EUROPEAN ACQUISITION FINANCE DEBT REPORT 2011

DLA PIPER

EVERYTHING MATTERS

FOREWORD

Following the horrendous conditions that existed in the acquisition finance market in 2009, our 2010 Survey Report produced last January gave us some hope that, although challenging, those surveyed expected deal activity in 2010 to at least increase on that in 2009. This year's Survey Report has clearly shown that activity in the acquisition debt market in 2010 did indeed exceed expectations for a significant proportion of our respondents. The results of our Survey also indicate that the late 2009 and 2010 upturn in the acquisition finance loan market has the potential to translate into a sustainable recovery although the cautious view is that there will be no return to 2007 levels. Whilst market perceptions may have previously suggested a lack of underwriting of new deal debt and related constraints on market debt terms, our Survey findings instead show that confidence is returning to the market, albeit in a realistic and controlled manner.

The Survey Report also gives us some interesting thoughts as to what 2011 might hold – an improvement on activity in 2010 in the upper/mid market is forecast, but there will, no doubt, continue to be acute focus on credit risk in delivering debt packages for the right transactions.

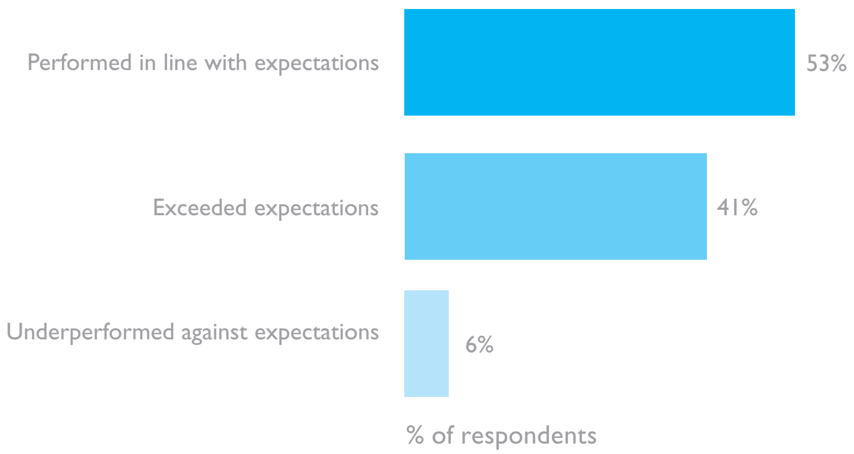
Philip Butler
Head of Leveraged Finance
DLA Piper UK LLP
T +44 (0)20 7796 6297
philip.butler@dlapiper.com

CONTENTS

REVIEW OF MARKET ACTIVITY IN 2010

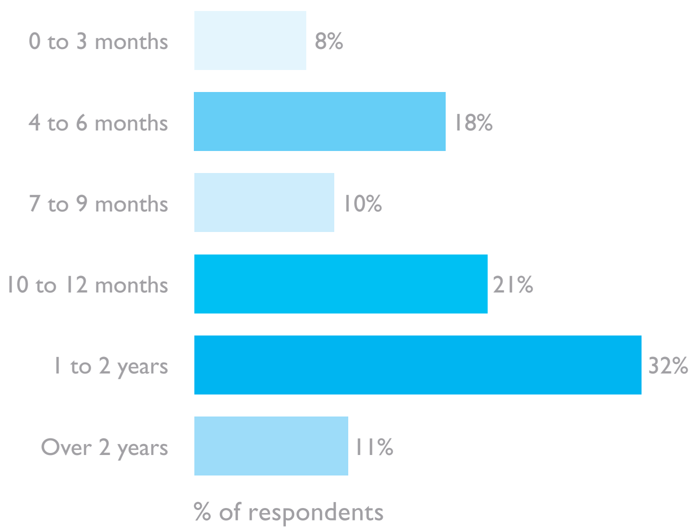
A significant proportion (41%) of our respondents found that market activity in the acquisition debt market in 2010 exceeded their expectations and a number of large and mid market transactions (such as Xaffinity, Pets at Home and Ambea) set the pace hitting the headlines in early 2010. While just over half (53%) of those that took part indicated that activity performed broadly in line with their expectations, only a very small minority (6%) found that market activity underperformed against their expectations. Since acquisition finance and the M&A sector were two of the biggest casualties of the economic crisis, this is a clear indication that the late 2009 upturn of the market has started to translate into a sustainable and sensible recovery.

Figure 1. Market activity levels in 2010



This year's responses send a clear message that margins are expected to remain at current levels for at least the remainder of 2011, with over 40% forecasting a period of at least one year or longer. Less support was evident for margins remaining at current levels for a shorter period, with approximately 25% predicting margins remaining at existing levels for less than six months.

