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MARKET REPORT

European Mid-Market Debt Update

Socially Distanced Deal Making Goes Viral as Economy Prepares for Recovery from Pandemic

Spring 2021

European Mid-Market Debt Update

Executive Summary

After an excellent start to 2020 in Q1, deal count contracted heavily in Q2 and Q3 as the pandemic unfolded and lenders focused inward, supporting existing clients. In some countries such as the UK, decreased deal count was also compounded by banks facilitating government loan schemes. While market sentiment improved over the summer, we didn't see a strong rebound in deal activity until Q4 2020. Key drivers for the rebound included pent-up PE demand and high levels of debt fund dry powder. The desire to deploy capital, combined with a flight to quality and heavy focus on COVID-19 insulated credits, resulted in a supply and demand imbalance and led to pricing and lending terms reverting to pre-pandemic levels.

The pandemic has accelerated the growth of market share held by debt funds. Banks remain cautious on 'new-to-bank' lending and have shown less appetite for super senior revolving credit facilities (SSRCF), resulting in increased borrower reliance on bridge financing by debt funds.

Deal count in the UK asset backed lending (ABL) market was less volatile compared to the leveraged loans space. However, ABL focused heavily on the smaller end of the market and on existing clients with very low levels of new LBO financing.

Fueled by optimism as various vaccines are rolled out, near record levels of liquidity and strong appetite for M&A, the strong deal momentum witnessed in Q4 2020 has continued into Q1 2021 and will likely drive activity going forward. However, there are reasons for caution. The unprecedented levels of emergency liquidity measures and government support will eventually dry up and need to be repaid, while at the same time many companies will need capital to finance renewed growth. We query how quickly lending appetite for more cyclical sectors will resume and, with the growing importance of environmental social and governance (ESG) considerations, some sectors may be in (even) less demand. The potential resulting funding gap may need to be plugged by ABL, or more expensive pools of 'special situations' capital, or else may result in higher levels of restructuring. Finally, the transition away from LIBOR/EURIBOR and the aftermath of Brexit may be unwelcome distractions during 2021.

European Debt Mid-Market Survey

Our inaugural survey covers leveraged loan transactions completed by over 50 mid-market lenders between July and December 2020 (H2 2020). Our survey focuses on the mid-market, which we define as transactions with total debt of between EUR 20 million (mn) and EUR 300 mn for leveraged loans and between GBP 5 mn and GBP 250 mn for ABL transactions. We asked debt funds to submit deals completed across Europe, however bank lending and ABL have a UK focus. We will consider expanding the geographical reach in future surveys.

"We are excited to present the spring 2021 edition of our quarterly market update, in which we provide the results of our inaugural debt mid-market survey, tracking deals completed by over 50 mid-market lenders in H2 2020.

We are also delighted to have witnessed a strong recovery in mid-market deal-making from Q4 2020 onwards. We discuss some of the key trends seen in 2020 and our outlook for 2021 in this report. Please do not hesitate to reach out to any of us in the European Debt Advisory team at Duff & Phelps if you would like to discuss the contents of this report or a potential new transaction."

J. Brouwer

Jacco Brouwer
Head of European Debt Advisory

Report Contents

Leveraged Loans – Key Trends

1 Strong Rebound of Deal Activity in Q4 2020

Following a strong Q1 2020 (175 debt deals recorded), COVID-19 resulted in a materially reduced deal count in Q2 (97) and Q3 (89)[1]. During this period, banks and debt funds were focused on existing clients and portfolio companies, and many effectively turned off new-to-bank/fund lending. Reduced loan supply alongside increased risk premiums caused a temporary spike in yields and M&A deal count dropped by over 30% between Q1 (253) and Q2 (171). [1]

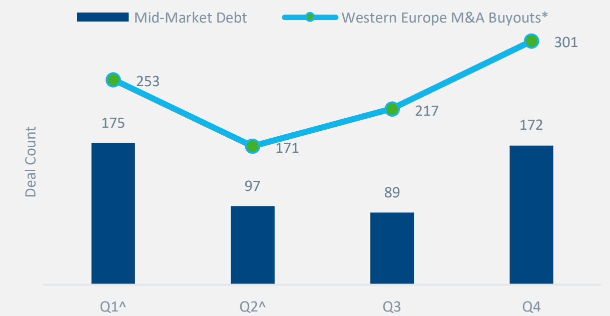
Whilst market sentiment improved over the summer, we didn't see a strong rebound until Q4 2020 in both mid-market debt deal count (172) and M&A deal count (301). Key drivers behind this strong recovery included:

- Significant debt fund dry powder looking to be deployed;
- Completion of previously started M&A processes that were put on hold due to COVID-19;
- Businesses that saw little, or even a positive, impact from COVID-19 taking advantage of favorable bias towards defensive sectors and going to market to either sell the business or raise debt capital. 69 percent of our surveyed debt transactions during H2 2020 were in sectors that could be considered defensive (see sector graph). The desire to focus capital deployment on defensive credits quickly led to pricing and terms in those sectors reverting to pre-pandemic levels; and
- Fears about potential changes to UK Capital Gains Tax rules contributed to the number of lower mid-market deals that came to market. Our survey results showed that 39% of all debt financings were below EUR 50 mn, which is above the historical levels of 20-30%.

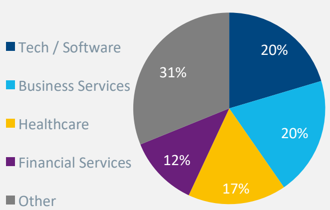
The trend of private debt funds taking market share from banks appears to have accelerated. Based on our survey, in H2 2020 non-bank lenders accounted for 77% of UK deals, compared to historical levels of approximately 60%. This trend was also reported by LCD. [2] This applied across the deal size spectrum, with non-bank lenders accounting for 78% of UK deals with a debt size above EUR 200 mn. Deals above EUR 300 mn, which are typically funded via the syndicated loan market, are attracting funding from debt funds at an increasing pace. A recent example includes the Ares Management led GBP 1.88 bn unitranche for Ardonagh Group. This has allowed direct lenders to gain both market share and access to larger and perhaps higher quality credits.

Market participants commented that lenders broadly remained very supportive to borrowers that were impacted by COVID-19.

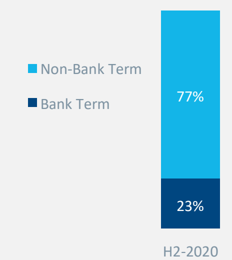
European Mid-Market Debt & M&A Deal Count [1]



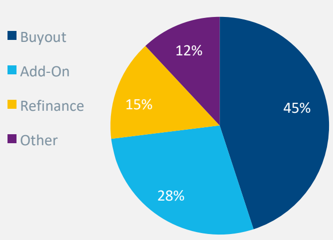
Sector



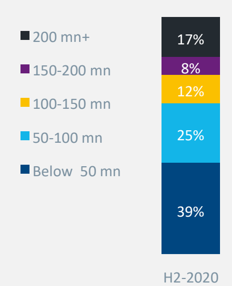
UK Bank/Non-Bank



Deal Purpose



Transaction Size



Source: D&P 2020 H2 Debt Mid-Market Survey

Notes:

1. M&A deal volumes have been sourced through Mergermarket, Western European 2020 Review. Mid-market Debt deal count figures for Q1 and Q2 have been sourced through Debtwire Par, December 2020 mid-market snapshot.
2. LCD, "European banks mull retreat from super-senior tranches, including RCFs", 24 February 2021

Leveraged Loans – Key Trends

2 Lender Activity Tables

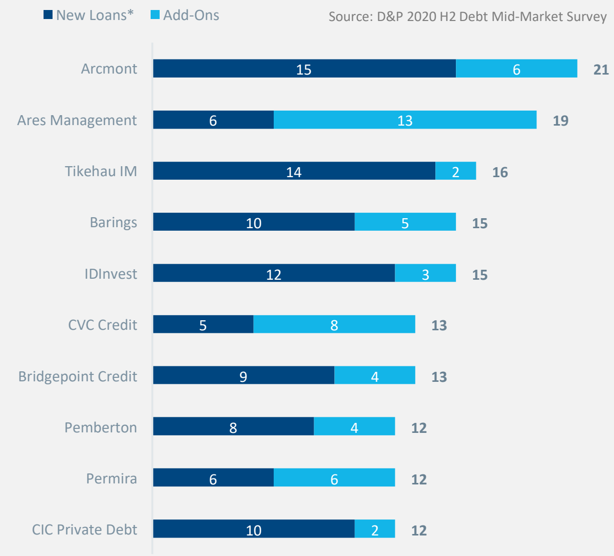
Based on our survey, Arcmont (21 deals), Ares Management (19) and Tikehau (16) were the most active European direct lenders in H2 2020. They were followed by Barings (15), IDInvest (15), CVC Credit (13), Bridgepoint (13), Pemberton (12), Permira (12) and CIC Private Debt (12). We note that for the full year 2020, Debtwire reported Ares Management in the No. 1 spot.[1] A full list of survey participants and their deal counts can be found in the appendix.

