WHITE & CASE

Ten years on: The surprising resilience of European leveraged finance

The European leveraged finance market paused for breath in 2018 after two feverish years, but a combination of new money issuances for LBOs and the rise of CLOs has kept the market stable

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Foreword

After the shock of the financial crisis a decade ago, a new landscape emerged across debt markets and has continued to mature and develop over the past decade

A boom in M&A activity over the past three years has boosted the market, with the volume of leveraged buyouts (LBOs) reaching levels seen pre-crisis—alongside the debt needed to fund the deals.

Investors, far from eschewing the riskier end of the lending spectrum, have been tempted up the yield curve, seeking out higher returns than those on offer in safer markets where quantitative easing has depressed yields. Encouraged by investors' desire for yield, riskier issuers/borrowers have started to demand looser terms on loans, knowing that investors, needing to deploy capital in competitive markets for deal allocations, would be more likely to accept.

For the moment, leveraged loans are in the ascendancy over high yield bonds, but large M&A deals in 2018 needed both sets of instruments to get across the line, with high yield bonds often required for that extra layer of debt. In addition, the continued growth of direct lending helped to provide financing packages that may not have been available in the syndicated or high yield markets. All the while, a backdrop of infrequent corporate defaults—assisted by low base rates—has comforted markets. Some pushback on pricing by investors was met by issuers, then reversed as the need for yield rebounded. In particular this year, investors have welcomed the return of syndicated debt instruments—2018 was a record year for collateralised loan obligations (CLO), with CLO markets breaking new issuance records in both the United States and Europe.

But if the leveraged debt markets have thrived in the post-crisis era, there are tough obstacles ahead. Geopolitical issues such as Brexit; global trade wars; Italian sovereign debt; volatility in the stock market; and a concern that default rates, low for so long, might begin to trend upwards have given the market pause. Underpinning everything is the US Federal Reserve, which is already leading the way in raising interest rates. The impact of increased borrowing costs is set to echo further afield—and could push other central banks to keep pace or react to the impact it causes.

However, despite uncertainty about what lies ahead, the market remains resilient and deals are still getting done. Ten years on from the darkest days of the crisis, the leveraged debt market has proven surprisingly resilient, but bumps may lie on the road ahead.

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Ten years on: The post-crisis rise of leveraged finance

A decade on from the onset of the financial crisis, the leveraged debt landscape is almost unrecognisable and continues to evolve as lenders, borrowers and advisers find new ways to come to market

In the aftermath of the financial crisis, low interest rates and quantitative easing (QE) squeezed fixed income investment portfolios to their thinnest margins in developed markets in recent years. In the United States, ten-year treasury yields fell to record lows of 1.4 per cent in 2016. A year earlier, German bunds, alongside government debt from some of their European neighbours, were trading at negative yields.

Major institutional investors such as pension funds and insurers—traditionally the main customers in sovereign and investment-grade markets—needed to move further down the credit curve to find satisfactory returns. Once on the fringes, the leveraged finance market is now a mainstay of many investors' portfolios. New buyers, sellers and advisers have made their way onto the field and the global market has doubled from US$1.2 trillion (in 2008) to more than US$2.4 trillion (in 2018), according to a report from the Bank of International Settlements.

The rise of loans and cov-lite deals

In the five years since the first White & Case leveraged debt outlook was published, investor interest has skewed towards the leveraged loan market, which has increased its market share against high yield bonds. For example, the percentage of the European leveraged finance market accounted for by loans grew from 54 per cent in 2014 to 74 per cent by 2018.

In addition, borrowers have had greater sway in setting market terms, which has led to an overwhelming number of so-called "cov-lite" loan deals—i.e., those with a lack of financial maintenance covenants. Lenders today have less bargaining power as they embrace greater risk in search of higher yield, with covenant and security protection often being weakened. The cov-lite phenomenon was imported from the US to Europe, which historically had much stricter terms. The cov-lite term once meant to indicate an outlier in Europe has now become the norm. Cov-lite accounted for 81 per cent of institutional loans in 2018 in Europe.

One of the key changes is that financial maintenance covenants for European borrowers, once a staple in the sector, now appear only once in every five issuances. This means lenders increasingly do not have the default triggers related to operational underperformance which signals a potential problem with the borrower's ability to pay and this may delay an inevitable debt restructuring.

What a difference a decade makes

Fears that the market would be unable to absorb debt maturity walls have so far turned out to be baseless. While at the start of 2009, in the US, the sector faced a wall of debt that would mature by the end of 2015 totalling US$1.4 trillion; some five years later, after lenders and borrowers met in the market to refinance ahead of this deadline, this 'wall' had been reduced to approximately US$350 billion according to Fitch—meaning the 2015 deadline passed without incident.

Overall, markets have matured and become established. In the past, when shocks hit, markets would shut down for three to six months. These days, they are less reactive to perceived crises and have been able to maintain stability. For example, despite the upheaval and political uncertainty wrought by Brexit, the UK dentist chain MyDentist was able to issue a GBP bond within a month of the UK's unexpected decision to leave the EU.

However, the market did experience a hiatus in the final days of 2018, as the US high yield market saw no issuance in the whole of December for the first time in a decade. This pause was broken in the US in early January, with the sale of a US$750 million bond by US gas pipeline company Targa, which sits at the riskier end of the credit spectrum. The deal was so popular, in fact, that the issuer added an extra maturity tranche and doubled the amount issued. In Europe, while there were some early-year deal launches, the market had a relatively slow start to 2019, though a pipeline of deals, including M&A, is beginning to emerge.

74%

The percentage of the European leveraged finance market accounted for by leveraged loans in 2018

81%

The proportion of institutional loans in Europe accounted for by "cov-lite" deals in 2018


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The market pauses for breath in 2018

HEADLINES

■ In Europe, leveraged loan issuance is down 28 per cent year-on-year to €202.5 billion in 2018, but is up on all years between 2014 and 2016 ■ High yield bond issuance is down 37 per cent year-on-year ■ Leveraged loans retain primacy over high yield bonds

From protectionism to trade wars to uncertainty over Brexit, 2018 was characterised by uncertainty and volatility. All the while, a divergence in policy between the world's major economies caused lenders and borrowers to sit up and pay attention. In Europe, the UK's withdrawal from the EU, concerns over a new government in Italy, disruption and protests in France and the rise of populism in a number of EU states took the shine off what had been set to be a bumper year in the leveraged debt market. In addition, growth forecasts for the EU fell in 2018. The European Commission estimated the eurozone would grow by 2.1 per cent in 2018, down from the 2.4 per cent growth recorded in 2017. In a report in July, the Commission estimated that growth in 2019 would fall to 2 per cent.

The story in the US has been a different one, with a central bank determined to stop the economy from overheating. Despite having a similar growth rate to Europe in 2017, the world's largest economy looked set to finish 2018 on a 3 per cent increase. This upturn took place despite four interest rate hikes from the Fed, with much of the momentum coming at the end of the year.

Meanwhile, regulators on both sides of the Atlantic have begun sounding the alarm on the amount of leverage in the market. While some observers think there will be intervention, it seems that most believe that regulators may be content to wait for nature to take its course, with a substantial blow-up being enough of a trigger to all market participants to dial down the level of gearing that will be used going forward. This has all led to a change in the dynamics of the market.

