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Redefining the leveraged landscape

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An increased regulatory environment has reduced systemic risk in the banking sector, opening up greater choice and flexibility for leveraged borrowers.

The regulatory reaction to leveraged lending

Leveraged lending attracted the attention of regulators after the 2008 financial crisis highlighted some banks' exposure to leveraged borrowers in what was considered a potentially overheated market. It could be argued that this was a result of lending practices, which led to significant discrepancies between banks with limited controls, and excessive balance sheet leverage presenting systemic risks to financial markets. The effects of over-leveraged transactions were felt post the financial crisis for both over-borrowed companies and participating banks who were sitting with non-performing loans weakening their balance sheets.

Leveraged lending can be defined in a number of ways. A common definition used is where the borrower's total debt is more than four times EBITDA (earnings before interest, taxes, depreciation, and amortisation).

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To boost the stability of the banking system and to assist financial institutions in providing leveraged lending to creditworthy borrowers in a safe and sound manner, the US Federal Reserve made a number of attempts to tighten the guidelines in March 2013. The guidance applies to all borrowing clients that are owned or controlled by Private Equity Funds, or are simply US borrowers or have US originated $ denominated loans. A number of non-US banks have also implemented the guidance globally to avoid any breaches and protect their licence to operate in the US leveraged finance market.

The guidelines particularly focused on the risk management of leveraged lending activities, requiring sensible loan structures that support the borrower's ability to repay; well-defined underwriting standards that define acceptable leverage levels; and systems for monitoring leverage exposures. They also included guidelines for conducting periodic portfolio and pipeline stress tests to quantify the potential impact of economic and market conditions on a bank's asset quality, earnings, liquidity, and capital.

A changing market

In the two years leading up to the financial crisis, private equity firms made a spate of acquisitions, especially in the US, which led to banks issuing a large volume of leveraged loans.

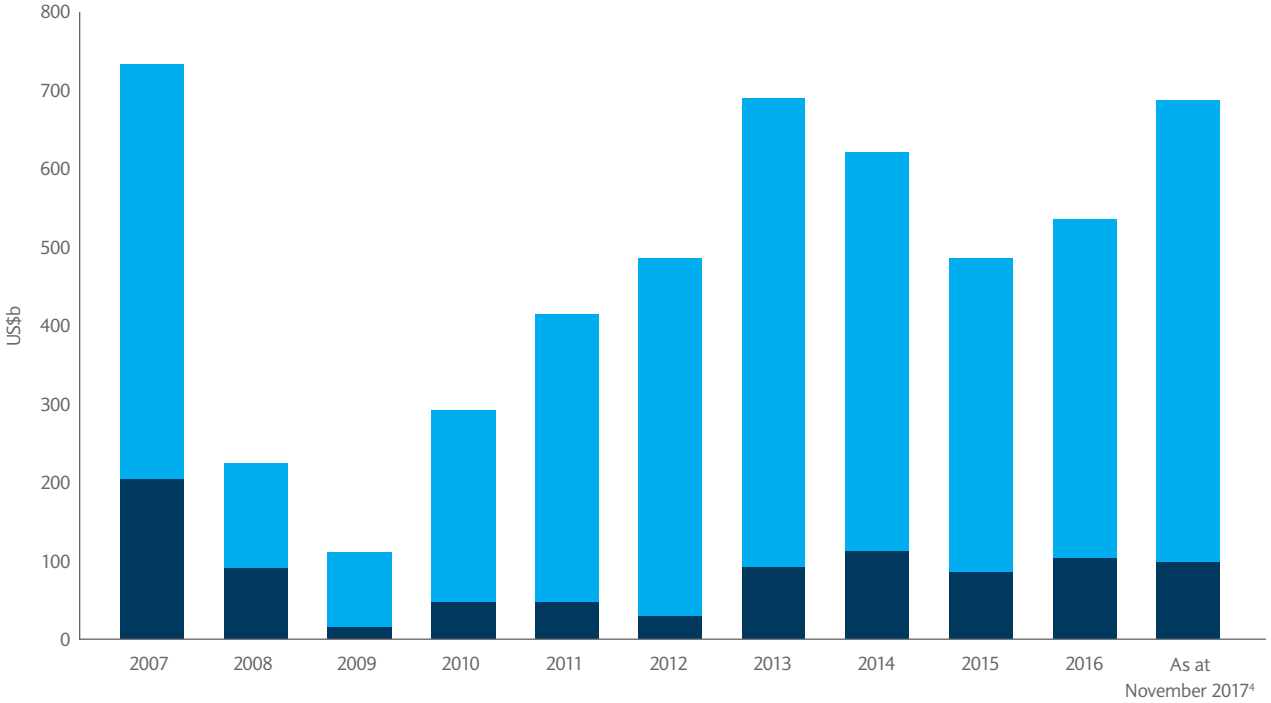
More than $700bn in leveraged lending was issued in Europe and the US in 2007, according to EY.[1]

While demand for leveraged loans fell steeply in the immediate aftermath of the crisis, we have seen a significant recovery since, with total loan volumes near the levels seen at the peak in 2007.[2] Over the past four years, the nature of the leveraged lending market has also changed, partly in response to the introduction of the Federal Reserve's guidance.