Of Arcmont's 21 deals in H2 2020, 15 were new transactions and six were add-ons, with an even spread of deal sizes across the surveyed range. Ares Management appeared to be more occupied by existing clients, with 13 of its 19 completed deals being add-on transactions. Geographically, 63% of its deals were completed in the UK, with a slight increase in deal numbers towards mid to lower size. Tikehau IM's 16 new transactions included 14 new money deals, and two add-ons. However, we note that 69% of Tikehau's deals were in France, and 63% of their deals were over GBP 100 mn.

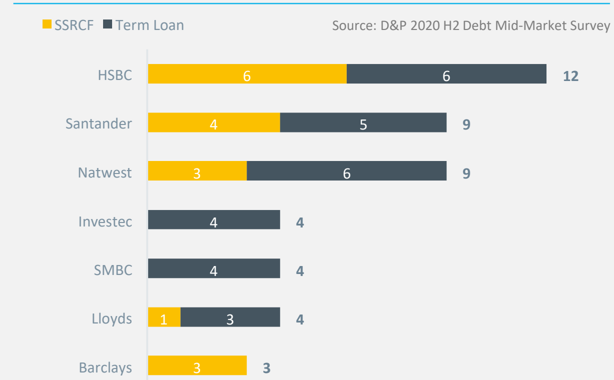
In the UK bank market, HSBC topped the activity table for both term loans and SSRCF deal count in H2 2020, followed by Santander and NatWest. Reported SSRCF transactions were noticeably low. This is consistent with a reported drop in clearing bank appetite for providing SSRCFs. The risk-adjusted return on these facilities often doesn't stack up for banks in view of expected facility usage, limited ancillary income, low asset coverage and overall leverage levels. In many cases banks have preferred to reserve SSRCF lending appetite for existing clients and/or priority financial sponsors. Alternatively, they demanded a super senior term tranche in a First Out Last Out (FOLO) structure to ensure better returns. This dynamic may also have been compounded by banks' restricted bandwidth during the pandemic, as they dealt with existing clients and government support schemes.

Historically, FOLO structures have been a popular middle ground (although more in certain jurisdictions than others). However, we have increasingly seen debt funds pushing back on these structures and stepping up to underwrite or bridge a SSRCF to facilitate deal closing. The intention is for these to be refinanced by a bank provider after closing. However, if the SSRCF cannot be refinanced, borrowers face either (i) the facility being cancelled or (ii) drawing down on the facility and having cash held on balance sheet. This trend has perhaps presented an opportunity for challenger banks and asset-backed lenders, although not many challenger banks currently provide SSRCFs, and not all businesses will have the asset base to facilitate an ABL solution for working capital.

H2 2020 European Deals — Top 10 Direct Lenders



H2 2020 UK Deals — Banks



* New Loans includes buyout, recapitalisation, growth finance and loan refinances

Source:
1. Debtwire Par Western Europe Direct Lender League Table, 01 Feb 2021

Leveraged Loans – Key Trends

3 Debt Fund Dry Powder and Fundraising

Private debt fund dry powder levels (across all lending strategies) remain robust at approximately USD 105 bn. As of Dec-2020, dry powder was at the second-highest level it has been since the end of 2018. This should provide borrowers with confidence that ample debt market liquidity still exists.

