ALTERI INVESTORS

Shifting sands

An analysis of the German retail sector debt market

DUFF & PHELPS

DEBTWIRE

Contents

Key Findings

In H1 2016, Debtwire conducted a survey of CFOs and financial controllers (or equivalent) from 100 German retailers on their views of current and future requirements for financing. The results paint a clear picture of a sector going through a transformational period, both in the way businesses retail and the shape of their debt financing.

Traditional term loan debt from banks remains the main source of capital for the German retail sector...

30% bank term loan (senior)

4% bank term loan (junior)

These figures are percentages of respondents' total debt.

...but availability of finance in the retail sector has tightened significantly in recent years.

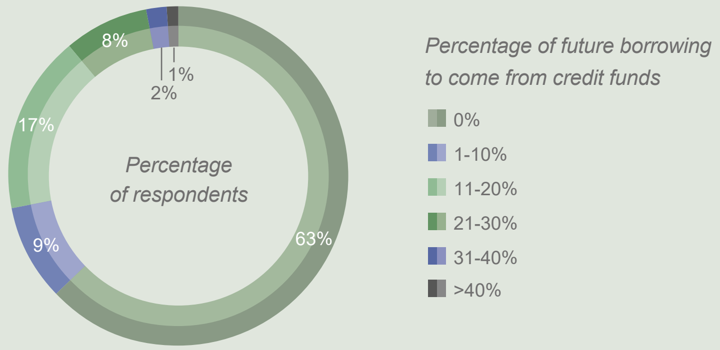
94% of respondents say lending standards imposed by banks have tightened significantly since the financial crisis in 2008.

70% of respondents agree with the statement, "We have not always been able to obtain the financing we needed when we needed it at a suitable price."

There is a clear appetite for non-bank lending.

11% of respondents' existing debt is composed of ABL and lending from direct lending credit funds (mean).

German retailers expect a healthy percentage of future borrowing to come from non-bank direct lending from credit funds (excluding lending from shareholders/investors).



Percentage of respondents who currently use asset classes as collateral for loans — retail assets and IP licensing are significantly underleveraged, opening the door to future asset-based lending:

95% cash in accounts/registers

72% real estate

47% shares

44% inventory

31% receivables

29% equipment

15% intellectual property

Maturity profiles and headroom indicators further support the future growth of alternative debt financing in retail.

Almost **80%** of respondents have bank term loans maturing within three years. In terms of headroom indicators, **38%** of respondents have less than **€20m** available in their existing facilities.

Foreword: Alteri Investors

Funding in retail's new norm

Major structural shifts, poor market performance, a relentless squeeze on retailer profitability as well as dampened bank appetite are driving significant changes in the German retail sector debt landscape.

Retail is dynamic by nature, but the sector has embarked on a period of colossal, permanent change. The pace of this transformation across Europe is arguably now faster than ever, and perhaps nowhere more so than in Germany.

The competitive landscape is intense with strong international chains and pure play e-tailers competing with domestic incumbents for the retail sector's declining share of consumer spend. Year-on-year German footfall indicators are perpetually negative and consumer demands for value have never been higher. With shoppers hooked on discounts, markdowns are getting ever deeper and moving to a year-round trend instead of the traditional end-of-season *Schlussverkauf*.

Although German consumers have been slower to embrace the digital world than some of their European counterparts, they are fast playing catch up. With Amazon and Zalando leading the charge, Germany's online retail sales are expected to grow 12% in 2016, according to figures from German e-commerce association BEVH, against a broadly flat overall retail market.

Indeed, sales of fashion retailers in 2016 have been worse than the previous year in all but two of the eight months to August, according to data from *TextilWirtschaft*, with the latest available numbers from September showing double-digit declines.

The trajectory in online growth (and corresponding pressure on offline channels) is expected to continue with Germany's e-commerce sales set to capture 10% of all retail sales by 2018, up from 7% in 2013 according to research from Forrester.

Space shakeout ongoing

These permanent changes in the way we shop have led to massive overcapacity of physical stores, high street locations in particular being most exposed to these shifts. While the degree of excess space varies by sector and country, we estimate that there is still in the region of 10% too much space in Germany, which equates to a staggering €41bn in annualised sales.

A Europe-wide process of rebalancing store portfolios to match today's consumption patterns is gradually taking place, albeit at varying paces with different countries at different points on the restructuring cycle.

Germany is currently in the midst of its own space shake-out, particularly in clothing, driven in part by major insolvencies, e.g Steilmann, and to a lesser degree by retailers' perennial pruning of their estates – Gerry Weber and Tom Tailor are just two businesses to announce store closure programmes. Some of the more structurally exposed sectors have already been through at least one major phase of rationalisation, notably DIY (Praktiker/Max Bahr), while the grocery sector is also seeing a reduction in store capacity, e.g Tengelmann Group.

Bank appetite stifled

The costs of managing these changes and emerging with a business fit to compete in the new norm can be a major drain on profitability. Add in other long-term margin headwinds, notably currency which represents a major risk to sourcing costs, the perpetual shift in consumer spend away from retail to leisure and the potential for future shocks to German consumer confidence, all set against the backdrop of Eurozone political uncertainty, and it is understandable why appetite from mainstream lenders is relatively muted towards the sector.

