WHITE & CASE

European leveraged finance: Choosing the right path

European leveraged finance markets paused for breath in 2022, due to rising interest rates, volatile geopolitics and a tightening of financial markets across the board—but what can we expect in 2023?

Contents

Foreword

Heading into 2023, European leveraged finance markets continue to deal with fierce headwinds, following 12 months of economic and geopolitical volatility that has prompted a general slowdown in issuance. What does this mean for the months ahead?

After the record-setting leveraged finance activity seen in 2021—as companies scrambled to refinance, M&A activity spiked and private equity (PE) went on a shopping spree—it was clear that pace was not likely to continue.

But in 2022, as the tail end of the pandemic worked its way through markets, companies were suddenly faced with a new reality. Conflict erupted in Ukraine, oil prices climbed and supply chains were disrupted. A decade of low inflation and interest rates came to an end across Europe. Financing began to tighten as debt became increasingly expensive.

By the end of 2022, while European leveraged loan and high yield bond markets began to see activity, it was well below normal levels and followed a prolonged period of lower issuances. Leveraged loan issuance in Western and Southern Europe was down 37 per cent year-on-year, while high yield bonds fell by 66 per cent during the same period. The third quarter of the year was one of the lowest quarterly totals for leveraged finance issuance in the region on *Debtwire Par* record.

In both cases, higher pricing was a major factor as it continued to climb throughout the year. On leveraged loans, almost 40 per cent of all deals saw original issue discounts (OIDs) of two or more points from par—by Q4, it was not unheard of for there to be OIDs in the low 90s on term loan B facilities. On the bond side, pricing seemed to finally peak by the end of the year, but only after six quarters of consistent rises.

Eye on the prize

At the same time, there were a few bright spots for leveraged finance markets throughout the year. First and foremost, buyout activity remained active in the first half of 2022 before dropping off in the second half. Notable deals include KKR's €3.4 billion-equivalent acquisition of independent beverage bottler Refresco and Bain's purchase of human resource consultants House of HR, backed by a €1.145 billion term loan and a €415 million note.

Second, new money financing represented a significant proportion of total issuance early in the year, as issuers raised term loan facilities to partially refinance drawn revolvers and fund new acquisitions. As with everything else, however, headwinds meant that most of the new money facilities issued towards the end of the year were smaller add-ons.

Third, CLOs continued to perform consistently (though they were not immune to the general slowdown in the market). Overall, there was €26.1 billion in issuance in 2022—down 32 per cent year-on-year but, in November alone, there was almost €3 billion in new CLO issuance, well above historical monthly averages, according to *Debtwire Par*.

The path ahead

While there are still shadows on the horizon, the cyclical nature of leveraged finance means that there are always new opportunities. The key is to be prepared. For example, inflation is starting to plateau in many jurisdictions, but interest rate rises may continue—in the UK, for example, in December, the Bank of England raised the benchmark to 3.5 per cent, up from 3 per cent. This was the ninth consecutive hike since December 2021, placing the rate at its highest level for 14 years. Companies will need to consider their options carefully to get their costs under control.

For those looking to proactively manage their debt, amend-and-extend facilities may be the best place to start. Small add-ons and maturity extensions will help many find their way through the forest until macro-economic conditions improve.

Those with the highest-quality credits will reap the benefits of the liquidity available in the market by upsizing as well as via likely tighter pricing during syndication (when compared to balance sheet lending). For example, *Debtwire Par* reports that French telephony firm Iliad and automotive supplier Valeo entered the market with €500 million notes, and both were upsized during syndication to €750 million.

While this points to a potentially bifurcated European market in the months ahead, where solid credits remain healthy and those already struggling may face an uphill battle, liquidity on the equity and debt ledgers remains strong, and leveraged finance activity is likely to pick up further to address their respective needs.

Hitting the brakes: European leveraged finance battens down the hatches

HEADLINES

■ Leveraged loan issuance in Western and Southern Europe reached €183.4 billion in 2022, down by 37 per cent year-on-year ■ High yield bond activity was down 66 per cent during the same period, at €50 billion ■ Loan margins were up by 0.64 per cent by the end of the year, while average yields to maturity for high yield bonds climbed by nearly 3 per cent

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

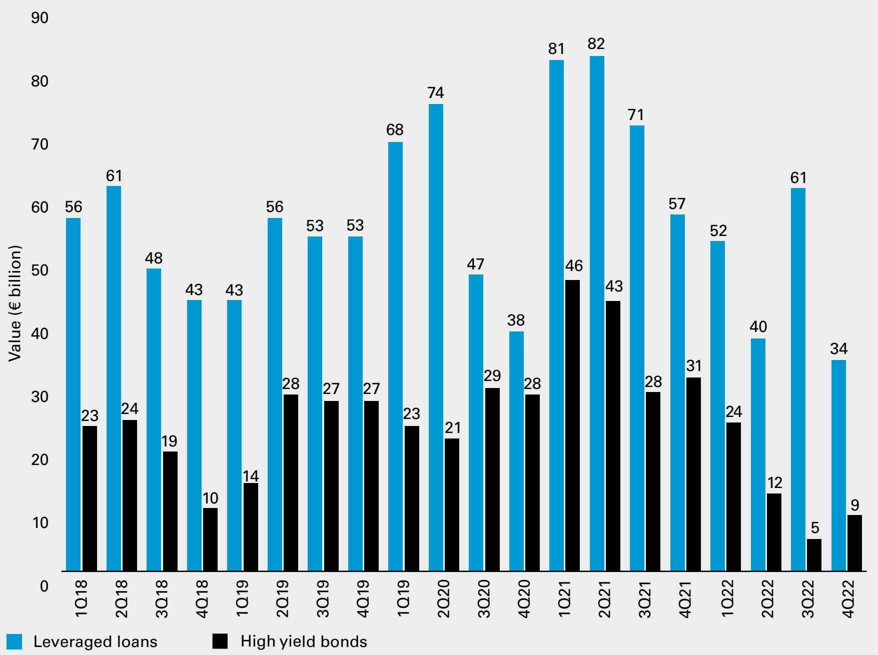
European leveraged finance markets saw significant inertia through the course of 2022 as high inflation, rising interest rates and cooling M&A activity put the brakes on leveraged loan and high yield bond issuance. How will these headwinds affect leveraged finance markets in the year ahead?

According to data from *Debtwire Par*, leveraged loan issuance in Western and Southern Europe was down 37 per cent in 2022, year-on-year, at €183.4 billion, with institutional loan issuance suffering an even steeper decline, down by 67 per cent at €52.9 billion. High yield bond markets in the region have seen similar slowdowns, with issuance down 66 per cent across the first ten months of 2022 at €50 billion.

The steep decline in activity came as the conflict in Ukraine dampened investor appetite for risk and central banks bumped up interest rates to keep a lid on surging inflation. This, coupled with political volatility (including multiple successive UK prime minister changes as well as the ongoing impact of Brexit), meant that markets had little positive momentum on which to rely in changing their risk assessment.

In the UK, with inflation reaching a 41-year high of 11.1 per cent in October, the Bank of England upped rates to 3 per cent in November and 3.5 per cent in December—the highest level since 2008. The European Central Bank also raised rates to the highest level in more than a decade by the end of 2022, with a 0.5 per cent increase announced in December to tackle inflation that is running above 9 per cent.

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



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

As interest rates have climbed, so have borrowing costs. The average margins on first-lien institutional loans were sitting at 4.02 per cent at the end of 2021 but spiked to 4.73 per cent by the end of Q4 2022. European high yield bond borrowing costs almost doubled, with the weighted average yield to maturity for fixed rate bonds up from 4.73 per cent at the end of 2021 to 8.23 per cent in Q4 2022.

37%
The decline in leveraged loan issuance in Western and Southern Europe in 2022, year-on-year

Refinancing unattractive as secondary market pricing plunges
Rising borrowing costs and a recalibration of risk appetite from lenders and investors has had a chilling impact on refinancing activity, which was a major driver of activity at the end of 2020 and through 2021.

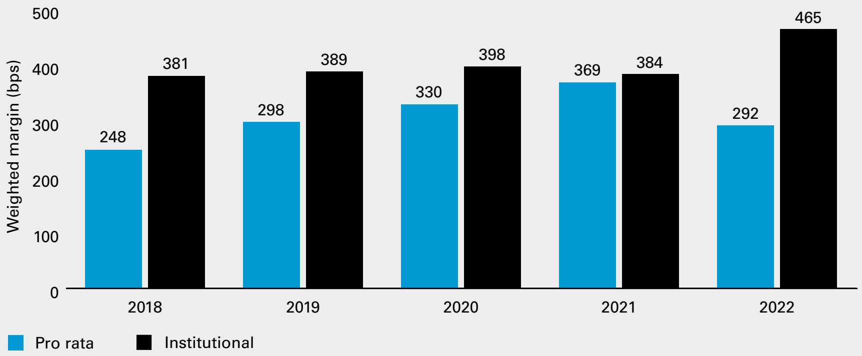
High yield refinancing deals dropped to just €19.2 billion for the year, a 77 per cent year-on-year decline, while loan refinancing volumes fell 45 per cent from €134.9 billion to €74.3 billion during the same period in 2022.

As the abundant liquidity and low debt costs dried up, and with many maturities already addressed, there has been limited scope for opportunistic borrowers to refinance existing credits on better terms and extend maturities. For lenders and investors, meanwhile, the deep discounts to par that have emerged in the secondary market have blunted the appeal of refinancings. *Debtwire Par* figures show that European leveraged loans priced at an 11 per cent discount to par in secondary markets in September and October, encouraging investors to pick up bargain secondary market trades rather than support refinancings.

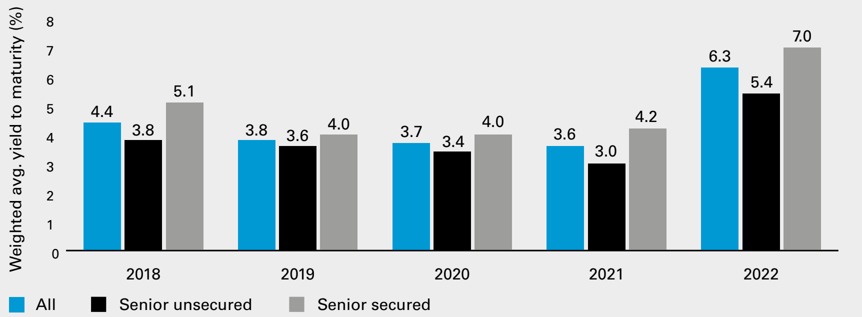
New money deals, meanwhile, have also contracted due to discounts in the secondary market. In order to gain any kind of traction for new deals, borrowers have been forced to accept significantly deeper original issue discounts (OID). This has prompted borrowers to put financings on ice until market conditions improve—and investors still seem inclined to wait for secondary market opportunities even when deep OIDs are offered.

These factors saw new money loan issuance fall 29 per cent year-on-year to €105.3 billion, while high yield new money transactions fell 52 per cent in 2022. Falling European M&A and buyout transaction flow—down 30 per cent year-on-year by the end of 2022—has also knocked new money activity. In loan markets, M&A and buyout issuance dropped by 69 per cent and 9 per cent respectively for the year, with high yield markets also recording an 81 per cent slide in M&A issuance, with buyout issuance decreasing by 52 per cent.

