

Debt Market Update

Q1 2011

In this publication:

Spotlight

Corporate Loans

Corporate Bonds

Asset-based lending

Leveraged Finance

Restructuring

***Our Debt Advisory
Services***

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Welcome to the Debt Market Update, Q1 2011

Foreword

2010 was a year of growth across a broad spectrum of the credit markets. Leveraged finance recovered some of its swagger after its crisis of confidence in 2009. Banks were more willing to take on significant underwriting positions and the bond markets continued to support borrowers' desire to diversify their sources of capital. Though the year was not without significant hurdles including the euro-zone debt crisis, the debt markets found a path through to post a strong year with a robust pipeline entering Q1 2011.

The high yield market continued to lead the way with record issuance driven by investor demand for yield and borrowers need to refinance debt. Although the market temporarily closed in May in response to initial Eurozone worries, it has continued to support a steady stream of new issues through the Irish crisis. The market has had a strong start to 2011 and will need to continue to perform well if the leveraged loan wall is to be refinanced. High yield pricing has tightened in recent months, but relative to other investments, speculative grade debt is still an attractive investment.

Aside from the Eurozone's woes, the other principal cloud on the horizon for the bond market is the build-up of inflation and the impact that could have on bond coupons later in the year. This may cause a surge in volume in the first few months of the year as treasurers look to lock in yields at what they anticipate may be an inflection point in pricing.

The leveraged loan market witnessed a strong recovery in 2010 with volume significantly higher than 2009. However, the bulk of leveraged loan issuance has been used to refinance existing debt rather than to support M&A activity.

Refinancing was a principal driver of activity in the corporate loan market in 2010. Leveraged and corporate loan market participants are hopeful of increased M&A activity in 2011 as cash rich corporate borrowers and private equity houses take advantage of more buoyant debt markets and the improved global macro environment.

We expect to see banks continue the trend of underwriting larger transactions as syndication committees gain more confidence around levels of market liquidity. Underwriting for mid-market transactions may remain less frequent unless new entrants appear in greater numbers to add depth to the market. We believe that club deals are likely to remain typical in this segment of the market.

If the European leveraged finance market is to continue an upwards trajectory it will require new investors to enter the market. This edition's spotlight focuses on the Collateralised Loan Obligation (CLO) market. The CLO market grew rapidly in the credit bubble years becoming the largest single source of debt financing for private equity backed buyouts. However, the CLO new issue market, along with most of the structured finance market, closed during the financial crisis and has struggled to re-emerge in the post-Lehman world. Barriers to renewed CLO issuance remain but the launch of some new vehicles in the US coupled with growth in leverage loans offer reasons for optimism.

The combination of more robust primary debt markets and improving macro-economic conditions led to a post-Lehman low in the corporate default rate in 2010. There were only 21 defaults in the European leverage market in 2010 compared to 90 in 2009. Our overall view is that, barring external factors such as a sovereign default restructuring activity levels are likely to remain in line with 2010. Beyond 2011 we expect the rising quantum of maturing leveraged loans to lead to increased levels of restructuring activity.

The sheer volume of borrowers needing to refinance in the coming years suggests there is merit in companies beginning to plan their refinancing strategy now. The more highly leveraged companies need to consider how they can reduce their debt to levels capable of being refinanced in the current market.



Simon Boadle

Head of Debt Advisory

PwC

Tel: +44 (0)20 7212 4118

Email: simon.boadle@uk.pwc.com

Contents

Spotlight

Corporate Loans

Corporate Bonds

Asset-based lending

Leveraged Finance

Restructuring

Our Debt Advisory services

What we do

Selected recent transactions

Contacts

Spotlight

Leveraged Finance – Are we on the cusp of a CLO renaissance?

At the peak of the debt market, CLOs were the largest source of debt financing for private equity backed M&A transactions, representing c.40% of the market.

When the liquidity provided by these vehicles disappeared, the LBO market immediately stagnated. In this article, we examine the issues that have prevented the re-emergence of CLOs and how and when these can be resolved.

In our view, there are encouraging signs to suggest new CLOs will come to market in Europe in the next 12-18 months. However, the stigma that remains around structured finance is likely to prevent CLOs regaining their previous dominance and other sources of capital (e.g. high yield bonds, unlevered credit funds) will be required to fill the gap.

Background

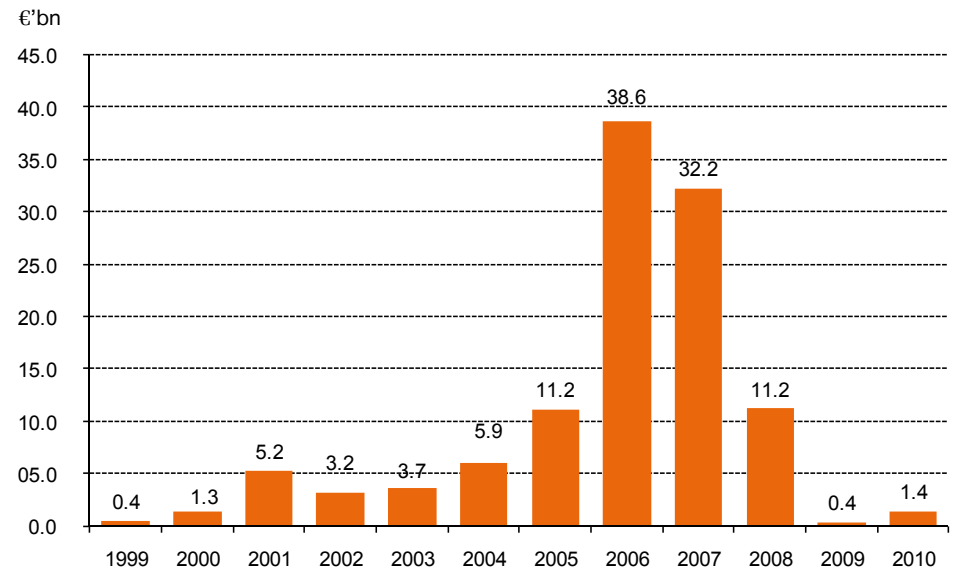
A Collateralised Loan Obligation ('CLO') is a form of securitisation. In essence, a Special Purpose Vehicle is created that raises funding in the form of debt and equity. The debt is tranching and assigned a rating (the most senior tranches are rated AAA and AA).

These funds are used to purchase a portfolio of leveraged loans. Cash flow from this portfolio of loans is then used to pay interest on the CLO's debt, with the surplus being used to fund equity dividends. Effectively, equity value is created through an arbitrage on the margin that is achieved on the asset side of the vehicle (the loans that the CLO invests in) and the margin it pays on its debt. The ability to pay dividends to the equity tranche depends on the available cash flow and the ratio of collateral (i.e. loans) and liabilities.

The CLO is one type of Collateralised Debt Obligation (CDO), which use the same financing technology to invest in all kinds of financial assets e.g. residential and commercial mortgages, auto loans and credit card receivables.

In the period up to spring 2007, CLOs provided a lot of the growth in the European leveraged market. However, later that year, investors lost confidence in mortgage backed CDOs, which then spread across the entire industry. As a result CLO issuance collapsed. (see Chart 1).

Chart 1: CLO volume since 1999



Source: S&P LCD

Excludes US Dollar Tranches Syndicated in the US

In 2007, CLOs bought nearly 40% of new leveraged loans, but demand collapsed following a loss of investor confidence in securitisation.

Recent performance of existing CLOs

Over the past 12 months, CLOs have started buying new leveraged loans again, recycling cash from the repayment of other loans in their portfolio. However, overall CLO activity is constrained by the lack of new investment vehicles. This issue holds back the entire European leveraged market given the importance of the CLO sector to previous levels of loan issuance and the contraction in the banking sector over the last four years.

Furthermore, the current recycling of cash into new loans by existing CLOs will come to an end in the next 2-3 years as their re-investment periods close, just as the well reported ‘maturity wall’ of pre-2007 vintage leveraged loans peaks. This will put further pressure on the leveraged market.

The question therefore is what is preventing new vehicles coming to market.

The leveraged finance market is constrained by the lack of new CLO structures. The question therefore is what is blocking new vehicles coming to market.

The creation of new CLOs is potentially hindered by several factors (discussed in more detail below):

- Achievable leverage within CLOs;
- Margins on AAA tranches of CLOs are still significantly higher than pre-crunch;
- Equity in existing CLOs is trading at a discount in the secondary markets;
- M&A deal flow is too small for CLOs to quickly invest the capital they raise in new loans;
- Regulation of structured finance vehicles has tightened.

Barriers to new CLOs

One of the key drivers of equity returns in the boom years was the level of leverage in CLO vehicles, often debt represented c.90% of funding. Post-crunch investors demanded much lower leverage to give greater protection over their investment (50% to 75%), which materially impacted potential equity returns in a new vehicle. However, the few CLOs that have been launched recently, admittedly in the US not Europe, have involved leverage of close to 90% with the AAA tranche representing 65% of the overall structure (again close to the pre-crunch norms). This suggests that the leverage problem can be overcome albeit examples so far are limited.

Cheap funding of the AAA tranche was also a key driver of CLO economics, such notes earned only 20 bps over LIBOR at the peak. While secondary spreads have come down from their post-crunch peaks, they remain at over 200 bps. Current economics therefore work against the creation of new CLOs. Whilst the loan margins on new leveraged loans are much higher than the pre-crunch level, improving the arbitrage spread, there is a concern that they could tighten in the future, squeezing the returns to equity.

