

Coming of age: The changing face of international leveraged debt

More convergence, more deals and more choice are transforming the world of leveraged debt finance

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International leveraged debt markets are on the move

2014 may well be seen as a landmark for European leveraged loans and high yield bonds—one that could change how investors and borrowers approach leveraged debt markets

The debt markets are on the move. Last year saw a sharp rise in values and volumes in both leveraged loan and high yield bond markets but, perhaps more importantly, there has been a significant shift in the way these deals are agreed.

What led to this shift? Strong demand in 2014 provided market participants with the opportunity to adapt, to their advantage, the international finance models that developed, sometimes by necessity, during the recent financial crisis. These changes are also evidenced by the ongoing convergence of markets, financial products and investor bases, further aligning global finance. For example, in an era when international corporates seek dollar-denominated borrowings in the United States while US-based sponsors look globally for investor yield, crossover becomes inevitable, in particular as markets continue to recover. These growth trends then further strengthen the relative negotiating positions of, and increase the willingness to innovate by, a growing base of globally aware market participants.

These key trends have big implications for those operating in Europe's leveraged debt markets. European corporates and sponsors now have a broader range of financial products available to them than ever before, and on terms that are less restrictive and more borrower-friendly. High yield's emergence as a competitor to bank finance as a primary source of capital, the growth of alternative capital providers and new structures for the legacy loan market all contribute to increasing choice for borrowers.

Additionally, the convergence of terms between both sides of the Atlantic Ocean means that sponsors and corporates are able to negotiate US-style terms for European-based loan transactions and looser terms in bond covenants. This is leading to new precedents being set. Incurrence-based covenants are becoming increasingly common in Europe as corporates—in particular those with quarterly covenant tests in their loan documents dependent on financial performance—now desire and, more crucially, can access less onerous restrictions both in the high yield market and the emerging covenant-lite loan market. And elsewhere, while Europe has seen significant developments in the leveraged finance arena, it's hard to ignore the rise of high yield bonds elsewhere in the world, as leveraged debt markets gain traction and become more sophisticated.

The overall picture is of an increasingly international leveraged finance market. Investors are seeking yield and diversity both by industry and geography, while borrowers are increasingly looking for a broader range of funding sources and improved terms. Now, it seems, parties on both sides of the equation are beginning to find them.



Rob Mathews
Partner, White & Case



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US loan figures are percentages of NY-law governed credit agreements/amendments reviewed by Xtract in 2013-14.
European loan figures are percentages of European-law governed credit agreements/amendments reviewed by Xtract in 2013-14.

A new dawn: Record year for debt heralds new era

HEADLINES

- European loan and bond markets see activity surge in mid-2014
- Attractive pricing and extreme liquidity fuel borrowers' market
- Greater M&A and private equity driving leveraged debt
- Covenant-lite loans arrive to complement high yield growth

Corporates in Europe had access to the most open leveraged loan and high yield bond markets in years, as record issuance defined the region.

Total values reached €97 billion for high yield bonds and €116 billion for leveraged loans. The volumes for both debt instruments in Europe peaked in Q2 2014.

While the United States saw a steadier trend in high yield bonds and leveraged loans, the respective markets are much larger than their European counterparts. Furthermore, growing collateralized loan obligation (CLO) issuance in the United States has proven a catalyst for its re-emergence in Europe.

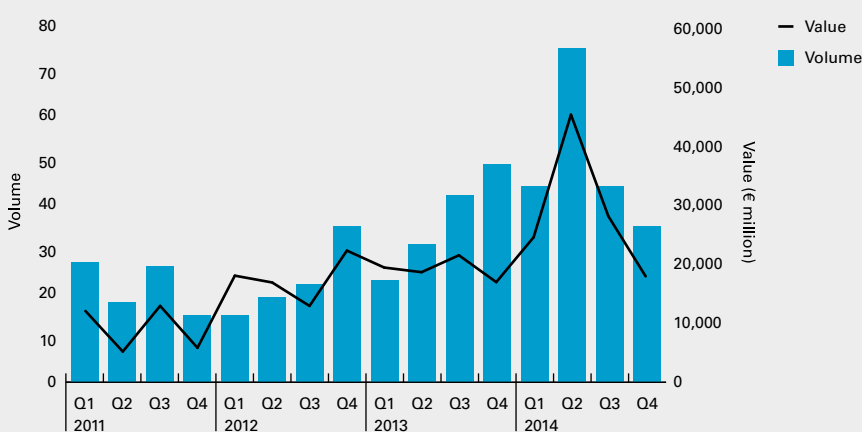
And while primary issuance from Q3 2014 onwards was hampered by factors such as worsening economic indicators, major geopolitical risks and falling commodities prices—forcing investors to reassess their risk profiles—the long-term trend is one of sustained growth in European high yield debt.

“The European debt market will continue to grow,” David Becker, partner in White & Case’s London capital markets team, says. “It is coming of age now as its investor pool has become increasingly sophisticated, providing funding across the loan and bond spectrum.”

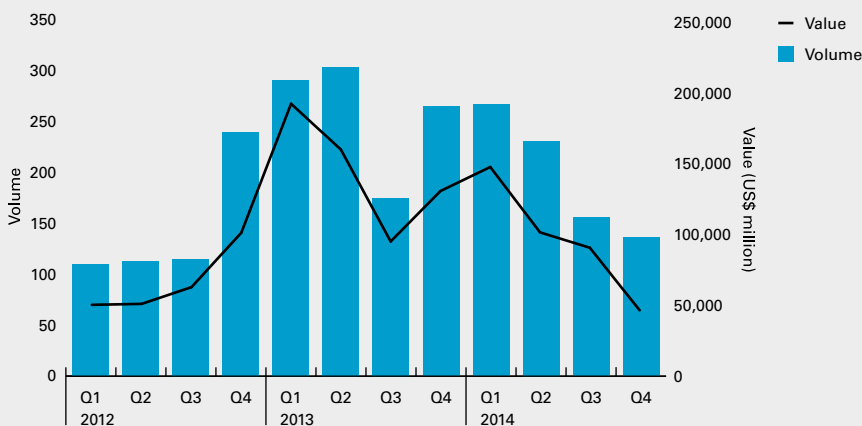
Lower yields, higher confidence

Historically low yields during 2014 were one factor that helped to reinvigorate the leveraged finance market. They provided strategic

Europe: Volume and value of leveraged loan allocations per quarter



US: Volume and value of leveraged loan allocations per quarter



Source: Debtwire Analytics

refinancing opportunities for high yield issuers, with bonds now in their call periods being refinanced at significantly lower coupons. This also allowed issuers and sponsors to issue new debt on less restrictive terms.

The iTraxx Crossover Index measures credit default swap risk for a portfolio of high yield issuers and is considered by market professionals to be a key indicator of the health of the bond and complementary loan markets, and provides a good pointer as to where confidence lies. According to the iTraxx Crossover five-year index, debt was priced at 248 basis points above the reference rate in July 2014, compared with more than 700 in 2012.

After declining between 2011 to 2013, average yields for leveraged loans increased slightly during 2014, although they remain at low levels by historical standards. Similarly for high yield bonds, average yield to maturity (YTM) and coupons went from 5.9 percent and 5.7 percent, respectively, in H1 2014 to 6.3 percent and 6.1 percent in H2 2014. This trend of increased YTM was seen across the credit rating spectrum, although it was most marked in the CCC+ bracket, where investors are clearly seeking higher yields in return for the risk taken.

This upward movement was partly driven by the volatility of Europe's economic outlook and the international situations described above. However, it also reflects a trend towards slightly higher pricing in the US market and the ability of European investor demand to provide all-euro tranches on deals, as the competitive pressure previously seen from the US market waned somewhat over the course of 2014. The specter of interest rate rises in the United States and possibly the UK, together with the tapering of quantitative easing in the United States (now completed), also contributed to the increased pricing in both markets.

Deals drive debt

Stronger global M&A activity throughout 2014, particularly in Europe, helped drive leveraged finance activity, with leveraged loans in particular seeing an uptick as a


€45
 billion
 leveraged loan
 issuance value
 in Europe in Q2 2014
 —the highest in the
 last three years

result. In the telecoms sector, the Altice/Numericable acquisition of SFR boosted values, as did Liberty Global's €3.7 billion leveraged loan allocated to acquire Dutch cable group Ziggo and Novator and Olympia's recapitalization of Play. In addition, aluminum systems developer Corialis Group's €485 million leveraged loan raised to finance its takeover by private equity (PE) house Advent International and The Co-op Pharmacy's £725 million leveraged loan deal struck for its acquisition by Bestway Group contributed to elevated values.

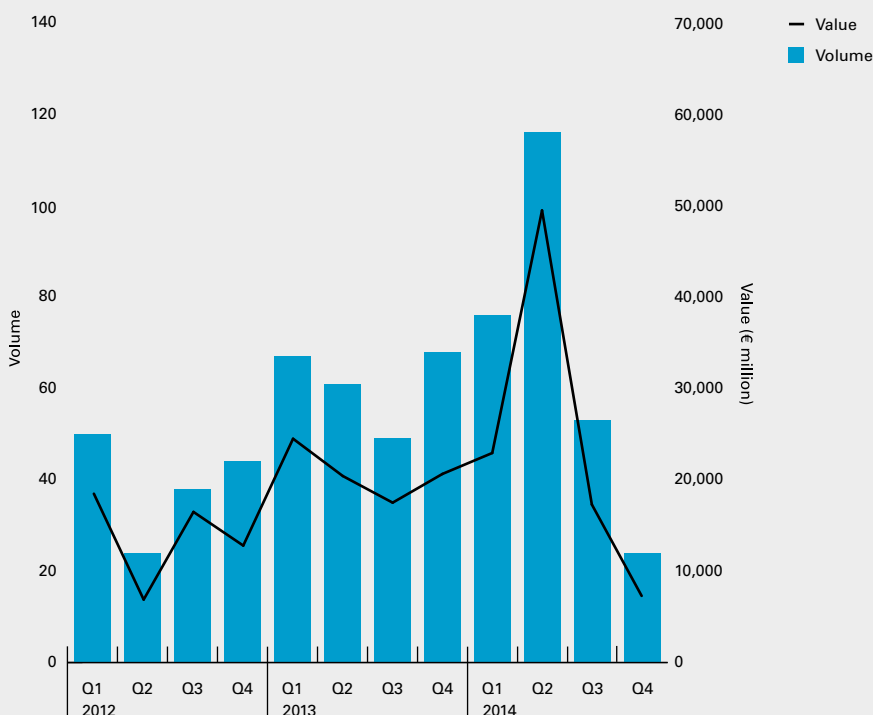
Global M&A values and volumes are starting to return to levels not seen since the crisis. This upward trend, absent a major shock, will continue to drive high yield bond and leveraged loan activity through 2015.