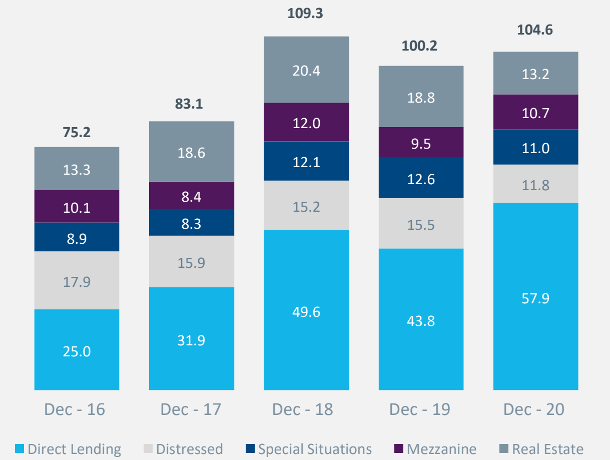
Private debt fundraising in 2020 was impacted by the pandemic, with the lowest level of fundraising seen for more than six years. [1] As the year progressed, institutional investors were having to get used to remote fundraising and due diligence processes. Furthermore, investors are now focusing on a smaller group of elite managers that have been through multiple cycles, which may result in increased concentration.

However, when compared to the same point in 2019, direct lending dry powder saw a significant increase by about USD 14 bn to USD 57.9 bn, solely representing more than 50% of total debt fund dry powder. This suggests that the increased levels of direct lending dry powder are likely driven by lower capital deployment in Q2 and Q3 as a result of the pandemic.

Some of largest European-focused debt fundraise closures in 2020 were GSO (USD 4.6 bn), Ardian and Permira (USD 4.3 bn) and Macquarie USD (3.4 bn).

Whilst direct lending dry powder levels increased, levels for distressed and special situations decreased by USD 3.7 bn and USD 1.6 bn, respectively. This suggests that distressed/special situations borrowing was relatively more in demand along with lenders that oversee multiple pools of capital taking the opportunity to deploy capital from higher yielding funds.

Dry Powder — European Debt Funds (USD bn)



Source: Preqin 30 January 2021

Source:
1. Private Debt Investor, Fundraising Report 2020

Leveraged Loans – Key Trends

4 D&P Outlook for 2021

Looking forward to the remainder of 2021, we think the following themes will prevail:

An incomplete and uneven recovery

Global economic activity in 2021 is expected to remain below pre-pandemic levels, with the road to recovery varying across countries. The UK and Europe are not expected to get back to 2019 economic levels until well into 2022. [1] Whilst we do expect lender appetite for more cyclical sectors to return (e.g., travel, consumer, aerospace, automotive and energy), we expect the current lender preference for defensive credits and those embracing new technologies and innovation to continue. Furthermore, for some companies the full impact of Brexit is yet to be felt as these may have remained uncovered during the pandemic due to government support programs and reduced trading levels.

Continued strong transaction activity *and* sharp increase in (dis)stressed (re-)financings

This will be driven by: (i) M&A deals put on hold in 2020 coming to market; (ii) corporate divestitures to raise money for core activities; iii) high levels of direct lender dry powder, combined with an eagerness to deploy capital to resilient sectors and businesses; (iii) need to refinance and restructure short-term debt products, particularly from the extraordinary levels of government loan schemes put in place (see graph), (iv) unwinding of other forms of government support, and (v) growth capital needed to finance post-pandemic business growth and working capital.

Transition away from LIBOR and EURIBOR

2021 will see the end of LIBOR/EURIBOR. Transitioning loan documents and systems to new rates such as SONIA, ESTER and Central Bank rates will be a time-consuming challenge for many.

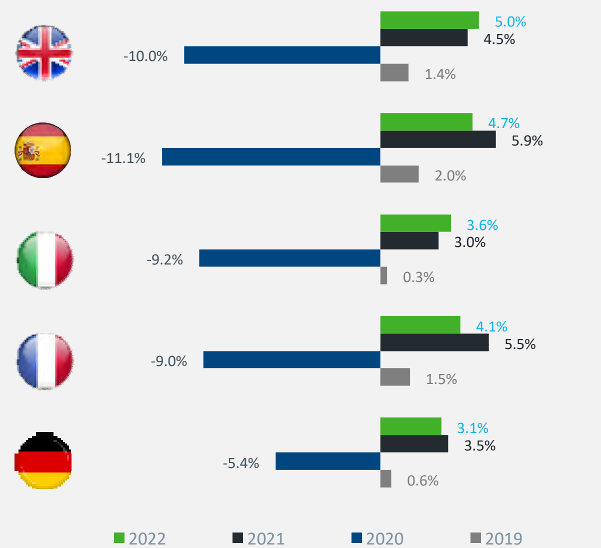
Sustainability and ESG

Environmental, Social and Governance (ESG) considerations are rapidly becoming a central theme for many sponsors and lenders, driven by LP demands and increased regulation. We have seen a number of lenders offering margin ratchets linked to ESG targets, and we expect this trend to continue, leaving some sectors less in demand.