Indeed, achieving an acceptable equity return is a key brake on new CLO issuance. The problem is exacerbated by the fact that equity in existing CLOs is trading at a discount providing a more attractive return than potentially available on a new vehicle. As evidence for this problem, Apollo decided to retain all of the equity in its most recent \$400m CLO issue. Such a solution is unlikely to be attractive to all CLO providers.

General conditions in the M&A market have also impacted the feasibility of launching a new CLO. For the economics to work, a CLO needs to raise €400m-€500m and invest it quickly in new leveraged loans. The lack of dealflow over the past couple of years clearly has hampered this process. The handful of CLOs that have come to market in Europe recently are therefore based on buying portfolios of pre-crunch LBO loans. A recent example of this is ICG's acquisition of RBS' mezzanine portfolio, which was structured as a CLO. There is a chicken and egg problem here: the leveraged loan market needs more CLO activity to grow, but the latter is predicated on a larger overall level of new loan issuance.

Regulators have also sought to align the interests of the originators of the CLO (e.g. a bank or investment manager) with its end investors. As a result, both in the US and Europe so-called 'skin in the game' regulations have been prepared. On 31 December 2010, the Committee of European Banking Supervisors published its final guidelines. Broadly speaking this requires originators to retain at least 5% interest in the CLO structure post origination: this exposure cannot be sold or hedged. Potentially this could lessen appetite of banks to arrange new deals.

Implications for borrowers

Appetite for new leveraged loan paper from existing CLOs is currently quite strong. There is an argument that borrowers should make use of this window before it closes because there is still uncertainty as to what will replace it, albeit the high yield bond market is currently taking up part of the slack.

Similarly, when planning refinancing strategy, borrowers should also look at their existing loan syndicate to understand the importance of CLOs in their lender base. These lenders will probably not form part of any refinancing in the medium-term creating a funding gap which will need to be filled by bond issuance or other lenders.

Improving conditions could spell return of new CLOs

There are a number of encouraging signs which are likely to support an opening up in the market in Europe over the next 12-18 months.

A small number of new CLOs have recently been launched in the U.S. (CLOs of Ares, Fraser Sullivan, GSO Capital Partners and Pinebridge). These new vehicles appear to have been able to increase leverage again to c. 90%, which certainly helps improve the economics from an equity perspective.

Apollo priced the AAA tranche of their most recent deal with a spread of c.175bps suggesting pricing could tighten further, which would improve overall CLO economics. Additionally, as reinvestment periods in existing CLOs begin to close, this could put upward pressure on underlying leverage loan margins, adding a further boost to the CLO spread arbitrage.

The European leveraged market grew significantly last year and the pipeline for new deal flow suggests 2011 will build

on this momentum. A bigger leveraged finance market will address the ramp-up problem described above.

Although the 'skin in the game' regulations could be a barrier for some arranging banks, on aggregate it doesn't necessarily have to be a major obstacle to increased CLO creation. Banks are looking to put capital to work again and senior CLO paper is attractive compared to similarly rated securities. In a way, this could actually help boost issuance as potential investors find comfort from the originators retaining an economic interest.

However, the stigma that surrounds structured finance has not completely lifted. If new CLOs do make in-roads again in Europe, they are unlikely to be as dominant as they were in the previous cycle. Rather, they may sit alongside other institutional vehicles (e.g. unlevered credit funds) in the investment universe (more akin to the US model).

Corporate Loans

Bank lending remains firm in the face of significant headwinds

Key trends

The loan market ended 2010 strongly with market sentiment positive going into 2011. The wider loan market continued largely unscathed by Ireland's debt woes and Q4 2010 European volumes demonstrated strong growth over both Q4 2009 and Q3 2010. Lenders remain keen to win new business and are increasingly willing to use their balance sheets to underwrite for the right deals. This trend has been more apparent in larger deals where banks have increasing confidence in overall market liquidity.

UK Mid-market liquidity has seen some improvement through the increased activity of certain overseas banks, but in general deals need to be completed within a fairly narrow group of lenders which continues to lead to more club deals within this segment of the market.

2010 was very much a year of refinancing with M&A activity failing to take off to a significant degree. Lenders are keen to increase the relative proportion of M&A lending activity to refinancing volume in 2011 due to the higher margin levels typical of M&A transactions.



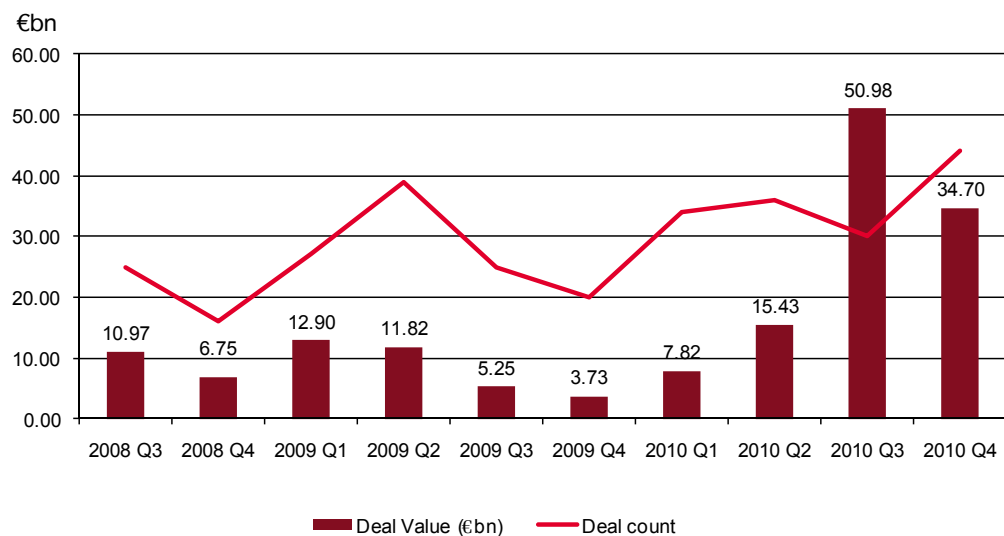
Outlook for 2011

The corporate loan market proved resilient to external shocks in 2010 such as the euro zone debt crisis, the UK Comprehensive spending review, global macroeconomic concerns and Basel III negotiations. These themes are likely to continue to be in focus in 2011. However, barring a systemic shock, such as a Spanish sovereign default, we expect the corporate loan market to continue the trends seen in 2010, ie. aggressive underwriting of some large cap deals coupled with a more cautious, club approach to mid-market borrowers.

Lending Volumes

Q4 UK corporate investment grade deal count was up 47% over Q3. Total value at €35bn was double the Q3 level if one excludes the loan raised to finance BHP's failed bid for Potash Corp from the figures. Total EMEA lending in 2010 was up 40% on prior year according to Thomson Reuters demonstrating the loan market's resilience to sovereign debt problems.

Chart 2: UK Corporate Investment Grade (AAA - BBB-)



Source: Dealogic LoanAnalytics



Client considerations

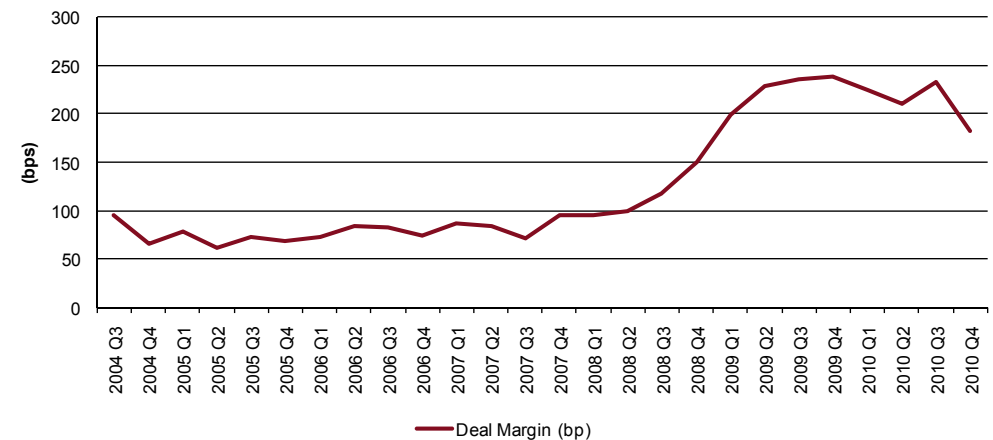
Our view is that whilst Banks are certainly open and keen to do good business, an overall cautiousness in the economy remains which can lead to less predictable approval processes. Our advice to mid-market companies seeking new financing would be to approach more banks than would initially appear necessary in order to maintain flexibility in the loan raising process.

Pricing / Structure

Pricing in the large cap arena witnessed some tightening towards the end of the year with margins on AAA -BBB falling to c.180bps from 210bps at the half year. Mid-market pricing has remained more sticky driven by the relatively small number of banks active in the market. Ancillary fee opportunities are as important as ever to lenders as they seek to boost overall yields to generate a return over continued high funding costs.

In terms of tenor, the typical maturity on mid-market corporate loans has lengthened to 4 years from 3 years, whilst 5 year deals are increasingly seen in larger deals.