Since 2013 banks have become more cautious in their lending approach; they are now performing far deeper analysis of companies' balance sheets and cashflows to inform their decision-making when assessing the leverage capacity of the borrower.

The amount of leverage being taken on by the borrower must be appropriate based on past performance, the current business profile and future prospects, industry dynamics and the macro-economic outlook. Highly leveraged transactions for borrowers are often justified on the basis of stable business risks and predictable operating cashflows. However, the use of leverage can magnify the impact of unexpected changes in a borrower's operating cashflow. Hence, to ensure that the borrower will be able to meet its obligations and generate sufficient cashflow, banks are doing more stress testing under varying economic scenarios to test the robustness and sustainability of cashflows to protect against another downturn.

Leveraged Loan volumes



Source: LCD (an offering of S&P Global Market)[3]

There are certain industries that can generally support elevated leverage levels, for instance those that operate in stable operating environments, e.g. highly regulated with significant barriers to entry, such as critical infrastructure assets. Asset-backed facilities and the Real Estate sector are other examples where the stringent rules do not always apply, if their primary source of repayment is not reliant on cashflows.

On the flip side, those operating in highly cyclical industries that are currently facing secular decline, such as print publishing, would warrant lower leverage multiples.

[1] www.ey.com/Publication/vwLUAssets/Credit-Markets-2016-2017/$FILE/EY-Credit-Markets-2016-2017.pdf

[2] LCD European Weekly, 10 November 2017.

[3] www.ey.com/Publication/vwLUAssets/Credit-Markets-2016-2017/$FILE/EY-Credit-Markets-2016-2017.pdf

[4] www.leveragedloan.com, November 2017.

The guidelines have helped to reduce systemic risk, with banks managing their risk more closely.

While traditional lenders have largely remained the same, new entrants have come into the market, taking up some of the slack as the more prominent lenders seek to avoid regulator spotlights. Private equity debt funds, direct investment vehicles and non-bank lenders, such as insurance and pension funds, are increasingly finding ways to participate in leveraged transactions of all sizes.

These lenders are generally not required to meet the same capital adequacy rules as banks, and have entered the market in search of good financial returns for their investors, in a low-interest-rate environment.

At the same time borrowers have become more sophisticated in their approach to managing their capital structure more efficiently, and we have seen this diversification play through on refinancings and acquisition finance where liquidity has been sourced from a mix of traditional bank finance, private institutional and debt capital markets.

There usually remains a role for traditional lenders offering relationship banking and supporting operational requirements, with non-bank lenders stepping in and providing the bulk of the leveraged loans.

The borrower advantage

While the nature of the market has changed, it still remains broadly favourable to borrowers. The supply of available liquidity continues to exceed demand due to market conditions with fewer transactions taking place, and many relying more on accumulated cash reserves (and less on additional borrowing) to finance the transactions they do undertake.

To stay ahead, innovative and maintain a strong foothold in the leveraged space, the market is seeing an increasing number of banks partnering with non-bank lenders.

Investment firms such as Ares, Blackstone and BlueBay are stepping in to fill the void, offering corporate borrowers more flexibility when considering a more leveraged capital structure.

In December 2015 Barclays Corporate and Ares Management announced an agreement to jointly provide financing solutions to financial-sponsor-owned UK mid-market companies. This non-exclusive arrangement enables Barclays to offer its clients financing options that bring together the best of the direct lender community with the flexibility provided by a traditional bank.

Ares partnership with Barclays

"Our partnership with Barclays has already helped our market-leading platform add value to our clients by bringing together two premier market participants to provide streamlined execution on meeting their growing need for customised financing solutions."

Mike Dennis, Partner in the Ares Direct Lending Group

"The arrangement has widened the range of financing solutions we can offer to clients in a dynamic and evolving market."

Ian Tetsill, MD at Barclays Debt Finance

LEISURE PASS GROUP	TAZIKER INDUSTRIAL	NoteMachine Financial Technology Services
Undisclosed Term Loan, SSRCF and Unitranche March 2017	**£42.5m** Term Loan and Revolving Credit Facilities March 2016	**£205m** Term Loan and Revolving Credit Facilities March 2016

Outlook for leveraged lending

The benign lending environment explains why today's leverage ratios for senior debt are very similar to what they were 10 years ago – despite the introduction of the Federal Reserve guidance.