Banks are adopting a selective approach to retail, with lending restricted to the best credits at historically modest debt leverage ratios and often where assets provide some downward protection. Their ability to lend into the sector has also been hampered by regulatory changes, post-Basel III.

Yet banks are not the only financial stakeholders to retrench from the sector. Credit insurers have become increasingly wary of retail, further compounding banks' nervousness. And the mid-cap bond market, a previously important source of finance to mid-sized retailers, has all but closed, given a recent run of defaults including Steilmann and Strenesse.

Our survey highlights the extent of the problem: 94% of participants confirm that bank lending standards have tightened significantly since 2008 and 70% have not always been able to obtain financing when needed.

Emergence of the credit funds

Access to traditional funding is tighter than ever before for many retailers, at a time when demand for flexible and stretch funding is at its highest, given the monumental changes taking place in retail.

Enter the asset-based lenders and credit funds, whose access to the German market has been eased by changes to banking licence requirements announced by the Federal Financial Supervisory Authority (*Bundesanstalt für Finanzdienstleistungsaufsicht*, or BaFin). The legal framework in Germany is relatively conducive to these new players – security is straightforward and predictable to realise, and the insolvency regime is rational and creditor friendly. In turn, direct lending funds and asset-based lenders are able to provide flexible financing, are more likely to understand some of the restructuring tools and refinance initiatives required by retailers, and are able to respond quickly with streamlined underwriting processes.

> "Access to traditional funding is tighter than ever before... at a time when demand for flexible and stretch funding is at its highest."
> Joerg Tybussek, Head of DACH, Alteri Investors

While the market still requires education in terms of borrowing base concepts, covenants and pricing, we are already seeing situations where relationship banks are exiting altogether and being replaced by direct lenders.

At Alteri, we think that this market will be widely accepted and part of mainstream lending in German retail within the next two years. This prognosis is borne out by our survey, with 34% of retailers expecting up to 30% of future external debt to come from credit funds. Nevertheless there remains huge uncertainty around the retention of passporting rights for UK funds (and US funds with UK headquarters) in the event of the UK leaving the single market.

Clearly, the sands of German retail still have further to shift.

Joerg Tybussek
Head of DACH,
Alteri Investors

Foreword: Duff & Phelps

The European debt market: State of play

Business, like nature, abhors a vacuum. When bank lending declined after 2008, the credit fund and non-bank direct lenders moved in to fill that gap. But now, people are choosing an alternate route to finance for different reasons.

Since the financial crisis of 2008, as European banks drew up the drawbridge on lending and governments tightened regulations to avert any future crises, there's been a notable shift to alternative sources of funding in the mid-market, to finance acquisitions, growth and recapitalisation.

When traditional bank term lending reduced, businesses did not have many other options. Alternative lenders – whether credit funds or non-bank direct lenders – helped to fill that gap, many of them established with mid-market leveraged finance transactions in mind.

The shift has been most visible in the UK, where non-bank lenders have made clear inroads, followed by France and now Germany. Europe is slowly moving towards the US model where non-bank lending makes up approximately 80% of the leveraged finance market.

There are now over 70 active non-bank direct lenders in Europe, with new ones appearing each month.

The credit funds have raised their capital from pension funds, insurance companies, sovereign wealth funds, endowments and family offices. In a low interest rate environment where yields are minimal, senior secured leveraged debt is an attractive asset class for investors.

What's the alternative?

Credit funds and non-bank direct lending can be more expensive than banks, so why turn to them? It's not entirely due to a lack of access to financing: it's also about speed, transparency, flexibility and the opportunity to build a partnership with a lender.

Bank lending can often be "banking by numbers", a box-ticking exercise that affects both access and speed. For example, if a business is trying to secure a deal in three to four weeks, it's not necessarily going to get it done with a bank in that timeframe, whereas it might have better luck with a credit fund.

European clearers and banks will often rely on a policy response – a company with an EBITDA of less than €10 million might be offered two-and-a-half times leverage, because that's what head office has decreed. A credit fund, on the other hand, has greater freedom and flexibility. It might recognise that a business is very good, even if it's small or considered high-risk, and would be comfortable lending a higher multiple of EBITDA.

It will also often have access to specialist expertise and be more tech savvy than banks, which means it will see opportunity where many traditional lenders see only risk.

> "I suspect we'll see greater collaboration between banks and credit funds, with the former providing a revolving credit facility or ABL facilities at the front end, and the latter offering term lending."
>
> Ken Goldsbrough, MD Debt Advisory, Duff & Phelps

Transparency is also important: bank salespeople might be initially enthusiastic about a financing but the credit committee may still say no. Credit funds, meanwhile, are usually able to provide an accurate response – the people in the room are often the ones making the decisions. This level of transparency is appealing to many mid-market businesses trying to secure funding in a volatile market.

In each case, it's a question of creating a more partnership-based lending relationship. Credit funds and non-bank lenders are looking for returns. They will work closely with borrowers to avoid problems where possible, so that both parties enjoy the benefits.