European leveraged loan pricing



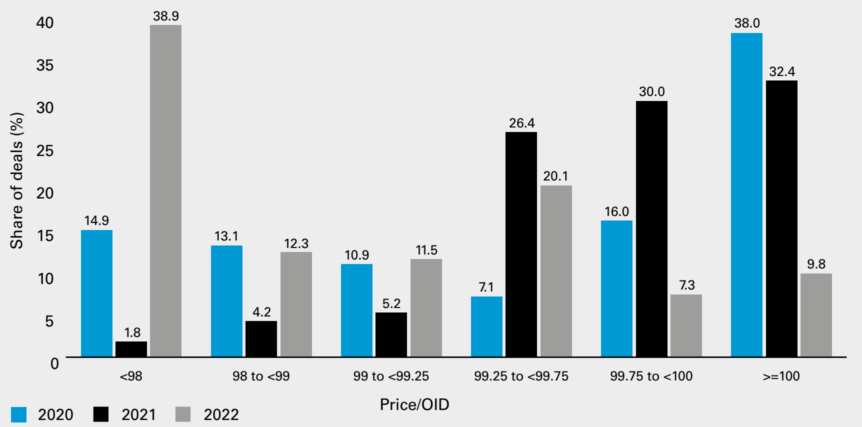
European high yield bond pricing—Fixed-rate bonds*



Source: *Debtwire Par*

**EUR issues only*

Original issue discounts (OIDs)* in Europe



Source: *Debtwire Par*

**Based on universe of deals where OID data available*

Adjusting to the new normal

Moving into 2023, loan and high yield activity is likely to continue facing headwinds. There is still limited visibility on when European inflation will peak and interest rates will top out. Lenders and investors will remain cautious while issuers will avoid coming to market unless strictly necessary.

Smaller deals and add-on deal financings—such as UK online retailer THG's £156 million add-on term loan B —will still find a way through loan markets, while high yield markets will open intermittently and facilitate some issuance, as seen with deals including Hunkemoeller, Fedrigoni, EnQuest and Cirsa, which managed to secure financing in the final quarter of 2022.

Overall, the European market will remain challenging. By the end of 2022, the pipeline for deals had slowed to a trickle—Carlyle's purchase of Italian motorcycle gear company Dainese and a refinancing for the UK insurance broker Ardonagh (backed by the Abu Dhabi Investment Authority) were the only deals on the horizon.

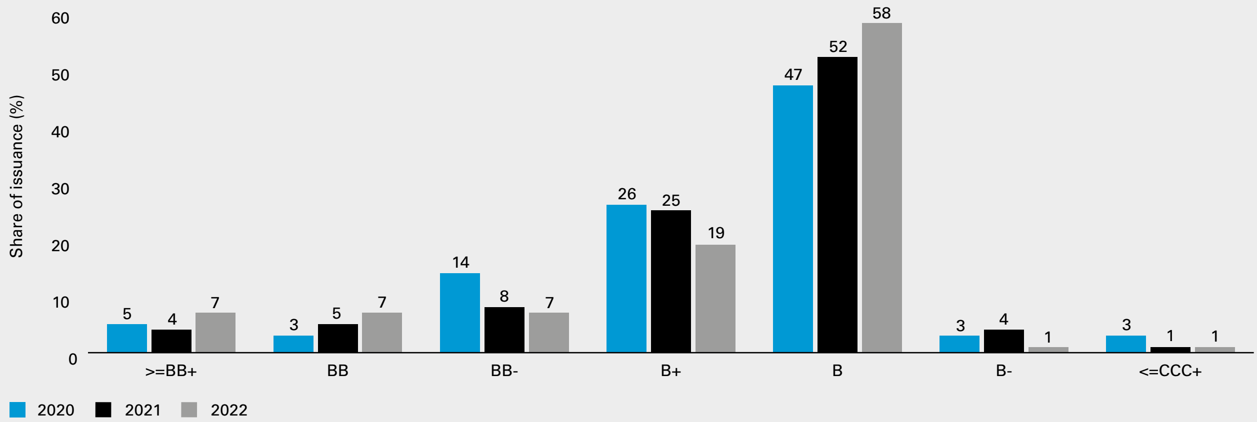
When deals do come forward, borrowers may have to scale back their expectations. For example, in October 2022, Dutch artificial turf manufacturer TenCate Grass postponed a €274.3 million add-on to its €315 million EURIBOR+ 500 bps term loan B due September 2028 because of the volatile market conditions.

Borrowers are also expected to run dual-track financing processes more often, with direct lenders in line to pick up an increasing volume of transactions that would otherwise have gone down the high yield bond or leveraged loan route. Italian specialty food ingredients producer Irca, for example, shifted the financing for its acquisition by Advent International from The Carlyle Group from a proposed €430 million high yield bond note to a direct lending package provided by CVC Credit.

Maturity extensions front and centre

Maturities during 2023 and onwards will need to be dealt with in creative ways. Typically, both borrowers and lenders want to avoid a restructuring where possible. This is expected to drive an increase in amend-and-extend deals, both in the loan market where this is more

European leveraged loan issuance by rating*



Source: *Debtwire Par*

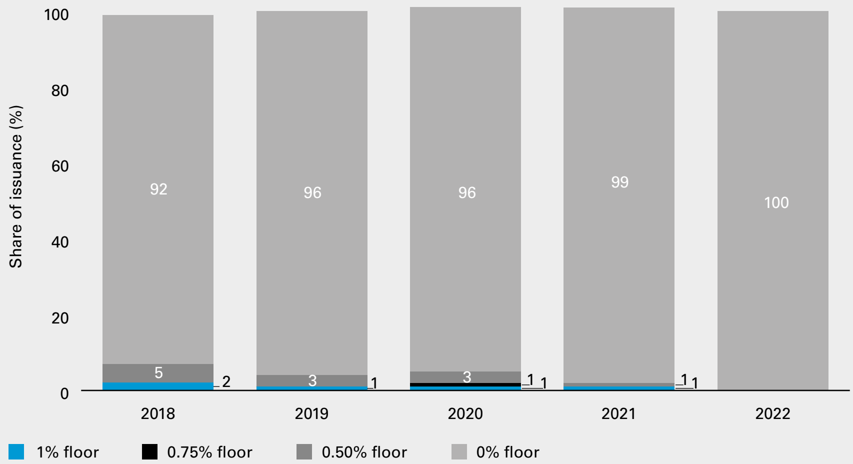
** Based on universe of loans that are rated. Where split-rated, higher rating is used. Only Moody's and S&P ratings are considered.*

traditional, but also in the high yield market, as seen in the exchange offer undertaken by German pharmaceutical company Stada in October 2022. These deals will see borrowers move to extend maturity walls by offering incumbent lenders higher coupons, additional covenants and/or additional credit support.

Equity injections may also become more common as sponsors see the need to support portfolio companies through a rough patch and to convince investors of long-term value in a business.

The scope for maturity extensions could be limited for certain CLO investors, as their weighted average life tests restrict their ability to roll debt. But when maturity extensions are an option, it is hoped that these arrangements will help to avoid large-scale insolvencies and full-blown restructurings in 2023, with lenders willing to accept more favourable pricing and terms in exchange for maturity extensions rather than crystallising losses.

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*

Five factors that will influence leveraged finance in 2023

HEADLINES

■ Amend-and-extend deals to come to the fore ■ Mid-market deals to take centre stage ■ Secondary market developments will drive primary market prospects ■ Restructurings may rise as maturities approach and cash balances run low ■ Sponsors will find it tougher to source financing, but we may not see a terms evolution

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

European leveraged finance markets have been completely reconfigured in the past 12 months. Inflation, rising interest rates and geopolitical uncertainty have squeezed liquidity and seen high yield bond and leveraged loan issuance decline as borrowing costs have climbed.

The wave of prolific refinancings secured in the hot market of 2021 has run its course and M&A-linked issuance has also fallen away as dealmakers pushed the pause button to assess the impact of macro-economic headwinds on deal targets.

What does this mean for borrowers and lenders in the next 12 months? Here are five key trends that we think will drive activity in the market in 2023.

1. Amend-and-extend (A&E) arrangements will increase

As leveraged finance markets have tightened, borrowers have no longer been able to rely on refinancing to push out loan and bond maturity walls or secure capital on more favourable terms.

With refinancing effectively off the table, borrowers with credits approaching maturity will look to A&E their existing debt tranches with amendment and extend deals and/or exchange offers. These deals will offer lenders a consent fee and a higher coupon in exchange for extending loan maturities by 12 to 24 months. Borrowers will also bring lenders onboard by putting equity injections, deleveraging, more covenant protections and/or additional credit support on the table. While common in the loan world, this trend likely will expand into the bond market as shorter-term extensions balance both immediate maturity concerns but also investor concerns over long-term commitments in an uncertain market.

In Q4 2022, German generic drug manufacturer Stada and UK consumer credit group NewDay were among the first high-profile bond credits to make A&E offers to lenders. Spanish paper manufacturer Lecta also turned to A&E during the same period, confirming that it had received consent from lenders to amend-and-extend its €115 million senior facility agreement.

Debtwire Par's inaugural mid-market survey, conducted in Q4 2022, confirms this trend is likely to continue in the months ahead. According to the survey, 32 per cent of respondents say they expect to see more A&E mitigation strategies employed in the next three to six months, second only to covenant waivers.

Expect more A&E to follow suit in 2023.

2. Pause in mega-market deals will open the door for mid-market financing to dominate

Inertia in syndicated loan and high yield bond markets has made it challenging for mega-market private equity (PE) firms to finance jumbo deals, which has seen a decline in big-ticket M&A value. Mid-market M&A, however, is proving more resilient.

According to data from *Mergermarket*, mid-market M&A deal value in Western Europe (deal valuations in the US$5 million to US$999 million range) slid by 13 per cent year-on-year in 2022, whereas deal value for US$1 billion+ transactions was a third off 2021 levels.

With capital markets expected to remain difficult to access for a time, mid-market M&A financing—which is currently predominantly provided by direct lenders that still have large dry powder cash piles to deploy—is set to remain available and help to sustain mid-market deal volumes. With the opening of a new year, banks are also expected to become more active in these markets.

With megadeals on hold for now, large-cap financial sponsors will be more likely to pursue smaller transactions, providing an additional boost for mid-market financing demand.

Dealmakers and lenders will also remain open to pursuing and financing public-to-private deals, an area that has remained active for M&A due to currency fluctuations and lower stock market valuations.

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3. Secondary markets will determine primary market prospects

European primary leveraged finance markets will only reopen on attractive terms when secondary markets improve.

As macro-economic headwinds intensified through 2022, European debt traded at ever deeper discounts. According to *Debtwire Par*, European leveraged loans were pricing at an 11 per cent discount to face value in secondary markets in September and October. This compares to discounts of less than 2 per cent at the start of the year.

Until discounts narrow, the prospects of a rebound in primary markets will be slim and will only be used where necessary or opportunistically for the right deals. So long as credits trade well below par, secondary market trades will remain significantly more attractive than refinancing opportunities and new money deals—even when issuers are prepared to offer wide original issue discounts. Spreads will have to narrow to incentivise lenders to get back into the game on the primary side.