In a growing sign of maturity, Europe has also started to see the refinancing of earlier high yield with new, more flexible high yield bonds at improved pricing. "We're now



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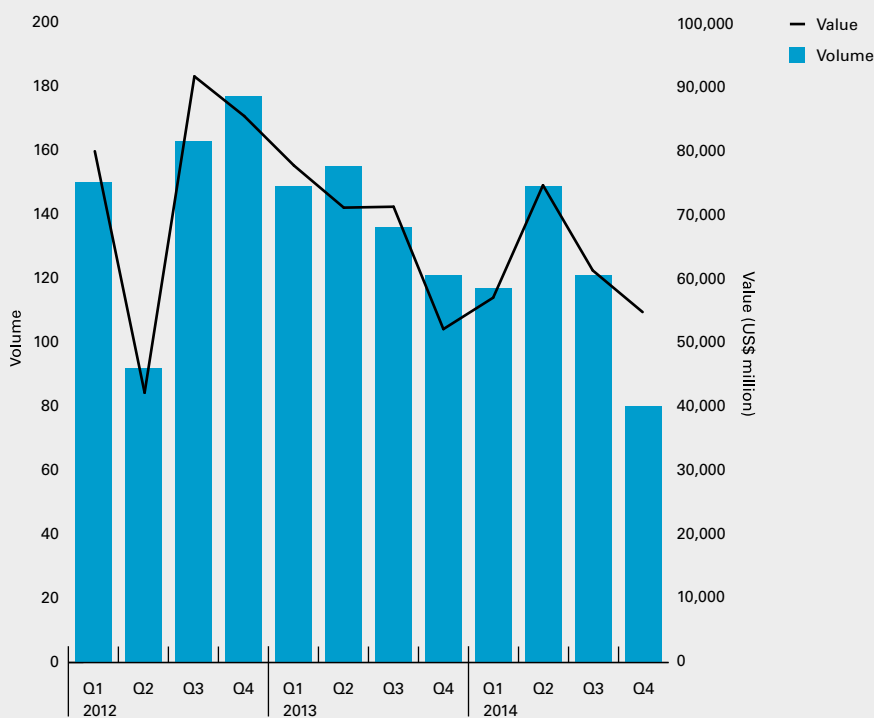
Europe: Volume and value of high yield bond issuance per quarter



Source: Debtwire Analytics



US: Volume and value of high yield bond issuance per quarter



Source: Debtwire Analytics

seeing more repeat issuers in the market,” says Jeremy Duffy, partner in White & Case’s London banking team. “They take advantage of the lower coupons and the better terms of the evolving markets, in particular during periods of high liquidity.”

PE sponsors have also underpinned activity in both leveraged loans and high yield bonds. The value of PE refinancings (including dividend recapitalizations) by the end of Q3 2014 stood at €36.6 billion, compared with a full-year total of €46.3 billion in 2013, according to the Centre for Management Buyout Research (CMBOR). “Sponsors influence activity because they are familiar with the product,” says White & Case partner Jill Concannon. “It hasn’t been possible for them to raise a jumbo term loan for acquisition financing in the last few years, so going to the bond markets has been a necessity. Once introduced to the bond process in Europe, sponsors are realizing that even though there’s a lot of upfront work involved, there are actually a lot of benefits to using high yield, even for a refinancing.”

CLO investors cross the pond

Another key trend has been the return of strong CLO issuance in the United States over the past few years, with Europe finally following its lead. And while Europe's CLO market is much smaller than in the United States, the emergence of US investors looking at European CLOs as they chase yield could assist with the reemergence of the European CLO market after it practically disappeared post-crisis.

Banks backing off

The other important driver underpinning activity has been, of course, the lack of availability of banks' balance sheets, forcing corporates to look elsewhere and supporting non-bank lending. A recent European Investment Fund report highlighted the growing trend in Europe towards non-bank financing methods. In the 2002 to 2008 period, close to 80 percent of company debt finance was sourced through banks. But in the 2008 to 2014 period, this had decreased to just over 50 percent



116

high yield bond issuances in Europe in Q2 2014—more than 90 percent up on Q2 2013



1,115

European PE buyouts in 2014, compared with 918 the previous year

as European companies increasingly tapped capital markets and alternative capital sources.

The rise of private placements and the growth of the direct lending market in Europe, in addition to the growth in leveraged loan and high yield bond markets, have provided European companies with a wider range of funding sources, creating a converging investor base. Europe is clearly taking its lead from the United States, where many of these funding sources have been around for many years.

Deal value ranges

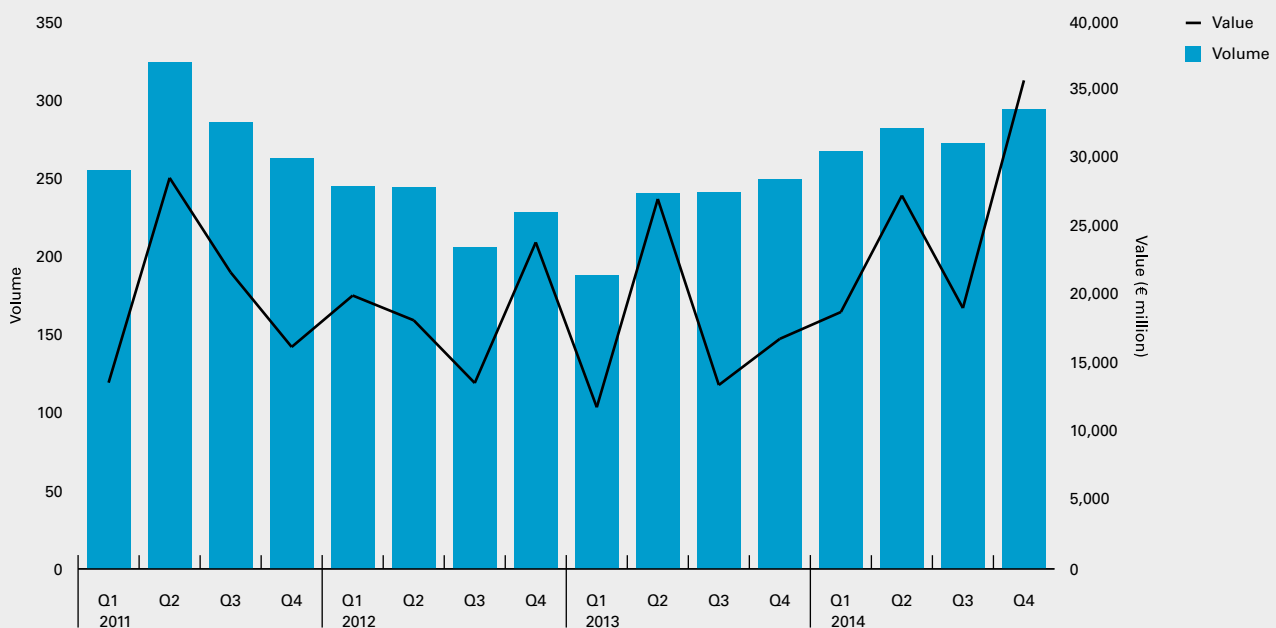
The high yield bond story is now a firmly established part of European debt markets. Since 2008, high yield issuances have increased every year, to 269 issues in 2014.

With this established, further nuances have appeared. One major change in the bond markets for 2014 was an increase in high value deals in Europe, both in volume and value. There were six deals worth more than €1.5 billion in 2014, compared with just one in the whole of 2013. This is a

reflection of some large European M&A deals during the year, but also the deeper and more liquid high yield bond market in Europe that is enabling larger issues to be funded in Europe.

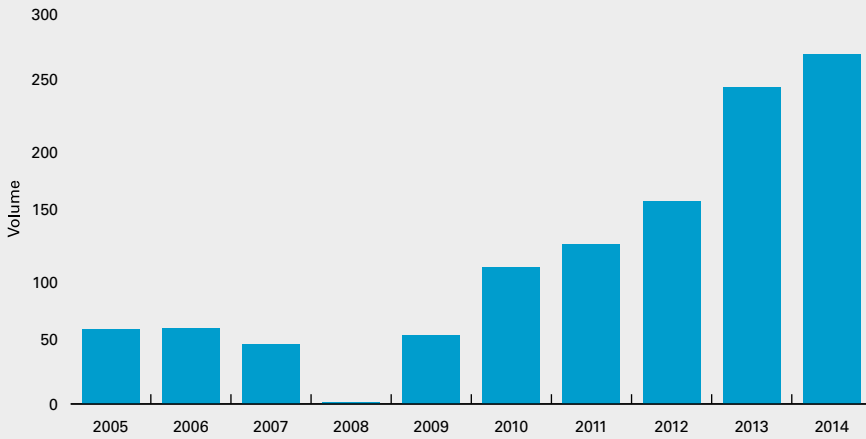
This shift to the high value market could largely be driven by CEOs and PE houses regaining the confidence to do big-ticket deals again. This has also been bolstered by the large amounts of liquidity available to investment funds.

