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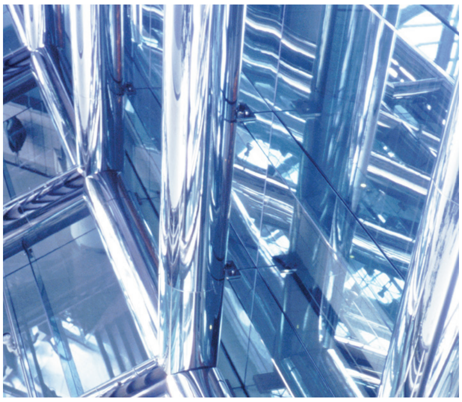
The Return of the Leveraged Loan Market

Increased confidence and appetite for risk developed in 2013 and has continued at pace into Q1 2014. 2013 brought us the highest annual new-issue loan volume in five years. This translated to an impressive year-on-year increase of 136% according to LCD S&P Capital IQ, cementing 2013 as the year of the return of the leveraged loan product. As the run of momentum continues, 2014 is so far not proving a disappointment. With €26.3 billion of leveraged loans issued in the first four months of 2014 alone, the heated market, intensified by an increasingly liquid investor base, has allowed borrower-friendly structures and pre-crunch aggressive deal terms to appear firmly back in focus. This article takes a look at some of the loan trends dominating the market so far this year.



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Yankee Loans

Between 2011 and 2012 when European bank lending stalled in the face of macroeconomic concerns and looming regulatory constraints, European borrowers began looking to the US market in order to find readily available sources of refinancing liquidity. Over the years, the volume of European borrowers accessing the dollar market has more than doubled; this growth in volume also reflects the broader category of borrowers that have been able to attract financing from US investors. Continuing from last year's trend, so-called Yankee Loans remain a focal point of this year. In the first quarter, €14.7 billion was syndicated into the US by European borrowers representing a 37% increase from the comparable period in 2013.[1]

Deeper liquidity, favourable deal economics and "covenant-lite / covenant-loose" structures are the key drivers of the Yankee Loan. Despite the additional time and expense in structuring marketable deals for US investors and drafting finance documents that reconcile the disparity in bankruptcy and restructuring regimes, the favourable metrics that can be achieved for some borrowers can often outweigh those initial costs incurred. European borrowers seeking higher leverage may find the US market more accommodating; investors on CeramTec and Springer Science & Business Media, which both launched in July 2013, took on a total leverage of 7x and 6.8x respectively. With a

1 "Cross-border deals fuel institutional new issuance surge" – *S&P Capital IQ LCD*

bigger US investor pool, tighter margins have been achieved in a number of deals offered in the US market; on average in Q1 2014, US components cleared 30bps inside its counterpart European tranches,[2] although this narrowed to near parity (including with respect to OID) on certain names towards the end of Q1 2014. The smaller equity contributions seen in cross-border financings, 29.6% on average compared to 47.2%[3] in a pure European deal, is particularly appealing to a sponsor looking for a bigger return on its investment. Additionally, borrowers operating in a more cyclical market are often drawn to the prevalence and widespread acceptance of "covenant-lite" structures in the US market.

Japanese liquidity

As well as existing lending competition from the US, there is also an emerging opportunity for growth in the Japanese bank lending market. Following the unveiling of the biggest monetary stimulus by the Bank of Japan in 2013, the sentiment in the economy has been steadily improving. Japanese companies are keen to expand and are increasingly exploring international buyout opportunities, fuelling an upwards shift in demand for finance. Japanese banks are also liquid, hungry for assets and are ever more willing to invest alongside companies in the European markets. As an example, Lixil Group in cooperation with the Development Bank of Japan completed a €3 billion acquisition of Grohe, a German sanitary fittings company, in January 2014, using bank finance facilities that were governed by English law and provided by three Japanese banks. As the domestic market in Japan gathers momentum, 2014 could see more Japanese banks and companies looking to invest in strong European credits.

Cov-lite loans

The fierce competition from cross-border cov-lite and the high yield market has in turn led to a more competitive environment in the European leveraged loan market: not only has there been a suppression of margins, but also the return of the cov-lite loan product.

European lenders have generally been reluctant to accept cov-lite loans, not least because of the thinning of maintenance covenants, it can, amongst other things, delay any ability of lenders to pre-empt a distressed situation and commence an early restructuring process or discussions following a breach of a financial covenant that has been tested periodically. However, the resurgence of cov-lite paper successfully placed in euros, contributed by the likes of Springer Science & Business Media and Oxea, shows that European banks on cross-border deals have become more flexible in adopting bond-like incurrence covenants in place of traditional financial maintenance covenants in order to compete in the more liquid and investor-driven US market. Indeed, the successful syndication of Europe's first domestic cov-lite facility in six years, Ceva Sante Animale, certainly suggests that for a healthy credit in the right sector, the appetite for European cov-lite is there. Total European cov-lite volume for Q1 2014 stood at €2.7 billion, almost double the volume recorded in the same period in 2013.[4]

Cov-loose

Further, lenders have shown more willingness to forego some maintenance covenants in recent months. The volume of covenant-loose European leveraged loans (a loan containing only one or two maintenance covenants) in the year through September 2013 was 42.9% compared to 80% of loans containing four or more tests in 2012.[5]

Bank/Bond

When the loan market was still in recovery mode from the crash, borrowers turned to the high yield market as an important alternative source of finance to bridge a funding gap.

A bond issue can be cheaper than obtaining financing through a mezzanine/subordinated structure. This element, together with the potential for more borrower-friendly terms such as portability and fewer covenants has enabled the high yield market to prosper.