4. Restructurings loom on the horizon

While it may be the main option of choice as described above, A&E will not be an option for all borrowers—lenders will favour credits that are performing well in stable sectors and demand generous sweeteners if A&E transactions are to proceed. Certain CLO investors, meanwhile, may not be able to extend maturities as their weighted average tests may restrict them from rolling debt. Meanwhile, PE firms will only invest resources in A&E deals if they believe portfolio companies have realistic prospects of returning to growth in the medium to long term.

Covenant-lite debt packages will provide credits that are under pressure with some breathing room, but this may just mask problems, leading to harsher restructurings in the future when maturities approach and cash balances run low.

Distressed debt funds, meanwhile, are marshalling new pools of capital and buying up discounted debt in anticipation of more distress and special situations where money can be put to work.

5. Sponsors will hold ground on terms

PE firms may find it more difficult and more expensive to source debt in 2023, but there are no signs of any major evolution in terms and documentation.

Cov-lite structures and flexible terms have become embedded in the market. Pragmatism will be prevalent on deals as key points of focus reach a compromise—but, with the penalty of increased borrowing costs, this will likely be seen as compensation enough, rather than the market turning back to old school documentation.

Ready for restructuring

HEADLINES

■ Rising interest rates and reduced refinancing options are increasing the likelihood of restructuring and financial distress in the next 12 months ■ Cov-lite debt packages have given borrowers breathing room, but may conceal underlying distress ■ Issuers in stable sectors have negotiated amend-and-extend (A&E) deals to push out maturity cliff edges, but not all borrowers have that option

By James Greene, Richard Lloyd, Jeremy Duffy and Ian Wallace—partners at White & Case

Borrowers and lenders have dusted off their hard hats and rolled up their sleeves in anticipation of an increase in restructuring and distressed debt situations in 2023.

For the first time in more than a decade, European leveraged finance markets, private equity (PE) sponsors and management teams are feeling the pressure from rising interest rates on capital structures, introduced to stem the steady rise in inflation.

The build-up of cash during more benign market conditions in the past 18 months, coupled with the fact that borrowers took advantage of buoyant debt markets in 2021 to refinance and extend maturities, shielded credits from the immediate impact of rising interest rates in 2022.

In 2023, however, market conditions have worsened materially as the full impact of the cost of living crisis and the ongoing war in Ukraine begin to bite. Higher interest payments are now taking a toll on cashflow and the option to refinance out of a tight spot is no longer on the table, with leveraged loan and high yield bond issuance earmarked for refinancing down by 51 per cent and 79 per cent respectively in 2022. High yield funds, meanwhile, have faced significant outflow through the course of 2022, limiting the capital available for refinancing.

According to Refinitiv Lipper, in the first nine months of 2022, the outflow from global bond funds had already reached its highest level in 20 years, at US$175.5 billion.

As these headwinds intensify, many borrowers that were once in a relatively comfortable position when it came to servicing capital structures may find themselves stretched. And borrowers that are running out of cash can no longer bank on raising new financing with relative ease.

Exploring options

As pressures mount, the first ripples of distress are already being felt. Bankruptcies and corporate insolvencies in the EU and the UK recorded double-digit increases in 2022 and, according to forecasts from Allianz, the UK, France and Germany may see business insolvencies climb by 29 per cent, 10 per cent and 17 per cent respectively in 2023.

According to Fitch Ratings, meanwhile, European credit defaults are expected to more than double in 2023, with high yield defaults forecast to rise from 0.7 per cent in 2022 to 2.5 per cent by the end of 2023, and leveraged loan defaults set to climb from 1.3 per cent to 4.5 per cent during the same period.

There is also likely to be a cohort of borrowers that do not appear to be in obvious distress but may be feeling the squeeze behind the scenes. Debt packages issued in the past five years have few or no covenants, so lender protections that might have triggered an early warning are not in place, thereby concealing underlying problems. As a result, some borrowers may not immediately seek out covenant waivers and facility amendments from their lenders. But when challenging market conditions really take hold, those same borrowers will be facing even more critical concerns as facility maturities approach and cash begins to run out. Restructuring under those circumstances will likely be more difficult and the financial pain suffered by borrower and lender alike could be significant.

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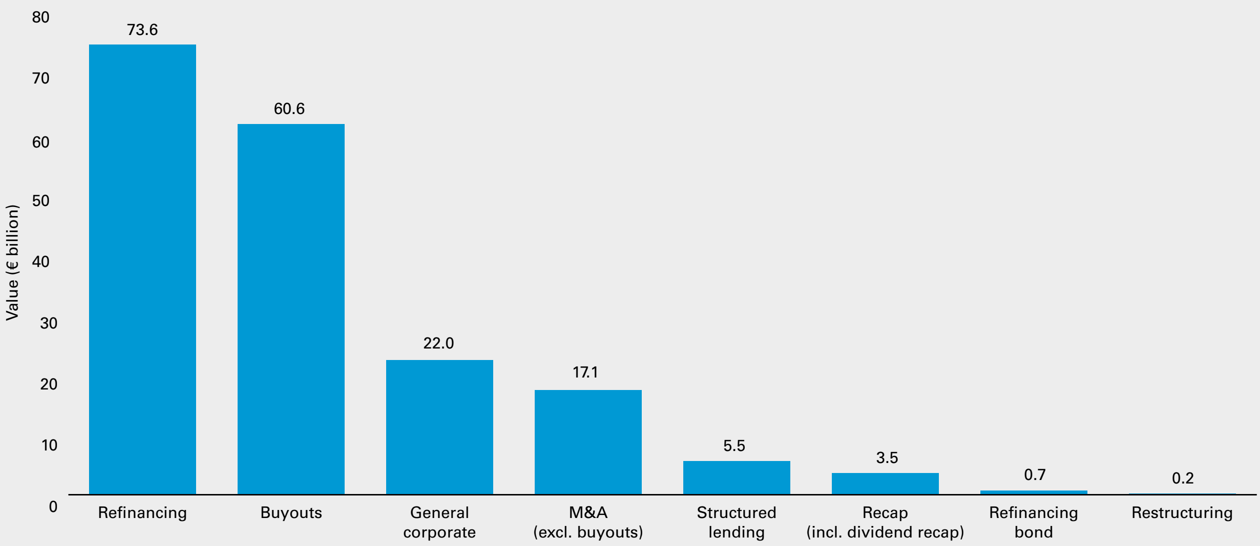
European leveraged loan use of proceeds (2022)

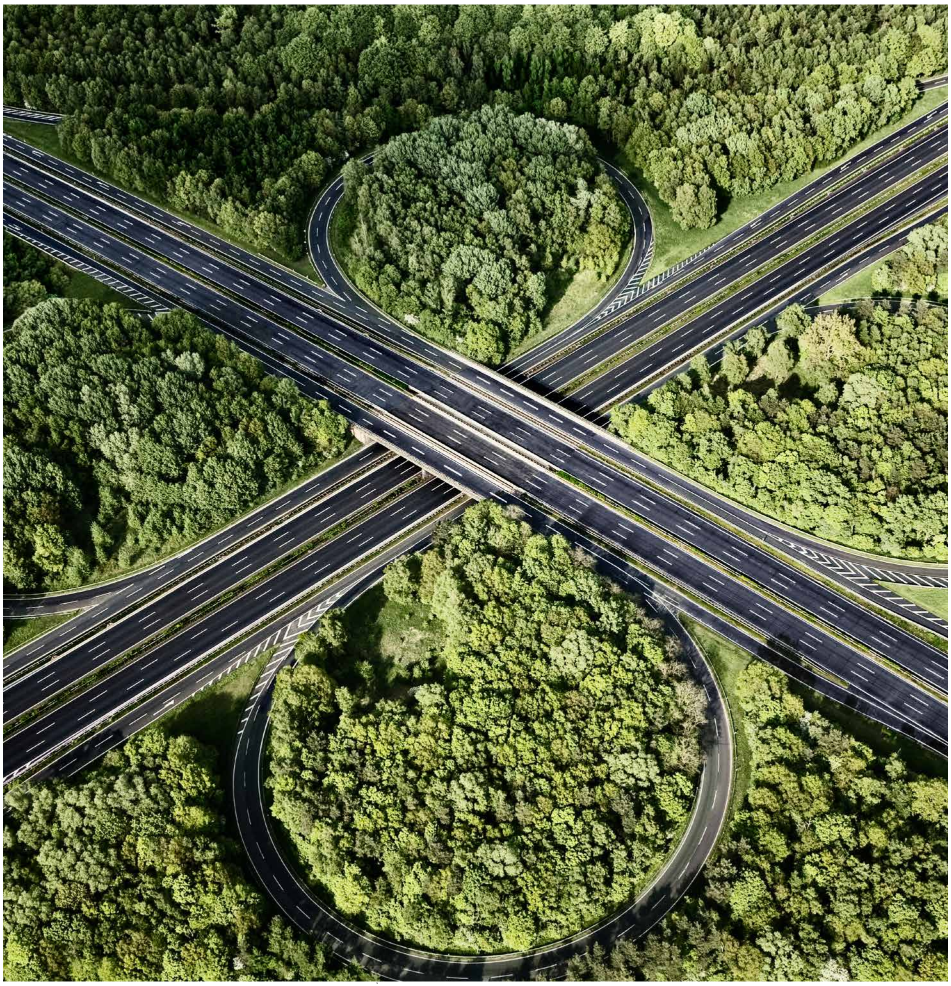


Source: *Debtwire Par*

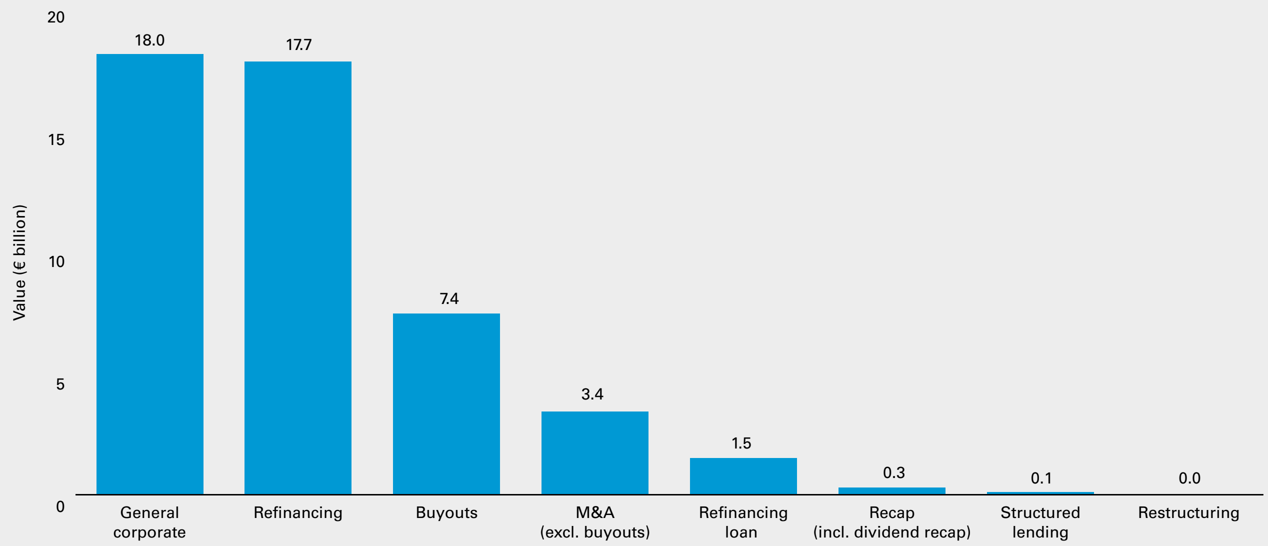
The fact that most borrowers took the opportunity to refinance and do not have to meet covenant tests, however, has given them some breathing room. Many are now exploring their options proactively to avoid a potential full-blown restructuring or insolvency down the road.