European private equity buyouts

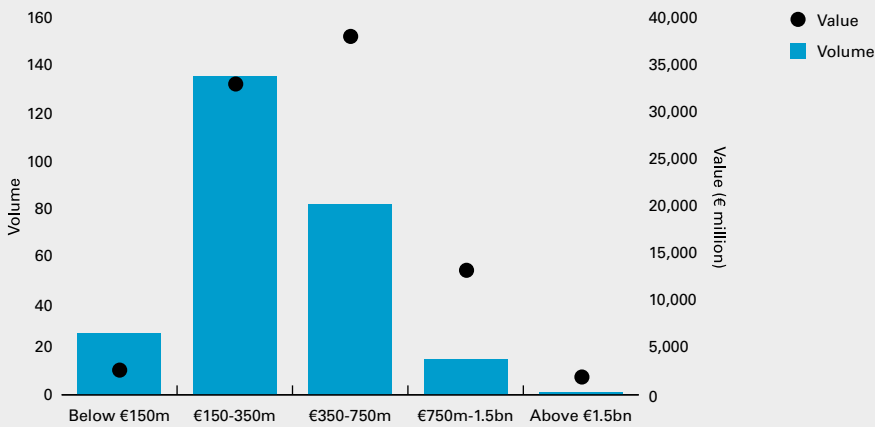


Source: Mergermarket

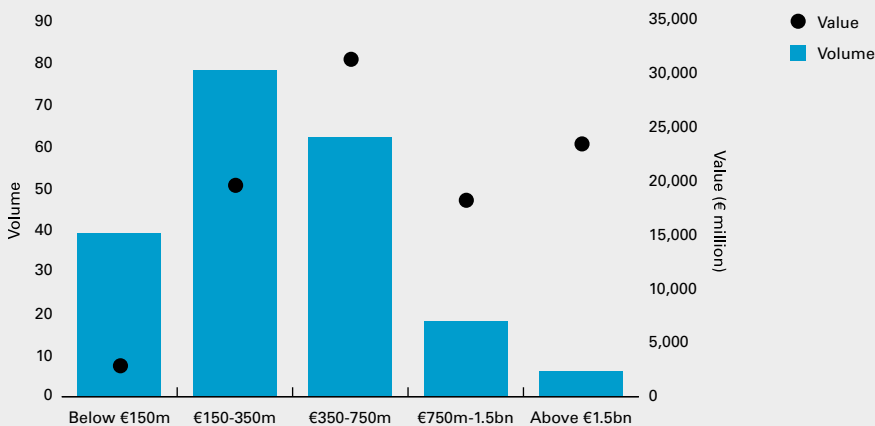
High yield bond issuance by year



Deal size range, 2013



Deal size range, 2014



Once introduced to the bond process in Europe, sponsors are realizing that even though there's a lot of upfront work involved, there are actually a lot of benefits to using high yield, even for a refinancing.

Jill Concannon, partner, White & Case



Paternoster Square, London

On good terms: Convergence drives issuer-friendly markets

HEADLINES

- Loan covenants loosen towards high yield bond standards ■ Convergence of US and European loan market terms
- Convergence leads to less onerous terms for borrowers ■ Portability becomes increasingly prevalent in European high yield bonds
- Emergence of alternative capital providers adds to choice

The convergence between US and European leveraged loans and high yield bonds became one of the biggest stories in the debt markets in 2014. Investors became more comfortable to increase activity in Europe in 2014 as confidence picked up around the prospects for a European recovery (in the first half of the year, at least), and this increased demand amongst investors has driven competition between the loan and bond markets. For borrowers, this has resulted in one of the busiest and term-friendly markets in years.

“The European debt market has been heavily influenced by terms in the United States that have been norms for the last 12 to 18 months there,” says Jacqueline Evans, partner at White & Case. “In larger deals, full covenants have gone, and what we would now consider cov-loose is the new European normal.”

Coming to terms

While European lenders have, until this year, resisted the aggressive loosening of covenants for leveraged loans, 2014 saw a significant shift towards more flexible, borrower-friendly terms that resemble more closely those of US loans and high yield bonds. In particular, there has been a marked increase of cov-lite loans in Europe over the past year. At the same time, bond terms have also moved in favor of issuers and towards leveraged loan pricing norms, as the



16%

European first lien loans that were cov-lite in 2014



27%

High yield bond issues in Europe featuring portability in 2014

erosion of call protection continued. Convergence between the two picked up pace over 2014.

“While the two forms of finance won’t converge completely, they are becoming more similar and the distinction between the two—which has historically been the result of the different types of investors behind them—is fading,” says Gareth Eagles, partner on the White & Case London banking team. “Ultimately, it doesn’t matter to borrowers whether they are raising finance through bonds or loans—what matters are the terms they can get.”

Loan covenants loosen

Europe arguably followed the US loan market’s convergence to high yield bonds. The move towards looser terms started in 2013, when a number of euro-denominated cov-lite tranches of US loans were completed. The trend gained significant momentum in March 2014, when Europe saw its first mainly euro-denominated cov-lite facility struck since the onset of the crisis, when veterinary health company Ceva Santé Animale arranged nearly €1 billion of cov-lite loans.

Indeed, there were no domestic European cov-lite loans in 2013. Yet 16 percent of European first lien loans were cov-lite in 2014. There is still a long way to go, but this trend indicates that, one step at a time, the European market is moving in some ways towards a US-style



Leveraged lenders have offered the best of both worlds: the same or better pricing than high yield and an adoption of incurrence covenants.

Jeremy Duffy, partner, White & Case

model, where cov-lite loans have gained a very strong position in the market over the last two years. In 2014, nearly half (47.7 percent) of US first lien loans were cov-lite, more than double what was seen in 2013.

This change has been driven by competitive pressure from high yield bonds, which saw record issuance value in 2014, and investor appetite for European exposure as well as CLO issuance. This has pushed banks to move towards looser leveraged loan terms in order to compete. (For more on CLO issuance, see page 11.)

“Leveraged loans have staged a comeback in Europe over the last year,” says Jeremy Duffy, partner on the White & Case London banking team. “Leveraged lenders have offered the best of both worlds: the same or better pricing than high yield and an adoption of incurrence covenants. Without the repayment fees typical in high yield bonds, cov-lite deals have appealed particularly to PE sponsors, which would be looking to sell three or so years down the line.”

The indications are then that loosening loan covenants are becoming an increasingly common presence in the European market.

Europe converges with the United States

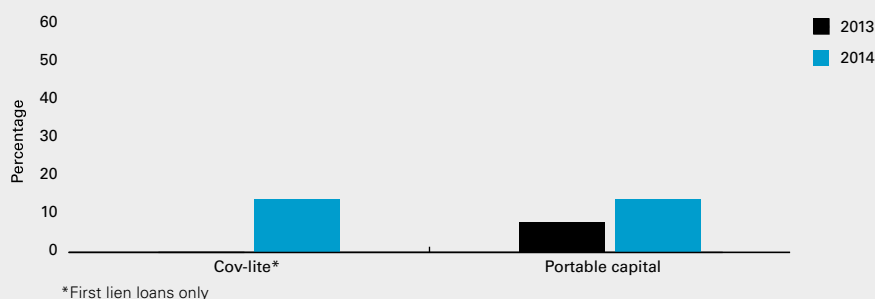
One of the principal drivers of the convergence has been the internationalization of both loans and bonds. European borrowers have increasingly sought dollar-denominated funding in the United States, where the market has remained deep and liquid and the increasing demand from institutional investors has both loosened terms and increased the debt multiples available.

From 2011 onwards, as banking regulatory reform hit hard and borrowers sought greater diversification in lending sources, European companies looked to the US debt market for so-called Yankee Loans. The attractions of cov-lite structures, favorable economics and deeper liquidity led to a near doubling of the volume of European borrowers tapping the US market between 2011 and 2012, according to S&P figures. In Q1 2014 alone, €14.7 billion was syndicated into the United States by European borrowers, up 37 percent on figures for Q1 2013.

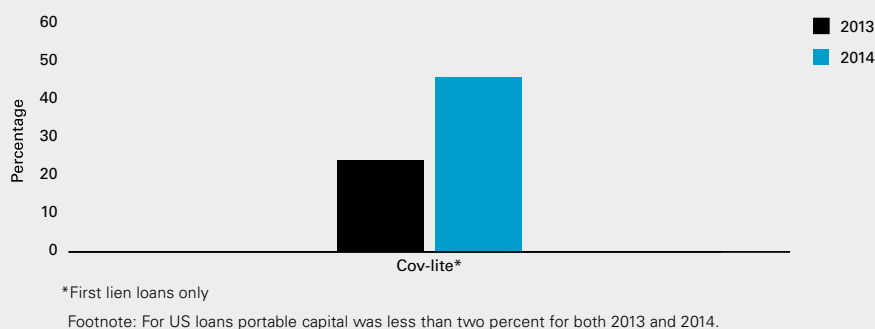
In addition, European companies have started to follow the lead of their US cousins in their capital structures. While European companies have historically raised around 20 percent of their debt capital through bonds and 80 percent via bank loans, US proportions have generally been the reverse of this. Greater availability of high yield capital in Europe over recent years, driven by yield-seeking investors as well as a move towards alternative sources of funding, such

