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Creative credit in private equity

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Editorial

Denise Ko Genovese
Associate editor
T: +44 (0) 20 3741 1192
E: denise.ko.genovese@acuris.com

Chris Papadopoullos
Research editor
T: +44 (0) 20 3741 1384
E: christopher.papadopoullos@acuris.com

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Creative with credit

Denise Ko Genevese
Associate editor

Acquisition finance isn't the only way to be creative with credit. It grabs headlines for the low pricing and quirky terms thought up by the increasing number of debt funds looking to stand out and take market share away from the banks, but it's a borrower's market elsewhere in private equity too. There is almost no area unleveraged in the sponsor-led space.

In our first edition of *Creative Credit in Private Equity*, *Unquote* looks at how debt is being used at every stage of the PE cycle; where each pocket of lending is at, how it has matured, and where it might be headed.

Who would have thought that fund-level financing – once only associated with a plain vanilla subscription line for capital call purposes – could morph into a sophisticated NAV facility secured on the equity in a sponsor's portfolio of companies? Or that you could even get a hybrid solution secured in part on the remaining LP commitments and in part on the portfolio companies?

And could we have imagined five years ago that banks and specialist funds would be actively promoting leverage on most secondaries transactions? With more players chasing a finite number of deals and rising valuations, today's secondaries buyers seem happy to use the readily available debt to leverage their equity and boost their spending power.

It seems everyone wants an increasing slice of the red hot PE action, and the same is true of LPs. Although more popular in the US than in Europe right now, credit co-invest – which essentially works in the same way as an equity co-invest – is gaining traction: an LP invests in a direct lending fund and when that direct lending fund provides the debt for a private equity buyout, the LP is invited in as a co-investor, averaging down fees and boosting its own returns.

There is also an emerging scene of LPs borrowing from specialist lenders to finance their own fund commitments, which makes you wonder whether there might come a day when there is little to no real equity in a deal on day one!

As the market matures and gets even more sophisticated, we shouldn't be surprised if debt providers think of even more creative ways to use credit over the next 12 months. ■

Competition drives flexibility in acquisition finance

Market saturation has created a borrower's market, with lenders offering flexible terms and a host of bespoke features to help them stand out

Private equity sponsors can expect a wide-ranging menu of pricing, leverage and terms as competition continues to encourage new developments in the acquisition finance market.

Recent years have seen the growing popularity of the senior-stretch; a lower-cost, lower-leveraged version of the unitranche, which is now regarded by some advisers to be one of the most popular options. On top of high leverage, funds are offering a variety of bespoke features and flexible terms as well as lending in different currencies and chunky undrawn facilities.

"Rather than putting in synthetic currency derivatives, borrowers are happy to consider matching the debt to the underlying cashflows, so having a natural hedge in there," says Tom Maughan, managing director at Bain Capital Credit. "Funds are now also able to provide undrawn committed facilities for M&A or capex."

Terms attached to traditional acquisition finance are being tweaked, providing greater flexibility to the borrower but with the cost of loading extra risk onto the lender. "What we've seen is stuff that has been heard of before but has crept back in – portability, auto-recap and add-backs to EBITDA," says Richard Roach, head of mid-market finance at RBS. "They are all designed to differentiate one fund from another. It's the most aggressive market I've seen."

Light and loose

Many deals now, especially in the €50m+ EBITDA range, are cov-lite or cov-loose: with no covenants or just a net leverage covenant. "There's no doubt that covenants are much more loose compared with five years ago, and in many cases there's no maintenance covenant at all," says Paul Bail, head of European debt advisory at Baird, who also notes that covenant headroom is creeping up.

In a bid to keep up with funds, banks have had to find opportunities to work with them. RBS, for example, has arrangements with a number of unitranche lenders and institutional investors, which it will look to bring in on deals.

Risk and reward

Advisers and lenders agree the market is saturated with providers, with little room for more mid-market debt funds. Such a competitive environment naturally brings risks, but it is expected to be concentrated among the funds, which tend to take larger holds on looser terms.

