward. Is the company able to cover leverage costs as rates rise? Is there a “war chest” that can sustain a prolonged downturn, or even be used to pick up market share when other companies fail.

We are, or will be, in a transition period shortly. The dealmaking environment is coming off an exuberant high; companies’ top-line and bottom-line growth is about to be sorely challenged.

The clouds are here, they’re getting darker, and are about to open.

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