Figure 2. Period margins expected to remain at current levels

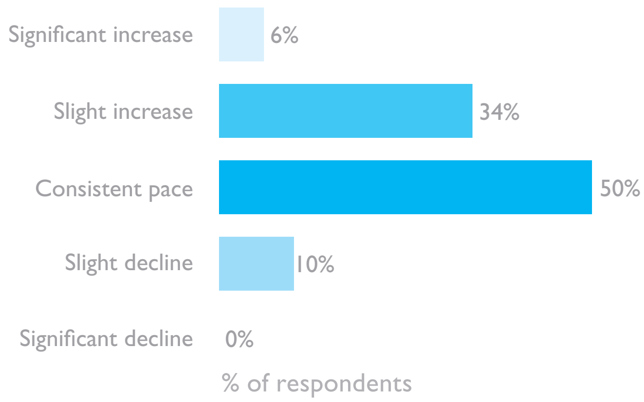


Paul Scott
Chief Investment Officer and
Head of Sponsor Coverage, EMEA
GE Capital

"While I think we will see a continuation of current margin levels in the short term for smaller transactions, there may be some softening of spreads over the next 12 months where transactions can tap institutional liquidity as a number of vehicles are chasing quality assets to lock in longer-term returns before their re-investment period ends. You then overlay this with the must-do deals for Banks in certain jurisdictions given the relatively low deal volumes and it shouldn't be a surprise. That said, the dynamics of lower levels of institutional liquidity as re-investment periods end and with few new vehicles coming to the market, together with the refinancing wall that is well documented and topped off with the challenges of Basel III, we may well see in the longer term margins increase above today's levels due to the scarcity of capital."

When asked about the expected speed of recovery in the market during 2011 in comparison to 2010, an overwhelming majority (84%) anticipated either a slight increase or a consistent pace of recovery. Encouragingly, no respondents believed that there would be a significant decline in the pace of recovery. More than half of respondents (53%), meanwhile, believed that both primary and secondary market activity levels in 2011 would increase on 2010 levels. These findings reveal a renewed confidence in the market.

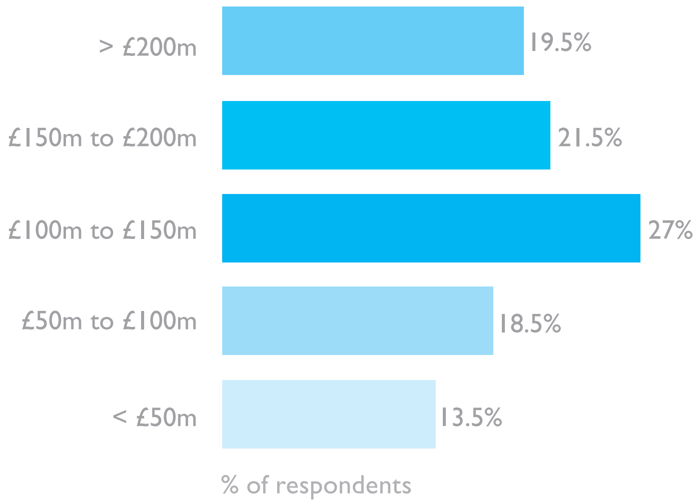
Figure 3. Expectations of market recovery in 2011



In our previous 2010 Survey, respondents predicted that there was likely to be more activity in transactions with values under £150 million (75.3%). One year later, the Survey results instead reveal that 63.6% of respondents found that to be true in 2010, while the number of transactions expected to be completed over £150 million (46.5%) in 2011 is almost double the forecast made 12 months ago, indicating a stronger recovery in the market than was previously expected.

Based on our understanding of Banks' recent conservative approach to holding debt on their books, these findings indicate that there is still strong support for club transactions of 3–6 banks although as underwriting capacity grows, the numbers of banks within such clubs may reduce.

Figure 4. Expectations for most active deal values in 2011



Our previous Survey accurately predicted that the traditional markets of the UK and, to a lesser extent, Germany, France and Scandinavia would be preferred by investors still recovering from the virtual closure of the market in 2008–2009 after the collapse of institutions such as Lehman Brothers. Also, as predicted, Benelux, and southern and eastern European emerging markets appear to have suffered most from investors' lingering nervousness of the challenging enforcement issues that these countries can throw up and were predominantly ranked as the least active. Close to 60% of respondents indicated that the UK had been the most active jurisdiction in 2010 and only a marginally lower number (54%) predicted that this trend would continue into 2011.