However, lenders are comforted by the higher proportions of equity they are seeing in deals compared with pre-crisis levels. What is more, because debt funds are funded by long-term commitments, they are seen be less systemically risky than banks, which are funded by retail deposits that can be withdrawn on demand. ■

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Private equity funds import new form of fund finance

Fund-financing in private equity has typically meant subscription lines, but a new form, NAV-lending, is gaining traction.

Subscription lines, which allow funds to draw down LP commitments at regular intervals and can give IRRs a lift, are now commonplace. The market is highly developed with most clearing banks offering the facility. "Less than half our clients would have asked about subscription lines five years ago; now it's almost all of them," says Ben Griffiths, global head of fund financing at MUFG.

While subscription lines are secured against the pool of undrawn LP commitments, NAV facilities are secured against the equity in a fund's portfolio of companies. These have been available in other areas of finance but have arrived late to PE. "It has taken a while for PE fund NAV facilities to develop," says Bronwen Jones, fund finance partner at Reed Smith. "Loan pools have been analysed for ages and securitisation has been around forever, so lots of lenders understand how to analyse a pool of loans. With PE it's a bit more difficult - it's not a very big pool. Then you've got the issue that all those assets have probably got acquisition finance on them already."

> "Less than half our clients would have asked about subscription lines five years ago; now it's almost all of them"
> *Ben Griffiths, MUFG*

A challenge for debt providers has been to bridge fund finance concepts and NAV ones, which are usually dealt with by separate internal teams. Meanwhile, on the demand side, LPs and GPs are becoming more used to having debt at the fund level. According to Leon Stephenson, who founded Reed Smith's fund financing team in London: "The NAV market has been driven by the fact that funds and investors are more comfortable with debt going in at, or close to, the fund level.

"At the same time, the range of lenders who provide facilities has expanded rapidly. Four or five years ago there were only a small handful of investment banks providing NAV facilities to credit funds based broadly around the CLO warehousing facilities."

For NAV facilities, lenders will typically conduct due diligence to work out an exit strategy. They look at one or two assets that are likely to be sold and account for that paying down the facility; a typical loan-to-value will be 10-20% of the fund's NAV.

Trials and tribulations

The market for these facilities is nascent and, while some are optimistic about its growth, some barriers remain. "Despite some volatility in the syndicated market over the summer, the direct lending market remains incredibly buoyant for raising finance at the portfolio company level," says Chris Skinner, head of UK debt & capital advisory at Deloitte. "Lending at portfolio company level should remain cheaper in the long run.

"If one looks at capital raised on an NAV basis,

Subscription lines, which have become commonplace in recent years, are being followed by the gradual emergence of NAV-based lending

– capital secured only on the equity stakes in the portfolio without any downstream protections from the fund – by definition it is subordinated. And while there is some portfolio diversification benefit, as a general principle that subordination outweighs the diversification benefit. That's exactly what we've seen in practice, with pure NAV facilities being typically priced in the high single digits or more."

Another challenge is GPs' reticence to use NAV facilities. Setting one up in or underneath an existing fund is normally permitted under most modern limited partnerships agreements (LPA). This is because the money is secured against the portfolio companies rather than LP commitments. The irony is that while it is legal to do, GPs can be wary from an investor relations perspective. Says Macfarlanes partner Christopher Good: "Although there's no strict prohibition, as soon as you tell an investor you're doing something different, that creates uncertainty, and that normally means something needs checking.

"LPs don't want to spend time and money re-evaluating structures they have already got approved as part of their primary fund investment process, and GPs are rightly nervous about doing anything unless they've got the backing of LPs to do it. As a GP you can find yourself worrying more about the attitudes of your LPs than the technical restrictions and provisions of your LPA."

Hybrids and LPs

NAV facilities can also be arranged as a hybrid. Rather than lending solely against the portfolio companies, a portion of the loan is secured against remaining LP commitments. Lenders like them due to the fact undrawn commitments can be used for regular interest,but the development of this area of the market is in its very early stages. "Although there's a lot of talk about hybrid facilities, we're seeing more noise than execution," says MUFG's Griffiths.

