WHITE & CASE

European leveraged finance: COVID-19 and the flight to quality

The European leveraged finance market remains resilient after a year of unprecedented hardship, as lenders dissect credits to determine the best possible deals, from pricing to documentary terms

Contents

Foreword

As we enter 2021, COVID-19 continues to weigh on every decision, from our health to our work and our long-term plans—and yet, despite these concerns, European leveraged finance markets have weathered the storm and remain positive about the year ahead

In March 2020, as lockdown restrictions took hold, the European leveraged finance markets ground more or less to a halt. Many feared the worst, as leveraged loan issuance dropped significantly that month and high yield bonds saw virtually no activity at all. Borrowers and lenders alike held their breath, shoring up their finances and waiting to see what might come next.

And then, just as quickly, investor sentiment began to improve. By the end of Q2 2020, leveraged loan activity had returned almost to pre-pandemic levels. And while it slowed somewhat in the latter half of the year, as new waves of COVID-19 swept across the UK and Europe, the final tally was up 11% on the year before—a remarkable achievement, confirming the market's long-term resilience.

The story in high yield bond markets was equally impressive, ending the year up 10% on 2019 figures, with every indication that it will retain a larger share of the market in the months ahead.

What does all of this mean for 2021?

First and foremost, the influence of COVID-19 will continue to be felt, even as vaccines are rolled out across Europe. Sectors hammered by the first wave—including entertainment and leisure, hospitality, retail, oil & gas and aviation—will struggle to secure financing, having already done what they can to survive. Within those sectors, those that require financing and are able to secure deals are likely to have to pay for the privilege, with leveraged debt either becoming more costly for those whose credit has taken a hit or only being made available on tighter terms.

Second, and in contrast, lenders will turn their attention to high-quality credits or sectors that have found new avenues for growth during COVID-19, such as technology and healthcare.

Third, loan supply will continue to open up—but primarily for those that meet the right criteria. For those well-positioned companies, this flight to quality will continue to offer favourable terms and pricing, and the light-touch covenant packages that were the norm pre-pandemic should remain in place.

At the same time, an anticipated recovery in mergers and acquisitions and leveraged buyout activity will provide an additional lift in the early months of 2021.

And finally, the issues that were front of mind pre-pandemic will continue to influence borrowing and lending decisions, especially environmental, social and governance (ESG) factors—investors will take a positive view of any credits that incorporate ESG criteria in a meaningful way. This will no doubt drive this trend in the months ahead as recovery takes hold and global debt markets return to growth.

Living dangerously: How has European leveraged finance fared in the pandemic?

HEADLINES

■ European leveraged loan issuance is up 11% on the previous year to €227.1 billion ■ High yield bond issuance is up 10% on 2019 figures to €100.5 billion ■ Average yields to maturity on high yield bonds widened from 3.8% to 4.7% in 2020 ■ Average margins on institutional leveraged loans increased from 338 bps in Q1 2020 to 401 bps in Q4

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

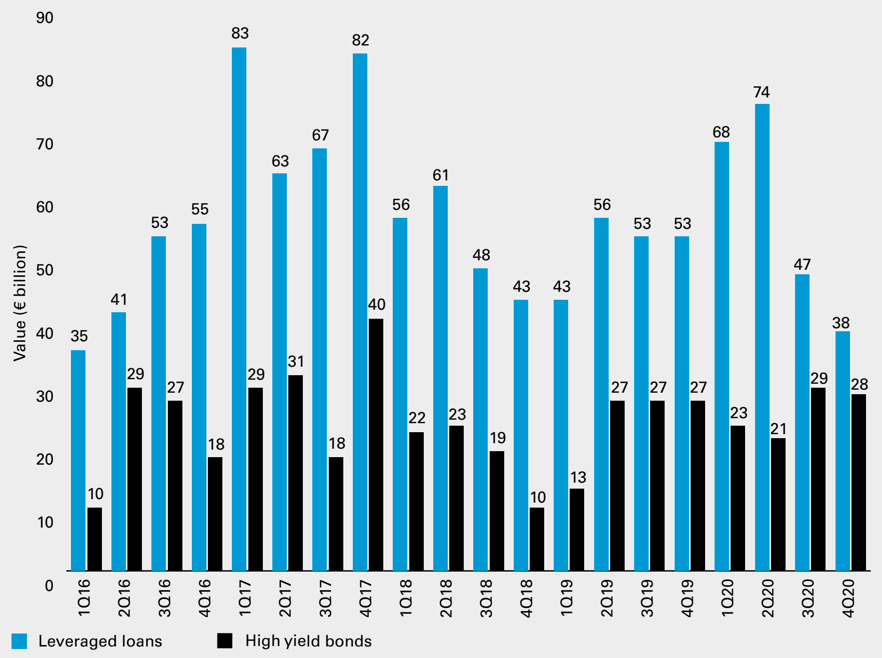
After a volatile year, European leveraged finance markets sparked back into life in the final quarter of 2020, proving more resilient than many anticipated and well positioned to continue building momentum.

Going into 2021, many of the elements that characterised leveraged finance issuance during the COVID-19 pandemic are likely to remain a feature of the market. For example, in the short-term at least, lenders will continue leaning towards high-quality credits or those in sectors that have seen COVID-19-linked opportunities for growth, such as technology and healthcare.

For borrowers that meet the criteria, the ongoing market recovery and appetite among lenders to catch up on lagging deployment schedules will support the ongoing march of flexible documentation and light-touch covenant packages that were typical pre-pandemic.

For example, the carve-out of ThyssenKrupp's elevator business, led by buyout firms Advent and Cinven as well as Germany's RAG Foundation, secured a package of loan and debt financing in June 2020 on borrower-friendly terms, including a cap of 25% on EBITDA adjustments, a 45-day holiday on ticking fees (i.e., fees charged on undrawn debt facilities) and scope to raise additional leverage.

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



Source: *Debtwire Par—figures rounded up to nearest whole number*

Positive signs

Despite a severe market dislocation in March and April, overall European leveraged loan issuance reached €227.1 billion for the year, up on the €204.5 billion recorded in 2019, according to *Debtwire Par,* although institutional loan issuance did see a larger decline, dropping 22% to €90.9 billion over the same period. High yield bond issuance has proven more resilient—up 10% on 2019 figures to €100.5 billion—and could well retain the market share won from loans through the course of 2020, especially lower

11%+

The rise in leveraged loan issuance in 2020, year-on-year

down the capital structure, with unsecured high yield bonds pricing competitively against second-lien loan debt.

Pricing on loans and bonds widened in 2020 and, despite tightening in the final quarter of the year, lenders expect to see pricing hold in their favour in the months ahead, as fewer opportunistic credits hit the market for a repricing than seen in prior periods.

Average yields to maturity on high yield bonds widened from 3.8% to 4.7% through the course of the year, while the average margins on institutional leveraged loans increased from 338 bps in Q1 2020 to 401 bps in Q4.

There are several examples of deals that were able to raise finance but at higher pricing, including BlackRock-owned Creed Fragrances, which priced a €250 million institutional loan at 5% over Euribor, and Blackstone-backed Building Materials Europe, which secured a €220 million refinancing at the same cost.

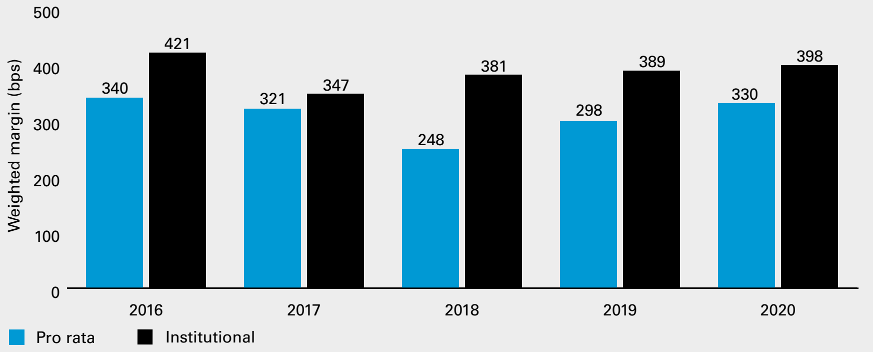
In the loan markets, lenders secured further pricing enhancements through deeper original-issue discounts (OIDs—the discount from par value at which a loan is offered for sale to investors) and, in some cases, improved LIBOR floors. The share of new loans with OIDs of 99 and below increased through the year, representing more than a quarter of new deals.

With regards to LIBOR floors, which lock in a minimum interest rate for borrowers even when interbank lending rates fall, the share of loans with floors of between 0.5% and 1% increased slightly in 2020, although 0% floors do still account for the bulk of issuance.

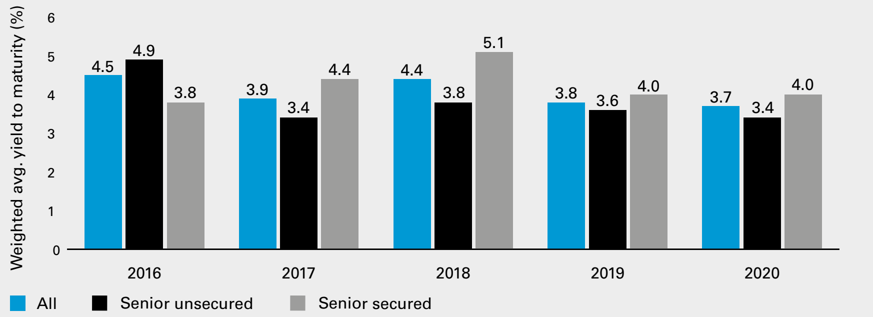
Reasons for optimism

While a second or third wave of COVID-19 poses ongoing challenges for the market, a series of approved vaccines with ongoing rollouts, along with a change in administration in the US, have raised hopes for improved deal flow in 2021. Vast quantitative easing programmes introduced by the Bank of England and the European Central Bank have injected large sums of liquidity into capital markets, which will be put to work by banks and investors.

European leveraged loan pricing

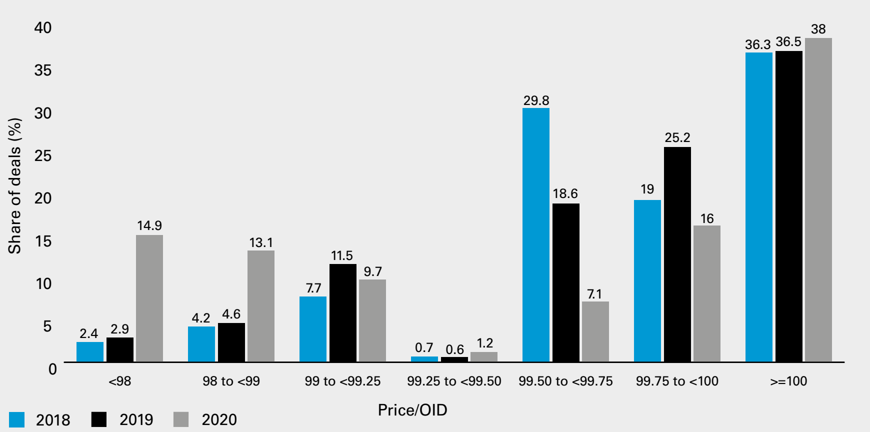


High yield bond pricing—Fixed-rate bonds*



Source: *Debtwire Par* *EUR issues only

Original issue discounts (OIDs)*



Source: *Debtwire Par* *Based on universe of deals where OID data available

Additional European government employment support schemes—which received applications from more than 40 million workers—and various state-backed loan schemes brought further liquidity into the marketplace when it was most needed, injecting billions into European economies.

