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Capital *Thinking*

An analysis of current debt and financing market trends from Grant Thornton

ISSUE 1 SEPTEMBER 2013

Bond financing is booming, underpinned by a contraction in traditional bank lending in the wake of the financial crisis and investors' search for yield (and willingness to accept higher risks) in a low rate environment. The increasing popularity of bonds has had a dramatic impact on the high yield and leveraged space and on the investment grade market too. A significant concern for investors has been the erosion of lender protection as bonds often carry higher risk compared with loans through diluted covenants. The key issue is whether these changes are temporary or structural and, if the latter is true, how these trends will play out across the different asset classes.

Bonds influence on the loan market: shadow or halo?

Despite the popularity of bonds, leveraged loan issuance proved surprisingly resilient in 1H 2013. New European loan volume surpassed bond issuance, with most being used for refinancing purposes as borrowers sought to address the wall of maturity. Borrowers have also been keen to take advantage of competitive rates as banks continue to compete with bond financing on the larger deals.

Bonds have had a greater impact on loan structures, with pari loan/bond structures becoming the, almost, default structure for deals, which can accommodate bonds. Stephen Mostyn-Williams of Debtxplained noted that:

> **"most of the structures we are seeing involve a super-senior RCF coupled with senior secured bonds, occasionally accompanied by a more junior tranche, which may be either secured (eg Perstorp) or unsecured (eg Avanza)."**
>
> Stephen Mostyn-Williams, Debtxplained

Competition between the asset classes has pushed leverage to 4.7x in 1H 2013, up from 4.5x in 2012, with leverage on some deals reaching the high levels more typical of the pre-credit crunch period. Deals with a high proportion of bonds invariably accommodate leverage one, or even two turns higher, because of the absence of amortisation. For example, CVC's acquisition of Ista, which included a sizeable TLB as well as senior and subordinated notes, had a total leverage multiple of roughly 7.25x and a senior multiple of 5.5x. Pricing, despite the contraction in bank balance sheets, has remained lower than expected and it seems likely that low bond yields have constrained spreads in the loan market, although this is difficult to prove.

The impact of competition between loans and bonds on pricing and leverage is fairly predictable, but has been accompanied by significant erosion of lender protection in loan documentation, which is potentially much more hazardous for investors. Pressure on lender protection was evident before the credit crunch, with the emergence of cov-lite deals in the US, but has intensified in the last few years driven by several powerful trends:

- Facing falling US bond yields, US debt investors have increasingly turned their attention to the European markets creating additional demand. As a result, an increasingly significant amount of European loan paper is being issued either into, or to US-based funds. These funds have been more willing than European credit investors to accept the more borrower-friendly terms generally applicable to US loan documentation
- European debt investors have been forced to abandon their 'silo investment model' of investing in either loans or bonds and are increasingly 'following the market' by investing in both loans and bonds
- The increasing popularity of bonds as a financing tool clearly indicates that both corporate and PE borrowers are agnostic about whether they source debt from loans or bonds, or both
- The rise of pari loan/bond structures featuring bonds as pari passu with senior debt is driving convergence between loan and bond terms

Grant Thornton's ***take:***

- *The market has undergone significant structural changes in the way both buy and sell side approach financing.*
- *The European bond markets have come of age and will make further inroads as bank lending remains under pressure in the medium term.*
- *Bonds will retain their attractions compared with loans, but the volatile political and economic climate in 2H 2013 may prompt investors to turn to the better quality credits until stability returns.*

Bond/loan convergence is creating a bifurcated loan market

The emergence of pari loan/bond structures has created new tensions as lenders seek to reconcile the very different approaches of the two types of debt. In general, leveraged or high-yield loans have always enjoyed much higher levels of lender protection than high-yield bonds.

In particular, loans typically include far more onerous covenants than bonds. First, information covenants in loans require both more detailed and more regular information than bonds; second, loans include financial or maintenance covenants, which are absent from bond documentation; and third, loans include onerous general undertakings designed to protect the borrower's asset base (eg the negative pledge and guarantor coverage test). Bonds do not have a direct equivalent to these general undertakings, but have a raft of incurrence covenants, which provide borrowers with a much greater degree of flexibility by allowing incurrence of additional debt, restricted payments (to equity), asset sales and other forms of leakage from the group not generally seen in leveraged loans.

These differences highlight the conflicting approach between loans and bonds. Loans are based on a credit case agreed at the outset and the covenants are designed to ensure that the borrower remains constrained by those covenants. Any material deviation from the base case, either up or down, triggers a default event with the potential for acceleration and enforcement. Conversely, bonds allow much greater leakage, providing the borrowers' financial performance allows it. Prior to its acquisition, for example, Virgin Media's capital structure featured a senior loan and three separate high-yield bonds issued by three separate vehicles. From the borrower's perspective, the bonds allowed a high degree of freedom, (eg debt incurrence), but the group was constrained from taking advantage of this by the far more restrictive loan covenants.