> "As a GP you can find yourself worrying more about the attitudes of your LPs than the technical restrictions and provisions of your LPA"
> *Christopher Good, Macfarlanes*

Another developing area of NAV lending is in the LP space. 17Capital, which raises funds much like a PE fund does, provides financing to LPs to finance commitments. "We help them bridge the gap between the opportunity they have in front of them today and the liquidity their fund will generate over the next three to five years," says 17Captial founder Pierre-Antoine de Selancy.

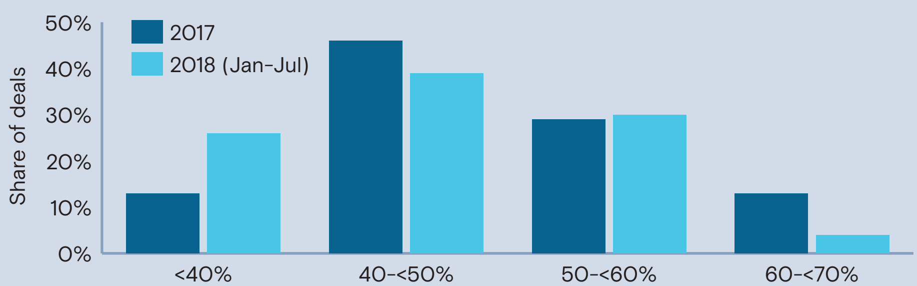
Because this area of the market is also less well established, the skill is in the pricing, which depends on a range of factors, including liquidity, diversification, tax profile and whether debt or preferred equity is used. LTV ratios can be up to 60%. The main funds using this so far have been endowments and family offices, but it is becoming more recognised and more accepted. "Ten years ago, it was fairly unusual," says de Selancy. "Now it is more recognised." ■

Debt market overview

Distribution of European buyout equity contributions

Source: *Debtwire Par*

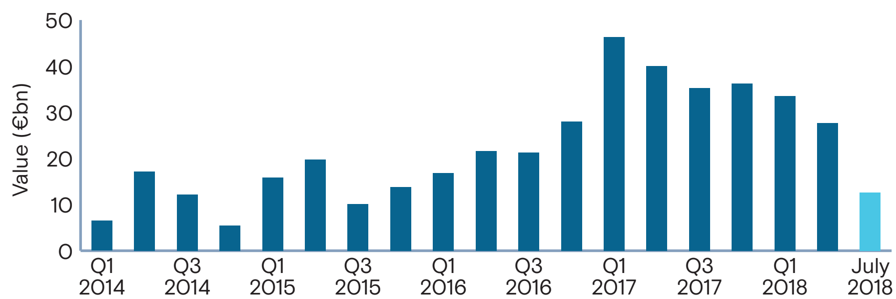
- Equity contributions have remained robust so far this year.
- Lenders say equity contributions are substantially higher than in pre-crisis deals.



European sponsored loan issuance (€bn)

Source: *Debtwire Par*

- Total lending to private-equity-backed companies, including refinancings, has grown solidly over the last several years.
- 2018 is on track to be slightly cooler than 2017.



European sponsored M&A loan issuance

Source: *Debtwire Par*

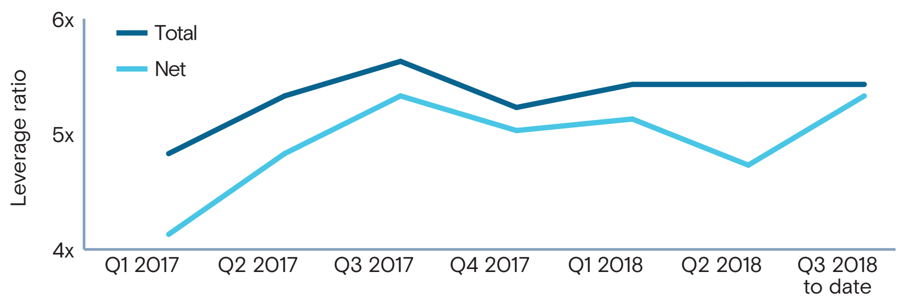
- Lending used for buyouts and acquisitions has had a run of strong quarters since Q1 2017.
- The quarterly average for Q1 2014 - Q4 2016 was €8bn compared with an average of €15.1bn since.