Direct lender consolidation

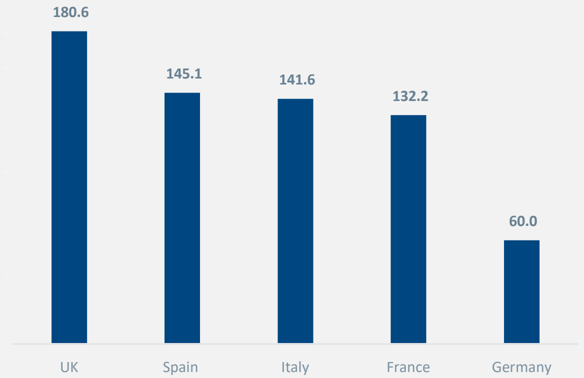
Investor capital and borrower preference are increasingly being directed towards established funds that have demonstrated a successful track record of investment and supporting clients through the cycle. This, combined with the pandemic's impact on portfolios, may result in some consolidation in the medium term.

GDP Actuals and Forecast (2019 - 2022)



Source: International Monetary Fund, World Economic Outlook, January 2021 Update

European Government Loan Schemes (EUR bn)*



Source:
1. International Monetary Fund, World Economic Outlook, January 2021 Update

*Graph Source:
Bank of England as of 24 Jan 2021, HM Treasury as of 24 Jan 2021, Bundesministerium fur Wirtschaft und Energie of 25 Feb 2021, Ministere De L'Economie Des Finances et De La Relance as of 25 Feb 2021, Ministerio de Asuntos Economicos as of 25 Feb 2021, Sace Simest Gruppo cdp as of 24 Feb 2021

UK ABL – Key Trends

5 Deal Count and Purpose

Our debt mid-market survey covered Invoice Discount Financings (IDF)/receivables only facilities and multi-asset class ABL financings completed by 13 asset-backed lenders in the UK. We have sought to remove any financings that were CBILS/CLBILS-only[1] facilities from the numbers but have included some deals where a new or increased asset-backed facility was combined with a CBILS/CLBILS facility. All active participants and their respective deal counts for H2 2020 are shown in the graph on the right.

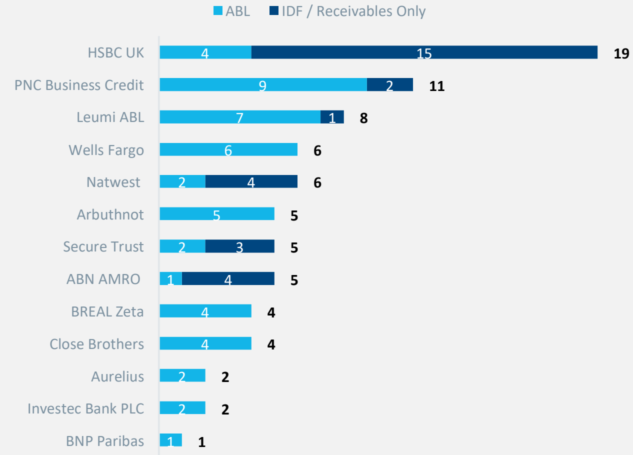
Across all participants, 78 asset-backed financings were completed in H2 2020. In the IDF/receivables only segment, HSBC UK (15) was most active, followed at some distance by NatWest (4) and ABN AMRO (4). In the multi-asset class segment, PNC Business Credit completed nine deals, followed by Leumi ABL (7), Wells Fargo (6) and Arbuthnot (5). Whilst our inaugural debt mid-market survey did not cover H1-2020, our research suggests that total H2 2020 deal count was relatively flat on H1. In this context we note that several asset-backed lenders remained active in Q2 2020 despite the COVID-19 outbreak, when they continued to deliver on ongoing transactions and commitments.