A number of key trends in European loan documentation have been driven either by the bond markets, or by borrowers. These include the arrival of 'covenant loose' deals in Europe, where many large loans now include only two (capex and leverage), or even one financial covenant (leverage) as opposed to the four in the Loan Market Association precedent. Reports indicate that the Ista deal featured two covenants while the Merlin transaction had only a leverage covenant in its recent A&E.

Change of control portability clauses, which were included in the recent Elior loan, are another import from the bond markets. Historically, a change of control invariably triggered mandatory repayment of the loan. The portability clauses now appearing in loans are conditional on leverage (at a pre-determined level, or no worse than prior to the change of control) and, occasionally, a 'permitted holder' qualification limiting transfer to established firms in similar sectors. Unlike bonds, these may also limit portability to a 12 or 24-month period.

Grant Thornton's *take:*

- *Structural changes coupled with the advent of an increasing number of US buyers will reinforce the creation of a bifurcated loan market.*
- *Large, syndicated deals will increasingly develop borrower-friendly, flexible terms typically seen in the bond markets.*
- *Club and bilateral loans, which are held on originators' balance sheets, will remain largely unaffected by these developments in view of the credit risk and lack of liquidity.*

Sponsors have been swift to capitalise on the liquidity in the markets by demanding greater flexibility in their loan terms which, unsurprisingly, mirror terms on bond documentation. The key area of credit erosion has been a relaxation in mandatory prepayments in a number of ways. One recent innovative approach incorporated step-downs in the cash sweep mechanism, whereby the applicable percentage did not apply to the excess cash, but only to the next step down, with the lower percentage being applied to any remainder. Again, cash sweep mechanisms are absent in bond documentation.

The net effect is that the loan market is evolving into a bifurcated market with smaller club and bilateral deals on the one hand and large syndicated loans on the other. The latter are almost all subject to erosion of lender protection, but the former are too small to accommodate a bond and continue to be documented in similar terms to the LMA loan precedents, which offer a high degree of lender protection, full security and financial covenants.

The return of bull market structures

Senior loans are not the only part of the credit spectrum under pressure from bond markets. The growing popularity of bonds, coupled with investors' willingness to seek higher returns has forced investors up the credit and risk curve. One notable effect has been the re-emergence of PIK, although now in note rather than loan form.

PIK, which was originally developed in restructuring markets to ease pressure on cash flow pending an improvement in financial performance, has always been seen as a bull-market product when used outside a restructuring situation. Some recent deals have included very aggressive PIK toggle features. R&R Ice Cream and Kloeckner Pentaplast, for example, included a toggle feature whereby the notes are cash pay, but may be 'toggled' to PIK from the obligation to pay 100% in cash, according to a sliding scale based on the capacity to make restricted payments. These types of PIK deal generally have the ability to toggle when a payment would reduce cash or cash equivalents to below a pre-agreed daily level.

Where PIK is used as a dividend recap, it typically offers investors minimal protection. Because it increases leverage, default rates are high and recovery rates correspondingly low as the holders of PIK notes seldom have a 'seat at the table' in a distressed situation.

Bonds have also had a dramatic effect on other parts of the capital structure, notably mezzanine and, to a lesser extent, second lien, and we will examine those matters in subsequent editions of Capital Thinking.

Grant Thornton's *take:*

- *The popularity of PIK in non-restructuring scenarios seems set to continue while the credit environment remains liquid and investors feel obliged to accept higher levels of risk.*

Corporate lending: asset-based lenders filling the gap

Corporates too small to participate in the bond market have yet to benefit from the trend towards more borrower friendly structures. In general, for liquidity reasons, bond investors prefer tranches of at least £250 million, although, increasingly, smaller deals are being brought to the market, such as Pendragon's £175 million Senior Secured Note, which was used for refinancing.

It appears likely that smaller bond tranches will become more common-place, but in the meantime, SMEs have been forced to seek alternative financing sources as traditional bank lending remains constrained. For these corporates a wider range of financing solutions has emerged since the crisis, although not all are suitable for every firm. Recent developments include retail bonds, crowd-funding and peer-to-peer funding.

Another increasingly viable option is being provided by asset-based lenders capitalising on the vacuum left by banks to offer a wider range of financing options. Historically, ABLs provided asset-backed funding embracing working capital and fixed assets. The traditional advantages of ABL of cost-effective finance, scalability in line with growth and the flexibility to finance small to large deals, are well understood. This flexibility has been enhanced in two ways. First, the range of activities which can be funded increasingly includes growth and M&A, as well as other situations, which were previously off-limits, such as refinancings, restructurings/turnarounds and even intangible assets (eg brands and trademarks). ABL funders have been involved in these types of deal for some time, but are increasing their exposure to this area of business as they are forced to compete in a liquid market. Second, asset-based lenders increasingly offer an expanded range of bespoke solutions, including cash-flow facilities, uncommitted facilities for balance sheet management and supply chain finance.

Cash flow facilities

As ABLs have sought to compete with traditional bank lenders, they have started to provide cash flow-based facilities as part of a comprehensive one-stop solution also embracing the traditional asset-based lines. Corporates have used these facilities for a wide range of purposes, including to release equity or to create a war chest for opportunistic acquisitions. In the case of sponsored deals, they have been used to retire more expensive PIK loans, or to release equity by repaying shareholder loan notes.