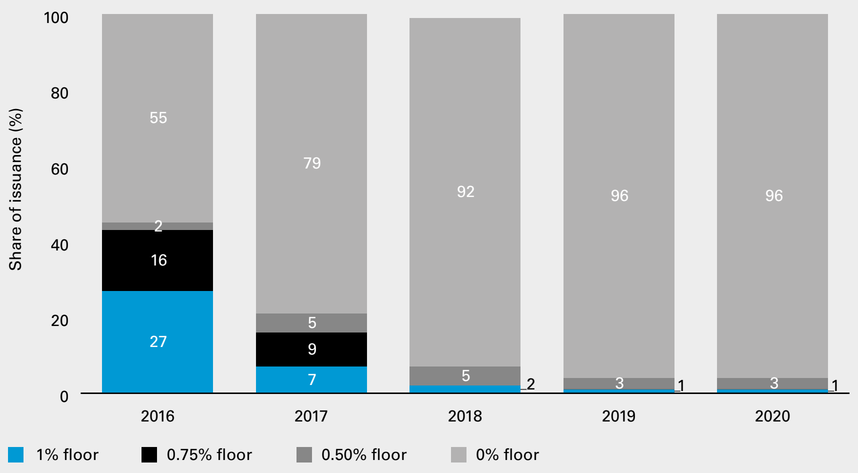
These measures, combined with low interest rates, have allowed many lenders to get their capital deployment targets back on track.

Government and central bank action also supported existing credits through the most volatile stages of the year, which meant that many borrowers could avoid restructuring scenarios. As a result, only €3.1 billion of leveraged loan issuance was secured for restructuring in 2020. Restructuring activity, however, could still increase as government support measures unwind.

An anticipated recovery in mergers and acquisitions (M&A) and leveraged buyout (LBO) activity will provide an additional lift in the early months of 2021. Leveraged loan issuance for M&A (excluding LBOs) rose 26% year-on-year to €46 billion, according to *Debtwire Par*, while LBO loan issuance was down by 6% to €36.8 billion.

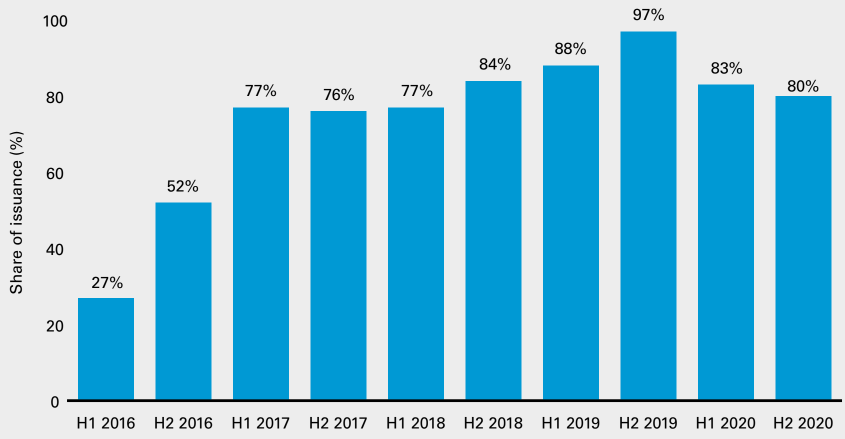
These shifts in issuance align with a wider M&A slowdown during the year. *Mergermarket* data shows that European M&A deal count fell 29% between Q1 and Q2 of 2020. However, M&A rebounded in the second half of the year, with deal values finishing the year up overall on 2019. LBO deal values followed a similar path, according to *Debtwire Par*, but deals started to pick up towards the end of the year.

Benchmark floors on institutional term loans



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

European covenant-lite share of institutional loans



Source: *Xtract Research*

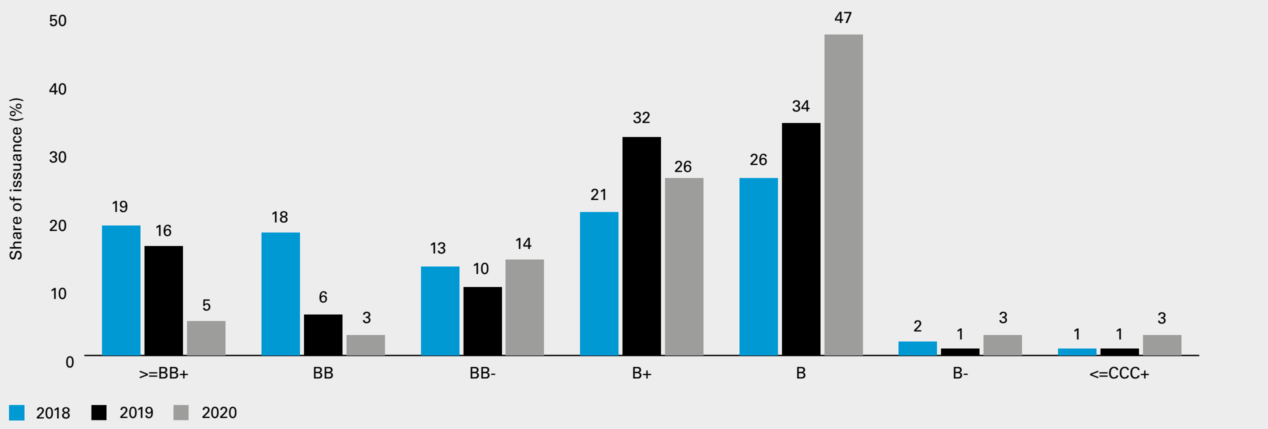
COVID-19 trends

The rise in M&A coupled with pent-up lender demand make for a positive outlook for leveraged finance activity going into 2021. This stands in stark contrast to the uncertainty the market faced when the spread of COVID-19 accelerated and lockdowns first came into force across Europe. Leveraged loan issuance almost halved between February and March 2020. European high yield bond markets shut down entirely, with almost zero issuance in March.

Secondary markets revealed further indicators of distress. In February, existing loans were pricing at an average of 97.4 (% to par) according to *Debtwire Par*. A month later, average prices in the secondary market had fallen to 82.3 (% to par), with 99.8% of all European loans in circulation suffering declines in face value, compared to 32% in January.

Against this challenging backdrop, new loan activity dried up. Liquidity became the primary focus for borrowers, who drew down on existing facilities and sponsors directed resources into portfolio management. According to data quoted in the *Financial Times*, at least 104 European non-investment-grade borrowers drew down around €32.2 billion from loan facilities through the first wave of COVID-19 lockdowns.[1] This, plus central bank and government stimulus

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.*

as well as higher secondary market prices, prompted a marked rebound in high yield activity towards the middle of the year—June saw more than a five-fold month-on-month increase in issuance, jumping from €2.9 billion in May to €16.2 billion.

With billions drawn down from existing facilities held by banks, bank balance sheets were extended. Deeper investor pools made high yield an attractive option for borrowers eager to lock in liquidity.

For lenders, a number of ratings downgrades as a direct result of COVID-19 saw a notable increase in 'fallen angels'—bond credits that lose their investment-grade status after a downgrade.

The underlying quality of these credits appealed to high yield investors. In September 2020, S&P Global reported that fallen angel issuance was on track to reach a record high of around US$640 billion (€527.4 billion) in 2020.[2] And as mentioned above, pricing also moved in favour of high yield investors, drawing more to the bond market. This showed that investors recognised that fallen angels remained good-quality credits with strong cash flows and attractive assets, though the financing structures may have had to introduce a set (or sub-set) of high yield covenants or may have required collateral to support the debt.

The focus on liquidity and on the management of portfolio assets by private equity also meant that most issuance was used for refinancing or general corporate purposes. Refinancing accounted for €74.7 billion of loan issuance in 2020, with €53 billion secured for general corporate purposes. LBOs and acquisitions amassed €36.8 billion and €40.8 billion respectively.

High yield has followed a similar pattern, with refinancing (€49.6 billion) and general corporate issuance (€13 billion) outpacing issuance for LBOs (€7.8 billion) and acquisitions (€9.3 billion).

The recovery in secondary prices as 2020 drew to a close is expected to support ongoing issuance for refinancing and general corporate purposes, with prospects for LBO issuance also upbeat.

Average secondary market institutional loan pricing recovered to more than 95% in December 2020, according to *Debtwire Par*. and even credits in the sectors directly impacted by lockdowns saw secondary pricing rebound. Cineworld, Hotelbeds and Vue Cinemas, for example, all enjoyed double-digit increases in secondary market pricing in Q4 2020.

Looking ahead

While COVID-19 sharpened the market's focus on liquidity and portfolio management, it amplified another trend that will carry into the year ahead: the increasing focus on environmental, social and governance (ESG) criteria in leveraged finance.

The pandemic has demonstrated—in the starkest possible terms—that businesses are not isolated from social and environmental factors. Institutional investors across all asset classes are recognising this fact and are increasingly adding an ESG filter to their criteria. Signatories to the UN Principles for Responsible Investment have grown from 100 when the organisation first launched in 2006 to more than 3,000 today.[3]

European leveraged finance markets still have work to do in this area, but they are clearly catching up with other asset classes, with an increase in working groups across many organisations tasked with deepening the understanding and implementation of ESG matters. There are also examples of loan documentation including provisions that give lenders a higher margin if agreed ESG criteria are not met, with a margin discount applying where such criteria are satisfied.

This theme should continue to gain traction in post-COVID-19 leveraged finance markets as investors and lenders alike pay greater attention to ESG metrics.

Five trends driving post-COVID-19 documentation

HEADLINES

■ Terms will move back in favour of borrowers/issuers (for now) ■ Lenders will hold the line in key areas ■ Forecasting and structuring will be a post-COVID-19 challenge ■ Pricing will continue to bifurcate by sector and rating ■ Competition will encourage private debt and syndicated markets to converge

By Richard Lloyd, Shane McDonald and Gilles Teerlinck—partners, White & Case

Although European leveraged loan issuance almost halved in March 2020 month-on-month and high yield bond markets largely shut down that same month, leveraged finance markets regained their stability relatively quickly following the initial shock of COVID-19 lockdowns.

Entering 2021, the underlying drivers—low interest rates and liquidity—remain firmly in place, with lenders eager for yield and any shifts in documentation and terms expected only on the fringes.

Any meaningful documentary changes introduced in 2020 were prompted largely by short-term covenant waivers or followed failed sell-downs. They typically involved the inclusion of liquidity covenants, carve-outs of pandemics from Events of Default or so-called 'EBITDA before Coronavirus' (EBITDAC) add-backs.

What does this mean for businesses, borrowers and lenders for the year ahead? Five key trends will likely shape the market during the next 12 months.

1. Terms will move back in favour of borrowers/issuers (for now)

Lenders have been able to secure some *quid pro quo* tightening of documents through 2020, due to the many covenant waivers that came around in the first half of the year.