In 2013, 40% of all leveraged M&A financings included a bond component. That said, the general shift in the market back to the loan product in Q1 2014 has led to an overall decline in bank/bond acquisition finance deals. In the year through March, 83% of acquisition financings had a loan-only structure and transactions structured as a bond and super senior revolving credit facility took only 6% of the share.[6]

Portability

Competitive pressure from the high yield market has compelled the erosion of comparatively bank-friendly terms in loan agreements and lenders have accepted these terms in order to compete for financing.

A number of loan documents in the past 12 months have included change of control "portability" provisions; a premium feature, more widely accepted in bond indentures and which permits a change of control of the business without the requirement to make a mandatory prepayment of the loan facilities in certain circumstances. This provision is particularly sponsor-friendly

2 "Cross-border deals fuel institutional new issuance surge" – *S&P Capital IQ LCD*

3 "Topical: Equity cheques shrink as syndications routes change" – *S&P Capital IQ LCD*

4 "Cross-border deals fuel institutional new issuance surge" – *S&P Capital IQ*

5 "Topical: Europe accepts fewer covenants, awaits cov-lite test" – *S&P Capital IQ LCD*

6 "PE-owned borrowers raise €4.7B for refis/recaps in 1Q14" – *S&P Capital IQ LCD*

because it is designed to make a future sale more economical and more attractive to potential buyers. Typically, the provision is subject to limitations, such as applicability periods, pre-approved white lists of acceptable buyers, leverage ratios and the use of the provision limited to once only. These limitations are considered broadly market standard, but recently there has been a push to extend the number of times the provision can be used; the bond issue from Integrated Dental Holding in May 2013 is an example where a more flexible portability provision was agreed.

Although it is not a new concept, it has never been as prevalent in the market; the 2005 Ahlsell recapitalisation (completed by White & Case (London)) was the first of its kind to include portability in the senior term debt finance structure. Subsequently, the refinancing of Odeon in 2011 and Cabot in 2012 included change of control portability constructs in the super senior revolving facility agreements. In 2013, the refinancing of Elior and the refinancing and dividend recap of Minimax Viking incorporated a portability clause and into 2014 the refinancing of Diaverum and the amend and extend of Eircom, amongst others, featured a portability clause.

It remains to be seen whether the feature will become more widely accepted in the leveraged loan space and whether the recent flexibility of the provision afforded to issuers in bond transactions will be translated favourably to borrowers in loan deals. As sponsors are starting to centre their focus on more flexible exit options, the portability provision is likely to move to the forefront of negotiations.

Lender diversity

Quantitative easing, suppressed interest rates and bank regulatory concerns were the key drivers in the 2013 peak of the share of non-bank lending in medium and long term finance. The injection of new currency into the economy has provided a continuous stream of liquidity; this, combined with the Monetary Policy Committee's decision to maintain interest rates in the UK at 0.5% and relatively strong pricing in the secondary markets has created a strengthening demand for yield in the riskier leveraged markets. The appetite for bank-lending has also reduced over the years as a result of the looming regulatory pressures of Basel III and the requirements to deleverage risk-weighted assets. This shift towards non-bank lending has consequently led to a move away from the classical senior/mezzanine debt structure to more flexible hybrid structures such as the unitranche.[7]

Unitranche providers have enjoyed a flow of deals in the mid-cap sector with at least eight transactions completed so far in 2014. Unitranche lenders can offer a mid-market borrower a streamlined capital structure with bespoke deal documentation tailored to the needs of the borrower. The competition (and partnering) between banks and unitranche providers will no doubt continue to provide mid-market borrowers the opportunity of securing finance on more competitive terms and structures albeit at a pricing premium.

Recent deal examples:

Issuer/Borrower	Deal size / purpose	Lender(s)
H.I.G. Capital France and Management buyout of Groupe Looping	€30 million acquisition facility	Alcentra
KP1	€215 million refinancing facility	GSO
Parkdean	£153 million refinancing facility (together with a subordinated debt piece)	GE Capital / Ares Management
DORC	€110 million working capital and acquisition facilities	GE Capital / Ares Management
Trust Inns	£130 million refinancing facility	Macquarie Lending
Steelite International Holdings	£29 million refinancing facility	HIG WhiteHorse

PIK issuance

European PIK volume reached a total of €4.8 billion in 2013[8] positively indicating that confidence in the market is back and lenders are willing to take on risk for higher yield.

Under a PIK structure, borrowers are able to accrue interest on the debt until the principal sum matures. PIK debt is often seen as a product of the pre-crisis bull market as lenders take the risk that on the final maturity date borrowers will be able to pay off all the debt and interest as a lump payment.

A steady pace of issuance has continued so far in 2014 with Ceva Sante Animale's pre-placed €255 million eight-year subordinated PIK facility with Ardian and Aston Martin's privately placed US$165 million senior subordinated PIK notes with Waddell & Reed.

7 DC Advisory – *DC Edge – Issue 3*

8 "Risky high-yield debt makes a return in Europe" – *Financial Times*

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Conclusion

Competitive pressure over 2013 and in Q1 2014 in, amongst others, the yankee loan market, the high yield product and from alternative sources of finance has shaped the leveraged loan market into an increasingly borrower driven environment. Banks are ever more willing to agree to concessions in loan documents including the removal of maintenance covenants or watering down standard change of control provisions in order to compete. It is expected that structures and documentation will continue to evolve over the course of the year, particularly with the growing disparity between new issue supply and demand intensified by CLOs looking to complete deals before the end of their reinvestment periods and issuance from new CLOs, and as borrowers actively seek to tap into all pockets of liquidity in both the domestic and international markets.