However, the number of 'new-to-bank' transactions was relatively low in 2020. This was consistent with developments in the leveraged loan market due to the drop in M&A volumes, increased lender focus on existing customers through facility increases and extensions, and availability of liquidity support under Government loan schemes.

In the ABL segment, facility extensions/increases are generally more common in Q4 compared to other periods. This is reflected in the deal purpose chart, with 45% of deals reported to have been used to refinance existing debt, followed by 26% for facility increases and extensions. Several lenders referred to a disappointing year for PE-led ABL transactions (Q3 was reported to be "barren" by some), and only 9% of recorded deals were for buyouts. Examples of PE-driven financings in H2 include Hovis (PNC financed the acquisition by Endless LLP) and GKN Wheels & Structures (Wells Fargo financed the acquisition by Aurelius Equity).

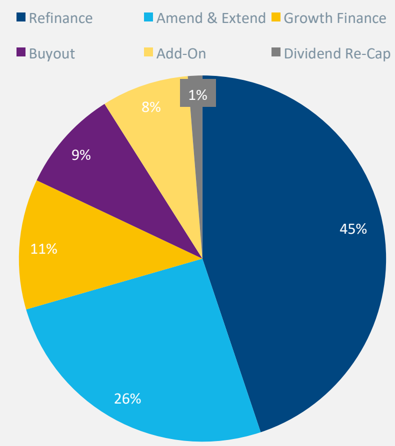
We also note that many lenders saw their lending books shrink, as utilisation rates under existing facilities went down due to reduced borrower activity. A pick-up in facility extensions and increases (as well as loans under various government schemes) was reported to only partially make up for this decrease for several lenders.

H2 2020 UK ABL Deal Count by Lender*



Source: D&P 2020 H2 Debt Mid-Market Survey

H2 2020 ABL Transaction Purpose



Source: D&P 2020 H2 Debt Mid-Market Survey

1. CBILS: Coronavirus Business Interruption Loan Scheme. CLBILS: Coronavirus Large Business Interruption Loan Scheme

* Debt value between GBP 5 mn and GBP 250 mn

UK ABL – Key Trends

6 Sector, Size, Asset Class and Outlook

IDF/receivables only deals represented only 38% of total deals recorded and 62% covered multi-asset class. The IDF/receivables only share is lower than we have seen in previous years. A contributing factor for this trend may have been borrowers tapping into the government loan schemes with various joint IDF/receivables and CBILS/CLBILS facilities being provided (noting that not all lenders participate in these schemes).

In the ABL segment, most transactions (74%) were backed by one or two asset classes. Only 13% of deals were backed by three asset classes and a further 13% of deals were backed by four asset classes (or more).

Looking at average transaction size, the market saw few large ABL deals and was dominated by transactions with debt values below GBP 50 mn (88%). The GBP 308 mn acquisition of Wolseley UK by Clayton, Dubilier & Rice announced in January 2021 is said to be supported by asset-backed financing and further details should be included in our next survey.

The most popular sectors were manufacturing/engineering (37%), food (10%), business services (10%) and consumer-retail (9%).

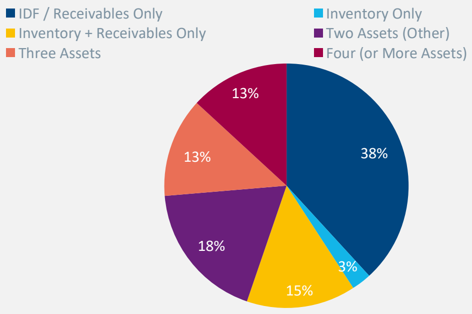
Some market participants commented that the market is expected to remain somewhat subdued for new-to-bank (or fund) clients in H1 2021 (in particular for multi-asset class deals) given:

- Current M&A activity is skewed towards more defensive and asset-light sectors;
- Many debt raises relating to restructurings and stressed assets have yet to come to market, in particular when government support dries up; and
- Many businesses will need financing to fund working capital in support of growth when the economic recovery takes off.

Crown preference came into force in December 2020 and is expected to continue to impact levels of inventory lending. We note however that several advisors are working on mitigating structures, which we expect to report on in our next market update.