28%

The fall in leveraged loan value in 2017 compared to 2018

€71.2 billion

The value of high yield bond issuance in 2018—down 37 per cent compared to 2017

Slowing down but not stopping

The leveraged finance market started 2018 at a feverish pace but slowed down considerably in H2. Overall, European leveraged loan issuance was down 28 per cent year-on-year to €202.5 billion. Meanwhile, high yield bond issuance dropped to €71.2 billion—down 37 per cent compared to the previous year. While the leveraged loan pullback is, perhaps, a correction on the meteoric rise of the instrument, the decline of high yield issuance reflected the continued migration of high yield issuers and new deals to cov-lite loans and direct lending. At €71.2 billion, the volume of high yield issuance for 2018 was way off the €113.9 billion issued in 2017.

A key driver of the downturn was the fall in refinancing activity, as many issuers had completed deals in 2017 and thus did not need to return to the market in 2018. This resulted in high yield bond refinancing activity dropping by 47 per cent year-on-year to €36.8 billion.

At the start of 2017, US interest rates were at just 0.75 per cent. In that year, borrowers in both the US and Europe rushed to market, eager to refinance debt. In 2017, €153.8 billion in leveraged loan refinancing was pushed through in Europe. This helped volume beat previous record levels. However, the story was beginning to change by the end of the year, as the US federal funds rate reached 1.5 per cent. A further 25 basis points was added the following March. As 2018 ended, rates hit 2.5 per cent. This continued increase in the cost of borrowing translated into a 44 per cent drop in leveraged loan refinancing in Europe in 2018—down to €86.7 billion—compared to a year earlier.

However, outside of the refinancing context, the European market benefitted from a number of public-to-private deals and an

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increase in corporate and sponsor activity—45 per cent of the leveraged loan issuance was used for leveraged buyouts (LBOs) and acquisition activity compared with only 26 per cent for refinancings. There was a spate of bumper deals, including Advent's acquisition of Zentiva and Carlyle's purchase of AkzoNobel—both carried out alongside large institutional investors. For more on LBO activity, see page 9.

The slowdown in the second half of 2018 was more pronounced in light of a bumper first quarter, which saw some 'jumbo' M&A deals that required significant financing from all corners of the debt markets. Despite some predicting 2018 to be an 'all-time high' for M&A, the winds of uncertainty blew through markets, leaving sponsors and other potential acquirers opting to wait for calmer waters. While 2018 did not match the heights of 2017, there needs to be some perspective—overall issuance was still up on issuance in 2016.

Loans in the ascendancy again

As noted above, the split between leveraged loans and high yield bonds skewed in favour of loans in 2018. Loans accounted for 74 per cent of European leveraged finance in 2018, according to Debtwire research. Compare that with a more even split in 2014, when 54 per cent of European issuance was leveraged loans and the rest composed of high yield bonds.

Rising interest rates have been one of the main factors driving investors towards loans, given their floating-rate basis (compared to high yield's typical fixed rate basis), which protects investors when central banks hike. In June, the US Federal Reserve announced its seventh interest rate hike since 2015, with a further two rises in both of the following two quarters. In the UK, the Bank of England increased rates to 0.75 per cent (their highest level since March 2009) in August, after an initial 25 basis-point hike in June.

The uptick in loan pricing has been one of the reasons for investors to favour loans. With the gap between bonds and loans narrowing, the potentially looser cov-lite loan terms, as well as more favourable financing features such as control of transfer, the soft-call protection of a loan compared to the hard-call protection of a bond and the non-public nature of loans have enhanced the attractiveness of the loan product. Additionally, loans can be quicker to bring to market and close, and do not require a detailed offering memorandum, which permits a lower outlay on costs and fees.

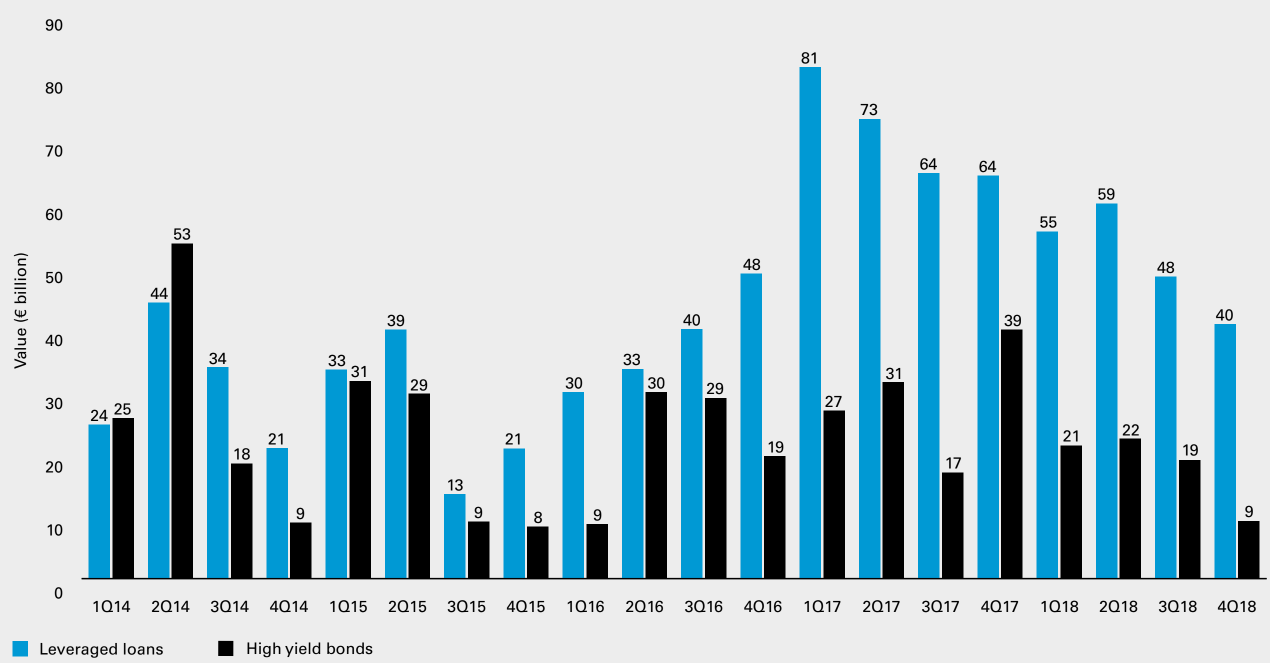
The growing division between the two parts of the leveraged debt market was also driven by the demand for collateralised debt obligations (CLO). The growth of CLOs has been a decisive factor in the growth of leveraged loans since CLOs favour floating rate products. In Europe, the CLO market set a new post-crisis record, with €27.2 billion of new issuance in 2018, up from €20.1 billion in 2017. The trend for reset/refinance transactions also continued in 2018, driven by competitive pricing, with a further €18 billion of issuance. For more on CLOs, see page 11.