Figure 5. Most active jurisdictions by volume in 2010 (ranked 1st by respondents)

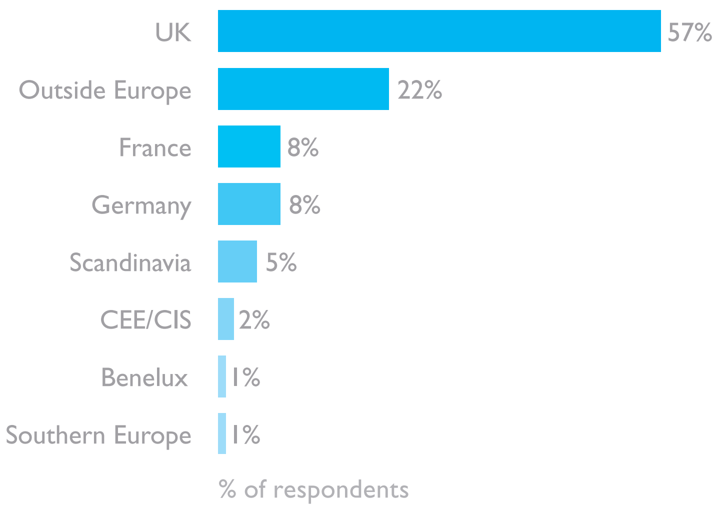
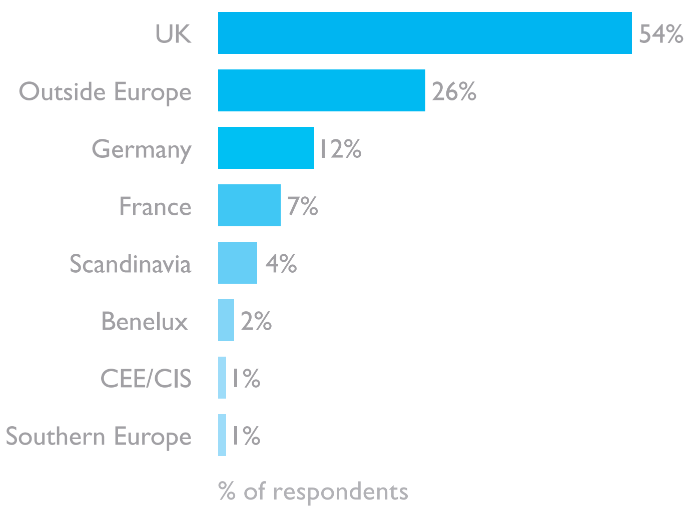
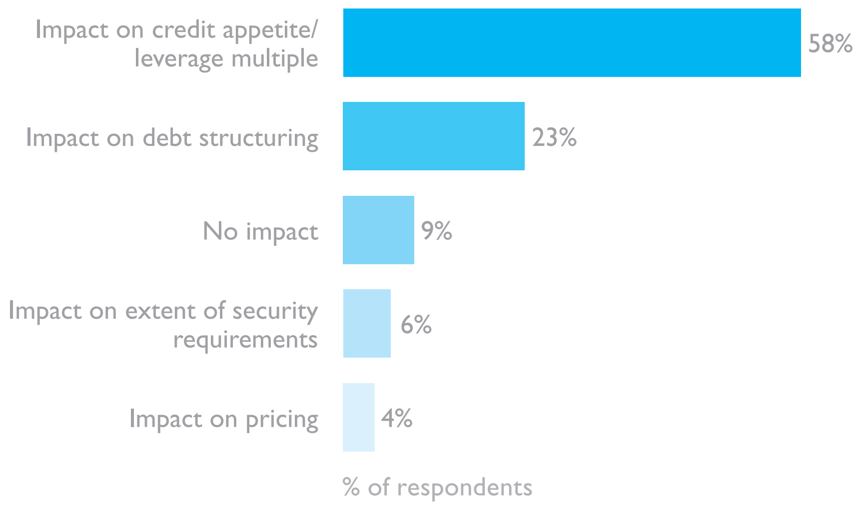


Figure 6. Jurisdictions predicted to be most active by volume in 2011 (ranked 1st by respondents)



