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Capital *Thinking*

An analysis of current debt and financing market trends from Grant Thornton

Europe's bond markets have filled the gap left by the contraction in bank lending in the wake of the global financial crisis. Bond financing is increasing in importance and looks set to make further gains as a complementary and supplementary source of funding to bank lending for companies. Reminiscent of the development of the US high yield bond market in the 1970s, this trend appears structural rather than cyclical. This year, marking the next phase of their development, the European bond markets have absorbed a number of smaller bonds, which, historically, would have been too small to attract institutional investors in the high yield markets. In this issue we analyse the factors underpinning this trend and assess the viability of bond financing as an alternative source of funding for mid-market companies. In addition, in a special supplement which accompanies this issue, we take a deeper dive into the advantages and disadvantages of bonds.

Europe's bond markets come of age

Historically, bonds were not an option for mid-market companies and remained available only to larger groups. Access to the bond markets was driven primarily by the need for liquidity and the constraints of leverage. In the past, a stand-alone bond (as opposed to a dual tranche issue) would be expected to be at least £200 million to have sufficient liquidity, which implied that the issuer required EBITDA of at least £50 million to avoid excessive leverage. However, this year, the markets have accommodated a number of issues at or below that threshold, such as Marlin's £150 million issue and Pendragon's £175 million note (the terms bond and note are used interchangeably). Whilst a few of these deals were completed by large groups (eg Pendragon) most were done by mid-market companies, which, previously, would not have been able to obtain bond financing because their EBITDA was too small to support a bond with adequate liquidity. Notable deals included Marlin, Bond Mission and Study Group, all of which had EBITDA in the £30 million range, whilst the smallest deal, Soho House's £115 million issue, was supported by EBITDA of only £19 million. The volume of these smaller transactions strongly suggests that the markets have opened a new chapter to admit mid-market firms.

For a closer look at the pros and cons of issuing bonds please see our special supplement: 'A bond market primer for new issuers', which accompanies this issue of *Capital Thinking*.

Table 1: Selected Stand-alone Senior Secured Bond issues in 2013

Issuer	Bond	EBITDA	Sector	Coupon	Term	Leverage	Rating
Bond Mission	£200m	£33m	Aviation / Defence	L+5.75	6 yr	4.8x	B
Brakes	£200m	£137m	Services	7.125	5 yr	7.3x	B-
Gamenet	€200m	€79m	Gaming / Leisure	7.25	5 yr	1.2x	B+
Grainger**	£200m	£113m	Real Estate	5.0	7 yr	n/ax	BB+
IVS**	€200m	€61m	Vending Services	7.125	7 yr	2.9x	BB-
Jerrold**	£200m	£89m	Financials	9.750	5 yr	3.6x	B+
Marcolin	€200m	€37m	Consumer Goods	8.5	6 yr	3.7x	B-
Marlin	£150m	£32m	Financials	10.5	7 yr	3.3x	B
Nuance	€200m	€82m	Retail	E+500	6 yr	1.4x	B+
Pendragon**	£175m	£110m	Automotive	6.875	7 yr	5.2x	B+
Soho House	£115m	£19m	Hospitality	9.125	5 yr	5.2x *	B-
Study Group	£205m	£28m	Education Services	8.875	5 yr	5.2x	B-
Zobele	€180m	€41m	Manufacturing	7.875	5 yr	3.7x	B

** Data provided in offering memorandum. Soho House depicts Senior Secured leverage; ** Non PE-sponsored*
Source: DebtXplained

Grant Thornton's *take:*

- *The European bond markets are open to a new group of borrowers who until now were too small to consider bonds as a viable complement to bank lending. Borrowers should consider using the current benevolent market conditions to establish themselves in the capital markets so opening a further attractive and flexible source of funding for the long term future.*

History doesn't repeat itself, but it does rhyme

Underpinned by investors' search for yield, Europe's bond markets have taken up the slack as bank lending has contracted. As a result, high yield bond issuance has surged to new record levels in Europe this year with issuance expected to exceed €70 billion, double the €35.4 billion issued in 2012[1].

These developments in Europe mirror the renaissance of the bond markets in the US in the mid-1970s, after the US experienced two oil shocks, a sharp spike in interest rates and a corresponding collapse in corporate/asset values. Banks responded by curtailing lending to all but the best credits. High growth firms found themselves cut off from access to financing, which forced these issuers to seek alternative funding from the capital markets and was instrumental in kick starting the US high yield bond market. This process is being repeated in Europe today with corporates using bonds to refinance part, if not all of their bank loans, whilst retaining an RCF to fund the fluctuations in the working capital cycle.

