WHITE & CASE

European leveraged finance: A bifurcated balancing act

Growth in the European leveraged finance market remained steady in 2019, with 2020 set to continue at pace, with enhanced focus on the trade-off of protection from risk versus a higher yield

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Foreword

A new decade starts with optimism and a strong pipeline, to build on the resilience of an ever-maturing market

As we enter the new decade, the resilient European leveraged finance market continues to grow and mature. The market is agile and has continued to deal with significant changes, ranging from the mix of leveraged loans and high yield bonds to the impact of direct lenders, sectoral and regional changes, as well as politics across Europe, including considerations relating to Brexit.

Against that backdrop, we begin 2020 with a pipeline of approximately €36 billion, nearly 70 per cent higher than 2019, year-on-year. Pricing is at an attractive level for borrowers, with the lowest high yield bond pricing levels for new issues in recent times; cov-lite has taken hold of the market; restructurings are at low levels; and a platform for social change, led by the UN Sustainable Development Goals, environmental, social and governance standards and investor sentiment, all point towards great market potential.

These trends are also penetrating more sectors, regions and deal types, as several countries see 'deal firsts' as trends flow across borders, and leveraged finance processes support alternative deal structures from traditional LBOs, to move into, for instance, the public-to-private space, with increasing pace.

Still, potential bumps in the road—central bank action causing interest rate hikes, the impact of the coronavirus outbreak (both in China and globally), full details of Brexit and the finalisation of trade deals across the globe—will all have details which will affect the market, but the market is better placed than ever to deal with these factors, as industry professionals put to work their experience of recent years in growing the market to good effect.


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Data dive: European leveraged finance 2020

HEADLINES

■ European leveraged loan issuance in 2019 was down slightly on the previous year to €209.1 billion ■ The covenant-lite share of European institutional loan issuance in 2019 reached 92 per cent ■ High yield bond issuance jumped more than 20 per cent to €95.5 billion

By Jeremy Duffy and James Greene—partners, White & Case

In the year ahead, European leveraged finance investors that have been dealing with rising term sheet erosion will have few other options in their pursuit of yield. But while they may be prepared to cope with fewer protections, many are also likely to scrutinise credit quality much more aggressively to mitigate risk in the months ahead.

The fact remains that the leveraged finance market, even with competitive pricing levels for borrowers, still offers investors levels of return that are difficult to come by in other asset classes. However, that must be balanced against potential rising default rates predicted by some (but not all) sources. These tensions will drive investor portfolios.

We expect larger deals will continue to be oversubscribed, as cashflow performance by borrowers in jumbo deals entices investors despite such competition driving down the yield offered by the transaction, while smaller deals offering higher risk will both price wider and face increased scrutiny, with lenders more likely to be able to dictate, or at least influence, terms.

Each of these trends to some extent mirrors the impact of the private credit market on the wider leveraged finance market.

On the one hand, private credit's march into the jumbo deal space means that traditional investors need to cede certain terms and offer competitive pricing to ensure keeping the deal in the syndicated markets.

On the other hand, in smaller deals, a borrower is more likely to take on board market feedback when the alternative offered by the private credit market may well be less flexible for their business. We see this divergence of approach between deals as likely to continue into 2020.

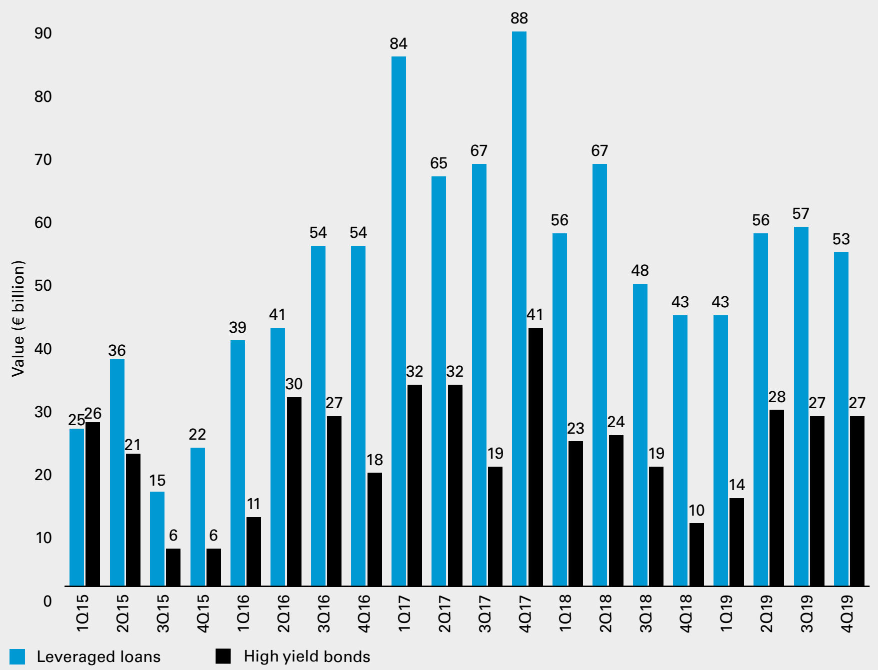
20%+

The rise in high yield issuance in 2019

Such has been the growth of Europe's leveraged finance market following the financial crisis that it is now more influential and established than ever before.

The numbers bear this out: According to data from *Debtwire Par*, leveraged loan issuance in 2019 was

European leveraged loan vs. high yield bond issuance (quarterly)



Source: *Debtwire Par—figures rounded up to nearest whole number* down slightly on the previous year to €209.1 billion while high yield rose to €95.5 billion—jumping more than 20 per cent on the previous year.

Throughout 2019, the market weathered a series of significant threats, from global trade wars to Brexit uncertainty and ongoing macroeconomic volatility, and came out the other side relatively unscathed, which hints at a solid year ahead.

M&A up, interest rates down

The growth in western European M&A activity since the financial crisis (deal value more than doubled between 2009 and 2018, according to *Mergermarket* data) has been a clear driver of issuance. This is likely to continue, as corporates and private equity firms tap into the loan and bond markets with ever-increasing frequency.

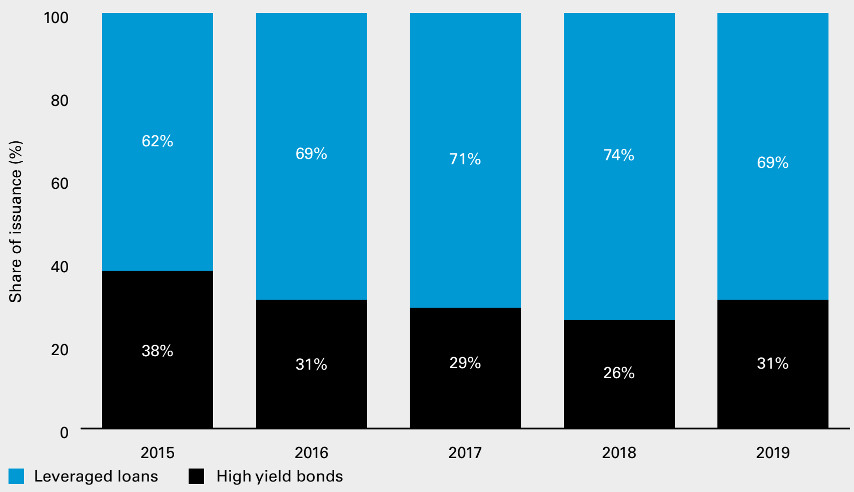
From an investor point of view, a prolonged period of low interest rates—the Bank of England's base rate sits at 0.75 per cent[1] while the European Central Bank has held rates around 0 per cent[2]—will continue to drive lenders to leveraged loans and high yield bonds as they search for yields that traditional fixed-income and bond instruments are not able to deliver.

The rise in M&A activity and investor appetite for yield has created a perfect storm for leveraged finance issuance and an ideal environment for borrowers to secure financing in 2020. New money issuance for 2019, for example, represented 54 per cent of issuance, whereas its share of the market in 2014 was only 44 per cent. This is indicative of the upward trend in new borrowers turning to leveraged finance for their funding needs.

This year is expected to offer the same dynamics as 2019, with room for growth. In the UK, for example, concerns over Brexit stifled volumes somewhat in the first quarter of 2019, but market performance was strong from the second half of 2019 onwards. Those that had waited for Brexit worries to pass were given the chance to catch up, and new money issuances, along with opportunistic refinancing deals, came to market to take advantage of the stronger market backdrop on offer.

