DLA PIPER

EUROPEAN ACQUISITION FINANCE DEBT REPORT 2015

EXECUTIVE SUMMARY

Welcome to DLA Piper's European Acquisition Finance Debt Report 2015. This report, now in its sixth year, presents detailed results of our survey of 300 debt providers, advisors, sponsors and corporates active in the European acquisition finance debt market. It also includes extracts from interviews with a number of senior dealmakers.

2014 was another busy year in the debt markets. Some 267 deals were executed last year, in line with the 269 transactions completed in 2013[1]. Survey data indicates that 2015 will be another busy year – 94% of survey respondents expect 2015 to be either more active or similar in terms of deal activity to 2014.

Notably, for the first time in many years, survey respondents expect primary deal activity to overtake the volume of refinancing transactions in 2015. This is being driven by improved economic confidence in Europe's largest markets and the passing of the refinancing wall.

Deal activity aside, 2014 will be remembered for growing competition between traditional bank lenders and direct lending funds. It was also the year when banks fought back by offering higher leverage, lower pricing and more flexible structures.

Competition is great news for borrowers. In addition to lower pricing, reduced fees and higher leverage, borrowers can now choose from a wider offering of debt products than ever before. In addition to senior, borrowers can now use mezzanine, unitranche, second lien, high yield and a variety of combinations of any of these products to finance their deals.

Despite competing fiercely, banks and funds also started to collaborate on deals in 2014. A small number of banks and funds established joint ventures. A larger number established heads-of-terms around intercreditor issues, enabling them to collaborate more easily on individual deals.

2014 was a mixed year for high yield – some 55 bonds valued at €50 billion were issued in Europe to fund acquisitions or refinance acquisition debt in 2014, a 15% increase on the number of bonds issued in 2013[2]. However, from July onwards, the high yield market was effectively shut for mid-market issuers as European high yield funds took fright and withdrew from the sector. High yield market conditions look somewhat brighter in early 2015, suggesting this year might be another bumper period for high yield issuance.

If you have any questions about the findings in this report, or would like to explore how DLA Piper can assist your organisation, please feel free to contact any of the DLA Piper Debt Finance Partners, whose details are listed at the end of this report.

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[1, 2] Source: Dealogic

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MARKET REFLECTIONS ON 2014

PRIMARY DEAL ACTIVITY REBOUNDED IN 2014

The volume of total European acquisition finance debt deals remained robust in 2014 following a significant annual increase in the previous year. Some 267 deals were executed in 2014, in line with the 269 deals transacted in 2013[3].

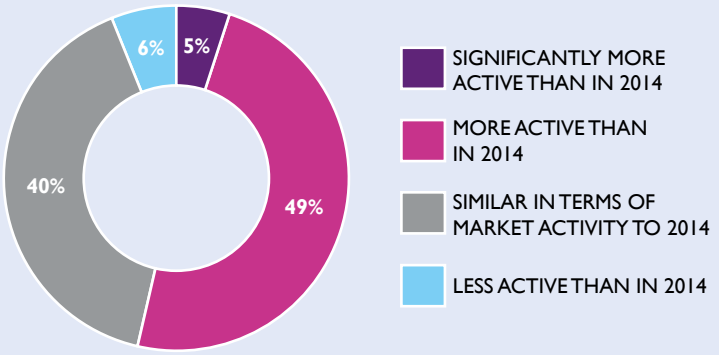
While the number of deals was similar to 2013, the composition of transactions altered with an increase in primary deal activity and a decrease in refinancing transactions. Some 192 loans were executed in 2014 to fund corporate acquisitions and primary and secondary buyouts, a 4% increase on the 184 deals structured in 2013[4]. Interviewees ascribed the increase in primary deal activity to improved economic confidence and an increase in liquidity, which enabled sellers' price expectations to be met. A drop off in high yield issuances in the second half of 2014 also boosted the loan market.

"For the first time in many years we saw an annual increase in new money deals in 2014 perhaps due to an improvement in economic sentiment," explained Mike Dennis, Partner at Ares Management. "In addition the debt market has been more liquid, which has supported marginally higher leverage multiples, which in turn supports attractive valuations. At higher valuations, people are naturally more predisposed to sell."

In contrast, the number of transactions involving the refinancing of acquisition debt decreased significantly in 2014 – 50 such deals valued at €29 billion were executed in Europe in 2014, a 28% decrease in value on the 65 deals totalling €40 billion in 2013[5]. This is due to the large number of leveraged buyouts structured in 2006 and 2008 with five to seven year debt terms that have already been refinanced.

2014 was also notable for another increase in the volume of bonds used to finance acquisitions and refinance acquisition debt. Some 55 acquisition-related bonds valued at €50 billion were issued in 2014, a 150% increase in value on the 48 bonds totalling €20 billion issued in 2013[6].

HOW ACTIVE DO YOU EXPECT THE ACQUISITION FINANCE DEBT MARKET TO BE IN THE COUNTRY WHERE YOU ARE LOCATED IN 2015?



[3] Investment statistics include debt raised to fund acquisitions and the refinancing of such debt. These statistics only include loans, not bonds.

[4, 5, 6] Source: Dealogic

ROBUST M&A ACTIVITY TO MAINTAIN DEAL VOLUMES IN 2015

According to our survey data, the high level of deal activity recorded last year looks set to be maintained in 2015 – 94% of our survey respondents expect 2015 to be either more active than last year or at least similar in activity to 2014.

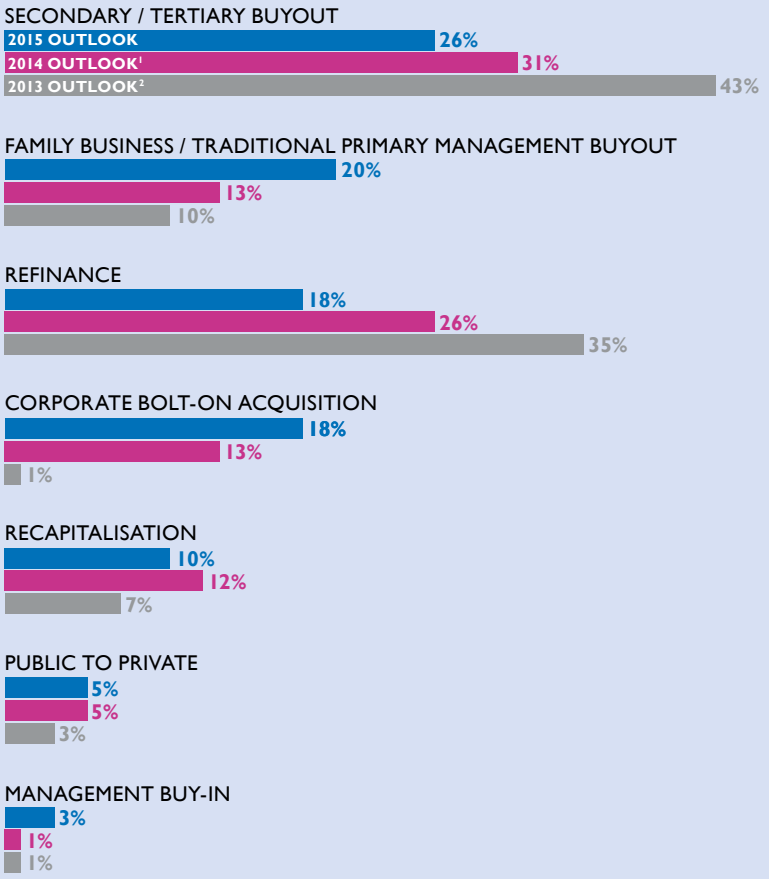
An uptick in deal activity in 2015 will be driven by an increase in buyout activity. Survey respondents predict secondary and tertiary buyouts to be the most common type of transaction in Europe in 2015. This is not surprising given the number of businesses already owned by private equity funds with defined fund lifecycles. However, it should be noted the proportion of survey respondents predicting secondary and tertiary buyouts to be the most common deal type has declined from 43% to 26% in the last two years.

More interestingly, for the first time in the past three years, survey respondents predict more traditional primary management buyouts in 2015 than refinancing transactions. This will be driven by the same factors that set this trend in motion in 2014 – improved economic confidence, greater liquidity and the passing of the so-called refinancing wall.

"We are running out of refinancing opportunities so I expect the percentage of refinancing deals to decrease in 2015," explained Owen Verrier-Jones, Managing Director at GE Capital. "So many deals have now been refinanced. We are no longer talking about a refinancing wall like we were 18-24 months ago. The overhang has been digested by the capital markets, whether it is from bonds, or from loans and bonds, from unitranche or senior deals. In short, it has been dealt with, or at least reduced to a manageable level."