Chart 3: European Investment Grade (AAA-BBB-) average margin over LIBOREURIBOR



Source: Dealogic LoanAnalytics

Corporate Bonds

High yield ends 2010 on a high, but overall market may soften through 2011 as inflation expectations build up

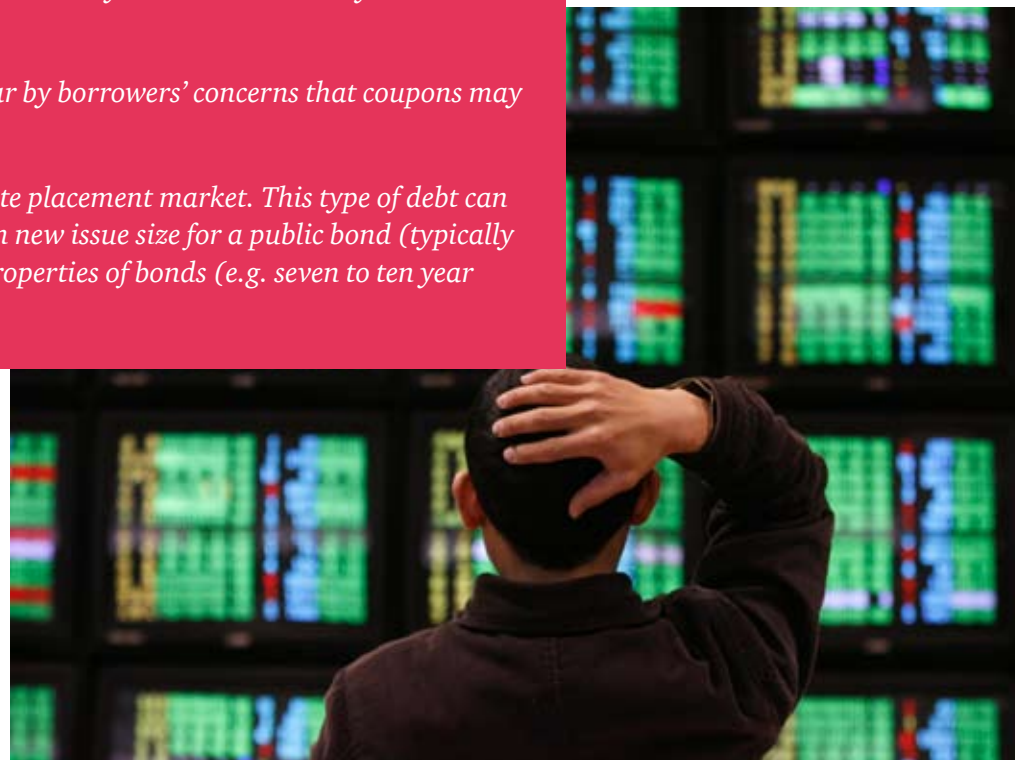
Key trends

The UK bond market supported a steady rate of issuance in 2010, in line with the trend seen in the second half of 2009. Full year volumes were, however, 40% down on the prior year due to the exceptional level of activity in the first six months of 2009.

In contrast to the overall trend, the high yield segment exhibited strong growth. Across Europe, issuance of €44bn was 80% up on prior year. The market shrugged off the Eurozone's woes with final quarter volumes in line with the high level of activity in first quarter. The continued strength of the high yield market is key to borrowers' ability to tackle maturing leveraged loans (see page 28 for more details).

The start of 2011 has already witnessed strong volumes, driven in particular by borrowers' concerns that coupons may increase later in the year in response to rising inflation expectations.

There continues to be a steady stream of new issues in the less volatile private placement market. This type of debt can be attractive to borrowers whose debt requirements fall below the minimum new issue size for a public bond (typically £150m+), but who still want to take advantage of some of the attractive properties of bonds (e.g. seven to ten year tenors).

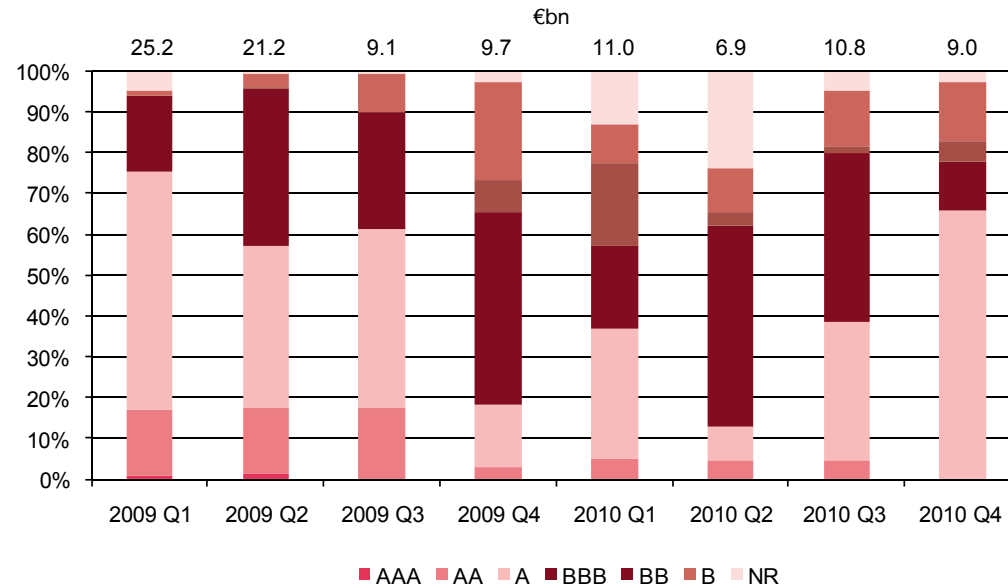


Volumes

Whilst quarterly volumes remained broadly steady in 2010 compared to the second half of 2009, full year issuance of €37.7bn was 42% down on 2009 and 31% lower than 2008. As investment grade spreads narrowed slightly over the whole year (albeit with peaks and troughs), this suggests lower volumes were broadly a function of borrower demand rather than lack of investor appetite.

Indeed, the high yield market showed strong growth in volumes in the UK and across Europe precisely because of the demand from corporates to tackle maturing leveraged loans, as well as in some instances to part-fund leveraged buyouts. High yield bonds used in LBOs represented ten times the level of new mezzanine issuance in 2010, demonstrating the former's dominance in the market for junior debt capital.

Chart 4: All UK bonds issued by rating (€bn)



Source: Dealogic LoanAnalytics

Investment grade bond issuance in 2010 was down on prior years, but this was principally a function of demand.

Whilst sub-investment grade spreads fell during 2010, they remain significantly above pre-crunch levels.

Investment grade bond issuance continued to be dominated by the energy and utilities sector, with over 50% of issuance coming from a relatively small number of high quantum deals. BP led the way in October with a €2bn A rated bond which was the largest single launch, but which was followed by three separate issues from BG (€250m, €875m and €766m) and one Thames water (€500m).

The UK construction sector, one of the biggest casualties of the UK recession, was again represented through Taylor Wimpey (€292m), Eversholt (€818m) and European Metal Recycling (€216m) and there were major bond issues from the transport (Motobility - €853m) and chemicals sectors (Bunzl - €108m).

Pricing

The fourth quarter of 2010 saw a narrowing of spreads between investment grade and speculative grade bonds. This principally reflects a decline in high yield bond as investment grade pricing only marginally tightened over the last 12 months.

The fall in sub-investment grade spreads has led to some speculation of a nascent credit bubble. In reality, whilst all-in coupons have fallen during the year, the spread over government debt remains significantly higher than the peak of the pre-crunch credit boom.

Chart 5: UK issues by sector

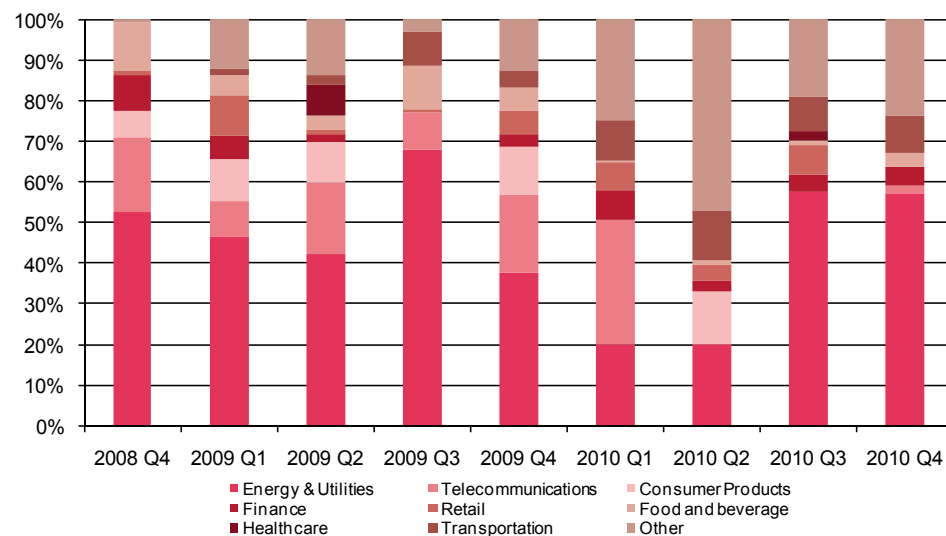
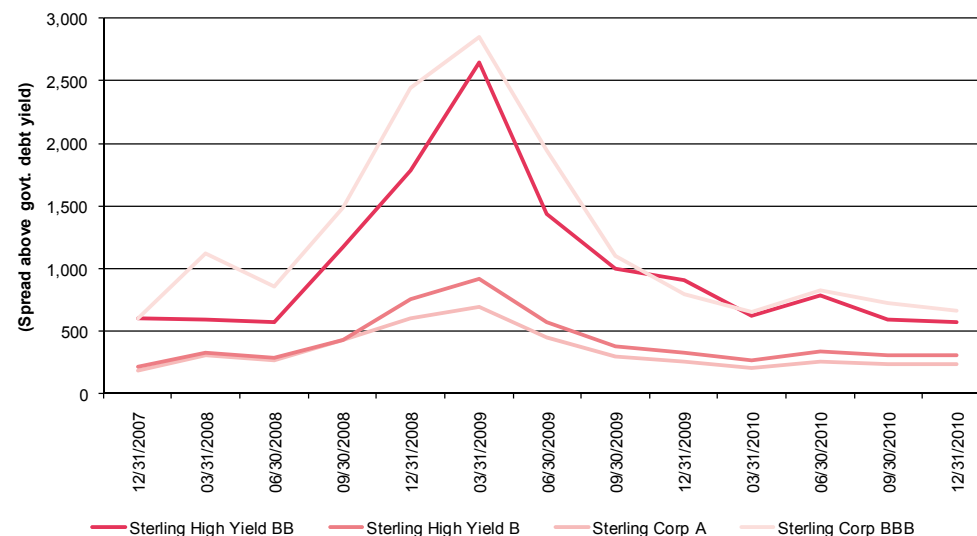