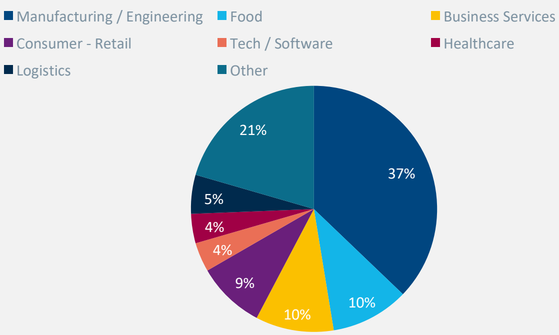
Whether ABL will step into the gap left by reduced clearing bank appetite for SSRCFs remains to be seen. Not all businesses will have the asset base to make this achievable, and inter-creditor issues remain a concern for many.

Asset Class Breakdown



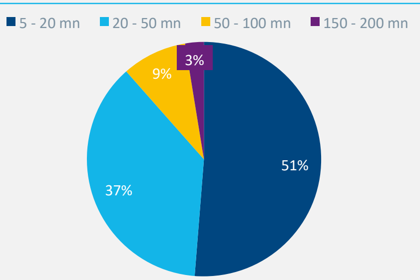
Source: D&P 2020 H2 Debt Mid-Market Survey

Sector Breakdown



Source: D&P 2020 H2 Debt Mid-Market Survey

Transaction Size



Source: D&P 2020 H2 Debt Mid-Market Survey

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Appendix – Further Survey Results and Data

European Direct Lender Deal Count H2 2020

Lender	Deal Count
Arcmont	21
Ares Management	19
Tikehau IM	16
IDInvest	15
Barings	15
CVC Credit	13
Bridgepoint Credit	13
CIC Private Debt	12
Pemberton	12
Permira	12
Apera	10
Kartesia	9
Alcentra	7
Muzinich	6
Blackrock	6
HPS	6
Crescent Capital	5
Cordet Private Debt	5
LGT Capital	5
Proventus	5
Five Arrows	4
Northleaf	4
Capital Four	4
Pricoa Capital	3
Ardian	3
HIG Whitehorse	2
M&G	2
Hayfin	2
Carlyle	1
Guggenheim	1
Total	**238**

UK ABL Deal Count H2 2020[1]

Lender	Deal Count
HSBC UK	19
PNC Business Credit	11
Leumi ABL	8
Wells Fargo	6
Secure Trust	5
Natwest	6
Arbuthnot	5
ABN AMRO	5
BREAL Zeta	4
Close Brothers	4
Aurelius	2
Investec Bank PLC	2
BNP Paribas	1
Total	**78**

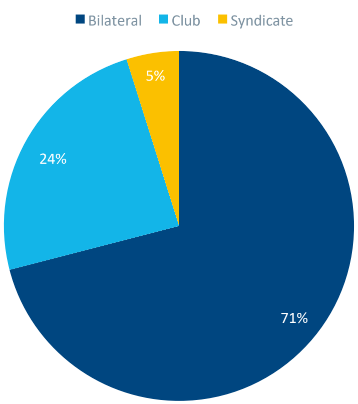
1. UK deal count only. Several lenders also lent across Europe during H2 2020 and these have not been included in this table

UK Bank Deal Count H2 2020

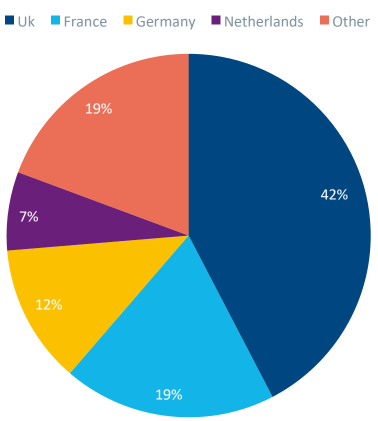
Lender	Term	SSRCF
HSBC	6	6
Santander	5	4
NatWest	6	3
Investec[2]	4	0
SMBC[2]	4	0
Lloyds	3	1
Barclays	0	3
Total	**28**	**17**

2. Some banks can provide unitranche loans. Investec, SMBC and Deutsche have submitted additional deals completed in Europe of 8, 3 and 3 respectively

Leveraged Loans by Arrangement



Leveraged Term Loans by Geography



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