Source: Xtract Research

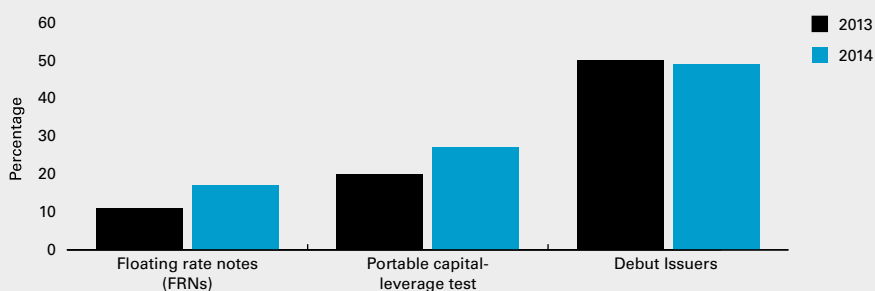
European leveraged loans



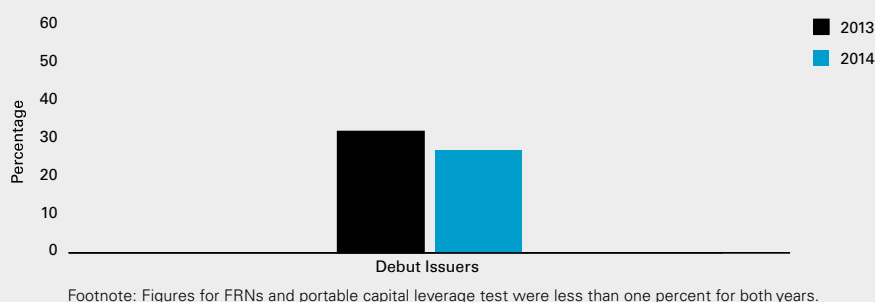
US leveraged loans



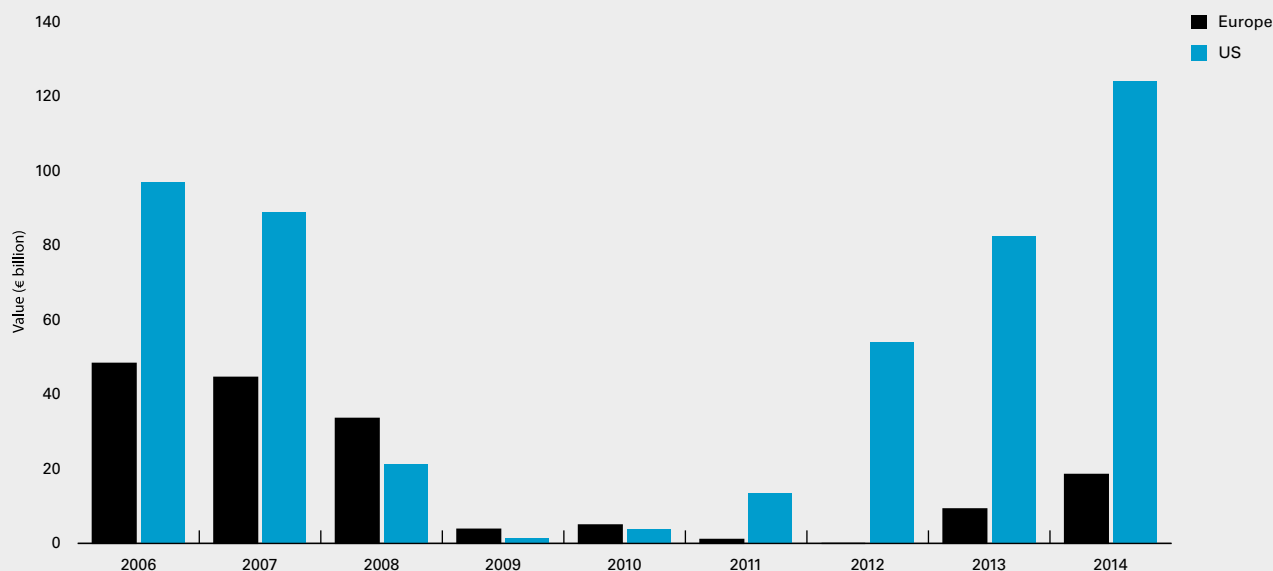
European high yield bonds



US high yield bonds



CLO issuance value – Europe and US



Source: S&P Capital IQ

as private placements, is starting to shift the percentage of bond finance in European company capital structures towards US norms.

The aforementioned convergence of loan and bond terms in the United States, with increasing cov-lite, was driven by convergence of the investor base; institutional investors, desperate for yield, began buying both products in a bid for returns.

This has slowly picked up in Europe, evidenced by institutional money finally coming back to the market with CLO issuance starting up. CLO issuance in Europe picked up markedly in 2013 to US\$9.27 billion, after being pretty much absent from the market following the economic crisis. In 2014, issuance in Europe again increased significantly to US\$18.52 billion by the end of the year. While this is still well short of US issuance, with regulations such as the retention stake rule requiring managers to retain a stake in the CLO delaying some activity, there is reason to believe European CLO issuance will continue to grow.

“As CLO issuance continues to grow in Europe, and as this capital is increasingly managed



17%

European high yield issues with a floating rate note in 2014, compared with 11 percent in 2013

by people who operate on both sides of the Atlantic, cov-lite deals will continue to get done—albeit on a less aggressive footing than in the US at the top of the market,” says Jake Mincemoyer, a partner focusing on banking in New York at White & Case, who was based in London from 2010 to 2014.

Looking to the future, the big question for the European leveraged loan market is whether institutional investors’ share of the market will ever reach US market levels. In 2006, institutional investors held more than 90 percent of US leveraged loans, while in Europe it was just over 50 percent. And while the United States is back to those levels, the question remains whether Europe will catch up—or will banks continue to hold more leveraged loans on their balance sheets than their counterparts in the United States?

“I think this time there is a good chance Europe will follow the US model,” says Mincemoyer. “The take-off in high yield over the past few years is a positive sign.”

While the European cov-lite phenomenon is developing, there

have still only been a relatively small number of cov-lite deals completed, and so set standards have yet to emerge. In the United States, by contrast, the greater maturity of cov-lite means that stronger precedents have been set, allowing borrowers to push on terms previously agreed to in other deals. “There are two aspects to cov-lite: the lack of financial maintenance covenants; and the high yield style covenant exceptions,” says Mincemoyer. “There is a standard set of what you can get in the US market on covenant exceptions, and the discussion tends to focus on what the threshold is. In Europe, however, we’ve not yet seen deals done with the full package of high yield style flexibility, although this will creep across.”

“There has been a split in the United States on the approach to high yield style covenants in credit agreements,” adds Eric Leicht, partner and head of the Americas banking section at White & Case. “In some instances, we see sponsors incorporate true high yield covenants into a credit agreement and then graft on some traditional credit agreement style protections



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such as caps on investments in, and debt of, non-guarantors. Creating this hybrid requires detailed knowledge of both high yield bond and leveraged loan products. In other cases, we see sponsors use a traditional New York law credit agreement with a bolt-on of key high yield elements such as extra baskets tied to incurrence-based financial tests and grower baskets tied to retained excess cash flow or cumulative net income. This is an ongoing area for debate.”

The United States continues to be a trendsetter for leveraged loan covenant terms. One new area, for example, is the timing of ratio tests for debt incurred to finance acquisitions being brought forward to the time of the deal being signed, rather than on completion of the acquisition. This is being used in the United States as a way of ensuring certainty of funds. “This hasn’t yet been seen in Europe, but we will start to see this relatively quickly as it catches on in the United States,” says Mincemoyer.

Falling call protection

For fixed-rate bonds, non-call periods continued their overall trend of decline, with the second quarter of 2014, in particular, seeing a sharp

dip, with the average for this period coming in below 2.5 years. This fall was driven by some particularly aggressive issuances, such as that of Alain Afflelou’s five-year fixed-rate bond, which had a 1.5 year non-call period. The average non-call period, however, did rebound in Q3 and Q4. In addition, the loosening of the equity-claw call from the previously market standard of 35 percent of bonds to 40 percent in a number of deals, following the trend in US high yield that started in 2013 and the rise in 2014 of the inclusion of a call option for 10 percent of the bonds at a price of only 103 percent, which increased in 2014, further marked the trend toward the erosion of call protection.

Meanwhile, as investors sought to reduce their exposure to potential interest rate rises, European high yield issuers responded to demand with an increase in floating rate note (FRN) issues, rising to 17 percent in 2014, compared with 11 percent for the previous year. While this part of the market has historically been popular lower down the credit rating spectrum, some large issuers such as Wind and Parex stepped into the market in 2014, pushing first call from the more standard 101 percent to par, although smaller issuers



While we will see a tightening of some of the call protection erosion, this is likely to be felt mainly by debut corporate issuers. But private equity sponsors will continue to push on these areas, and on portability in particular.

Michael Immordino, partner, White & Case

struggled to reach such terms, with several FRNs abandoned over the year as a result.

However, the volatility in the market following the summer also led to investors becoming choosier, leading to a slight increase in non-call periods towards the end of the year. These results can also be impacted by the length of the agreements in place—for example, it should be noted that this data includes bonds with lengthier maturities, which naturally have longer non-call periods.

“We’ve seen something of a reversal in non-call periods,” says Gernot Wagner, partner in White & Case’s capital markets practice in Frankfurt. “In the run-up to summer, we were seeing five-year bonds with one-year non-call. However, there was a move back towards the more standard five-year bonds with three-year non-call terms in the latter part of the year. That said, at times when demand from investors has outstripped supply, non-call erosion has remained a feature.”

Portability on the rise

Portability, which allows a change of control without a requirement to prepay the debt, is yet another example of the convergence between the loan and bond markets—in the European market, at least. This feature is primarily driven by PE sponsors seeking greater flexibility to exit portfolio companies and to attract potential buyers who value the ability to keep existing facilities in place following the acquisition.

In this area, Europe is leading the way: around 14 percent of leveraged loans featured portability in 2014, up from 8 percent in 2013.

Similar to European leveraged loans, portability became a more significant feature of high yield bonds in 2014. More than a quarter of issues (27 percent) in 2014 were portable, up from the 20 percent seen in the whole of 2013.

In the United States, by contrast, portability has not become a common feature, with high yield issuers instead focusing on shorter tenors and reduced non-call periods to gain the same advantage of flexibility around selling the business.



48%

US first lien loans that were cov-lite in 2014

However, there may be signs of a push-back among investors of this particular feature in European high yield. Leverage-based portability became increasingly common in Europe in H1 2014, with issuers such as Wind and Numericable taking advantage of the trend.

“While we will see a tightening of some of the call protection erosion, this is likely to be felt mainly by debut corporate issuers,” says Michael Immordino, executive partner for Italy at White & Case. “But private equity sponsors will continue to push on these areas, and on portability in particular.”

Alternative solutions

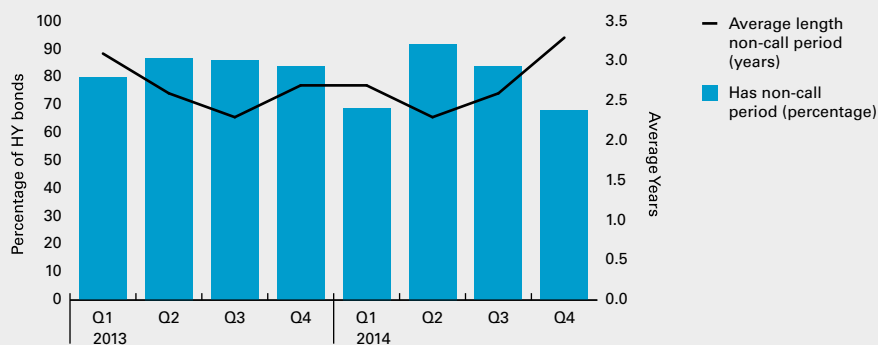
The emergence of alternative capital providers and solutions has led to further convergence of loan and bond terms, with traditional loan and



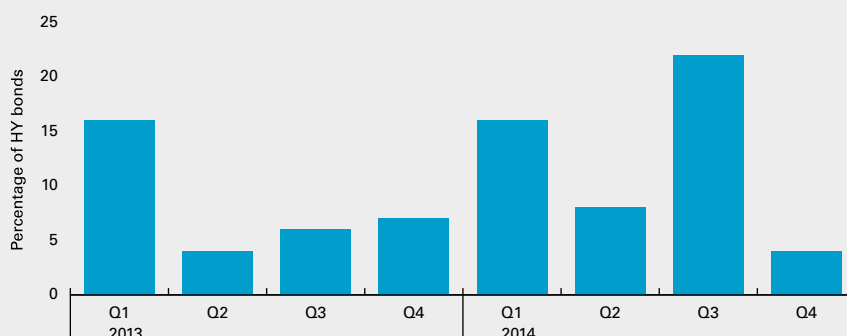
From a credit fund’s perspective, the issue of whether a debt instrument is term loan B or high yield is for many cases form over substance—the credit funds providing the capital are often not sensitive to this.