"People are generally focusing on high quality credits," added Mike Barnes, Head of Debt Advisory at Wyvern Partners. "There is an increasing focus on quality, even if as a consequence valuations are higher."

WHICH OF THE FOLLOWING DEAL TYPES DO YOU EXPECT TO BE THE LARGEST BY VOLUME (DEAL NUMBERS) IN 2015?



[1] DLA PIPER EUROPEAN ACQUISITION FINANCE DEBT REPORT 2014
[2] DLA PIPER EUROPEAN ACQUISITION FINANCE DEBT REPORT 2013

A TWO-TRACK EUROPE

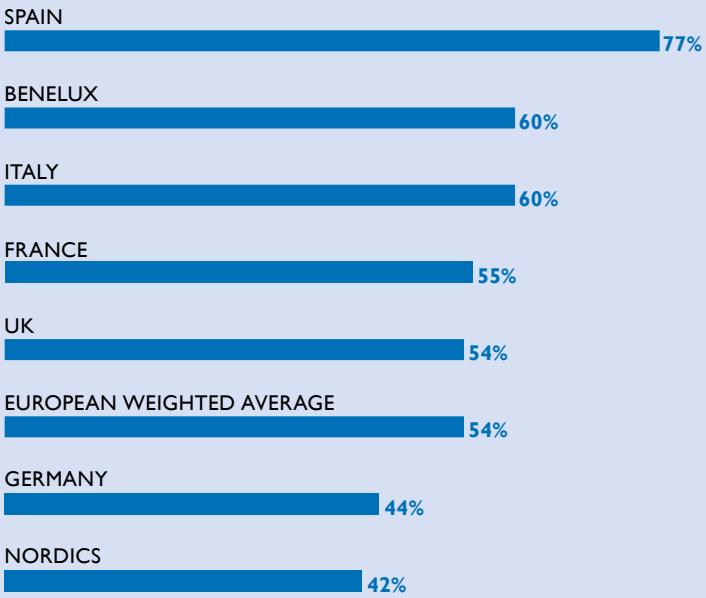
Whilst the majority of survey respondents predict an increase in deal activity, there is also consensus that any increase will be relatively muted due to anticipated weak economic growth across many of Europe's largest economies.

An increase in deal activity will also be uneven across Europe. Over three quarters (77%) of Spanish survey respondents expect deal activity to increase in Spain in 2015, while 60% of Italian and Benelux respondents expect deal activity to increase in their respective countries. At the other end of the spectrum, only 44% and 42% of German and Nordic respondents expect deal activity to increase in their respective countries.

This is a direct result of the divergent economic growth outlook across Europe. The IMF only expects Germany's economy to grow by 1.3% in 2015, while France's national statistics institute predicts 0.7% economic growth in 2015. In contrast, the UK and Spanish economies are expected to grow by a relatively robust 2.6% and 2% respectively in 2015.

"Spain rebounded in a big way in the second half of 2014 and there was certainly an increase in deals," explained Neale Broadhead, Managing Director at CVC Credit Partners. "A year ago the banks had retrenched, people were really worried about Spain and you couldn't raise a thing. But now we are seeing more deals. The same goes for Italy, where the mini-bond market has opened up. New regulation in Spain and Italy has also made it easier to lend. I expect deal activity to continue to pick up in Spain and Italy in 2015."

HOW ACTIVE DO YOU EXPECT THE ACQUISITION FINANCE DEBT MARKET TO BE IN THE COUNTRY WHERE YOU ARE LOCATED IN 2015?



A MORE COMPETITIVE LENDING LANDSCAPE IN 2015

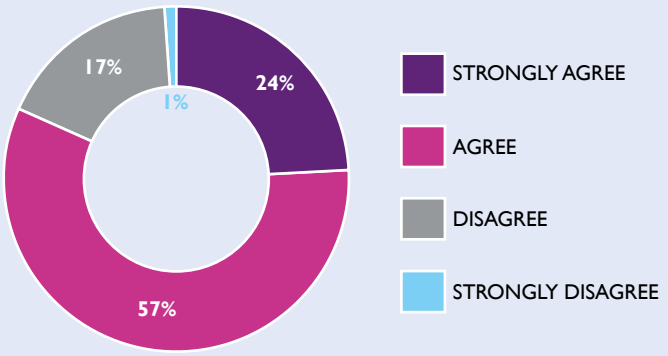
ALTERNATIVE LENDERS DRIVE INNOVATION IN NEW DEBT PRODUCTS

The most profound change in the European acquisition finance debt market during 2014 was the intensification of competition between lenders and debt products – 84% of survey respondents believe competition between lenders increased during the past 12 months and 81% believe competition between debt products was more pronounced in 2014.

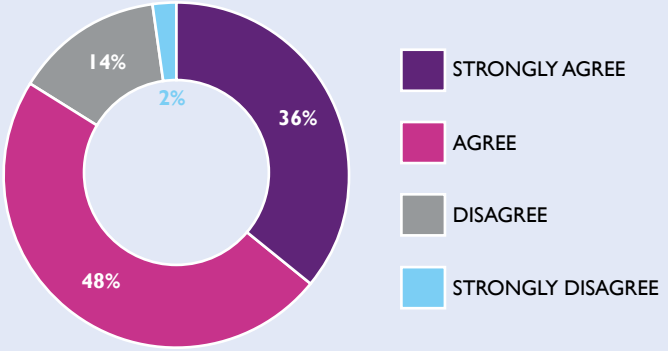
In the mid-market, this was catalysed by the growing presence of alternative lenders offering a variety of different structures, and banks' competitive response. Alternative lenders completed 142 deals in the European mid-market in the first three quarters of 2014, a 67% increase on the 85 deals in the corresponding period in 2013, according to data compiled by Deloitte[7].

The intensification of competition between alternative lenders and banks resulted in a wide array of funding products being offered to borrowers in the mid-market, including senior-only structures, term loan B tranches, mezzanine, unitranche, second lien and various combinations of these products. As shown in the graph opposite, survey respondents expect unitranche structures, which combine senior and subordinated debt into one debt instrument at a blended price, to be the most common non-bank acquisition debt finance structure in 2015.

TO WHAT EXTENT DO YOU AGREE THAT COMPETITION BETWEEN DEBT PRODUCTS HAS INCREASED DURING THE PAST 12 MONTHS?



TO WHAT EXTENT DO YOU AGREE THAT COMPETITION BETWEEN LENDERS HAS INCREASED DURING THE PAST 12 MONTHS?



Unitranche structures are compelling because they have low or often zero amortisation and enable sponsors to inject greater leverage (around 1-1.3x EBITDA higher according to survey respondents) into deals than is achievable

[7] Deloitte Alternative Deal Tracker, December 2014

with a senior only structure. It also provides comparable leverage to senior plus mezzanine structures, but often with less complex intercreditor issues to deal with. Direct lending funds offering unitranche structures are also able to offer much larger hold sizes than banks, thereby reducing the complexity and time needed to execute deals.

As Ian Crompton, Deputy Head of Middle Market Financial Sponsors at HSBC explains, debt funds are also much more flexible than banks. "Some banks can be finicky about some of the negotiations and are perhaps driven more by credit committees than the actual deal," he said. "Funds can potentially take a more pragmatic view because they only have to answer to themselves."

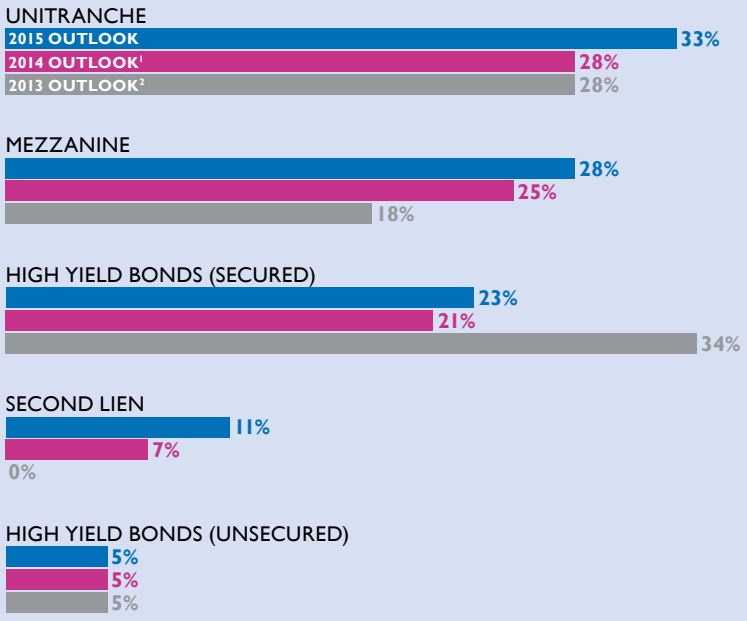
While direct lending funds have been active for many years, many interviewees believe that 2014 marked the year in which unitranche reached a certain level of maturity and acceptance amongst the sponsor community. It is also the first year that direct lending funds started to make significant inroads into continental Europe, particularly in France and Germany.

