

A nighttime photograph of the London skyline. The London Eye is prominent on the left, illuminated with a pinkish light. In the center, Big Ben and the Houses of Parliament are brightly lit. The River Thames flows in the foreground, with light trails from boats creating streaks of white and red. The sky is dark with some clouds.

TRAVERS SMITH

Calling the shots:

the evolution of
European PE funding

 DEBTWIRE

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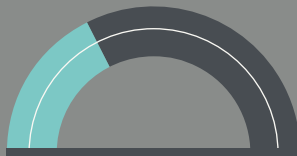
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Key findings



65%

Alternative debt instruments accounted for two-thirds of PE financing in the past 12 months



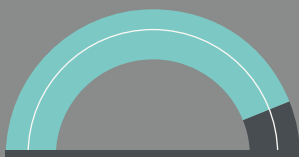
35%

Traditional bank debt amounted to just over a third of PE funding in the past 12 months - a significant shift from the pre-crisis days



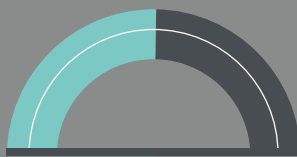
21%

Mezzanine financing is on the way back. Over a fifth of respondents see it playing a greater part in deals in the next 12 months



88%

Unsecured high yield bonds will become more expensive in the next 12 months, according to most respondents



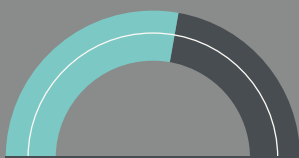
51%

More than half of respondents expect an **increase in leverage** in deals they do over the next 12 months



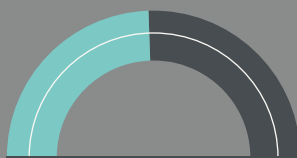
60%

of loans over the past 12 months were either **cov-lite or cov-loose**



56%

Flexibility for M&A was the top consideration for debt packages arranged over the past 12 months



49%

Pricing (margin and fees) and flexibility for M&A are joint top considerations for the next 12 months - chosen by nearly half of respondents



26%

of respondents chose **obtaining an appropriate rating** as the biggest challenge when arranging finance in the next 12 months

From famine to feast

The last few years have witnessed a transformation of the European debt landscape. In a short space of time, what was once a bank debt-dominated market has become a highly diverse and dynamic environment.

A pause in bank lending following the global financial crisis, coupled with a low interest rate environment, encouraged not only the entry of new debt funds, but also a growth in appetite among investors for high yield bonds. In addition, there was the development of new products such as unitranche and an increased willingness among issuers to consider options such as private placement.

The result is that debt famine has turned to feast: private equity sponsors now have a wealth of choice when it comes to financing their deals. As our survey shows, just 35% of acquisition finance was sourced from bank-arranged transactions over the last 12 months, with direct lending, unitranche, private placements and high yield bonds clearly taking market share.

With so much liquidity in the debt markets, and a range of options from which to choose, competition is also leading to highly favourable terms for sponsors. Cov-lite or cov-loose is becoming widespread at the upper-mid and larger end of the deal spectrum and sponsors are seeking increasing flexibility in the packages they put in place. Non-amortising tranches in particular have risen in prominence, enabling sponsors to focus on investing cash flow in portfolio company growth rather than servicing debt repayments.



Matthew Ayre
Head of finance, Travers Smith

Our survey also highlights that flexibility to make add-on acquisitions is now top of the priority list when securing finance. European M&A activity has picked up over the last year and competition is fierce for high-quality assets. This, together with buoyant stock markets, has driven up valuations. Private equity sponsors are therefore seeking to pursue buy and build strategies with their portfolio companies in a bid to create value, reach new markets and turbo-charge growth.

The intense competition in lending, together with the increase in valuations, is inevitably leading to higher leverage ratios: while the norm is between 3 and 4, a significant proportion of respondents to our survey point to averages of 4.5 and above, and over 50% believe that ratios will increase over the coming 12 months.

In the midst of this generally benign environment, respondents see the introduction of new European rating regulations as the top challenge to overcome, with many of those surveyed pointing to the inflexibility and stringency of the new requirements.

Overall, the results of the survey underscore just how rapidly the market has evolved – and continues to evolve – with sponsors taking full advantage of the attractive terms and pricing on offer. With the favourable interest rate environment and an improving macroeconomic outlook, there seems little prospect of liquidity abating in the near term. Bank lenders are now attempting to claw back market share, while alternative debt providers are building theirs. The increase in debt options and the improved terms available are allowing sponsors to achieve highly-tailored credit solutions for their portfolio companies.



Split decisions

Private equity is shifting towards alternative financing and away from traditional bank funding

Mezzanine-style products, unitranche and senior secure high yield bonds are predicted to be the types of debt with the largest proportionate increase in the next 12 months

Flexibility, availability and lower restrictions are the key advantages to the various alternative funding models

PE firms are shifting towards non-amortising debt

Leverage ratios are on the rise



Chapter 1

Increased funding options for private equity firms are driving a shift in debt structures and increased leverage

Now, more than ever before, private equity houses have a plethora of choice when it comes to acquisition finance. Where, just a few years ago, the European market was dominated by bank lending, the emergence of new sources of funding in the wake of regulatory pressures on financial institutions has provided private equity with genuinely competitive alternatives. A recent European Investment Fund report found that bank lending in Europe was close to 80% of company finance between 2002 and 2008; between 2008 and 2014 this had fallen to just over 50%.

“The big trend in leveraged finance has been the growth of non-bank lending for transactions,” says Matthew Ayre, head of finance at Travers Smith. “The arrival of debt funds and other alternative sources of finance has changed the European landscape. While banks have seen the need to refine and tailor their products to win back market share, this is also leading the non-bank lenders to reassess their offerings. What we have today is a dynamic and liquid market.”

This rapid evolution of the European debt market comes across loud and clear in our survey results. Over the last 12 months, bank debt accounted for an average of 35% of acquisition finance. This remains the largest single type of debt and, as our results show, the cheapest by some margin, with an average interest rate of 5.4%. However, this is a significant shift from the pre-crisis days, when banks typically provided between 80% and 90% of the finance for a deal and demonstrates that pricing is not always the most important consideration for private equity firms seeking debt packages in today’s market.

“Banks have been feeling the pressure based on new regulatory guidelines,” said a partner in a mid-market German firm. “With their lower cost of funds, banks can still compete on pricing but regulatory pressure has added to the attractiveness of other forms of lending.”



Split decisions

■ BEYOND THE BANKS

Senior secured high yield bonds provided nearly a fifth (19%) of finance on average, reflecting the buoyant market seen in Europe. “Senior high yield bond investors are eager to lend and this is making it easier to get financing at more favourable terms,” said a Norway-based managing partner. This is despite the fact that this remains a more expensive option than bank finance. The average interest rate for all respondents was 8.7%, with larger deals (over €1.5bn) paying the highest rate, at 9.3%.

Direct lending and unitranche accounted for 23% of acquisition finance, underscoring the growing importance of debt funds in the European market. In terms of interest rates, direct lending was most expensive at the smaller end of the deal spectrum (less than €250m), at an average of 9.1%, and cheapest for the mid-range of €250m to €1.5bn, at 8.1%. However, for some firms, direct lenders’ flexibility and the quantum they can offer offset the higher cost compared with bank lending.

“Direct lenders are making use of the current financial climate,” commented a UK-based mid-market managing partner. “As bank lending is not available to the extent that is demanded, direct lenders are building a position as preferred lenders. These loans come with higher interest rates but offer the benefit of greater availability and flexibility.”

As for unitranche, the efficiency of execution is a big attraction of private equity firms and this compensates for its higher interest rate (averaging at 9.3%).

“Unitranche is attractive because of the accelerated credit approval processes,” revealed the managing director of a German firm. For more on unitranche, turn to page 18.

Private placement, a form of bond finance that has seen rapid growth over recent years among European companies, accounted for 13%. This was significantly cheaper for mid-sized to large deals, with average interest rates of 8.5%, than for smaller deals, which averaged rates of 9.6%. The popularity of this type of finance is evidenced by the estimated €30bn to €35bn of private placement raised by Europe-based companies in

2014 according to M&G Investments, putting it on a par with the UK’s sterling bond market, where £24bn (€32bn) of bonds were priced last year.