David Becker, partner, White & Case

Non-call periods (Europe)



Has 10% at 103% call redemption (Europe)



Source: Xtract Research



Private placements on the rise in Europe

Faced with an increasing need to diversify their sources of capital as bank lending has tightened, many European companies are looking to the private placement market—both in the United States and in the various European markets. While in 2010 fewer than 100 European companies issued bonds in the private placement market, by 2012 this had more than doubled. Most activity is cross-border, with European companies tapping the US private placement market, where traditional insurance company and pension fund investors have been joined by private fund investors. And with so much interest from European issuers, some US investors have set up European offices and are now offering euro- and sterling-denominated funding in addition to dollars.

On top of this, private placements have also seen markets develop in Europe, away from its US home territory. For instance, the UK and France have seen markets develop, and they are growing. In Germany, the *Schuldschein* market originally used by German states has become increasingly popular with corporates. Furthermore, several European industry bodies are looking to standardize documentation in an effort to develop a Europe-wide market.

This shift, together with the flexibility on quantum (the market can offer as little as US\$25 million or as much as US\$1 billion) and the fact that no credit rating is needed, are proving attractive to European companies as an alternative to bank lending.

While private placement terms reflect the long-term nature of this form of finance (some of these deals have a tenor of up to 35 years) and non-call periods generally remain long, there are some moves on terms. “We are seeing high levels of interest in European private placements from insurance companies,” says Michael Immordino, executive partner for Italy at White & Case. “That is offering a new form of liquidity in some markets, such as Italy. We’re seeing some deals being done under UK rather than US law and based on high yield covenants. In effect, this is creating new financial instruments.”

bond terms often being incorporated into hybrid financings.

“From a credit fund’s perspective, the issue of whether a debt instrument is term loan B or high yield is for many cases form over substance—the credit funds providing the capital are often not so sensitive to this,” says David Becker, partner on the White & Case London capital markets team. “They are seeking long-term yields for their investors. What’s of most importance to them is that they have call protection on their investment.”

In addition, US direct lending funds are also increasingly looking at the European market, while at the same time European funds are looking to the United States. US-based Ares Management, GSO Capital Partners and Crescent Capital Group have all recently raised Europe-focused funds. Meanwhile, Europe-based Quilvest Private Equity, Ardian and Generation Investment Management are all increasingly seeking US exposure through direct lending.

While the proportion of direct lending funds focused on Europe stood at approximately 20 percent between 2009 and 2013, there has been a notable increase in 2014,

with more than a third of all capital raised by these funds now focused on Europe according to Preqin figures (see table below).

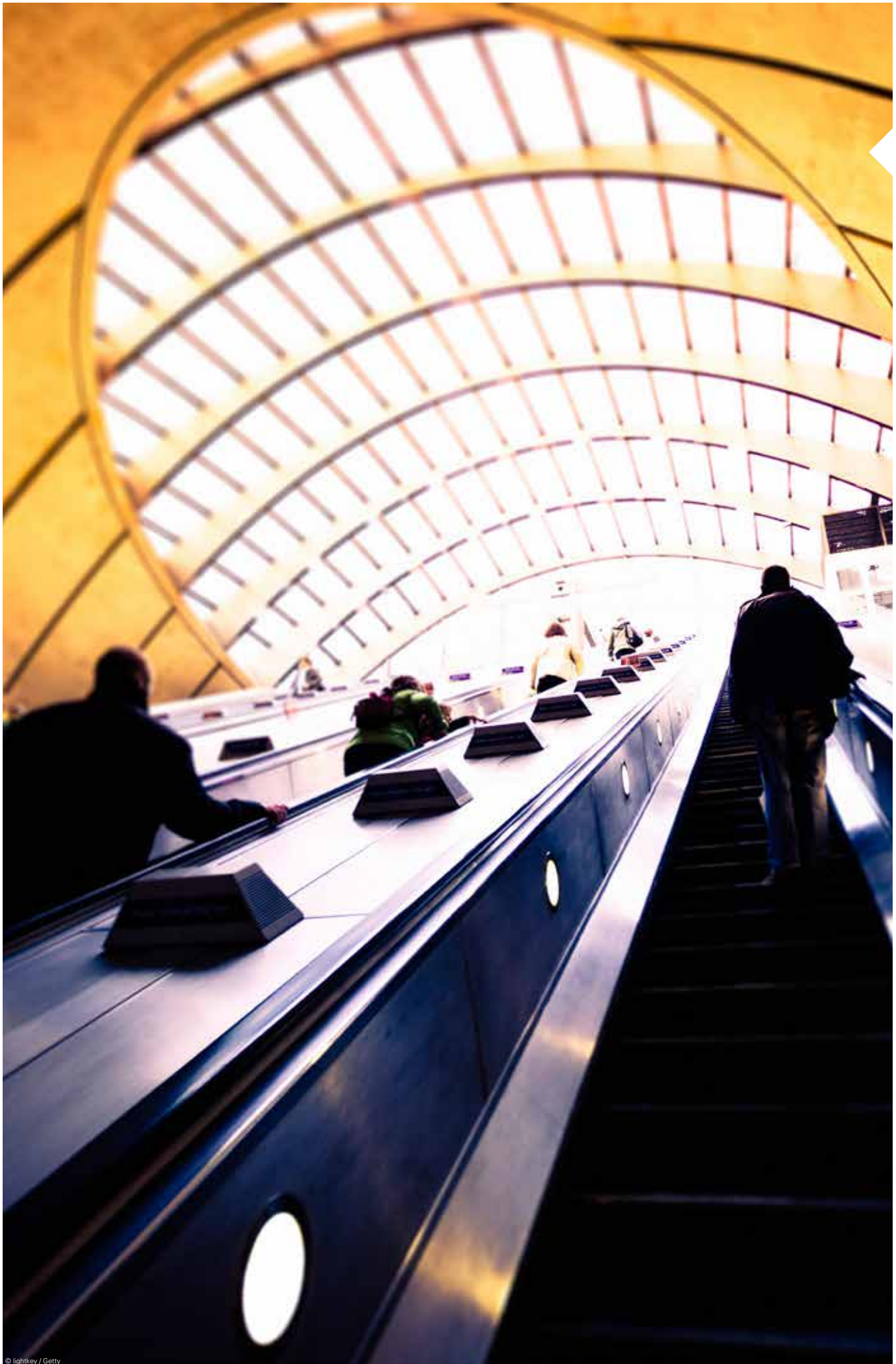
This accelerated internationalization of funding sources is leading to greater homogeneity between the United States and Europe, with European debt markets taking on some US-style terms such as cov-lite rather than following the slower, more evolutionary path towards borrower-friendly terms seen in the United States to date.

Indeed, as the European market has adopted US norms, so the proportion of the market accounted for by Yankee Loans has reduced. With the prospect of increased interest rates in the United States during 2015, it may be that this decline continues to some degree as pricing on Yankee Loans increases and borrowers look to potentially cheaper euro tranches, given that interest rates in the eurozone look set to remain low, at least for the medium term. In addition, regulatory scrutiny of the cov-lite phenomenon and multiple leverage limits in the United States may curtail the Yankee Loan market to a degree over the coming years.

Proportion of direct lending funds by geography

Year of final close	Proportion of direct lending funds		
	Asia & rest of world	Europe	North America
2009	17%	22%	62%
2010	17%	22%	61%
2011	15%	20%	65%
2012	17%	26%	57%
2013	13%	21%	66%
2014	15%	34%	51%

Source: Preqin



Commuters
at Canary
Wharf, London

State of play: Global debt markets positioned for growth

HEADLINES

- Western European loans and bonds bounce back in 2014
- Frontier markets see increasing leveraged debt demand
- Southern Europe rebounds after rough few years
- Private equity a key driver of European activity

Leveraged loan and high yield bond values and volumes were up in nearly all Western European markets in 2014. This is a testament to greater confidence around European recovery prospects—in the first half of the year, at least—and an increasingly liquid market, which led borrowers and issuers to capitalize on the favorable terms available from lenders and investors.

The rising loan and high yield totals were most apparent in Northern European countries, with the UK and Ireland, France, the Nordics and Benelux countries leading the way. In Southern Europe, growth continued from a relatively low base,



198

volume of European leveraged loans in 2014, compared with just 145 in 2013

with Spain's high leveraged loan value boosted by two deals—FCC and Grifols—which together accounted for €8 billion of the total. In Italy, the €3.75 billion Wind issue accounted for a large share of the country's high yield value increase.

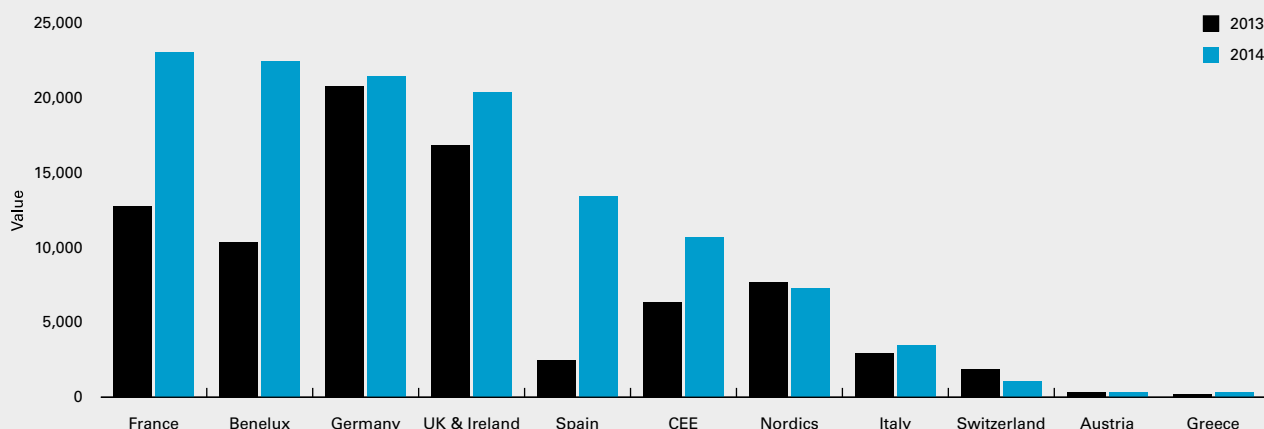
In Central and Eastern Europe (CEE), deals last year such as Polish mobile phone operator Play's €870 million high yield issuance in January 2014 exemplify a rising appetite for leveraged finance in the area. "There is an increasing level of sophistication in the types of deals happening," adds David Plch, partner and head of banking and FRI practice at White & Case. "Five years ago



Dividend recaps give sponsors the ability to, at least, recoup their capital invested. It's a trend that will continue as long as these assets remain in the portfolio.