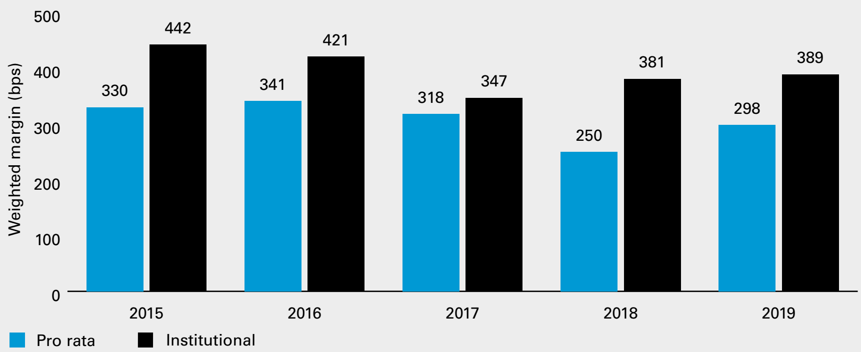
With a strong pipeline in place at the start of 2020 and a potential

Share of leveraged loan/high yield bond issuance in Europe



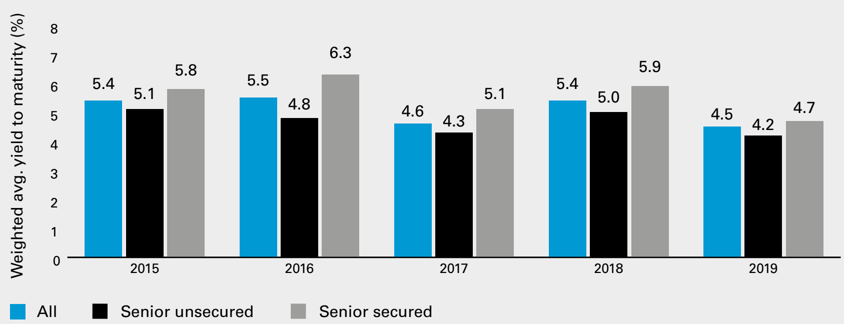
Source: *Debtwire Par*

European leveraged loan pricing



Pro rata loans typically include the revolving credit facility and the amortising term loan ('Term Loan A'). These are packaged together and usually syndicated to, and held by, banks. Institutional loans primarily involve non-bank lending institutions. The pro rata data cited here excludes £400 million Debenhams and New Look £80 million and £100 million facilities, all issued as part of a restructuring transaction.

European new issue high yield bond pricing*—fixed-rate bonds



Source: *Debtwire Par*

** where yield to maturity available*

'Boris Bounce' in the first half of the year following the UK general election at the end of 2019, 2020 should be a growth year—barring significant market events—though with ever-increasing scrutiny on credit quality, in particular if default rates do increase.

A good time to borrow

Given the demand for yield among lenders, loan covenants have been chipped away as the market has moved strongly in favour of the borrower. Data from *Debtwire Par* shows that the cov-lite share of the region's institutional loan issuance in 2019 reached 92 per cent, a significant shift in just a few years—cov-lite's share of European issuance was just 27 per cent in H1 2016 and 52 per cent in H2 2016.

There is a growing consensus that, even if the cycle turns and the market moves back in favour of lenders, cov-lite is here to stay. This is partly due to the competition between high yield bonds (which are cov-lite by nature) and loans, and the fact that investor demand for particular covenants has fallen away—the market has not lost participants in particular transactions purely for technical reasons.

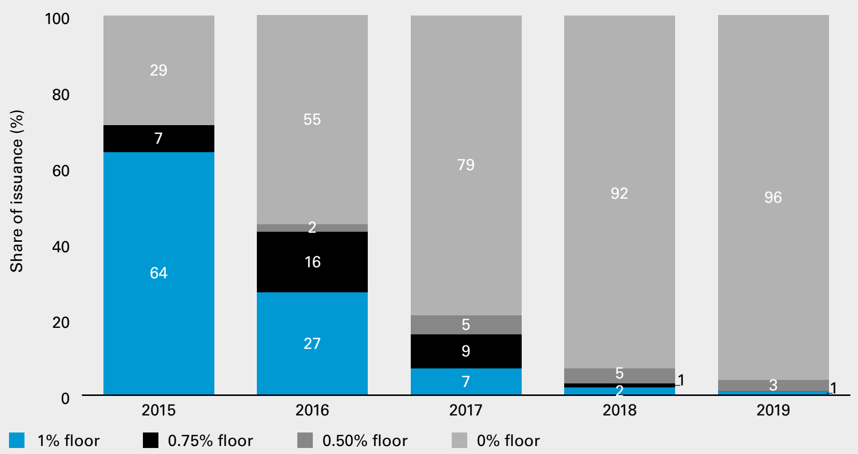
Pricing has moved in a similar direction. By the end of 2019, pro rata leveraged loans—which include the revolving credit facility and the amortising term loan, and are packaged together and usually syndicated to, and held by, banks—were pricing at 298 bps versus 318 bps in 2014.

Downward flexes, which push margins down if demand is strong, meanwhile, continue to outnumber upward flexes in institutional loans, which are term loans structured specifically for institutional investors.

For high yield bonds, new-issue bond pricing across senior secured and senior unsecured tranches eased from 5.4 per cent in 2018 to 4.5 per cent in 2019.

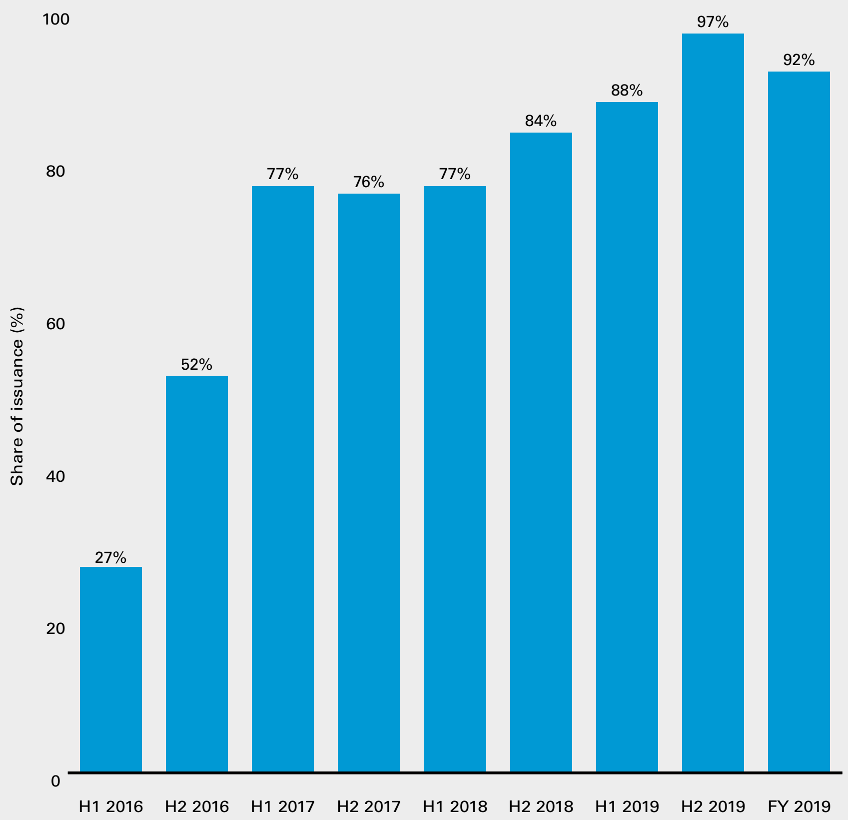
Risks that may preoccupy lenders in the months ahead will be the ongoing pushback of protections in loan documents, with EBITDA add-backs and 'grower' baskets now standard rather than exceptional. LIBOR floors, meanwhile, which dictate a minimum interest rate that borrowers must pay if rates fall,