Finding the right hybrid

Does this mean the end of traditional bank term lending in Europe? Not at all. Banks remain the main source for financing for business and will continue to do so for the foreseeable future.

But I can see the European debt market becoming more like the US market, with banks acting more like local utilities providing a service.

I suspect we'll see greater collaboration between banks and credit funds, with the former providing a revolving credit facility or ABL facilities at the front end, and the latter offering term lending. Banks will continue to provide ancillary business services, from swaps to payments and so on, and they will lend money, but at the safer end of the credit stack. Specialist lenders will take on the riskier part of the capital structure.

We may also see more hybrid deals between ABL and credit funds, where there's a good marriage of interests. If you can raise €15–20 million on receivables from ABL at 1.5% interest and €30–40 million from a credit fund at 6% or 7%, the blended rate becomes quite competitive with bank financing.

Different types of lenders used to live in parallel universes but I think they are learning each other's language. For borrowers, the challenge will not be a lack of access to funding in future, but finding the lender that speaks their language.

An experienced debt adviser can help borrowers navigate the often bewildering number of funding choices now available and help them obtain the right funding package and financing partner for them.

Ken Goldsbrough
Managing Director,
Debt Advisory,
Duff & Phelps

Survey Insights

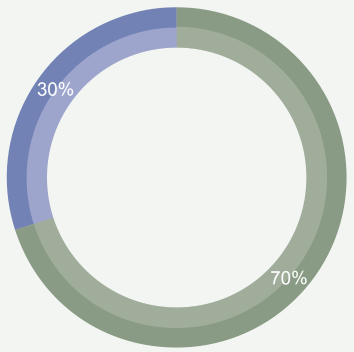
German retail: Looking for alternatives

With traditional bank funding increasingly constrained, companies in the German retail sector are starting to embrace alternative debt sources.

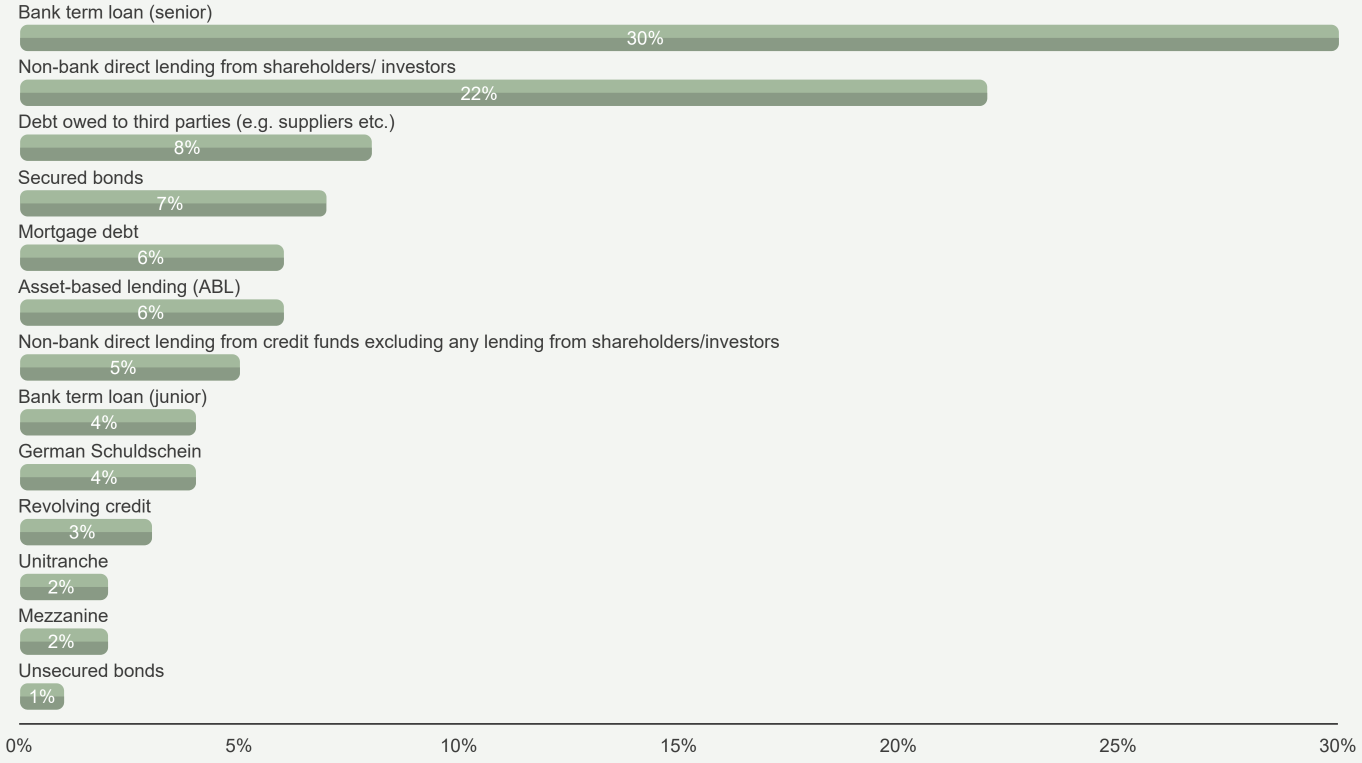
Traditional bank lending is still the main source of finance for German retailers, with senior term debt accounting for on average 30% of their total debt.