CLO

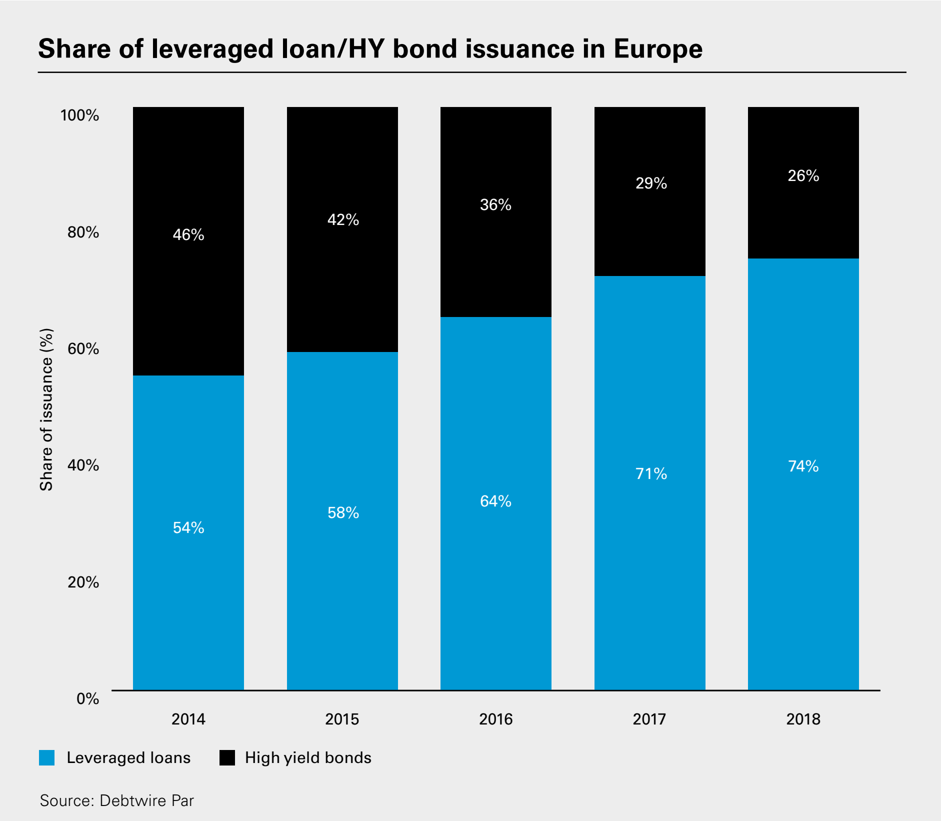
€27.2 billion

The value of new issuance of CLOs in Europe in 2018—a new post-crisis record

European leveraged loan vs. high yield bond issuance—quarterly



Source: Debtwire Par



> **The split between leveraged loans and high yield bonds skewed in favour of loans in 2018. Loans accounted for 74 per cent of European leveraged finance in 2018, according to Debtwire research**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LBOs and CLOs boost the market

HEADLINES

■ European loans backing LBOs are valued at €56.5 billion, up 37 per cent from last year ■ Cov-lite deals dominate the loan market, with the share of cov-lite institutional loans standing at 81 per cent in 2018 ■ CLOs are driving the demand for the asset class, with a new post-crisis record of €27.2 billion of new issuance and a further €18 billion of reset/refinance issuance in 2018

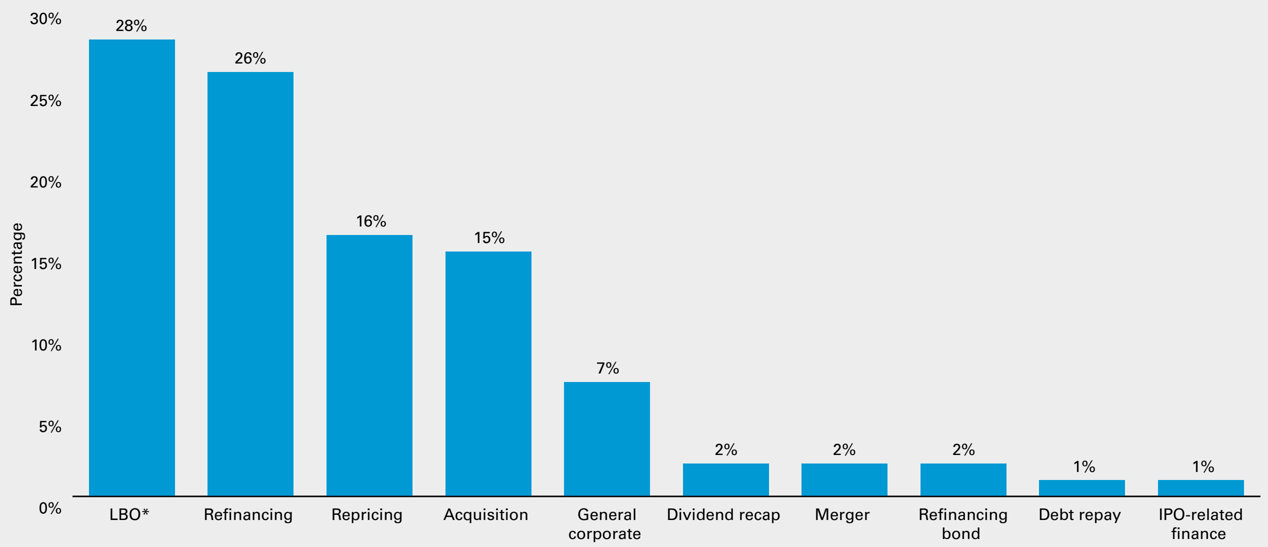
Loans backing LBOs have driven the market in Europe this year, with volumes reaching €56.5 billion, up 37 per cent from €41.3 billion in 2017. By the middle of 2018, total loans in the US breached US$100 billion, up a third on the same period a year earlier. Encouraging signals from the Federal Reserve, which said it was comfortable with the level of risk banks were taking when financing LBOs, helped bring megadeals to the fore. Even in October, when markets had slowed down slightly, KKR's US$5.6 billion buyout of Envision Healthcare Corp. added to the large deals in 2018.

This was also the case for high yield bonds. Bonds backing LBOs accounted for €10.5 billion of new issuance in Europe in 2018, up from just €2.2 billion in 2017. One major addition to this high yield bond pile was Spanish company Cirsa Gaming's €1.56 issuance backing its buyout by Blackstone. Another was the €1.3 billion bond issued by CVC in October for its majority take-private of the Italian pharmaceutical group Recordati.