In return for waivers, investors have negotiated items such as liquidity covenants and increased reporting. The UK's digital rail-and-coach ticketing platform, Trainline, along with cinema chain Cineworld and transport group Stagecoach are just a few of many examples. Equally, the muted investor reception to deals that closed prior to the onset of lockdowns meant that pricing widened and covenants were strengthened as these deals struggled to sell.

The waiver changes, however, will soon expire and, as markets normalise, borrowers will likely resist the full extent of these terms on new deals.

Indeed, the terms of financings launched during COVID-19 were little changed from those seen before the market's enforced closure in March, and sustained investor demand for yield was further illustrated when both online classifieds group Adevinta and food ingredients producer Solina reverse-flexed recent loan issues late in 2020.

2. Lenders will hold the line in key areas

Although lenders may make some concessions, they will hold the line in certain areas. Weaknesses in documents that came to light during the pandemic will have to be addressed as borrowers, issuers and lenders take a pragmatic approach to deals with the biggest loopholes.

Debt capacity will be in the spotlight, with restrictions on dilutive and structurally senior capacity—which will include limiting the potential for incurring debt at unrestricted subsidiaries and blocking the transfer of valuable assets, most notably IP, to those entities.

UK sports car maker McLaren, for example, recently saw bondholders mount a successful challenge to stop the company from raising additional capital via an unrestricted subsidiary structure.

Super-senior debt capacity may also now be specifically addressed. While there have been high-profile and contentious fundraisings in the US, European credits have successfully raised super-senior liquidity via existing capacity, consensual amendments or through court-sanctioned schemes of arrangement. Lenders will look to switch off the taps for this capacity or prevent any future misuse of covenant loopholes.

Borrowers and issuers may be encouraged to take a sensible approach, rather than pushing for the most aggressive terms in all areas, accepting more justifiable levels in return for useful flexibility elsewhere.

3. Forecasting and structuring will be a post-COVID-19 challenge

If the market resets in 2021, it will be interesting to see how new deals progress when it has been so difficult to judge creditworthiness on the basis of 2020 earnings figures, particularly for any credits hit by negative rating agency adjustments.

EBITDAC adjustments were a noteworthy feature of loan and high yield bond deals through the year, with many borrowers and

issuers relying on historical EBITDA numbers and/or data that excluded the impact of COVID-19.

Blackstone-backed measuring technology business Schenck Process, for example, added €5.4 million back to its profits in 2020 on the basis that it would have realised these profits had COVID-19 not struck.

German beauty retailer Douglas, meanwhile, added back €15 million to its earnings when reporting its second quarter results at the end of March, citing additional costs related to store closures.

The European Leveraged Finance Association (ELFA) has already voiced concerns about how EBITDAC has been applied.[4] This raises questions about what LTM (last 12 months) numbers will be used, and how and when the market will transition back to standard EBITDA figures. How will dealmakers and lenders forecast and structure new deals? What happens to credits where covenants were waived? These are questions that the markets will be asking for months to come.

4. Pricing will continue to bifurcate by sector and rating

Borrowers in sectors hit particularly hard by lockdown measures—such as leisure, hospitality, aviation and automotive—were able to secure financing during the year, but at higher interest rates than those available to credits in favoured, more resilient sectors.

Cruise liner operator Carnival, for example, had to pay 12% for three-year secured bonds in the spring of 2020. By comparison, market research platform Nielsen launched a European term loan B offer a month later that was priced at just 3.75%.

Carnival announced plans in November 2020 to raise a US$1.6 billion unsecured bond priced at 8%, but this is still more expensive than the options available to companies in sectors like technology and healthcare.

The market also bifurcated when it came to ratings, with more than 90% of leveraged loan and high yield bond issuance coming from credits rated 'B' or above during 2020.

This 'flight to quality' could be the ultimate legacy of COVID-19, as lenders continue to analyse sectors and credits on a very granular basis in order to determine pricing levels and documentary terms.

5. Competition will encourage private debt and syndicated markets to converge

All indications are that high levels of liquidity will remain a feature of capital markets in 2021, which may lead to a wave of opportunistic M&A driven by available cash, as well as investing in distressed assets that are fundamentally sound but require capital.This dynamic is expected to drive up competition for transactions, pushing private debt funds to look at deals with increasingly borrower-friendly terms.

A blurring of lines between traditionally 'tight' private debt terms and 'permissive' distributed debt is on the horizon—with cov-lite possibly becoming the single product being accepted across the majority of the market.

The use of cov-lite and high yield-style incurrence covenants has spread through the large-cap and top-tier syndicated term loan market in the past five years and this product may now push on to cover the mid-cap and private debt market during the year ahead.

Buyout rebound reflects optimistic outlook

HEADLINES

- Private equity deal value in Europe totalled €26.5 billion in Q2 2020, the lowest quarterly figure since Q3 2013
- High yield bond issuance for leveraged buyouts (LBOs) in Europe is up 39% year-on-year to €7.8 billion
- European leveraged loan LBO issuance declined by 6% to €36.8 billion year-on-year

By Jill Concannon, Richard Lloyd, Patrick Sarch, Gilles Teerlinck and Ben Wilkinson—partners, White & Case

The first half of 2020 was challenging for finance issuance around LBOs in Europe, but a rebound in activity late in the year offers encouragement for lenders and borrowers in 2021.

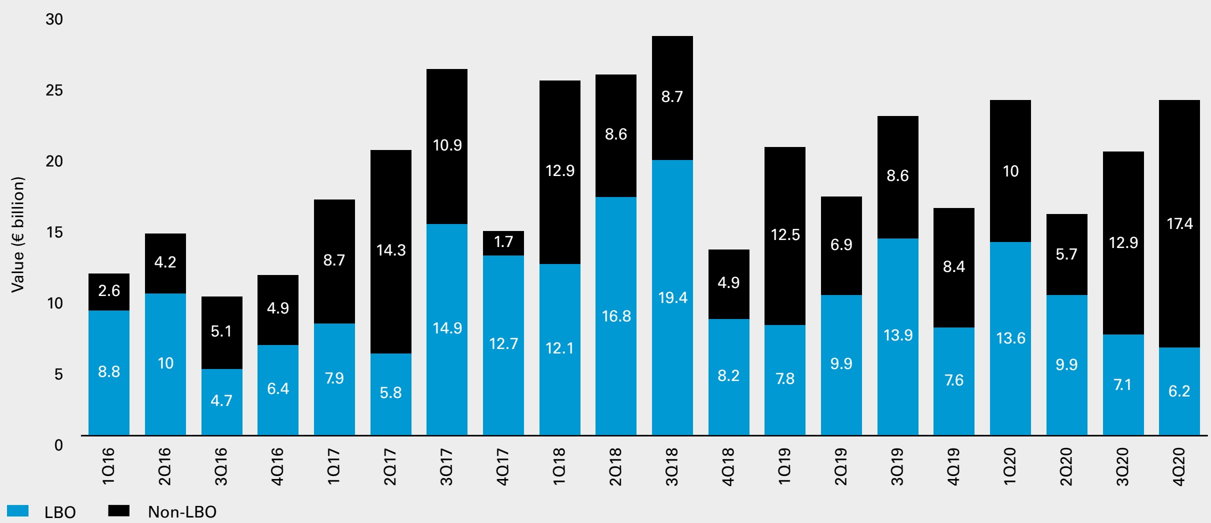
Private equity deal value in Europe reached its nadir in Q2 2020, totalling €26.5 billion—the lowest quarterly figure since Q3 2013, according to *Mergermarket*. Private equity deal volumes for the year, meanwhile, declined by around 10% year-on-year.

This hiatus in private equity deal activity following COVID-19 lockdowns weighed heavily on LBO debt issuance. Even though high yield bond issuance for LBOs has been strong—up 39% year-on-year to €7.8 billion—the much larger European leveraged loan market saw LBO issuance decline by 6% to €36.8 billion over the same period, according to *Debtwire Par*. Financial sponsor deal activity, however, bounced back at the end of the year, pointing to improved deal flow going into 2021.

Lender demand remains resilient

For all the uncertainty imposed by COVID-19, the combination of low interest rates and extensive quantitative easing means that lenders remain eager to deploy capital. This was true throughout 2020—when there was limited deal flow and LBO deals came to market, appetite was robust.

European M&A leveraged loan issuance 2016—2020 (quarterly)



Source: *Debtwire Par*

Banks underwriting the debt for the €17.2 billion carve-out of ThyssenKrupp's elevator division by Advent and Cinven, for example, were able to sell €8 billion of loans and bonds to finance the deal, despite pandemic uncertainty. The banks behind TDR Capital-backed pub chain Stonegate, meanwhile, sold down £1.2 billion of bonds in July to finance Stonegate's takeover of the UK's largest pubs operator, Ei Group.

With recent LBO deals—including Permira's buyout of pharmaceuticals group Neuraxpharm and Ardian's purchase of Angus Chemical—also tapping into leveraged finance markets successfully, indications are that lenders will continue displaying strong interest when deals come to market.

Outlook promising for M&A

The signs for overall M&A deal activity going into 2021 are positive, with a clearer view of future earnings and pricing, which should give lenders more transactions to finance.

Opportunities to acquire assets at more reasonable valuations have also opened up, according to the Argos Index, which tracks the multiples paid for private European companies valued in the €15 million to €500 million range. In the first half of 2020, multiples paid by investment funds dropped to 9.2x EBITDA on average, according to the Index.

Pricing recovered later in the year but, by Q3 2020, deals trading at multiples of 20x EBITDA had all but disappeared from the market.[5]

Dealmakers are also replete with capital. Bain & Co figures put the amount of dry powder available to private equity firms, globally, at US$2.5 trillion, of which US$800 billion is targeting buyouts.

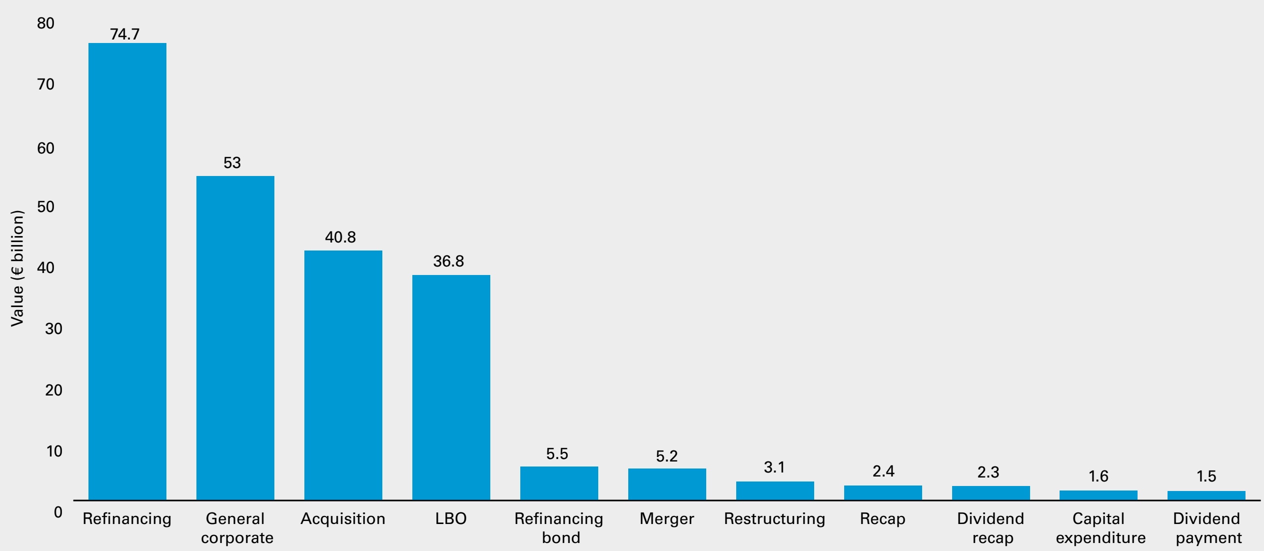
On top of this equity war chest, financial sponsors have also benefitted from cash-rich private debt lenders who are eager to lend.