Lending to sponsor-backed and sponsorless firms has been rising, terms have been getting looser, but equity contributions have been holding up, according to the latest statistics from *Unquote* sister publication *Debtwire Par*

Leverage ratios

Source: *Debtwire Par*

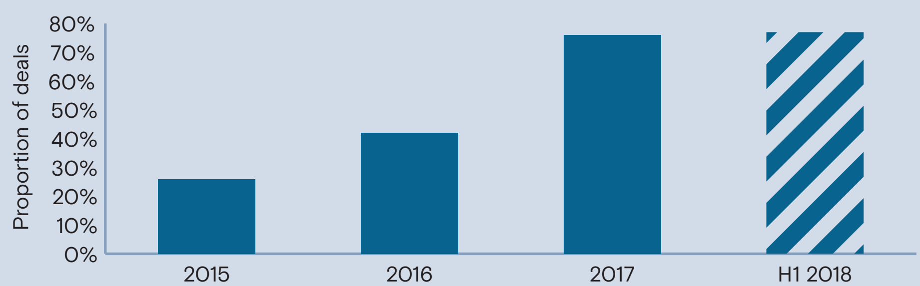
- Both total and net leverage for leveraged M&A deals have crept up since 2017.
- Lenders and advisers have said they are yet to see any impact from the ECB's leverage guidance.



Covenant-lite

Source: Xtract

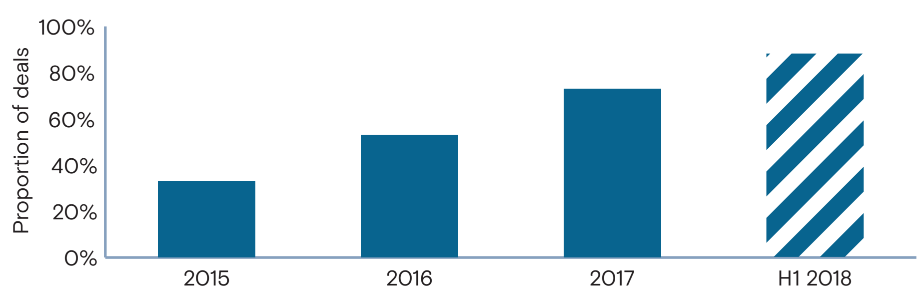
- Most deals will now be cov-lite or come with just a net leverage covenant.
- Features of covenants have also become lighter, such as headroom.



EBITDA cure

Source: Xtract

- EBITDA cures allow net leverage to be sliced by injecting new capital into EBITDA rather than paying off debt.
- These terms, which make the net leverage covenant far more forgiving, are now commonplace.



Crowding into credit co-investment

A hot private equity market will tend to tempt institutional investors into direct and co-investments. The story is no different in the private debt market but entering the market is a challenge and can also raise several issues for private equity sponsors.

"Over the cycles, [LPs making direct and co-investments] definitely ebbs and flows," says Graeme Delaney-Smith, head of European direct lending and mezzanine investments at Alcentra, a global asset management firm focused on corporate credit. "In a hotter market, people talk about it a lot more. Then there's the practicalities and logistics, which knocks some enthusiasm. The other side of it is in a bad market - it's not really their [debt fund investors'] day job."

Credit credentials

Debt funds will only feel comfortable with co-investors that have a long track record, which they are confident will deliver, and preferably that have experienced tougher times. "It depends on the experience of the investor and their longevity in the market," says Alcentra's Delaney-Smith. "Have they been through some ups and downs? Have they experienced a downturn in the market and everything that comes with that in terms of monitoring positions, having to take an impairment? Is their balance sheet and mentality able to cope with those sorts of things?"

In a downturn, a co-investor may be less likely to provide follow-on funding to help the business through, which is naturally problematic for other lenders and the private equity sponsor.

> "An investment might be beyond our desired hold level for diversification reasons, so we syndicate a bit with a co-investor"
> *Paul Shea, Beechbrook*

Laying the groundwork

It can take a great deal of work before an institutional investor is set up for co-investments, and it helps if they have people on standby who can react quickly to an incoming deal. How much work the co-investor does depends on a number of factors. For example, they may want to inspect every deal very closely, or they may be happy to put their trust in the debt fund manager.