37%

The rise in loans backing LBOs in 2018 compared to 2017

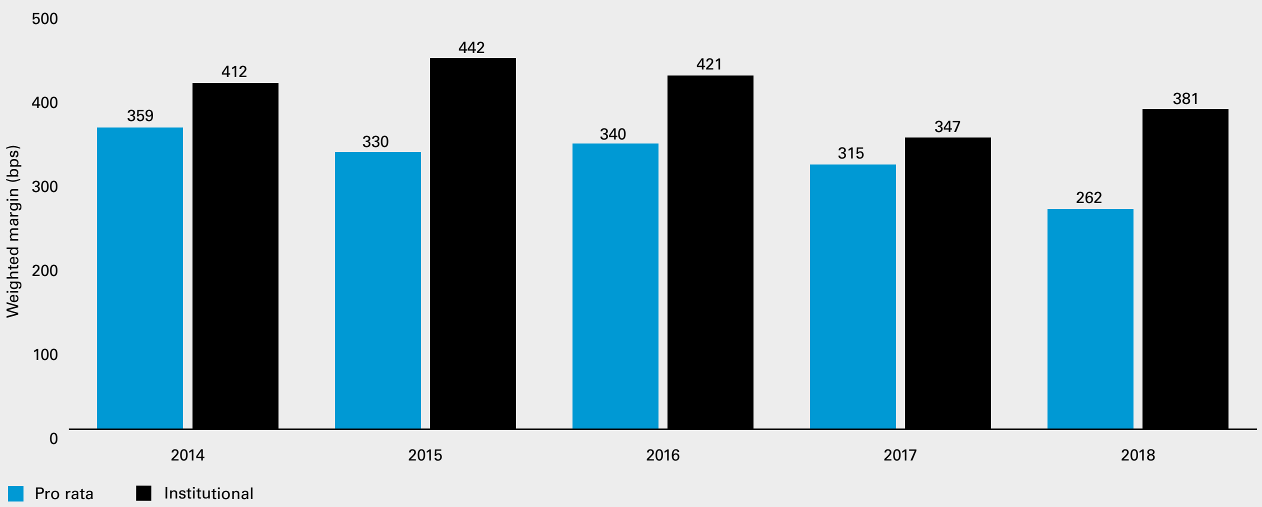
European leveraged loan issuance use of proceeds, 2018



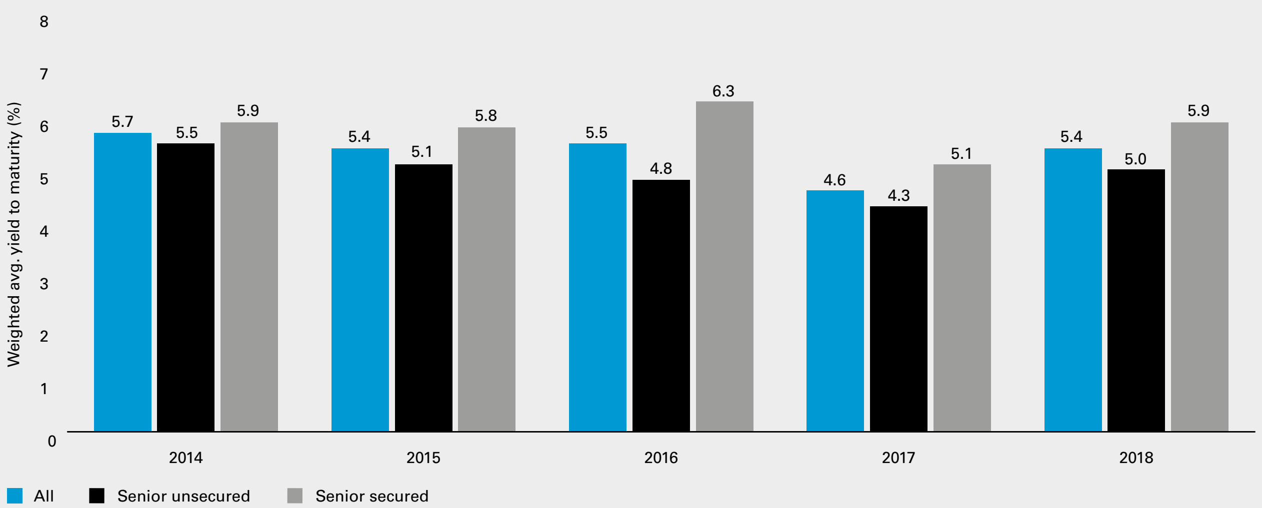
*Includes SBO, MBO incremental stake acquisition and spinoffs

Source: Debtwire Par

European leveraged loan pricing



European high yield bond pricing



Source: Debtwire Par

Still an issuer's market
As the volume levels dropped from a bumper 2017, borrowers still found an eager market as lenders remained hungry for yield. However, perhaps due to the number of deals seeking to borrow from the market, there was a pushback from lenders in early summer, pushing up pricing by between 25 and 50 basis points. Some borrowers—and their backers—had to decide whether to compromise on terms or pay a little more for flexibility. By the end of the summer, though, the power had shifted back to the issuers, with downward flexes returning as the norm. In September, downward flexes outpaced those moving upward by seven to zero. Notably some of the deals that flexed in September were jumbo loans such as Akzo Nobel, with lenders still keen to stay with the market.

The record amount of dry powder in private equity coffers looking

"As the volume levels dropped from a bumper 2017, borrowers still found an eager market as lenders remained hungry for yield

CLOs are go

Liquidity in the market has been given an additional boost through the resurgence of the CLO market.

Following a collapse in issuance after the crisis, the post-crisis CLO 2.0 has found favour again. CLOs reached a new post-crisis record, with €27.2 billion issued in 2018. As well as new issues, the trend for reset/refinance transactions also continued in 2018, driven by competitive pricing, with a further €16.1 billion of issuance.

Due to the increased presence of CLOs in the market, banks are able to syndicate deals widely and hold less on their balance sheets, enabling a greater volume of deals to be done. While still only at half the volumes seen before the financial crisis, these structured instruments are finding increasing favour with investors. New US CLO issuance was a record US$150 billion in 2018, surpassing the previous US$124.1 billion high set in 2014.

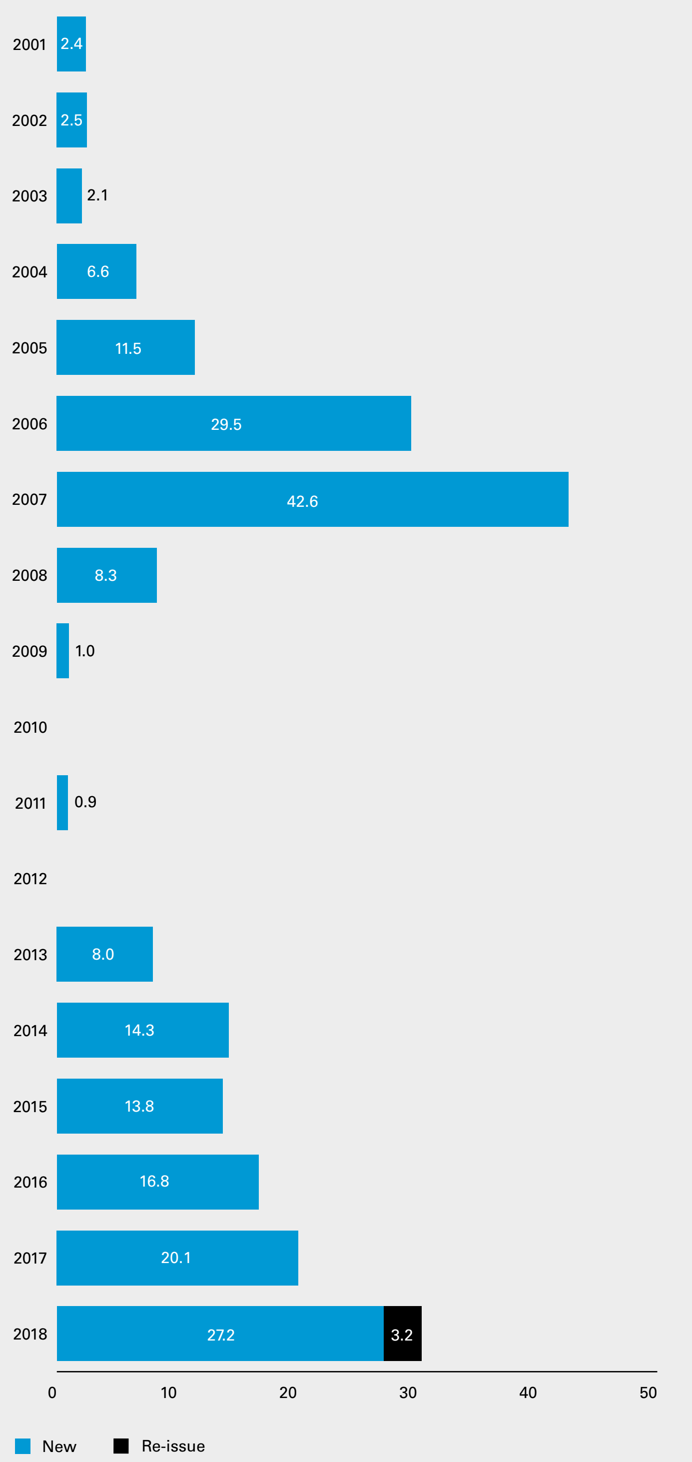
Although a much bigger market in the US, CLOs in Europe seem set to grow as investors' hunt for yield continues, thereby increasing the demand for additional paper from borrowers. Default rates for CLOs continue to be low, as diversification within each CLO should dampen the risk of default in a market stress scenario.