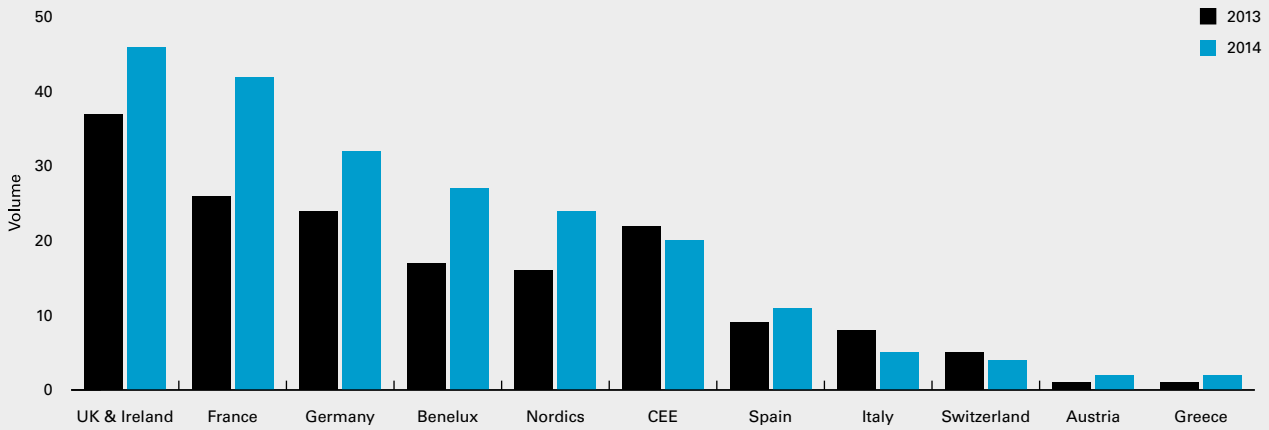
Gernot Wagner, partner, White & Case

Value of European leveraged loans by country (€ million)

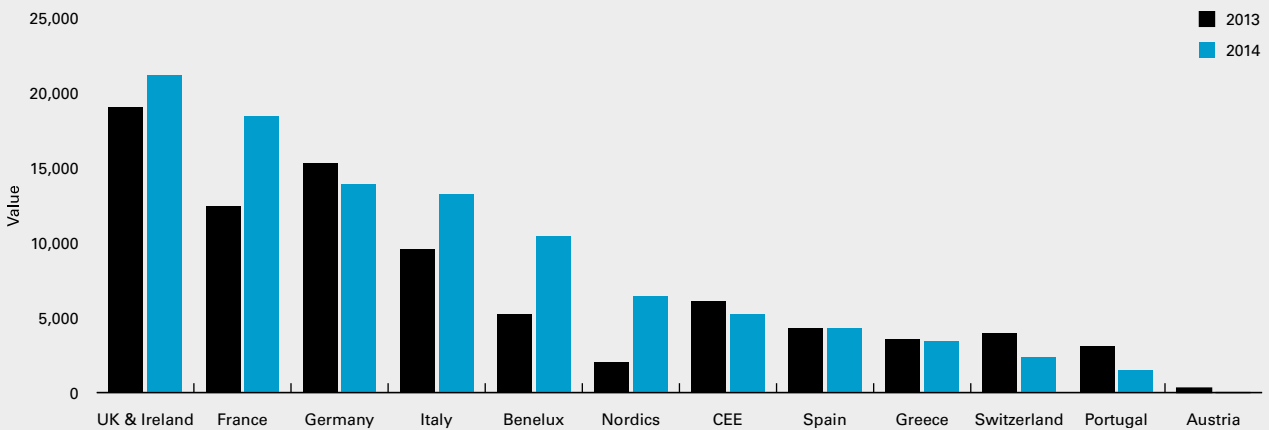


Source: Debtwire Analytics

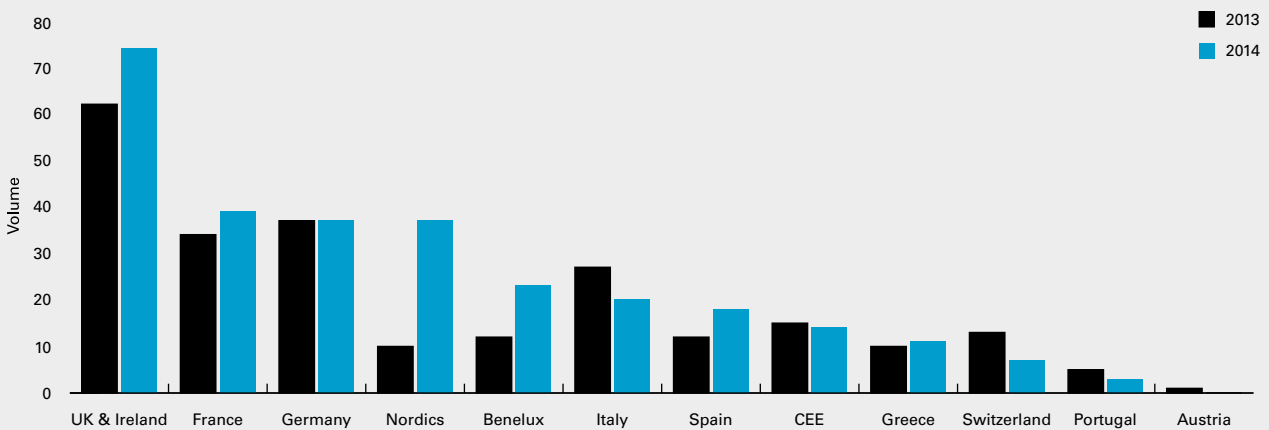
Volume of European leveraged loans by country



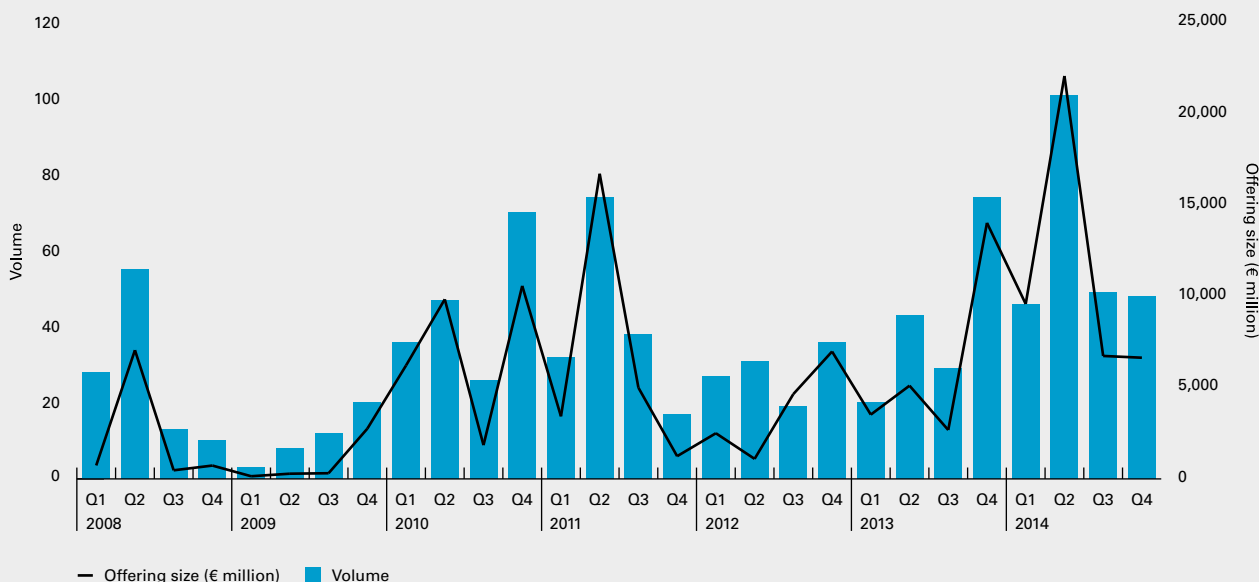
Value of European high yield bonds by country (€ million)



Volume of European high yield bonds by country



European IPOs



Source: Mergermarket

the market was completely bank-finance dominated. Now, successful regional companies that reach their lending limit, need flexibility or have an aggressive acquisition strategy are increasingly looking at the high yield market as a source of liquidity.”

One reason for this is “that CEE players are hiring more sophisticated CFOs and investment advisors to help broaden their investor base,” says Jonathan Weinberg, partner at White & Case. “This means the shock at the price CEE companies originally experienced when looking at bond deals is less relevant once they realize just how flexible bonds can be, both when you want to grow or are in trouble.”

Debt drivers

The return of dividend recapitalizations was a key driver of the high yield bond market’s growth in 2013 and 2014. The recaps, which hadn’t been seen since the crisis, started in 2012 as sponsors sought a means of returning capital to their investors in a difficult exit environment.

“Nearly all private equity exits we work on are triple-track, exploring the IPO, M&A and dividend recap options,” explains Gernot Wagner,

partner at White & Case. “With many of the pre-crisis deals struggling to attract valuations through IPO or a sale that would return adequate capital to sponsors, the dividend recap gives them the ability to, at least, recoup their capital invested. This trend will continue as long as these assets remain in the portfolio.”

More recently, PE sponsors have also looked to the PIK toggle as a means of generating cash from its investments. Eight out of the nine European PIK toggle transactions rated by Moody’s in 2013 were completed by PE sponsors—of which six were used for dividend recapitalization.

However, the softening of the market in the second half of 2014 has also stemmed the use of PIKs, according to White & Case partner Jill Concannon. “It’s a cycle,” she says. “When the market’s hot, you can do a PIK; when it isn’t, you can’t. The moment that led to the questioning of PIKs as appropriate was the Phones4U default in September, with them having issued a PIK toggle only a year before that. Although that wasn’t really anything to do with the PIK, it sent jitters through the market.”