For example, in July 2020, Ares Management arranged the largest-ever unitranche loan when it made a £1.875 billion financing commitment to UK insurance brokerage Ardonagh Group. Preqin data, meanwhile, shows private debt assets under management sitting at a record US$823 billion, of which US$279.4 billion still needs to be deployed.[6]

Add in pent-up demand from CLO and high yield investors, and it looks as though fierce competition among lenders will support strong M&A leverage going into 2021.

The signs for overall M&A deal activity going into 2021 are positive, with a clearer view of future earnings and pricing, which should give lenders more transactions to finance

European leveraged loan use of proceeds in 2020



Source: *Debtwire Par*

Sponsors show support

Transaction activity will also be bolstered by a broader pool of dealmakers and investment strategies: Financial sponsors are clubbing together with other funds and investors to open up new sources of deal activity.

Cinven and Advent, for example, joined the RAG Foundation to pursue the ThyssenKrupp deal, while Bain Capital partnered with Finland's Ahlstrom and Ehrnrooth families to take private Finland-based fibre solutions provider Ahlstrom-Munksjö in a €2.1 billion transaction, according to *Unquote* data.

Further public-to-private deals are expected to remain a feature of dealmaking, with appetite for take-privates holding up well into the second half of 2020, as observed with KKR, Providence and Cinven securing the US$3 billion delisting of Spanish telecoms group MasMovil in the early autumn.

Activist investors may also continue to spur deal activity—in 2020, *Activistmonitor* recorded 52 new live activist campaigns in Europe (meaning that the activist had both disclosed a stake and made at least one demand), up from the 50 campaigns recorded in 2019.

The influence of Special Purpose Acquisition Companies (SPACs) in the US on European deal activity should also not be underestimated. Around 248 US SPACs—shell companies that list and then seek acquisition targets—have come to market in 2020, raising US$82 billion, according to *Dealogic*. These vehicles have two years to invest the capital. Managers are incentivised to transact with a 'promote' that grants the SPAC sponsor a 20% share of the vehicle's equity.

Even though the domestic SPAC market in Europe has been subdued when compared to the activity in the US, SPACs are likely to come shopping in Europe for deals to deploy their large cash piles.

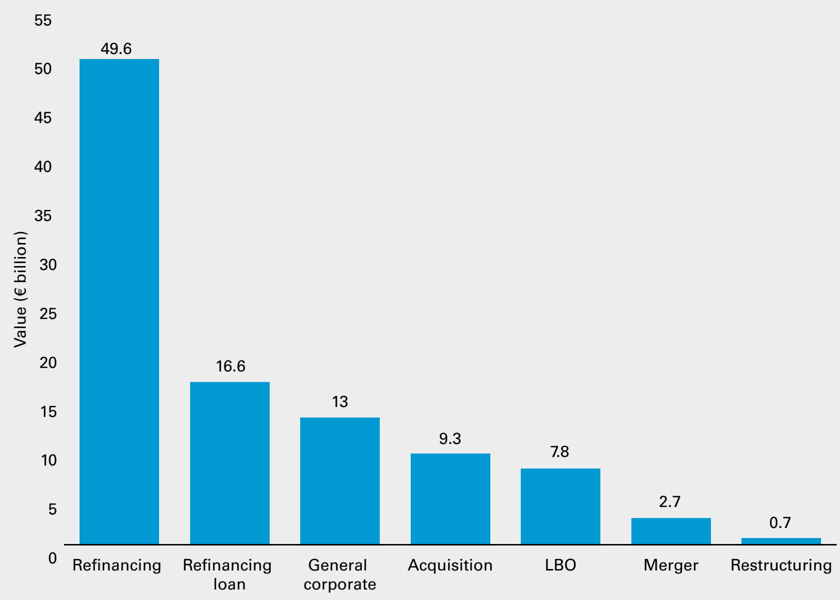
With such a broad range of investors scoping out transactions, valuations should widen, which will help to see more deals over the line.

Selective investors

European deal activity is poised to take off in 2021, but financial sponsor-buyers and lenders may remain highly selective—they will likely coalesce around high-quality assets and distressed companies, where investors can buy in to sectors directly impacted by lockdowns at low valuations.

Lenders appear to be positioning themselves along these lines. According to Preqin, for example, special situations fundraising this year climbed just under sevenfold from March to April, while distressed debt fundraising in May and June was close to quadruple the levels seen in March and April.[7]

European high yield bond use of proceeds in 2020



Source: *Debtwire Par*

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Market reset could trigger restructurings in 2021

HEADLINES

■ In March 2020, credit insurer Euler Hermes forecast a 43% increase in insolvencies in the UK in 2021, as well as a 26% uptick in France and 12% in Germany ■ By December 2020, ratings agency S&P was forecasting European defaults rising to as much as 8% by the end of 2021

By Ben Davies, Morvyn Radlow and James Greene—partners, White & Case

There have been fewer European insolvencies and restructurings than anticipated during the COVID-19 pandemic, but distressed deal activity may accelerate as soon as economies are finally able to reopen.

The European Central Bank's expanded €1.85 trillion quantitative easing programme, coupled with tax deferrals, state-backed loans, employee wage support schemes and a focus, among lenders, on liquidity rather than financial covenants have all helped to keep companies afloat.

Lenders have also been reluctant to foreclose on debts and crystallise losses when valuations and value breaks in capital structures remain unclear, in particular with a backdrop of regulator announcements warning lenders against hasty action in the face of COVID-19 challenges, and a number of European jurisdictions introducing legal restrictions on such action.

A new round of full lockdown measures introduced in various European countries early in 2021 has seen the further extension of job retention schemes and state-sponsored loan and liquidity measures, but as soon as these support efforts wind down and markets reset (most likely in the second half of 2021), a wave of distressed situations are expected to come to market.

Back in March 2020, credit insurer Euler Hermes was already forecasting a 43% increase in insolvencies in the UK, as well as a 26% uptick in France and 12% in Germany in 2021.[8] By December 2020, ratings agency S&P was forecasting that default levels could climb to as much as 8% by the end of September 2021.[9]

8%+

The anticipated rise in European defaults in 2021, according to ratings agency S&P

At some point in the next 12 months, it is likely that borrowers and lenders will have to assess whether earnings are going to recover to pre-COVID-19 levels or whether capital structures established pre-pandemic (or indeed post-pandemic) remain appropriate, with higher levels of debt incurred to support liquidity through the crisis.

Some companies in sectors directly impacted by lockdowns—from aviation and leisure to hospitality—managed to stay afloat in 2020 by tapping into markets to shore up liquidity reserves.

Jet engine maker Rolls Royce, for example, launched a £5 billion recapitalisation plan that included a bond and loan package, as well as a rights issue, to navigate disruption due to COVID-19, while UK food and fashion retailer M&S raised its first high yield bond after losing investment-grade status early in 2020.

With lenders focused on liquidity, some borrowers have taken the view that cash raised now can be repaid later in the cycle when economies recover. The question is whether these changes to capital structures are sustainable and what proportion of future cash flows will be required to service these loans and bonds over the long term. If companies are found to have borrowed too much too early, this may trigger restructuring deals long after the pandemic has passed.

Troubled credits flushed out early

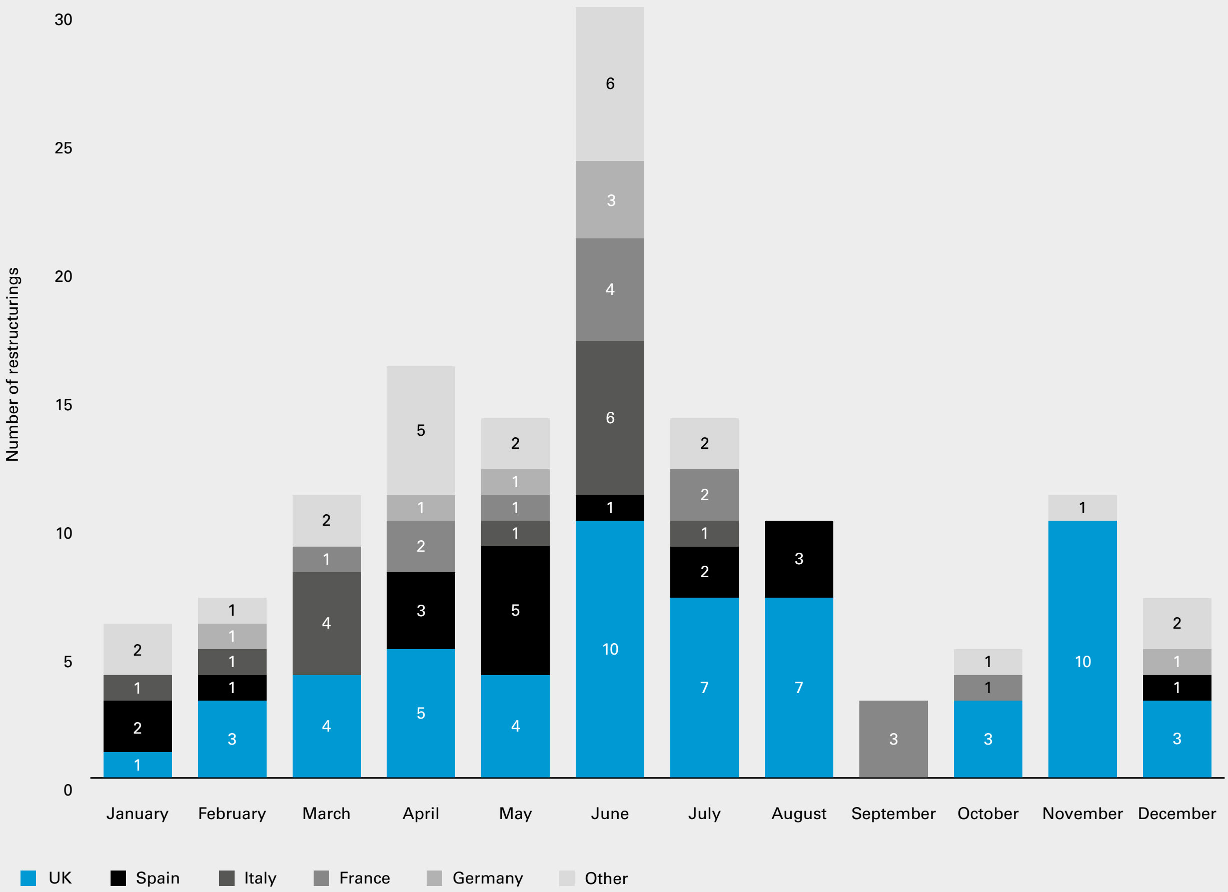
Distressed deals and restructurings that came to market in 2020 typically involved credits that were already on restructuring candidate watchlists, especially in the UK. Sectors facing long-term headwinds, including physical retail, real estate and casual dining restaurants, account for a large proportion of the recent casualties.