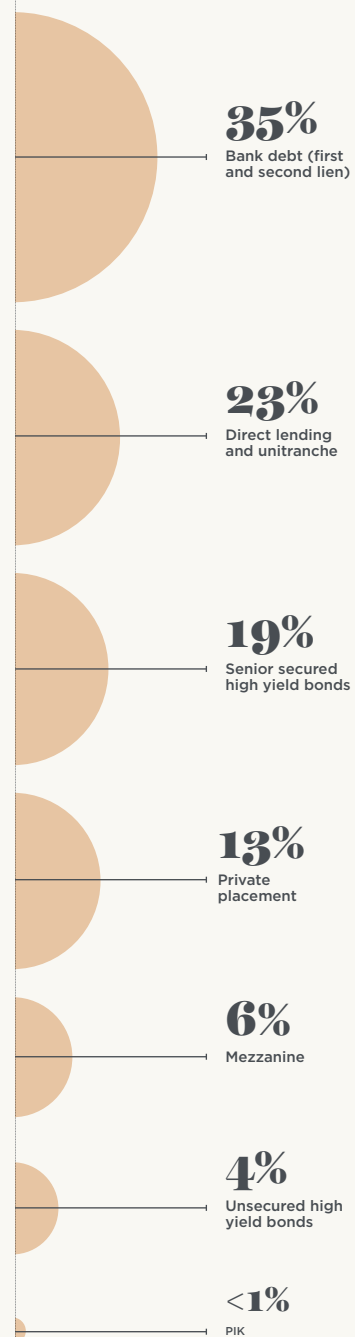
Mezzanine accounted for 6% of acquisition finance and is regaining traction in the market. The lower impact on leverage is proving to be a draw.

One respondent, a Sweden-based partner in a firm targeting the smaller end of the market, said: “Mezzanine financing is attractive because if a business can’t make timely cash payments, they can exchange funds for stock. Mezzanine financing is also treated like equity on a company’s balance sheet which means that other traditional financing is easier to obtain.”

“The arrival of debt funds and other alternative sources has changed the landscape in Europe. While banks have recognised the need to refine and tailor their products to win back market share, this is also leading the non-bank lenders to reassess their offerings. What we have today is a highly dynamic market.”

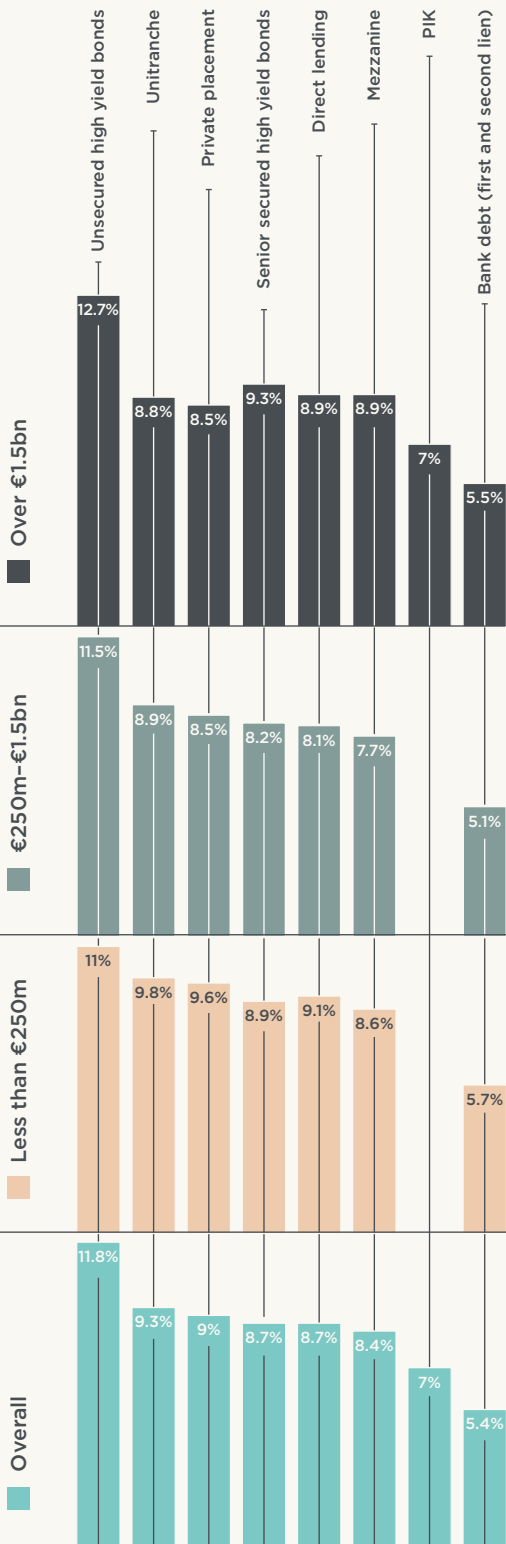
Matthew Ayre,
head of finance,
Travers Smith

FOR THE DEALS IN WHICH YOU WERE INVOLVED OVER THE LAST 12 MONTHS, WHAT PROPORTION OF FINANCE WAS OBTAINED USING THE FOLLOWING INSTRUMENTS?*



* average proportion across portfolio of deals closed in last 12 months

WHAT WAS THE AVERAGE INTEREST RATE FOR EACH INSTRUMENT USED?



5.4%

Bank debt was by far the cheapest form of finance over the past 12 months, with an average interest rate of 5.4% across all deal sizes

11.8%

Unsecured high yield bonds were the most expensive instrument with an average interest rate of 11.8% across all deal sizes

FLEXIBILITY DRIVES FUTURE FUNDING

Over the last year, banks' attempts to find ways of competing with alternative funding sources, particularly with regard to pricing and flexibility, have not gone unnoticed by private equity houses. While there is unlikely to be a major increase in the use of bank debt over the next 12 months, (in our survey, 23% of respondents expect to increase their use of bank debt while 19% expect to use a lower proportion giving a net score of 4%), the fact that banks have stemmed the erosion of their market share may suggest a turning point. As one France-based director in a small firm said: "Banks have been showing more interest in providing debt with convenient terms. The availability is increasing and we will definitely consider this in the deals to be carried out in the coming months."

When it comes to other forms of financing, there looks set to be some significant shifts over the coming year, according to our survey results. Private equity sponsors are expecting to use mezzanine and unitranche far more extensively over the next 12 months. Part of this shift may be driven by an expectation of lower pricing in these areas. However, our responses show that, as for the past 12 months, pricing will only form part of the decision about which type of debt funding to use.

“Banks have been showing more interest in providing debt with convenient terms. The availability is increasing and we will definitely consider this in the deals to be carried out in the coming months.”

Director,
France



Split decisions

MAKING THE CHOICE

1 MEZZANINE: FLEXIBILITY AND LOW COST

Mezzanine, a part of the market that for many years has lagged behind in the popularity stakes, is set for a comeback, with a positive net score of 21%. Donald Lowe, finance partner at Travers Smith, notes: “Although traditional mezzanine has become something of a rare beast, the mezzanine houses have continued to find other ways of working with sponsors such as being part of the unitranche offering.”

The flexibility mezzanine funds are offering is proving attractive to sponsors. As one UK-based partner in a large firm comments: “Mezzanine-style financing is growing in popularity. It has proven to be a vital source of flexible, long-term capital and it is less expensive than some other forms of financing.”

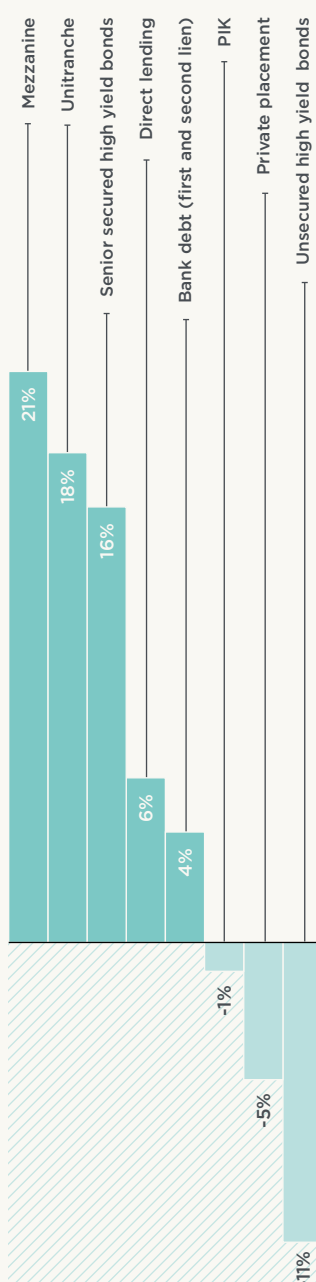
In addition, respondents also mention the tax advantages that mezzanine financing can offer. “Mezzanine funds offer low cost to capital with less equity dilution and mean that our funds can target higher returns,” said the investment director of a Norway-based firm. “There are also various tax benefits on using mezzanine funds and that is why we are considering higher mezzanine debt in the next 12 months.”

“Mezzanine houses have continued to find ways of working with sponsors such as being part of the unitranche offering.”

Donald Lowe, finance partner
Travers Smith

DO YOU EXPECT THE PROPORTION OF EACH INSTRUMENT TO BE ANY DIFFERENT IN THE DEALS YOU CARRY OUT OVER THE NEXT 12 MONTHS?