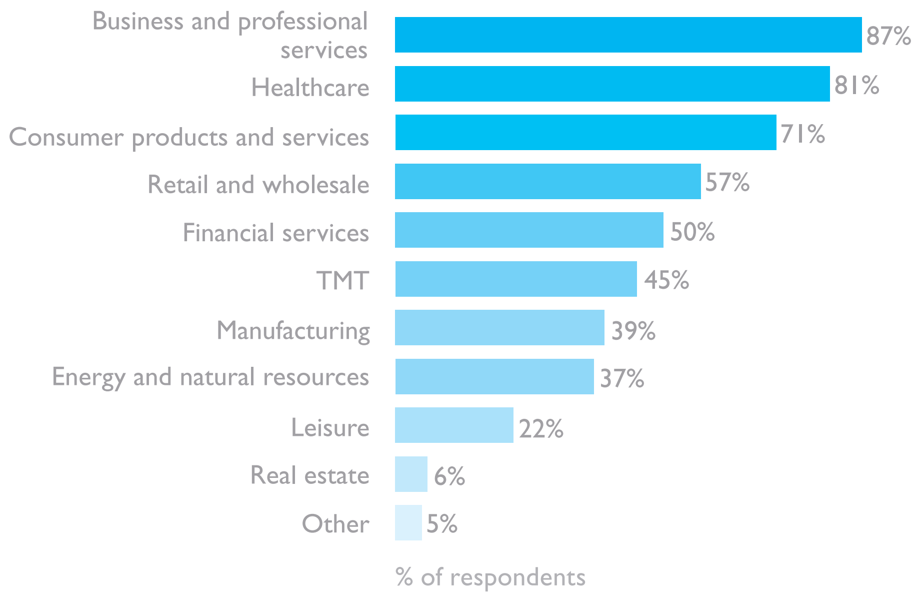
Differences in the insolvency regimes and guarantee/security packages available in different jurisdictions are expected to continue to have a decisive impact on credit appetite, leverage multiples and debt structuring in 2011, according to responses (over 80%). Meanwhile, less than 10% of respondents thought that this issue would have no impact on the assessment of cross border transactions.

Figure 7. Expected effects of the lack of a uniform insolvency regime in Europe and the weakness of guarantee and security packages in certain jurisdictions on cross border transactions in 2011



With caution remaining the watchword when making acquisitions, securing support for a deal will continue to hinge upon sector considerations. Our previous Survey accurately pointed to hesitation on the part of investors to return to support real estate and leisure, but retail and manufacturing showed far better than expected results. There is a clear expectation that sectors such as business and professional services, healthcare and consumer products and services will continue to be preferred in 2011.

Figure 8. Predicted active sectors in 2011



Neale Broadhead
Managing Director
Acquisition Finance, London
Lloyds Banking Group

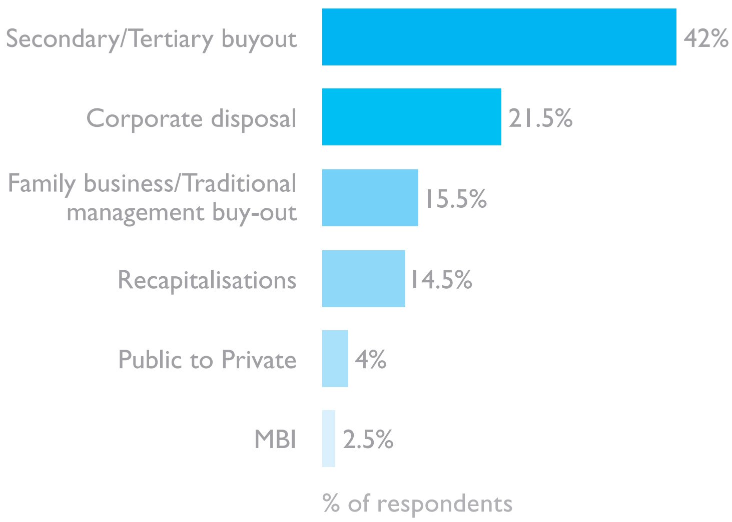
"The market has seen a large number of retail deals in 2010 and Lloyds has been a big supporter (e.g. DFS, Republic, Snow and Rock, Cath Kidston and Nandos). However, we still remain cautious about the sector – which has been the graveyard of many a Leveraged Financier over the years. The key to retail is to support our core Sponsor relationships on only the best credits that require only modest leverage."

DEAL SOURCES IN 2011

Almost all of the industry's most highly publicised and best-known deals this year were Secondary or Tertiary buyouts. We expect this phenomenon to continue to dominate deal activity in 2011 (accounting for 69% of respondents' predictions for likely deal sources in 2011).

We have historically seen an increase in the volume of secondary, and tertiary, transactions when the economy has been more buoyant. Progress made in 2010 may well explain the nearly two-fold increase in preference towards secondary/tertiary deals for 2011, which only 12 months ago held second place behind corporate disposal, the then better-favoured source, which is now ranked second (21.5%) ahead of Family business/Traditional management buy-out (15.5%) and recapitalisations (14.5%). However, rather than signalling a sustained resurgence in the European market, this may reflect a more gradual recovery over the next few years as confidence returns to the market.