"Funds are now bolstering their origination resources across Europe and a number have already opened offices in Benelux, Germany, France and Spain to widen the net for deal sourcing and become less reliant on the competitive UK market," confirmed Floris Hovingh, Director – Head of Alternative Lender Coverage at Deloitte. "But the rate of adoption will differ across Europe. In Germany, where mid-market private equity is less active and businesses are more family / founder owned, it will take longer for alternative lenders to be accepted. Other considerations for private debt funds are differences in legal systems in each jurisdiction and the associated level of creditor protections."

That's not to suggest that direct lending funds didn't face competition in 2014. In the first half of the year, banks fought back by offering higher leverage, lower pricing and in some cases looser terms. Some banks were also offering non amortising term loan B structures and underwriting deals to compete with the low amortisation and larger hold sizes offered by direct lending funds. This has resulted in some direct lending funds, especially the funds newest to the market, being forced to work very hard to find appropriate opportunities to invest in.

Increased optionality is not just enjoyed by European mid-market borrowers. As David Parker, Partner at Marlborough Partners explains, borrowers at the large end of the market now also have more financing options than at any point since the financial crisis. "In the large market, there are three fully functioning markets borrowers can go to - the US loan market, the European loan market and

WHICH OF THE FOLLOWING NON-BANK LENDER ACQUISITION DEBT FINANCING STRUCTURES DO YOU THINK WILL BE THE MOST COMMON IN 2015?



[1] DLA PIPER EUROPEAN ACQUISITION FINANCE DEBT REPORT 2014
[2] DLA PIPER EUROPEAN ACQUISITION FINANCE DEBT REPORT 2013

the bond market," he said. "This started in 2013 but continued in 2014. Today all three markets can be relied upon to offer financing either individually or in combination - 18 to 24 months ago perhaps only one of these was regularly open at any given time."

COLLABORATION, NOT JUST COMPETITION

For many years, a small number of established lenders and funds, such as GE Capital and Ares Management, have worked together through joint ventures. During 2014 collaboration between banks and direct lending funds increased. For example, Barclays and BlueBay Asset Management collaborated to offer UK mid-market companies unitranche debt in January 2014. A number of other funds and banks have also established heads of terms and in some cases more detailed longer form documentation to enable them to move quickly in the event of collaboration on an individual deal.

As Richard Roach, Managing Director, Financial Sponsors UK at RBS explains, this enables banks to remain competitive when sponsors require greater leverage or flexibility. "We have an arrangement with three debt fund partners," he said. "We have put together detailed intercreditor agreements governing these arrangements and did our first deal with one of them in December 2014. The fund provided the junior debt in the form of a unitranche facility and we provided the super senior RCF. If in certain circumstances the sponsor wishes to take higher leverage or greater flexibility, it is great to be able to offer the combined product."

A significant number of deals were executed in 2014 that included both bank and fund lenders. Deals involving both types of lenders can take a variety of forms, ranging from both parties investing senior debt alongside each other on a pari-passu basis, to banks investing in less risky second loss, or first lien tranches, while funds provide the higher margin first loss, or second lien tranche. Irrespective of the structure, banks will also provide ancillary services such as hedging facilities, revolvers and acquisition lines.

"There is a role for both traditional banks and direct lending funds and they can certainly co-exist," explained Max Mitchell, Head of Direct Lending – Credit Fund Management at ICG. "We have done lots of deals with banks involved as well as deals on a bilateral basis."

> "There have only been a handful of second lien deals thus far, but it is currently something that is getting considered a lot more than it used to, particularly for deals with a 5-6x total leverage package."

SECOND LIEN TO HAVE A GREATER ROLE IN 2015...

Although second lien structures are yet to make a significant impact on the European acquisition finance debt market, interviewees indicate that second lien is now more frequently discussed as a potential funding structure than a year ago. This is underpinned by the need for direct lending funds to invest in higher yielding structures when faced with declining margins.

"There have only been a handful of second lien deals thus far, but it is currently getting considered a lot more than it used to, particularly for deals with a 5-6x total leverage package," explained Tara Moore, Head of Debt Finance Origination at Barclays. "Fund liquidity is really driving this. While some funds have put leverage on their funds and can lend at a senior level, they still need to deliver an overall IRR to their investors and higher yielding debt still needs to be achieved. The ability to do second lien as cash and PIK notes gives them the yield they were getting from unitranche some 6-9 months ago."

Survey data also highlights the growing recognition of second lien – 11% of survey respondents expect second lien to be the most common non-bank lender acquisition finance debt structure in 2015, compared with 7% in last year's survey and 0% the year before.

...ALTHOUGH INTERCREDITOR ISSUES NEED TO BE RESOLVED

For structures involving both funds and banks to become more mainstream, these parties must work together to resolve the inevitable intercreditor issues that arise. As James Ranger, Co-Head Mid Markets, Acquisition Finance at Lloyds, explains, intercreditor issues in these structures may prove more complex to resolve than in traditional senior-mezzanine structures.

"The biggest debates arise from the fact that the fund is providing the majority of the capital in these structures with the banks taking a more passive role than they have been used to," he said. "Intercreditor debates are generally focused on the level of control banks get and at what stage banks need to be able to come to the table if there is an issue. Usually the debates are around voting rights, independent rights of acceleration for the banks and the standstill period that applies."

Such intercreditor issues only really arise where there is a subordinated piece in the debt structure (ie second lien / first loss). However, most deals are currently funded on a pari-passu basis so intercreditor issues have not yet become a major concern.

"We have completed deals where we have arranged the transaction and a bank has come in and taken a small piece," explained Graeme Delaney-Smith, Head of European Direct Lending and Mezzanine Investments at Alcentra. "We have also invested on a club basis on day one and are fine with both. We don't really have any intercreditor issues with banks as we are investing alongside them in the same debt tranches to a large degree. People are talking a lot about the first loss or second lien piece but there hasn't been too much of this used yet."

A YEAR OF TWO HALVES FOR HIGH YIELD

2014 was another record year for high yield. Some 55 bonds valued at €50 billion were issued in Europe in 2014 to fund acquisitions or refinance acquisition debt, an increase of over 150% in value on the 48 acquisition-related bonds totalling €20 billion issued in 2013[8].

However, high yield issuances were much stronger in the first half of the year than the second due to a number of high-profile insolvencies, significant outflows of cash from high yield funds and increasing competition from the loan market offering looser covenants. This resulted in bond margins increasing by 100 bps at the large end of the market since the summer of 2014.

[8] Source: Dealogic

"Issuances tailed off in Q4 because spread compression reached levels that people did not deem acceptable," explained Carlo Fontana, Head of Leveraged Debt Capital Markets at Lloyds. "Also, a few major names have folded or have gone through troubled times and that scared the market. This reminded investors that investing in a CCC credit or even a low single B can be challenging. That triggered a series of portfolio reviews which then resulted in some people selling positions."

In the first half of the year, the high yield market was sufficiently liquid to the extent that many mid-market issuers, including many first time issuers, completed bond offerings. However, the pull-back from high yield investors in the second half of the year meant the window for mid-market issuers trying to raise under €200 million was shut for a time, particularly for sterling-denominated bonds.

"The bond market flirted with the mid-market in the first half of the year," explained Owen Verrier-Jones, Managing Director at GE Capital. "But in parts of the second half we saw exactly why the bond market needs to be treated with caution. Many borrowers realised that bonds can suddenly either become very expensive or the market can just shut, especially for first time and/or mid-market issuers. If you have been working on a refinance this can be annoying, but you can at least go back to the loan market. However, if you are trying to structure an M&A deal around a bond issuance, this can be disastrous and mean the end of your transaction."

Survey data indicates that 2015 may be a challenging year for high yield – 23% of survey respondents expect secured high yield bonds to be the most common non-bank acquisition finance debt structure in 2015, making it the anticipated third most common structure behind unitranche and mezzanine. Two years ago, survey respondents expected high yield bonds to be the most common non-bank structure.