Showing net percentage (percentage saying higher minus percentage saying lower)



“With unitranche financing, we face fewer barriers to financing and it is also known to speed up the deal process – it will soon be a preference for us for all acquisitions.”

Managing partner,
UK

2 UNITRANCHE: SPEED AND ROOM TO MANOEUVRE

Unitranche is also set for continued growth. Our survey shows a net score of 18% of respondents looking to increase their use of this form of finance over the next 12 months. The speed with which this type of debt can be arranged, plus the flexibility to make further acquisitions, are some of the drivers for growth in unitranche.

“The main obstacle businesses face is with documentation for loan approvals. With unitranche financing, we face fewer barriers to financing and it is also known to speed up the deal process. It will soon be a preference for us for all acquisitions,” said a UK-based managing partner in the mid-market.

The director of a PE fund based in Germany added: “Using unitranche financing also increases our ability to make add-on acquisitions, so there are more opportunities for increasing performance.”

3 SENIOR SECURED HIGH YIELD BONDS: FLEXIBILITY AND FAVOURABLE TERMS

Despite an expectation of higher pricing over the coming year, senior secured high yield bonds scored a net score of 16% among respondents, the third highest percentage. This is largely down to the flexibility in terms it offers sponsors, featuring bullet maturities and less restrictive covenants than some other forms of finance, such as bank loans.

“Senior secured high yield bonds will be sourced for our future transactions as they offer low volatility and less pressure on the management due to the flexible terms,” commented an investment director in Germany.

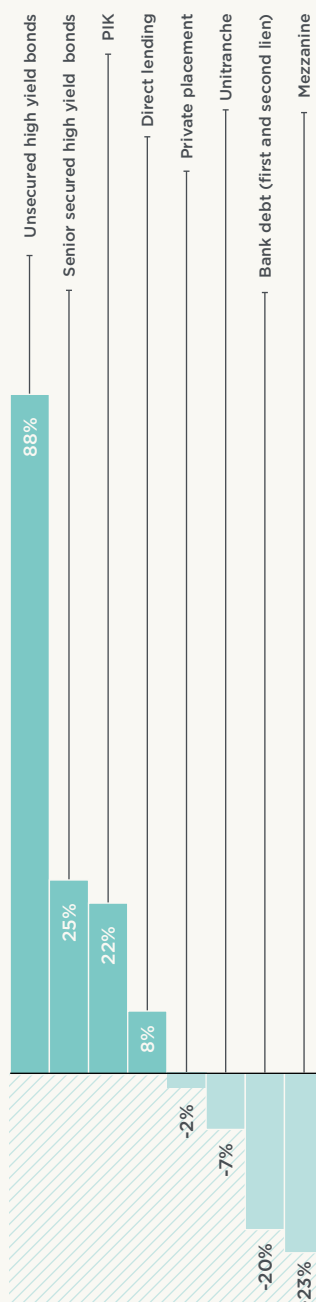
With competitive pressures still a major factor in the European market, together with investors’ search for yield leading to high availability of capital, there is an expectation that even if pricing increases, other terms may loosen further.

“Senior secured high yield bonds will be sourced for our future transactions as they offer low volatility and less pressure on management due to the flexible terms.”

Investment director,
Germany

DO YOU EXPECT FUNDING FROM EACH SOURCE TO BE MORE OR LESS EXPENSIVE OVER THE NEXT 12 MONTHS?

Showing net percentage (percentage saying more expensive, minus percentage saying less expensive)



“Direct lending plays a bigger role in the European loan market as demand for the product remains very strong.”

Partner,
Denmark

4 DIRECT LENDING: AVAILABLE AND LESS RESTRICTIVE

While the use of direct lending was not expected to increase markedly (it had a net score of 6%), our responses do show quite how far the market has swung in its favour, to the detriment of the banks.

“Direct lending plays a bigger role in the European loan market as demand for the product remains very strong,” said a Denmark-based partner (€750m–€1.5bn). “Even though the banks have started to improve their lending activity it is unlikely that we will approach them as they still face huge regulatory and legal challenges and therefore the weakened covenants from direct lending and other alternate sources of funding will gain more importance.”



INSIDE TRACK

High levels of competition between the different types of finance - and indeed between the different finance providers - are creating a dynamic environment, where private equity sponsors are increasingly able to tailor their packages according to the characteristics of the portfolio company.



Split decisions

■ HOLDING YOUR INTEREST

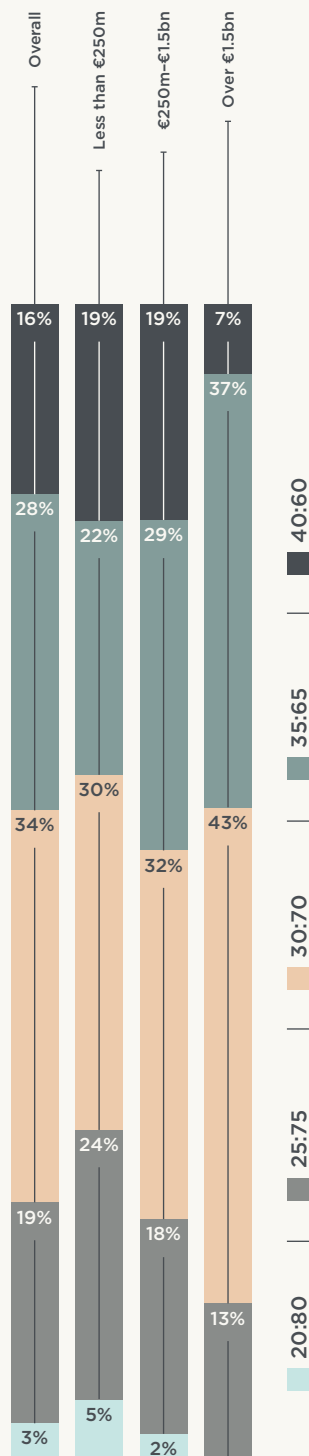
With the increasing variety of products on offer in the European market, private equity sponsors are now seeking debt funding that gives them greater flexibility to re-invest cash flow in the businesses they back rather than using capital to service debt repayments. Non-amortising debt, a feature of unitranche, high yield bonds and many forms of direct lending, is becoming an increasing part of financing deals, despite its higher cost. “Interest rates are high when it comes to non-amortising debt but the flexibility of the long-term duration provides real benefits to dealmakers,” commented a UK-based partner in the large deals space.

This is shown clearly by the responses to our survey. Over two-fifths (41%) of respondents said they expected to increase the proportion of non-amortising debt in their deals over the next 12 months. This feature is particularly important for sponsors at a time when entry valuations are high as it allows them breathing space to focus on growth by investing in capex and making bolt-on acquisitions. “We are trying to reduce the monthly payments on our lending and an increase in non-amortising debt will allow us to achieve this,” explained a Germany-based managing director. “We can then use the excess capital to fund investment that will enhance our returns.”

Just over a third of respondents said they expected the proportion of non-amortising debt to remain the same over the coming year. Yet our survey also shows that the proportion is already high. Banks are having to find ways of competing with the newer alternative sources of debt, and one of the ways they are doing this is by offering more bullet-style repayment schedules via Term Loan B (TLB). A 30:70 split of amortising to non-amortising debt is now the norm in bank debt loans, with 34% of all respondents quoting this as the average ratio and 43% of sponsors targeting larger deals saying this.

“Banks are having to work hard through the products and terms they can offer to be more competitive,” says Matthew Ayre, Head of finance at Travers Smith. “They are being encouraged by sponsors to lessen the debt service burden on sponsor-backed deals and so, for the right credit, there is a definite shift to non-amortising TLB structures and this will continue. For some deals, it’s possible to achieve 100% TLB, although the size and credit has to be right.”

FOR THE BANK DEBT LOANS, WHAT WAS THE AVERAGE TLA (AMORTISING) VERSUS TLB (NON-AMORTISING) SPLIT?

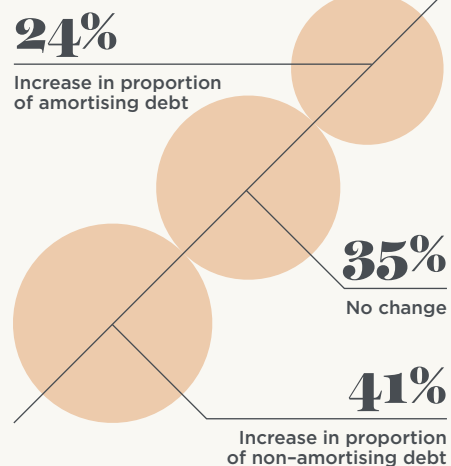


In addition to the bullet-style repayment schedule, TLBs generally* also offer sponsors the benefit of being able to pay back the loan before it is due. This is unlike some high yield bonds, for example, which can impose significant penalties in the event of pre-payment. As one UK-based managing partner said: “Term loan Bs have limited call protection and allow us to benefit from the greater flexibility to pre-pay. This is very important for us.”