Borrowers facing maturities in the next 12 to 24 months are already undertaking exchange offers and amend-and-extend deals that offer a mix of higher coupons, refreshed call protection, improved covenant packages, better collateral protection, equity injections and debt paydowns in return for extending maturity runways. PE-backed generic pharmaceuticals group Stada and consumer finance group NewDay were among the first borrowers to bring forward amend-and-extend options, followed by a string of companies taking the same path.

Some PE sponsors may also agree to put additional capital into a portfolio company, but ideally only if that capital can go in at the top of the capital structure as super-senior debt. Lenders are adopting a similar playbook when injecting additional funding into businesses following debt-for-equity swaps.



European high yield bond use of proceeds (2022)



Source: *Debtwire Par*

Barings and Farallon Capital Management, for example, swapped a portion of the debt they held in UK cinema chain Vue for equity, and injected an additional £75 million of cash into the business in the form of a super-senior term loan.

Distressed debt investors ready to step in

Borrowers that move early to head off restructuring risk early will likely be in the best position to renegotiate debt packages consensually with lenders. The timing may be ideal, as many lenders will be open to supporting liability management plans rather than crystallising losses or facing the reputational risks that come with enforcing a restructuring.

Given the relatively borrower-friendly terms in recent debt documents, it is possible to imagine a wave of "stage 1" restructuring processes in 2023 where lenders agree to a degree of short-term relief. This may include limited debt service relief or injecting new capital on a senior basis in return for more traditional lender protections being re-inserted in the debt documents. These may include financial covenants or allow lenders to trade their debt more freely.

Not all credits, however, will be able to undertake amend-and-extend (A&E) deals. To date, successful A&E transactions have been brought forward by companies that are performing well and based in stable sectors, such as healthcare, infrastructure and TMT. An A&E deal brought forward by French medical diagnostics company Sebia, for example, was well received by existing and new lenders.

Borrowers also must ensure that any amendments to pricing and terms are attractive enough to get lenders onboard. For example, *Debtwire Par* reports that one lender decided against getting behind an extension deal brought forward by UK sports betting company Entain because the pricing was deemed to be too tight.

PE firms, meanwhile, are expected to triage portfolios and only invest resources in liability management exercises when portfolio companies are expected to return to growth in the medium-to-long term. There will be limited appetite from sponsors to inject equity and time resources into companies that are unlikely to improve in the year ahead. Parties are also grappling with the challenges presented by CLO investors that are unable to extend their investment periods due to underlying constitutional restrictions.

Credits trading at deep discounts to par will also be on the radar of distressed debt investors. Many will be preparing to buy up debt at a discount with a view to selling on the paper when prices recover, or positioning themselves to transfer debt positions into equity ownership if borrowers run aground and run out of cash. Specialist players will also manoeuvre into capital structures by offering to inject more cash into a business if their capital can sit at the top of the structure.

With the likes of J.P. Morgan and Zetland Capital both closing funds focused on investments in troubled businesses in 2022 and established distressed investment players Oaktree Capital Management and GoldenTree Asset Management approaching investors for additional capital, distressed debt players are set to play an increasingly prominent role in debt restructurings in the year ahead.

M&A and buyouts—slowing the pace

HEADLINES

■ M&A leveraged loan issuance in Western and Southern Europe is down 69 per cent year-on-year, while high yield is down 81 per cent ■ Buyout loan and high yield bond issuance is down by 9 per cent and 52 per cent respectively ■ Dislocation between buyer and vendor expectations on M&A deals expected to weigh on deal activity in 2023

By Yannick Adler, Shane McDonald, Richard Jones and Evgeny Scirtò Ostrovskiy—partners at White & Case

69%

The year-on-year decline in leveraged loan issuance earmarked for M&A in Western and Southern Europe in 2022

After a blow-out year in 2021, European leveraged finance issuance for M&A and leveraged buyouts has declined through the course of 2022, as deal activity has tailed off in the face of unprecedented geopolitical and macro-economic volatility.

In 2022, leveraged loan issuance for M&A in Western and Southern Europe dropped by 69 per cent year-on-year, with high yield M&A issuance falling by 81 per cent during the same period, according to *Debtwire Par*. Issuance for leverage buyouts has proven more resilient, with loan issuance down by just 9 per cent year-on-year, though high yield fell by 52 per cent during the same period.

Buyout issuance remained steady through the first half of 2022, as the market worked through an overhang of deals from the previous year and private equity (PE) firms continued to deploy significant levels of dry powder despite the conflict in Ukraine and rising interest rates. Notable deals in the first six months of 2022 include Spanish slate miner Cupa Group pricing a €480 million term loan B (TLB) to back a US$1 billion buyout by Brookfield and Triton securing a €735 million TLB to finance the acquisition of cancer pharmaceuticals company Clinigen, according to *Debtwire Par*.

Through the second half of the year, however, buyout issuance has fallen away as PE tapped the brakes on new deals. European buyout deal value overall dropped from US$124.3 billion in Q2 2022 to US$25.8 billion in Q4 2022—the lowest quarterly total since the first round of COVID-19 lockdowns in Q2 2020.

Buyout loan and bond issuance has declined in line with this drop in buyout volumes. In Q4 2022 2022, loan issuance for buyouts dropped to just €4 billion, according to *Debtwire Par*—a far cry from the €26.7 billion of issuance posted in Q3. High yield markets, meanwhile, saw no buyout issuance at all in Q3, with just €1.6 billion in issuance recorded in Q4.

M&A headwinds build

Moving into 2023, PE and M&A deal activity is expected to remain subdued, limiting demand for deal financing.

Vendors that were planning to sell assets in 2022 have pushed back deal timetables or pulled sales processes altogether as the gap between buyer and vendor pricing expectations has widened.

In the past year, the average earnings multiples paid for European mid-market companies declined from 11.6x EBITDA to 10x EBITDA, according to the Argos Index. Vendors have been reluctant to sell businesses at discounts to the valuations that were available relatively recently. Buyers, however, have become more cautious and are unwilling to pay yesterday's multiples for companies that now face heightened uncertainty and downward pressure on earnings.

When deals do go ahead, it is also taking longer to get buyers and sellers over the line. According to insurance advisor WTW, in the first six months of 2022, 60 per cent of transactions took more than 70 days to close, compared to just 54 per cent during the same period in 2021, and this may continue in 2023. Increased regulatory scrutiny—including new foreign direct investment regimes in a number of jurisdictions—is only adding to these delays, contributing to flatter M&A and buyout debt issuance.

Securing debt to finance deals has also become more challenging and expensive, which in turn has constrained the amount of capital buyers can corral to reach vendor price tags. Sponsors arranging debt packages to fund buyouts have seen pricing on buyout loans climb from 4.24 per cent at the start of 2022 to 5.47 per cent by the end of the third quarter before falling to 4.89 per cent in the fourth quarter. Sponsor-backed issuers have also had to offer deep original discounts (OIDs) to lure in buyers, with OIDs widening to 8.81 per cent in the fourth quarter.

Financing big-ticket transactions, meanwhile, has proven particularly challenging, with banks still trying to clear credits that have been stuck in syndication from their books. Bloomberg figures estimate that US and European banks are still holding more than US$40 billion in buyout debt that has not been syndicated. Until these positions are exited, capacity to underwrite new transactions will be limited.

A change in approach

While M&A may be somewhat muted for at least the first six months of 2023, pockets of activity will continue to deliver deals. Sustained weakness in the British pound against the US dollar and euro, for example, has been noted by US buyers. Listed companies in the UK that are undervalued could be trading at attractive discounts for US buyers investing dollars.

Companies with strong cash flows, particularly in healthcare, such as UK-based specialty diagnostics company The Binding Site—sold to US corporate Thermo Fisher in a US$2.6 billion deal—will also continue to draw interest from corporate and PE buyers.

Among the biggest healthcare deals in 2022 was the €35.5 billion demerger of Haleon—the consumer healthcare group running dental health brands like Sensodyne, as well as treatments for colds, the flu, allergies and pain—which was spun off from pharma giant GSK. The deal accounted for more than two-fifths of European consumer deal value in 2022, according to *Debtwire Par*.

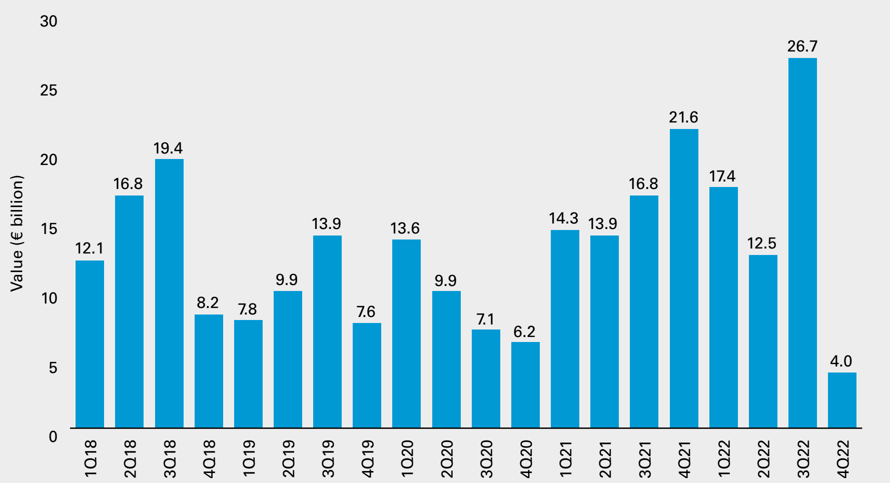
High-quality deals that do emerge from these pockets of activity will also find that financing is available, with direct lenders continuing to lend and eager to deploy into a market where they can be selective and benefit from rising base rates as well as wider margins.

Even for jumbo financings, direct lenders have shown that they can move beyond their core mid-market offering to deliver sizeable debt packages that would usually be the preserve of syndicated loan and high yield bond options. Access Group, for example—a business software company backed by PE firms Hg and TA Associates—secured more than £3 billion for a refinancing, including a £1 billion acquisition finance line. The direct lending arm of Carlyle and private debt manager HPS, meanwhile, provided funding for Clayton, Dubilier & Rice's acquisition of the UK, Ireland and Asia operations of French services business Atalian.

Direct lenders have been able to negotiate better pricing and documentation, including tighter provisions around call protections and unrestricted subsidiaries, and include debt servicing covenants. Dealmakers, noting the changes in the market, have also been willing to take on lower leverage multiples and put larger equity cushions in place to give lenders comfort and move deals to completion.