Chart 6: UK Corporate Bonds - spread over government debt by rating



Source: Dealogic LoanAnalytics

Source: Bank of America Merrill Lynch

Private placements

Issuance of Private Placements (“PP”) by UK corporates saw a relatively strong end to 2010 with major deals from Cookson (\$250m) and MITIE (\$150m) pricing in Q4. Table 1 summarises recent UK issues.

As the table indicates, PP investors are able to accept relatively small issues (e.g. Logica, Northern Foods) and will invest in a wide range of sectors. This enables corporates who are not keen to issue a bond (either because they do not want a credit rating or their debt requirements are smaller than a typical bond issue) to tap longer maturities (7-10 years).

PP investors typically tend to focus on borrowers with leverage of up to 2.5x. Therefore, for smaller highly leveraged companies, they are not a substitute for the high yield bond market.

Table 1: Recent UK Private Placements

Issuer	Business Description	Issue Date	Final Maturity	Principal Amount (\$ mil)	Spread above US Treasuries (bps)
Bunzl plc	Business Services	Oct-10	n/a	150	n/a
European Metals Recycling Limited	Industrial Manufacturing and Services	Oct-10	Oct-22	300	270
Intertek Group plc	Business Services	Oct-10	Oct-20	250	130
Cookson Group plc	Industrial Manufacturing and Services	Oct-10	Oct-20	250	240
MITIE Group plc	Outsourcing	Sept-10	Sept-19	160	165
Cookson	Manufacturing	Sept-10	Oct-20	250	n/a
Britvic	Beverages	Sept-10	Sept-20	150	135
Informa plc	Business Services	Sept-10	Sept-20	730	177-215
Whitbread plc	Hotels and restaurants	Aug-10	Aug-18	150	200-220
JLT Group	Insurance Broking	Jul-10	Jul-20	125	265

Source: Private Placement letter

Client considerations

The bond market remains an important tool for mid size and larger borrowers to diversify sources of capital and spread the maturity profile. Companies with relatively high levels of leverage, but not in financial distress, should consider the high yield market to address upcoming maturities.

Some corporates have been using HYBs as an alternative to IPOs since they offer both a means for shareholders to realise value and raise new money without the uncertainties and dilutive impact of equity issues. It can be sensible to run IPO and HYB scenarios in parallel.

With credit ratings a key driver to the pricing of corporate bonds, the positioning of the business in front of the agencies is critical to obtaining the best possible rating.

Borrowers with a smaller level of long-term core debt should consider the private placement market to replicate some of the benefits of tapping the capital markets.

Outlook for 2011

Globally, there has been a very strong start to 2011, with over \$100bn of debt sold in the bond markets in the first week of January. This partly reflects concerns around the impact of rising inflation expectations on bond yields, which may temper volumes later in the year.

The other key theme for the bond market this year is the continuation of the Eurozone crisis. The high yield market coped with this in 2010 and our base view is that it will continue to remain open unless there is a major sovereign default. Indeed, demand is likely to continue to remain strong in this segment as the quantum of maturing loans from buyouts completed in the boom years begins to climb. This may put some upward pressure on yields, but for borrowers access to the market is likely to be more critical than price.



Growing market share, but the breakthrough still hasn't come

Current Trends

Total Asset Based Lending (“ABL”) to UK corporates in Q3 2010 increased to £15.1bn from £14.6bn in Q2 (Q4 data is not yet available), against a background of falling total net lending to UK businesses. The majority of ABL advances (circa £12bn) relates to pure invoice financing, with the remainder being more comprehensive ABL where senior debt is secured against a range of assets in a single structured finance package.

Yet despite this growth in market share, ABL has not really broken into new areas of the debt market following the credit crunch, as some predicted. And with improving liquidity in traditional “cash flow” corporate and leveraged lending, it could be argued that ABL has missed this opportunity, as is born out by our experiences in two different areas of the debt market.

- For corporates with strong credit ratings, the potential pricing advantage of ABL facilities (e.g. receivables securitisations) over traditional unsecured revolving credit facilities is narrowing, and given the other perceived disadvantages of ABL, such as increased reporting and less flexibility, it is becoming less likely to be the chosen option.

- In the private equity buy-out market, it is relatively rare for ABL alone to provide sufficient leverage to make the transaction attractive, and a material slice of top-up debt, usually mezzanine is often required. With the improvement in liquidity in the leveraged market, the ABL plus mezzanine option is becoming less competitive.

Additionally, lack of capacity resulting from complications in clubbing or syndicating ABL deals, can be an issue in both of the above examples, and this combined with short supply of quality deals, is driving an increase in hold sizes (up to £100m now being considered by some major ABLs).

Despite the above comments, ABL remains competitively-priced, although margins now appear to have stabilised following a gradual decline over the last year. Average margins for receivable and inventory lines now stand at 150 to 300bps over LIBOR and 250 to 350bps for term debt secured over property, plant and machinery.

Lenders continue to typically be willing to advance up to 85 per cent of receivables with lower advances for plant and machinery (up to 50–70 per cent of 120-day realisable value), property (up to 50–70 per cent of 180-day realisable value) and inventory (up to 20-50 per

cent). Fixed asset realisation values, particularly for plant and machinery but also for industrial property, have fallen significantly over the last two years. This has reduced the quantum of finance available against these assets.

Client considerations

Despite the many attractions of ABL, potential borrowers should be aware that a marked downturn in trading can have a particularly strong impact for an ABL-backed business. It will not only suffer trading losses, but also a reduction in working capital assets to fund against.

In addition, it is critical to an ABL's funding criteria that advance rates are sufficiently conservative for it to be confident it can recover its lending in full in the event of an insolvency. Therefore, once lending requirements go beyond those advance rates, the right commercial decision for the ABL will be to recover its lending rather than to advance further funds.

This is one of the reasons why a relatively high failure rate is experienced by ABL backed businesses, although the failure rate is also significantly influenced by ABLs' willingness to back turnaround businesses, and so their clients will, on average, be higher risk. For some companies, particularly those which are asset-rich and cash flow poor, ABL may be their only remaining source of debt funding.

Leveraged Finance

The rebuilding of the market has been predominantly driven by the refinancing pressures

Key trends

Although we remain far removed from the peak of the market in 2007, the past year has been a positive step forward for leveraged finance. Full year leverage loan and high yield volumes of €87bn were more than double the level of 2009 activity and 55% higher than 2008. Refinancing activity was the key driver of volumes, representing nearly two thirds of total issuance. This compares starkly with the pre-crunch market, when new deals and recaps dominated the market.

Lenders have become more confident over the course of the year evidenced by rising leverage, the reappearance of underwriting for borrowers generating over €50m of EBTIDA and even a small number of dividend recaps (typically financed through the bond market).

CLO managers, who were the single largest source of liquidity in the pre-crunch era, have re-entered the market, investing proceeds from the repayment of other loans in their portfolio. However, their overall activity is constrained by the inability to set up new investment vehicles (see p5 for more detail).

Partly filling the gap has been the buoyant high yield bond market. Although only 12% of issuance has been used to fund new buyout activity (Source: S&P LCD), with the bulk of new issues being used to refinance existing debt.

We expect further growth in the market in 2011 as banks increase their budgets and borrowers and shareholders demand capital to finance M&A activity and to refinance upcoming maturities.