But that tide may be starting to turn as mainstream banks reduce their focus on the sector and alternative lenders start to fill the void, providing retailers with flexible funding as they manage their transformation into true omnichannel retailers.

Which statement best describes your experience of obtaining bank credit over the previous three years?



What percentage of your company's debt comprises the following instruments? (Mean shown)



"The German retail sector has entered a significant period of restructuring as it grapples with major structural challenges. We're already seeing a substantial reduction in store capacity, as retailers right-size their portfolios and invest in digital capabilities to match the demands of today's consumers," says Joerg Tybussek, Head of DACH with Alteri Investors. "But restructuring increases risk for a retailer's financial stakeholders – it raises uncertainty over who will emerge as winners and losers, and ultimately increases the potential for default."

Challenging sector dynamics, coupled with stricter measures and reforms introduced in the aftermath of the global financial crisis in 2008, mean that banks are adopting a much more cautious approach to the sector.

"Banks are now highly selective in their lending into the retail sector, restricting their exposure to only the best credits at historically modest debt ratios. It's very unusual to see bank debt at more than three times EBITDA unless underpinned by significant assets," adds Fraser Pearce, Director of Lending at Alteri.

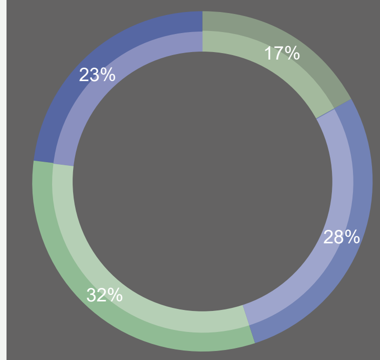
Alongside a move towards asset-backed instruments to minimise the risk of loss in default, we have also seen banks looking to partner with direct lending funds, partly as a means to retain what can be a very lucrative money transmission business.

This view is backed up by our survey: according to 94% of respondents, bank lending standards have tightened significantly since the financial crash in 2008, while 70% have not always been able to obtain financing when they needed it at a suitable price.

Methodology

In H1 2016, Debtwire surveyed 100 CFOs/Financial Controllers and equivalent of Germany-based retail businesses, 83% of which have annual revenues of more than €100m.

What is your company's annual turnover?



What is your company's primary retail sub-sector of operations?

28% Clothing

28% Other

16% Grocery

10% Electricals/Electronics

7% Footwear

6% Department store/mixed goods

5% Homewares (including furniture)

The changing lending landscape is putting pressure on German retailers already battling a volatile commercial environment, as the CFO of a grocery retailer points out: "There were times when we were denied use of our existing credit lines as they were slashed. Over the past few years, we have borrowed sparingly and only for survival purposes, not for new investment purposes."

This lack of access to funds is having an impact, as the head of finance at one clothing retailer explains: "We need continuous credit for operations, supply chain, new investments and partnerships, but business has been stagnant due to these tightened lending standards."

Diving into new pools for finance

With access to traditional funding tight, German retailers are starting to turn to alternative sources for funding. Non-bank direct lending from credit funds and asset-based lending (ABL), now comprises 11% of German retailer debt, according to our survey.

"Retailers need to invest in order to adapt to the new consumer environment – to build e-commerce platforms and the associated fulfilment capability, implement store closure programmes, etc – and there is simply not enough flexible debt capital available from traditional lenders at the moment. There is a growing gap in the market which can be filled by credit funds," says Tybussek.

Regulatory changes have also eased access to the market for credit funds. New rules introduced in 2015 by BaFin, the German Federal Financial Supervisory Authority, opened the door to a wider group of debt providers. Loan origination is now permitted by domestic and other European Alternative Investment Funds whose managers are authorised under the Alternative Investment Fund Managers Directive (AIFMD), without the need for a banking licence. Lenders including Grovepoint, Hayfin and Alteri, among others, have all been active in the German retail market, typically lending into turnaround and restructuring situations.

> "There is simply not enough flexible debt capital available from traditional lenders at the moment. There is a growing gap in the market which can be filled by credit funds."
> Joerg Tybussek, Head of DACH, Alteri Investors

"Finding capital in challenging refinancing situations – including bond restructurings and formal schemes of arrangement – is fertile ground for debt funds looking for decent returns," says Tybussek.

Most retailers of scale would have already been familiar with alternative credit markets and the withdrawal of some lenders, for example, Landsbanki and GE Capital, will have forced some retailers to at least look for new options as part of their refinancing efforts. But many still have much to learn about this new type of lender.

"Experience with alternative lending is still patchy among German retailers," says Pearce. "Understanding how facilities are structured and priced is still part of the learning curve. There is a nervousness surrounding the motivation of some funds and some questions concerning the type of protections that are used to mitigate risk, such as equity cures and standstill periods."

