Beyond the banks: the rise in alternative financing

Low interest rates, minimal yields on government bonds and quantitative easing programs have combined to reopen global debt markets, but not necessarily in the way we might have expected. Leverage levels are up, covenant-lite structures are reappearing and new lenders are moving into the market to provide European borrowers with a range of options beyond senior debt from banks.

Five years on from the dawn of the credit crunch, conditions for borrowers are looking increasingly positive. Base rates in the United States and the United Kingdom continue to sit at historic lows of 0.25 percent and 0.5 percent, respectively, which has kept borrowing costs below 6 percent, according to *Bloomberg*.

Quantitative easing programs, meanwhile, have seen the world's six largest central banks inject more than US$7 trillion into the monetary system, according to *Bloomberg*, ensuring that there are substantial pools of capital to invest.

Despite these conditions, commercial banks have not been lending as freely as they did before the liquidity freeze: "Banks are showing signs of recovery, but many of them are still some way off," says Lee Cullinane, a partner and EMEA Regional Section Head in White & Case's banking group. Many are still in the process of rebuilding their balance sheets, while new capital adequacy regulations, such as Basel III and Solvency II, have placed further constraints on their ability to supply loans.

As a consequence, borrowers have sought out alternatives, and there has been a range of options from which to choose. High yield bonds, asset-based lending (ABL) and debt from credit funds have all been freely available.

According to S&P Capital IQ LCD, high yield bond issuance hit record levels in Europe in 2013. ABL and credit fund lending are also gaining market share. According to corporate finance adviser DC Advisory Partners, non-bank lending in UK mid-market leveraged buyouts climbed from 17 percent in 2011 to 46 percent in 2013.

> **"Banks in Europe have been struggling, and there has been an urgent need for liquidity. Out of necessity, borrowers have turned to the highly liquid US term loan market to secure finance"**
> Jake Mincemoyer, partner, White & Case, London

New faces

Mike Dennis, a partner at global alternative investment firm Ares Management, believes that, far from being a temporary filler, alternatives to senior debt from banks have become an established part of the market.

"We launched the Ares direct lending business in Europe in 2007 and now have approximately €4 billion in assets under management. We set up the business because we saw an opportunity to be the first mover in a systemic shift in European corporate lending," Dennis says.

"As banks de-leverage their balance sheets, we are placing risk capital onto our balance sheet, since the banks have very limited appetite to take it on."

New entrants to the lending market haven't just expanded the pool of finance providers either; they have also developed a range of innovative debt products and pricing structures.

Credit funds like Ares have pioneered a "unitranche" offering, providing borrowers with blended mezzanine and senior finance in one debt strip at a single pricing point. The product allows borrowers to prepay a blended cost of debt rather than the lowest coupon first, which helps reduce financing costs through the course of a deal.

Asset-based finance

Asset-based loans are typically secured against receivables and inventory. They do not place the same strain on cash flows as senior loans and are usually covenant-lite. In the past, these loans have been provided "on demand," which has made them less appealing, but terms and documentation are changing to make this product more accessible. Asset-based lenders—typically traditional banks—have worked hard to improve their documentation and have added in cash flow strips on top of their core asset-backed loans to meet borrower requirements.

European benefits

The rise of credit funds and the reviving of high yield bond markets have been particularly beneficial to European borrowers. Institutional debt markets have been a feature of the US debt markets since the 1980s, when the first high yield bonds were issued, but the latter only emerged in Europe a decade later.

The high yield bond market was known for its volatility, but it has grown significantly in Europe since the credit squeeze, and it has become more reliable.

According to Hermes America, the United States made up 89 percent of global high yield issuance in 1998, with Europe accounting for just 3 percent. By 2013, however, Europe's market share had climbed to 27 percent, with the United States dropping to 57 percent.

"The European high yield market was always much smaller and less stable than the United States, but European high yield was much more resilient in 2013," says Cullinane. "The public reporting requirements and pricing made high yield unattractive in comparison to bank debt, but as banks have retrenched and pricing has become more competitive, users have become more comfortable with high yield."

As European borrowers have become familiar with raising institutional debt on their domestic markets, many have begun tapping the larger and more established US credit markets.

"Banks in Europe have been struggling and there has been an urgent need for liquidity. Out of necessity, borrowers in Europe have turned to the highly liquid US term loan market to secure finance," says Jake Mincemoyer, a White & Case partner in London. "Investors in the US term loan market have been hungry for yield. The pricing and covenant-lite terms on offer have been attractive for European borrowers."

David Parker, a partner at independent debt advisory firm Marlborough Partners, estimates that debt volumes in the United States are 15 times higher than in Europe. Even though the European high yield market has expanded and matured, the large pool of capital in the United States has made it a market that European companies and buyout firms cannot afford to ignore.

"During the past 18 months, it has become quite common for leveraged European companies to raise debt in the United States, especially those with large international business interests," says Parker. "Issuing debt in dollars sometimes used to be a bit of a problem, because it left European businesses with large currency hedging requirements. Now borrowers can denominate part of their loans raised on the US markets in euros."