Moreover, the growth of CLOs has contributed heavily to the overwhelming preference for loans over bonds. CLOs only invest in floating rate instruments, which means that loans would be their preferred investment.

A corollary effect of the emergence of CLOs is the increased demand for floating rate bonds (even though overall issuance of HY bonds has diminished) since CLOs often retain some space in their portfolios for a limited number of floating rate bonds. A typical European CLO usually has a maximum bucket of 30 per cent for high yield.

> **Following a collapse in issuance after the crisis, the post-crisis CLO 2.0 has found favour again. CLOs reached a new post-crisis record, with €27.3 billion issued in 2018**

European new issue and re-issue CLO volume

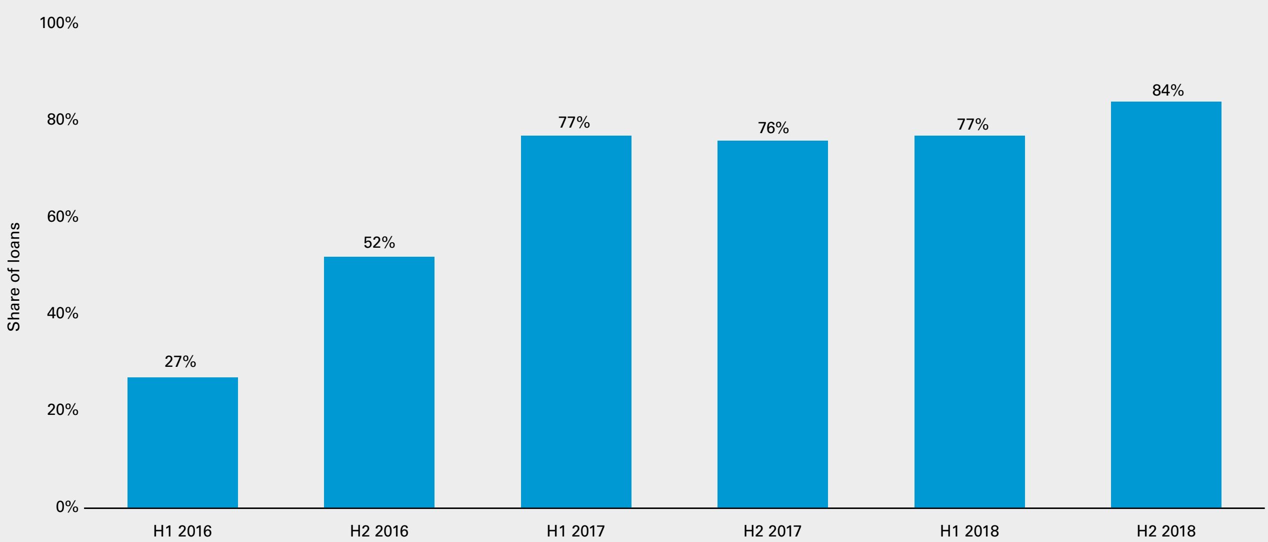


Source: Creditflux, Wells Fargo

to be put to work—estimated to be approximately US$1.14 trillion by Moody's Investor Services—combined with an increasingly sophisticated set of debt and credit investors who have become used to cov-lite terms, suggests a market likely to continue favouring borrowers/issuers for some time to come. In the US, for example, Bloomberg reported that some US$4.9 billion was repriced in October of 2018, as issuers demanded better deals from lenders in the year's leanest month for issuance so far.

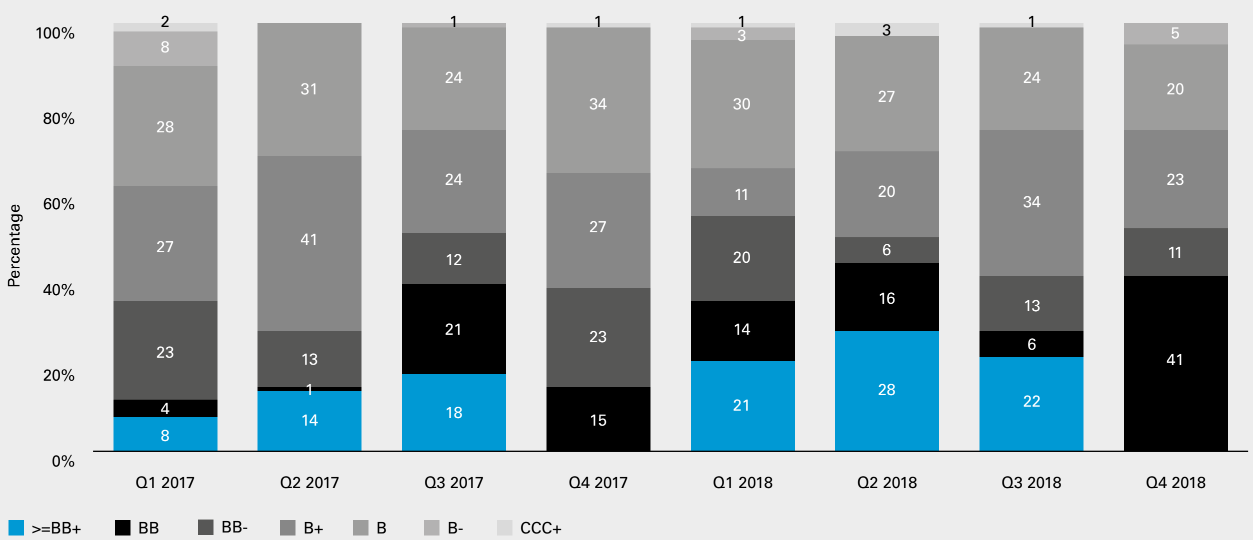
This supply/demand imbalance meant looser terms, and better pricing for borrowers was on offer in the loan market than for the high yield bond market. Meanwhile, the search for yield means that these same investors are willing to move towards riskier credits. In Q3 alone, 59 per cent of European loans were rated B+ or below. Meanwhile, high yield bonds rated B+ or below accounted for 46 per cent of total European issuance in the same period.