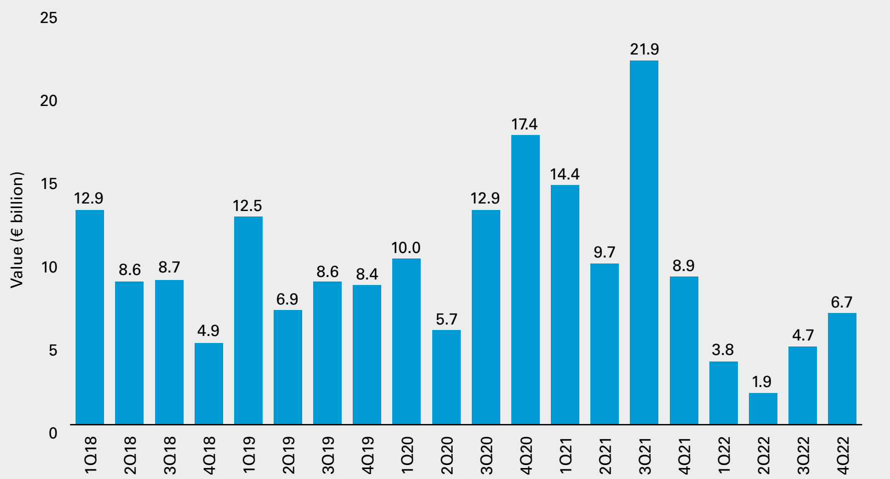
These shifts may mean that debt packages are not as generous for lenders as they were a year ago, but, for good deals, financing is still available.

European buyout leveraged loan issuance (quarterly)



Source: *Debtwire Par Restructuring Database*

European M&A (excl. buyouts) leveraged loan issuance (quarterly)



Source: *Debtwire Par*

Getting the deal done: How is European PE securing debt in a tight market?

HEADLINES

■ Private equity (PE) deal value in Europe dropped from US$599.2 billion in 2021 to US$369 billion in 2022 ■ Private debt fund structures in the region will ensure that buyouts and deal financings continue despite a tough market ■ Debt funds have appetite to fund large-cap as well as mid-market transactions ■ Club deals are becoming commonplace, as direct lenders take on bigger deal financings and diversify risk in their mid-market portfolios

By Nicola Chapman, Martin Forbes, Colin Harley and Evgeny Scirtò Ostrovskiy—partners at White & Case

European PE dealmaking declined in 2022—down 38 per cent year-on-year, according to *Mergermarket*—as macro-economic uncertainty intensified, valuations became increasingly volatile, and financing tightened.

Under the circumstances, the outlook for 2023 is uncertain. To what extent will structural incentives encourage sponsors and lenders to continue doing deals? How will an expanded universe of debt providers be able to overcome the obviously difficult macro-economic conditions?

Financial sponsors will not be sitting on their hands in the months ahead, even with a possible recession on the horizon.

Sponsors need to continue investing their limited partnership (LP) commitments through the cycle to deliver the expected returns. A downturn can also open new opportunities—dollar and euro-denominated funds will see potential value in chasing UK assets due to weaker sterling, while that same phenomenon, coupled with depressed values of some listed companies, may encourage more take-private deals.

The fact that financing is more expensive and difficult to secure could make dealmaking more challenging, but not enough to override the existential requirement for financial sponsors to sustain activity. As firms look ahead to the new year, here is a five-point checklist on what to expect from deal financing in 2023:

1. PE funds will keep deploying capital (and so will debt funds)

Regardless of whether syndicated loan and high yield bond markets reopen for buyout financings or not, in the months ahead, private debt funds will continue to serve as a steady source of acquisition financing. According to Deloitte, European private debt assets under management have increased five-fold in the past decade. With debt funds adopting similar fund structures used in the buyout space and sharing some of the same types of institutional investors, private debt fund managers should be similarly compelled to keep deploying their large capital pools across the cycle.

For most of 2022, private debt has been the best option available to sponsors, including for large-cap transactions that would usually be financed with syndicated loans and bonds.

According to *Debtwire Par*, more than ten transactions earmarked for potential syndication in 2022 were bankrolled by direct lenders, either in full or in part. So long as investors in the syndicated loan and high yield markets remain cautious, sponsors should be ready for direct lenders to take a firmer stance on pricing and terms—many direct lenders may become more selective before underwriting new deals in 2023.

With debt funds being the go-to option for sponsors in recent months, a key question for financial sponsors will be at what point high yield and

> “So long as investors in the syndicated loan and high yield markets remain cautious, sponsors should be ready for direct lenders to take a firmer stance on pricing and terms—many direct lenders may become more selective before underwriting new deals in 2023

loan markets come back into the frame, issuing new debt at a margin that is competitive with the offering of debt funds.

2. More sponsors are joining the club

Historically, direct lenders have preferred to do deals by themselves, but with new opportunities emerging to take on bigger deals, direct lenders have joined forces and undertaken club deals in increasing numbers.

A club of direct lenders, for example, funded a more than £3 billion refinancing for Hg and TA Associates-backed software company Access. The direct lending arm of The Carlyle Group and HPS financed Clayton, Dubilier & Rice's acquisition of the UK, Ireland and Asia operations of French services business Atalian.

One of the more recent examples is EQT Infrastructure's efforts to acquire Trescal, specialists in calibration services based in France. The sponsor reportedly secured more than €600 million in commitments from a private credit club that includes Apollo, CVC Credit, Goldman Sachs, KKR Credit and Park Square-SMBC. The deal was also dual-tracked—Marlborough Partners was mandated to arrange bank-supplied staple financing, with direct lenders standing by. In the end, however, EQT Infrastructure opted for private credit providers, a noteworthy break from its historic reliance on bank-led financing.

For sponsors, the emergence of direct lender clubs marks a "back to the future" moment, as putting a direct lending club together is akin to marshalling old-fashioned bank lending clubs.

Direct lender internal processes are typically faster and nimbler than those of banks, so getting direct lenders to move in the same direction should be more straightforward than the more challenging bank club processes of earlier years. Nevertheless, bank club deal experience will prove valuable as sponsors focus on how to corral lenders in anticipation of more of these transactions in 2023.

3. Debt-raising dynamics will have to change

As direct lending club deals become more commonplace, the dynamics of intermediated acquisition finance raising processes will have to change.

In the more benign liquid markets of the past ten years, sponsors have set up financing processes as auctions. They have specified their terms and lenders have competed to get in on deals. With a surfeit of lenders ready to fund deals in 2022, sponsors have been able to pit them against each other to land the best financing package.

This competitive structure has worked well when a single lender underwrites a deal, but when deal sizes increase and more lenders are required, it becomes increasingly difficult to herd lenders through a process.

In borrower-friendly markets, sponsors can (within reason) limit the time available to direct lenders, as well as their scope to comment on terms. When markets are tighter and lenders can be more selective, however, it will be increasingly challenging for sponsors to let direct lenders fall by the wayside if they want more time or have more complex documentation requirements. On larger credits, even a lender that will only hold the sort of minority stake that would not ordinarily afford it much influence may have to be accommodated.

Sponsors may have to relinquish some control over the process timetables if they hope to keep all lenders onboard.

4. Speed will be of the essence

While syndicated loan and bond markets have been choppy and may remain so in the near term, financing windows will still open—albeit intermittently—and sponsors should be prepared to move quickly.

Windows for issuance opened in 2022 when the outlook on inflation and interest rates improved and issuers, including Hunkemoeller, Fedrigoni, EnQuest and Cirsa, managed to navigate the market turbulence to secure high yield financings.

Although there is limited activity at present, European high yield bond and leveraged loan markets have become far more efficient in recent years. For example, if issuers are well prepared and have updated their disclosure, they could be prepared to launch a high yield bond offering in a matter of weeks and not months. Such windows will continue to open in 2023, providing financing opportunities for nimble sponsors.

5. Be ready to refinance when the time comes

Should inflation and interest rates top out, as trends late in 2022 suggested, secondary pricing in loan and bond markets is likely to recover, and markets for primary issuance will revive. As soon as they do, sponsors that agreed to tighter covenants, higher pricing and lower leverage multiples to finance deals in the past 12 months should lay the groundwork to refinance.

Given the higher proportion of deal financings done by direct lenders in 2022, sponsors looking to refinance when market conditions improve should be particularly mindful of deal terms. Direct lenders putting their money to work over a set period and planning to hold debt to maturity will typically include pre-payment fees and non-call provisions in documents. Sponsors should be very clear about what is required to refinance or reprice, and not assume that they will be able to roll into another structure whenever they choose without some financial pain.

Sector focus: European infrastructure financing flows

HEADLINES

■ Global infrastructure debt refinancing issuance reached US$222.8 billion in 2022, versus US$260.7 billion in 2021 ■ Infrastructure issuers have been shielded from rising debt costs as most capital structures are hedged or have fixed interest rate charges ■ Rapid growth in provision of infrastructure finance from private debt providers adds options for borrowers

By Jeremy Duffy, Katie Hicks and Monica Holden—partners at White & Case

In the face of rising interest rates and macro-economic uncertainty, infrastructure finance has proven relatively resilient when compared to the dislocation in other debt markets.

Infrastructure's fundamental characteristics as an asset class anchored by predictable, long-term revenue streams that are often linked to inflation have positioned the sector well to withstand recessionary risk and choppy markets. Investors nervous about inflation and its impact on company profit margins have seen infrastructure as a safe haven and continue to allocate capital to the asset class.

European infrastructure deal activity has remained robust as result, with private equity (PE) investment in European infrastructure climbing to more than US$40 billion by the end of Q3 2022, reaching a five-year high, according to Pitchbook.

Large infrastructure transactions, such as Blackstone's €21 billion acquisition of "last-mile" logistics asset Mileway, have continued to progress, and infrastructure managers have attracted significant support from investors when raising new funds. Global asset manager player Brookfield announced a US$21 billion first close for its flagship infrastructure fund in November 2022, while Antin has raised €5 billion towards its fifth fund, which is targeting €10 billion and will be the infrastructure-focused manager's largest vehicle ever. Ardian Infrastructure also launched its latest Europe-focused flagship fund—Ardian Infrastructure Fund VI—with a €10 billion target, targeting brownfield transport, environment, renewables and energy assets in Europe.

With funding continuing to flow into new infrastructure vehicles, demand for assets and valuations has held up in the face of volatility, with vendors maintaining high valuation expectations. CK Infrastructure Holdings, fronted by Hong Kong billionaire Li Ka-shing, for example, pulled out of a £15 billion deal to sell British electricity distributor UK Power Networks to a consortium led by KKR and Macquarie because the buyers were not willing to go ahead when the selling price was increased.

Infrastructure lenders open for business

With deal activity and valuations holding up and infrastructure managers still raising new funds, the pipeline of opportunities for lenders to finance infrastructure deals has continued to flow.

According to *Infralogic*, for example, global infrastructure debt refinancing issuance across loans and capital markets came in at US$222.8 billion in 2022 versus US$260.7 billion in 2021. Although down year-year-year, the drop in infrastructure refinancing issuance has not been as steep as that observed in leveraged loan and high yield bond markets overall.

15%

The decline in global infrastructure debt refinancing issuance in 2022

Infrastructure debt refinancing issuance remains above pre-pandemic levels.

In addition to traditional bank, private placement and capital market financing sources, infrastructure dealmakers have been able to turn to a growing cohort of infrastructure debt funds to source capital for deals.