Benchmark floors on institutional term loans



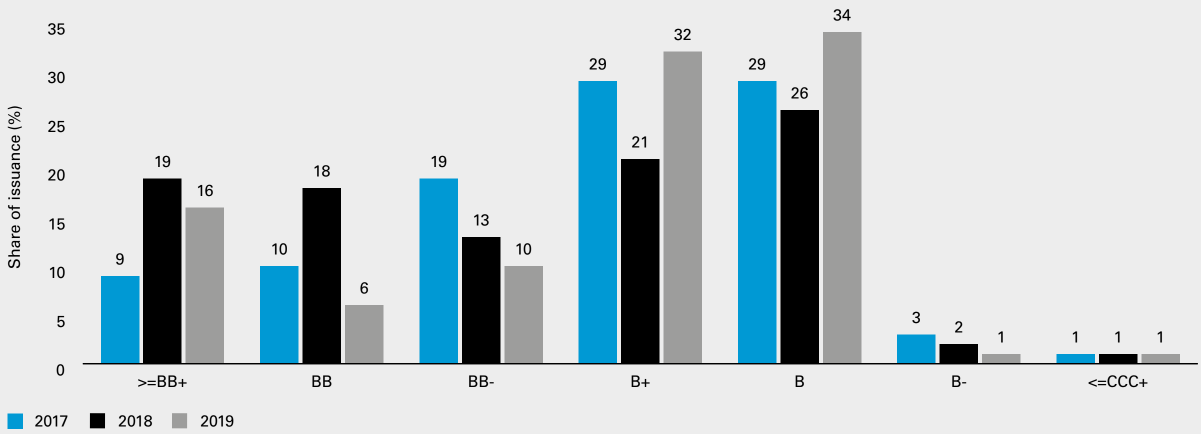
Source: *Debtwire Par—based on universe of deals where benchmark floors are present and the base rate is EURIBOR*

European covenant-lite share of institutional loans



Source: *Xtract Research*

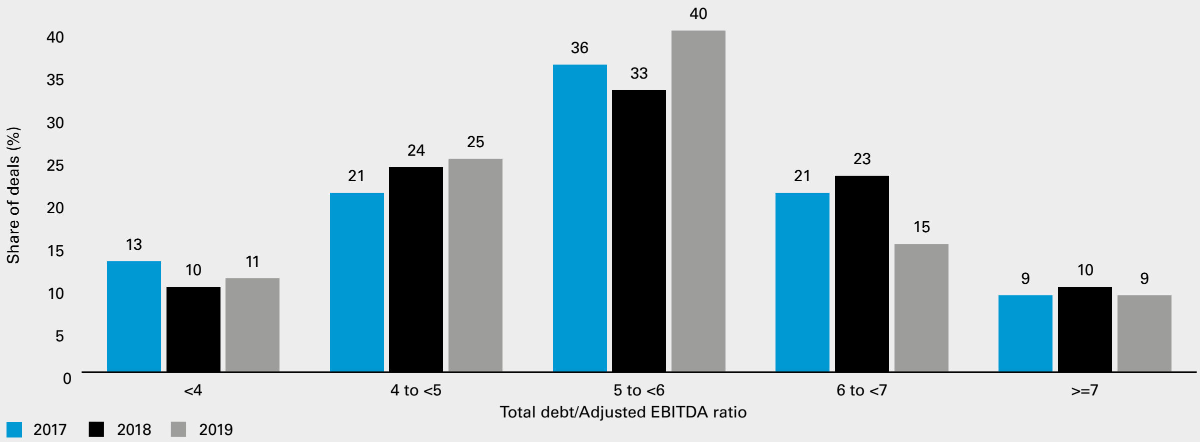
European leveraged loan issuance by rating*



Source: *Debtwire Par*

**Based on universe of loans that are rated. Where split-rated, higher rating is used. Only Moody's and S&P ratings are considered.*
NB: BB+ rating category volume is driven by €6.3 billion Fiat Chrysler Automobile revolving credit facility.

Distribution of total leverage



Source: *Debtwire Par—based on deals for which Debtwire collected leverage ratio data*

One notable development in 2019 was that investors were homing in on credit quality in the absence of protections in documents, which has produced a bifurcated market at the start of 2020

were set at 0 per cent in Europe for 96 per cent of loans in 2019, versus approximately 10 per cent of loans with a 0 per cent floor in 2014.

Even though default rates are at historic lows and not expected to move much above the 1 per cent to 2 per cent range, the expansion of the leveraged finance space and the dilution of lender protections has caught the attention of regulators. The International Monetary Fund's (IMF) recent *Global Stability Report* warned that 'covenant protections have weakened' and that up to US$19 trillion of corporate debt, representing close to 40 per cent of company borrowings in major economies, could be at risk of default in a downswing.[3] The Bank of England, Central Bank of Ireland and EU watchdogs have also raised concerns about the scale of the leveraged loan market.[4]

With default rates expected to remain low, investors' best protection against defaults may well be to continue to diversify their portfolios across industries, jurisdictions and capital instruments, to cushion any particular credit issues in one of their investments. In the current cov-lite markets, unexpected liquidity issues or very specific credit issues can cause a default and/or restructuring. Given the wider macroeconomic conditions, we expect these to remain the principal drivers for stressed credits and for default rates to remain low, even if they begin to increase somewhat in the year ahead.

It's also worth noting that, in the modern cov-lite era and across a number of credits in 2019, many sponsors and corporates have reached out to creditors when facing a potential default and, more often than not, a mutually acceptable solution has been achieved.

Similarly, distressed debt funds are proactively identifying and engaging in potential restructuring processes earlier to provide rescue capital and market expertise to relevant credits, thus warding off default.

Quality balances risk

One notable development in 2019 was that investors were homing in on credit quality in the absence of protections in documents, which has produced a bifurcated market at the start of 2020. Pristine credits will sail through in the months ahead, pushing successfully for looser terms and better pricing, but as soon as there are any wrinkles, lenders will step back or insist on tighter controls and higher pricing.

Lower leverage levels will continue to offer lenders a degree of comfort in the ongoing absence of covenants. Debt/EBITDA multiples averaged out to 5.4 times and, in 2019, 40 per cent of deals were levered at between 5 times and 6 times, with 36 per cent at multiples of 5 times or less.

That said, as noted above, EBITDA add-backs and the definition of EBITDA appearing in documentation for both leveraged loans and high yield bonds continue to take an increasingly aggressive stance.

The growth of direct lenders adds even greater nuance to these dynamics. Fundraising for European direct lending is estimated to have grown from less than €15 billion in 2014 to more than €20 billion in 2018. With larger war chests at their disposal, direct lenders have expanded their reach beyond their mid-market base and represent an alternative to credits that would otherwise have always gone into traditional bank syndication or a high yield bond issue.

As direct lenders are typically take-and-hold investors, they may still demand covenants and higher pricing, but offer faster execution and remove the risk of flex for borrowers. These direct lending players will continue to offer a new source of capital in 2020 and provide borrowers taking on leveraged finance with options they might not have considered.

A bright outlook for 2020?

Despite concerns that the credit cycle is peaking and that credit protection in documents has deteriorated, there is optimism that 2020 will be another solid year for leveraged loans and high yield bonds. Based on *Debtwire Par* coverage, there was an estimated €36 billion in the pipeline at the start of 2020—nearly 70 per cent higher than 2019, year-on-year.

With few loans carrying covenants, there are limited triggers for restructurings, which will protect against an increase in defaults, and M&A activity could climb if there is greater clarity around Brexit and global trade tensions subside.

In 2020, the year began with more optimism than 2019, with a path to Brexit identified and market sentiment high following a strong end to 2019, and we predict this to continue. The market is sufficiently robust to take on bumps in the road, but market participants must be cautious and identify where a bump is, in fact, a roadblock.

This caution, combined with a focus on credit quality and the bifurcation of the market into quality deals that are oversubscribed and lower credit deals that are appropriately negotiated, could, in fact, be a strong platform for a growing market. Market participants may concentrate on one or other of these market segments, thus providing localised liquidity, where attention to detail can be key.

5.4x
Average debt/EBITDA multiples in 2019

As long as base rates remain low—which seems likely, given the European Central Bank's decision to cut its bank deposit rate to an all-time low of –0.5 per cent and restart its quantitative easing programme in September 2019—lenders will continue chasing yield, which means Europe's leveraged finance growth has a way to run yet.