A turning point

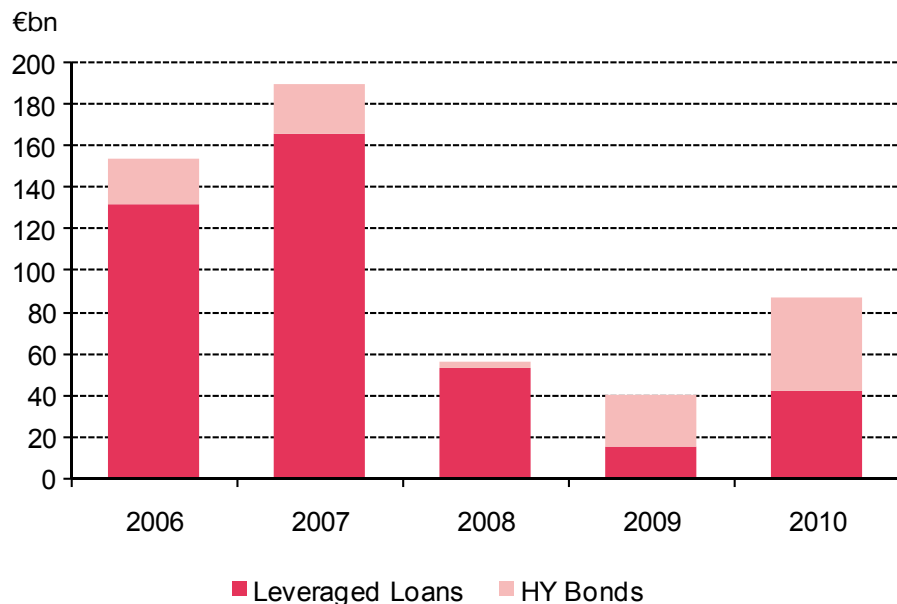
Leveraged loan volume in 2010 was significantly up from the 2009 low, from €15.4bn to €42.4bn. This was further amplified by the large issuance of HY bonds, which resulted in a combined volume for loans and bonds of €86.7bn, more than double the 2009 volume and representing 46% of the combined 2007 volume. However, the use of funds was markedly different. Nearly two thirds of all leveraged loan and bond issuance in 2010 has been to refinance existing debt, whereas in 2007 the proportion was approximately 20%, when new buyout and recap activity dominated.

2010 saw the return of the underwritten deal, although this was only the case for larger transactions. Partially this was the result of investors returning to the primary leveraged loans market, as secondary prices have rebounded (driving down yields) and CLOs received repayments from refinancing to re-invest. Another key reason is that banks have been competing heavily to win high yield mandates, thereby making the ability to underwrite any loan component a potential competitive edge.

The leveraged finance community has also begun to respond to the limited number of loan investors through the creation of some low-levered credit funds (which were common up to the 90s before the dominance of CLOs). However, concerns around overall market capacity remain.

Whilst the volume of new leveraged debt last year recovered to 45% of the 2007 peak, nearly two thirds was to refinance existing debt compared to 20% in 2007.

Chart 7: Leveraged Loan & High-Yield Bond New-Issue Volume



Source: S&P/LCD

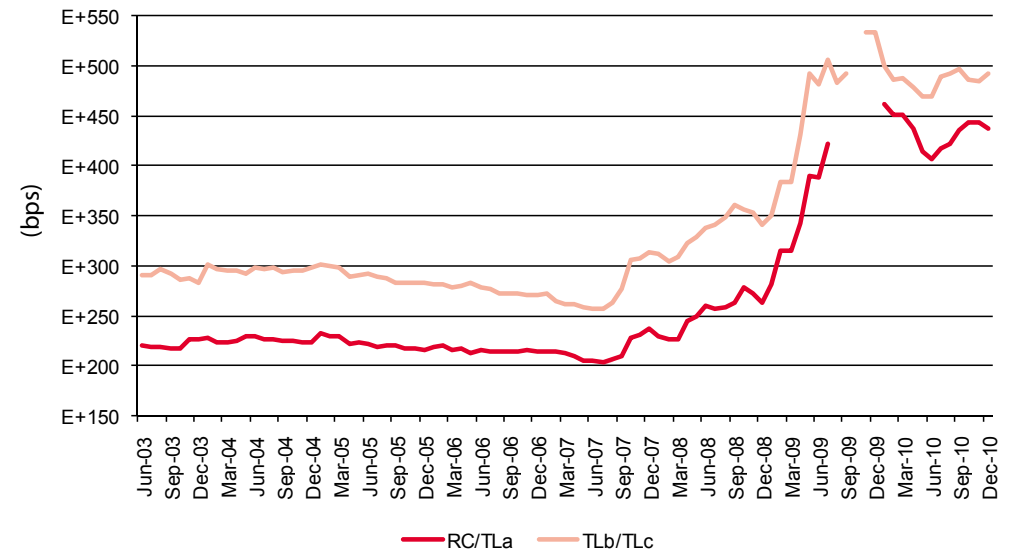




Pricing stays level

Average margins for leveraged loans in Q4 remained relatively stable at +441bps and L+482bps on senior A and B respectively (see chart 8). Arrangement fees remain at around four per cent on senior debt.

Chart 8: European weighted average new issues spreads

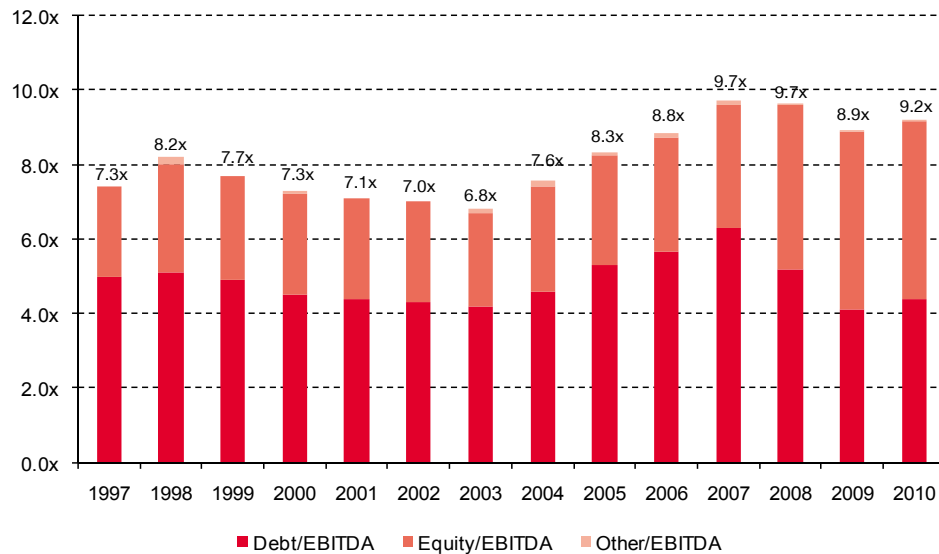


Source: S&P LCD

Gearing goes up

Compared to recent years, debt multiples continue to slowly creep up, driven by competition in the banking market for mandates. Average debt to EBITDA multiples increased slightly in 2010 to the region of 3.5x for senior debt and 4.4x for total leverage. Some larger deals have secured multiples significantly higher (e.g. total leverage in Lion's acquisition of Pincard Sergeles was c.5.6x).

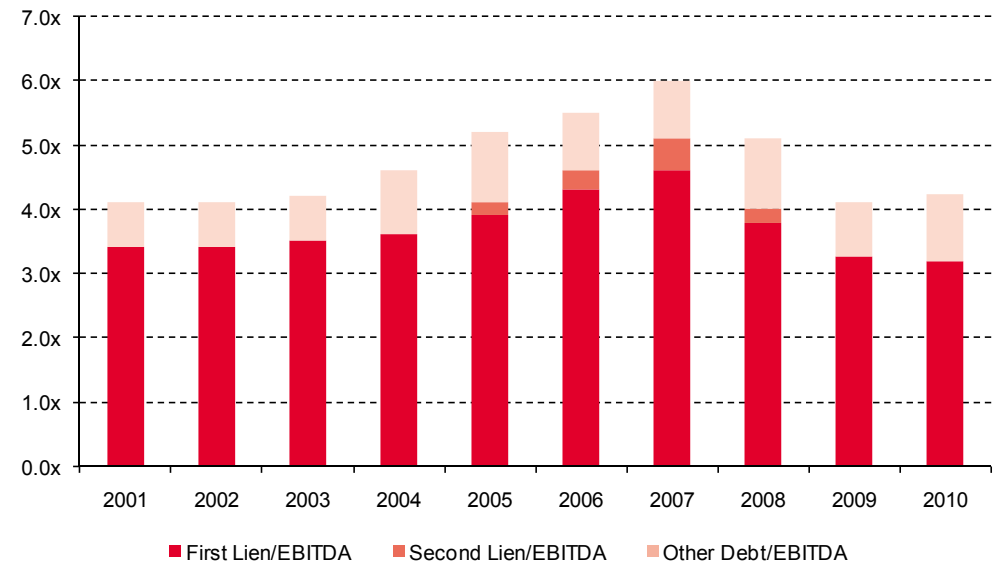
Chart 9: Sources of proceeds as a multiple of EBITDA of European LBOs



Source: S&P LCD

Purchase price multiples have moved in line with the increase in leverage multiples with equity contributions remaining at c.50% in 2010.

