Debt Capital Markets update

Unfunded tax cuts, energy price guarantees and the revolving door at No.10

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Lenders balance uncertainty with finding good opportunities

While already an age ago in political terms, the then UK government's now infamous "fiscal event" on 23rd September, which announced unfunded tax cuts of £45bn and long-term energy price guarantees in the absence of an OBR report, further unsettled already volatile financial markets, exacerbating existing concerns around high inflation, the cost of living crisis, recession, ongoing post-Brexit trading complications and the Ukraine war.

Despite somewhat calmer markets since, almost all of the tax cuts have been reversed. Much of the impact is now baked in and nervousness continues to affect the leveraged lending market. Only time will tell the impact of Rishi Sunak becoming prime minister.

As things stand, underwriters of larger syndicated loans have struggled to sell these down with some solving this via large discounts. Debt funds have been looking to increase margins and reduce leverage in anticipation of increased risks, the current consensus being spread increases of 25bps to 100bps. Bank lenders have evidenced concerns by requesting larger amortising strips versus bullets. The majority of deals will now likely suffer worsening terms in general, for example, increased controls to limit cash leakage and more onerous covenant packages.

Expectations of base rate rises have been reflected in the forward curve for SONIA rates. SONIA is currently 2.19%, whereas the three-year SONIA swap rate is 4.49% (rates from 25th October), up from about 1% a year ago. The markets expect SONIA to be over 5% from June next year.

Impact of recent events

A lot has changed in the last few months. Below are the key movements we have seen in the wider economy and a summary of their impact on the leveraged market.

High inflation and rising Bank of England base rate

The Bank of England is trying to control rising inflation by increasing base rates, which is then reflected in rising SONIA rates increasing total lending costs. The markets expect a further material increase by Q1 next year.

Impacts:

- As the total cost of borrowing rises, lenders are likely to focus increasingly on cash generation and debt service headroom for new lends
- The chance of being able to close a deal with a sole leverage covenant is decreasing. Cash cover tests will be more aggressively negotiated
- SONIA volatility has led to increased interest in hedging. Some lenders are now talking about requiring borrowers to hedge a portion of their debt (through swaps, caps and collars)

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ANDREW SHELLARD,
PARTNER, UK

GUY TAYLOR,
DIRECTOR, UK

- LBO returns will come under pressure from increasing debt costs and company valuations are also likely to come under further pressure
- We are seeing valuations being impacted already as return models are rerun with updated total debt costs.

Stressed economic environment

A recession is likely to begin (UK GDP fell by 0.3% in the three months to August) and is anticipated to worsen through 2023 alongside the ongoing cost of living crisis.

Impacts:

- Discretionary spending under pressure
- Possible declining company sales in certain sectors and increasing overheads for all, negatively impacting profits and cashflow
- Lenders increasingly concerned about future defaults and the level of loss given default
- Level of analysis of credit strength and the ability to suffer stress increasing on all deals
- Credit committee discussions for lenders likely to become increasingly difficult
- Leverage levels reducing and pricing increasing as lenders seek to maintain real returns
- All deals will be reviewed and stress tested for rising costs and any potential impact of reduced consumer or B2B spending
- Lenders more focused on transactions in what are generally considered to be the more resilient sectors such as healthcare, technology and B2B models
- The performance of existing lends will be more actively monitored, reviewed and managed.

No pressure to deploy capital

Many banks and funds deployed higher levels of capital than they expected in 2021 and H1 of 2022. Many are now ahead of their forecast deployment levels.

Impacts:

- Many lenders are now able to take a pause with no pressure to deploy – many are likely to do so
- Increasing flight to the best quality deals. Lenders will continue to compete for the best opportunities
- Credit processes likely to be more intensive and investment committee discussions more challenging.

Lenders continue to lend

Although challenges have increased in the current leveraged market, we continue to see new deal flow, lenders continue to be interested in participating in processes and we continue to complete transactions. The key is finding the right pockets of availability and interest.

All the above highlights the need to engage with an experienced debt advisor if you are looking to raise debt in this environment. Should you wish to explore any aspects contained in this article or any other debt matters, we would be keen to discuss how we can support you.

Selected recent UK debt capital markets experience

2022	Bowmark Capital	BUY-SIDE ADVISORY	littlefish
2022	LDC	BUY-SIDE ADVISORY	cellhire
2022	Sovereign Capital Partners	BUY-SIDE ADVISORY	Actica consulting
2022	Inflexion Private Equity	BUY-SIDE ADVISORY	Blue Light Card
2022	Mr.Fothergill's	BUY-SIDE ADVISORY	Harwood Capital Management
2021	Pollen Street	REFINANCING	Markerstudy Insurance Services Limited
2021	charterhouse	REFINANCING	SLR
2021	Livingbridge	BUY-SIDE ADVISORY	semafone

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