> **"Despite concerns that the credit cycle is peaking and that credit protection in documents has deteriorated, there is optimism that 2020 will be another solid year for leveraged loans and high yield bonds**

Leveraged loan issuance: Lenders look beyond buyouts

HEADLINES

■ Buyouts and M&A secured a combined €75.4 billion of loan issuance in 2019 ■ Proceeds used for buyout issuance alone were down by more than 30 per cent to €38.7 billion when compared to the €56.6 billion total in 2018

By Shane McDonald, partner, White & Case

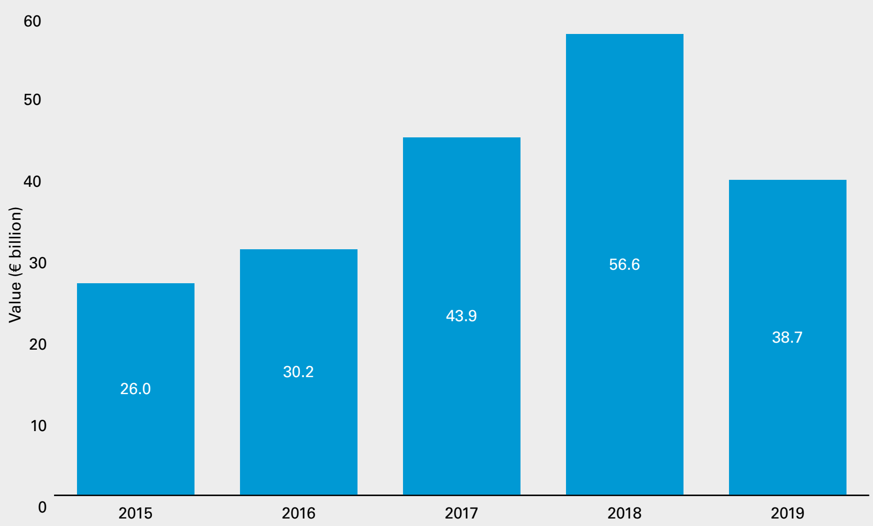
An almost 25 per cent drop in European M&A deal value to €642 billion in 2019 on the previous year, according to *Mergermarket* data, saw leveraged loan issuance for buyouts (LBOs, MBOs and SBOs) and corporate M&A slide during the year.

Proceeds used for M&A (excluding buyouts) were more or less level with 2018 at €36.7 billion. The fall in buyout issuance, however, was pronounced, down more than 30 per cent to €38.7 billion on figures for 2018. The drop in headline M&A activity has seen a shift in leveraged loan issuance patterns towards refinancing and repricing, which accounted for an increasing share of issuance through 2019. Issuance for repricing and refinancing was just 3 per cent lower than 2018 at €94 billion and remained substantially higher than issuance figures for buyouts and general M&A.

€38.7 billion

The value of European buyout issuance in 2019

Buyout loan issuance—annual



Source: *Debtwire Par*

A focus on repricing

The fact that M&A was down in 2019 did not stop leveraged loan investors from looking for ways to deploy capital. The situation created opportunities for borrowers to return to the market and refinance or reprice loans.

Leveraged loan investor demand has been a major driver of activity for repricing and refinancing activity. CLOs, for example, raised €30.1 billion in new capital from investors during the year, according to *Creditflux* data, which is up on the €27.2 billion secured in 2018.

With leveraged loan investors actively looking for ways to invest their capital, their appetite for repricing has been strong. Repricing occurs when loans come out of their call periods and the market is there to support them. Given the significant demand from leveraged investors, borrowers can refinance an existing tranche with cheaper debt on the same terms with the same quantum of finance.

Similar dynamics are at play with respect to refinancing, with borrowers taking the opportunity to refinance in a hot market and extend loan maturities, and potentially take advantage to refinance on more favourable terms.

Borrowers have also noted the opportunity to push out maturity walls on loans, or taken the view that the benign market will allow them to secure looser terms and provide more flexibility.

With investors eager to deploy, borrowers can refinance relatively painlessly. This is more straightforward than trying to renegotiate terms on an existing tranche, which may require the consent of all affected lenders.

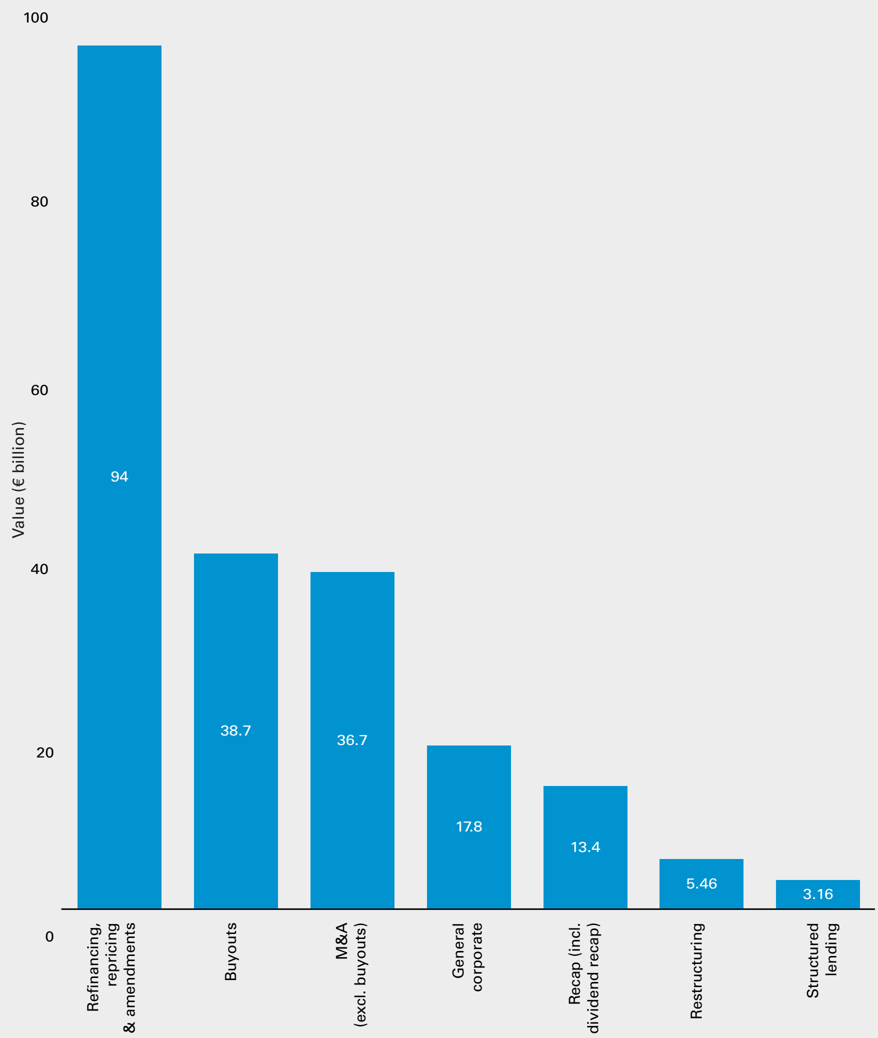
The future for LBOs

Looking ahead, there are hopes that a revival of European M&A activity, prompted by a clearer direction of travel on Brexit and less volatility around global trade, will support a corresponding rise in leveraged loan issuance. Default rates remain in the 1 per cent to 2 per cent range and, with interest rates unlikely to rise, there is still demand for leveraged loan paper.

European markets were dominated by Brexit in 2019. The first quarter was quiet and, although things started to move again in the middle of the year, borrowers and lenders remained cautious. Although Brexit was viewed as a UK issue, the EU was just as invested. Many of the CLOs, investors and pan-European firms sit in London and would have felt the effect of negative Brexit sentiment.

With the general election at the end of 2019 returning a majority government committed to leaving the EU, there is less uncertainty in the market, and the immediate risk of a no-deal cliff edge has receded in the short term. It is hoped that this will allow for a return to business as normal, a revival of M&A and a consequent rise in leveraged loan issuance.

European leveraged loan issuance use of proceeds, 2019



Source: *Debtwire Par*

> **Looking ahead, there are hopes that a revival of European M&A activity, prompted by a clearer direction of travel on Brexit and less volatility around global trade, will support a corresponding rise in leveraged loan issuance**

CLOs: New pockets of sustainable growth

HEADLINES

■ European collateralised loan obligation (CLO) new-issue volume reached €30.1 billion in 2019 ■ This was 11 per cent above the €27.2 billion netted over the previous year ■ The fourth quarter of 2019 saw €8 billion in CLO issuance

By Chris McGarry, partner, White & Case

Demand for CLO exposure among investors grew in 2019, driven by a decade of low interest rates and cash, treasuries and corporate bonds offering minimal yield.

Data from *Creditflux* confirms the CLO's ongoing popularity: New issue volume achieved a post-crisis record, reaching €30.1 billion in 2019. This was 11 per cent up on the €27.2 billion in 2018 and more than double the €14.3 billion in new CLO issuance seen in 2014.