€97
billion

Value of European high yield bonds in 2014 – 17 percent up on the previous year

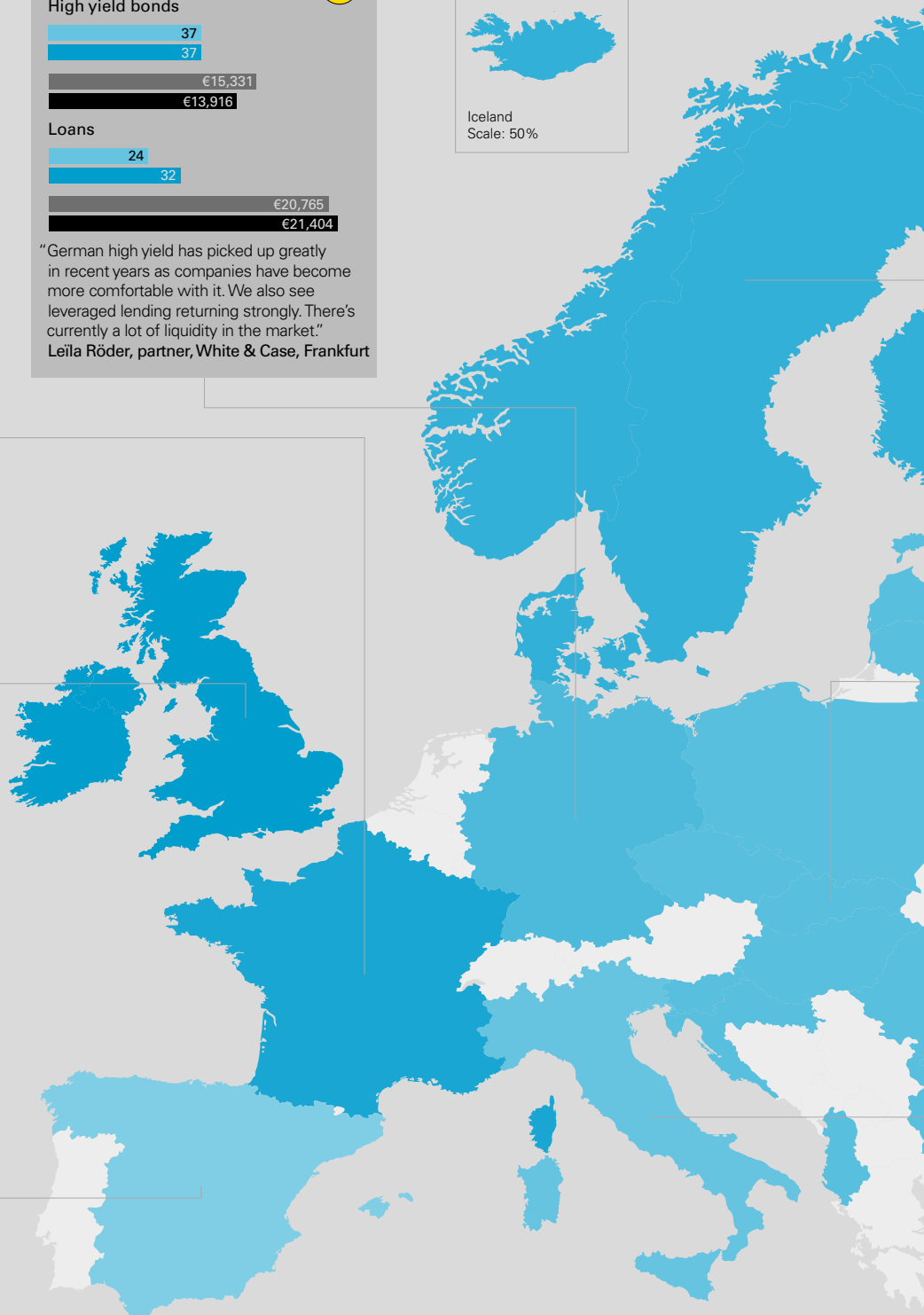
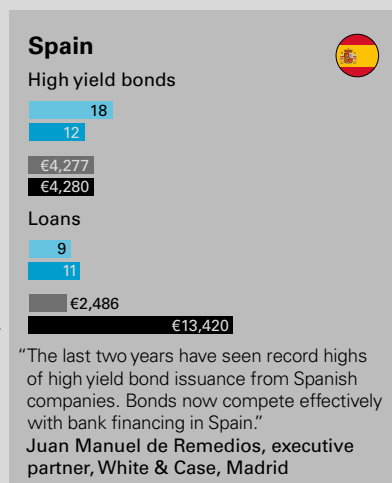
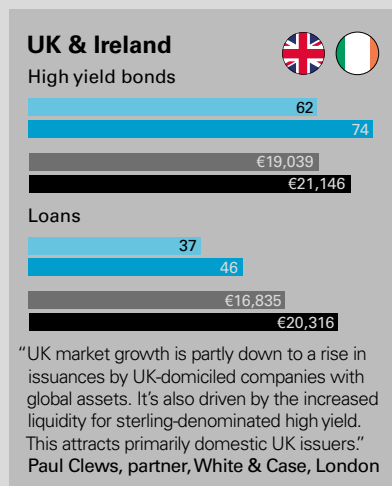
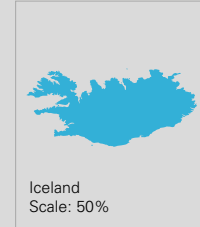
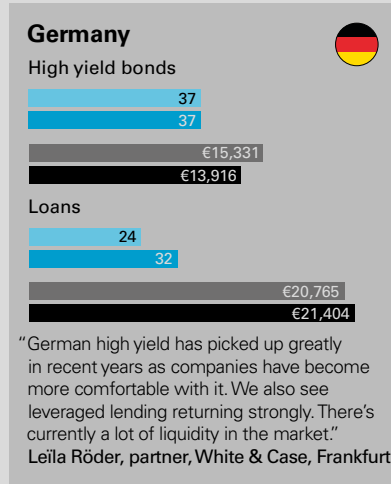
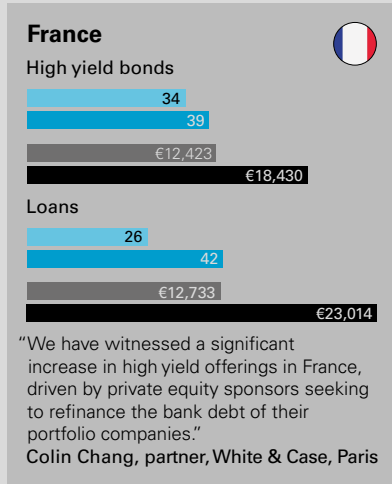


270%





Increase in Nordic high yield bond issuance year on year

European leveraged debt in focus



Selected European leveraged loan and high yield bond markets by volume



All graph legend

 Volume 2013	 Value (€m) 2013
 Volume 2014	 Value (€m) 2014

Map legend (overall activity ranking)

 Lowest	 Highest
--	---



The Nordics

High yield bonds

10 (light blue bar) 37 (dark blue bar)

€1,828 (light grey bar) €6,443 (dark grey bar)

Loans

16 (light blue bar) 24 (dark blue bar)

€7,696 (light grey bar) €7,238 (dark grey bar)

“The recent convergence of terms between Nordic countries, more acceptance of global features and new structures have led to a surge of international interest in Nordic markets.”
 Carl Hugo Parment, partner, White & Case, Stockholm

CEE

High yield bonds

15 (light blue bar) 14 (dark blue bar)

€6,109 (light grey bar) €5,265 (dark grey bar)

Loans

22 (light blue bar) 20 (dark blue bar)

€6,314 (light grey bar) €10,662 (dark grey bar)

“CEE growth is fueled in part by the strong Polish economy and the growth in manufacturing-based issuers across the region, including the Czech Republic.”
 Marcin Studniarek, partner, White & Case, Warsaw

Italy

High yield bonds

27 (light blue bar) 20 (dark blue bar)

€9,539 (light grey bar) €13,233 (dark grey bar)

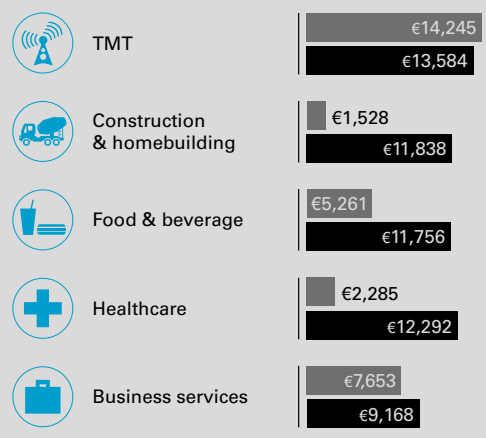
Loans

8 (light blue bar) 5 (dark blue bar)

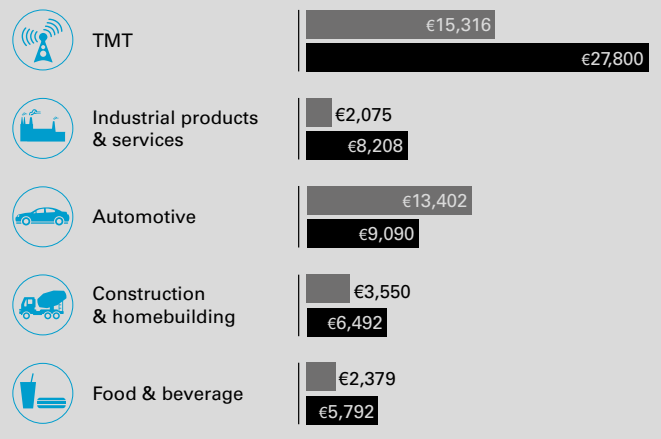
€2,920 (light grey bar) €3,464 (dark grey bar)

“Legislative reforms opened a path for private companies to issue bonds, leading to issuances by more corporate and PE-backed companies in recent years.”
 Michael Immordino, executive partner, White & Case, Italy

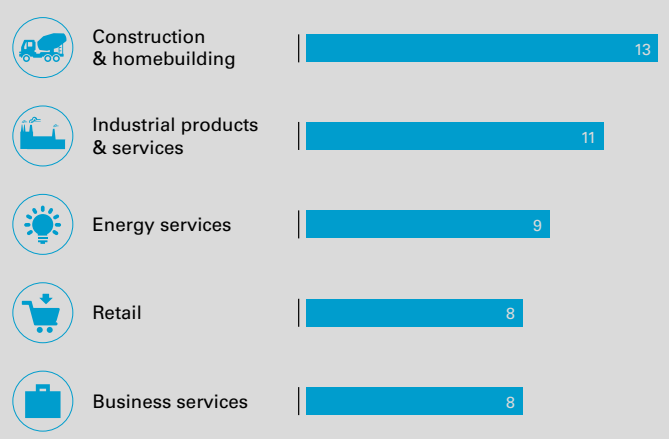
Top five most active sectors—leveraged loans



Top five most active sectors—high yield bonds



Sectors with highest number of debut issuers





Rest of the world

United States

While high yield bond issuance in the United States remained relatively steady over 2014, leveraged loan activity was more subdued. One of the main drags on lending for 2014 was the effect of increased regulatory scrutiny on the market. In particular, leveraged lending guidance published by the Federal Reserve and Office of the Comptroller of Currency in March 2013—which said that banks should avoid financing takeover deals that involve putting debt on a company of more than 6x EBITDA—was reiterated this year in letters from both public institutions.