Figure 9. Deal types expected to be most prevalent by volume in 2011

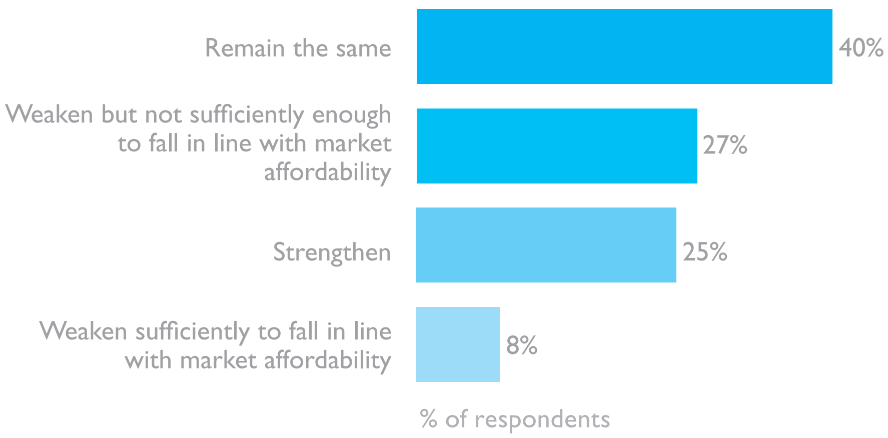


VENDOR PRICING

Whilst over 65% of respondents thought that pricing expectations would remain the same or weaken only slightly, a sizeable minority also thought that pricing expectations would strengthen (25%). The number of respondents who thought it might weaken significantly has fallen by more than half since this Survey was last made one year ago.

As noted later in our Survey results, senior debt leverage remains at or around 4x, at least for the next 12 months. If vendor pricing expectations strengthen, this does beg the question "Who will fill the funding gap?". We expect to see an increase in deals that include junior debt and/or increased equity investment.

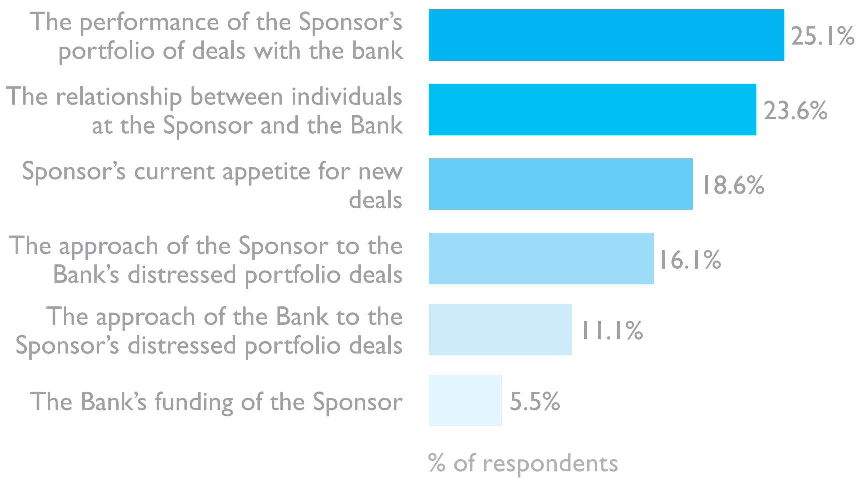
Figure 10. How will vendor pricing expectations in 2011 compare to 2010?



BANK/SPONSOR RELATIONSHIPS

This year's Survey reveals a marked reduction in the influence of a sponsor's attitude approach to distressed transactions within a bank's portfolio (from 19% in 2010 to 11.1% in 2011) which may partly be the result of less restructuring activity having taken place in 2010. Other findings concerning investors' own experiences were more consistent, including a clear message coming from the lender community that the performance of a sponsor's existing portfolio, and the relationship between individuals at the sponsor and the bank, will deeply affect the assessment of any new deal activity with that sponsor. The sponsor's current appetite for new deals was also seen as a key influencer.

Figure 11. Factors that will have most influence on the relationship between a sponsor and a bank in 2011



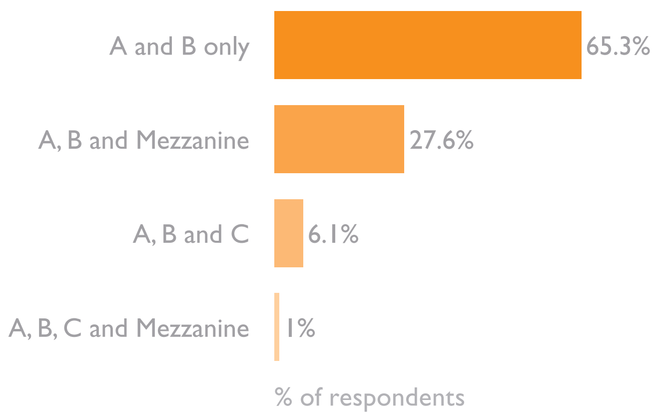
WHAT WILL DEALS LOOK LIKE IN 2011?

Our Survey explored a number of questions about the likely structures and cost of capital of deals in 2011.