European covenant-lite share of institutional loans



Source: Xtract Research

European leveraged loan issuance by rating



Source: Debtwire Par

The rise of direct lending

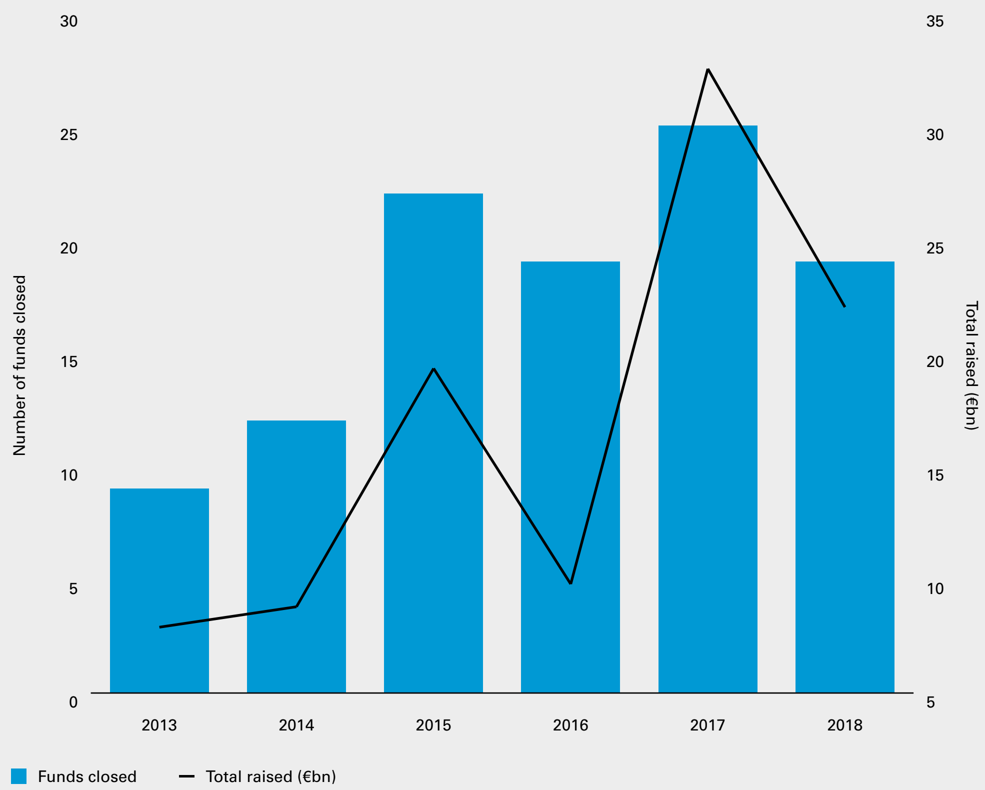
Direct lending funds have emerged in Europe and the US to provide financing to the smallest SMEs and even larger mid-market companies. Direct lenders are often able to offer a bespoke financing package that may not be available in the syndicated loan or high yield markets. From less than €8 billion raised in 2013 by nine such funds, some €32.5 billion flooded in from investors in 2017, filling 25 vehicles in Europe. Volumes in 2018 reached only €22 billion in 19 funds, as those raising capital took a break to allocate their assets.

Where once these managers traditionally stuck to US$100 million deals or below, larger funds are able to offer more substantial loans, with single funds offering US$500 million or more on an increasing basis. This is mainly due to the amount of capital they have to deploy. Ares, one of the largest managers in the sector, closed the largest fund of its type in the past 18 months in Europe at €6.5 billion. Intermediate Capital Group was not far behind with a €5.2 billion close.

Some of these managers seek a single layer of debt or unitranche. Ares struck one of the largest deals in this sector in 2018, with a €364 million loan to UK veterinary group VetPartners, which was also topped up with an equity stake. This funded a management buyout (MBO), although the company was scooped up by private equity giant BC Partners just a few months later. The secondary buyout has been a theme for direct lenders. Some five of the top-ten deals in the past year have funded such acquisitions, with just one refinancing, one MBO and three LBOs being funded by unitranche lenders.

Since 2007, these funds' assets under management grew from approximately US$200 billion to close to US$650 billion by the end of 2017, according to Preqin. With such huge amounts of dry powder, it is likely that more of these buyout deals in 2019 will involve direct and unitranche lenders, who have the money already on tap, rather than by new capital raisings in uncertain political and economic territory.