> **"The market has been more and more accepting of smaller tranche sizes in 2013 and we believe this trend will continue in the coming years as more corporates look to diversify their funding and bond investors become more comfortable with the profile of such issuers. However, we also believe that investors will continue to look for a minimum size to ensure liquidity in the secondary market and this will likely keep tranche sizes at the levels seen to this point."**
>
> Tanneguy de Carne, Global Head of High Yield Capital Markets, Société Générale CIB

These structures suit both borrowers and lenders albeit for differing reasons. Borrowers retain their relationship with their bank lenders via the RCF and gain access to a new source of long term funding from the capital markets. Lenders maintain their relationship with their clients, but reduce their exposure to longer-term facilities, which are becoming increasingly expensive to fund in light of regulatory constraints, Basel 3 capital requirements and higher funding costs from a continuing lack of confidence in bank balance sheets.

High yield bonds must not be confused with the much smaller UK retail bond market, which has proved a welcome additional funding source for corporates, with £3.4 billion of issuance since 2010. A discussion of those bonds is outside the scope of this article but they are aimed at retail, rather than institutional investors and documentation is still evolving as the market develops.

How small is beautiful?

The deals in Table 1 illustrate that capital markets are now receptive to smaller bond deals from mid-market companies, which are significantly smaller than traditional issuers and which potentially provide a large new group of issuers keen to diversify away from being reliant on bank and other traditional funding sources. The constraints on issuing small bonds are driven by two factors: first and foremost, by the desire for liquidity from institutional investors and; secondly, by the relatively high fixed costs of launching a small issue. There are two explanations why investors are increasingly willing to buy (smaller) bonds with limited liquidity. The first is that in a low yield environment with a dearth of quality assets, bonds offer very attractive risk-adjusted-returns to the extent that enough investors are prepared to trade liquidity for access to higher yields.

> **"Investors' search for yield has manifested itself in a declining premium applied to liquidity risk, allowing a number of smaller issuers to complete primary market transactions."**
>
> Stephen Baines (Kames Capital)

A second reason is that those funds which are obliged to mark their assets to market, seek less liquidity for part of their portfolio as it dilutes the volatility in their valuations, which helps reduce their need to sell assets quickly, (sometimes as early as T+3), to repay investors.

Whilst there is obviously demand for these smaller deals, the broader question is what is the new market threshold in terms of issue size and EBITDA? The evidence strongly suggests that the market is currently open for firms with EBITDA of c. £30 million and there is obviously sufficient demand for issues in the £150 million-£200 million range as mentioned earlier. The Soho House transaction is perhaps the most intriguing, because whilst one transaction does not make a trend, there were encouraging signs in the deal pointing to the markets' willingness in exceptional cases to digest very small issues by comparatively small firms. These positive signals were that the deal's size was increased to £115 million from £105 million in response to strong investor demand, which, according to market sources, included a retail element; and that while EBITDA was positive, the group reported a pre-tax loss (as per Soho House Offer Memorandum). Despite this, the market was willing to rely on a credible growth story even though the group's overall leverage was boosted to 7x by a £25 million super senior RCF. Nevertheless, in our view, this deal for the time being remains an outlier rather than the first of a rash of new issues of this size.

> **"Reduced liquidity of a security may help lower portfolio volatility during times of technical market pressure."**
>
> Dr Tatjana B Greil Castro (Muzinich & Co.)

Bonds offer a viable alternative and supplement to bank loans…

All of the notes in Table 1, which were structured as senior secured, were used to refinance existing bank loans and thus represent a viable alternative and

[1] 'European high yield bond funds see €270M investor cash inflow' www.highyieldbond.com

supplement to traditional bank loans for corporate borrowers. Whilst bonds are ideal for long-term funding, the fact that they are fully drawn at issuance and have bullet repayment profiles means they are not well suited to funding fluctuations in the working capital cycle. For this reason these bonds are often supplemented by an RCF from a bank, which invariably enjoys super-priority vis-à-vis the bonds.