Chart 10: Annual Pro-forma Debt-EBITDA ratios of European LBOs



Source: S&P LCD

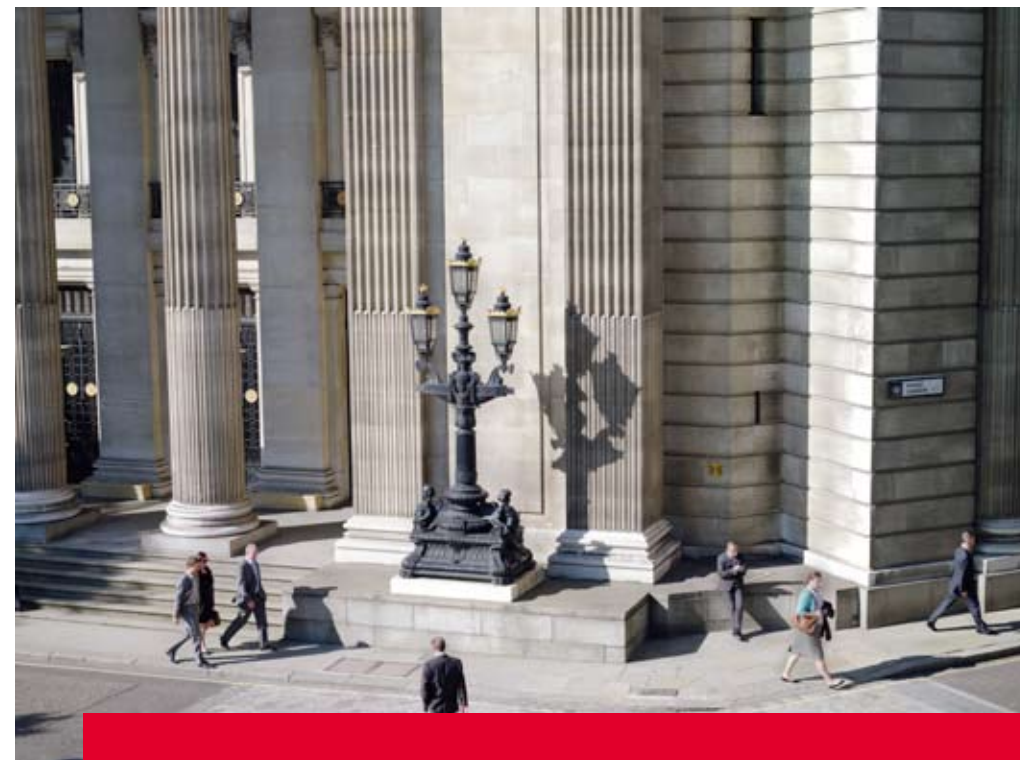
Outlook for 2011

Our base view, barring a major systemic shock, is for further growth in loan volumes in 2011. Recent conversations with leveraged finance banks indicate 2011 budgets are up on 2010 levels (indeed one bank commented that their available balance sheet had doubled in size).

In terms of new deals, PE Houses are under pressure to realise cash from their investments and there is greater confidence generally to conduct M&A.

From the refinancing perspective, we expect more borrowers to approach the market to address upcoming loan maturities.

Leverage levels are likely to continue to rise as banks compete for mandates and the high yield bond market, for the moment, appears amenable to taking on leverage. Pricing may remain more static as the demand for credit puts pressure on a limited supply of capital.



Client considerations

The loan market is likely to face increasing pressure over the next few years from companies seeking to refinance their maturing leveraged debt (see our commentary on the 'maturity wall' on page 28). There is merit in borrowers looking to tackle their upcoming maturities early both to beat the rush, but also with the knowledge that the high yield bond market has historically tended to open and close at short notice.

Restructuring

The default rate dropped significantly in 2010, but it is likely to begin to climb from 2012

Key trends

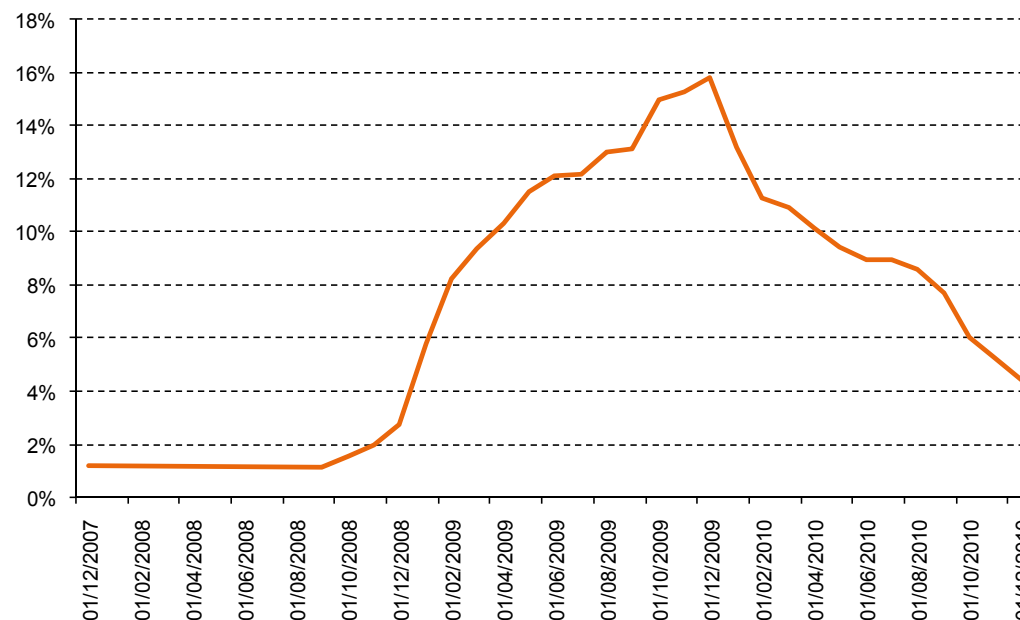
The number of new leveraged corporate defaults in Europe in Q4 2010 fell to a post Lehman low of two, both of which related to deals that have already been restructured before. In total there were 21 defaults in 2010 compared to 90 in 2009.

The reduced level of activity in the restructuring market has led some banks to move a number of their work-out bankers back into live lending.

Nevertheless, certain sectors (e.g. project finance) and countries, most notably Spain, continue to cause concern and expectations remain that there will be a steady stream of borrowers getting into financial difficulty over the coming year, if not at the levels seen in 2009.



Chart 11: European 12 month trailing default rate – S&P European Leveraged Loan Index (ELLI)



Source: S&P LCD

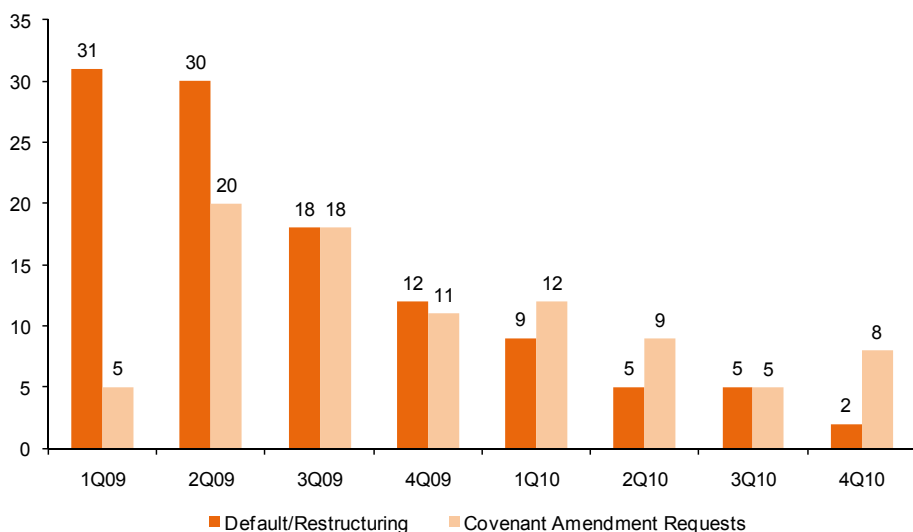
Default rates

The number of European leveraged companies incurring payment defaults, or entering into formal restructuring negotiations, fell to just two deals in the final quarter of 2010. Both of these borrowers have been through previous rounds of restructurings, which supports the widely held view in the market that a number of restructurings over the last couple of years were sticking plasters rather than fundamental fixes.

The rolling 12 month default rate also continued to decline to c.4.5% S&P LCO expect the rate to fall slightly further in 2011 before rising again as the wave of loans contained in the 'maturity wall' begin to fall due (see further comment later in this section).

The number of covenant amendments did spike upwards in the final quarter of the year, but a look below the surface indicates that half of these requests were related to business expansion or the extension of loans rather than a symptom of distress.

Chart 12: Number of new restructurings and covenant resets – European leveraged loans



Source: S&P LCD

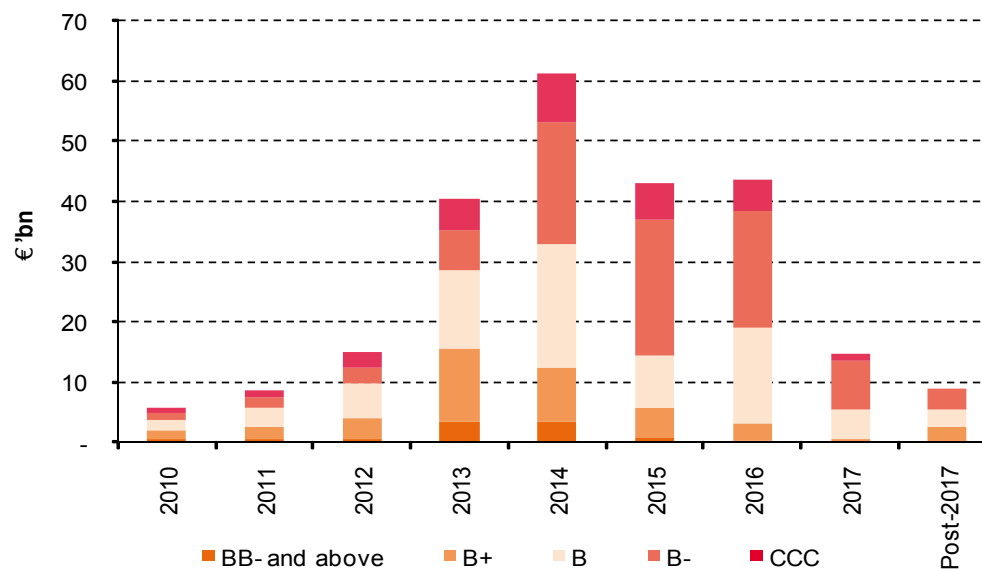
Maturity wall

Whilst the default rate is falling, the market continues to be concerned about the quantum of leveraged loans which are set to mature over the coming years, principally from 2013 onwards.

