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Debt Markets

The debt advice market has mushroomed in recent years. We take a look at what owner managers need to know

Integral role

Nearly a decade since the financial crisis struck, the European funding market has changed significantly and the debt market has grown exponentially, with hundreds of new alternative lenders now ready to finance company growth plans. This environment has in turn created a part for debt advisors who can play an integral role in guiding company owners through this complex range of choices when it comes to determining a suitable capital structure for their needs.

The funding market remains one of two halves. Since the economic crisis large companies have been generally seen as safe havens by lenders with a flight of capital to quality and size.

By contrast, smaller companies have continued to face greater challenges in terms of raising finance. As such, alternative lenders – a catch-all term describing a wide range of non-bank institutions – are busy trying to enter this space, and in so doing financing ever larger deals while also deploying different structures.

Leading accounting and boutique corporate finance advisory firms are growing their teams in this space and competing with traditional investment banks by offering a full range of debt advisory services.

The central role of a debt advisor is to help companies identify the best capital structure for a particular business and its shareholders, and then optimise the debt package and the source of that funding.

Debt advisors can also:

- help companies develop business plans and analyse investment projects
- assist businesses in identifying key risks as they develop optimal structures of financing
- organise competitive lender selection processes enabling clients to raise the optimal finance structure in a timely manner
- negotiate debt terms and help business owners understand movements and risks in debt markets

The funding options

There is a vast range of funding options for companies looking to secure new investment or to restructure existing loans. These include: senior bank debt; syndicated and club deals; unitranche; bond issues; private placements; bridging finance; junior financing; senior stretch; and securitisation.

We are seeing increased cooperation between alternative lenders and banks. Banks are partnering with funds, providing super senior and senior ranked facilities. Indeed, a number of banks and alternative lenders have recently created formal and informal partnerships to create packaged finance. For instance, The Royal Bank of Scotland formed a joint venture with asset managers AIG, Hermes and M&G.

Rise of debt funds

Debt funds are taking an increasingly large slice of the mid-market. One of the attractions of this funding model is that larger firms are able to underwrite a single tranche of debt and provide a speedier alternative to bank clubs or the bond market.

As the market has rapidly matured there has been a notable increase in the suite of financing options that a debt fund will offer, such as first-loss second-loss structures and senior stretch. Funds are also increasingly willing to take minority positions and co-investments as they look to differentiate themselves from their competitors.

The specific terms that a debt fund would offer very much depends on the size of the business in question and the risk. For a unitranche loan the terms would typically be 600-900 basis points (6-9%) above a LIBOR floor, while the terms would have up to three financial covenants based upon the size and risk of the transaction.

Viewpoint: Andy Stewart, Consultant, JCRA

Tell us about JCRA?

We are independent hedging advisors, focused on interest rate and FX risk. We are a complement to the debt advisor and part of our role is making other advisors in the transaction aware of the impact of any hedging, preferably well in advance of the deal completion. Too often, we find that the hedging is considered a peripheral issue, and at worse, an afterthought which can lead to suboptimal outcomes further down the road.

What has been the impact of regulatory change?

The post financial crisis world is all about creating transparency in what are very opaque financial markets. This desire for transparency increases the documentation companies must complete, and can lead to significant delays in executing a derivative. For example, under EMIR (European Market Infrastructure Regulation), all counterparties (companies and financial institutions) have to report their derivatives transactions to the trade repository regardless of size and declare their counterparty classification, which can be arduous to say the least.

What has been the effect of continued low interest rates?

The low interest rate environment has meant swap rates (fixed rates) have continued to fall in the UK over the past few months, allowing borrowers to fix their cost of debt at a lower rate than current floating LIBOR. Of course, many would take the view that they don't need to hedge now as rates are so low. However, it actually makes a lot of sense to hedge at the point where it is 'cheap' to do so such as when the market is expecting a low probability of the event which you are hedging against (i.e. rising rates). It seems odd that businesses were hedging their interest rate risk at rates of 4.5% only a few years ago, but are cautious about hedging at 0.40% because they think they might get a better deal if they wait.

Are there risks from low interest rates?

Yes, definitely. A bank's profitability is determined by net interest margins and these are incredibly tight when rates are low, further adding to the pressure of increasing capital requirements. For a borrower, paradoxically, the risk is rates moving into negative territory (as they have done already in other European markets). Lenders hedge against this by putting in place interest rate floors (minimum rates of interest). In putting a debt facility together, debt advisors need to be aware that these floors are not benign. It is effectively a sold option by the borrower and can have material repercussions for accounting as well as any hedging strategy.

What has been the impact of Brexit so far?