DEBT STRUCTURES

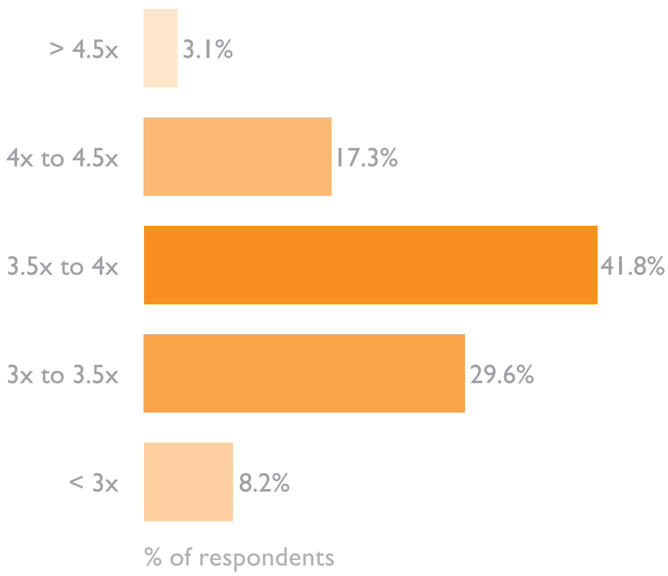
The most typical debt structures are expected to continue to be the amortising A loan and bullet B loan. Support for the idea that mezzanine strips will feature this year has fallen by almost half since one year ago.

Figure 12. Predicted typical debt structures in 2011



Respondents sent a clear message that they expect senior debt leverage levels to predominantly stay between 3x and 4x. What is noticeable, however, is the significant rise from last year in the number of respondents predicting senior debt leverage above 4x (from 0% in 2010 to 20.4% for 2011) and a corresponding fall regarding senior debt leverage below 3x (from 23.6% in 2010 to 8.2% for 2011).

Figure 13. Expectation for average senior debt on transactions in 2011



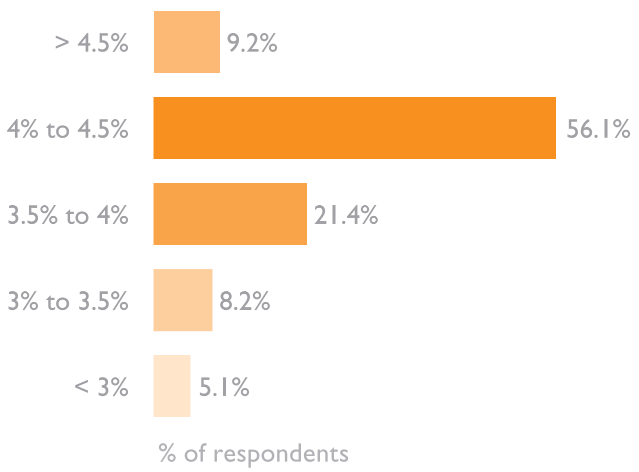
Ian Crompton
Deputy Head of Leveraged Finance, London
HSBC Bank plc

"At the start of 2010, only a small number of exceptional credits achieved senior debt leverage multiples above 4x. By the end of 2010, this leverage was being achieved on a growing number of larger mid-market transactions, as well as exceptionally on a number of smaller transactions."

PRICING

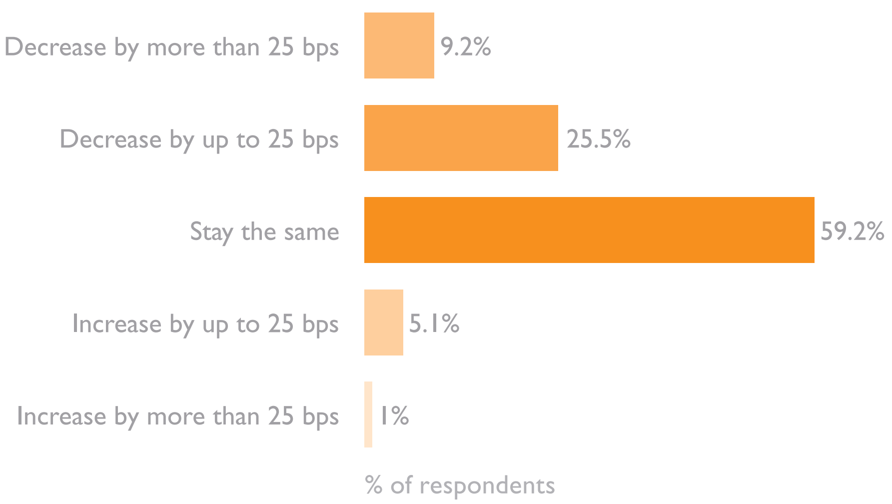
The cost of debt funding, according to the Survey, looks set to remain very much the same as in 2010. Over three-quarters of respondents (77.5%) believe that arrangement fees will remain in the range of 3.5% to 4.5% of total commitments in 2011. This not only supports the previously mentioned trend of continued caution and a sense of realism in the debt funding market, but may also suggest that growth strategies in the market will need to be adapted to accommodate what could be a sustained period of low growth in Europe.