"

There is cautious optimism for high yield based on 2014 being a record year. Many smaller issuers and first time issuers used high yield for the first time last year. This market was shut for smaller issuers from late summer to early December but people seem to have shaken that off. Early indications for 2015 show resumed market acceptance of small and first-time issuers with straightforward stories. I expect this market to continue to grow in 2015 as long as there aren't any very aggressive structures that turn 'sour'.

Tony Lopez
Partner
DLA Piper, London

CONTINUED PRESSURE ON MARGINS, PRICING AND TERMS

MARGINS AND FEES CONTINUE TO DECLINE

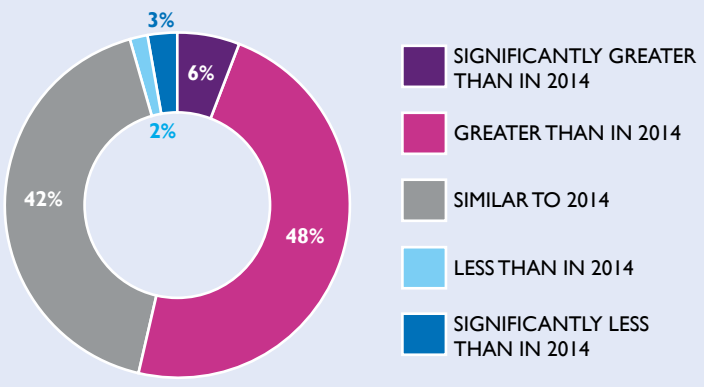
Greater competition has resulted in a reduction in loan margins and arrangement fees of around 25-50 bps during 2014. In contrast, interviewees state that the price of bonds widened last year, increasing by around 100 bps since the summer alone.

Given that the majority (54%) of banks and alternative lender survey respondents plan to increase their acquisition finance lending targets in 2015 and that new lending funds are coming to market, pressure on loan pricing and margins will continue in 2015. Over 80% of survey respondents expect the typical senior term loan A debt margin to be below 4% in 2015, a marked increase on the 60% forecasting sub-4% margins in last year's survey and 11% a year previously. The majority of survey respondents (67%) expect term loan B debt to be priced between 3.75% and 4.5%.

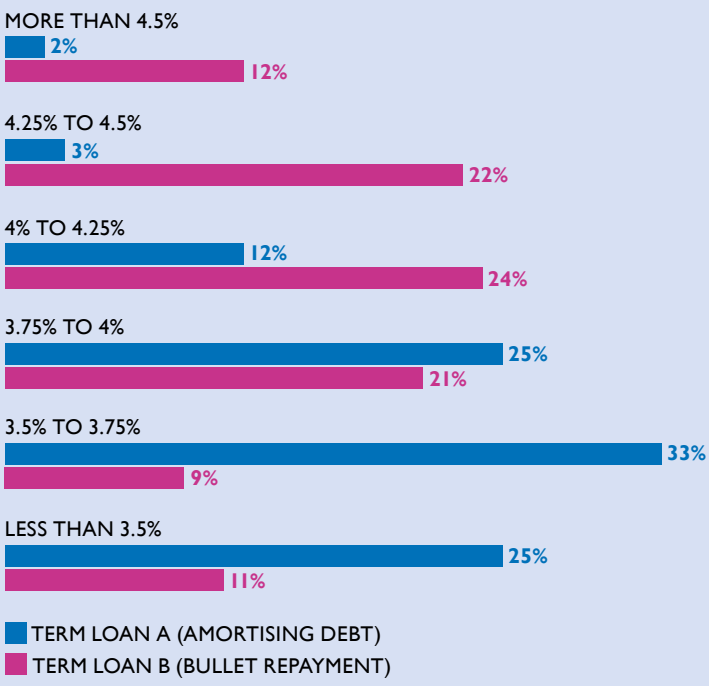
Survey respondents predict that alternative debt products will be priced at a significant mark-up to senior in 2015. On average, our survey data indicates the following margins: unitranche - 6.1%, secured high yield bonds - 6.2%, second lien - 6.5% and mezzanine - 9.2%. In contrast, respondents expect the average senior term loan A and term loan B margins to be 3.7% and 4.1% respectively in 2015.

Of course, bond prices are largely influenced by the rating, the currency and the size of the offering.

HOW DO YOUR INSTITUTION'S ACQUISITION FINANCE LENDING TARGETS FOR 2015 COMPARE WITH 2014?



WHAT DO YOU THINK WILL BE THE TYPICAL SENIOR DEBT MARGIN FOR A TRANSACTION IN 2015?



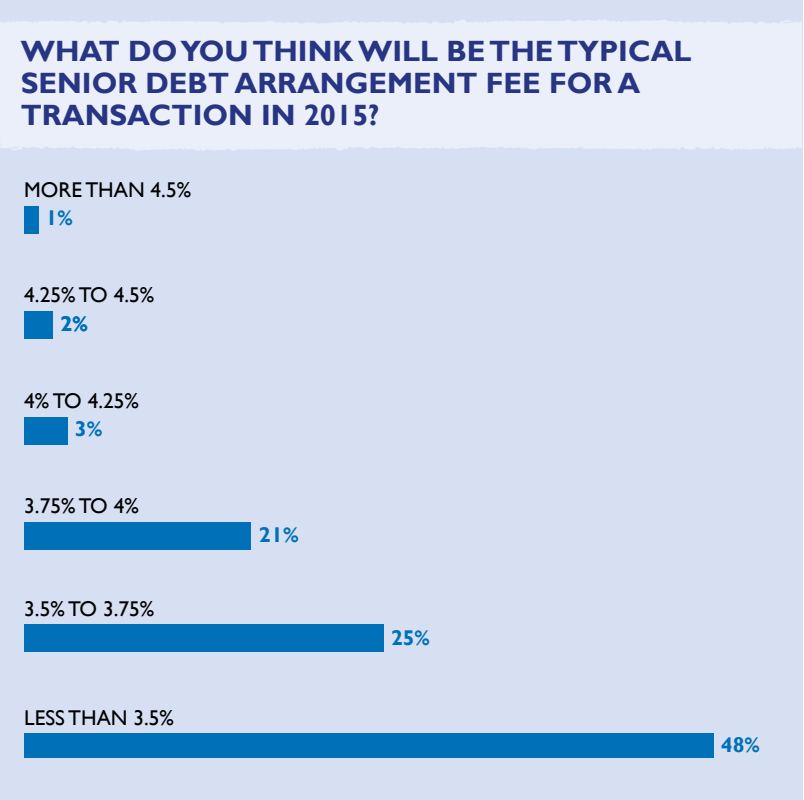
According to Carlo Fontana, Head of Leveraged Debt Capital Markets at Lloyds, issuers should expect BB-rated bonds to be priced at a circa 200 bps premium to B-rated bonds and for sterling bonds to be priced at circa 100-150 bps wider than euro bonds.

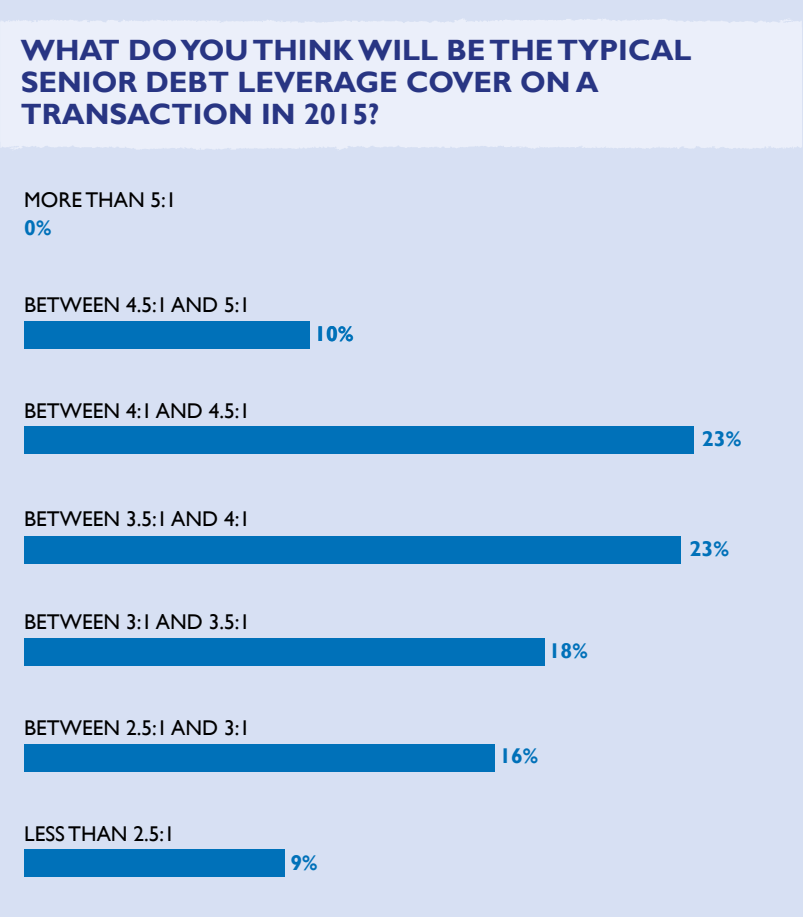
Pressure on arrangement fees also looks set to intensify in 2015 – the majority (73%) of survey respondents expect the typical senior debt arrangement fee to be below 3.75% in 2015, a significant increase on the 50% predicting sub-3.75% fees last year. In addition, almost half of respondents (48%) expect senior debt arrangement fees to be less than 3.5% on average during 2015.