INSIDE TRACK

The split between amortising and non-amortising debt is probably reaching its peak - while it is possible to go higher than the more usual 30:70 split, as the survey shows, anything above a 25:75 split is rare. Banks are keen to be accommodating to sponsors to win back market share, but they will want to see some element of amortising debt in the structures they agree to unless a TLB structure works for the relevant credit.

DO YOU EXPECT THIS SPLIT TO CHANGE IN THE DEALS YOU DO OVER THE NEXT 12 MONTHS?



* Certain TLB structures marketed at institutional funds in particular have bond-like call protection (albeit with shorter NC periods).

LEVERAGE RISING

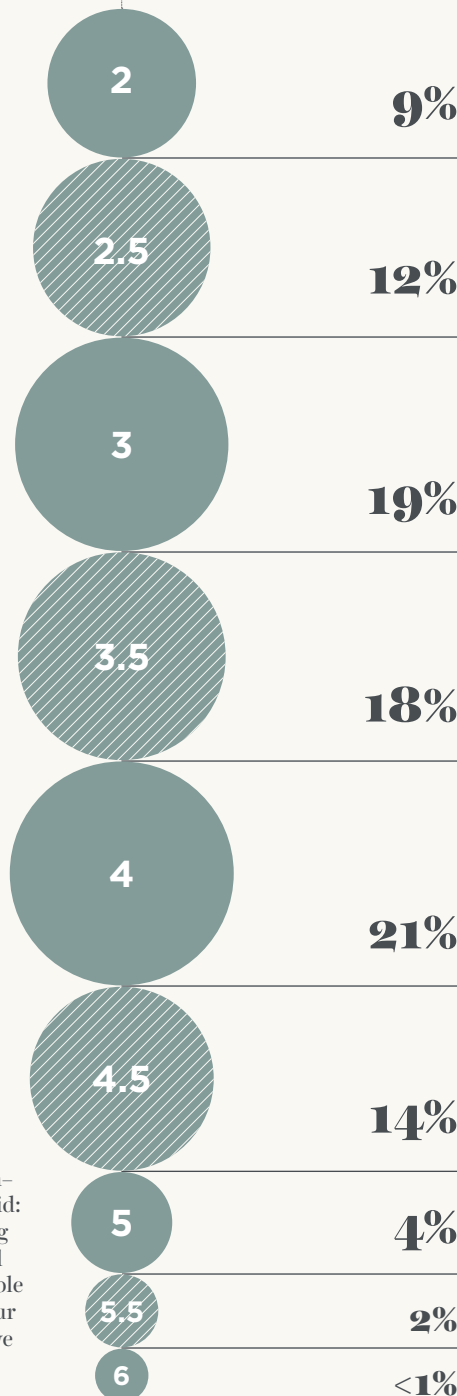
With so much competition in the European debt market, leverage ratios are inevitably creeping upwards. The most common average leverage ratio in deals over the last 12 months was between 3 and 4, with 58% of respondents citing this. However, there was a substantial proportion of respondents (around 20%) who said the average ratio in the deals with which they were involved was 4.5 or above.

This is a trend that looks set to continue, with 51% of respondents expecting to increase the leverage ratios in the deals they complete over the next year, including 5% who expect a significant increase. “Leverage ratios for our deals are likely to increase as banks now offer funds at competitive rates, while there is also an increased availability of options in financing,” said a Sweden-based managing director.

And part of the rise in leverage ratios will be driven by a change in stance as banks try to remain competitive. “Bank credit committees are having to recalibrate their attitude to risk to keep up with the market. For the right credit, banks will be able to stretch the terms they are willing to offer,” says Matthew Ayre, Head of finance, Travers Smith.

Sponsors are also showing a sense of increased optimism about deal opportunities over the next year, possibly as a result of an improved economic outlook in the region. This is leading them to be more confident about raising the amount of debt they use to finance deals in the next 12 months. One respondent, a Sweden-based partner in a smaller fund, said: “We see great opportunities coming up within our domestic market and the debt markets are more favourable so the average leverage ratios for our deals will increase moderately as we are willing to make the most of the available opportunities.”

WHAT WAS THE AVERAGE LEVERAGE RATIO OF THE DEALS WITH WHICH YOU WERE INVOLVED?

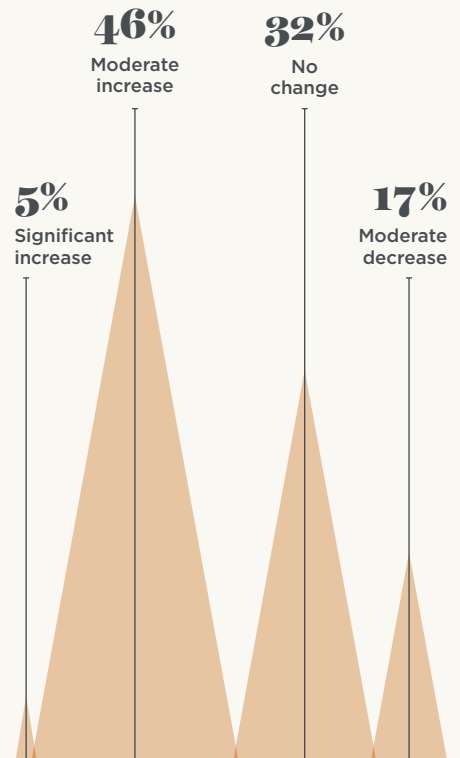


A Germany-based managing partner concurred with this view. “Leverage ratios will increase moderately as the opportunities that we see within our target region and industries have increased,” he said. “The availability of debt is also higher compared to the recent past.”

INSIDE TRACK

It is very likely that we will see an increase in leverage ratios in the next 12 months. The comments from most respondents bear this out, who cite five key drivers for the rise in leverage ratios: increased availability, favourable dealmaking conditions and more opportunities, market momentum, firms reducing equity and a less risk-averse mind set.

HOW DO YOU EXPECT LEVERAGE RATIOS FOR THE DEALS WITH WHICH YOU ARE INVOLVED TO CHANGE OVER THE NEXT 12 MONTHS?





Loosening the reins

Cov-lite and cov-loose loans are on the rise in the European market — particularly at the higher end of the deal spectrum

As banks respond to increased competition, covenant headroom is set to widen

Unitranche financing is on the rise, as respondents feel it offers more borrower-friendly terms than bank loans

Opinion is divided on whether restricted payment clauses will become more or less restrictive

Chapter 2

Increased competition means that cov-lite and cov-loose are taking hold in the European bank finance market

Faced with such intense competition from other sources of finance during the last few years, banks have had to regroup in recent times to determine how they can claw back, or at least retain, market share. As discussed, the move towards non-amortising debt has been one part of the evolution of bank-arranged debt finance, but possibly the most dramatic change has been in the availability of debt with more flexible, or even no, financial covenants. In the first quarter of 2015, more than 43% of European institutional leveraged loans were cov-lite, according to S&P Capital IQ LCD figures, worth a total of €5bn. This is on track to beat cov-lite volumes in 2014 – a record year – when €12bn of cov-lite leveraged loans were issued.

Our survey demonstrates this trend clearly. When asked about their deals involving bank debt over the last year, respondents said that nearly a quarter (24%) had only springing financial covenants rather than the more traditional maintenance financial covenants. A further 9% had neither springing nor maintenance financial covenants.

In addition, a large proportion (40%) of the deals that had maintenance financial covenants were completed with leverage and/or interest covenants only (otherwise known as cov-loose).



Loosening the reins

“The European debt market has matured quite rapidly over the last 12 to 18 months, in large part in response to the twin threats of buoyant US high yield bond and ‘yankee-loan’ markets”, says Donald Lowe, finance partner, Travers Smith. “We only really started to see the re-emergence of cov-lite as an established product in Europe in the first quarter of 2014 and mainly in opportunistic ‘best-efforts’ rather than fully underwritten deals. Yet in today’s market, most larger, highly liquid credits are either cov-lite or cov-loose. It has become the norm in Europe.” The market has moved substantially away from traditional covenant structures, with a total of 60% of bank-arranged loans being either cov-lite or cov-loose.

As a Denmark-based partner commented: “Banks are offering better lending terms in order to attract borrowers back to them. These borrowers were driven away when the banks were focused on building capital due to regulatory changes.” It’s a shift that is set to continue, with sponsors unsurprisingly supportive of the new environment. “We have seen changes in the banking industry’s appetite and vision, and I think the covenants on bank debt are set to be much weaker compared with the past,” said a Germany-based partner. “This has been evident in the way that the banks are raising their supply of finance to facilitate the growth of businesses.”