According to *Infrastructure Investor*, capital raised by infrastructure debt funds mushroomed from approximately US$80 billion to more than US$139 billion between 2020 and 2022. The growth in the number of private infrastructure debt players has driven the development of a wide spread of financing products (including junior debt strategies) targeting a mix of infrastructure deals. These range from classic infrastructure assets such as utilities, roads, rail and ports into other areas such as broadband roll-out, data centres and logistics, which offer investors different risk/reward metrics.

The ability of infrastructure lenders across all categories—banks, capital markets and funds—to continue lending has also been boosted by the stability of issuers and infrastructure portfolios.

According to ratings agency Fitch, issuers of infrastructure and project finance in Europe, the Middle East and Africa are well placed to navigate rising debt costs and refinancing. More than four-fifths of the issuers tracked by Fitch either have fixed rate interest rate structures or floating rate

structures that are hedged against rising rates. Most issuers also have access to bank and capital markets and processes in place to refinance borrowings well ahead of maturities.

Data centres and the energy transition drive deals

Looking ahead to 2023, infrastructure's solid foundations and inflation-hedging attributes should sustain deal and financing activity, particularly in the telecoms infrastructure and energy transition sub-sectors.

With remote working, data analytics and digitally enabled service provision now embedded across all industries, there has been a huge demand for data centre and other telecoms infrastructure to support this accelerating usage.

As a result, despite a significant slowdown across wider M&A markets, activity from trade buyers and PE firms in the data centre space, for example, has barely missed a beat. Data from Synergy Research forecasts that data centre M&A value in 2022 could exceed the record US$41 billion in activity registered in 2021. Big-ticket data centre deals secured in 2022 include KKR and Global Investment Partners teaming up to buy CyrusOne for US$15 billion, while, on the strategic buyer side, DigitalBridge made an US$11 billion bid to take Switch private.

Robust data centre M&A activity has filtered through to debt markets, with lender appetite to finance transactions where enterprise value multiples are still running strong at approximately 25x EBITDA—and occasionally higher. These deals have tapped a range of financing pools, including acquisition, real estate and infrastructure financing. Although sponsors are now turning their attention to building out data centre assets rather than selling on, multiples and debt supply have remained robust when data centres do change hands.

Adjacent technology areas like telecom towers are also expected to generate substantial opportunity. This has already been seen in deals like the €10 billion bid by Brookfield Infrastructure Partners and DigitalBridge for a 51 per cent stake in Deutsche Telekom's tower company, GD Towers, in July 2022. According to *Debtwire Par*, this was the largest telecom towers-related deal in the past two years, and it may not be the last—Telenor is reportedly preparing to carve out its tower portfolio for next year, while Telefonica's tower business Cornerstone, along with Liberty Global and Vantage Towers, are all potential deals for 2023.

The urgency of tackling climate change, meanwhile, has made investment in infrastructure with a focus on energy transition another busy area that could be relatively insulated from macro headwinds. This is not something governments can afford to delay and—with McKinsey forecasting that the world will have to invest US$275 trillion by 2050 (or US$9.2 trillion a year) to deliver on net-zero pledges by 2050—the runway for infrastructure investors and lenders will be vast. Multiple opportunities to invest in energy transition across the entire risk spectrum are already emerging.

In addition to the priority given to energy transition and the growing demand for investment in data centre infrastructure, the day-to-day financing requirements for capital expenditure and government investment in infrastructure as a tool to support economic recovery will put the finance ecosystem on a sure footing in 2023.

European direct lenders step in to fill the gap

HEADLINES

■ Direct lenders were able to take on large-cap financings in 2022 as loan and bond markets pulled back ■ Nimble managers are taking out hung bridges and buying up debt in non-conventional syndication processes ■ Direct lending moves into 2023 in good shape, but pressures on portfolios and tighter fundraising markets could slow deployment

By Monica Barton, Gareth Eagles, Emma Foster and Paul Yin—partners at White & Case

Inertia across European leveraged loan and high yield bond markets in 2022 opened a window of opportunity for direct lenders to fund larger credits and strengthen their core mid-market franchises.

Despite the challenges posed by rising inflation and interest rates, as well as supply chain bottlenecks and the fallout from the Ukraine conflict, direct lending activity sustained high levels of deal flow.

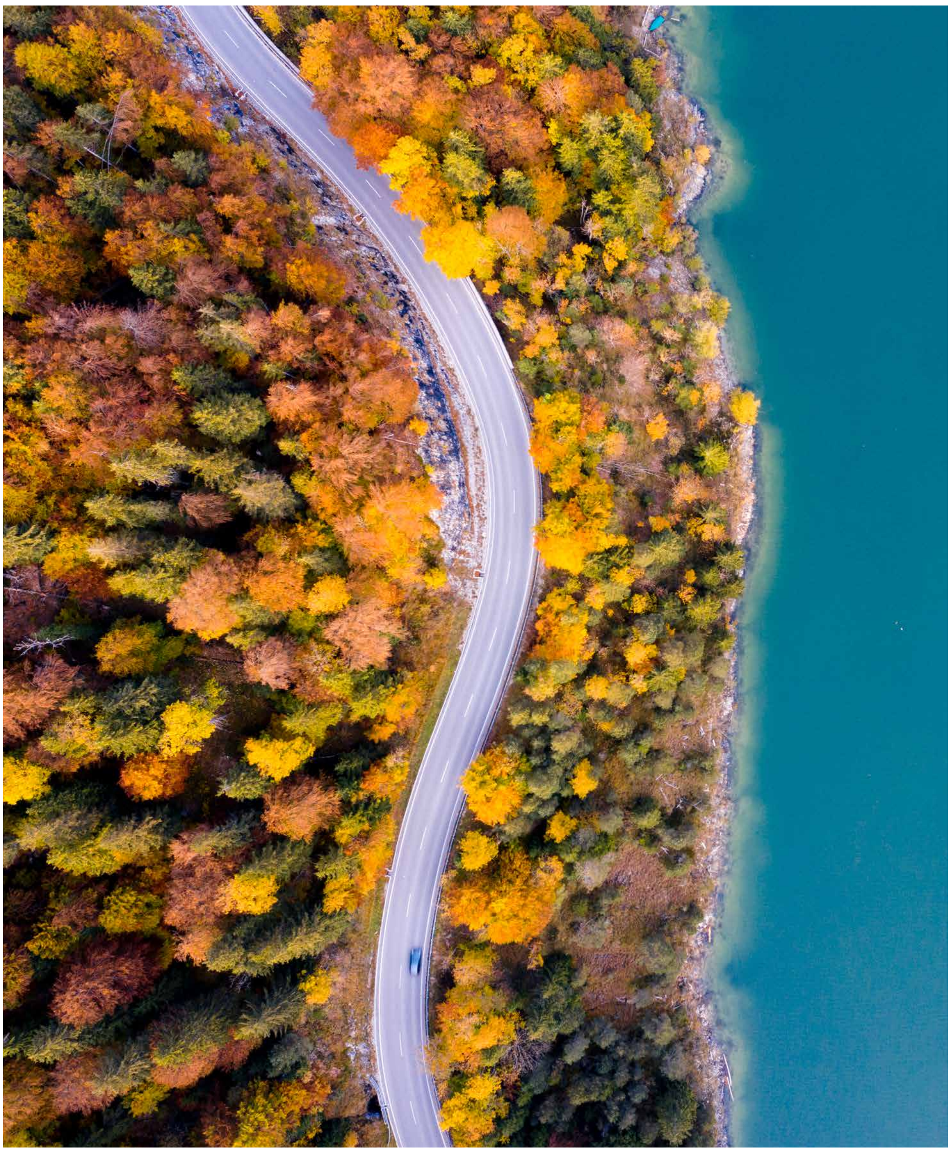
According to *Debtwire Par*, European direct lending issuance came in at €51.6 billion in the first nine months of 2022, well ahead of the €38.8 billion posted in 2021. Deal count of 705 transactions for the period, while down from the 899 deals in 2021, also held up well ahead of pre-pandemic levels.

These levels of direct lending activity—particularly in the first half of the year—stood in contrast to the double-digit declines observed in syndicated loan and high yield bond markets, where issuance has slumped in the face of macro-economic headwinds and investors have preferred buying up discounted credits in the secondary market to new deals.

Filling the gap

The slowdown across capital markets has given direct lenders an opportunity to fund larger credits that would normally have been funded with loans and bonds.

Replete with dry powder following a strong run of fundraising in the



past 24 months, direct lenders have routinely stepped in to take on credits that shelved or shunned public bond and leverage loan plans and opted for private debt solutions instead.

Advent International, for example, initially lined up a €430 million floating rate note to partially finance its acquisition of Italian ingredients manufacturer IRCA, but switched to a senior acquisition finance package provided by CVC Credit Partners as public credit markets turned.

Other examples of deals switching to direct lenders include France based buyout firm Astorg's acquisition of drug development company CordenPharma, where banks were initially expected to provide financing. Instead, Astorg went with a €1.5 billion financing from a club of four private debt providers.

Direct lending clubs, like the one that funded the CordenPharma, have become increasingly common, as direct lenders band together to diversify risk and combine their financial firepower to take down jumbo credits. The £3 billion refinancing of software company Access and the debt provided for Clayton, Dubilier & Rice's acquisition of French services business Atalian have both been financed by clubs of direct lenders.

Direct lenders have also taken advantage of the flexibility and nimbleness of the private debt model to provide banks and borrowers with variations on classic syndicated deals.

In the acquisition of Danish pharmaceutical company Norgine, by the private equity arm of Goldman Sachs, for example, the financing was underwritten by Jefferies, KKR Capital Markets and Goldman Sachs with a plan to syndicate directly to private credit firms rather than institutional investors, according to Bloomberg.

Private debt funds have also stepped in to provide liquidity for underwriting banks stuck with debt that they have not been able to syndicate. At the end of 2022, US and European banks were sitting on approximately US$42 billion of buyout debt stuck in syndication because of the more risk-averse market, according to Bloomberg.

“Despite the challenges posed by rising inflation and interest rates, as well as supply chain bottlenecks and the fallout from the Ukraine conflict, direct lending activity sustained high levels of deal flow

Direct lenders have seen an opportunity to buy up this paper and help banks clear their books. Specialist debt fund manager Pimco, for example, bought more than €1 billion of loans from banks that underwrote the buyout of French payments business Worldline as well as €500 million of debt used to back the buyout of UK supermarket chain Morrisons.

In addition to the opportunities presented at the large cap end, the mid-market—a core market for direct lenders—has continued to tick over. Mid-market M&A involving companies valued at less than €1 billion has proven more resilient to the deteriorating economic backdrop than mega-deal activity, ensuring a steady flow of transactions to finance for direct lenders.

Maintaining momentum

With syndicated loan and high yield bond markets expected to remain relatively moribund into 2023, direct lenders are well positioned to continue winning market share in the large-cap market, strengthening their position as the go-to option for mid-market deals.

The next 12 months, however, will not be without their challenges.

There are signs that direct lender bandwidth will be shifted from new deals to portfolio management. According to *Debtwire Par*, there are hints that borrowers across European direct lending portfolios are already bracing for squeezes on profitability that could see credits push up against covenants.

Amend-and-extend and refinancing deals may stave off some covenant breaches, and direct lender credits are also parsing through their accounts to identify EBITDA add-backs and so-called "exceptional items" that could help them squeeze through covenant tests.