Direct lending fundraising in Europe



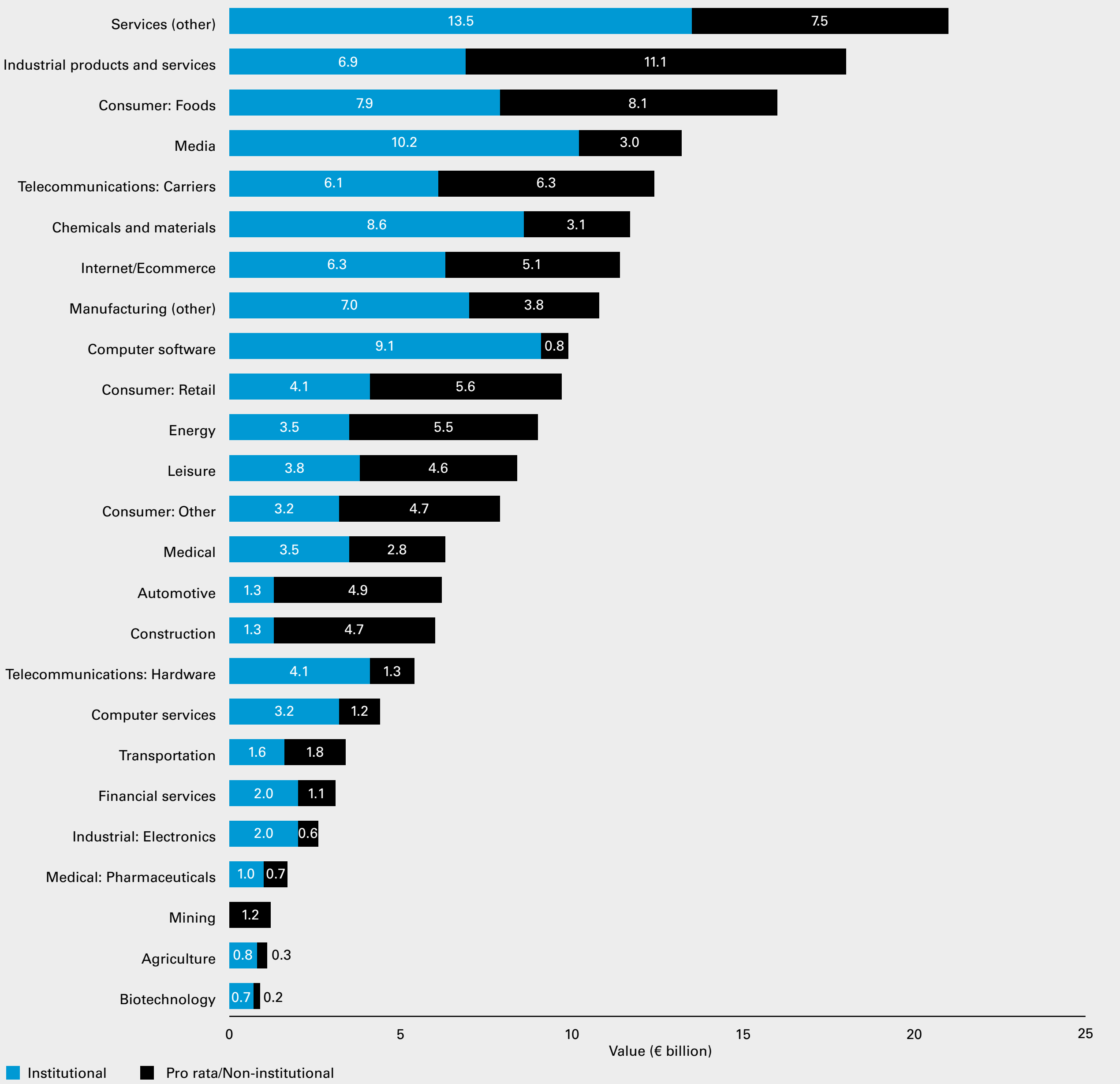
Source: Debtwire Par, Creditflux

Sector watch

In 2018 in Europe, services (€21 billion), industrials products and services (€18 billion), and consumer: foods (€16 billion) were the top-three sectors, accounting for around 27 per cent of leveraged loan issuance.

On the high yield side, services (€8 billion), last year's top sector financial services (€7 billion) and energy (€6.5 billion) were out in front. Financial services tops the list by number of deals, with 29.