Retail assets are significantly under-leveraged

Asset-based lending (ABL) has been on the rise in many countries and is well established in the US and Canada, Australia, the UK and the Netherlands. In the UK alone, ABL based on hard assets such as inventory, machinery and property has increased by 7% in the past year, from £3.38bn to £3.63bn, according to the Asset Based Finance Association.

ABL has attracted lenders because of the benefits derived from its collateral position and the historically low loss rate in asset-based facilities, while issuers can take advantage of increased operating flexibility compared to traditional cash-flow loans. German legal structures and the regulatory environment are particularly conducive to asset-based lenders and credit funds.

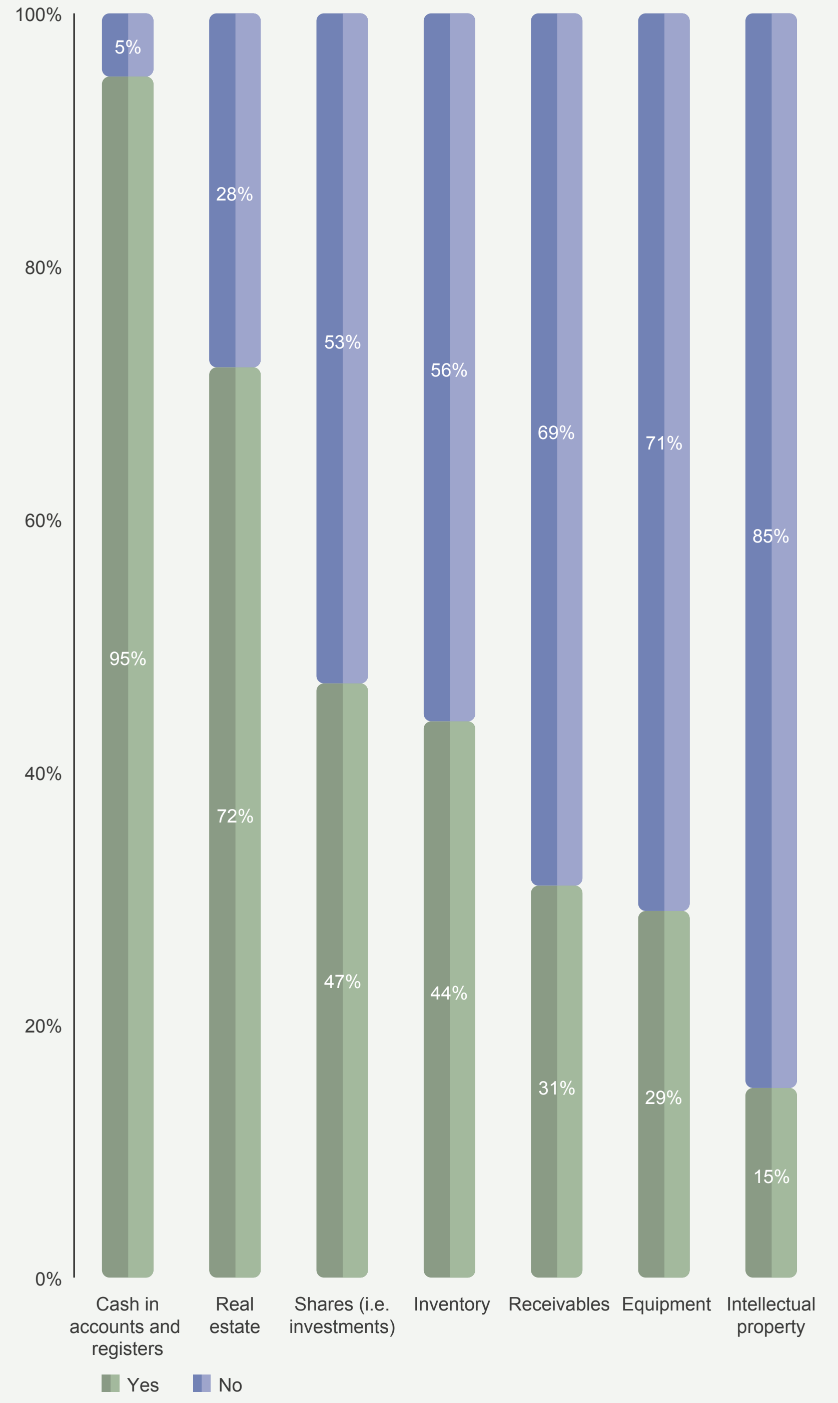
"Security is straightforward and predictable, while the insolvency regime is rational, effective and creditor friendly," says Tybussek.

But many retail borrowers in Germany still appear to be discovering the full picture. Factoring and invoice discounting are well understood, but inventory and other aspects of ABL less so, from revolving credit facilities to borrowing base concepts, covenants and pricing.

In our survey, excluding cash in accounts, real estate is the main asset used as collateral for loans for 72% of respondents versus 44% for inventory, 31% for receivables and 29% for equipment.

"Retail has a preponderance of what traditional lenders would see as unattractive assets, from inventory to IP. They are also substantially under-levered, but this plays to the strengths of debt funds and traditional

Do the following categories of assets currently serve as collateral for loans?