LEVERAGE STILL CREEPING UP BUT HITTING A CEILING

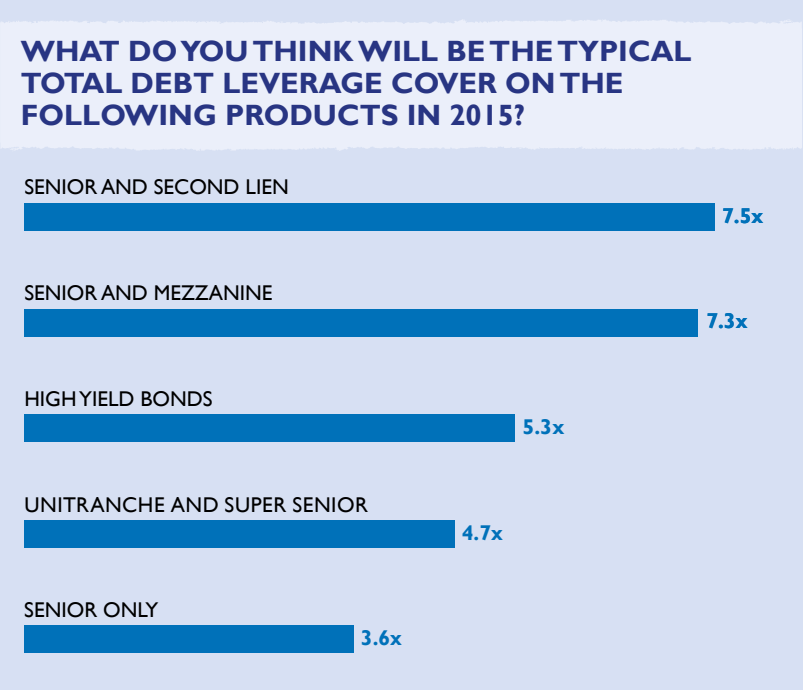
Fiercer competition between lenders and debt products also resulted in leverage increasing by approximately 0.5 of a turn of EBITDA during 2014. Pressure on leverage will continue in 2015 with a third of survey respondents expecting average senior debt leverage to be over 4x in 2015, compared with 23% of respondents in last year's survey and 16% two years ago.

"We are rapidly reaching a position in the mid-market where leverage will struggle to go much higher, simply because it will be hard to justify the company's or borrower's ability to service that level of debt," explained James Ranger, Co-Head Mid Markets, Acquisition Finance at Lloyds. "There is always a natural ceiling. There is probably some room for further leverage inflation during the next twelve months but I personally think we are approaching the top of the market."





As shown in the graph opposite, survey respondents expect alternative debt products to provide substantially more leverage than senior-only deals. On average, respondents expect leverage to be 5.3x on high yield bonds, 7.3x on senior and mezzanine and 7.5x on senior and second lien. On average, respondents expect leverage on senior-only deals to be 3.6x in 2015. Interestingly respondents viewed unitranche products as having considerably less leverage than other non-senior products.



COV-LITE NOW THE NORM IN LARGE DEALS

Covenant lite structures have now become a permanent feature of the large end of the European acquisition finance market. Covenant lite lending volume[9] totalled $21.2 billion in the first eleven months of 2014, up almost eight times on the $2.7 billion lent during the equivalent period in 2013[10]. The surge in covenant lite loans is a direct result of the increase in financing options to borrowers at the large end of the market, which now include high yield, the European loan market and the US loan market, where covenant lite loans and Yankee loans have long been a feature.

However, covenant lite loans have not penetrated the mid-market in any material way, primarily because there is less of a market for lenders to sell on their loans as there is at the larger end of the market. However, as Dino Marabese, Head of Middle Market Financial Sponsors, Europe at HSBC explains, increased competition between lenders in the mid-market has resulted in higher covenant headroom.

"Covenant lite and covenant loose loans in the large cap leveraged buyout market became more common in Europe during 2014, although this has typically been on more proven/established credit stories," he said. "In the mid-market, we haven't seen a wholesale shift to covenant loose packages, but have witnessed some looser terms (either covenant tests or covenant headroom) on specific transactions, alongside more bullet debt, again on a deal by deal basis."

"Concern in that area is genuine," added Andrew Tully, Head of Structured Finance – Financial Sponsors, Santander UK. "There is a lot of competition and hot money burning a hole in people's pockets – the funds will accept things that the banks won't. The mid-market, where we work, is a take-and-hold market, not a syndicated one and it's syndication that was responsible for a lot of the worst behaviour amongst lenders. If you're not holding something on your balance sheet, you just need to know that you can sell it. If you have to stick with it, you'll be more concerned about the quality of the asset."

[9] This includes all covenant lite loans, not just acquisition related loans.

[10] Source: Dealogic

UK

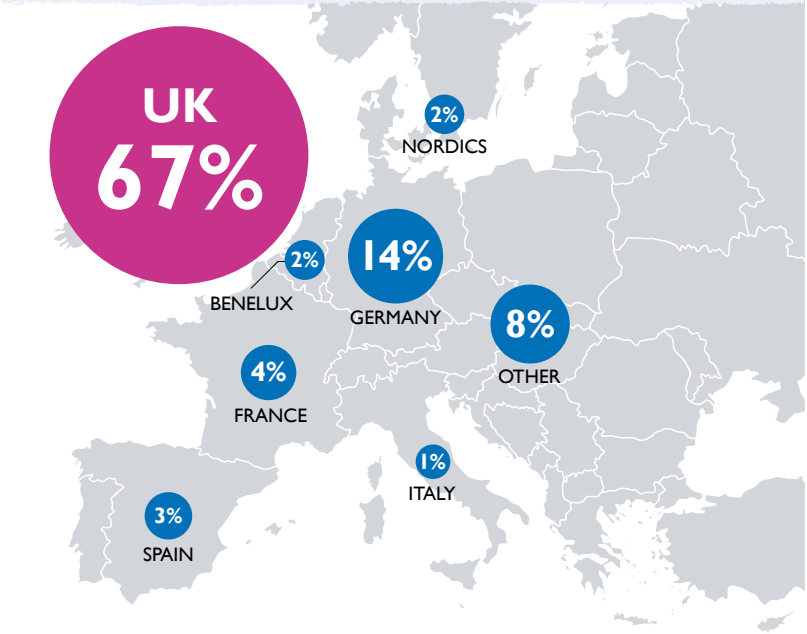
BANKS FIGHT BACK IN EUROPE'S MOST COMPETITIVE MARKET

Deal activity remained robust in 2014. Some 56 acquisition finance debt transactions valued at €43.5 billion were completed in 2014, in line with the 57 deals executed in 2013[11]. This made the UK the joint most active market in 2014 alongside France measured by total number of transactions. This level of activity looks set to be maintained in 2015 – some 54% of UK survey respondents expect deal activity to increase next year, while 43% expect deal activity to be constant. In addition survey respondents expect the UK to be the most active market in Europe – 67% expect the UK to be the most active European market in 2015, followed by Germany (14%) and France (4%). This is in line with predictions made in last year's survey.

Our survey data indicates that an increase in deal activity will be underpinned by growth in primary transactions. Some 58% of UK survey respondents expect corporate acquisitions or leveraged buyouts to be the most common deal type in 2015, significantly more than the proportion that predict refinancings (23%) or recapitalisations (14%) to be the most common.