Nevertheless, in a mid-market lender survey conducted by *Debtwire Par*, 15 per cent of respondents say they expect between a fifth and half of their portfolios to be vulnerable. More than 40 per cent expect covenant waivers to be the main restructuring mitigation strategy in the next three to six months.

Anecdotal reports are also emerging that direct lenders are starting to tap the brake on the pace of deployment more generally after a frenetic period of activity through both 2022 and 2021.

Fundraising across all private markets has slowed in 2022, with increasingly risk-averse investors scaling back their exposure to alternative assets. As most direct lenders are well ahead of deployment schedules, there is no rush to fully deploy existing vehicles and face a choppier fundraising market earlier than necessary, according to Deloitte.

Direct lenders are still open for business but can afford to be choosier about the credits they back.

US versus Europe: On different footing for 2023

HEADLINES

■ US leverage loan issuance for 2022 fell 24 per cent, year-on-year, reaching US$1.1 trillion ■ High yield bonds in the US were hit particularly hard, dropping 78 per cent during the same period to US$96.5 billion ■ Leveraged loan issuance in Western and Southern Europe by comparison was down 37 per cent year-on-year for 2022, at €183.4 billion in 2022 ■ High yield bond activity in Western and Southern Europe dropped 66 per cent during the same period, to €50 billion

By James Greene, Eric Leicht, Shane McDonald and Andrew Weisberg—partners at White & Case

Leveraged finance markets in the US and Europe faced similar challenges over the past year, with climbing inflation, rising interest rates and deep discounts in secondary markets putting the brakes on issuance.

Deeper, more liquid US markets weathered these headwinds better, although activity remains subdued. US leveraged loan issuance dropped 24 per cent year-on-year to US$1.1 trillion, with high yield issuance off 78 per cent over the same period. In Western and Southern Europe, by comparison, leveraged loan and high yield bond issuance fell by 37 per cent and 66 per cent, respectively.

Central banks in the US, UK and EU all lifted interest rates in 2022 to the highest levels observed since the global financial crisis, in a collective effort to curb surging inflation. The pace and scale of rate rises may diverge slightly in 2023, but central bankers in each jurisdiction have signalled that more rate rises are on the horizon, suggesting that high interest rates will continue to shape leveraged finance activity on both sides of the Atlantic for the immediate future.

Rising borrowing costs chill issuance

Higher base rates have pushed up borrowing costs across the board. In Europe, the average margins on first-lien institutional loans climbed by almost 1.5 per cent in the first nine months of 2022 according to *Debtwire Par*, reaching 4.73 per cent by year end. Weighted average yield to maturity for fixed rate bonds was up from 4.73 per cent at the end of 2021 to 8.23 per cent in Q4 2022.

US loan margins escalated at a similar clip, with average margins on first-lien institutional loans climbing from 3.73 per cent in the final quarter of 2021 to 4.24 per cent by the end of 2022, while the weighted average yield to maturity for US senior secured high yield bonds was up to 10.38 per cent at the end of Q4 2022, from 6.71 per cent over the first quarter.

Rising borrowing costs have chilled issuance, which has also been hampered by widening discounts in secondary markets, with investors preferring to buy up existing credits at discounts to par rather than putting money to work via new issuance. In the US, loans in the secondary market changed hands at an average of 91.49 per cent to par in December 2022, with European paper trading at 90.6 per cent in the same month.

US TLA and ABL markets soften the landing

In addition to benefitting from a larger fixed-income investor base, US borrowers have also been helped by the country's more established and sophisticated term loan A (TLA) and asset-based lending (ABL) markets.

According to *Debtwire Par*, TLA issuance in the US, also known as pro rata debt, was up 55 per cent year-on-year at US$765.7 billion. Unlike term loan B (TLB) debt—which underwriting banks will parcel and sell down to institutional investors, including mutual funds, insurers and CLOs—commercial banks typically fund TLAs and hold them on their balance sheet. These amortise materially over the life of the loan, unlike TLB packages, where loans are subject to only de minimus amortisation prior to maturity, and come with financial covenant protection.

24%

The decline in leveraged loan issuance in the US in 2022 year-on-year—in Western and Southern Europe, it fell by 37 per cent during the same period

These more lender-friendly characteristics give banks greater protection by providing for potential earlier warning triggers given the additional payment requirements and a financial covenant. In the red-hot debt markets of 2021, borrowers favoured the loose terms available in the TLB space but, as the institutional market has jammed up and syndication risk has intensified, borrowers have pivoted to the more predictable TLA space.

Notable deals in this space in 2022 include debt financing that combines TLA, TLB and high yield facilities for Univision Communications, a Spanish-language content and media company. The financing includes a five-year, US$500 million senior secured TLA facility and a US$500 million TLB, alongside a US$500 million senior secured high yield bond.

ABL activity has also climbed, rising 42 per cent year-on-year to US$111.8 billion. ABL debt is also provided by banks and is secured by more-liquid assets (e.g., receivables and inventory), offering a better shield against swings in the credit cycle than cash flow lending, which is driven by interest rates and forecasts for borrower earnings.

Direct lenders seize opportunity
While neither TLA or ABL activity contributed to overall lending in Europe in a meaningful way, one area where it mirrored the US is in the private debt space.

In the US and Europe, direct lenders have stepped up to fund credits that would normally have gone down the syndicated loan or high yield bond route. As take-and-hold lenders, private debt funds have provided greater certainty of execution for borrowers in volatile credit markets.

In the US, direct lenders have taken on some jumbo credits, including approximately US$5 billion in financing provided by a Blackstone-led group to fund Hellman & Friedman and Permira's leveraged buyout of software company Zendesk and Ares' and Blackstone's participation in a US$4.5 billion loan to fund an investment in Information Resources. Deals in the €1 billion-plus range in Europe have also found direct lenders open for business, including Astorg's acquisition of drug development company CordenPharma.

Individual direct lenders tapped the brakes somewhat as 2022 progressed, gradually reducing cheque sizes, but private debt players have proven adept at clubbing together to spread the risk while continuing to provide financing for transactions of scale.

In the US and Europe, direct lenders have also moved to buy un-syndicated debt from banks, often at discounts. At the end of 2022, US and European banks were sitting on more than US$40 billion in buyout debt stuck in syndication because of a more risk-averse market, according to Bloomberg. In certain of these situations, some private credit funds came in aggressively as buyers of these loans and bonds, often either taking on the entire tranche at a discount or purchasing large tickets.

For example, in Q3 2022, Los Angeles-based stressed and distressed debt investor Oaktree noted that banks were disposing of hung debt at attractive prices. New York-based private markets manager Apollo raised more than US$2 billion to buy up hung debt paper. In Europe, the direct lending arm of Pimco bought up loans used to fund the buyouts of supermarket Morrisons and payment group Worldline.

It remains to be seen whether direct lenders can defend these gains in market share when syndicated loan and high yield bond markets eventually do revive but, in the US, underwriting banks are anticipating that competition from direct lenders will become a feature of the market in the long term.

In response to the competition for financing deals from private debt, for example, J.P. Morgan has set up a division that, like direct lenders, will hold debt on its own balance sheet to maturity rather than syndicate.

In Europe, meanwhile, the direct lender will sometimes come in as an anchor investor and the remaining debt will then be sold down to more traditional participants. Some underwriting banks, however, are looking to capitalise on momentum in the direct lending space by placing debt with direct lenders rather than going down traditional institutional channels.

US versus Europe: Leveraged loan and high yield bond issuance by value (2018 – 2022)

Source: *Debtwire Par*

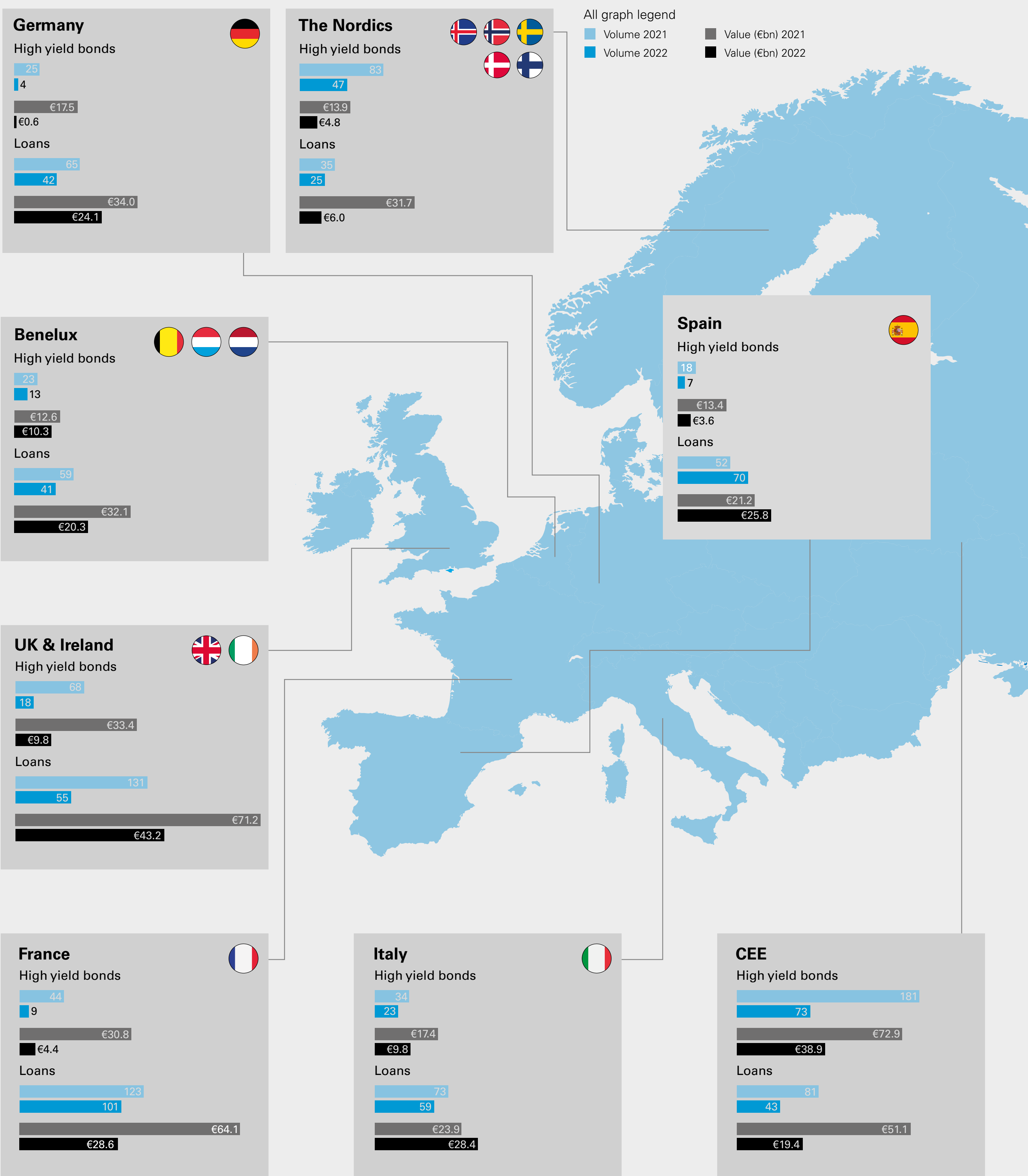
Hoping for green shoots… but challenges remain
Moving into 2023, lenders and borrowers in both markets will be hoping that interest rates and inflation peak by the middle of the year, bringing stability to debt prices in secondary markets and encouraging primary markets to reopen.