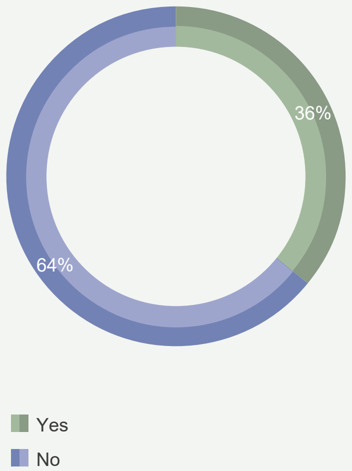


ABL players," says Pearce. Notably, intellectual property serves as collateral for only 15% of respondent companies, yet 36% license their IP, suggesting its full value is not being leveraged.

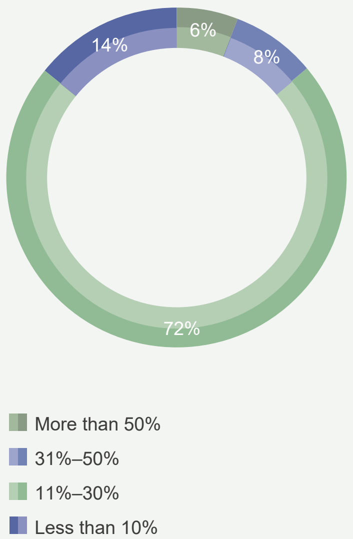
And, of those who license their IP, almost three-quarters (72%) say that 11%–30% of their company turnover is generated by licensing agreements, while 14% of respondents put the figure at more than 30% of their company turnover. In other words, there is considerable scope to tap into IP as debt collateral.

> "Retail has a preponderance of what traditional lenders would see as unattractive assets, from inventory to IP. They are also substantially under-levered, but this plays to the strengths of debt funds and traditional ABL players."
>
> Fraser Pearce, Director of Lending, Alteri Investors

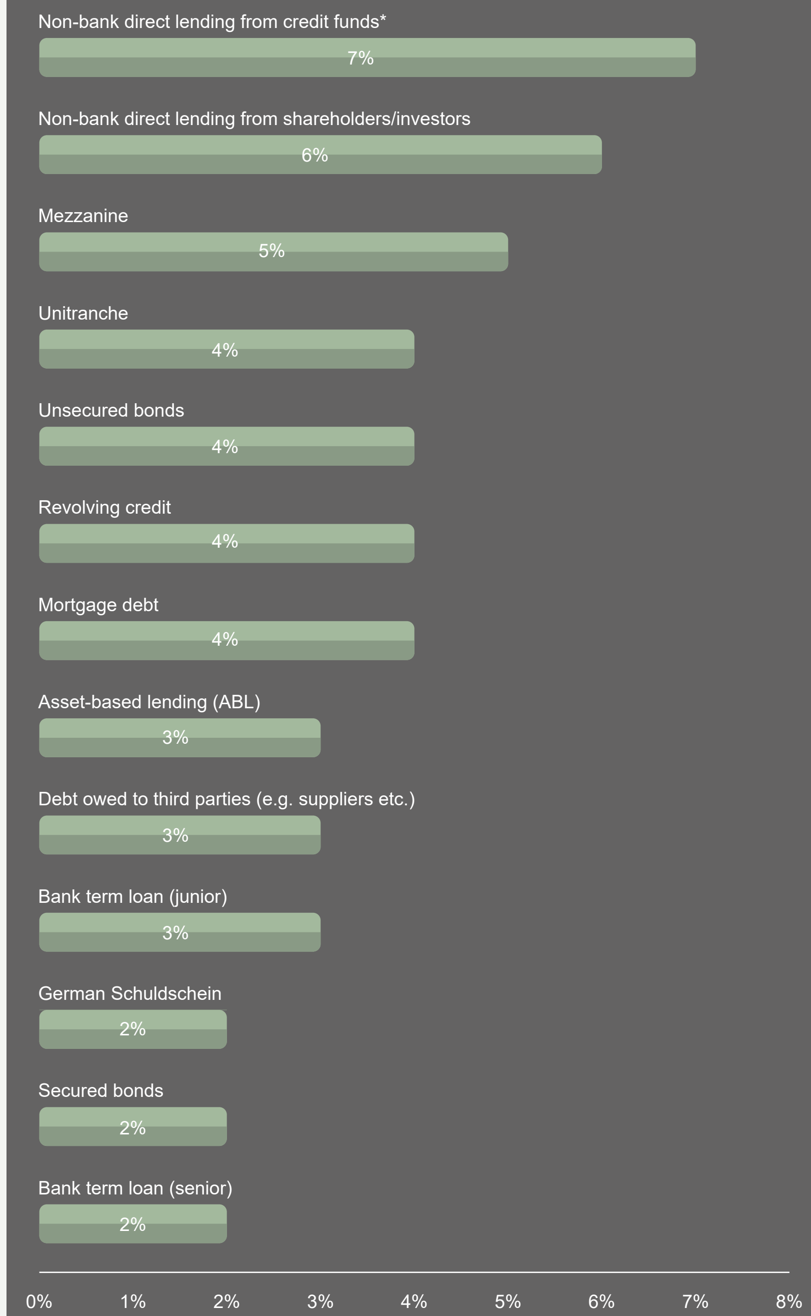
Do you own IP that is licensed?



