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CORPORATE FINANCE

Debt Capital Markets

Gambit Review

Q4 2020

Executive Summary

Jason Evans
Partner, Debt Advisory

Jason Evans is the partner that leads Gambit's Debt Advisory team. Prior to joining Gambit, Jason was Regional Director for Lloyds Banking Group, heading up the regional corporate banking team in the mid-market and working with businesses with turnover between £10m and £750m.

After graduating from the University of Reading in 1991 with an honours degree in economics and accounting, Jason began his career at Coopers & Lybrand Deloitte. During his 28-year career, Jason has held various senior roles, including Divisional Head of Leveraged Finance for HSBC.

He is an Associate of the Securities and Investment Institute, holding an advanced corporate finance qualification from the Institute of Chartered Accountants in England and Wales (ICAEW). Jason has also been voted "Corporate Banker of the Year" on a number of occasions at the Insider Dealmaker Awards.

In Summary

- The UK economy bounced back from recession in Q320, registering growth of 15.5% between July and September, however, the reintroduction of social restrictions is likely to set back what was a promising period of initial economic recovery and UK GDP is set to shrink by 10.4% in 2020.
- UK loan issuance has continued to grow significantly on an annualised basis, driven by increased demand for short term and government backed loan facilities, particularly from small and mid-market businesses.
- Statistics for the key government backed loan schemes continue to show strong levels of utilisation and the Treasury's decision to extend these out to January 2021 prolongs the availability of a vital source of liquidity for those that have not yet applied.
- The Office for Tax Simplification's review into Capital Gains Tax is now complete and potential changes may lead to an acceleration of sellers in the market, creating a value maximisation opportunity for business owners to benefit from tax relief and a chance for buyers to capitalise on a rise in available assets.
- Mainstream lenders continue to proritise existing customers' liquidity requests and covenant amendments over new client wins, allowing alternative lenders to further grow in prominence and importance in the debt market.
- The impending phase out of Libor in favour of the Sterling Overnight Index Average is expected to impact mid-market businesses most and those with loans expiring at the start of 2022 should seek advice from a trusted advisor to ensure the technicalities are understood and potential issues are mitigated.
- The debt markets have become further polarised, with strong competition amongst lenders for quality assets in Covid-19 resilient sectors, allowing borrowers to obtain flexible financing terms akin to those available pre-pandemic.
- Despite Covid-19 related uncertainty significantly affecting M&A deal volumes, market valuations have remained stable, buoyed by healthy levels of capital availability and appetite for companies with a demonstrable level of Covid-19 resilience.
- The majority of direct or alternative lending deals continue to be M&A related and buyers are looking to continue building and adding to their acquisition facilities with a view to undertaking opportunistic transactions with the support of the agile private debt market.
- As mainstream banks' attention continues to be focused on supporting corporate clients' immediate cash needs, M&A activity will continue to be sustained by the support of alternative funders, but approaching the right funder pool is key.

The UK Economy

Economic Overview

- The reintroduction of lockdown measures has prompted an overall slump in economic activity, stifling an initial period of recovery and prompting the extension of many of the UK government's flagship business support schemes into Q121.
- Loan schemes such as CBILS and CLBILS continue to be well-utilised, with the recent extension providing renewed impetus for companies to secure vital liquidity.
- The Bank of England (BoE) has announced another £150bn of quantitative easing, £50bn more than expected, taking the total stock of assets purchased from £745bn to £895bn.
- BoE governor Andrew Bailey has also signalled that he would consider loosening financial regulations to act as a catalyst for higher, longer term and productive investment to support the UK's economic recovery.
- The introduction of negative interest rates continues to be assessed, with the BoE writing to UK banks to assess their level of preparedness, although the base rate was maintained at 0.1% at the last committee vote.