However, the benefits of the CLO model have the potential to extend well beyond delivering yields for pension funds and institutions.

The bond market—and CLOs in particular—have the reach and access to liquidity to raise the US$100 trillion the UN believes will be required to deliver its Sustainable Development Goals (SDGs) by 2030.

11%

The percentage rise in new issue CLO volume in 2019, up from the year before

CLOs and SDGs

The formation of sustainable CLO markets may be one of the best ways to fund environmental and other SDG projects at the pace required to confront climate change and to deliver the SDGs by 2030.

Banks alone will not be able to provide the necessary volume of sustainable lending. But fund managers can turn sustainable loans into tradeable, liquid CLO securities. While some broadly syndicated loan (BSL) CLOs have criteria that exclude investments based on sustainable environmental, social and governance (ESG) standards, these could be turned into 'SDG-positive' structures.

Such SDG-positive BSL structures will soon begin to appear in the market, while other types of SDG CLOs with different types of loan collateral are also in the works and expected in 2020—for example, SDG-aligned infrastructure loans, including clean-energy CLOs.

Ratings firms are already prepared to rate SDG infrastructure CLOs, and banks are planning both true sale and synthetic structures. This asset class is expected to develop in 2020 alongside SDG-positive BSL CLOs and SDG sovereign bonds.

Forward momentum

The market's coalescence around SDGs as the standard on which the sustainability of a CLO is judged is a game-changer for these new structures. The SDGs enable borrowers to enter into sustainability-linked loans and bonds.

Under sustainability-linked loans, borrowers could be penalised if they fail to deliver on the SDGs to which they had committed and incentivised with lower front-end coupons.

At the moment, there are not enough leveraged loans linked to SDGs, which means CLOs cannot realistically include minimum SDG benchmarks. Instead, SDG-positive CLOs will include economic incentives that will be triggered once the level has been ramped up with sufficient sustainable assets.

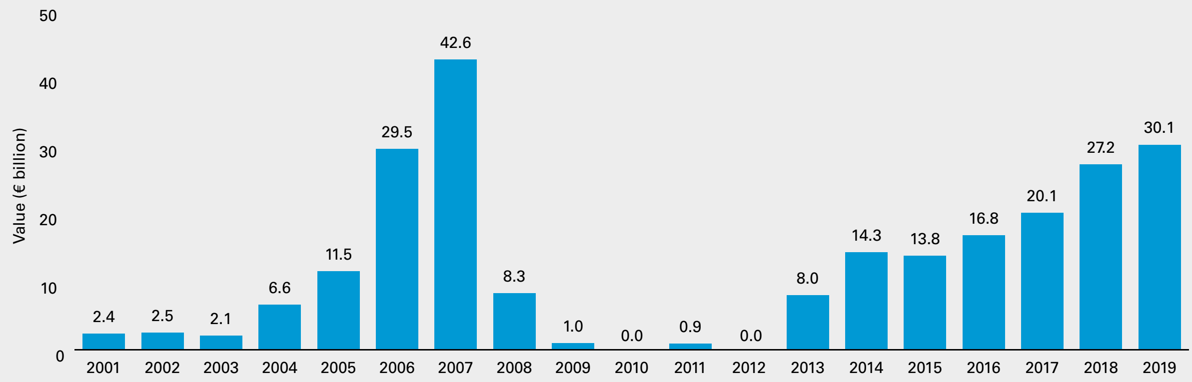
There could also be modification provisions, such as covenants designed to maintain minimum levels, and that would help SDG CLOs qualify as European Central Bank repo collateral in due course.

Investors in CLOs are already working with CLO managers to find ways to incorporate ESG elements into their decision-making when constructing leveraged loan portfolios. For example, ESG-focused Hermes Investment Management is reportedly having discussions with CLO managers to find out how they are engaging with ESG issues and to find ways for loans to improve those efforts.

Managers point to the lack of ESG-linked information provided by borrowers as an obstacle to deciding who has genuine SDG credentials. But with the introduction of SDG benchmarks and standards, nothing stands in the way of SDG CLOs' expansion.

We cannot wait for the regulators and central bankers to catch up; we need to get to work now.

New issue CLO volume



Source: *Creditflux*

Restructuring: When is the right time?

HEADLINES

■ Default levels remain historically low at 1 per cent to 2 per cent ■ Prevalence of cov-lite loans in Europe may be concealing some underperformance, but there are no conventional triggers for lenders to act

By Ben Davies and Ian Wallace—partners, White & Case

Despite concerns that the economic cycle is peaking, and the impact of geopolitical and trade volatility on corporate earnings, leveraged finance default rates show little sign of rising during the next 12 months.

According to *Debtwire Par*, loan buysiders do not expect to see defaults spike as levels hold steady in the historically low 1 per cent to 2 per cent range. With interest rates in the UK and Europe expected to remain low, and more than 90 per cent of European institutional loans issued on cov-lite terms in 2019, lenders have little scope to step in when credits show signs of underperformance. This has resulted in a relative lack of restructuring negotiations regarding leveraged loans and high yield bonds, despite growing macroeconomic concerns and uncertainties around borrowers' ability to refinance loans in the medium to long term.

Restructuring activity has occurred in some sectors, including shipping, retail, casual dining and leisure, but the persistent low interest rate environment has contributed to relatively benign conditions for borrowers.

Signs indicate, however, that more financial distress is creeping into the system, especially in the United States, where developments can foreshadow events for Europe.

Clouds on the horizon?

According to Goldman Sachs, high yield bond defaults topped 5 per cent in 2019, up from just 1.8 per cent a year ago.[5] Meanwhile, the *EY Profit Warning Stress Index*, which tracks the number of profit warnings issued by UK-listed companies, recorded 313 profit warnings in 2019, the highest total for profit warnings since 2015. Of the companies tracked, 17.8 per cent issued warnings last year, which represents the highest percentage of businesses to do so in a year since 2008.[6]

The absence of covenants, however, means that borrowers may choose to act only if their loans are approaching maturity or they are running out of cash. As much of the loan and bond issuance from recent years is long-dated, and traditional levers to commence restructuring discussions are often unavailable, lenders concerned about the health of the credits in their portfolios are forced to adopt a more creative approach when borrowers show signs of distress.

Revolving credit may open doors

Revolving credit facilities (RCFs), which have typically retained financial maintenance covenants, are one potential way to exert influence. In practice, RCF covenants will often only come into play on a 'springing' basis, when the RCF has been drawn to a meaningful level. But should the company become more stressed, it is likely to turn to the RCF and other sources of liquidity, and the financial covenant may become relevant.

Other creditors in the company's capital structure may find this comforting, but it is very different from having direct covenants, as would have been the case in previous generations of loan documents. Borrowers often find ways to manipulate their cashflows to avoid tripping the springing covenants, even in relatively distressed circumstances. If they cannot avoid a breach, they may be able to negotiate a separate waiver with the RCF lenders that leaves the term lenders and other creditors on the sidelines.

Degrees of proactivity

Some lenders, absent conventional default triggers, have looked to take steps to challenge directors of distressed borrowers, taking a more interventionist approach if they feel it necessary and reminding directors of their fiduciary duties, as well as

“

Lenders concerned about the health of the credits in their portfolios are forced to adopt a more creative approach when borrowers show signs of distress

querying whether the action being taken is in the best interest of the company's stakeholders.

Not all sponsors and management teams will allow things to go this far, however, and more creative sponsors may look to step in early and work alongside lenders to deliver solutions proactively. This strategy can be very effective in the right climate, as sponsors will typically have considerably more negotiating power as to a portfolio company that is not in breach of its loan documents than they might otherwise have later in the cycle when default is unavoidable or has already arisen.

Factors such as the nature of the capital structure and the mix of creditors, the health of the underlying business and the sponsor's stance will determine a borrower's willingness to come forward. In some cases, a borrower's simple act of commencing a restructuring dialogue with its lenders can act as an unwanted catalyst and precipitate a deterioration in the business, making borrowers and sponsors alike wary of instigating discussions prematurely.

That said, coming to the table early may be the smart course of action and create enough of a runway for the sponsor and the management team to present a turnaround strategy to the lenders and agree on the framework within which it can be realised.