These facilities are ideal for firms in defensive sectors with stable cash flows, but could also be used by firms in sectors that have high barriers to entry, or have well-known brand names. Cash flow facilities, which typically amortise over two to four years, are subject to financial covenants. Typically these include a DSCR (the ratio of cash available for debt servicing to interest, principal and lease payments) of at least 1.5x and sometimes an interest cover covenant of 3.0x (although occasionally as low as 2.5x). Margins and fees are generally competitive with traditional bank lending, while documentation is less complicated than loans allowing quicker access to funds.

Grant Thornton's *take:*

- *The provision of cash flow facilities suggests asset-based lenders are being forced to offer a wider range of products and assume a higher level of risk to stay in the game.*
- *ABLs' ability to provide a one-stop-shop could provide increasingly stiff competition for bank lenders for firms with an asset base.*

Uncommitted facilities

Uncommitted facilities for balance sheet management are a recent stand-alone financing solution, which enable corporates to convert invoices to cash at key times to strengthen the balance sheet and boost liquidity, for example, at year end.

A typical transaction would involve the sale to the financier of a batch of invoices, for example, £30 million. The invoices are non-recourse to the seller, but will require credit insurance, typically 90%-95%, to cover the risk of debtor insolvency, which is borne by the financier. The financier makes an upfront cash payment to the seller of slightly less than the insurance limit, so if cover were 90% the initial payment would be approximately 85%.

At around 200bps, the margins are competitive and commitment fees are modest. Steve Websdale, Managing Director of ABN AMRO Commercial Finance, said:

> **"commitment fees are typically around £5,000 per month for a facility of £30 million and we are willing to offer these with a tenor of two to three years."**
>
> Steve Websdale, Managing Director of ABN AMRO Commercial Finance

Uncommitted facilities are a highly flexible solution, which can be tailored to each customer's needs, but tend to be used by corporates seeking a cash injection into the business. The longer maturity provides a greater degree of comfort than an overdraft. Another advantage of these facilities is that they resolve the perennial problem of larger firms delaying payment terms to suppliers at year, or even month end.

Supply chain finance

Another, more recent, innovation in the armoury of asset-based lenders is supply chain finance. The conflict between large customers and small suppliers is well documented and uncommitted facilities are one, ad hoc, attempt to reconcile this. Corporates are keen to optimise working capital, of which supply chain management is one aspect, but also wish to obtain better pricing from their suppliers and maintain product quality. Suppliers, particularly smaller companies, are at a significant disadvantage and delayed payment is much more critical for them given that their access to finance is either constrained or very costly. These pressures can threaten the business relationship to the detriment of both parties.

Supply chain financing offered by asset-based lenders seeks to reconcile these issues. It is generally aimed at smaller firms supplying large corporates, and allows the latter to maintain agreed payment terms with their suppliers. The key event occurs once the supplier invoice has been approved for payment by the customer, creating an irrevocable payment obligation. Once this has occurred the supplier is able to sell (or in some cases auction) the invoice. So where payment terms are 75 days, the supplier may receive payment within five days of approval.

Illustrating the growing popularity of this financing solution, several platforms have been established that allow the supplier to auction their selected invoices for designated customers. Platform Black and Market Invoice are two of the better known examples.

The advantages of supply chain financing are that it improves cash flow and the costs can be very attractive, as they are based on the customer/buyer's credit rating, which is generally much better than the supplier's. For larger corporates, it allows them to retain a cash buffer and maintain financial ratios.

Grant Thornton's ***take:***

- *Asset-based lenders will be compelled to offer a wider range of innovative products to supplement their traditional offerings. Uncommitted facilities, which are based on cash flow, are an excellent example.*
- *We believe that this trend, coupled with the problems facing traditional bank lenders, will mean that ABL will become an increasingly attractive source of finance.*
- *As this market develops, increased competition will accelerate the trend and will force providers to assume higher levels of risk, which will be to the benefit of smaller corporates.*

Debt Advisory contacts

Shaun O'Callaghan
Partner, Head of Debt Advisory
T +44 (0)20 7865 2887
M +44 (0)7545 301 486
E shaun.m.ocallaghan@uk.gt.com

David Ascott
Partner
T +44 (0)20 7728 2315
M +44 (0)7966 165 585
E david.p.ascott@uk.gt.com

Michael Dance
Consultant
T +44 (0)20 7383 5100
M +44 (0)7525 352 760
E michael.dance@uk.gt.com

Jonathan Jones
Associate Director
T +44 (0)20 7728 3103
M +44 (0)7970 972 261
E jonathan.jones@uk.gt.com

Christopher McLean
Manager
T +44 (0)20 7865 2133
M +44 (0)7825 865 811
E christopher.mclean@uk.gt.com

Jonathan Mitra
Manager
T +44 (0)20 7865 2407
M +44 (0)7815 144 280
E jonathan.mitra@uk.gt.com

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grant-thornton.co.uk

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