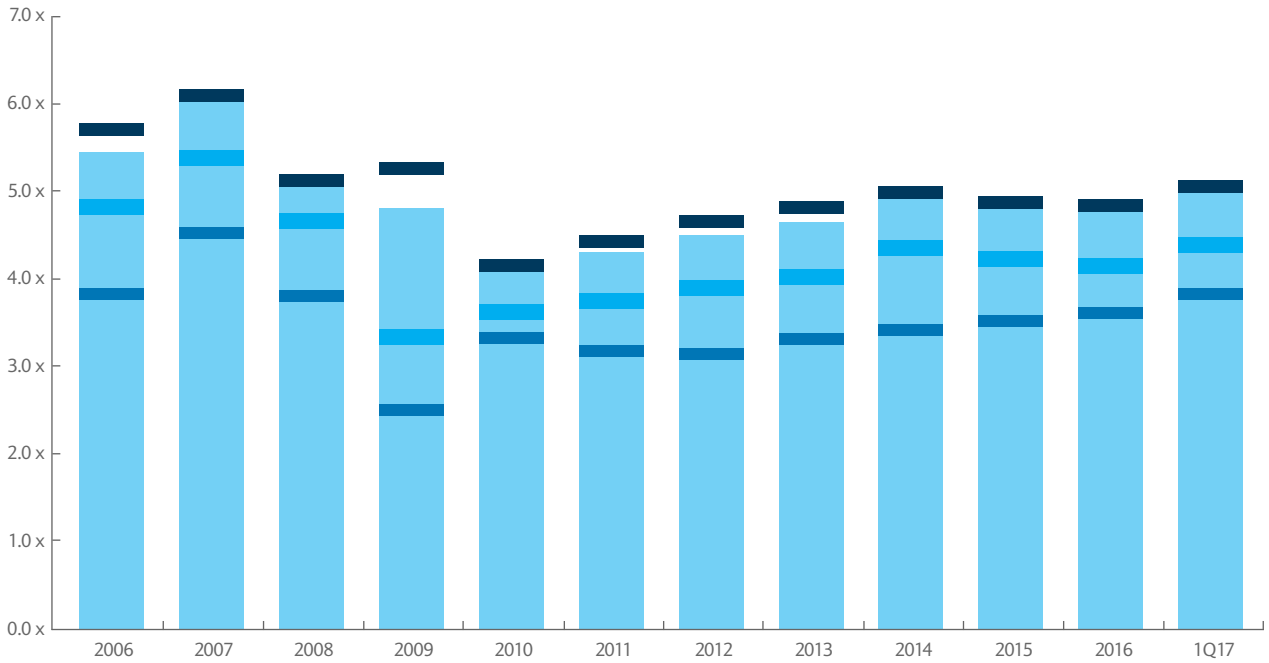
According to LCD, an offering of S&P Global Market Intelligence, the average senior leverage on European-sponsored deals in 2017 is 4.5 times EBITDA, compared with 4.6 times EBITDA in 2007.[5]

There is more of a difference in the leverage ratios for transactions that are backed by private equity firms. Today, the average leverage for European loans that involve a private equity sponsor stands at 5.2 times EBITDA, compared with 6.1 times in 2007. This suggests that banks and other lenders have become more reluctant to support very highly leveraged transactions and are perhaps showing more restraint.

Looking ahead, it is likely that non-bank lenders will play an increasingly important role in leveraged lending, with banks predominantly providing working capital support in the form of revolving credit, trade and overdraft facilities. This is not just a result of the Federal Reserve's guidance – it is also due to developments in Europe. The European Central Bank (ECB) recently issued its own guidance on leveraged transactions, which applies to all the significant credit institutions that it supervises.

The ECB guidance is generally viewed as being tighter than the US Federal Reserve's guidance with regard to risk management, stress testing and monitoring procedures. The ECB feels that closer supervision and scrutiny of lending in leveraged transactions is required to counterbalance the leniency in some credit institutions' credit policies.

Pro Forma Debt/EBITDA for Sponsored Deals



Source: LCD (an offering of S&P Global Market)[6]

Average | 3rd Quartile | 1st Quartile | Median

As in the US, banks are somewhat concerned that the guidance will create an uneven playing field that will favour those institutions not regulated by the ECB, such as US, Japanese and (post Brexit) UK banks. The US and ECB versions of the guidelines are aligned, and some banks are already subject to US rules, particularly those with global operations. It is not certain how long businesses have left to enjoy highly favourable borrowing conditions, especially in light of recent and predicted further interest rate rises, and the volatile political climate.

Also, there is a possibility that the balance between supply and demand in the loan market might start to shift in favour of lenders as refinancing activity picks up. For now there are good opportunities for borrowers looking to secure finance and, in an ever-changing environment, early and ongoing discussions with lenders are encouraged.

[5]LCD European Weekly, 22 September 2017.

[6]DBRS Illustrative Insights, 24 May 2017.

To discuss future and potential funding requirements, please talk to your Relationship Director.

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December 2017. BD06342.