Economic Outlook

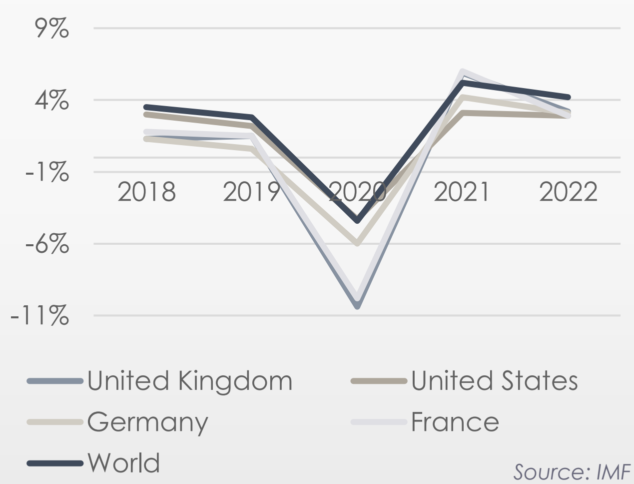
- Latest IMF growth forecasts show that UK GDP will shrink by 10.4% in 2020, a revision from the 9.6% fall predicted prior to the domestic emergence of a second wave of Covid-19.
- The UK economy will be affected by an adjustment period in H121 as the UK leaves the EU on 1 January 2021, with the widely held view being that a free-trade agreement will be in place before this date.
- While forecasts vary, the BoE does not expect the UK economy to reach pre-pandemic levels until Q122, although the emergence of a vaccine in the near-term may result in a sharper recovery.
- To mitigate a potential upcoming unemployment spike, significant investment in UK infrastructure is in the pipeline and the Prime Minister has moved to offer £12bn of government investment to create and support 250,000 jobs in green technology.
- With the latest statistics showing government debt standing at 104% of GDP, the Treasury is expected to seek out ways in which the deficit can be reduced in 2021, whilst also protecting jobs and the economy.
- The Office for Tax Simplification's review into Capital Gains Tax is now complete and the Chancellor is expected to consider the findings in due course, with any changes likely to lead to a change in shareholder objectives and motivations.

UK Support Scheme Statistics*

	CBILS	CLBILS	BBLS
Value of approved facilities	£17.2bn	£4.6bn	£40.2bn
No. of approved facilities	73,094	623	1.3m
Total no. of applications	159,277	1,034	1.7m

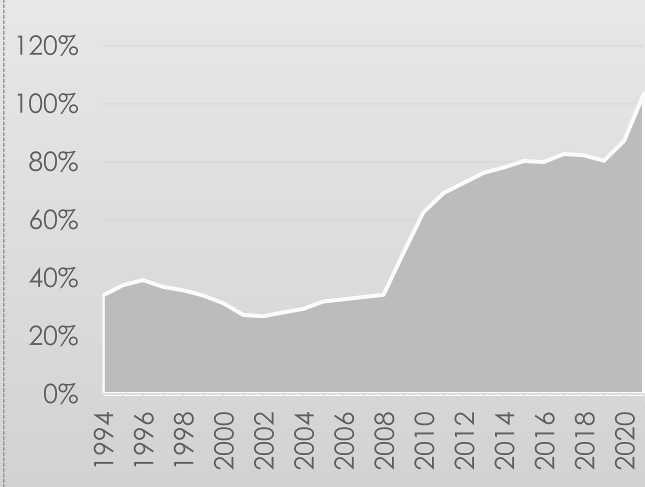
Source: GOV.UK
**Correct at time of publishing*