Figure 14. Expectations for typical arrangement fees in 2011



Senior A margin: In comparison to the 2010 Survey findings, the number of respondents who believe that senior A margins will remain at current levels has increased (from 51.7% in 2010 to 59.2% in 2011). The sense that more deal activity may push margins down has stayed roughly in line with 2010 figures with 34.7% in our latest Survey feeling that the senior A margins may decrease by up to 50 bps in 2011 in comparison with 37.1% 12 months earlier.

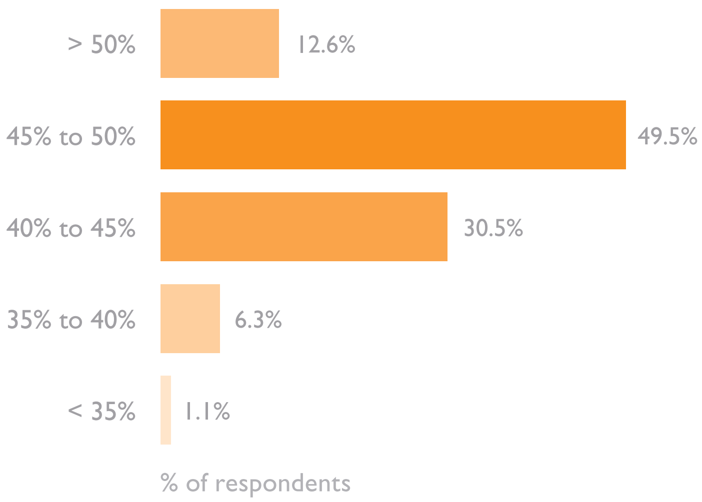
Figure 15. Expected changes to Senior A margins in 2011 compared to 2010



CAPITAL STRUCTURE REQUIREMENTS

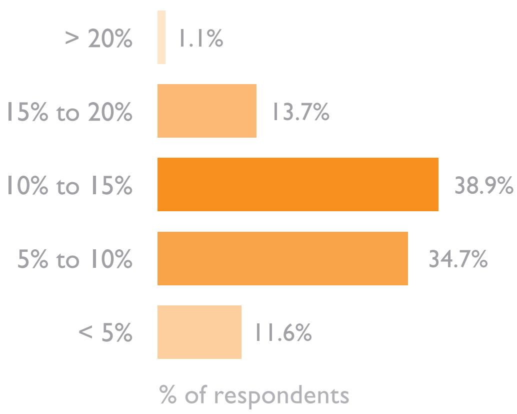
It is interesting to see from the Survey that a small but noticeable shift in the capital structure of deals is predicted to take place reducing from 50% in 2010 being the minimum for equity contributions to 40 – 45% in 2011. In our latest Survey, over 30% of respondents suggested equity will make up 40% – 45% of the capital structure of new deals in 2011 compared with just over 10% one year ago. The proportion of respondents expecting the figure to be 45% or higher has fallen from 88% in 2010 to just over 60% for 2011.

Figure 16. Expected equity percentage of capital structure in 2011



Similar to figures recorded in 2010, over 70% of respondents agree that the mezzanine element of deals will range from 5% to 15% of the capital structure. In fact, respondents from the mezzanine community indicated a clear desire to be positioned at the upper end of this range, to ensure greater visibility and negotiation strength with other stakeholders.

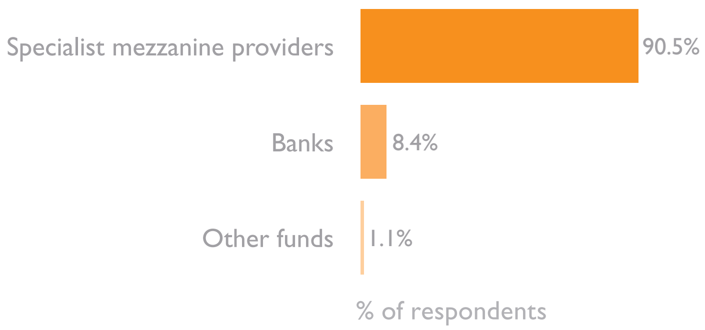
Figure 17. Expected percentage of mezzanine debt of capital structure in 2011



MEZZANINE FINANCE

The Survey also sends a clear message that specialist mezzanine providers are expected to further cement their position as the dominant provider of mezzanine finance, with over 90% agreeing with this view for 2011 compared to 85% in 2010. Banks and other funders are expected to continue to show little appetite for arranging mezzanine finance.

