Duff & Phelps

Protect, Restore and Maximize Value

European Mid-Market Debt Update – Late Autumn 2020

Bounce Back of Lending Appetite with a Strong Focus on Defensive Sectors

European Mid-Market Debt Insights

Executive Summary

Since our last market update in April 2020, there have been numerous positive market developments, giving rise to a more optimistic outlook when compared to earlier in the pandemic. Only a few months back, we saw a short-term supply shortage in new lending which resulted in a temporary spike in yields. This has since normalised with loan margins tailing off and deal flow increasing. However, whilst there is increased M&A activity, European market data is demonstrating relatively low deal activity with year-to-date (YTD) value down 36% compared to the previous year.[1]

The improvement in debt market conditions has mainly been driven by direct lending funds with robust dry powder levels. On the contrary, the majority of banks remain cautious, which is also extending to the provision of super senior debt facilities. Many funds are reporting a strong pipeline for Q4 2020, with a particular focus on defensive credits. As a result, lending terms for these types of deals have largely reverted to pre-COVID-19 levels.

COVID-19 related government schemes have been a major factor across the European debt market and have proven successful in most countries. Across the UK, Germany, France, Italy and Spain, EUR 542.9 billion (bn) of loans have been approved, however the UK schemes have been largely off limits for PE-owned businesses.[2]

Going forward, there is continued uncertainty surrounding the resurgence and lasting effects of COVID-19, compounded by the geo-political environment and uncertainty as to who will be the winners and losers when government support schemes come to an end. Incumbent lenders have generally been supportive of their clients to date, with little action taken on riskier loans; however, this behaviour may change in the medium term. Overall, we expect an uncertain and bifurcated debt market outlook. This will likely be characterised by direct lending funds' focus on defensive sectors and with borrowers in more cyclical and COVID-19 affected sectors forced to turn to asset-backed lending or more expensive pools of capital. We also expect increased restructuring activity in the medium term.

We discuss the above trends in more detail, with additional market data, on the following pages.

Source:
1. Mergermarket as of 30 September 2020
2. Sum of various government loan schemes listed in right hand side box

Key Government Loan Schemes

Europe

UK – GBP 141.8 bn/EUR 156.0 bn of state-guaranteed loans across multiple schemes

- **CBILS** – **Coronavirus Business Interruption Loan Scheme**
  Approved: c. 67k loans, GBP 15.5 bn of new funding
- **CLBILS** – **Coronavirus Large Business Interruption Loan Scheme**
  Approved: 566 loans, GBP 3.8 bn of new funding
- **BBLS** – **Bounce Back Loan Scheme**
  Approved: c.1.6 mn loans, GBP 38.0 bn of new funding
- **CCFF** – **COVID-19 Corporate Financing Facility**
  Approved: 222 loans, GBP 83.8 bn of committed new funding (notional drawing capacity)
- **Future Fund** – **Coronavirus Future Fund**
  Approved: 711 loans, GBP 0.7 bn of new funding

Germany – EUR 56.9 bn of state-guaranteed loans approved, across c. 137.1k borrowers

France – EUR 120.7 bn of state-guaranteed loans (Prêts Garantis par l'Etat –'PGE') across c. 588k borrowers

Spain – EUR 103.8 bn of state-guaranteed loans across c. 841k loans approved

Italy – EUR 105.5 bn of state-guaranteed loans

Source:
Bank of England as of 20 September 2020
HM Treasury as of 21 October 2020
Bundesministerium fur Wirtschaft und Energie of 21 October 2020
Ministere De L'Economie Des Finances et De La Relance as of 02 October 2020
Ministerio de Asuntos Economicos as of 16 October 2020
Sace Simest Gruppo cdp as of 14 October 2020

Key Trends

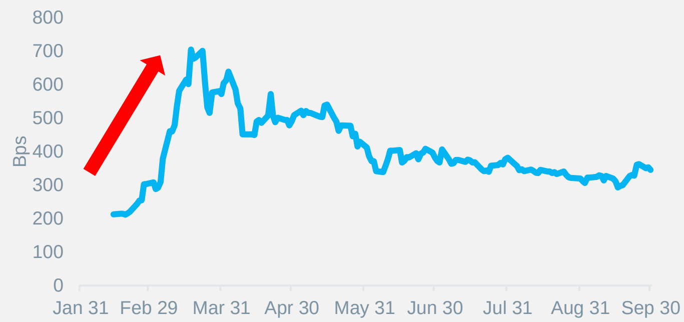
1 First Wave of Liquidity and Waiver Requests Subsided in June 2020

During April and May 2020, banks were inundated with requests for revolving credit facility (RCF) drawdowns, additional liquidity, and waivers; this was compounded by applications under the various government loan schemes. Existing customers took precedence with few banks having the bandwidth or risk appetite to consider bringing on new clients or entering into new money situations. The majority of private debt funds were likely focused on existing portfolios and were either closed for new business or seeking higher margins to match the spike in yields seen in the secondary (large-cap) markets (see top right graph). In our view, lenders have generally been supportive during this unprecedented period and have strived to be a long-term partner to their clients. Since the end of June 2020, we have seen the first wave of COVID-19 liquidity related requests subside and a significant improvement in appetite for new deals and clients, in particular from direct lending funds.