There are some suggestions that inflation may be peaking in the US and the UK, which will ease the pressure on central banks to up interest rates. In Europe, however, where monetary policy tightened later, it may take longer for inflation and rates to flatten out and for debt markets to spark back to life. And even if the pace of rate rises cools, restructurings and defaults are on the horizon in both jurisdictions as the rate hikes of the past 12 months start to feed through.

Hopes may be rising that conditions for new debt issuance will improve in 2023, but the next 12 months will continue to be challenging for US and European debt markets nonetheless.

European leveraged debt in focus

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



Country focus: United Kingdom

UK leveraged finance markets have come through a challenging period in 2022, with issuance across leveraged loan and high yield markets declining as rising interest rates, inflation and the conflict in Ukraine hit activity

UK leveraged finance issuance in 2022 fell by just over 50 per cent year-on-year, tracking the drop-off in issuance observed across the wider European market. Private debt lending has proven more resilient but has also felt the impact of rate hikes and geopolitical uncertainty, with fundraising markets and deal flow from M&A targets tightening through the course of the year.

The UK market faced a unique set of challenges. As a result, the Bank of England (BOE) hiked interest rates nine times through the course of 2022 to 3.5, the highest level observed since the 2008 financial crisis. The European Central Bank (ECB), meanwhile, upped rates four times in 2022, with its benchmark rate now sitting at 2.5 per cent to 1 per cent below the BOE level.

UK lenders and borrowers were already contending with political volatility, in the form of successive changes of prime minister and a catastrophic "mini-budget" in late September 2022. This catalysed a slew of collateral calls and forced sales of UK government bonds, requiring the BOE to step in and backstop bond markets to prevent the dislocation from spreading into other parts of the economy. Financing conditions are expected to remain calm in 2023 in the UK, with limited impetus to kickstart markets back into life.

But there are some early signs of green shoots. For example, after raising rates in December 2022, the BOE argued that inflation may have peaked, slowing from the four-decade highs recorded earlier in the year. Assuming inflation has topped out as predicted, there will be more scope for the UK central bank to halt or slow any further interest rate rises.

A change in the direction of travel on rates will provide issuers and investors with more certainty, help debt prices in secondary markets to recover and encourage primary issuers to come forward and test market appetite for new debt issuance.

The drop in corporate valuations and the weaker price of sterling relative to the US dollar and euro, meanwhile, could drive significant interest from overseas buyers on UK take-private deals in 2023.

Appetite for UK take-private deals has remained strong in 2022, despite macro-economic headwinds. According to *Dealogic*, UK companies valued at more than £40 billion were already taken off UK public markets in the first nine months of 2022. Public-to-private transactions are expected to continue providing a pipeline of M&A deals and financing opportunities in 2023.

Conclusion

Stalled issuance, growing concerns around rising costs, supply chain bottlenecks and the conflict in Ukraine—it's been a whirlwind of a year, with many remaining challenges for the year ahead

Typically, the pattern of peaks and valleys witnessed in leveraged finance since the start of the pandemic suggests we may be set for a rise in activity at some point in 2023—were it not for the various headwinds continuing to blow against potential progress. What can markets expect to see in the year ahead?

Debt in Europe is not getting less expensive anytime soon

In December 2022, the Bank of England Monetary Policy Committee, the European Central Bank (ECB) and the US Federal Reserve all decided to increase base rates yet again. President of the ECB, Christine Lagarde, warned of more rate increases in 2023, while US Fed official John Williams added fuel to the fire by warning that the Fed's policy rate may exceed the expected 5.1 per cent level.

While the public will be worrying about mortgage payments and the cost of living, this will concern any borrower hoping to secure new debt in 2023 without paying a premium. Average margins on first-lien institutional loans peaked at 5.39 per cent in Q3 2022, before cooling to 4.73 per cent in Q4—though still much higher than the 4.09 per cent seen at the start of the year.

It's been a similar story for European high yield bond borrowing costs—the weighted average yield to maturity for fixed rate bonds climbed from 5.39 per cent in Q1 2022 to 8.23 per cent at the end of the year.

All these factors will challenge any highly leveraged borrower hoping to maintain their current standing in the market.

From A&Es to add-ons

These pricing pressures paint a challenging picture for 2023. Fitch Ratings anticipates that ratings on high yield bond and leveraged loan issuers in Europe will deteriorate in the coming months. In addition, Fitch predicts that default rates could reach as high as 4 per cent in 2023 and 2024. By comparison, the institutional leveraged loan default rate finished 2021 at 0.6 per cent—the lowest rate in a decade.

Borrowers feeling the pinch will have fewer options to finance their way out of a rising debt load than they once did. Those facing maturities in the next two years are likely considering everything from amend-to-extend deals to improved covenant and/or security packages, equity injections or add-ons to push those maturity dates out further. As *Debtwire Par* reports, telecoms group Altice International based in Luxembourg, sports betting business Entain in the UK and French medical diagnostic firm Sebia all closed amend-and-extend deals late in 2022, targeting maturities between 2024 and 2026.

Credit quality will also be a factor for those chasing liquidity, with quality credits or those in "safe haven" sectors such as defence or infrastructure taking precedence—though that is not limited to the top end of the rating scale.

For example, per *Debtwire Par*, December transactions included UK nurseries operator Busy Bees (B-/B3 rating) which secured a fungible €105 million TLB add-on to repay revolver drawings, and French laboratory service provider Cerba Healthcare (B/B2), which secured a €220 million non-fungible add-on to its EURIBOR + 400 bps February 2029 TLC, priced at a margin of EURIBOR + 550 bps and a 96.5 OID. This demonstrates that transaction opportunities are not closed to mid-rated companies where supported by the market.

€183 billion

The value of leveraged loan issuance in Western and Southern Europe in 2022

This flurry of activity inspires confidence at a time when investors do not know where things will land. Assets deemed safe and secure will continue to attract attention in the months ahead.

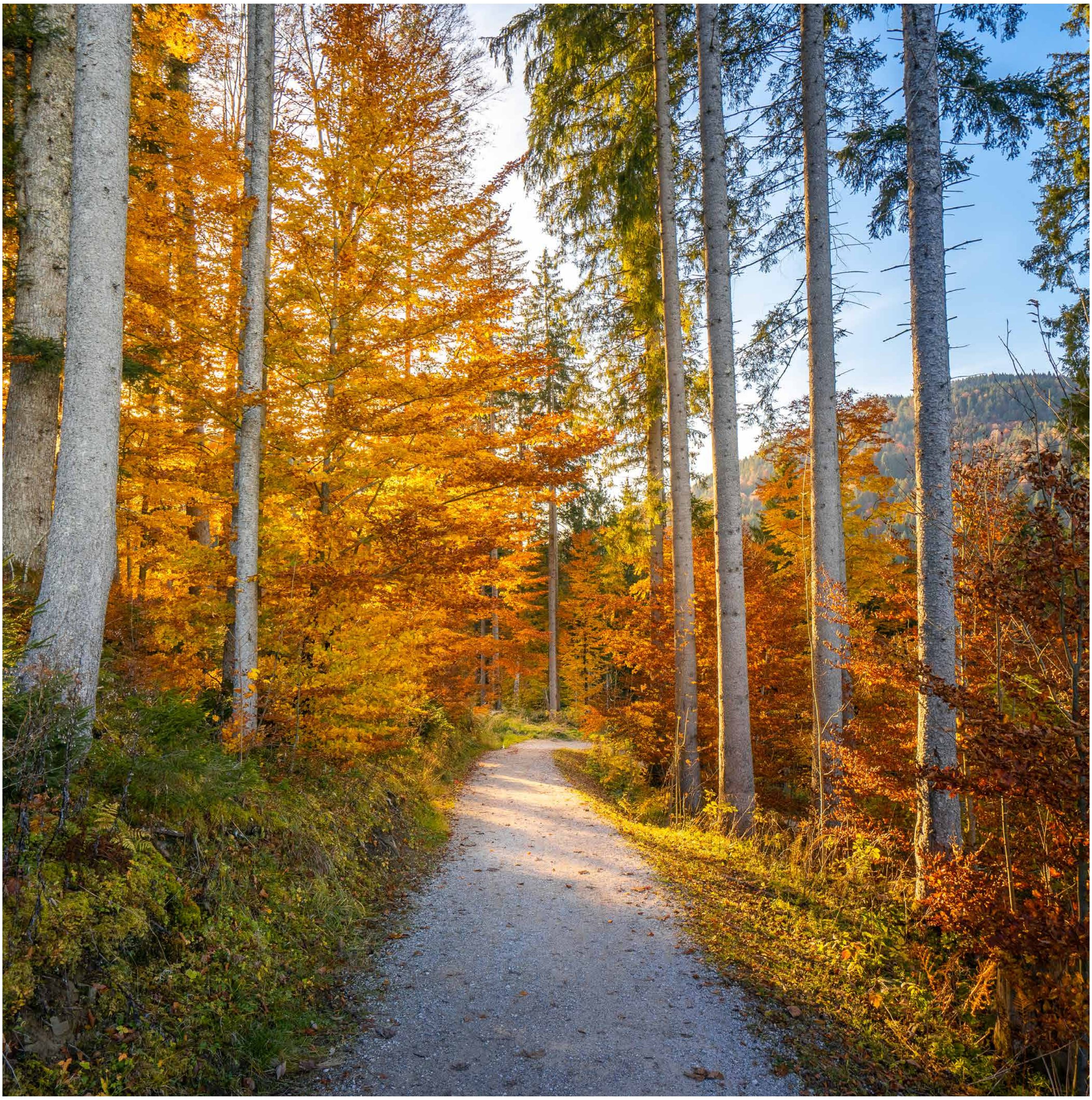
For those unable to pursue options like amend-and-extend deals or add-ons, private credit funds may also offer something of a lifeline. However, this may come with a hefty price tag. Decreased availability of bank debt means private credit margins have been climbing—*Debtwire Par* reports that they are up by at least 2 per cent on the start of the year.

Anyone hoping private debt will offer an escape from looming maturities may find themselves priced out in the coming months. Private investors may also worry about a company unable to secure an amend-and-extend deal, as this may flag a company in greater distress than is apparent.

Focus on the positive

The fact remains that, at the start of 2023, the economic dust of the past 12 months has not yet settled. We may hope that the worst has passed, but as we have learned through recent events, stability and consistency are not guaranteed.

When inflation began to climb, many argued that it was simply a market correction, likely due to the pandemic and rising oil prices. When



the conflict began in Ukraine, many suggested that it would last a matter of weeks at most. As rates began to rise, many suggested it was only for the short term and central banks would settle down soon enough.

A year later and it's clear that factors such as these will continue to influence the market for some time to come, along with wider geopolitical and economic volatility.

One thing is clear: Choosing the right path in 2023 with be a challenge for everyone.

€50 billion

The value of high yield issuance in Western and Southern Europe in 2022

> **The fact remains that, at the start of 2023, the economic dust of the past 12 months has not yet settled. We may hope that the worst has passed, but as we have learned through recent events, stability and consistency are not guaranteed.**

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