An increase in primary deal activity is entirely feasible given the current performance of the UK economy – initial estimates suggest the economy grew by around 2.6% in 2014. Growth in 2015 is also predicted to be 2.6%. An increase in primary deal activity

WHICH EUROPEAN JURISDICTION RANKED BY VOLUME (DEAL NUMBERS) IN THE EUROPEAN ACQUISITION DEBT MARKET WILL BE THE MOST ACTIVE IN 2015?



> An increase in primary deal activity will be welcomed by the banks but their challenge will be to maintain their dealflow levels of 2014 through primary activity whilst not compromising on the quality of the credits they support.

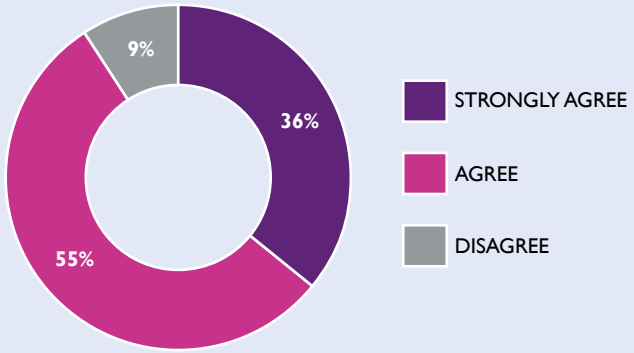
Julie Romer
Partner
DLA Piper, London

[11] Source: Dealogic

"While many of the 2006/2007 genre of deals have been refinanced there remain good refinancing opportunities within the post-financial crisis deals of 2010, 2011 and 2012 which were generally deals with strong credits but lower leverage and hence ripe for early refinancing if a sale is ruled out for any reason.

Philip Butler
Head of UK Finance
DLA Piper, London

TO WHAT EXTENT DO YOU AGREE THAT THE GROWTH OF NON-BANK LENDERS AND THEIR IMPACT ON TRADITIONAL BANK LENDERS HAS BEEN LESS SIGNIFICANT THAN ANTICIPATED 12 MONTHS AGO? (UK SURVEY RESPONDENTS)



will also be catalysed by the significant volume of capital that private equity houses, banks and alternative lenders all need to deploy. Whilst the old 'wall of refinancing' is certainly on the wane, our survey suggests refinancings will continue to form a strong element of the market.

A distinguishing feature of the UK market is the strong presence of alternative lenders. According to data compiled by Deloitte, 45% of mid-market deals with alternative lenders in the past two years (4Q12-3Q14) were in the UK, almost double the proportion in France (25%) and nearly four times the proportion in Germany (12%)[12].

In last year's report we predicted that alternative lenders would continue to gain market share from the banks. However, this has not been as extensive as some may have thought as banks have increased leverage and priced debt very cheaply for strong credits. The strict return requirements of many direct lenders renders it impossible for them to compete with lower senior pricing. Tellingly, nine out of ten UK survey respondents believe non-bank lenders actually made less of an impact on the UK acquisition finance debt market than anticipated 12 months ago.

[12] Deloitte Alternative Deal Tracker, December 2014

The influx of alternative lenders and the ensuing response from the banks has resulted in UK borrowers being offered a wide range of different structures including senior, unitranche, mezzanine, high yield and second lien (in a variety of combinations). Banks and funds are also investing increasingly alongside each other on a pari passu basis. There has also been much talk of debt funds and banks investing together in second lien structures, in which funds take a higher margin, first loss tranche. However, very few of these structures have been executed thus far.

The intensification of competition between different types of lenders has resulted in an increase in leverage and a decrease in pricing. In addition, mid-market deals are increasingly only including two financial covenants instead of the usual four. "Pricing came down quite dramatically both on margins and arrangement fees during 2014," explained David Miles, Head of London Debt Finance at DLA Piper. "Leverage was driven up significantly for good quality assets - we have seen leverage moving north of 4-4.5x for senior in certain situations, which is a higher multiple than banks traditionally like."

"At the beginning of last year we felt the funds would be pretty dominant by the end of 2014. But I think it is fair to say that this hasn't materialised. If the credit is strong, banks will increase their leverage capacity aggressively, price debt relatively cheaper than where funds can get to and retain the credit. Funds come into their own when the credit isn't as strong, or has a quirky structure and the banks just can't get comfortable as quickly.

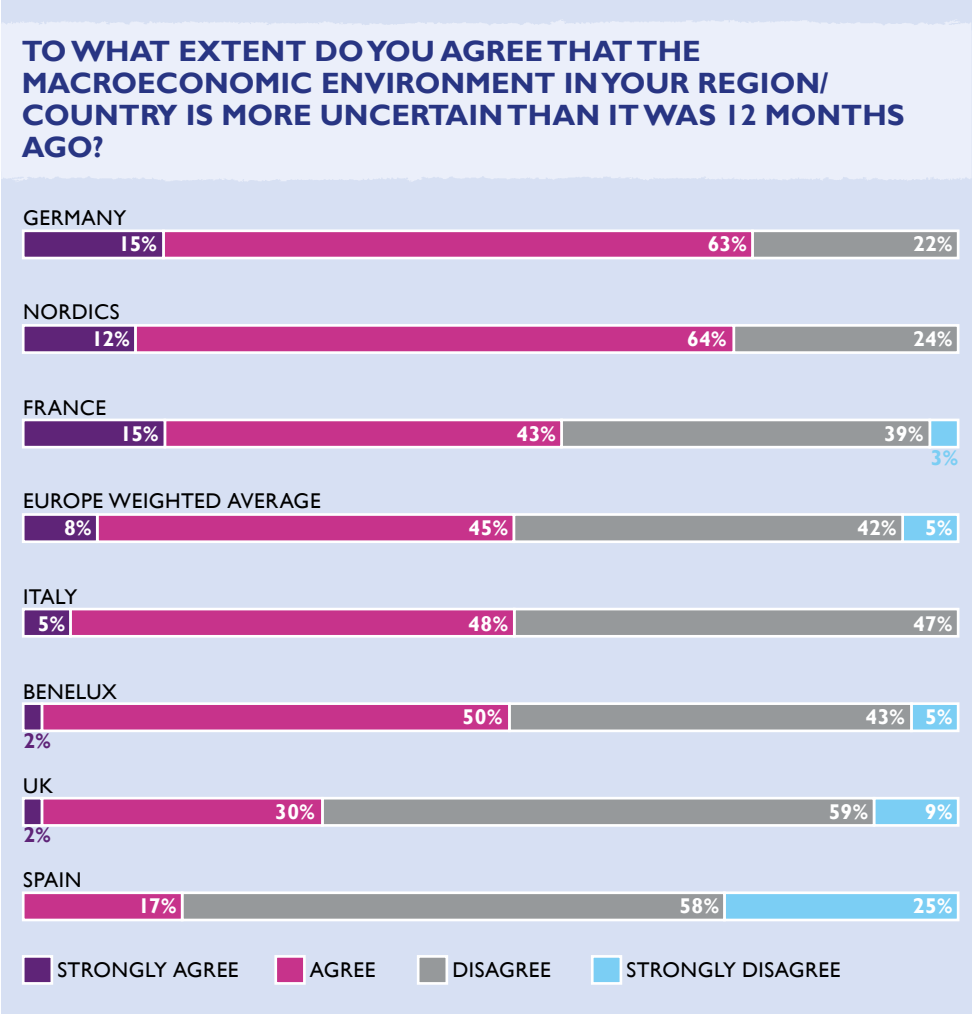
Alexander Griffith
Partner
DLA Piper, London

GERMANY

DEAL ACTIVITY EXPECTED TO STABILISE IN 2015 AFTER A STRONG 2014

Deal activity ticked up in Germany in 2014 – 45 deals valued at €63.9 billion were executed in 2014, an increase on the 42 deals executed in 2013[13]. Opinion is mixed on whether deal activity will increase in 2015 – 44% of German survey respondents expect an increase in deal activity next year, while 44% expect deal activity to be similar to 2014. If deal activity does increase, it will likely be a relatively small uptick given the weak outlook for overall economic growth.

In December 2014 the Bundesbank (the German central bank) halved its forecast for German economic growth to 1% in 2015. According to



[13] Source: Dealogic

preliminary estimates in early 2015, Germany's economy grew 1.5% in 2014. In June 2014 the Bundesbank predicted growth of 1.9% in 2014 and 2% in 2015. Tellingly, 78% of German survey respondents agreed that the macroeconomic environment in Germany is more uncertain than it was 12 months ago, compared with only 53% of all survey respondents across Europe. In fact, German survey respondents were the most downbeat of everyone surveyed when it came to the question on economic uncertainty and how it compared with conditions twelve months ago. Nonetheless, survey respondents still expect Germany to be the second largest European market for acquisition finance debt deals behind the UK.