INSIDE TRACK

Cov-lite has become the market norm in Europe at the larger end of the deal spectrum very quickly and we may see this feature move down towards the less-liquid mid-market over the coming year. Nevertheless, the conditions have to be right and if sponsors are seeking cov-lite terms, they may need to be less aggressive on pricing and in pushing for other flexible terms such as controls on debt transfers.

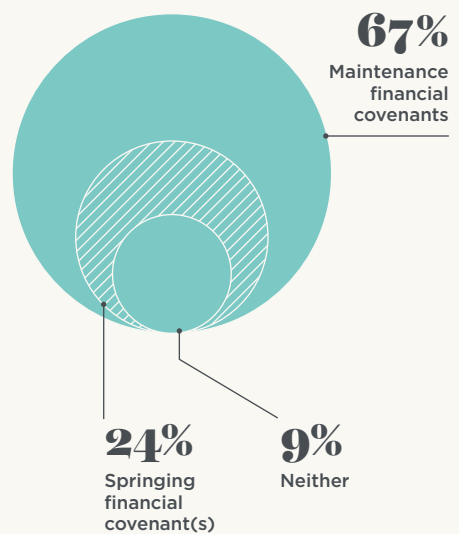
24%
Cov-lite

Just under a quarter of the loans agreed over the past 12 months had springing financial covenants rather than traditional maintenance covenants

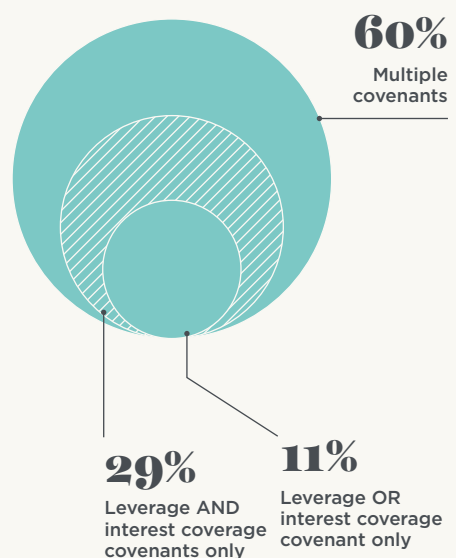
27%
Cov-loose

Of the 67% of loans that had traditional maintenance covenants, some 40% had only leverage and/or interest covenants, meaning that 27% of loans were agreed on a cov-loose basis

LOOKING AT THE BANK DEBT LOANS FOR EACH DEAL, HOW MANY OF THESE LOANS HAD MAINTENANCE FINANCIAL COVENANTS, HOW MANY HAD SPRINGING FINANCIAL COVENANTS AND HOW MANY HAD NEITHER?



FOR THE BANK DEBT LOANS THAT HAD MAINTENANCE FINANCIAL COVENANTS, HOW MANY HAD MULTIPLE COVENANTS, HOW MANY HAD LEVERAGE AND INTEREST COVERAGE COVENANTS ONLY AND HOW MANY HAD ONLY LEVERAGE OR AN INTEREST COVENANT?



MAX HEADROOM

For bank debt loans that had maintenance financial covenants, headroom was relatively generous. Nearly half (45%) of respondents said that the average headroom above base case was 21–30%.

Mid-market deals had the most headroom on average, with 49% of respondents in the €250m–€1.5bn category saying the average was 31–40%, while both larger and smaller deals had slightly tighter headroom.

This reflects the current state of the market, where the increased prevalence of cov-lite is mostly a large deal phenomenon.

“Cov-loose rather than full blown cov-lite structures are becoming a common feature of deals in the mid-market,” explains Donald Lowe, finance partner at Travers Smith. “Many deals will have only one or two covenants and sponsors are also pushing for increased headroom to give them more latitude in the event a business does not perform to plan.”

Nearly half (49%) of respondents expected headroom to widen over the next 12 months, while most other respondents (42%) expected it to remain at current levels. Less than a tenth of respondents expected headroom to tighten.

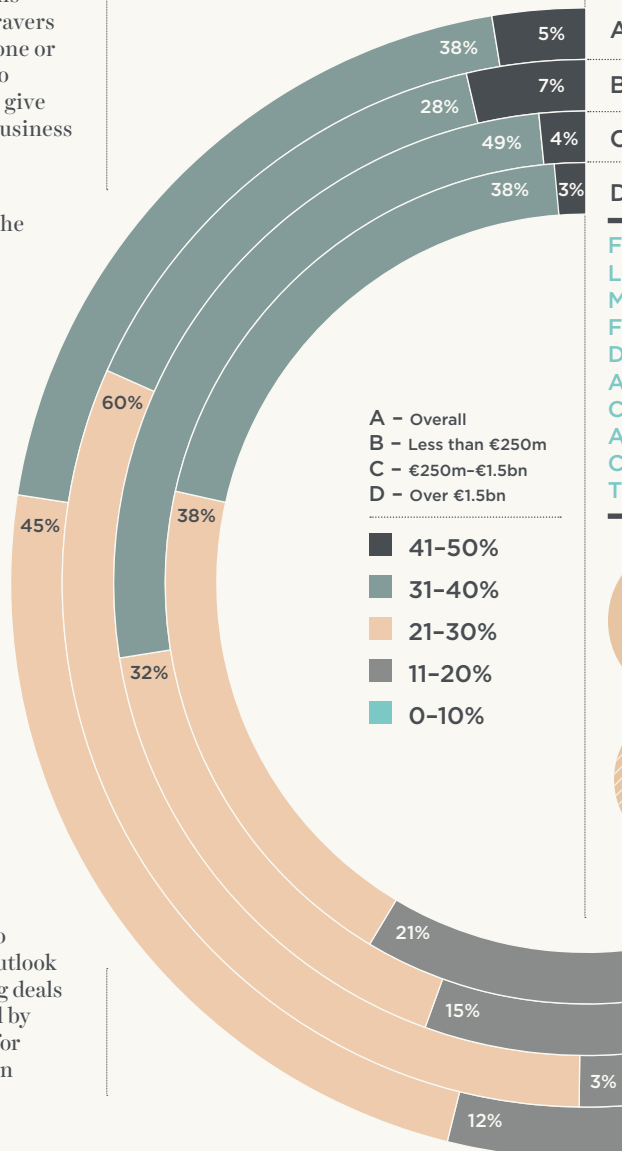
The main driver of this increase in headroom is clearly the banks’ response to increased competition from other, more flexible sources of finance. “Competition for lending is getting stronger and banks are now more eager to lend which is resulting in conditions on loans which are more relaxed,” said a Denmark-based partner.

“The average financial covenant headroom will get wider as banks are now keen to leverage the available opportunities,” added a Norway-based investment director. “They are pro-actively investing in riskier profiles to procure higher returns.”

Nevertheless, many respondents also pointed to the improved economic outlook and the good performance of existing deals (even where they have been financed by alternative lenders) as a key reason for banks to take a more bullish stance on

covenant headroom. One UK-based partner commented: “Lower chances of defaults and improving business conditions will positively influence debt providers and this will be reflected in the favourability of covenant headroom over the next 12 months.”

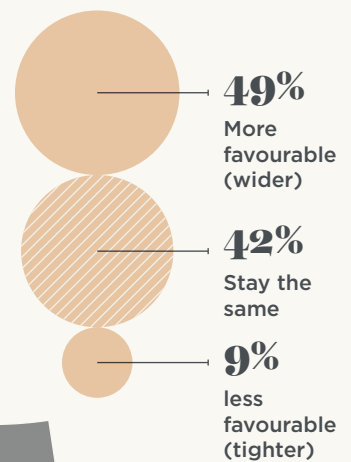
FOR THE BANK DEBT LOANS THAT HAD MAINTENANCE FINANCIAL COVENANTS, WHAT WAS THE AVERAGE FINANCIAL COVENANT HEADROOM ABOVE THE AGREED BASE CASE?



INSIDE TRACK

The creditor markets have regained their interests in European targets and have been rewarded with profitability in these portfolios. Banks now have more trust and confidence, so the average covenant headroom will be wider in the next 12 months.

FOR BANK DEBT LOANS THAT HAVE MAINTENANCE FINANCIAL COVENANTS, DO YOU EXPECT THE AVERAGE FINANCIAL COVENANT HEADROOM ABOVE THE AGREED BASE CASE TO CHANGE DURING THE NEXT 12 MONTHS?



Loosening the reins

UNITRANCHE ON THE RISE

As more players have entered the European market and sponsors have become more accustomed to the features of unitranche over recent years, so this form of finance is earning a sizeable place in the deal-funding spectrum. Indeed, our survey shows that 18% of respondents are looking to increase their use of this type of finance in the next 12 months (see page 10 for graph).