I am fairly bullish on the long term economic outlook, although the short-medium term impacts are still to be fully felt. The uncertainty will definitely mean more volatility, particularly in the currency markets. We have had a large increase in clients looking to hedge GBP currency risk (particularly versus USD), and this looks set to continue as they try and pin down as much certainty as possible for the months ahead.

European market

2016 has been marked by considerable volatility in global equity and bond markets amid concerns over China's growth slowdown, the impact of sustained lower global oil prices and Brexit. As such, European banks and funds have become more cautious of certain cyclical and discretionary spending linked sectors with lenders tightening terms and reducing appetite.

The mood is borne out in recent figures[1] which show that private debt fundraising over a rolling five-year period rose to €413bn this year, compared with €353bn in 2015 and €284bn in 2014. However, of this year's figure €340bn was raised by North-American headquartered organisations compared with €73bn by those in Western Europe.

Yet European funds still have plenty of dry powder, especially to invest in the mid-market, while a record number of new funds have also been raised across the continent in the last 18 months.

The mid-market is still dominated by the banks, representing two thirds of all deal participations tracked in 2015[2], however there is an increasingly diverse mix of non-bank lenders active at both the lower (sub €20m bilateral debt) and upper (club/syndicated deals above €200m) ends of the market.

Unitranche financing

One of the biggest shifts in the market has been the increased penetration of the unitranche product by non-bank lenders. Ares, Alcentra, BlueBay and Permira Debt Managers are among the most active unitranche lenders, and unitranche facilities are expected to continue to play a key role in mid-cap leveraged buyouts as new players enter the market and incumbent funds raise ever larger funds.

[1] Private Debt Investor

[2] Alix Partners: Midmarket Debt Survey - 2015 (Europe)

Viewpoint: Colin Wright, Director, European Capital

Tell us about European Capital?

Founded in 2005, European Capital has teams in London and Paris and provides flexible debt products, mostly in the form of unitranche and mezzanine loans to mid-market companies. In recent years we have made the transition from investing balance sheet capital to investing funds raised with external investors.

We are currently deploying our first two funds raised with third party investors. One is a £100m UK SME fund set up in partnership with the government-backed British Business Bank, and the other is a circa €475m pan-European mid-market direct lending fund. Over the last year we have invested in nine companies across the UK, France, Netherlands and Spain.

What do you look for in a deal?

Companies which have market leading positions that are defensible and with high quality ambitious management teams. Understanding their business models and thinking how we can tailor solutions appropriately is one of the most interesting parts of our job. We've invested in a wide variety of sectors over the last year, including: housebuilding for housing associations (Westleigh); consultancy services for pharmaceutical companies (Xendo); herbal extracts (Euromed); educational services (Inseec); and food products (Poult).

What do you see as the main advantages of debt funds over banks?

Debt funds can offer greater flexibility, in particular on structure and with covenants, and can put together loans that are bespoke to a company's needs. A good example is Westleigh where we were able to structure a loan that was more flexible than a conventional bank approach to the housebuilding sector and which gave the business room for growth but retained asset cover protection for us as a lender.

Another advantage is that debt funds operate with small teams and this can bring benefits of speed of execution with direct access to decision makers and short credit processes. Furthermore, the team making the investment will be the same as that looking after the investment throughout its life, irrespective of how well or not the business performs.

Do you see debt funds continuing to grow?

Definitely. Debt funds have now taken a big share of the lending market following a growing understanding of the benefits by advisors and PE sponsors. On the supply side there has been strong appetite from investors and significant long-term capital raised in recent years which looks set to continue.

What has been the impact of Brexit so far?

For new investments it is still early days, but we think Brexit will present an opportunity for direct lending funds like us with long-term capital to invest. Bank lenders are likely to be more risk adverse and selective on which opportunities they pursue.

For portfolio businesses we have not had any material impact to date on the movement in exchange rates post Brexit. The more significant question will be how consumer spending develops over the coming months and the impact on the broader economy.

Country Focus

UK

Despite reduced activity in the syndicated loan market, appetite for private debt deals – from both banks and debt funds – remains very strong. Strong M&A activity in the mid-market continues to drive debt transactions, albeit some caution has been felt since Brexit.

We expect to continue to see new players enter the market, while various existing institutional lenders are in the process of raising new funds. High levels of liquidity in the debt markets continues to yield structures with high leverage, lower pricing and more flexibility on terms for strong credits.

Case study: Westleigh

Westleigh is one of the largest UK housebuilders focusing on the affordable homes market and expects sales to rise to around €200m by 2018. Three years ago the company employed Clearwater International to undertake a strategic review to support both its growth and succession plans in order to capitalise on this fast-growing market.