Delaney-Smith adds: "There are absolutely people in the market who are set up, they have experienced people in the team, they've been doing it for a while and they've been through all these things, and they understand the risks. They tend to be large investors in a fund, and see it as a way of averaging down their fees.

"It comes down to the relationship between the two parties. How can they respond, how much comfort do they take from due diligence work undertaken by the fund, or do they want to see all the reports, and what level of detail are they going into?"

Due to the difficulties involved, Delaney-

More LPs are looking to invest alongside debt funds. From flexible deal sizes to diversification, there are a few key factors to weigh up for private equity sponsors

Smith believes the market will continue to be dominated by capital coming directly through funds and sees little room for a great increase in co-investment capital.

Deals involving credit co-investors will vary greatly from one to the next. Co-investors can be interested in various bits of the balance sheet; it may prefer senior, second-lien or mezzanine.

Friends with benefits

From a GP perspective, there can be a number of benefits from working with a debt fund that has a co-investment operation with some of its investors. The GP can maintain a relationship with a certain debt fund even if a deal size is a little beyond the fund's reach. It can also provide follow-on funding.

Paul Shea, co-founder of Beechbrook – a direct lender focused on SMEs – acknowledges the boon of working with co-investors: "The investment might be beyond our desired hold level for diversification reasons, so we syndicate a bit with a co-investor."

Beechbrook took this approach with Beinbauer, a large German industrial business recently bought by HIG. In other cases, an LP may come in if the company grows very quickly, outgrowing its initial investment and any add-ons, requiring additional funding beyond a fund's desired holding level.

"The investors particularly like those because they are generally successful investments that we've been in for a year or two," says Shea. The LP will come in on the deal on the same terms as the debt provider, typically it will just be a single LP."

> "The majority of sponsors believe that, if there is a downturn, it is helpful to have more people holding smaller tickets"
> *Chris Skinner, Deloitte*

Casting the net wider

While credit co-investments may offer flexibility on deal sizes and follow-on funding, there can be downsides in terms of diversification, which is especially important in a downturn. Chris Skinner, head of UK debt and capital advisory at advisory firm Deloitte, notes the popular opinion among investors: "Different sponsors have different perspectives on this, but the majority believe that, if there is a downturn, it is helpful to have more people holding smaller tickets.

"Put differently, most borrowers like diversification in their syndicates. Where it can become awkward, and we've seen this in practice, is where you find yourself having one manager and a group of their LPs where, as often as not, they will have the same view and adopt the same approach as each other.

"That undermines the benefit of diversification; sponsors may prefer to bring multiple lenders in from day one." ■

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Supply and demand lift secondaries leverage

Leverage is becoming a common feature in secondaries transactions. Market players put it down to increased competition and rising valuations

The vast majority of secondaries transactions are now using leverage, in stark contrast to just a few years ago. While fund-level facilities such as subscription lines and NAV-based lending have been used by secondaries funds for some time, leveraging individual transactions has been a more recent growth market.

Sunaina Sinha, founder of placement agent and secondaries market adviser Cebile Capital, says: "There's a supply-side issue that is causing secondaries GPs to look at leverage, but there's also pressure from the LP side - secondaries funds have competitors going out to fundraise with much better IRRs than they have because the competitors used leverage.

"There is a higher inclination in the market to use leverage in order to compete and stay relevant in the market."

High valuations are also key, with buyers borrowing to meet prices. All responders to Setter Capital's H1 2018 survey said leverage in secondaries was up or the same on the previous year; not a single one said it was down.

For a single secondaries transaction, LTV ratios are typically around 50%, up from years past, while pricing on these loans has fallen. Rates tend to range between 4-8% over Libor, with large secondary fund managers able to haggle rates down to as low as 1.5% or 2% over.

Sure thing

Current leverage levels are generally considered low risk, though it can be a different story for larger transactions. "There are pockets of the market where leverage levels are not as conservative," Tarang Katira, a principal on the fund investment team at Hamilton Lane, recently told Unquote. "On some of the larger deals, things are fairly aggressive, especially by historical standards. Ideally, in a bull market, leverage can enhance returns. But if a market turns and assets are devalued, then returns could disproportionately worsen."