In addition to the efficiency of execution, many of those surveyed suggested that unitranche offered more borrower-friendly terms than traditional bank loans. “Unitranche lenders are still relatively new to the market and therefore keen to gain the attention of borrowers by offering minimal covenants,” said a partner in the UK. “The amount of headroom provided by unitranche lenders is slightly more than that of the banks and so they have gained a competitive edge in the lending market,” adds a France-based managing partner in the €750m–€1.5bn space.

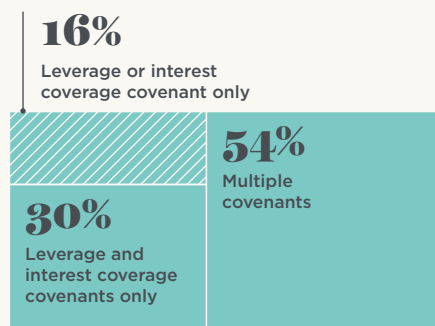
In our survey, 46% of facilities agreements had leverage and/or interest coverage covenants, while the remaining 54% had multiple covenants. Meanwhile, covenant headroom in unitranche loans was similar to that agreed with banks, with 50% of respondents saying that 21–30% above base case was the average. And while half expected headroom to remain the same over the next 12 months, a sizeable proportion (41%) said they anticipated it to broaden.

Given the similarity of responses for covenants and headroom across both bank loans and unitranche in our qualitative analysis, it may be that some sponsors’ views on banks have yet to catch up with where terms have moved to. This may reflect a legacy of discontent with bank lending among some private equity houses due to the retrenchment of financial institutions following the financial crisis, a view reflected in the comments from a Germany-based managing director. “The dependability of bank relationships has declined and therefore unitranche loans are providing increased value.”

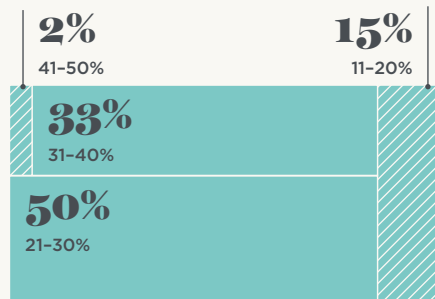
FOR EACH OF THE DEALS THAT YOU WERE INVOLVED IN, HOW MANY USED UNITRANCHE FINANCING?



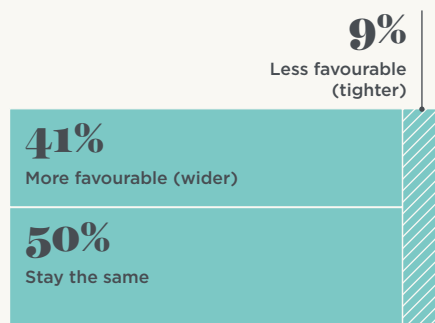
FOR SUCH UNITRANCHE LOANS, HOW MANY HAD MULTIPLE COVENANTS, HOW MANY HAD LEVERAGE AND INTEREST COVERAGE COVENANTS ONLY AND HOW MANY HAD ONLY A LEVERAGE OR AN INTEREST COVENANT?



FOR SUCH UNITRANCHE LOANS, WHAT WAS THE AVERAGE FINANCIAL COVENANT HEADROOM ABOVE THE AGREED BASE CASE?



FOR UNITRANCHE LOANS, DO YOU EXPECT THE AVERAGE FINANCIAL COVENANT HEADROOM ABOVE THE AGREED BASE CASE TO CHANGE DURING THE NEXT 12 MONTHS?



RESTRICTIONS NOT LIFTING

Restricted payment clauses are often the focus of intense negotiation between lenders and sponsors, but the reality is that little has moved in this area over recent times despite the shift towards looser terms in other areas.

Our survey shows that these clauses on deals completed over the last 12 months were generally seen as moderately restrictive for both loans (61% of respondents) and bonds (68% of respondents). However, on balance, the terms for bonds are a little looser than for loans.

As for the future movement on these restrictions, opinion was divided: 37% expected these clauses to become less restrictive, in line with a general loosening of terms, but 32% expected clauses to become more restrictive. A further 31% expected no change.

Of those that expected greater restriction, most suggested lenders were taking a more cautious approach, possibly the result of regulatory factors as well as concerns over how borrowers utilised their resources.

As one partner in Germany commented: “Regulatory concerns are rising and the banks are trying to stabilise their positions, this will impact their response towards restrictive payment clauses which will be more stringent in terms of conditions.”

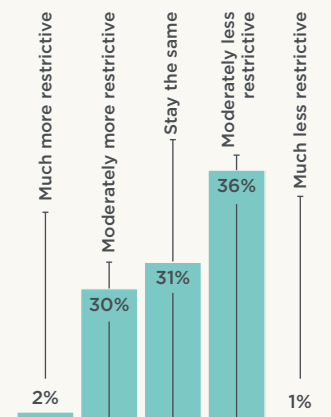
Yet respondents that anticipated a loosening of restrictions suggested that lenders would have greater confidence in their credits as a result of an improving economic outlook and that restrictive payment terms would follow the lead of other terms that have loosened over recent times. “Lending terms have got more liberal across the majority of Europe and this will be accompanied by restricted payment clauses getting less restrictive in the next 12 months,” said a managing director in Germany (€75m–€249m).



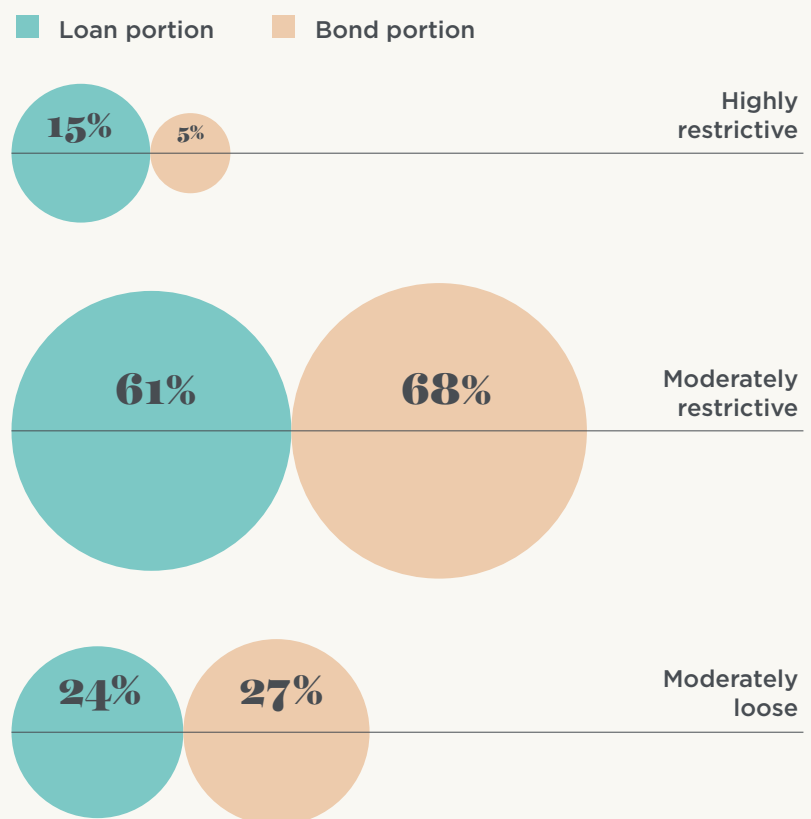
INSIDE TRACK

Restricted payment clauses should get moderately more restrictive as transparency has become the prime factor that lenders are looking at. While, for the right party, lending institutions may show flexibility on terms, on the whole, payment clauses are likely to get more restrictive.

DO YOU EXPECT RESTRICTED PAYMENT CLAUSES TO GET MORE OR LESS RESTRICTIVE IN THE NEXT 12 MONTHS?



HOW WOULD YOU DESCRIBE THE RESTRICTED PAYMENT CLAUSES FOR THE LOAN AND BOND FINANCINGS YOU HAVE IMPLEMENTED IN THE PAST 12 MONTHS?





Deals drive debt

Flexibility to do M&A has been and will be the most important consideration in debt package deals for PE firms

Despite challenges from high valuation and trade buyers, PE is very focused on deals and looking to generate returns through acquisitive growth

Pricing on debt packages will become a much greater consideration for PE firms in the next 12 months

In the next 12 months, PE firms believe that obtaining an appropriate rating will be the most significant challenge when arranging finance

Chapter 3

The flexibility to do future M&A is the top consideration when deciding on debt packages but there are concerns around changes to rating regulations

In a deal environment characterised by high levels of competition – from strategic and financial buyers, as well as buoyant public markets – entry multiples are rising. In the first quarter of this year, median buyout entry multiples stood at 10.4x EBITDA, an increase on the already elevated level of 10x in 2014 and dramatically higher than the 7.4x seen in 2009.