Real GDP Annual Percent Change



Source: IMF

Public Debt as % of GDP



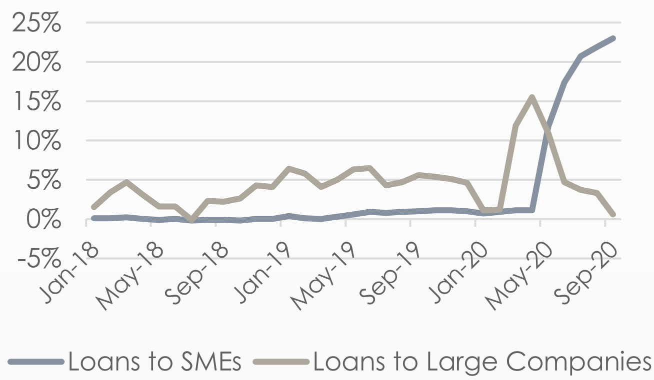
Source: ONS

Debt Market Landscape

Overview

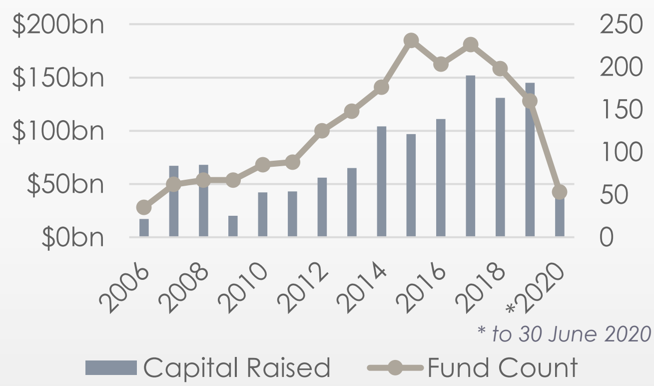
- In contrast to 2008, banks have, at large, been able to support clients with liquidity solutions due to quantitative easing, stronger capital positions and recourse to government guarantees via C(L)BILS and BBLS.
- For some mainstream financial institutions, UK loan issuance has grown at c.60% in comparison to H119, driven by increased demand for short term facilities, particularly from mid-market businesses where lending volumes have soared.
- Mainstream lenders continue to proritise existing customers' liquidity requests and covenant amendments over new client opportunities, increasing the prominence and importance of alternative lenders in the debt market.
- With a high concentration of maturities set to arise in 2021, lenders expect to see a relatively large refinancing wall in 2021.
- Interest rates show no sign of rising and are set to be 'lower for longer', allowing lenders to fully test the debt markets and obtain financing solutions at near all-time low funding costs to fund strategic activity.
- The terms now being proposed by alternative funders are not too dissimilar to pre-Covid-19 terms, and stronger credits are increasingly approaching the market for support.
- The retrenchment of non-UK lenders to service home markets may see a reduced level of competition in the domestic lending market, which may result in a potential liquidity gap, therefore, an effective funder pool is key to securing funds.
- Given auditors' requests for 18 months of liquidity to sign off as a going concern, lenders are bracing for a busy six months of refinancing as businesses look to demonstrate a sufficient solvency level.
- The phase out of Libor in favour of the Sterling Overnight Index Average, is expected to impact mid-market businesses most and those with loans expiring at the start of 2022 should consider seeking advice on any amended agreements or revised terms.
- Although private debt fundraising is running at a relatively lower level, significant capital has been raised by credit funds in the past few years and a significant amount of this remains undeployed.

Annual Growth of Lending to Businesses



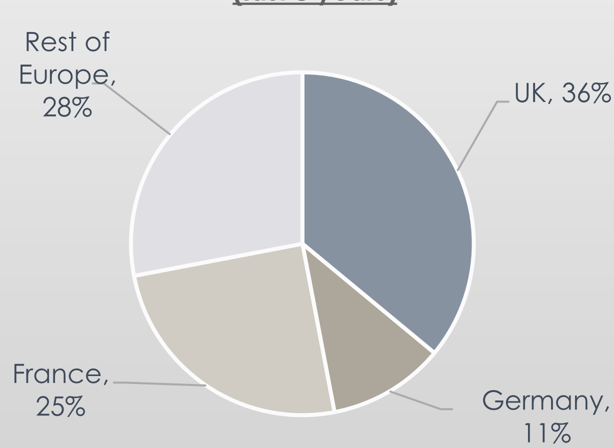
Source: Bank of England (October 2020)

Private Debt Fundraising



Source: Gambit Analysis, November 2020

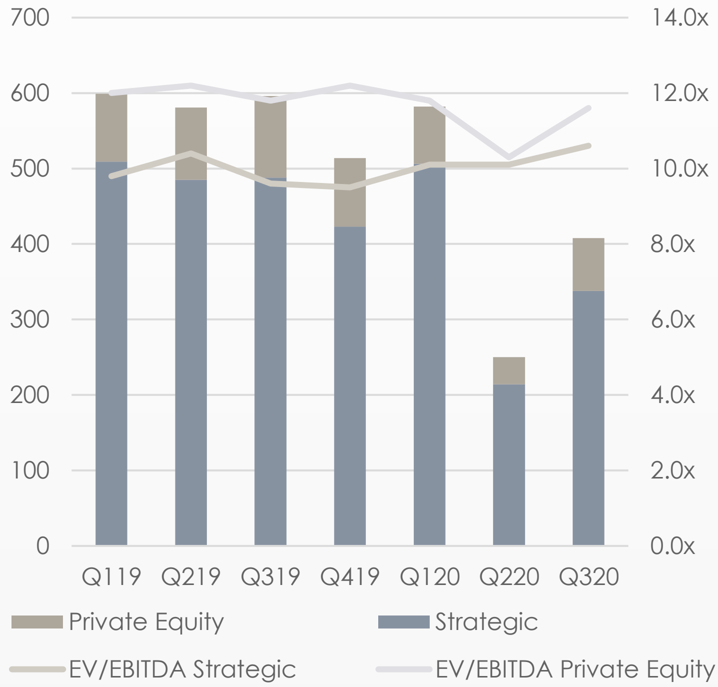
Deployment of Funds by Direct Lenders (last 8 years)