With foreign exchange risks no longer an issue and US credit investors feeling more comfortable with Europe as the sovereign debt crisis has subsided, European companies have been eager to take advantage of the financing available in the United States. The private placement market, which allows issuers to avoid the reporting requirements of listed high yield bonds, has made raising debt in the United States even more appealing for European borrowers.

Leverage lift

With debt now widely available from a range of alternative providers at attractive prices, leverage levels in Europe are beginning to climb higher, up from less than four times EBITDA in 2009 to 4.5 times in 2013, according to Standard & Poor's (S&P).

For leveraged buyout (LBO) deals in Europe, average equity contributions from sponsors are also trending lower, down from 53 percent in 2009 to 44 percent in 2013. Covenant-lite structures, a feature of the bull market, have made a strong comeback, too: according to S&P Capital IQ, at the end of March this year, €2.8 billion of euro-denominated cov-lite loans had been issued. Last year, €8 billion of euro-denominated cov-lite loans were issued, compared to just €1.4 billion in 2012 and more than the €7.73 billion issued in 2007.

Cov-lite has accounted for more than a quarter of the leveraged loans sold to institutional investors in Europe this year, up from 21 percent last year. S&P believes there is growing acceptance of cov-lite structures, as investors are hungry for assets and willing to buy loans without maintenance covenants.

Higher leverage levels and cov-lite structures could be viewed as a worrying sign that the market has failed to learn from past mistakes, but the market is still a long way from repeating the excesses of the credit boom. In 2007, according to S&P, more than half of LBOs were leveraged at six times EBITDA or higher. Last year, only one-eighth of deals were leveraged at six times EBITDA or more, and average equity contributions to LBOs were 10 percent higher than in 2007.

There is also a recognition among institutional investors buying up syndicated loan paper and high yield bonds that maintenance covenants are not always needed to meet their requirements. Many institutional investors prefer selling loans in a liquid market to using covenants as a tool to enforce security. Some investors would rather hold a loan that had no maintenance covenants than a loan that forced the borrower to hold back on investment and conserve cash, in order to pass quarterly covenant tests.

The path ahead

The provision of finance from debt markets and credit funds shows little sign of slowing. As long as interest rates remain low, institutions will have a strong appetite for yield. Investors also take confidence from low default rates, and high yield and leveraged loan defaults are well below historic averages.

Alternative forms of finance look set to continue, offering borrowers a wide variety of debt products at attractive prices and on favorable terms. As debt markets reopen following the financial crisis, European borrowers have more financing options available to them than ever before.

Fit for purpose: alternative debt products

Borrowers in Europe have traditionally relied on commercial banks to meet their financing requirements. As Europe has emerged from the financial crisis, institutional investors have become an increasingly important source of capital. High yield bonds, US term loans and unitranche debt have all become credible financing alternatives to senior debt packages from banks.

Banks, of course, remain crucial players in debt markets. Their balance sheets are still needed to back high yield and US term loan issues before paper is sold on to institutions, and they still underwrite and arrange these facilities. It is institutional investors, however, that are now holding debt that would have otherwise sat on bank balance sheets.

This has presented borrowers with a range of new financing options to choose from. Here are some of the options:

Unitranche

The unitranche product, which combines senior and mezzanine debt into one lending facility at a single price point, has been a valuable source of finance for mid-market borrowers too small to raise debt on the high yield bond markets. Unitranche lenders have been willing to fund sectors that banks have been reticent to lend into, such as retail, and have also been open to financing dividend recaps, another area where banks have been more cautious. The structure is simple and saves borrowers having to corral a club of banks and mezzanine lenders.

The unitranche product also allows borrowers to continue making use of finance from commercial banks. Unitranche providers have made term loans available, with commercial banks stepping in to supply the undrawn facilities, such as credit revolvers, capital expenditure finance or acquisition finance facilities that are unavailable from unitranche lenders.

Unitranche pricing varies from deal to deal, but is almost always more expensive than senior bank debt, which is one of its drawbacks.

High yield bonds

The strength of the high yield bond market has been of great benefit to borrowers refinancing existing bank debt or raising capital for acquisitions. High yield bonds, being incurrence-based in structure, are well-suited to businesses that are cyclical, highly leveraged or capital-intensive. Without maintenance covenants in place, temporary falls in cash flow or deterioration in trading do not necessarily result in a breach of financial covenants. As a consequence, borrowers do not find themselves having to renegotiate covenants or pay fees.

Recently, some bond structures have allowed "portability," enabling the debt structure to be carried over if the owner of the business decides to sell. Another feature that has appealed to borrowers has been the option to combine raising its term debt via the high yield market with a super senior revolving credit facility.

High yield bonds, however, typically are more expensive than senior loans, and the high yield bond market does open and close intermittently, particularly in Europe.

Collateralized loan obligations (CLOs)

US-based CLOs have been eager to recycle capital and have been on the lookout for opportunities to deploy capital beyond their domestic market. European borrowers have been among the beneficiaries and have been able to increasingly source debt from CLO funds.