Private equity houses have to seek out ways of driving value addition through portfolio companies. One of the main ways they are doing this is through bolt-on acquisitions. In the second half of 2014, there were nearly 170 add-on deals made by European private equity firms, the highest level seen since 2011, according to a recent Silverfleet Capital/Mergermarket report.

“Although private equity houses face fierce competition from cash-rich trade buyers and public equity markets, they are, for now at least, maintaining their discipline on pricing and seeking to generate returns through acquisitive growth,” says Donald Lowe, finance partner, Travers Smith. “Over the last 12 months, we’ve seen private equity clients increasingly focussed on permitted acquisition terms in the documentation in order to protect their underlying investment case.”

■



Deals drive debt

■ M&A TOPS THE BILL

Our results reflect this trend clearly. Flexibility to do M&A was the top consideration for debt packages arranged over the past 12 months, chosen by 56% of respondents. This was followed by ability to incur additional debt, with 46% citing this as important in financing packages, again a measure designed to ensure that private equity houses have the option to use debt to acquire add-on businesses.

As one UK-based partner operating on larger deals commented: “Flexibility to conduct M&A with no interference during the deal flow is the most crucial aspect that we consider when deciding upon the debt package. We want to retain our independence in making decisions.”

This is a trend that shows no sign of abating. Flexibility to do M&A will also be the joint top priority for private equity houses over the next 12 months, with 49% of respondents citing this factor. “Bolt-on M&A deals are growing in significance and are likely to continue to deliver success thanks to improving the economic environment,” said a managing partner in Denmark.

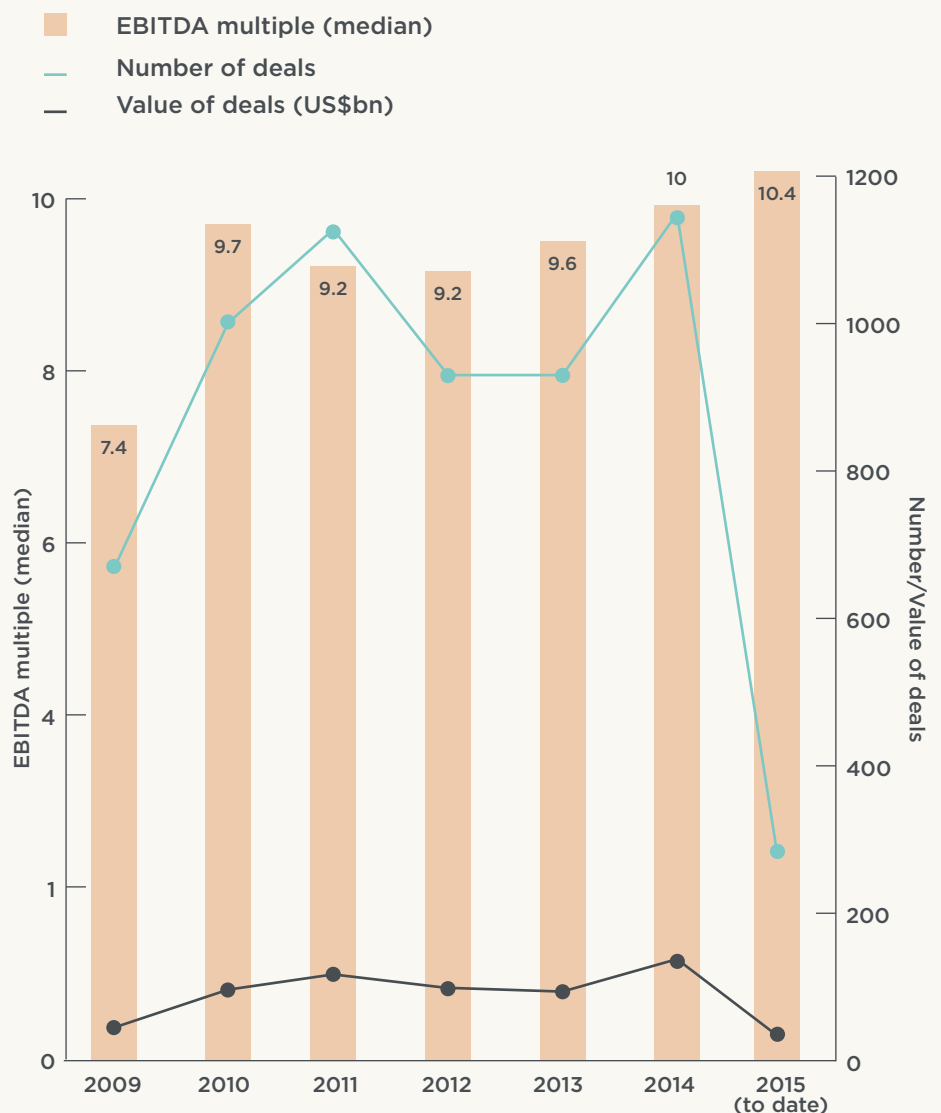
Numerous respondents echoed this sentiment, including a UK-based managing director: “Flexibility to do M&A and develop our growth strategy will be the most important factor,” he said. “We are constantly focusing on capitalising the available opportunities and leveraging the maximum benefits from deals.”

PRICING COMES INTO THE PICTURE

Interestingly, given the continued competition in the debt markets, pricing is becoming more of a factor in choosing a debt finance package for private equity. Indeed, pricing (margin and fees) moved from fourth most important over the past 12 months (with 41%) to joint first (with 49%) over the coming year. This may reflect the difficulty in making deals work with the recent boom in asset prices. “Controlling our debts and reducing pressure on the management due to the liabilities is our primary concern,” said a Norway-based partner. “So, when seeking financing we will prioritise the pricing, margin and fees of the debt package.”

Yet, it may be that sponsors are also expecting some movement on pricing, which has been relatively stable for some time now. “There is a lot of money out there and a lot of debt funds and banks vying for market share,” says Andrew Gregson, finance partner at Travers Smith. “For a while, pricing has been stuck at margins of around 4% for TLA and 4.5% for TLB so there may be some expectation that pricing will reduce. Nevertheless, the fact that there are so few decent targets in the market, while dry powder and debt availability are high, is likely to mean that leverage multiples will creep up possibly without pricing reducing.”

EUROPEAN BUYOUT VALUATION TRENDS



TRANSFER TARGETS

Another important area for private equity is the issue of debt transferability. This was the third most important factor over the last 12 months, with 41% of respondents citing this. It also occupies the third spot for the coming 12 months, with the same percentage rating this as important. While the newer entrants to the debt markets are now starting to build up track records, sponsors clearly remain concerned about how debt is traded and – importantly – who it is traded with. Having been through testing times in the past, they want to know who will be holding the paper in the event that a business does not perform to plan. “A crucial factor will be control on debt transferability as it is important to remain flexible at times when the debt pressures build up,” said a France-based partner.