Source: Gambit Analysis, November 2020

M&A & Credit Markets

UK M&A Deal Volume & EBITDA Multiple



Source: PCPI

Valuation & Leverage Multiples

- Despite Covid-19 related uncertainty significantly affecting deal volumes, market valuations have remained stable, buoyed by healthy levels of capital availability and appetite for companies with a demonstrable level of Covid-19 resilience.
- A significant rise in September M&A loan volumes served to facilitate a spike in the multiples paid by Private Equity acquirers, with EV/EBITDA multiples in Q320 rising by 12.6% when compared with Q220.
- The debt markets have become further polarised, with strong competition amongst lenders for businesses that have performed well through Covid-19 and such assets are largely being funded at pre-pandemic levels.
- Mid-market LBO leverage multiples are inherently inflated, but Debt/EBITDA multiples continue to hover between 4.0-5.0x, with businesses in Covid-19 resilient sectors able to attract a multiple at the higher end of this range (e.g. Healthcare).
- The debt landscape continues to evolve on a weekly basis and it is best practice to speak with a specialist corporate debt advisor to establish the latest position on what is likely to be achievable.

Overview & Outlook

- Deal values dropped to record lows in Q220, before increasing nearly two thirds higher in Q320, a sign that a degree of confidence has returned to the market and both buyers and sellers have increased their level of risk tolerance.
- Strategic acquirer appetite rose by c.58% between Q220 and Q320, as listed entities sought to strengthen their war chests through equity raises in order to undertake opportunistic M&A activity.
- Having utilised the equity markets, strategic buyers may continue to build positions and attempt takeovers of undervalued companies by testing the debt market to secure flexible acquisition financing facilities.
- The majority of direct or alternative lending deals continue to be M&A related, with 67% of UK and European raises being used to fund a buy-out, with ample levels of dry powder serving to buoy short term M&A activity.
- As mainstream banks' attention continues to be focused on supporting corporate clients' immediate cash needs, M&A activity will be sustained by the support of alternative funders, but approaching the right funder pool is key.
- Corporates may look to sell non-core assets to address near term liquidity, leverage and valuation issues.
- The envisaged changes to CGT may lead to an acceleration of sellers in the market, creating a value maximisation opportunity for business owners to benefit from tax relief and buyers to capitalise on a rise in available assets.
- Whilst Brexit related uncertainty continues to have a bearing on domestic M&A activity, the agreement of a UK/EU trade deal will provide stability to the market, with a degree of pent-up demand leading to an increase in both local and cross border opportunities.
- Sellers will be encouraged by the market's resilience in view of improving deal volume and valuation data, with those that were considering an exit at short notice prior to the pandemic perhaps now actively considering initiating a transaction.

Gambit Corporate Finance – Debt Advisory

Jason Evans

Partner, Debt Advisory

Office: +44 (0) 845 643 5500

Mobile: +44 (0) 772 544 6741

Email: jason.evans@gambitcf.com

Simon Marsden

Director, Debt Advisory

Office: +44 (0) 845 643 5500

Mobile: +44 (0) 779 644 1330

Email: simon.marsden@gambitcf.com

Michael Dunn

Analyst, Debt Advisory

Office: +44 (0) 845 643 5500

Email: michael.dunn@gambitcf.com

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Gambit Corporate Finance

Established in 1992, Gambit Corporate Finance ("Gambit") is an independent corporate finance firm specialising in advising private and public organisations on mid-market transactions in the UK and overseas. With offices in London and Cardiff, Gambit is widely recognised as a market leader in corporate finance advice having built up detailed industry knowledge and an enviable track record in deal origination and execution.

www.gambitcf.com

Corporate Finance International

Gambit is the exclusive UK shareholder of CFI, a global partnership of middle-market investment banks and corporate finance advisory firms. With over 200 professionals located in 26 offices throughout the world, CFI members specialise in cross-border acquisitions, disposals, capital raising, and related services. CFI was ranked number 16 in Europe and 21 globally by Thomson Reuters for transactions valued up to €200 million in 2019.

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