In other areas where leverage is being used, the competition to provide it has led to complex debt structures. But in some respects, leverage in the secondaries market has become simpler. Cebile's Sinha adds: "Creative structures to get deals done are being offered by buyers all day every day. Very few sellers want to take them.

"Sellers know that this is a very hot secondaries market and that they should be able to get the pricing they need on a straight cash basis. On almost every deal we run we get asked by the buyer 'can we use deferral? Can we use earn-out? Can we use this and that?' And 90% of the time sellers say no."

Preferred equity can work for sellers who believe there is upside left in the portfolio. Instead of offering leverage through deferred payment, the vendor takes some cash up front and then receives a slice of the distributions beyond a certain point. ■

Debt providers in Europe

A look at which debt providers are currently active in the European mid-market and the services they have on offer to private equity funds

Leading debt providers in the European market

	Main European Lenders	Type of Finance			
		Buyout	Secondaries	Subscription lines	NAV
Clearing banks and banking groups	AIB Group	✓			
	Banco Santander	✓		✓	
	Bank of America	✓			
	Bank of Scotland	✓		✓	
	Barclays Bank	✓		✓	
	BNP Paribas	✓			
	Clydesdale and Yorkshire Bank	✓		✓	
	Commerzbank	✓			
	HSBC Bank	✓		✓	
	ING Group NV	✓			
	Investec	✓	✓	✓	✓
	Lloyds Bank	✓		✓	
	MUFG			✓	✓
	Rabobank	✓			
	Raiffeisenbank International	✓			
	Royal Bank of Canada	✓		✓	
	Royal Bank of Scotland	✓		✓	
	Société Générale	✓		✓	
	Silicon Valley Bank	✓		✓	✓
	Sumitomo Mitsui	✓			
	UniCredit	✓			
Direct lenders & other fund-based lenders	Alantra	✓			
	Alcentra	✓			
	Ares	✓			
	Ardian	✓			
	Bain Capital	✓			
	Barings	✓			
	Beechbrook Capital	✓			

Leading debt providers in the European market

	Main European Lenders	Type of Finance			
		Buyout	Secondaries	Subscription lines	NAV
Direct lenders & other fund-based lenders	BlueBay	✓			
	Capzanine	✓			
	Cordet Capital Partners	✓			
	Crescent Capital	✓			
	EMZ	✓			
	EQT Partners	✓			
	Hayfin	✓			
	ICG	✓			
	Incus Capital	✓			
	Indigo Capital	✓			
	Idinvest	✓			
	Kartesia	✓			
	KKR	✓			
	LGT Capital Partners	✓			
	Metric	✓			
	Mezzanine Partners	✓			
	Natixis Private Equity	✓			
	Permira	✓			
	PNC Business Credit	✓			
	Pricoa	✓			
	Siemens Venture Capital	✓			
	Total Capital Partners	✓			
	Tikehau	✓			
	Vision Capital	✓	✓		✓
	Whitehorse		✓		✓
	17Capital		✓		✓
Investment banks and asset managers	Blackrock	✓			
	Credit Agricole Corporate & Investment Bank	✓			
	Credit Suisse	✓	✓		✓
	Deutsche Bank	✓			✓
	Goldman Sachs	✓			✓
	Jefferies International	✓			
	Mediobanca	✓			
	Macquarie Group	✓			
	Mizuho Corporate Bank	✓			
	Morgan Stanley	✓			
	NM Rothschild	✓			
	Nomura Securities	✓	✓		✓
	UBS Investment Bank	✓			✓

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10 Queen Street Place, London, EC4R 1BE
+44 (0)20 3741 1000

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Copy & Production Editor – Tim Kimber
Managing Director – Catherine Lewis

For advertising enquiries – Justin Raveenthiran
+44 (0)20 3741 1390 justin.raveenthiran@acuris.com
For subscription enquiries – Omar Khazen
+44 (0)20 3741 1388 omar.khazen@acuris.com