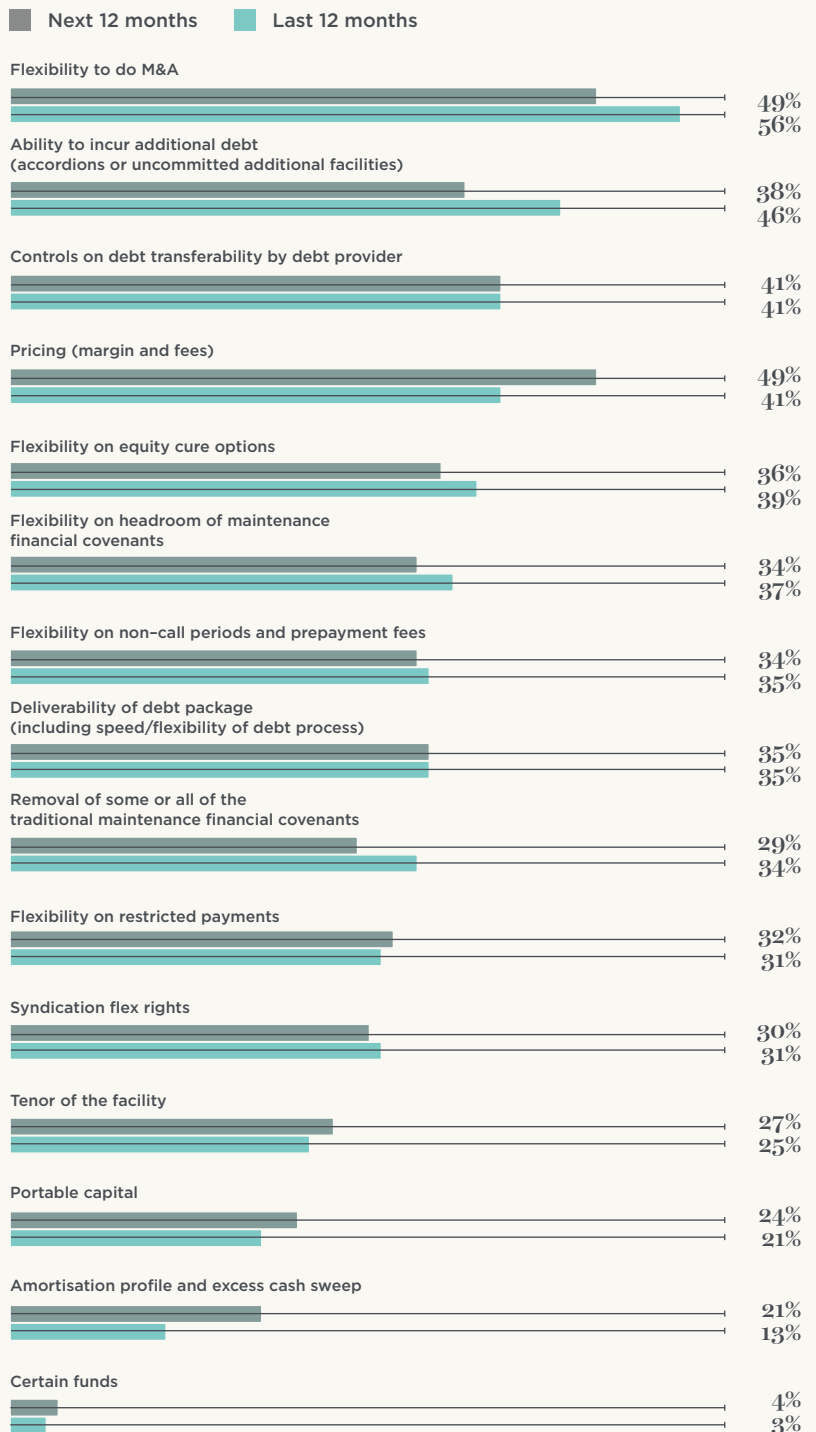
Another French respondent commented: “With controls on debt transferability, it is easier for us to consolidate amounts and work collectively to meet the needs of a single debt provider. This results in less complex situations and better performance on repayments.”



“Flexibility to conduct M&A with no interference during the deal flow is the most crucial aspect that we consider when deciding upon the debt package. We want to retain our independence in making decisions.”

Partner
UK

WHICH OF THE FOLLOWING WAS MOST IMPORTANT TO YOU IN THE DEBT PACKAGE FOR DEALS CARRIED OUT OVER THE LAST 12 MONTHS AND WHICH DO YOU SEE BEING THE MOST IMPORTANT OVER THE NEXT 12 MONTHS?



Deals drive debt

❑ RUEING THE RATINGS RULE

Over the last 12 months, the biggest challenges identified by private equity sponsors have centred around agreeing covenants (cited by 32% of respondents), finding funding sources (29%) and obtaining required leverage (27%).

Yet the next 12 months sees a very different set of challenges. The biggest concern relates to obtaining an appropriate rating, with 26% of respondents citing this as the biggest challenge.

Respondents gave a number of reasons why gaining an appropriate rating would become more difficult. These included stricter regulatory guidelines; heightened creditor expectations; the negative impact of past default rates; and the economic slowdown in Europe.

As one Germany-based managing partner commented: “Obtaining an accurate credit rating based on the actual cash-flows is difficult as the evaluation metrics have become more severe and it is difficult to manage all the possible complexions.”

Many are particularly worried about the potential inflexibility of creditors. An investment director in Finland also said: “Obtaining an appropriate rating and complying with the new guidelines set by the regulators will be challenging as the requirements are pretty rigid and I think we will have to work hard to get an appropriate credit rating.”

Agreeing covenants, meanwhile, is set to become far less of an issue for sponsors than last year. This challenge fell from first place to fourth. This perhaps reflects

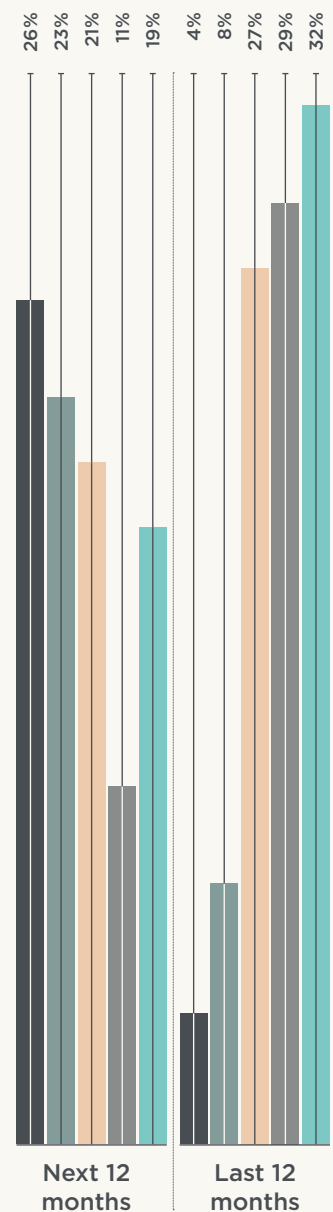
the easing of terms that increased competition has brought about.

However, allied to the responses to the question on what will be most important to sponsors over the coming 12 months, pricing moved up to second place (from fourth). This suggests private equity houses are anticipating a year during which it will be difficult to make their required returns on new deals, given the elevated asset prices that are resulting from increased competition among strategic buyers.

And perhaps unsurprisingly, given the wealth of choice now available to finance private equity deals, finding funding sources was seen as a challenge for just 11% of respondents.

WHAT WAS THE BIGGEST CHALLENGE FACED IN ARRANGING FINANCING OVER THE PAST 12 MONTHS?

- Obtaining appropriate rating
- Obtaining required pricing
- Obtaining required leverage
- Finding funding sources
- Agreeing covenants



26% of respondents cited obtaining an appropriate rating as the biggest challenge

Conclusion: Make your move

Our survey shows that the market is on a high, but there are five key points that sponsors and private equity-backed businesses should consider

The European debt market has never been so vibrant, offering private equity sponsors and their portfolio companies a veritable smorgasbord of different options. Our survey demonstrates that private equity is embracing this newly created choice with open arms, taking advantage of the flexibility, quantum, borrower-friendly terms and attractive pricing that is on offer.

This rapid development and continuing evolution, combined with longer term trends, suggests that the following five points will be highly relevant to private equity sponsors over the coming months and years:

1 GO BESPOKE

The market is already offering a high degree of tailoring of debt finance to sponsors'/portfolio companies' specific needs. However, as the market matures and debt finance becomes more diverse still, there will be an even greater choice, both in type of lender and type of debt package. With the number of debt funds proliferating in the European market, many will seek to differentiate themselves by providing specific advantages and pursuing individual strategies to generate their returns.

2 MID-MARKET MOVES FOR COV-LITE

Many of the cov-lite deals over the last 12 months have been driven by refinancings. With the number of refinancings now on the wane, cov-lite lenders will be looking at new areas to deploy funds. The number of deals at the upper end of the market seems unlikely to satisfy this demand and so cov-lite terms may well creep down the deal size spectrum.

3 COV-LITE FEVER

Cov-lite terms may have received a large share of the limelight, but there are many other flexible features and terms available in the debt market. Sponsors need to look very carefully at which terms are most suited to the needs of their portfolio companies and negotiate accordingly. "Cov-lite is not a zero sum game and there is a balance to be struck. There is little point in sponsors trying to push for it on the wrong credit or if they otherwise have to compromise on other key terms, for example flexibility to do M&A, that are fundamental to their investment case," says Donald Lowe, finance partner, Travers Smith.

4 STAY ON TREND

The fact that the market is changing at such a rapid pace means that sponsors may find themselves out of touch with new market developments very quickly. Firms will need to maintain contact with a wide variety of lenders on a regular basis or use debt advisors to make sure they get the best financing deal available for the transaction or portfolio company in question. "It's impossible for private equity houses to keep tabs on 40-50 debt funds when each fund may only be doing two or three deals a year," says Andrew Gregson, finance partner, Travers Smith. "More private equity houses will need to use debt advisors to maintain those contacts for them."

5 WATCH FOR ANY CHANGES IN LIQUIDITY

High liquidity has been a feature of the market for a number of years, but it has been driven largely by low interest rates and quantitative easing. When monetary policy starts to tighten, which it will, competition for paper will reduce as banks re-examine their cost of capital and other lenders, such as CLOs, reassess arbitrage. When this happens, terms are likely to level off or possibly worsen for sponsors. Yet there has been so much movement and body of established precedent in favour of borrowers, the pendulum is unlikely to swing back entirely in favour of lenders in the medium term.

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