One notable positive development in Germany during 2014 was the continuing increase of liquidity from the banking sector driven by ongoing expansion by international banks into Germany. Despite the weak economic outlook, on average German corporates have better credit ratings and are less leveraged than most European corporates, which makes them attractive prospects for banks.

This increase in banking liquidity has resulted in a modest decrease in pricing and an increase in leverage during 2014. While this has created attractive conditions for borrowers, it has put direct lending funds offering unitranche structures, which are so prevalent in the UK, at a significant competitive disadvantage. Still, the number of unitranche financings closed in Germany increased significantly from a handful in 2013 to 13 in 2014, according to Altium Capital's MidCapMonitor[14].

Wolfram Distler, Partner at DLA Piper, Frankfurt, believes this has only been possible as the overall number of acquisition financings, including bank financings, increased significantly in 2014. In addition debt funds have accepted lower margins in Germany than predicted. It remains to be seen if this trend will continue in 2015. Notably, every German survey respondent expects senior only structures to be the most common middle market debt structure in 2015. In contrast, only 50% of the wider group of European survey respondents expect senior only structures to be the most common structure in 2015.

Another potential obstacle for private debt funds targeting Germany is the prospect of tighter regulation aligning debt funds and banks. Regulation to this effect was outlined in the coalition agreement between the CDU and the SPD. There has been little progress on its implementation thus far but it remains a concern for private debt funds.

"In the mid-market we saw much more activity in 2014 than in the last couple of years. Despite a growing appetite of bank lenders to underwrite, most of the financings are structured as club deals. Due to this increase in bank liquidity, debt funds can only gain market share by offering lower margins and accepting looser covenants than elsewhere.

Wolfram Distler
Partner
DLA Piper, Frankfurt

[14] Altium MidCapMonitor, Issue Q4 2014

THE NORDICS

UNCERTAIN MACROECONOMIC CLIMATE TO DAMPEN DEAL ACTIVITY

Some 24 deals valued at €21.2 billion were executed in the Nordics (Sweden, Denmark, Norway, Finland & Iceland) in 2014, compared with 30 deals during the previous year[15]. For the second year running this made the Nordics as a region the fourth most active European market behind the UK, Germany and France measured by deal value.

Unfortunately, there are few signs that deal activity will pick up in 2015 – the majority of survey respondents (52%) located in the Nordics expect deal activity in 2015 to be similar to last year. The Nordics is also home to the lowest proportion of survey respondents in any surveyed European country predicting an increase in deal activity.

The weak outlook for deal activity is directly associated with a series of downgrades to the outlook for economic growth in the Nordics' major economies. For example, in December 2014, Norway's central bank cut its forecast for mainland economic growth, which excludes oil revenues, to 1.5% in 2015. Three months earlier it predicted mainland economic growth at 2.25%. The country's Prime Minister also noted in a December announcement that the overall economic growth outlook for 2015 might have to be cut due to declining oil prices.

There were also downward revisions or at least talks of downward revisions to 2015 economic growth projections in Denmark and Sweden during the second half of 2014. It is therefore no surprise that over three quarters (76%) of survey respondents in the Nordics believe the macroeconomic environment is more uncertain than twelve months ago, a proportion that is significantly above the European average (53%).

> "Many Swedish banks are able to offer 5x or 5.5x leverage and very attractive covenant headroom, meaning unitranche funds need to be very competitive to win deals."

Despite the weak outlook for deal activity, survey respondents still expect the Nordics to be the fourth most active market for deal activity behind the UK, Germany and France in 2015. The size of the market also means there will still be plenty of activity despite the low expectations for overall deal volume growth.

One of the most notable developments in the acquisition finance debt market in the Nordics during the past two years is improved liquidity in the banking sector. Following a period of fundraising and cost cutting, Swedish banks now meet their capital adequacy requirements and are open to lend. This, combined with the depth of the Scandinavian bond market, has provided borrowers with plenty of financing options.

As is the case in Germany, the diverse range of financing options has restricted the ability of direct lending funds to make a pronounced impact in the Nordics. Many Swedish banks are able to offer 5x or 5.5x leverage and very attractive covenant headroom, meaning unitranche funds need to be very competitive to win deals. Therefore, many private debt funds have been forced to lend in special situation transactions that have been rejected by banks.

[15] Source: Dealogic

"Increasing uncertainty in the Eurozone dented activity somewhat towards the end of 2014, as did the ongoing situation in Ukraine. The political situation in Sweden has also been a bit fluid as we did not have a functioning government for a protracted period of time. One interesting development is that the bigger banks have become a bit conflicted in terms of whether they should arrange Scandinavian high yield bonds, which are great fee events. However, if they do this on a regular basis then the loan book starts to shrink and they also miss out on lots of ancillaries. Some banks are asking themselves what role they should play in the leveraged finance space.

Bjorn Sjoberg
Partner
DLA Nordic, Stockholm

FRANCE

EMERGENCE OF ALTERNATIVE LENDERS CREATES MORE COMPETITIVE LENDING ENVIRONMENT

Some 56 acquisition finance debt deals valued at €35.4 billion were executed in France in 2014, an 8% increase on the 52 deals transacted in 2013[16]. This made France the joint most active country in terms of deal numbers in 2014 alongside the UK. The increase was caused by a surge in the number of leveraged buyouts – 25 buyouts valued at €8.3 billion were executed in 2014, a 79% increase on the 14 buyouts transacted in 2013.

It is particularly notable that the volume of buyouts jumped despite the woeful level of economic growth. The country's economy grew by only 0.3% in the third quarter of 2014 following a 0.1% decline in the second quarter and zero growth in the first. According to Maud Manon, Partner at DLA Piper, Paris, the spurt of buyout activity was in particular driven by sellers deciding to sell after concluding that their price expectations were unlikely to be met in the near future.

The majority (55%) of survey respondents expect deal activity to increase further in 2015. This will be underpinned by further buyout activity and continuing refinancing transactions, for which there is a robust pipeline of deals in France. An increase in deal activity will also be aided by an anticipated modest increase in economic growth. In December 2014 France's national statistics institute stated that France's

[16] Source: Dealogic

economy will grow by 0.7% in 2015, an increase on the 0.4% economic growth forecast for 2014.

Deal activity aside, a major development during 2014 has been the influx of alternative lenders into France – alternative lenders completed 35 deals in the French mid-market in the first three quarters of 2014, almost double the 18 deals completed in the corresponding period in 2013, according to data compiled by Deloitte[17]. This makes France the second most active country for alternative lenders in the mid-market after the UK.

The abundance of new lenders in the market has created a very competitive lending environment with significant pressure on margins and fees. Indeed dealmakers report that there are on average seven to eight proposals to provide debt for each deal, more than there has ever been since the financial crisis.

> French sponsors were a lot less reluctant to borrow from debt funds offering unitranche structures in 2014 than ever before, especially in the small-mid and upper-mid cap market. Two years ago sponsors and borrowers were very suspicious of unitranche. Now they have realised that the debt funds are just as professional as the banks. Funds are also more flexible and sponsors like the convenience of only having to deal with one party on closing. We are seeing both French and UK debt funds looking at deals in France, as well as traditional mezzanine funds adapting to offer products similar to unitranche. However, for large cap deals, the market share held by traditional banks is still greater than any other funder.

Maud Manon
Partner
DLA Piper, Paris

[17] Deloitte Alternative Deal Tracker, December 2014

SPAIN

IMPROVED ECONOMIC OUTLOOK TO DRIVE INCREASE IN DEAL ACTIVITY

Deal activity began to recover in Spain in 2014 following a fallow period since the 2008/9 financial crisis. Some 17 deals valued at €7.2 billion were completed in 2014, a 21% increase on the 14 deals transacted in 2013[18]. This increase meant Spain was the fifth most active country measured by the number of deals in 2014.

This growth is likely to be maintained in 2015 – 77% of survey respondents expect deal activity to increase next year, significantly more than the proportion anticipating increased deal activity across the whole of Europe (54%). In fact, the largest proportion of survey respondents forecasting an increase in deal activity was in Spain.

The anticipated increase in deal activity is underpinned by the country's return to economic growth. In December 2014 Spain's central bank forecast economic growth of 2% in 2015, up from an estimated 1.4% in 2014. The economy flat-lined in 2013 and was in recession in 2012. Survey data confirms this optimism about the Spanish economy – 83% of Spanish survey respondents disagree with the statement that the macroeconomic environment is more uncertain than it was twelve months ago, significantly more than the proportion that disagreed with this statement Europe-wide (47%).