2 Improved Debt Appetite Despite Lower M&A Volumes and Values

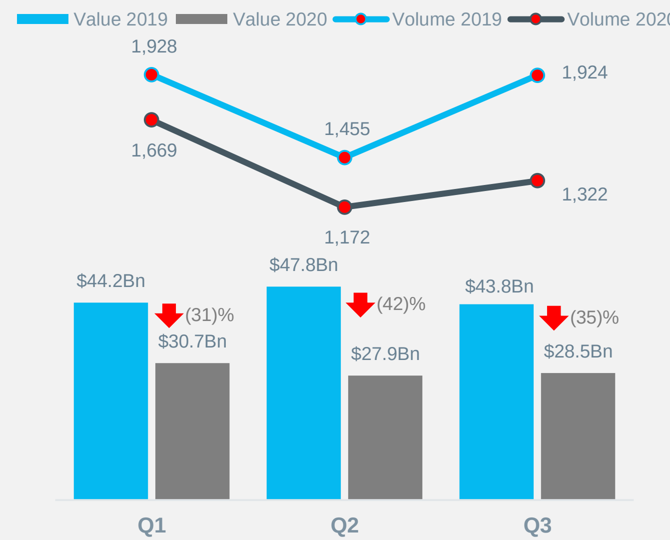
Whilst the market has become more receptive to new deals, there are some notable differences in clearing bank lending appetite across Europe. Many market participants are reporting some recovery in M&A activity; however, European market data tells a different story, with quarterly 2020 deal values down when compared to the same period in 2019 (see bottom right graph for more data points). Lenders have generally favoured defensive sectors (e.g. healthcare, defence, telecommunication and technology), resulting in more competitive bid processes with pricing and terms reverting to pre-COVID-19 levels. Conversely, companies in sectors that were significantly impacted by COVID-19, such as travel, leisure, retail and aerospace, are struggling to find mainstream lender appetite, with funding options limited to asset-backed lending or private debt at premium interest costs (including "special situations" pools of capital), leading to a bifurcation in the market. Processes are generally delayed due to extended credit and business plan questioning, as well as due diligence requirements by both sponsors and lenders. Additionally, we are seeing added caution with respect to super senior RCFs, amid concern that these facilities will be used to fund liquidity rather than for working capital.

Itraxx European Crossover Index



Source: Markit 30 September 2020

M&A Deal Volume and Value Post-COVID-19



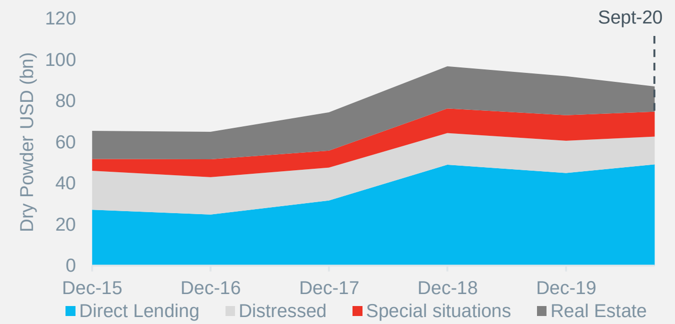
Source: Mergermarket 30 September 2020
M&A Value shown is based on publicly disclosed amount only

Key Trends

3 European Debt Market Dry Powder

Private debt fund dry powder levels remain robust at c. USD 86 bn, an encouraging sign for the longer-term market recovery. This is spread over direct lending (USD 49 bn), distressed debt (USD 13 bn), special situations (USD 12 bn) and real estate (USD 12 bn).[3] These higher levels of dry powder can often provide borrowers with confidence that liquidity in the credit markets remains robust, unlike previous levels seen during the global financial crisis of 2009. Credit funds will likely continue to face challenges regarding optimal capital deployment to maximise risk-weighted returns.