For example, clothing group Arcadia and the department store chain Debenhams went into administration in November 2020. In the restaurant space, Casual Dining Group fell into administration in July and Carluccio's was bought out of administration in May.

The headwinds faced by these sectors have prompted a knock-on effect for real estate companies, with retail and restaurant administrations reducing occupancy rates and rental income. The impact of lockdowns on rental revenue and a £4.5 billion debt pile, for example, saw the UK's largest shopping centre operator, Intu, fall into administration in August. British Land, meanwhile, reported a 15% decline in its retail portfolio as annualised rents fell by £11.6 million.

Restructuring activity in 2021 is likely to continue along sector-specific lines, though more

European restructurings by country in 2020



Source: *Debtwire Par Restructuring Database*

industries could move onto watchlists if consumer and client habits show long-term changes following COVID-19. It is also worth remembering that some businesses that were performing well pre-pandemic are currently on watchlists purely because of the sector in which they operate (e.g., leisure, aviation, etc.). They may be more than capable of bouncing back, depending on how long the pandemic continues.

Considering all options

Some companies turned to very 'light touch' restructurings, for example by resetting covenants or extending maturities to bridge to an anticipated recovery post-pandemic.

Others sought out more cash from existing lenders or third parties at the senior or super-senior level to provide emergency liquidity and extend runway. For example, in October 2020, French hotel property business AccorInvest held talks with 19 banks regarding a possible restructuring of more than €4 billion of debts. In August, aviation company Swissport announced that it had secured bridge financing, which was then used to facilitate a restructuring that completed in December 2020.

Financial sponsors provided cash injections for some. Hunter Boot, best known for its Wellington boot lines, received a £16.5 million cash injection after a period of weak trading from existing shareholders, including Goldman Sachs, Searchlight Capital and Pentland. Sponsors will need to assess whether these injections were enough to stave off a more fulsome financial restructuring later in 2021.

Borrowers also made use of restructuring tools such as company voluntary arrangements (e.g., shoe retailer Clarks), schemes of arrangement (e.g., Swissport) and restructuring plans (e.g., airline Virgin Atlantic and casual dining operator Pizza Express).

A number of these processes were used by these companies to implement debt-for-equity swaps—including Swissport, Pizza Express and New Look, the latter of which was implemented despite its CVA being challenged by landlords.

Special-situations firms will also provide a route out of distress in 2021. According to Preqin, special situations fundraising in April 2020 was more than triple the amount raised in the first quarter of the year.[10] These investors will be on the lookout for deals—and with restructuring activity likely to pick up in 2021, there will be plenty of options.

European CLOs: A mere flesh wound?

HEADLINES

■ New issuance of European collateralised loan obligations (CLOs) peaked at just under €4 billion in October 2020 from 12 deals—the highest monthly level since October 2019 ■ European CLO new issuance declined 26% year-on-year, with refinancing volumes falling from €6 billion in 2019 to zero in 2020 ■ By the end of March 2020, credit ratings on an estimated 10% of loans held by CLO managers were downgraded or put on notice of downgrade—however, the rate of loan downgrades eased and stabilised in the second half of 2020

By Chris McGarry, partner, White & Case

European CLOs ploughed through the worst of the cycle in 2020, despite COVID-19 uncertainty, ratings downgrades and loan pricing volatility, with CLO managers returning to market to secure investor support and resume normal dealmaking following the onset of the pandemic.

European new-issue CLO volume in 2020 fell by 26%, year-on-year, to €22 billion—down from €29.8 billion in 2019. CLO refinancings played a big part in this decline, dropping from €6 billion in 2019 to zero in 2020.

Some may have feared the worst in March 2020, when leveraged loan prices plummeted, but CLOs have shown yet again (as they did in the aftermath of 2008) that they are designed to operate smoothly through economic cycles, to the point where we can say that the events of 2020 proved to be barely a flesh wound for the CLO market.

While, by the end of March, credit ratings on an estimated 10% of the loans held by CLO managers were either downgraded or put on notice of downgrade[11], the rapid recovery of the leveraged loan market—combined with the ability of CLO managers to avoid riskier sectors and otherwise challenging positions—has already seen CLO portfolios recover significantly, both from a ratings and an over-collateralisation perspective.

€4bn

The total for European CLO new issuance volume in October 2020—the highest monthly level since October 2019

Banks providing 'warehouse' facilities to CLOs—lines of credit that allow CLOs to buy up portfolios of loans before they are packaged into tranches and sold on to investors—were also cautious midway through 2020, as investor appetite for buying up CLO tranches waned. According to the *Financial Times*, between 40 and 50 'warehouse' lines were outstanding by the end of March 2020.[12]

But there have been signs of recovery since the first round of COVID-19 restrictions were implemented in the summer: The primary CLO new issuance market was back in near full swing by October 2020, when €4 billion of CLO new issuance was priced from 12 deals—the highest monthly level since October 2019. Liability spreads also tightened through the year, to the point where US-dollar deals have once again been marketed in Europe.

The start of the vaccine rollout in December 2020 provided another boost for markets globally, and the market expectation is for reset and refinancing activity to return to Europe in 2021, as has already been the case in the US.

Lessons learned

The resilience of CLOs is partly thanks to lessons learned following the 2008 financial crisis. Prior to the collapse of Lehman Brothers, which precipitated the 2008 credit crunch, CLO portfolios included a higher level of high yield bonds, and managers had longer windows in which to reinvest interest payments and proceeds from existing portfolios into additional loans.[13] These structures were dubbed 'CLO 1.0'.

From 2010 onwards, however, CLOs adapted by narrowing windows for reinvesting proceeds, reducing or eliminating high yield bonds from asset pools and strengthening credit quality and support.[14] These post-credit crunch vintages have been labelled 'CLO 2.0'.

CLOs have also held firm thanks to other features of the product's structure, including the typical requirements for 90% of a portfolio to comprise senior secured loans, portfolio diversification by borrower and by industry, restrictions on illiquid loans and the increasing prominence of ESG criteria, which have protected CLOs from investments in riskier sectors.[15]

COVID-19 has also sparked a new wave of CLO evolution. Although CLOs had a fair degree of flexibility when faced with restructurings, there were some restrictions on the ability of CLOs to 'follow their money' when their underlying credits have encountered distress. This has historically put CLO managers at a disadvantage in restructuring situations versus hedge funds, which do not face the same limitations.

Post-lockdown deals, however, have started to adjust, giving CLOs more room to take part in rescue financings and restructurings. According to S&P Global, a recent deal by CLO manager CVC included documentation that gave the company scope to acquire loans in default, insolvency or restructuring scenarios if the purpose was to mitigate losses. CLO managers Redding Ridge and GSO are reported to have secured similar terms.

In the immediate aftermath of lockdowns, CLOs also adapted by launching short-dated CLOs, with non-call periods of 12 months rather than two years, to take advantage of sharp drops in loan pricing in the secondary markets. Permira and Oaktree are among the managers who moved quickly to build portfolios of deeply discounted loans in the secondary market. By the fourth quarter of 2020, deals were back to the typical two-year non-call period and shorter reinvestment periods also became a feature of activity.

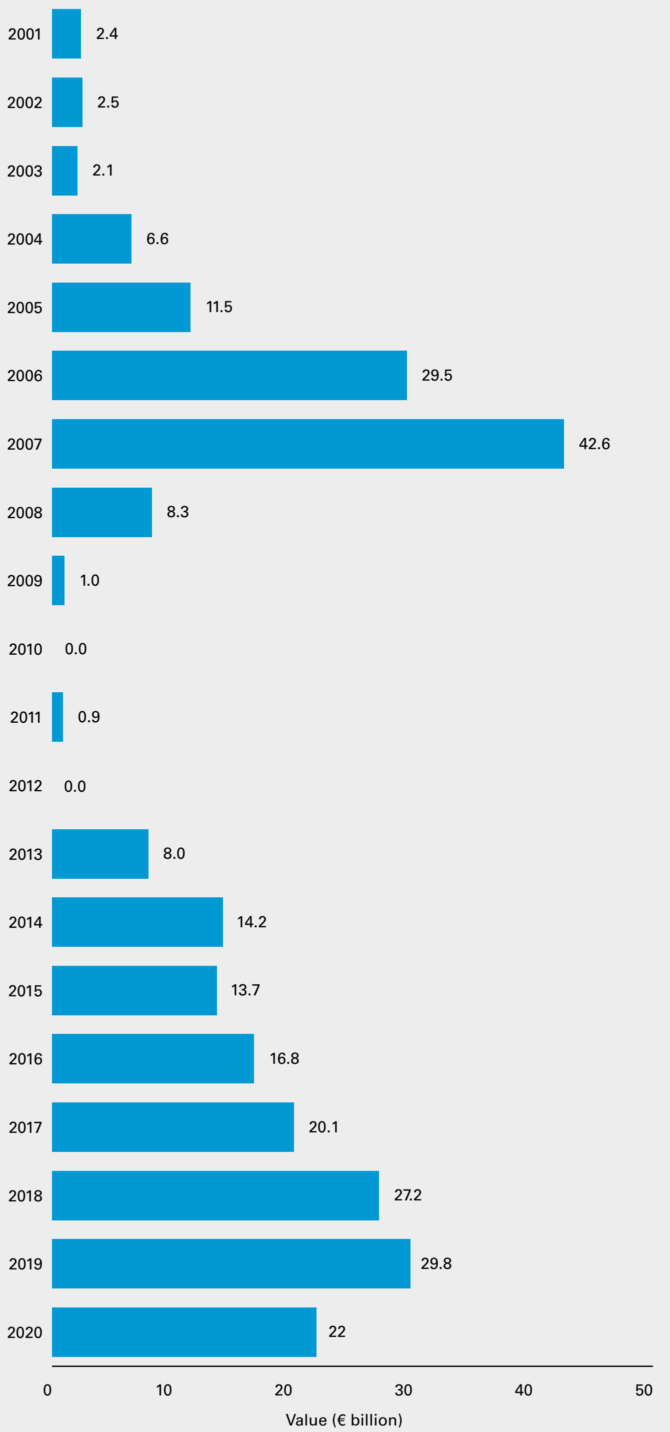
A focus on sustainability

In the midst of the CLO market's adaptation to the immediate challenges posed by COVID-19, the industry has also continued to make progress in the areas of ESG and sustainability. CLOs are an important source of financing for the US$100 trillion needed to deliver the 2030 Sustainable Development Goals. Banks are accelerating their underwriting of sustainability-linked loans, but need to recycle their capital by moving these loans into the capital markets via CLOs.

The G20's White Paper on sustainable securitisation (co-authored by White & Case) recommended that G20 central banks should start buying sustainable assets. This recommendation has been adopted by the European Central Bank, starting in 2021, which paves the way for the next-step change in the growth of the sustainability-linked loan market.

VodafoneZiggo's debut green bond issuance in December 2020 is the latest example of the largest leveraged issuers joining the sustainability party, and further evidence that this will continue to be an important driver of future CLO new issuance.