Public-to-private: Private equity on the hunt for new value

HEADLINES

■ In 2019, European take-private deals backed by private equity reached €34.5 billion over 31 deals ■ This is 14 per cent higher than 2018 and more than five times the total deal value seen just five years earlier ■ Equivalent UK total deal value in 2019 was more than double the year before

By Richard Lloyd, Ben Wilkinson and Patrick Sarch—partners, White & Case

European public-to-private (P2P) deal activity has surged over the past decade, with take-private deals becoming a key generator of deal flow for private equity (PE) firms as they seek to deploy capital.

Data from *Mergermarket* shows that European PE-backed P2P total deal value at the end of 2019 reached €34.5 billion, up 14 per cent on the 2018 full-year figure of €30.3 billion and substantially higher than every other year since 2008. Meanwhile, UK P2P deal value hit €23 billion (£19.6 billion) in 2019, more than double the €9.7 billion (£8.3 billion) reached in 2018.

P2P: How did we get here?

This consistent growth in P2P activity reflects the rise of private capital and a shift from public markets, which has resulted from a combination of underlying factors.

Private M&A processes have become ever-increasingly competitive between PE bidders and among the institutions looking to finance them.

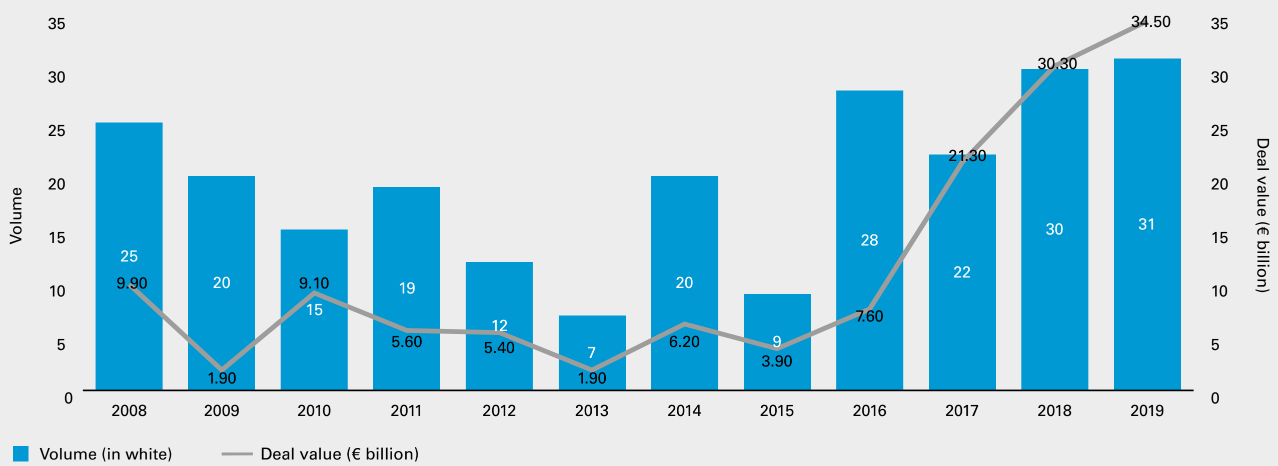
Record inflows into PE funds, the rise of private credit, an endless appetite for new debt issuance from CLOs and an ongoing low interest rate environment has meant that there is significant debt and equity dry-powder and ever-increasing pressure to deploy those funds. A scarcity of good-quality and available privately held assets has led to a greater sense of adventure into the public markets.

In deploying these funds, PE firms have been able to take advantage of recent volatility in public markets to acquire undervalued assets. This has been further exacerbated in the UK by a fall in the value of sterling

€34.5 billion

Overall PE-backed P2P deal value at the end of 2019, up 14 per cent on the 2018 full-year figure and substantially higher than every year since 2008

European PE-backed P2P deals, 2008 – 2019



Source: *Mergermarket*

caused by uncertainty surrounding Brexit. There may also have been instances of public company managers and more vocal activist investors who feel their companies are undervalued and that PE can offer the multiples they are expecting.

To some extent, increased PE activity in P2Ps, especially on big-ticket deals, has meant that PE is more comfortable with the regulatory process and regulators are more familiar with PE. Historically, there may have been some concern about the regulatory obligations involved in a public takeover, including whether a regulator would be sympathetic to buyout investors.

A reluctance to publicise deal terms and perceived higher execution risk (where deals are subject to counter-offers, 'bumpitrage' and longer than usual timelines) may have also previously appeared as barriers to entry.

Increased deal flow has meant that PE firms are increasingly comfortable operating in the public sphere, while old-fashioned perceptions from regulators that PE represents a threat to good corporate governance have evaporated.

Where are we headed?

The P2P trend looks likely to continue into 2020 as many of the underlying fundamentals remain supportive.

Growing interest among new entrants to European public takeovers will also continue to contribute to an uptick in public activity. These new players include: mid-market PE firms focusing on smaller targets (as big-ticket opportunities are more competitive); direct lenders, who are increasingly willing to lend bigger tickets on more competitive terms; and US bidders, which will add greater complexity to NY law credit agreements and US syndication processes in order to comply with European and UK regulation.

Caution may be warranted

Despite strong P2P tailwinds, some triggers could slow activity or add layers of complexity to the process. The UK, for example, appears to be subject to a continuing degree of economic certainty following the 2019 general election, which may result in fewer opportunities for pricing arbitrage. Meanwhile, a benign environment of easy monetary policy has allowed global stock markets to hit recent record highs (although the UK market is still relatively cheap).

If equity markets continue to grind higher, public targets will start to look less and less attractive. In these circumstances, it will be interesting to witness whether the financing markets (under pressure to deploy capital) out-muscle high prices in the equity markets (with PE always reluctant to increase multiples). In the short term, this will undoubtedly lead to greater pressure on more thorough and exhaustive diligence to find the right targets.

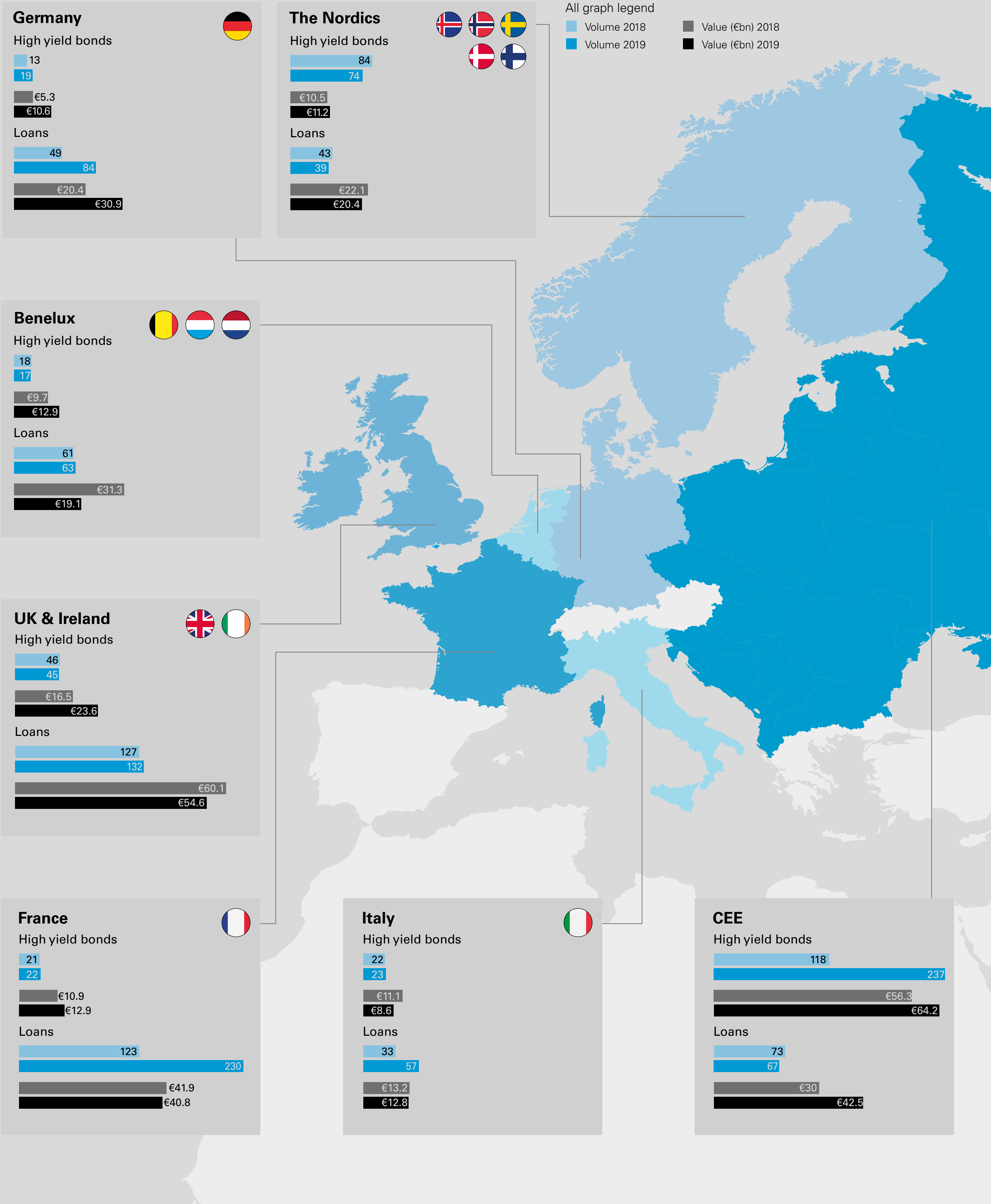
Regulation of P2Ps is also evolving as watchdogs across Europe catch up with the rise in take-private deal activity. Squeeze-out thresholds are shifting in certain jurisdictions, deals are being documented as short-term bridge financings in order to avoid having to agree (and publicise) long-term documentation on rushed timetables, levels of disclosure (particularly around flex terms) are commonly now being discussed in greater detail, and the alignment of deal timelines with 'certain funds' and regulatory requirements are likely to come under increasing scrutiny.