Fitch estimates that of the companies they provide shadow ratings on in Europe (approximately 300 borrowers representing €240bn debt), 60% by value is due to mature between 2013 and 2015.

Just over half the debt currently has a shadow credit rating of B or above with an average leverage of up to 5.4x. On the basis the high yield bond market continues to support strong rates of issuance, these loans are more likely to be refinanced in a conventional manner. The remainder, €117bn, is shadow rated B- or worse and with a current leverage on average above 6.5x represents a significant challenge to refinance in today's credit markets.

Chart 13: Scheduled amortisation split by rating



Source: Fitch

Maturity wall (cont'd)

The ability to refinance this wave of maturing loans is made more challenging by the fact that the majority of CLO investment vehicles (which were a key driver of market liquidity in the boom years up to 2007) will cease to be able to reinvest their funds just as the quantum of maturing loans reaches its projected peak. We comment on this issue in more detail on p6.

In conclusion, we expect that the majority of healthier corporates will be able to use high yield bonds and new leveraged loans to address their upcoming maturities. However, we expect there will be a significant number of companies who are forced to enter restructuring negotiations to resolve upcoming maturities.

Secondary prices

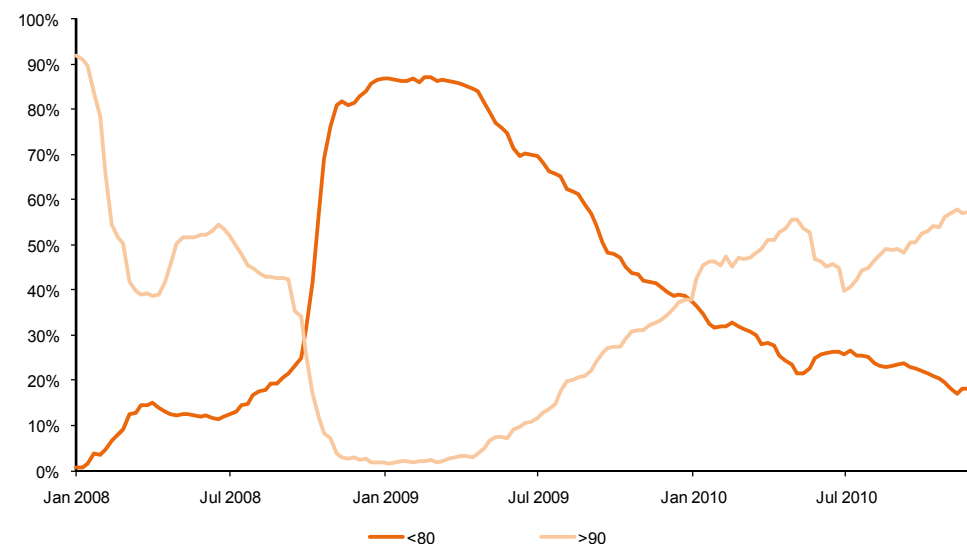
Indeed, whilst the proportion of European leveraged loans trading at over 90 in the secondary market has risen steadily over the last year, c.20% of issuers continue to trade at below 80 (see Chart 14). This suggests the market continues to have concerns over the financial stability of a significant proportion of borrowers.

We have also seen evidence recently of banks selling down significant stakes in restructured deals. For example, Varde recently built up a majority stake in the debt of Crest Nicholson as part of a strategy to implement a more drastic debt for equity swap than was executed in the original restructuring. Bank of America also sold its debt in the restructured Foxtons Group to an investment fund, Haymarket Financial.

With the overall price of secondary loans having increased substantially since the post Lehman low (see Chart 15), and with significant pressure on the use of capital, we would expect banks to continue to exit credits on a selective basis.

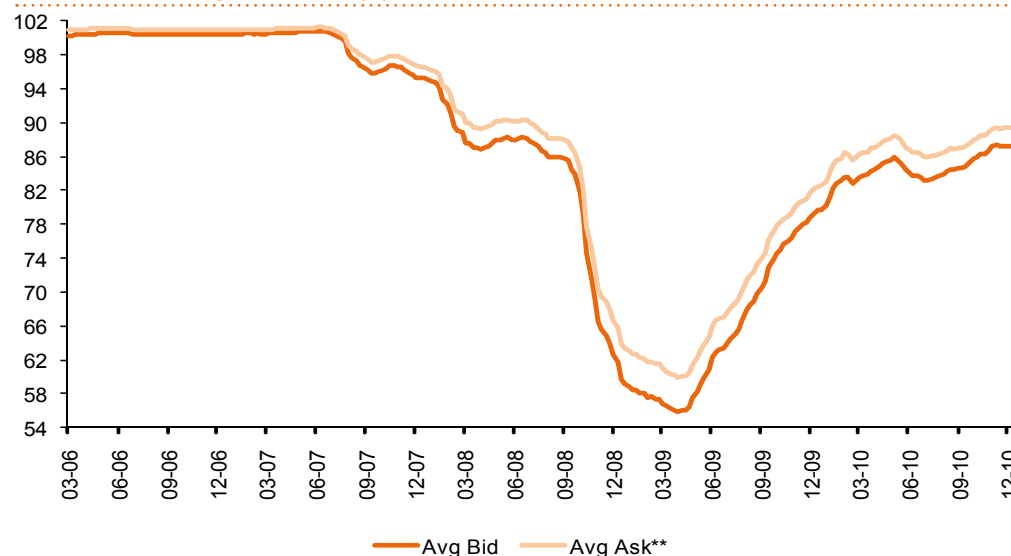
C.20% of issues continue to trade at below 80p in the £ in the secondary market highlighting concerns over repayment.

Chart 14: Percentage of issuers trading in different pricing bands



Source: S&P LCD, ELLI Index

Chart 15: Average secondary prices: S&P ELLI Index

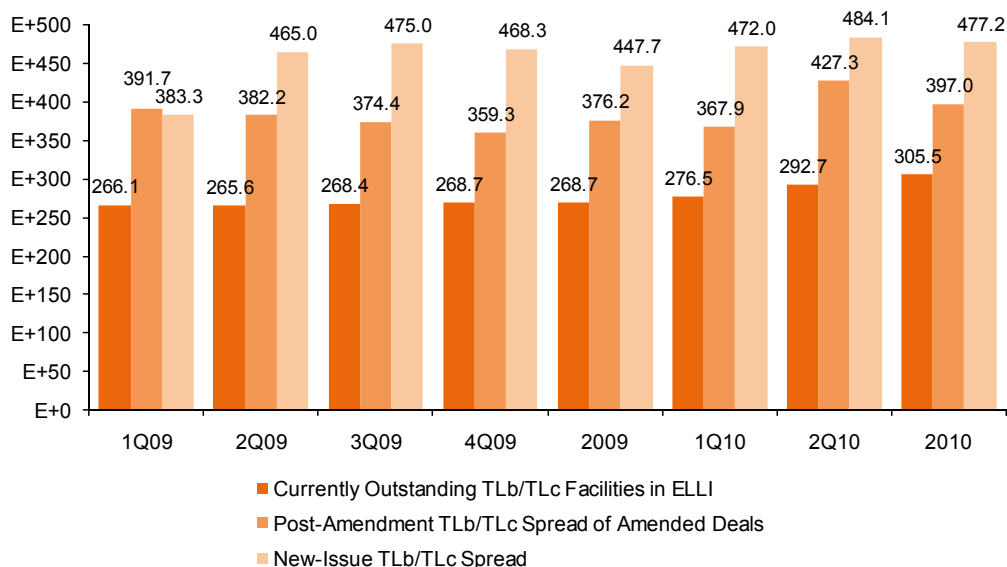


Source: S&P LCD ELLI Index

Pricing and covenants

Restructured facilities typically involve a c.100bps increase in margin as lenders seek to re-price the loans to their underlying risk profile, however these are still not reflective of market rates.