European new-issue CLO volume (2001—2020)



Source: *Creditflux*

Sector split: The very different impact of COVID-19

HEADLINES

■ Weighted average bids for healthcare and telecoms credits both priced at approximately 99% of par by the end of 2020 ■ Entertainment and leisure and retail loans, meanwhile, priced in the 90% to 93% of par range ■ Between March and September 2020, only the transport and automotive sectors suffered more ratings downgrades and negative outlook changes than the oil & gas industry

By Jeremy Duffy, Monica Holden and Shane McDonald—partners, White & Case

Leveraged finance lenders have taken an increasingly selective approach in the wake of COVID-19, but quality credits in the right sectors will continue to receive favourable terms and pricing.

While the pandemic had a global impact on business, some sectors were hit harder than others. Lockdowns and travel restrictions had an immediate effect on the entertainment and leisure, hospitality, retail, oil & gas and aviation industries. Businesses in sectors like technology, services and healthcare, by contrast, continued to trade strongly through the course of 2020 and have been favoured by lenders.

Secondary pricing has reflected this sector bifurcation. Weighted average bids for healthcare and telecommunications credits, for example, both priced at approximately 99% of par by the end of 2020. Entertainment and leisure and retail loans, however, priced in the 90% to 93% of par range—though pricing in both sectors climbed from lows in the 85% range around September. These sectors, and others particularly affected by COVID-19, managed to outperform through the end of the year, though pricing continued to be affected.

Assessing sector filters

Under COVID-19, many lenders assessed sector exposure by broadly grouping credits into three categories: Those that were under financial pressure prior to lockdowns and whose decline accelerated as the pandemic spread; those that were solid credits pre-pandemic but were hit severely by lockdowns; and those that performed well before and during the pandemic.

Physical retail fell into the first category, with euro area retail sales down despite strong performance from supermarkets and online retailers. The shutdown of 'non-essential' retail stores through lockdowns was too much for many businesses that were already struggling.

Liquidity lines have now run dry for many of these companies, particularly in the UK. Retail conglomerate Arcadia, for example, went into administration in November after unsuccessful attempts to secure a £30 million rescue loan from potential lenders. Department chain Debenhams succumbed to liquidation following two administrations.

The global oil & gas industry is another sector that was already feeling the pressure before encountering deep disruption under COVID-19, when lockdowns suppressed demand and hit oil prices even further. Between March and September 2020, only the transport and automotive sectors suffered more ratings downgrades and negative outlook changes than the oil & gas industry.

Bond markets remained open for European oil majors, including BP, Shell, Total and ENI, but smaller independents turned to alternative sources of funding. Reserve-based lending (RBL) facilities, which provide capital secured against a borrower's undeveloped reserves, offered oil & gas companies an additional line of finance. The size of these facilities, however, is reviewed biannually and determined by the price of oil. Oil & gas companies therefore have to keep a close eye on balance sheets to ensure that falling oil prices do not leave them at risk of default. FTSE 350 independent Tullow Oil, for example, reduced its RBL facility through the course of the year as oil prices shifted.

Oil & gas companies also had access to revolving credit facilities and support through COVID-19-linked loans from governments and central banks.

66%

The decline in global air traffic in 2020 due to the pandemic, according to the International Air Transport Association

Long-term view

The situation facing companies in the second category, which includes aviation and leisure businesses, has been somewhat different. Despite being severely impacted by lockdowns, these credits were fundamentally sound and are expected to recover as COVID-19 restrictions are eased in 2021.

Lenders have been willing to take a longer-term view on such businesses. The global aviation sector, for example, suffered a 66% decline in 2020 air traffic, according to the International Air Transport Association. The sharp fall in bookings resulted in a swathe of European airlines having their credit ratings downgraded to high yield during 2020, including national carriers like British Airways.

Airlines nevertheless continued to access liquidity via bond markets and government-backed loan schemes. For example, in April 2020, Air France-KLM, one of Europe's largest airlines, received a €10 billion rescue loan from the Dutch and French governments.

Raising finance for companies in this category, however, has been more expensive. Finnish airline Finnair, for example, raised a €200 million bond with a 10.25% coupon.

Carnival—the cruise line operator that was an investment-grade credit pre-pandemic before a downgrade to high yield in the summer—provides a further example of this theme. Early in the pandemic, the company priced a US$4 billion high yield bond at 11.5%. A year earlier, it had raised €600 million at a price of 1%, illustrating how swiftly lending markets have shifted in certain sectors.

The cruise operator's bond, raised in April 2020, also had to be secured against the company's fleet as collateral.

High-quality credits in demand

Prices have also edged higher for the more resilient borrowers who fall into the third category, but not nearly as much as for credits in harder hit sectors like travel and retail.

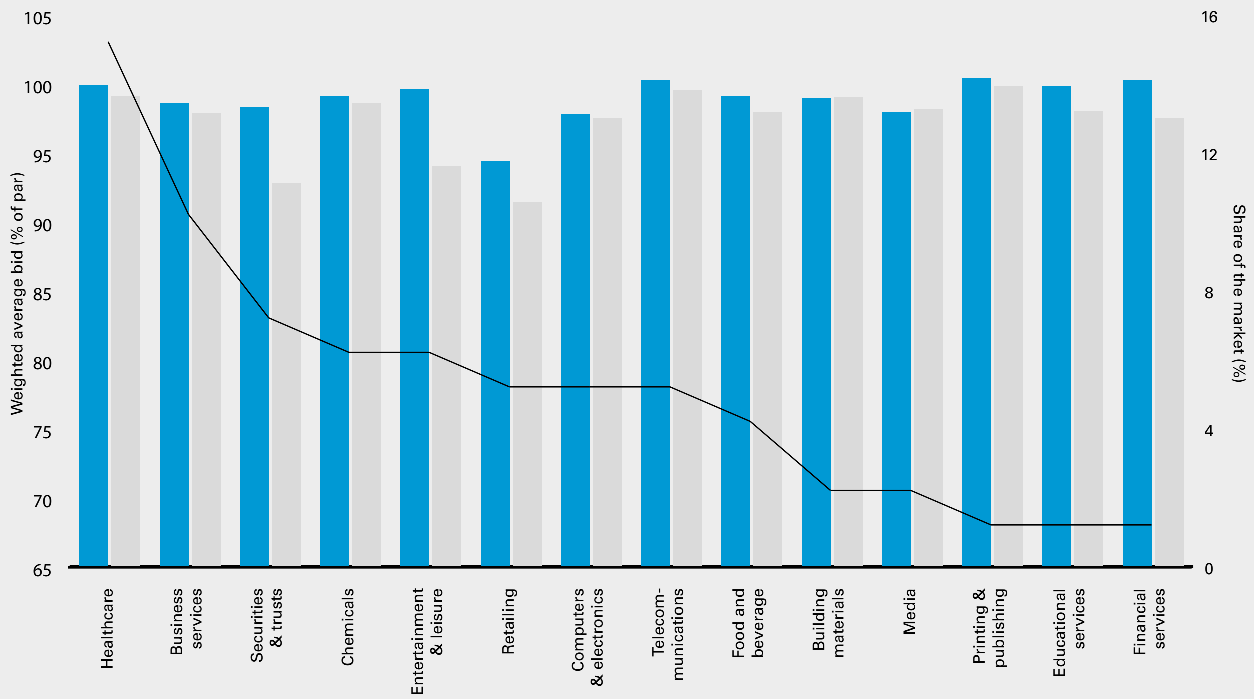
Companies in technology and healthcare have been the major beneficiaries, but other credits with strong fundamentals, such as industrials and services, have also been favoured. Loan and high yield markets remain open and eager to support high-quality credits in these select industries.

The €17.2 billion carve-out of ThyssenKrupp's elevators business led by buyout firms Advent and Cinven, along with Germany's RAG Foundation, for example, secured a €10.3 billion package of loan and debt financing in the summer after receiving orders of more than €20 billion from investors.

Despite nervousness from arranging banks about investor uptake following lockdowns, the oversubscribed offer was completed ahead of deadline. Arrangers were able to maintain pricing levels on loans without being flexed, and tighten pricing across all bond tranches. The credit did have to make some concessions on terms, but overall still secured a borrower-friendly document.

Credit quality and sector resilience are expected to continue colouring lender appetite going into 2021. Lenders will remain selective around the credits they back and willing to provide flexible pricing and terms for the right borrowers. The increasing attention paid to environmental, social and governance factors by CLOs will also see the market favour credits that can address this vital subject. Ongoing money printing and strong anticipated liquidity will build momentum behind these trends.

Sector pricing versus share of the market: European industry snapshot



Source: *Debtwire Par, Markit*

Leveraged finance: The United States versus Europe

HEADLINES

■ In the US, leveraged loan issuance for 2020 totalled US$861.7 billion, a 4% year-on-year decline ■ The high yield bond market in the US saw a 69% year-on-year increase to US$428.3 billion ■ The European leveraged loan market increased by 11% to €227.1 billion year-on-year ■ The region's high yield bond market was up 10% to €100.5 billion

By Jill Concannon, Jeremy Duffy, Eric Leicht and Andrew Weisberg—partners, White & Case

Leveraged finance markets in the US and Europe reacted to the impact of COVID-19 in much the same way through the course of 2020. Both experienced a steep decline in activity when lockdown measures first came into effect but then saw combined high yield and leveraged loan issuance return to relatively healthy levels by year end. Despite the uncertainty and dislocation, both markets revived swiftly through the second half of the year, setting the stage for a busy 2021. Pricing in the secondary market has recovered, as has M&A activity.

As for COVID-19, infection rates in Europe remain a risk, with further lockdowns and restrictions being implemented. The rollout of vaccines, however, has given all markets confidence, with the Dow Jones and the MSCI Europe back in the black.

Up and down and up again

After a volatile 2020, leveraged finance markets in the US and Europe are poised for a more stable year. Both experienced a rollercoaster of activity in 2020 before rebounding in the second half of the year, restoring a much-needed sense of normalcy to the markets and setting the stage for deals in 2021.

The leveraged loan market in the US, for example, was particularly robust at the start of 2020, with January issuance of US$125.1 billion—up 70% on the US$74.5 billion figure recorded for December 2019, according to *Debtwire Par*. This momentum carried into February, with issuance of US$139.2 billion, before activity more than halved in March to US$65.3 billion and then dropped further still in April to US$41.4 billion.

Institutional loan issuance in the US saw an even deeper decline, dropping from US$103.5 billion in February to US$27.8 billion in March and US$17.6 billion in April.

Despite concerns about this extreme decline in activity, leveraged loan issuance in the US came back to hit US$65.6 billion in June and then climbed to US$73.3 billion in September before peaking at US$88 billion in December.

By year end, data from *Debtwire Par* shows leveraged loan issuance in the US totalled US$861.73 billion, a 4% year-on-year decline but still far healthier than many expected after such a turbulent year. Institutional loan issuance, meanwhile, climbed 11% year-on-year, despite the fall in activity during the spring.

The European leveraged loan market, similarly, had a steady January and February according to *Debtwire Par,* with leveraged loan issuance of €29.6 billion and €26.2 billion respectively, before COVID-19 uncertainty saw activity fall significantly in March 2020. In June and July, European leveraged loan issuance bounced back to €33.7 billion and €23.1 billion respectively, in line with figures earlier in 2020. By the end of the year, the European leveraged loan market was up by 11% year-on-year to €227.1 billion.