How much of your company's turnover is generated by licensing agreements?



What is the average interest rate for each of the following instruments you hold? (Mean shown)



**Excluding any lending from shareholders/investors*

Value for money?

For many respondents in the survey, the higher costs of non-bank direct lending are offset by ready access not only to financing for investment, but also to the specialist retail expertise and networks offered by some non-bank direct lenders. As the head of finance at one electronics retailer explains, "With the ecosystem of lending shifting to non-bank lenders, it makes sense to work with industry experts to maximise investments and yield maximum profits from these investments with the help of their expertise."

This is particularly important for German retailers as they extend their multi-channel capabilities.

According to the head of finance at one mixed goods retailer, "We always look to partner with specialist lenders and make full use of the additional advisory services they provide. We get that extra external help through their knowledge and vast network… yielding a higher ROI at the end of it and hence benefit from a kind of partnership."

Conclusion

On the cusp of major growth

The conditions are ripe for non-bank lenders in Germany to enjoy even greater participation in the retail sector, and loan maturity and headroom indicators suggest that this may happen even sooner than expected.

Many respondents already expect to turn to non-bank direct lenders more often in future – 25% say they expect between 11%–30% of their future borrowing to derive from these non-traditional players.

As the head of finance at one electronics retailer points out: "We definitely want to work more with our non-bank lenders, given the uncertainty involved in obtaining bank credit these days. We want to be as competitive as possible and for that, we need continuous support for finance so we don't miss out on new investment opportunities and business growth."

And it may not be too long before we see this evolution in the market. Around 80% of respondents have bank term loans due to mature within three years and 38% have less than €20m in available headroom.

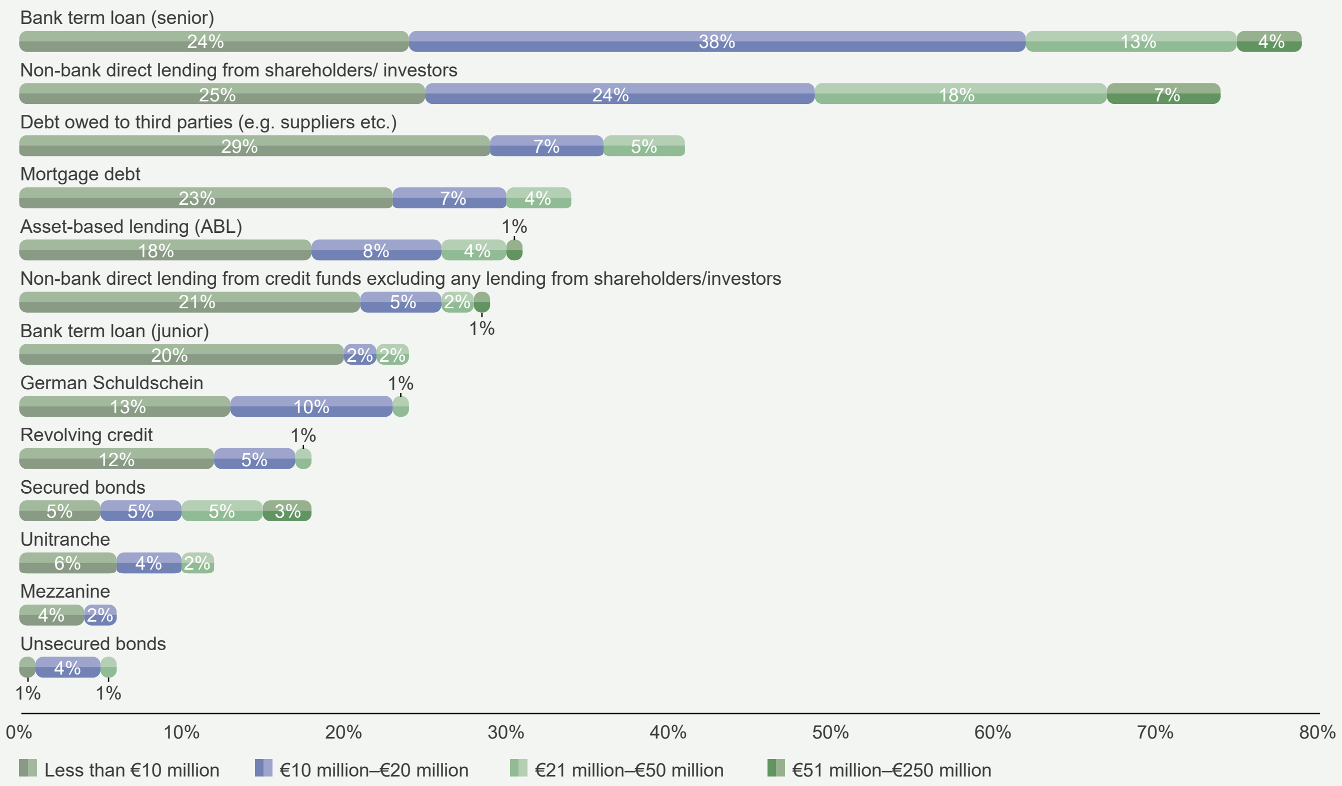
For alternative lenders, while the economics are yet to be fully proven, there is real excitement about the market prospects.