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



Source: Debtwire Par

European leveraged debt in focus

Selected European leveraged loan and high yield bond markets by volume

Benelux

High yield bonds

43
18

€17,891
€9,660

Loans

65
58

€33,163
€29,814

Germany

High yield bonds

22
13

€7,811
€5,328

Loans

75
49

€41,965
€20,550

France

High yield bonds

38
21

€14,063
€10,897

Loans

139
124

€65,197
€40,751

UK & Ireland

High yield bonds

77
46

€29,492
€16,468

Loans

164
123

€75,980
€56,417

Spain

High yield bonds

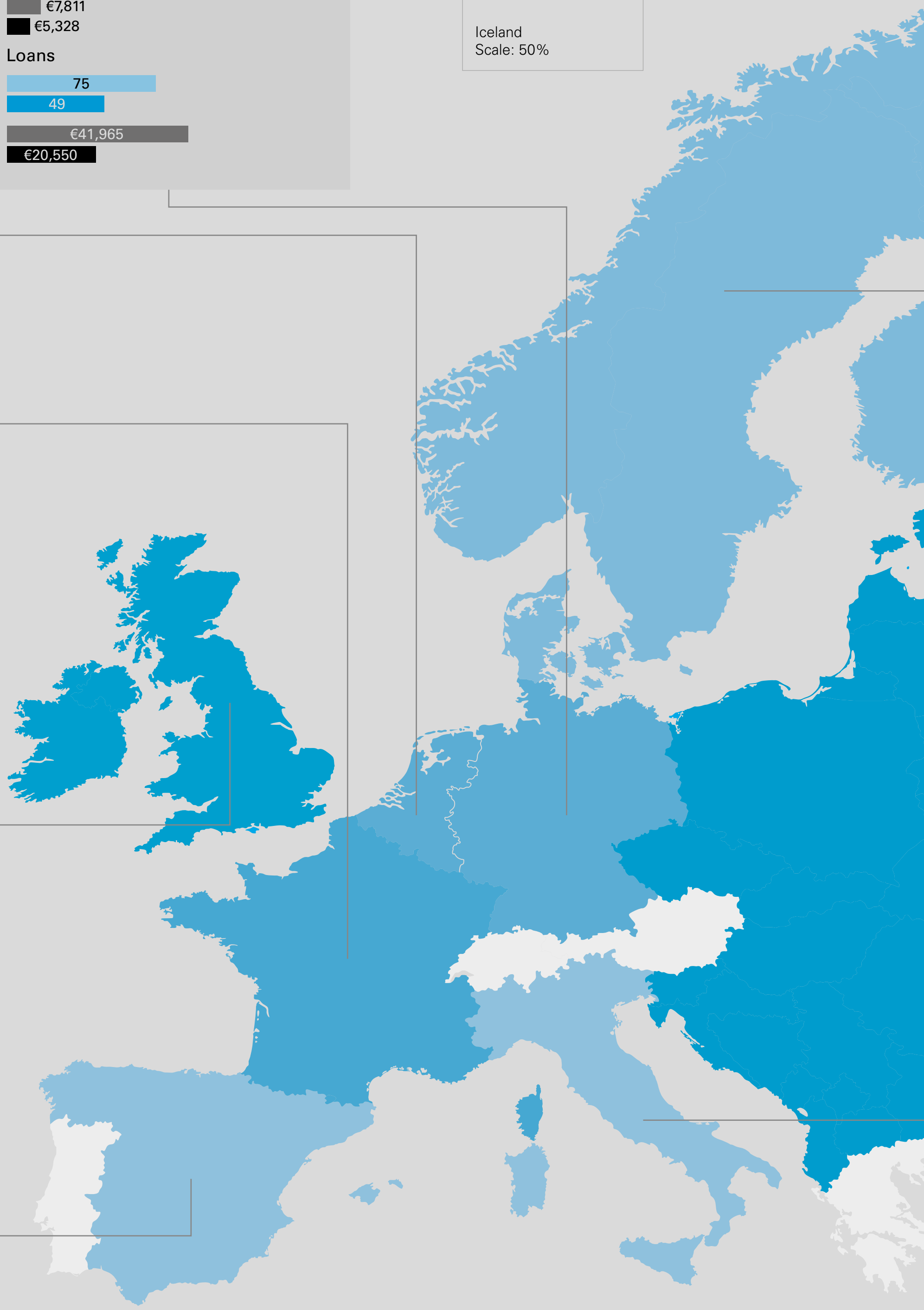
11
6

€4,550
€3,750

Loans

30
34

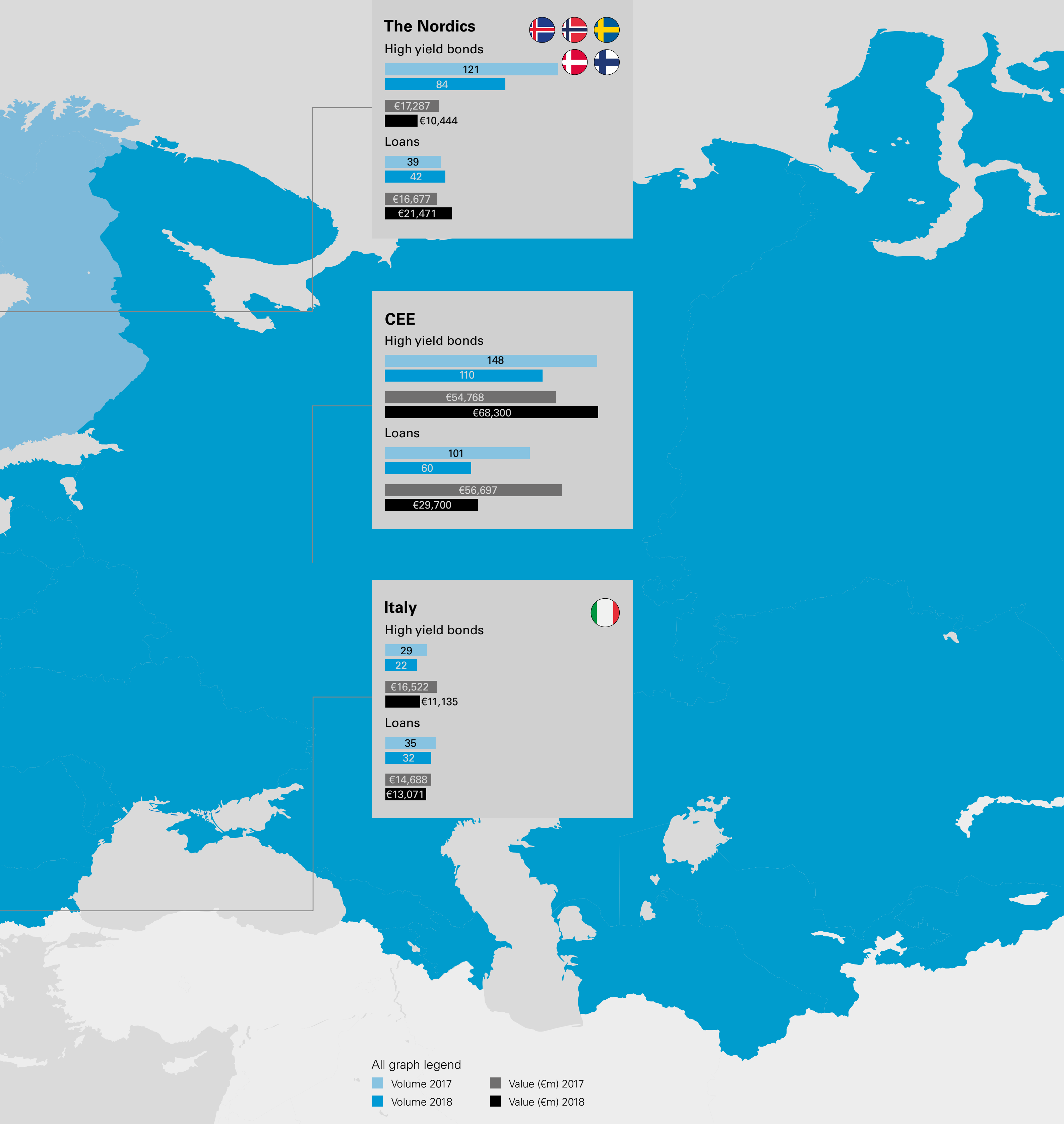
€16,070
€12,248



Map legend (overall activity ranking)

Lowest — Highest

Source: Debtwire Par


The Nordics
High yield bonds
121
84
€17,287
€10,444
Loans
39
42
€16,677
€21,471
CEE
High yield bonds
148
110
€54,768
€68,300
Loans
101
60
€56,697
€29,700
Italy
High yield bonds
29
22
€16,522
€11,135
Loans
35
32
€14,688
€13,071
All graph legend
Volume 2017
Volume 2018
Value (€m) 2017
Value (€m) 2018

Market outlook for the year ahead

As the leveraged debt market has matured at pace in the past decade, many are hopeful that it will maintain an upward trajectory, at least in the medium term

Acquisitions and LBO financing will continue to account for a large share of issuance in 2019. Corporate portfolio management and a surfeit of dry powder at PE funds may well keep the leveraged debt market going

As noted in the report, times have changed, and 2018 has seen a different dynamic than in the previous two years. The rise in US interest rates has had a significant impact on the market, with the move from bonds to loans speeding up and the pace of refinancing activity slowing markedly.

In addition to those shifting dynamics, macroeconomic and political factors such as Brexit, further interest rate rises and continued volatility in a number of EU markets could all have a bearing on the market and drive its development for the year ahead. While it's difficult to chart an exact course, there are several tendencies that may play out and, indeed, possibly co-exist in 2019.

A deep and mature market

While economic volatility and events such as Brexit could hurt issuance levels, the market has evolved in the past decade into a robust and diversified market that caters to the needs of a variety of lenders and borrowers. There are more products and more options available than ever before, and it is difficult to predict which of those will be in the ascendancy in 2019.

Acquisition and LBO financing should continue to account for a large share of issuances in 2019; most issuers that want to refinance have already done so. A strong M&A pipeline, corporate portfolio management in response to changing economic times and a surfeit of dry powder at private equity funds may well keep the leveraged debt market going. Meanwhile, demand from investors will likely sustain the issuance for the foreseeable future.

The renewed growth of CLOs also look set to keep refreshing bank balance sheets as investors seek yield. This should ensure the flow of capital continues until interest rate increases hit underlying issuers and potentially cause investors to return to safe havens.

And if interest rates stabilise, demand for fixed rate instruments could begin to reassert itself and we could find bonds coming to the fore once again.

A test for funding providers

The broadening of the leveraged finance market to include asset managers and other debt providers has been a notable development in the post-crisis world. They have stepped into the breach at times when banks have been in retreat, succeeded in gathering assets and become a key part of the lending ecosystem—but that is only half the battle. As a relatively new phenomenon, certainly at such scale, direct lenders and relevant debt providers have not been tested in a true market downturn. That test may emerge in 2019.

With billions in capital to put to work, they have entered deals at pace and often with high leverage levels. Should the market hiccup or hit a severe correction, many investors in these funds may find their holdings with lower recoveries than other leveraged finance sectors.

Watch for defaults

One development that has the potential to destabilise the market would be a marked increase in default rates. The continued supremacy of cov-lite could be delaying defaults and shielding poor credits.

So far, the story has been that if the covenant is not there to breach, there is no danger of default. With interest rates as low as they have been, it has been hard for companies to run into difficulties outside of a liquidity crisis, as there are no covenants that give lenders an early trigger. However, should economic conditions worsen or interest rates rise further, default rates could spike.

It may take just a couple of distressed situations in which a lender loses its investment to shake investor confidence in the burgeoning new market. This could have a knock-on effect for those accepting the looser terms in the term loan B market.

The Bank of England Financial Policy Committee has expressed concern about the rapid growth of leveraged loans and pointed out just how far lending terms had loosened in the UK, with maintenance covenants currently featuring in only approximately 20 per cent of loans versus close to 100 per cent in 2010. The IMF is the latest to voice its concern: "With interest rates extremely low for years and with ample money flowing through the financial system, yield-hungry investors are tolerating ever-higher levels of risk and betting on financial instruments that, in less speculative times, they might sensibly shun."

With a more diverse range of financial products, it is less clear where the risk in the market ultimately lies. We saw with the US sub-prime crisis that risk in the market can be concentrated in unexpected locations. As investors have been chasing yield for the past decade, an unexpected downturn in the leveraged finance market could ricochet into other areas and compound any slowdowns.

With so many factors in play, market participants will be reluctant to make any hard and fast predictions for 2019. However, if history is any guide, the market is likely to continue to evolve to meet the needs of issuers and borrowers and, macroeconomic shocks aside, will continue to offer a wide range of options for all participants.

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