Dry Powder – European Debt Funds



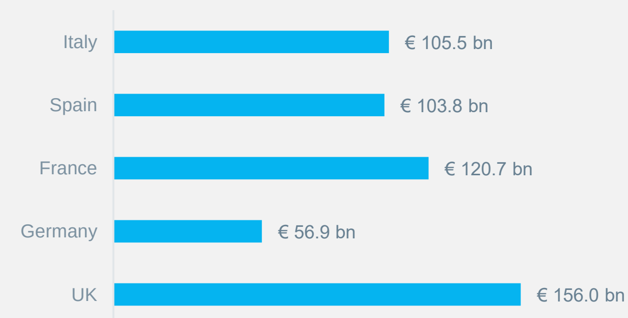
Source: Preqin 30 September 2020

4 Government Loan Schemes Have Generally Proved Successful Except for UK PE

The UK government loan schemes, notably the CBILS, experienced initial hindrances caused by an initial lack of clarity around the loan process and how the schemes would tie in with lenders' credit processes and criteria. However, with time, consultation and refinements, a significant amount of capital has been successfully allocated to date. Overall, a combined GBP 141.8 bn has been approved across various COVID-19-related UK funding schemes. Allocations to companies that had institutional equity capital were relatively small. This was due to (i) many capital structures falling foul of (the interpretation of) state-aid rules; (ii) PE sponsors preferring not to take government-backed loans; and (iii) intercreditor concerns raised by incumbent lenders who demanded a stakeholder solution.

Government support around Europe has been mixed (see bottom right graph for loan approval figures). In France, banks lent willingly to all businesses that demonstrated a strong financial position prior to COVID-19, with some commentators suggesting banks leveraged the schemes to improve their risk profile on existing short-term liquidity lines. In Germany, government loan support was less easily available, with added red tape creating complications in the loan approval process. In Spain, approval numbers appear strong. In Italy, businesses reported that applying for government loans was time-consuming and that not all Italian banks were eager to grant loan approvals.

COVID-19 Government Loan Schemes Approvals



Source:
Bank of England as of 20 September 2020
HM Treasury as of 21 October 2020
Bundesministerium fur Wirtschaft und Energie of 21 October 2020
Ministere De L'Economie Des Finances et De La Relance as of 02 October 2020
Ministerio de Asuntos Economicos as of 16 October 2020
Sace Simest Gruppo cdp as of 14 October 2020

Source:
3. Preqin as of 30 September 2020

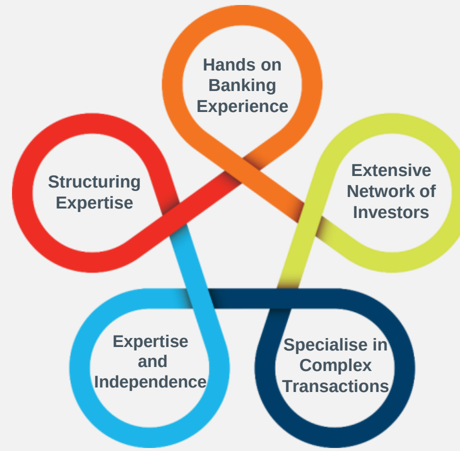
Conclusion

Medium Term Debt Market Outlook

The (potential) unwinding of government support, the current COVID-19 resurgence and the depth and potential shape of the recession sets the scene for an uncertain debt market outlook. This outlook is compounded by political uncertainty in relation to Brexit, the aftermath of the U.S. elections and general geopolitical tensions. The increased leverage in the financial system will need to be serviced and repaid. In many cases, the various schemes have delayed the inevitable, with ongoing expectations for increased corporate failures going forward. This will likely lead to a strong bifurcation in the market, with mainstream lenders strongly favouring defensive credits.

We expect some consolidation within the private debt market, which may eventually lead to smaller and less specialised lenders being squeezed out or combined (either through acquisition or merger). We have started to see this already, with a recent example being EQT selling its c. EUR 4 bn credit arm to Bridgepoint earlier this year.[4] Some funds fared better than others during COVID-19; however, the real impact on portfolios will likely be evident in the medium term.

Why use Duff & Phelps European Debt Advisory?



Services Offered

- Short Term Liquidity Funding
- Acquisition and Growth Funding
- Refinancing and Liquidity Events
- Special Situations and Hybrid Capital

Product Capabilities

- Revolving Credit Lines and Capex Facilities
- Senior Bank Term Facilities
- Stretched Senior / Unitranche Facilities
- Hybrid Debt including Mezzanine and PIK Debt
- Asset Backed Lending (Senior and Second Lien)

Source:
4. Private Debt Investor as at 26 October 2020

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