In 2016 this led to the sale of a minority stake in the business to Palatine Private Equity with debt funding provided by European Capital and AIB. The deal will now help Westleigh continue to flourish in what should remain an attractive market for many years due to the shortage of housing in the UK.

Chairman and co-founder of Westleigh Chris Beighton explained: "The strategic review led by Clearwater provided a clear direction for the business, and the key milestones we needed to reach to achieve our goals. Via attendance at board meetings Clearwater managed our transaction agenda and continued to input into our strategy. When it came to executing the deal Clearwater mobilised a diverse multi-skilled team so that private equity, debt options and wider strategic choices could be benchmarked concurrently. The team inspired us to stretch our business and go a yard beyond what we might otherwise have achieved."

Germany

The first quarter of 2016 saw half the number of transactions[1] compared to the previous quarter. The majority of the deals were club financings as syndicated market conditions remained challenging.

Senior banks are increasingly participating in unitranche structures for mid-cap LBOs as debt funds become more prominent in the market. Competition in the mid-market remains high given the number of active players, so pressure on fees and margins is likely to remain. Meanwhile, there is evidence of the wider acceptance of unitranche structures in the market.

France

2015 was a strong year in France's acquisition finance debt market as a result of a surge of alternative lenders providing financing. However, although alternative lenders are gaining market share, banks are still very active. For instance the main restructuring advisors continue to be investment banks such as Lazard and PJT Partners. Yet new players such as accounting or management consulting firms are growing rapidly.

Denmark

The market is still driven by the large Scandinavian banks delivering acquisition finance packages. However, PE groups have started to show interest in unitranche debt structures where bank and alternative non-bank lending is combined. UK non-bank debt providers are, together with a small number of Scandinavian players, showing interest in the less developed Scandinavian market and we expect to see growth here.

Spain

Although banks still provide more than 80% of debt financing to the corporate sector, it is expected that their market share will fall as a consequence of the capital requirements imposed by Basel III rules. Larger mid-size companies are starting to more frequently use capital markets for bonds issues, typically around €100m each issue, but smaller companies cannot enter this pool of finance and this has created an opportunity for direct lending funds, both domestic and foreign. Meanwhile pension, insurance and other institutional investors are now starting to allocate a small fraction of their liquidity to this asset category.

Ireland

Reduced competition has prevailed in recent years stemming from the financial crisis, which has led to a credit gap in the Irish SME market. To fill this gap the government, through the Irish Strategic Investment Fund (ISIF), has provided direct funding to alternative lenders such as BlueBay Asset Management, the Strategic Banking Corporation of Ireland, BMS Finance and WLR Cardinal Mezzanine Fund. Swedish PE house Proventus and Pricoa Capital have also been active in the market. The invoice discounting market is competitive with players such as Aztec Finance, Bibby Financial Services and Credebt Exchange.

[1] Altium European mid-cap monitor

Conclusion

Debt advisors are playing an ever-increasing role in not just helping company owners choose the right financial instruments for their business, but also in terms of offering advice on their wider company plans in order to maximise growth potential and market opportunities

Given the fast-moving nature of the finance industry - typified by the rise of unitranche financing, debt funds and alternative lending options - successful advisors also need to take a very flexible and pragmatic approach built upon long-standing and trusted relationships with their clients.

Some of our recent deals

Our Debt Advisory team is very active across its geographies and has undertaken a wide range of transactions, including: acquisition finance; refinances; recapitalisations; working capital funding; capital markets and bonds; real estate; and restructuring.

Day Lewis Group

Independent pharmacy chain

Clearwater International advised the shareholders of Day Lewis Group on securing €200m of revolving committed debt and €60m accordion from a club of banks

Reverse Logistics

Reverse logistics services

Clearwater International advised Reverse Logistics on the structuring of two loan notes facilities with RiverRock

Beech Properties

An award winning property developer and lettings business

Clearwater International advised Beech Holdings on raising finance for further development

TXM Plant Ltd

Provider of specialised operated equipment hire to the rail industry

Clearwater International advised private equity firm LDC on raising a bespoke debt package to fund the MBO, with funding provided by PNC Business Credit

Verdant Leisure

Boutique holiday park operator

Clearwater International advised Palatine Private Equity on the secondary MBO of Verdant Leisure, including raising senior and junior debt facilities from Yorkshire Bank and Tosca Debt Capital respectively

Meridia Capital Partners

Spanish private equity group focused in real estate

Clearwater International advised Meridia on a debt raise to purchase real estate in Spain

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