Importantly, liquidity amongst the banking sector has improved considerably over the past two years. Although there are now less than ten banks active in the Spanish acquisition finance debt market, compared with around 40 pre-crisis, the banks that are active have fully restructured and are ready to lend. There are also signs that unitranche funds are starting to target Spain, although the number of completed deals is still well below the UK level.

This increase in liquidity has resulted in a decrease in mid-market debt margins from 400-600 bps at the beginning of 2014 to 300-400 bps at the beginning of 2015. There is also more optionality at the large end of the market, with some large deals over €500 million tapping the bond or US loan market in 2014.

> "The Spanish market is certainly recovering and liquidity is increasing. Local banks are back on track although we are still far from 2006 levels. There have been a number of deals where alternative lenders have taken the lead and there is an expectation in the market that this trend will continue to grow. In 2014 some of the larger deals went to the US market or searched for liquidity in the bond market. But this is not the norm. The good news is that we expect deal activity to increase significantly in 2015.

Cesar Herrero
Partner
DLA Piper, Madrid

[18] Source: Dealogic

ITALY

NEW LEGISLATION WILL OPEN MARKET UP TO ALTERNATIVE LENDERS

Deal activity growth was flat in Italy in 2014 – some 22 deals valued at €12.1 billion were executed in 2014, in line with the 21 deals that were completed in 2013[19].

The majority (60%) of Italian survey respondents are forecasting an increase in deal activity in 2015. However any increase will likely be muted given the poor performance of the Italian economy, which has not posted a single quarter of economic growth in the last three years. In December 2014, the Italian government announced it expects the economy to have contracted by 0.3% during 2014 and grow by 0.6% in 2015.

On a positive note and in line with most other European countries, banking liquidity has improved significantly in the past three years to the extent that banks are now ready and prepared to lend again. In addition, Italy has introduced new legislation that opens up the acquisition finance market to alternative and international lenders, effectively aligning the country with most other major European countries. The legislation is in place although a small number of implementation regulations still need to be enacted. The impact on liquidity will not be known until the end of 2015.

> Banking liquidity was a significant issue in the past because it was insufficient to meet demand for refinancing and also for acquisition finance. Banking liquidity has improved significantly in the past three years. The new legislation will also further improve the supply of funding.

Ugo de Vivo
Senior Counsel
DLA Piper, London

> We do see a positive outlook for M&A in Italy and therefore an increase in demand for acquisition finance, but against this the Russian sanctions, affecting Italian exports, and the deflationary spiral threatened by the recent drop in the oil price may slow the recovery of Italy's economy.

Mario D'Ovidio
Partner
DLA Piper, Milan

[19] Source: Dealogic

BENELUX

ALTERNATIVE LENDERS STARTING TO MAKE INROADS

Some 21 transactions totalling €23.8 billion were completed across the Benelux region in 2014, a slight increase on the 18 deals executed in 2013[20]. The Netherlands is by far the largest market in the Benelux region, accounting for three quarters of the total number of deals in 2014.

Survey respondents expect deal activity to gather pace in 2015 – 60% of respondents located in the Netherlands, Belgium and Luxembourg expect deal activity to increase in 2015. Only Spanish respondents are more optimistic that deal activity will increase this year.

Economic conditions are conducive to an uptick in deal activity. According to preliminary estimates, the Netherlands posted positive economic growth in 2014 following two years of contraction. Although senior-only structures are the norm across the Benelux region, a few unitranche deals were structured in 2014. The most notable was Ares Management and GE Capital's provision of a €110 million unitranche financing to Montagu Private Equity to fund the acquisition of Netherlands-based DORC Holding, a provider of equipment for ophthalmic surgery.

Both Gerard Kneppers, Partner, DLA Piper, Amsterdam and Johan Mouraux, Partner, DLA Piper, Brussels, do not expect a significant increase in domestic alternative lending activity in 2015 although it is apparent that these structures do get used more frequently by foreign lenders who provide inbound financing for Benelux based transactions.

> "There are many medium sized enterprises in Belgium that are good targets for foreign companies and private equity houses. With Europe being quite slow these companies need to team up with larger companies to develop export markets. Just operating in Belgium is insufficient. This should underpin an increase in deal activity over the next three years.

Johan Mouraux
Partner
DLA Piper, Brussels

> "The general sentiment in the Netherlands is one of careful optimism and this, coupled with the latest macro-economic trends, suggests total transaction volume will increase in 2015. Whilst there seems to be a lot of interest for alternative financing structures such as unitranche, the number of domestic unitranche transactions that have closed remain low.

Gerard Kneppers
Partner
DLA Piper, Amsterdam

[20] Source: Dealogic

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For further information regarding our European and Global contacts and capability, please contact Alexander Griffith via his contact details above.

PREVIOUS EDITIONS

ABOUT THE RESEARCH

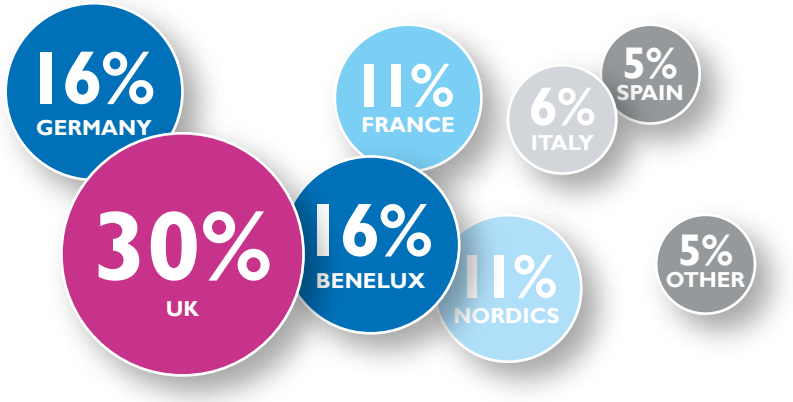
The survey and report were written in collaboration with The Lawyer Research Service, a joint initiative between The Lawyer and VB/Research. The survey was undertaken in November and December 2014, and was completed by over 300 debt providers, advisors, sponsors and corporates across Europe.

Survey respondents include: Alcentra, Ares Capital Europe, Armada Mezzanine Capital Oy, Babson Capital Europe Ltd, Barclays Bank PLC, Beechbrook Capital LLP, Canaccord Genuity Group Inc, CVC Credit Partners, Danske Bank A/S, DC Advisory Ltd, Deloitte LLP, Ernst & Young LLP, GE Capital, HSBC Bank plc, ICG plc, ING Groep N.V., Investec Bank PLC, KPMG LLP, Leonardo & Co, Livingstone Partners LLC, Lloyds Banking Group plc, Marlborough Partners, NAB Group, NIBC Bank N.V., Nordea Bank AB, PwC LLP, The Royal Bank of Scotland Group plc, Banco Santander S.A., SEB AB, Swedbank AB, UniCredit Bank AG and Wyvern Partners.

To supplement the survey, interviews were conducted with the following individuals:

- Graeme Delaney-Smith, Head of European Direct Lending and Mezzanine Investments, Alcentra
- Mike Dennis, Partner, Ares Management
- Tara Moore, Head of Debt Finance Origination, Barclays Bank
- Andrew Lynn, Managing Director, Canaccord Genuity
- Neale Broadhead, Managing Director & Portfolio Manager, CVC Credit Partners
- Floris Hovingh, Director – Head of Alternative Lender Coverage, Deloitte
- Owen Verrier-Jones, Managing Director, GE Capital
- Dino Marabese, Head of Middle Market Financial Sponsors, Europe, HSBC Bank
- Ian Crompton, Deputy Head of Middle Market Financial Sponsors, HSBC Bank
- Max Mitchell, Head of Direct Lending – Credit Fund Management, ICG
- Callum Bell, Head of Corporate & Acquisition Finance, Investec Bank
- Carlo Fontana, Head of Leveraged Debt Capital Markets, Lloyds Bank
- James Ranger, Co-Head Mid Markets, Acquisition Finance, Lloyds Bank
- David Parker, Partner, Marlborough Partners
- Robbie O'Sullivan, Business Development Director, NAB Group
- Richard Roach, Managing Director, Financial Sponsors UK, RBS
- Andrew Tully, Head of Structured Finance – Financial Sponsors, Santander UK
- Mike Barnes, Head of Debt Advisory, Wyvern Partners

RESPONDENT BREAKDOWN BY COUNTRY



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