Chart 16: Average Margins on LBO facilities

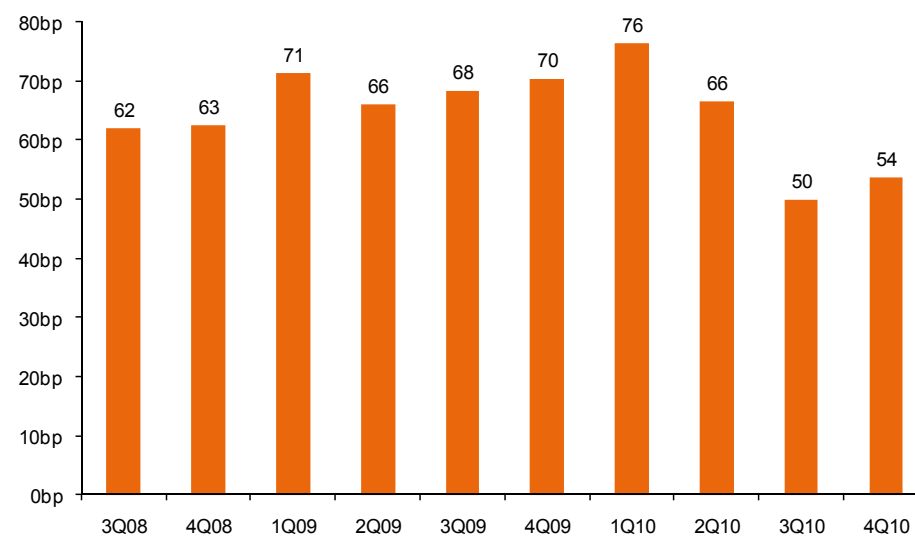


Source: S&P LCD

Note: Limited number of observations in Q3 and Q4 2010

The average amendment fee has fallen in the last couple of quarters to c.50bps compared to a previous run rate of c.65bps to 70bps. In our view, this probably reflects a simplification in the types of waivers being sought rather than a change in the market price for seeking an amendment. A number of recent waivers have been more to do with relaxing loan restrictions to support growth rather than seeking additional covenant headroom in the face of softening underlying trading.

Chart 17: Average amendment fee



Source: S&P LCD

Outlook for 2011

Barring a systemic shock, such as a sovereign default in Spain, we would expect 2011 to follow a similar pattern to 2010. There will continue to be a number of borrowers getting into financial difficulty even as the overall default rate declines. Issues around covenant headroom are likely to be more common than a full scale financial restructuring involving a haircut to the value of the debt.

Secondary debt trading should also be supported by the recent rise in debt prices. From our previous experience, this is likely to make those restructurings that do occur more

complicated for the borrower as the creditor group will comprise widely different agendas which have to be reconciled.

Debt trading may also precipitate a restructuring in some cases as hedge funds agitate for a more transformational solution to over-levered credits.

Client considerations

Notwithstanding the decline in defaults, the approach of lenders to a covenant breach has not changed. Therefore, borrowers should continue to monitor debt covenants carefully and approach lenders significantly before any anticipated covenant breach. Although this is unlikely to achieve much of a pricing benefit, it will give lenders enough time to work through the process – which may require due diligence – prior to the breach actually occurring.

The opening up of the high yield and leveraged loan markets offers options for mid sized to larger corporates to tackle upcoming debt maturities and avoid a complex negotiation with incumbent lenders.



Our Debt Advisory services

How we can help you

Securing committed facilities has never been more critical

Whether you face a covenant breach, need to restructure existing facilities, have facilities due for refinancing over the next 24 months, or are considering raising debt to finance an acquisition, we have an experienced team to help you achieve your financing objectives.

We are in regular contact with 50+ banks, debt funds, asset based lenders, credit agencies and bond arrangers and can assist you in:

- maintaining control of the agenda in a debt restructuring, through our detailed knowledge of the approach lenders are taking in this rapidly changing market;
- negotiating better terms and conditions;
- advising on the appropriate debt capacity and structure in the current market in addition to the likely pricing for your transaction;
- identifying and approaching lenders which are still active in your sector;
- evaluating your business plan and testing your financial models to help to ensure they are robust; and
- credit ratings advisory / improvement of credit ratings.

Managing the process from start to end, allowing you to focus on running your business



What we do

Our Debt Advisory team provides an extensive range of services which include:

Refinancing

- Ensure ongoing funding for the company
- Investigate alternative sources of funding
- Optimise finance costs

Acquisition finance

- Increase competitive position of client by securing funding
- Assist in negotiating pricing, documentation and setting covenants

Financial/debt restructuring

- Ensure ongoing funding of the company
- Restructure debt to avoid financial distress

Covenant negotiation

- Analysis of forecasts to support new covenant proposal
- Negotiate pricing, covenants and other terms with lenders

Staple financing

- Debt discovery exercise to confirm market appetite
- Underpins price expectations

Bond Market Advisory

- Assess ability to raise non-bank finance (bonds, private placement debt etc.)
- Advice through the bond raising process

Credit ratings advice

- Provide indicative credit rating analysis
- Negotiate with credit ratings agencies

ABL Finance

- Evaluate ABL capacity
- Arrange with lenders appropriate structure
- Manage surveying process



Selected recent transactions

<p>UK Sep 10</p> <p>Debt raising</p>  <p>Total Debt €65m</p>	<p>UK Aug 10</p> <p>Financial restructuring</p> <p>UK Hotels Group</p> <p>Total Debt £750m</p>	<p>Switzerland Aug 10</p> <p>Refinancing</p>  <p>Total Debt CHF180m</p>	<p>UK Jul 10</p> <p>Refinancing</p>  <p>Total Debt £55m</p>	<p>UK Dec 09</p> <p>Financial restructuring</p>  <p>Total Debt \$15bn</p>	<p>UK Oct 10</p> <p>Financing strategy and restructuring of swaps</p>  <p>Total Debt £1.7bn</p>
<p>Switzerland Jun 10</p> <p>Financial restructuring</p>  <p>Total Debt CHF2,500m</p>	<p>UK/US May 10</p> <p>Financial restructuring</p>  <p>Total Debt \$300m</p>	<p>UK Sept 10</p> <p>Acquisition finance</p>  <p>Total Debt £16m</p>	<p>UK Feb 10</p> <p>Debt raising</p>  <p>Total Debt £48m</p>	<p>UK Nov 10</p> <p>Acquisition Finance</p>  <p>Total Debt £295m</p>	<p>Europe July 09</p> <p>ABL acquisition finance</p>  <p>Total Debt €45m</p>
<p>UK Mar 10</p> <p>Refinancing</p>  <p>Total Debt £350m</p>	<p>UK Mar 10</p> <p>Refinancing</p> <p>UK property & media company</p> <p>Total Debt £125m</p>	<p>UK Mar 10</p> <p>Refinancing</p> <p>MATALAN</p> <p>Bank debt and 9.625% Senior notes</p> <p>Total Debt £525m</p>	<p>UK Jan 10</p> <p>8.375% Senior secured notes</p>  <p>Total Debt £250m & \$425m</p>	<p>UK Mar 09</p> <p>Refinancing</p>  <p>Total Debt £200m Public Bond</p>	<p>UK, Ireland Mar 10</p> <p>Amendment and extension of facilities</p>  <p>Total Debt €250m</p>

Contacts

For further information, except for US residents enquiring about corporate finance related services, please contact:

London			
Simon Boadle	Partner, Head of Debt Advisory	+44 20 7212 4118	simon.boadle@uk.pwc.com
Michael Berkowitch	Partner	+44 20 7213 1429	michael.berkowitch@uk.pwc.com
Jason Green	Partner	+44 20 7212 2535	jason.green@uk.pwc.com
Paul Ambrose	Director	+44 20 7804 0737	paul.ambrose@uk.pwc.com
Ruud Kole	Director	+44 20 7212 3650	ruud.kole@uk.pwc.com
Chris Tilbrook	Director	+44 20 7212 4773	chris.j.tilbrook@uk.pwc.com
Duncan Turner	Director	+44 20 7804 7823	duncan.turner@uk.pwc.com
Rohan Choudhary	Assistant Director	+44 20 7212 2343	rohan.choudhary@uk.pwc.com
George Fieldhouse	Assistant Director	+44 20 7212 1425	george.j.fieldhouse@uk.pwc.com
Georgy Naydenov	Assistant Director	+44 20 7804 9542	georgy.naydenov@uk.pwc.com
Sandeep Pradhan	Assistant Director	+44 20 7213 3231	sandeep.v.pradhan@uk.pwc.com
Carlo Rusche	Assistant Director	+44 20 7804 5610	carlo.rusche@uk.pwc.com
North			
Colin Gillespie	Partner	+44 161 245 2404	colin.gillespie@uk.pwc.com
Andy Parker	Partner	+44 161 245 2388	andy.parker@uk.pwc.com
Stuart Warriner	Partner	+44 113 289 4514	stuart.warriner@uk.pwc.com
Midlands			
Matt Waddell	Partner	+44 121 232 2224	matt.waddell@uk.pwc.com
Russell Worrall	Partner	+44 121 265 5709	russell.p.worrall@uk.pwc.com
Andy Skinner	Director	+44 121 265 5591	andrew.m.skinner@uk.pwc.com
Scotland			
David Leslie	Partner	+44 141 355 4122	david.leslie@uk.pwc.com
Sara Miller	Director	+44 141 355 4123	sara.miller@uk.pwc.com
Steven O'Connor	Manager	+44 141 355 4127	steven.oconnor@uk.pwc.com
South			
Jon Harrison	Partner	+44 1293 56 6770	jonathan.g.harrison@uk.pwc.com
Andy Morgan	Partner	+44 118 938 3191	morgan.andy@uk.pwc.com
Gary Partridge	Director	+44 29 2080 2277	gary.partridge@uk.pwc.com
Capital Markets			
Clare McDowall	Partner	+44 20 7213 3964	clare.mcdowall@uk.pwc.com
Giles Hawthorne	Director	+44 20 7804 9881	giles.hawthorne@uk.pwc.com
Sarah Millar	Manager	+44 20 7213 3545	sarah.l.millar@uk.pwc.com

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