However, appetite from US sponsors could continue to support leveraged lending figures for the year ahead. The trend towards rising leverage levels—nearly 50 percent of US leveraged buyouts had debt-to-EBITDA levels of 6x or more in 2014, according to S&P figures, the highest percentage since 2007—may be on the wane, which may lead to an adjustment of expectations among PE firms.

“The shape of the leveraged lending market in the United States will depend on how that adjustment plays out,” says Eric Leicht, partner and head of the Americas banking section at White & Case. “It may be that private equity will be prepared to accept lower debt quantum. However, they may also be able to find enough capacity among the unregulated funds to continue to do deals at multiples of over 6x. If that’s the case, there are a lot of deals that can be done in the United States.”

Africa

Interest in Africa seems to be increasing on a consistent basis. This is true in the debt capital markets space as well as bank financing.

“We had the BRICs first, now the MINTs, with the likes of Nigeria, which has now overtaken South Africa as the continent’s largest economy,” says Chris Czarnocki, partner on the White & Case banking team. “They are growing at a rate that isn’t seen elsewhere with any consistency. And this is happening across numerous countries in West and sub-Saharan Africa.

“The economics of it also dictate that this isn’t a trend which will subside. Quite the contrary—stats indicate this will be an active part of the world, and more active than many others.”

Middle East

This market is currently not as developed as others but it is growing, and is very much location-dependent. In particular, companies in Turkey have started to look for high yield financing solutions, including hybrid high yield/project bonds for infrastructure.

In the Gulf States, however, many potential high yield issuers are able to issue investment-grade

bonds because the ratings agencies notch up the ratings as a result of sovereign support.

“If you look at the potential for high yield issuances in the future, countries such as Turkey and Egypt, with a developed middle class and companies that cater to the middle class, are primed to develop their markets,” says Sean Johnson, capital markets partner at White & Case. “In the markets where many of the enterprises are state-owned and the state itself has a high credit rating, there is less potential for a high yield market to develop in the future. Further, bank financing has been the traditional source of financing in the region and bonds are still an outlier as a capital source. However, this bias towards loans has started to change with the development of a robust sukuk capital market.”

Asia

Convergence of markets is also inevitable in Asia, although influenced by different geopolitical factors. A primary driver of the growth of global finance in many Asian jurisdictions is the more cautious approach taken to international investment. For example, India recently clarified regulations to prohibit certain off-shore funding arrangements designed to allow international creditors to gain indirect security over on-shore assets. At the same time, market strategists are predicting favorable economic reforms in 2015 under anticipated new fiscal policies from the Modi government.

In addition to regulatory constraints, international investing in Asia is also influenced by a number of factors, including the availability of local financing in local currencies, the uncertainty of insolvency or enforcement regimes (when secured lending is permitted in the first instance), currency controls, the unavailability of on-shore credit support, language and cultural barriers and, in the case of high yield offerings, the challenges of preparing offering documents to international standards.

Also, while the historical development of the international Asian bank lending model (UK law) and the high yield model mirrors the European infrastructure, including the emerging use of high yield bond and term loan B structures and protections, the factors above, together with more technical aspects of establishing proper protections for multiple creditor classes, increase the challenges for multi-tier bank-bond structures.

“While the continued internationalization and convergence of the Asian financial markets seem inevitable,” explains Kaya Proudian, partner in White & Case’s Singapore capital markets group, “factors unique to the region add additional challenges and opportunities.”



Rebuilding abroad

International restructuring tools can also provide value preserving options for companies looking to restructure their debt, as demonstrated by the increasing flexible and prevalent use of the UK Scheme of Arrangement. Below we highlight four key points to consider in relation to UK Schemes of Arrangement.

Access for foreign companies. While foreign companies using UK Schemes of Arrangement as a means to restructure their debt obligations have been increasingly prevalent in the last few years, the sanction of German parking solutions company APCOA's recent Schemes of Arrangement (see case study, right) was one of the hottest topics of the 2014 restructuring market. APCOA represents the first case where a company amended the governing law of its finance documents in order to create sufficient connection with the UK to avail of its restructuring tools. APCOA otherwise had no real UK assets or connection. "APCOA represents a milestone in the market because it was the first case where sufficient connection was based on a change of governing law of the company's finance documents. Of course, such proposals are not without risk and need to be considered on a case by case basis taking all relevant factors into account," says Laura Prater, partner in the financial restructuring and insolvency group at White & Case, London.

It's flexible. The scheme provides a flexible means of negotiating restructurings through a court-sanctioned compromise. This can include relatively simple amends and extends and debt for equity swaps all the way through to highly sophisticated and complex compromises. The threshold to approve a scheme is 75 percent by value and majority by number of each class of creditor present and voting, and it has the effect of binding dissident creditors to the arrangement.

An option other than a COMI transfer. Transferring the center of main interests (COMI) of a group company to avail of the UK jurisdiction can be challenging and administratively burdensome. The APCOA decision has paved the way for foreign companies to consider another option when looking to take advantage of the flexibility of the UK restructuring tools. "Do we think this will lead to a rush of foreign companies looking to change the governing law of their finance documents to avail of the UK jurisdiction? Not necessarily," says Prater. "However, the ability to change the governing law of a company's finance documents, with relatively low creditor consents, to create sufficient connection to the UK jurisdiction has been a long debated topic amongst restructuring lawyers, and there is no doubt that this precedent will lead to other companies considering this as an option."

A value preserving option in a growing bond environment. With high yield instruments becoming increasingly prevalent, the flexibility offered in the form of a UK Scheme of Arrangement, should a restructuring be necessary, is certainly a plus for foreign companies. "The increased flexibility of UK Schemes of Arrangement as a restructuring tool is a very welcome development, particularly as we see the European high yield bond market deepening and lower-rated companies issuing" says David Becker, partner on the White & Case London capital markets team. "Over the next few years, we may well see some of these having to undergo a restructuring, and the smoother the path, the better for borrowers and creditors alike."

CASE STUDY: APCOA PARKING

APCOA has been one of the hottest names in the restructuring market in 2014. It broke new ground in relation to an "amend and extend" scheme in early 2014 when it established sufficient connection to England off the back of a change in governing law. This was followed by a second scheme in late 2014, which was aggressively opposed, and its sanction by the High Court was appealed to the Court of Appeal (although ultimately the appeal was withdrawn).

The APCOA group is a leading car park operator managed by its German parent, APCOA Parking Holdings GmbH, with operations across Europe. The group was in severe financial distress and needed to find a way to restructure its debts in the face of dissenting creditors.

In recent years, schemes have become the international restructuring tool of choice in part because of their flexibility and the sophisticated compromises that can be implemented under them. They can also be used to override unanimous contractual provisions and implement restructurings, with the consent of 75 percent by value and a majority in number of creditors present and voting at a creditors meeting. However, in order for a foreign company to use a scheme, it must have "sufficient connection" with the UK. Grounds for "sufficient connection" include where the company has assets or operations in the UK, or financing arrangements governed by English law. More recently, it has also been achieved by shifting a company's centre of main interest to the UK.

APCOA had no real assets or operations in the UK, it was not in a position to shift its center of main interest and its finance documents were German-law governed. However, APCOA was able to change the governing law of its facilities agreement from German law to English law on majority lender consent. Before APCOA, it was unknown whether the English courts would sanction this as a legitimate way of creating sufficient connection. The uncertainty was answered when the Court sanctioned the APCOA scheme of arrangement, allowing APCOA to use a scheme to restructure its debts. Following the court's judgment, we can expect that other foreign companies, otherwise lacking the ability to assert sufficient connection, will use APCOA as a precedent for this route to establish sufficient connection and to take advantage of the flexibility provided by a scheme and UK restructuring tools.

World
Financial
Center,
China





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Leveraged debt markets in 2015: The convergence era

Europe's leveraged debt markets experienced a huge upheaval in 2014. The volumes and values increase significantly, and the very nature of the market changed and expanded. As a result, investors, products and the markets became more integrated across Europe and the world.

Several factors have underpinned these developments. The rise in private equity activity has guided the loosening of regular covenant protection in high yield bond markets, while leveraged loans received a boost as M&A activity picked up, particularly in the telecoms sector, with corporates and sponsors competing for deals. New precedents are also being set around covenants: Incurrence-based covenants have become increasingly prevalent in European loans, allowing sponsors and corporates to negotiate more US-style terms for their deals. The growing popularity of these deals could build to a wave of deals similar to those seen in the United States.

Formerly risk-averse investors are now looking across the European leveraged debt market spectrum in search for yield as central banks keep interest rates low. This trend has come to the fore as CLO issuance picks up across Europe. At the same time, alternative capital structures that benefit from these developments are on the rise.

Europe's mature markets, such as France and the UK, have shown growth in leveraged debt, but a major part of the growth story has been in markets that had been rocked by a series of economic crises. Spain's leveraged loan market, for instance, has returned in part due to a booming construction sector, while high yield demand is expected to increase.

The European leveraged finance market will continue to converge

in 2015 and beyond from a number of perspectives, each of which presents new opportunities and challenges for issuers and borrowers alike:

Convergence of markets. Historic differences in approaches due to legacy lending and diverse country-by-country infrastructures will continue to give way to a more global market.

Convergence of investors. In the loan market, US investors looking for global investment opportunities will meet European corporates and sponsors seeking dollar-denominated borrowings. In the bond market, classic Eurobond international investors seeking high yield risk will meet high yield investors expecting US-style deal constructions.

Convergence of products. As high yield bonds solidify their place as a mainstream financing alternative in Europe, term loan B emerges as the cov-lite alternative in the loan market, with New York law and English law becoming more interchangeable alternatives within product groups. In addition, the emergence of alternative finance providers could see an even greater blurring of lines and the rise of hybrid finance structures, as investors continue to search for yield.

Market participants, encouraged by these developments, will continue to push barriers as new products and markets develop. On top of this, companies with existing debt, or sponsors considering transformative transactions, will start to think laterally about their capital as markets and courts become more receptive to precedent-setting deals. As markets, investors and products continue to meld, issuers and borrowers must adapt to these changing conditions to reap the most from leveraged debt.



The European leveraged finance market will continue to converge in 2015 and beyond from a number of perspectives, each of which presents new opportunities and challenges.

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