This highlights a further advantage of using bonds to fund the bulk of lending: banks may be relatively relaxed about advancing an RCF, if it represents a small part of the borrower's debt funding and will be 'supported' (priority) by a much larger tranche of longer-term funding. Whilst this suggests that the main purpose of bonds will be to refinance existing bank loans, it is clear from deals such as Soho House that the capital markets are also willing to support much smaller issuers who present a credible case for growth.

Although most of the issuers in Table 1 are private equity owned, non-sponsored issuers are not excluded from the market. Surprisingly, data from S&P LCD indicates that, since 2009, non-sponsored bond issuance has exceeded sponsored issuance in every year. Four deals in the list were by non-sponsored corporates providing further evidence of bond market acceptance of smaller issues from both sponsored and non-sponsored borrowers.

...but their advantages come at a price for small issuers

The bond market for smaller companies is still embryonic and pricing for these smaller issues remains expensive in comparison with bonds issued by larger issuers. This is illustrated by the fact that pricing on recent PIK notes, which are unsecured and typically the most junior debt instrument in the capital structure, has attracted coupons in the 9%-10.5% range, which compares with the coupons for the secured notes of Marlin (10.5%), Soho House (9.125%) and Study Group (8.875%).

A good example is Xella's five year, €200 million PIK-toggle notes (B3/B-), which priced at 9.125% cash/9.875% PIK, a very similar level to Soho House. Although the credit ratings of Xella and Soho House are the same, PIK notes have little or no collateral, have capitalised (PIK) coupons and are deeply subordinated, whilst Soho House is a senior secured obligation. The relevance is that in any restructuring, investors in Soho House will have a seat at the table whilst PIK holders usually have little or no leverage in a restructuring.

Pricing for smaller issuers in the bond markets appears expensive vis-à-vis loans of comparable rating, size, and tenors, but potential borrowers should consider a number of other mitigating factors. Apart from the obvious advantages of lower debt service because of their bullet repayment structure, most bonds are fixed rate, so issuers accessing the market now can lock in rates at the bottom of the cycle. Second, fixed rate bonds may remove the need to arrange a swap, which is usually required for a loan. This is expensive to arrange and can leave borrowers with high interest costs and high break costs, if market conditions change.

Grant Thornton's ***take:***

- *At first glance bond coupons for small issues appear high, but current market conditions are probably 'as good as it gets' and borrowers should use the window of opportunity to lock in flexible long-term funding at attractive rates.*

One further benefit is that the all-in fees and cost of arranging a bond compare favourably with a loan unless the bond is very small. In most cases issuers can expect to pay 3%– 4% all in for issuing a £200 million bond. Fees for large bonds and repeat issuers will be comparatively cheaper.

Taken as a whole, the all-in cost of issuing a bond may actually be cheaper than a loan despite the higher legal fees and the cost of obtaining the credit rating, because the spread paid to the lead managers is usually lower than the arrangement fees paid for a loan. For example Marcolin and Bond Mission had total costs of around 3.5% on bonds of c £200 million.

Looking to the future, if capital markets continue to evolve and accept smaller bonds from mid-market companies it seems likely that issuers can expect to see some improvement in both pricing and terms.

Bonds are worth the extra work for issuers

Whilst bonds offer numerous advantages to borrowers, there are a few key factors which potential issuers should consider before going down the bond route. The main hurdle for new issuers is the initial investment in management time and effort required to draft and verify the prospectus and to navigate the ratings process. For smaller management teams these aspects together with the roadshow will prove testing. Whilst some of this work can be delegated to advisors, finance directors, in particular, should not underestimate these factors, which will be more onerous when launching the company's first issue.

There is some good news. Once the company has launched a bond on the markets repeat issuance is much easier. For established issuers, this can be completed within a few weeks simply by providing updated financial information and a revision of the management's strategy. For UK-based companies, investors also accept UK GAAP without the need for a formal US GAAP reconciliation – a section highlighting the main differences in accounting treatment is sufficient. This is in part because UK GAAP is considered to be reliable and also as many of the investors will be UK-based. Foreign companies may find that they have to present financial information in compliance with IFRS, which may present another hurdle.

Grant Thornton's *take:*

- *The preparation required for a company's first bond issue is time consuming, but must be seen as an investment, which will offer borrowers numerous advantages in terms of funding options and flexibility.*

Please click here for our special supplement "A bond market primer for new issuers", which accompanies this issue of Capital Thinking.

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