69%+

The increase in high yield issuance in the United States in 2020—in Europe, high yield bonds rose by 10%

High yield surge

The patterns for high yield issuance in each region followed a similar path. In Europe, high yield activity more than halved in February, at €6.6 billion, down from €16.5 billion the month before, before completely shutting down in March with almost zero issuance, according to *Debtwire Par*. But by the end of Q4 2020, it was up 10% year-on-year to €100.5 billion.

This shift in fortunes was even more pronounced in the US high yield market, with issuance at US$34.8 billion in January before dropping to US$4.5 billion in March. By the end of 2020, however, a surge in activity meant the US high yield market posted a 69% year-on-year increase to US$428.3 billion.

What was behind these dramatic turns? Borrowers scrambling to secure liquidity as secondary market pricing was falling, with everyone assessing all available options to strengthen their balance sheets.

The vast government stimulus of the CARES Act in the US and various state-sponsored employment retention and rescue loan schemes in Europe gave a degree of stability to both economies. Initially, leverage tests and dividend restrictions limited the use of these packages for leveraged borrowers, although steps were taken subsequently to open up these support loans. Many borrowers turned to the US high yield bond market for liquidity, where issuance more than doubled, quarter-on-quarter, to US$151.1 billion in Q2 2020— its highest quarterly total in five years.

The US Federal Reserve's move to buy corporate bonds cemented the recovery of the US HY bond market. So too did its move to cut rates, which made fixed-rate bonds more attractive than floating-rate assets.

The rise in US high yield issuance was also partly a result of a slowdown in the leveraged loan market, where bank balance sheets were stretched following substantial drawdowns on revolving credit facilities. According to S&P, US borrowers drew down US$274.9 billion from credit revolvers between March and May.

With the loan market restricted, the appetite for deals among US high yield bond investors was strong, especially if issuers offered security. The market share of secured bond issuance climbed to around 45% in Q2 2020 from around 30% in Q1 2020.

The US high yield market was also supported by the Federal Reserve's decision to continue buying the bonds of 'fallen angels' (credits downgraded from investment-grade to 'junk'), which injected further liquidity into the US high yield space.

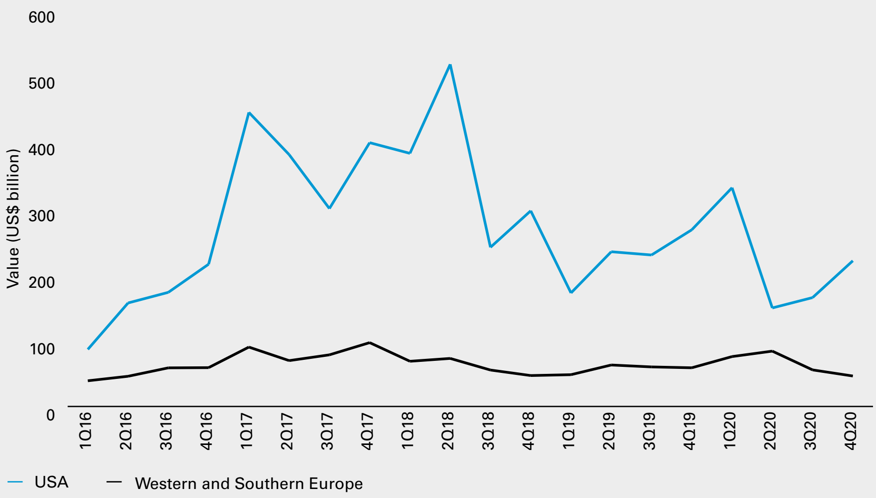
European high yield markets also reopened in Q2 2020, but took longer to rebound. Issuance in April and May was still in the low single digits—volumes only showed a noticeable increase in June, rising to €16.2 billion.

Unlike the US, the bond buying programme of the European Central Bank (ECB) did not include scope to invest in fallen angels, but the ECB did loosen rules to allow banks to offer fallen angel bonds as collateral when accessing ECB liquidity. Normally, collateral had to be investment-grade.

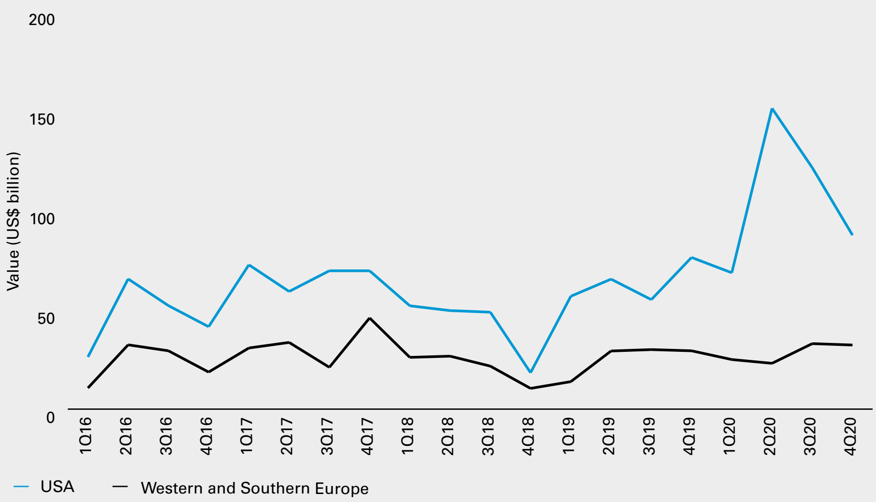
Markets recover and M&A returns

The pace of recovery has been swifter in the US, with GDP rebounding 33.1% in the third quarter of 2020[16] versus 12.7% for Europe[17]—and signs are that this will carry into 2021, which will give companies and investors alike cause for optimism.

US versus Europe: Leveraged loan issuance by value (2016—2020)



US versus Europe: High yield bond issuance by value (2016—2020)



Source: *Debtwire Par*

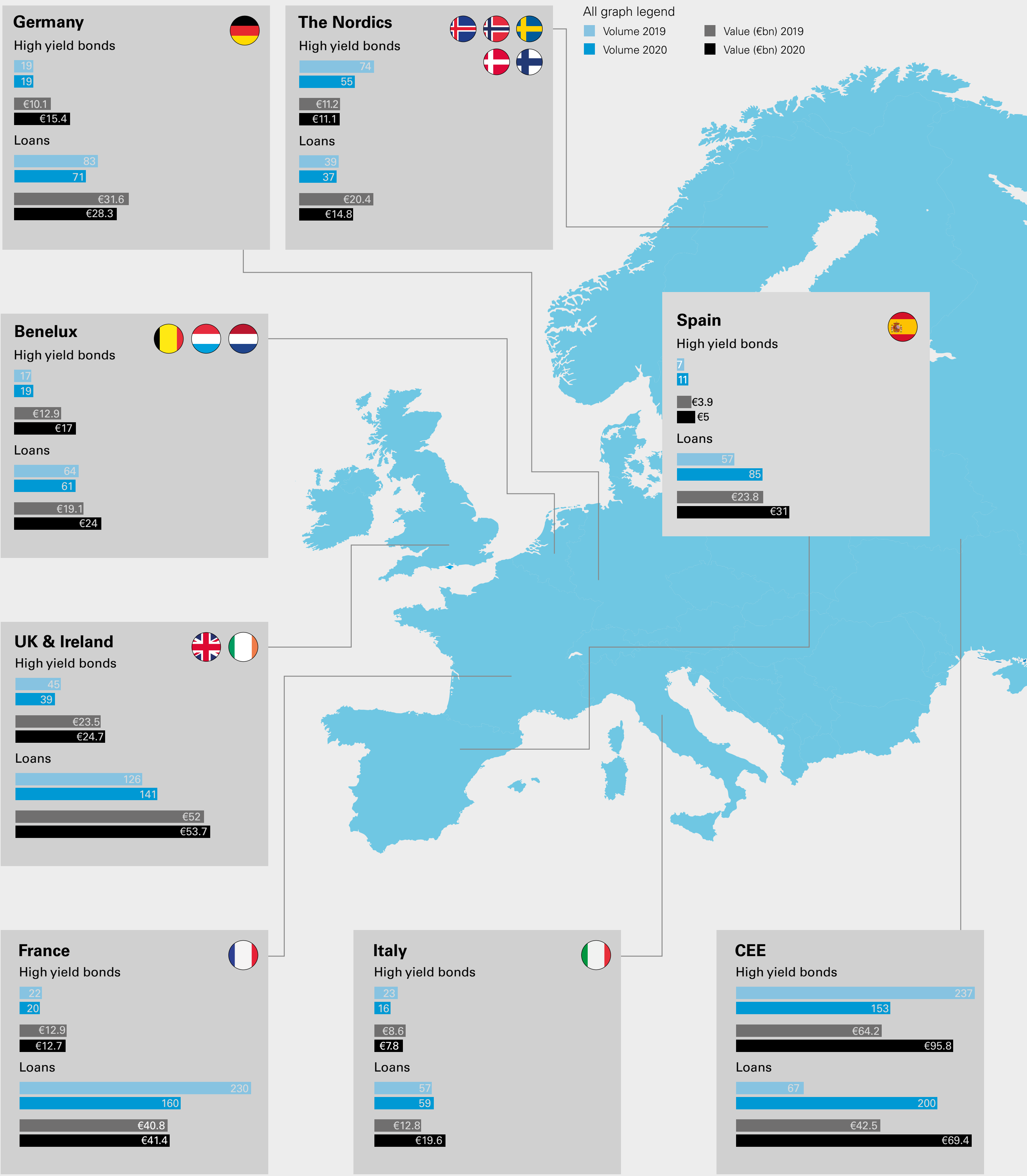
M&A also revived in the US, with values climbing more than five-fold from Q2 to Q3 2020. In Western and Southern Europe, M&A values more that doubled over the same period. The US election provided some additional stimulus for M&A, with US dealmakers moving to clear pent-up demand and get deals done.

European dealmakers were more cautious, with the risk of new waves of infection and further lockdowns moving onto the horizon earlier than in the US.

All in all, the signs of recovery in the debt markets in both the US and Europe far outweigh the negatives, with companies and investors alike eager to put 2020 behind them.

European leveraged debt in focus

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



What is shaping sponsor debt decisions for 2021?

HEADLINES

■ Leveraged loan issuance for European LBOs dropped 6% year-on-year ■ High yield LBO issuance, however, was up 39% year-on-year to €7.8 billion ■ European direct lending volumes fell from 189 deals in 2019 to 138 deals in 2020 ■ Ares Management underwrote the largest unitranche on record with the provision of a £1.875 billion financing package for Ardonagh

By Colin Harley, James Greene and Martin Forbes—partners, White & Case

COVID-19's impact on debt markets in the first half of 2020 has prompted financial sponsors to step back and reassess their debt-raising options.

At the start of 2020, leveraged loan markets were in good shape and continuing to provide finance on attractive terms. The onset of the pandemic, however, saw activity grind to a halt as banks and financial sponsors retreated to manage their portfolios.

Although leveraged loan activity showed signs of recovery in the second half of the year, issuance for leveraged buyouts (LBOs) was still down year-on-year, dropping 6% to €36.8 billion.