"Critical mass and volume are needed to run a sustainable lending book profitably through origination, underwriting, maintenance and renewal. While we expect niche and established funders to thrive, others will write a handful of credits and then disappear," says Pearce.

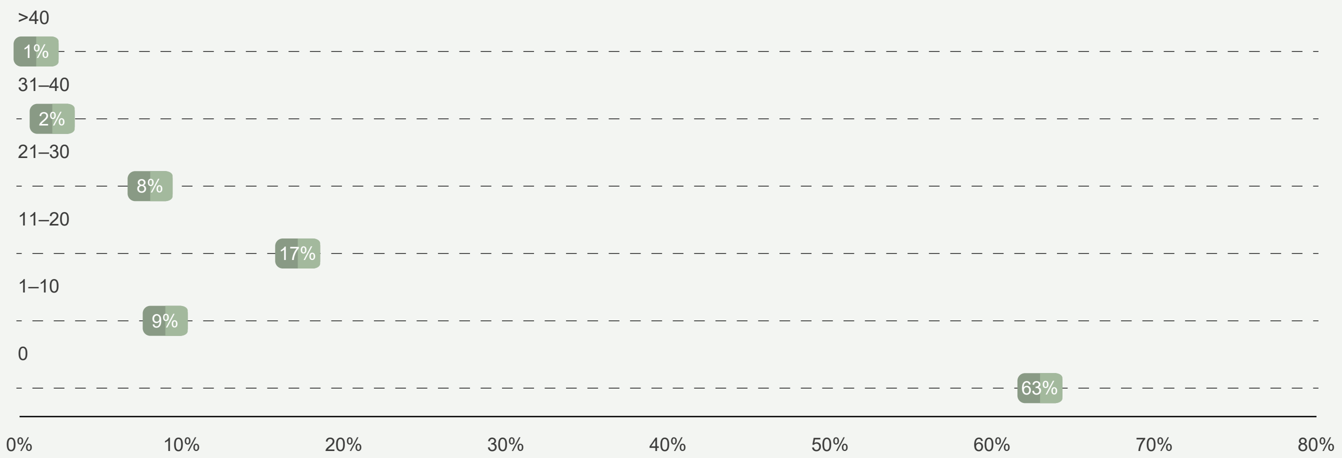
"However we're already seeing situations where relationship banks are exiting altogether and being replaced by non-bank direct lenders."

We expect this trend to accelerate over the next two years, as requirements from retailers for flexible liquidity persist and the sector as a whole gets more comfortable with the dynamics of non-bank direct lending.

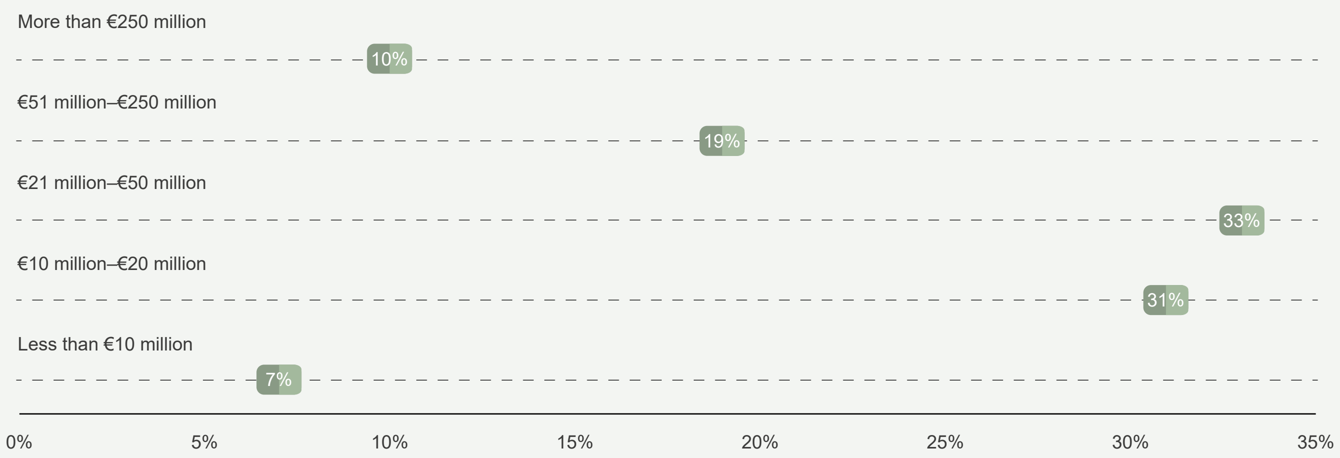
For each of the following that you hold, how much value is set to mature within the next three years?



Looking forward, what proportion of your new borrowing is likely to come from non-bank direct lending from credit funds excluding any lending from shareholders/investors? (provide %)



What is the total headroom currently available to your company?



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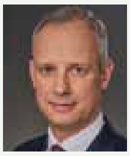

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