While bid financing has coalesced into relatively established market standards, increased regulation and a spotlight on PE activity in the public markets could require new or more innovative approaches to P2P transactions.

> **"To some extent, increased PE activity in P2Ps, especially on big-ticket deals, has meant that PE is more comfortable with the regulatory process and regulators are more familiar with PE**

European leveraged debt in focus

Selected European leveraged loan and high yield bond markets by volume and value



Regional focus: Spain finishes strong

By Fernando Navarro, partner, White & Case

The Spanish leveraged finance market went from strength-to-strength in 2019, with a selection of large deals and the market's capacity to execute complex deal structures pushing issuance to four-year highs.

High yield offered few surprises in 2019, but the leveraged finance market in Spain has enjoyed a particularly good year, boosted by several larger deals and significant activity in the mid-market, which is the biggest market in the country. The market has matured, grown more sophisticated and, as far as investors are concerned, is more closely aligned with Western European trends than ever before.

By the end of 2019, Spanish leveraged finance issuance (loans and high yield) totalled €27.7 billion across 64 deals. This was well ahead of the €15.7 billion issued during all of 2018 and the €20.7 billion of issuance in 2017.

Maturity matters

The market's maturity is evidenced by pricing in Spain, where spreads have narrowed. In 2014, institutional Spanish loans were priced at 389 basis points (bps) versus 424 bps in the UK, 410 bps in France and 416 bps in Germany, according to *Debtwire Par* data. In 2019, Spanish loans were pricing at 342 bps on average, versus 381 bps in the UK, 407 bps in France and 396 bps in Germany.

The growth of Spain's market is further reflected in the big-ticket deals the market has been able to digest and deliver.

KKR's €602.23 million (US$667.5 million) take-private of pizza group Telepizza, for example, saw the investment firm start out with a standard bridge loan and revolving credit facility, with a view to refinance the whole facility through a €333.8 million (US$370 million) high yield bond priced at 6.25 per cent, according to *Debtwire Par*.

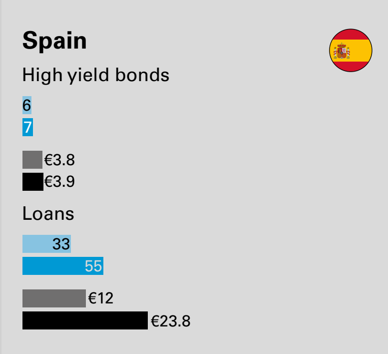
This deal was particularly notable in that the bridge loan was subject to English law, while the covenant package was subject to New York law. A few years ago, the Spanish market would have found it difficult to understand a complex structure like this. In today's more sophisticated market, deals like these are no longer unusual.

Grifols is another prime example: The pharmaceuticals group secured a refinancing involving a term loan B (TLB) that sat alongside a high yield bond and a super-senior revolving credit facility. Spanish telecoms group MásMóvil, meanwhile, sought to refinance a convertible bond and simultaneously increase its debt in 2019 by combining a covenant-lite loan with the issue of preferred equity.

While TLB structures were considered better suited to London and New York a few years ago, they are now viewed as another viable source of financing by banks and borrowers in Spain.

Spain enters new territory

Deal momentum is expected to carry the market in 2020, with airline operator IAG's €1 billion (US$1.11 billion) acquisition of Air Europa and a bidding war for Spanish Stock Exchange group BME both expected to tap into leveraged markets.



Despite the positive outlook and cov-lite characteristics of loan issuance, however, an uptick in restructuring activity is anticipated. Deals like the €1.8 billion (US$2 billion) issue for supermarket cooperative Eroski have already made a telling contribution to restructuring values. With the Spanish Socialist Workers' Party winning the most seats in the November 2019 general election, rising taxes are also a distinct possibility and could weigh on both consumer spending and corporate cash flows.

While acquisitions are in the pipeline, the market may see more restructurings by Q3 and Q4 2020, running in parallel with acquisitions. This is new territory for Spain, and should make for an interesting year ahead.

> **"The leveraged finance market in Spain has enjoyed a particularly good year, boosted by several larger deals and significant activity in the mid-market, which is the biggest market in the country**

Map legend (overall activity ranking)

Lowest — Highest

Sector watch: Hot or not?

HEADLINES

■ Industrials and chemicals in aggregate accounted for the largest share of loan activity (20 per cent) and high yield bonds (22 per cent) in Europe ■ Pharma, medical and biotech issuers were the second most active in European leveraged loans, (14 per cent of deals in aggregate) ■ Services topped the list for loans in Europe with 11.2 per cent of issuances for the region

By Jill Concannon, partner, White & Case

As Europe's leveraged finance market has matured and filled the space vacated by banks following the financial crisis, investors have broken free of sector silos and embraced a much broader spread of industries.

Pre-crisis, the European high yield market was focused primarily on telecoms and other fast-growing industries. It has since become far more diverse. This was already evident in the US, where the market had broadened beyond the traditional group of high-growth issuers.

Issuance figures for European high yield and leveraged loans in 2019 show that no individual sector accounted for more than 23 per cent of the market, and that none of the 10 most active sectors accounted for less than 4 per cent. Leveraged finance has become a broad church when it comes to diversification by industry.

Diverging paths for leveraged loans and high yield bonds

In broad terms, industrials and chemicals in Europe have been most active for issuance in both the leveraged loan and high yield bond spaces. According to *Debtwire Par* data, industrials and chemicals combined accounted for the largest share of activity in loans (20 per cent) and high yield bonds (22 per cent).

This, however, is where the similarities end, with issuance diverging by sector between leveraged loans and high yield bonds. In leveraged loans, pharma, medical and biotech issuers were the second most active, accounting for 14 per cent of deals, but only 3 per cent of high yield issuance. There is a similar imbalance in the financial services sector, which made up only 5 per cent of European leveraged loan issuance in 2019, but 16 per cent of high yield bond activity.

The types of borrowers active in these sectors have coloured issuance numbers. Private equity firms, for example, are active in the services space and have recently demonstrated a preference for loans, as illustrated by 2019 figures showing buyouts as the second-largest source of loan issuance at €39.2 billion (behind refinancings/ repricing at €87.7 billion).

In high yield bonds, however, services is only the third-largest sector by issuance (5.1 per cent), and LBO takings of €5.6 billion are less than 15 per cent of the €51.1 billion raised for refinancing.

The predominance of chemicals/ industrials as well as financial services for 2019 issuances may reflect the softer high yield market earlier in 2019, with issuers that are more 'sure bets' coming to market and those that are either new to the space or in possession of other financing options taking a different route.

A focus on credit quality and sector-specific terms

Both leveraged loan and high yield bond investors in general have made an obvious shift to focus on credit quality. Sectors that are under particular pressure, such as automotive and consumer retail, accounted for only 4.4 per cent and 6.8 per cent of deal activity, respectively, in the European loan space in 2019. In the high yield bond market, consumer retail made a small appearance with 2.8 per cent, while automotive only represented a 6.9 per cent share of deals.