Commercial banks, meanwhile, have been stretched, managing existing books and dispersing government-backed COVID-19 rescue loans. In the UK alone, the government's various bounce-back and business interruption loans paid out £69.1 billion in more than 1.5 million facilities. Banks across Europe saw similar levels of demand for other state-backed loan programmes, leading to reduced appetite and bandwidth for sponsor-backed deals by the end of 2020.

With these core private equity credit lines in dislocation, high yield bonds and direct lending moved firmly into the frame for sponsors.

High yield versus direct lending

High yield has been a clear winner, from a sponsor perspective, through the course of 2020. European high yield bond issuance was up 10% year-on-year to €100.5 billion. High yield LBO issuance in the region, meanwhile, was up 39% year-on-year to €7.8 billion. Sponsor-backed high yield bond issuance was up by 49% year-on-year to €22.4 billion by the end of 2020.

High yield bonds have always come to the fore in the absence of competition. When banks were reassessing their balance sheets and direct lenders were triaging portfolios, the deep pool of high yield investors, free from these considerations, could provide finance quickly—especially for higher-rated credits offering collateral or enhanced covenant packages.

After initially focusing on their portfolios, European direct lenders also saw opportunities open up early in 2020 as syndicated loan markets and banks retrenched. Direct lending was not immune to the impact of the pandemic, of course—data from *Debtwire Par* shows a fall in European direct lending volumes for LBOs from 189 deals in 2019 to 138 deals in 2020.

Although dividend recaps and refinancings by European direct lenders suffered significant declines in 2020, sponsors still found direct lenders open to financing LBO deals.

The appeal of private debt as a predictable alternative to the more volatile syndicated loan market can also not be underestimated.

As syndicated loan markets locked up between March and May 2020, some arranging banks found themselves sitting with hung bridge loans—estimated to run into the tens of billions—that they feared they would be unable to refinance. Although this carried no immediate financial risk for sponsors holding portfolio companies with hung bridges, the inability to syndicate loans has always reflected unfavourably on sponsors.

Since the first round of lockdowns, a number of hung bridges have subsequently been taken out, including TDR Capital-backed Stonegate Pubs and ThyssenKrupp Elevator. Direct lending, however, could still serve as the best option to take out outstanding bridges or as an option to avoid syndication risk altogether, with direct lenders potentially attracted by the pricing caps on hung bridges, which offer higher margins.

Indeed, the growth of direct lending assets under management to US$1 trillion, according to Preqin figures, has seen direct lenders expand in scale and build capability to digest increasingly larger tickets.[18]

As mentioned earlier in the report, Ares Management underwrote the largest unitranche on record in June 2020, with the provision of a £1.875 billion financing package for Ardonagh, the UK's largest insurance brokerage group, backed by HPS Investment Partners and Madison Dearborn Partners. The deal comprised a £1.575 billion unitranche loan and

39%+

The rise in high yield LBO issuance in 2020 year-on-year

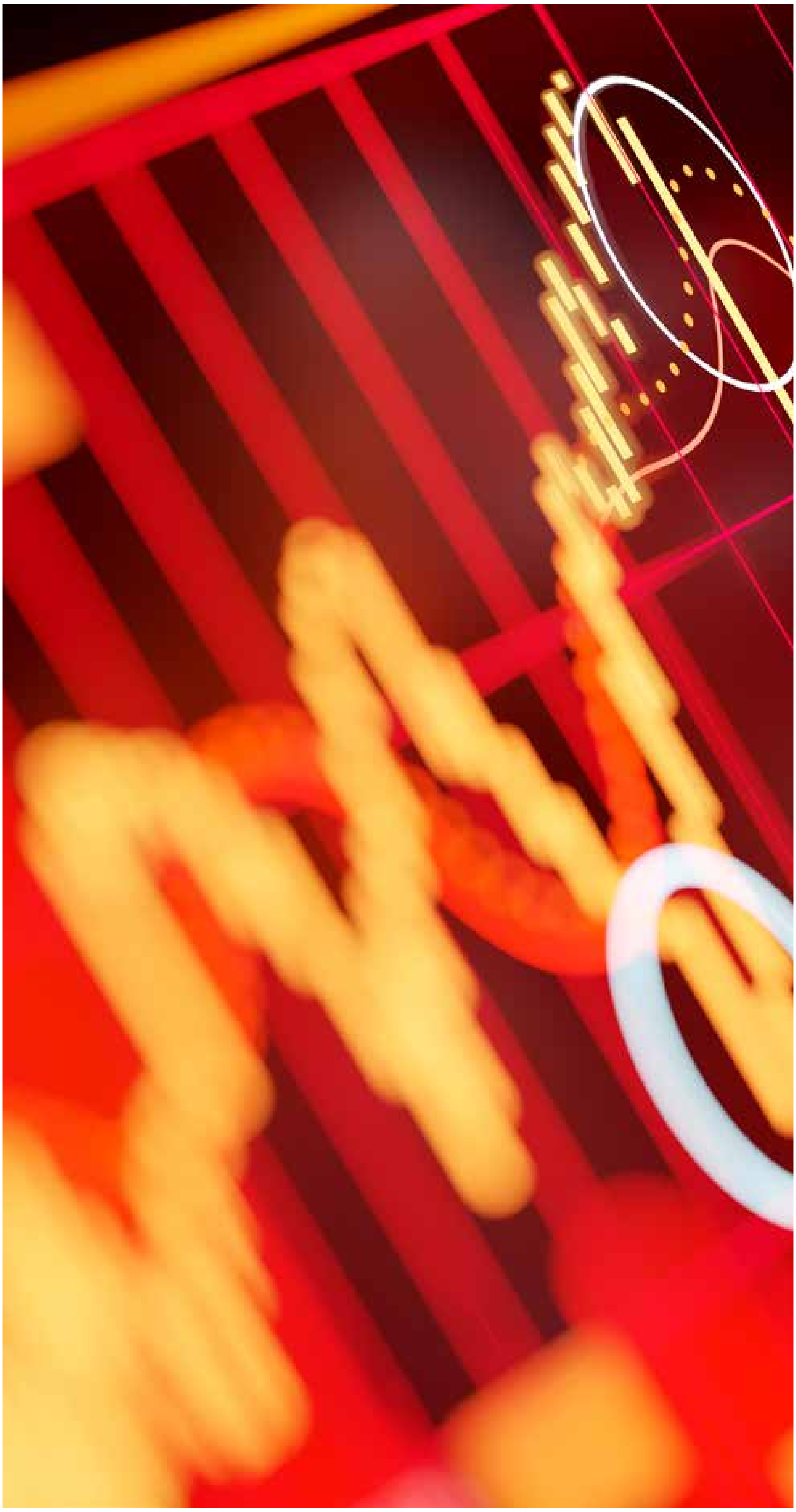
a £300 million committed capital expenditure facility.

Larger platforms and institutions are also moving into the space. Alternative assets manager Apollo and UAE sovereign wealth fund Mubadala teamed up to launch a US$12 billion direct lending platform that will invest in deals of up to US$1 billion in size. Mubadala has launched a similar initiative with Barings, while Credit Suisse and the Qatar Investment Authority have also established a direct lending offer.

Beyond the pandemic

The recovery in secondary loan pricing and a return of some stability saw leveraged loan activity return to healthier levels in the latter part of 2020. With the prospect of vaccines rolling out and a light at the end of the COVID-19 tunnel, the outlook for 2021 is brighter. Financial sponsors will no doubt turn back to leveraged loans to finance deals in the months ahead.

The resilience of the high yield market through the course of 2020, and the expanding scale of direct lending providers, who have the firepower to take on credits of increasing size, however, may prompt a sustained shift to these options long after COVID-19 has passed.



Conclusion

After years of warnings about maturity walls, impending cliff edges, downturns and interest rate hikes that failed to emerge, COVID-19 was the event that brought everything to a temporary standstill—but there's every chance that the markets will explode with activity in the months ahead

European leveraged finance markets kicked off 2021 on a relatively positive note, with investor appetite pushing pricing tighter, robust demand from CLOs, continued inflows into high yield bond funds and the expectation of greater M&A and buyout activity following months of relative stagnation—all of which suggests the markets could see a burst of activity in the months ahead, as economies begin to open up once again.

A remarkable comeback

This optimism follows a challenging year for European leveraged finance markets, as COVID-19 lockdowns were imposed, loosened and then imposed again, and businesses scrambled for liquidity to shore up their finances.

Between February and March 2020, European leveraged loan issuance fell significantly. But by June and July 2020, it had climbed back up to pre-pandemic levels. And while issuance dipped again in the final quarter of the year, leveraged loan issuance overall managed to finish the year up 11% on 2019.

In a year that saw entire sectors effectively shut down around the world, from aviation to hospitality, leveraged loan markets came back to life much faster than many anticipated.

High yield bonds proved even more resilient, despite hitting rock bottom in March with almost zero issuance. By June, as initial lockdown restrictions began to ease in many parts of Europe, the market was back up to €16.2 billion—almost on par with January's figures. By the end of 2020, high yield bond issuance was up 10% on the previous year, as investor appetite for bonds remained robust.

European collateralised loan obligations (CLOs) followed a similar path. In 2020, new-issue CLO volume fell by 26%, with CLO refinancings dropping to zero, but by October 2020, primary CLO new issuance hit its highest monthly level since October 2019. News of vaccines provided another boost across European markets, with reset and refinancing activity expected to return to Europe in force in 2021.

Short-term thinking, long-term goals

This return to relatively healthy activity in leveraged finance markets has been bolstered by a pragmatic approach to documentation and terms. For the most part, lenders reacted to the pandemic as a short-term, albeit undeniably dramatic, concern. Depending on the sector, businesses that were viewed as trustworthy credits before COVID-19 continued to be viewed as such, and this was reflected in amended processes in 2020, which tended to focus on liquidity and enhanced reporting alongside a reset or suspension of covenants.

For the time being, lenders will mitigate risks by analysing deals even more closely in search of quality credits—which will in turn affect pricing. Any weaknesses or loopholes in documentation will be scrutinised and lenders may be more cautious in their forecasting.

M&A and buyouts may bloom

Looking to the future, there are plenty of signs that Europe's leveraged finance markets will see robust activity in the months ahead, even as a new wave of COVID-19 lockdown restrictions are introduced.

€227 billion

The value of European leveraged loan issuance in 2020

10%+

The rise in European high yield issuance in 2020 year-on-year

Lenders still want to lend—encouraged by low interest rates and extensive quantitative easing—and borrowers are eager for financing. More transactions are likely to emerge, for example in M&A, with a clearer view of future earnings and pricing. The range of dealmakers and investment strategies is also likely to expand, from financial sponsors in search of new opportunities to activist investors driving deal activity.

This does not mean deals will be guaranteed, of course: Buyers and lenders will be increasingly selective, along sector-specific lines. They will focus on high-quality assets to minimise risk, as well as distressed companies, buying in to sectors hit by lockdowns at low valuations.

Throughout the rest of the year, lenders and borrowers alike can expect to face unprecedented challenges, as COVID-19 restrictions rise and fall and vaccines roll out, but there is every chance that 2021 will also offer up unique opportunities for growth for those who take the plunge.

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6071.17
13550.83
13487.21
12278.00
12262.50
24108.11
24061.67
28795.42
2258.09
1586.73

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