The focus is now very much on the business model. Lenders are taking a closer look at the fundamentals of a business and its sector than they did just a year or two ago.

Sector is also influential when it comes to terms. Historically, the market has been sympathetic to the relaxation of certain terms for companies in specific industries. For example, chemical companies as well as oil & gas operators have been given wide flexibility to invest in joint ventures without further controls, given that this is how the companies have tended to operate their businesses.

The market has also been sensitive to credit-specific points applicable to certain sectors (for example, issuers in the debt purchase and servicing space typically have had tighter controls on securitisations, although that has loosened for certain names in their subsequent issuances).

However, companies returning to the leveraged finance market

20%

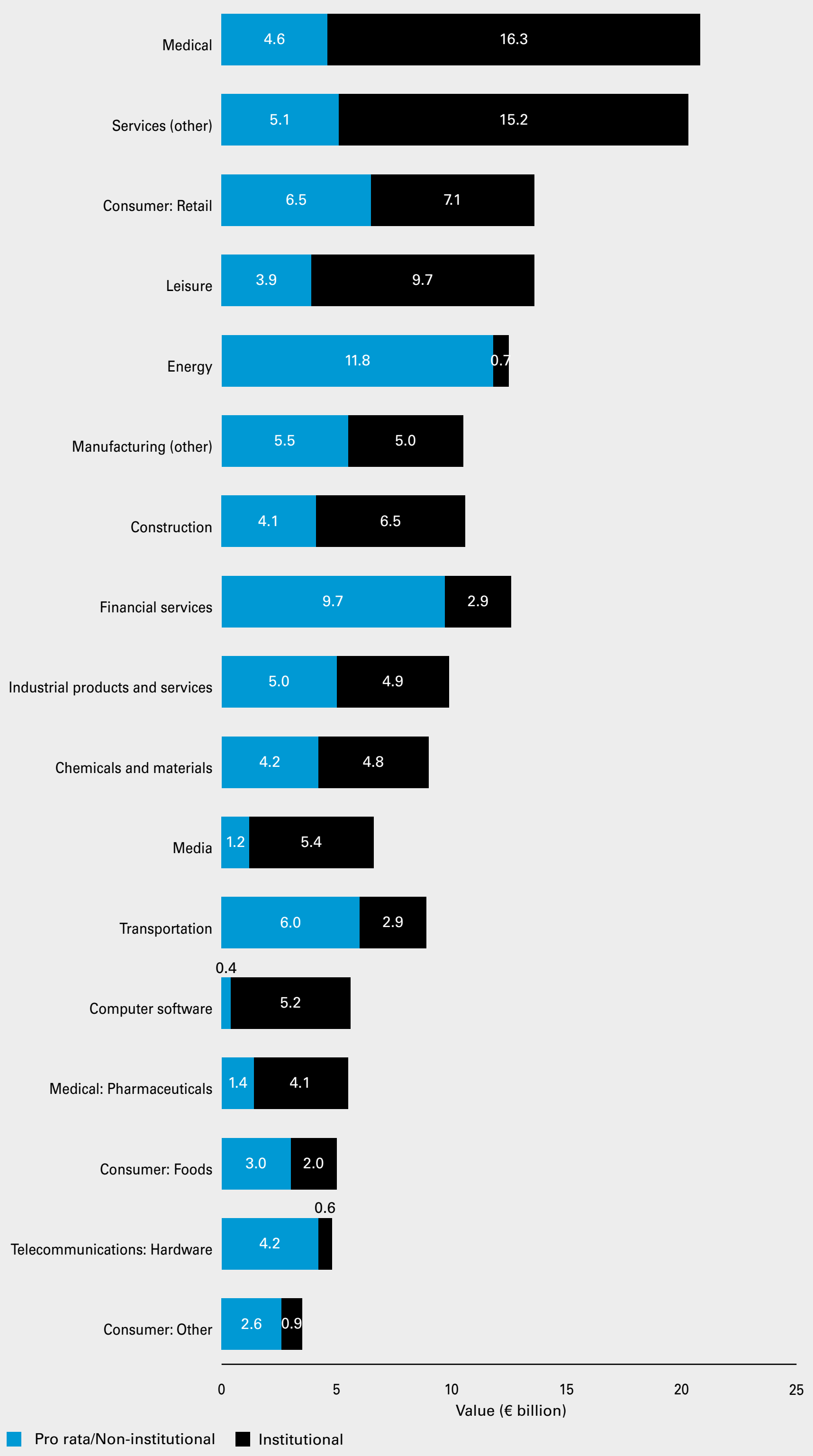
The proportion of leveraged loan activity in Europe issued in the industrials and chemicals sector, in aggregate

from sectors where there have been quirks in covenant packages in the past may find that investors are looking very closely at terms and asking whether they still make sense, or whether they could create too much flexibility for the issuer in a downturn.

It is almost certain that operators in distressed sectors (such as retail) will need to tighten covenant packages if they are coming back to market, although businesses in more resilient areas, such as software-as-a-service, will have an easier process.

Some sector borrowers, especially those under pressure and seeking favourable terms, may discover that they must do their homework if they want to attract willing lenders in the months ahead.

European leveraged loan issuance by industry subsector—pro rata vs. institutional



Source: *Debtwire Par*

Conclusion

In a market that has seen notable highs and lows since the financial crisis, while remaining ever-vigilant for red flags, a degree of consistency is beginning to take hold in European leveraged finance

The European leveraged finance market is looking stable overall for 2020, after topping €300 billion in 2019. Leveraged loan issuance in the region remained steady, reaching €209.1 billion, while high yield bond issuance enjoyed a notable uptick, jumping by more than 20 per cent to €95.5 billion.

At the same time, the picture emerging from the data is one of a bifurcated market, highlighted by the fact that almost all leveraged loan issuance was for credits rated B or higher, with negligible interest in credits with lower ratings.

Similar dynamics were observed in the high yield bond market, where issuance for bonds rated B+ or higher was almost three times higher than that for credits rated B or lower.

Lenders are increasingly putting credit in the spotlight, willing to accept loose covenants and aggressive pricing for good credits, while questioning documentation and pricing for more difficult credits. The pressure is on to find deals that balance higher yield with potential risks.

Finding new routes to yield

Collateralised loan obligations (CLOs) offer one potential path to higher yield, and the market is taking note. New-issue volume of CLOs reached more than €30 billion in 2019, a post-crisis record and 11 per cent higher than the year before.

The fourth quarter of 2019 was particularly active for European CLOs, with €8 billion in issuance, a sign that this trend is likely to continue. Refinancing/Repricing, which secured €50.8 billion of institutional loan issuance in 2019—up 32 per cent on the previous year—has been a major driver of this activity, as CLOs search for ways to invest their capital.

CLOs are also opening new paths for interested investors, in the form of sustainable CLO markets focused on the UN's Sustainable Development Goals (SDGs). Will 2020 be the year we see a rise in 'SDG-positive' broadly syndicated loan CLOs that exclude investments based on sustainable environmental, social and governance standards?

Searching for regional and sector hotspots

The European leveraged finance market is also flexing its muscles across the continent, with Spain's growth in this arena making particular waves. Leveraged loans in the country totalled more than €23 billion in 2019—almost double the issuance for 2018 and the highest values seen in five years.

The larger deals that have come through in 2019, from KKR's take-private of pizza group Telepizza to Spanish telecoms group MásMóvil's refinancing activity, confirm the country's maturity and ability to handle a larger share of the market.

€300+ billion

Overall European leveraged finance for 2019

As maturity levels continue to grow in these markets, investors may see new pockets of potential emerging in the months to come.

On the European sector front, meanwhile, the focus on credit quality comes into sharp relief.

For example, the pharma, medical and biotech sectors were the second most active leveraged loans issuers, in aggregate, accounting for 14 per cent of deals, but only 3 per cent of high yield issuance. There is a similar imbalance in the financial services sector, which made up only 5 per cent of European leveraged loan issuance in 2019, but 16 per cent of high yield bond activity.

Leveraged loan and high yield bond investors alike are turning to 'safe bets' such as industrials and chemicals—which accounted for the largest share of loan activity (20 per cent) and high yield bonds (22 per cent). Sectors that are under pressure, from automotive to consumer retail, represented a far smaller proportion of deal activity in the European leveraged loan and high yield bond market. They will need to step up their game if they want to attract lenders in the next 12 months.

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