Figure 18. Anticipated active arrangers of mezzanine debt in 2011



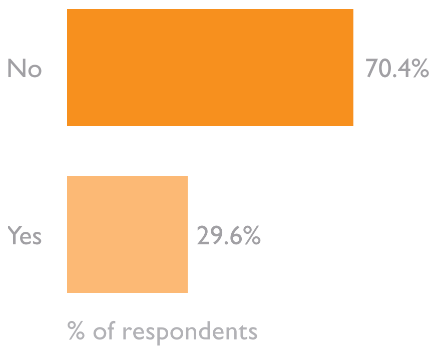
Gordon Watters
Senior Partner
Ares Capital Europe

"With a perceived lower recovery rate and an underlying difficulty in holding junior debt on their books, banks will continue to avoid investing in mezzanine and other subordinated debt instruments. However, we are seeing new entrants to the junior debt market and it is likely that the range of institutions with direct access to funds (for example pension funds) willing to arrange and underwrite junior debt will grow as the market returns."

LIQUIDITY

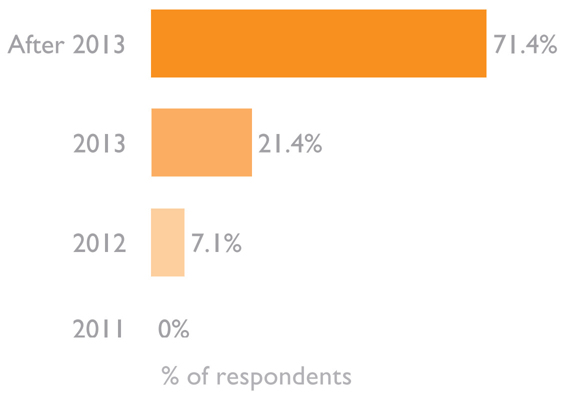
Liquidity levels are unlikely to return to pre-September 2007 levels in the near future, according to our Survey – and it is particularly striking that over 70% of respondents felt they would never return to this level. It is also worth noting that the number of participants that share this sentiment has increased by almost 10% since our 2010 Survey.

Figure 19. Will the syndication market for senior debt ever return to 2007 liquidity levels?



Of those that think liquidity will return to 2007 levels, over 70% (a marked rise from 60.6% recorded in our 2010 Survey) think this will not occur before 2014. A contributing factor towards this market view is likely to be the continued uncertainty regarding the economic outlook and the search for evidence of a sustained, rather than stuttering, recovery.

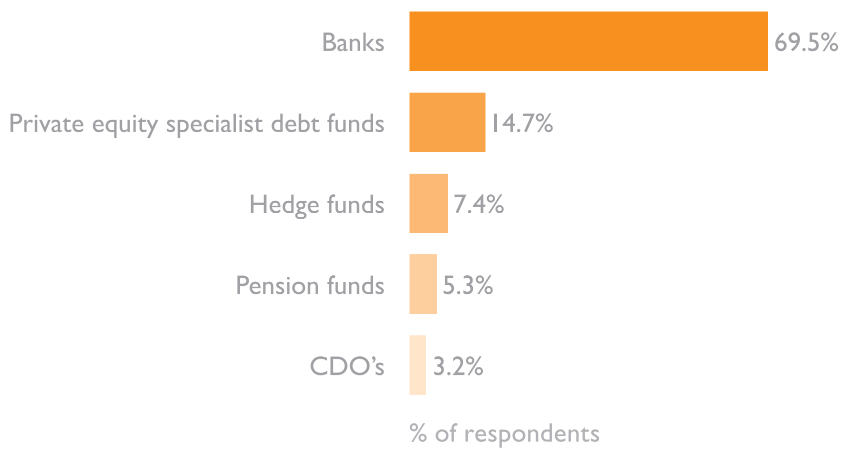
Figure 20. When will the syndication market for senior debt ever return to liquidity levels seen in 2007?



The continuing domination by banks of the senior debt market is made overwhelmingly evident by our Survey, with PE debt funds and hedge funds sharing the modest leftovers.

The number of respondents who perceive CDOs as active participants has doubled since our 2010 Survey. Although this means, in real terms, a revised total of just 3.2% of respondents, this modest rise may translate into an increase in CDOs influence within the market over the coming years.

Figure 21. Anticipated active participants in relation to the syndication of senior Debt in new deals in 2011



METHODOLOGY

Our research was carried out through an online Survey of the European Acquisition Finance market. Responses were received from over 35 financial institutions active in the lending community. Financial institutions providing responses to our Survey include Ares Capital Europe, Babson Capital, Barclays Bank, Beechbrook Capital, BNP Paribas, Clydesdale Bank, GE Capital, HSBC Bank, Indigo Capital, Investec Bank, Lloyds Banking Group, Nomura International, NIBC Bank, N.V., Rabobank International, Santander, Skandinaviska Enskilda Banken AB, and The Royal Bank of Scotland.

All figures used in this report are based on the responses received. Where respondents were asked to rank their answers, average rankings have been calculated to provide an accurate representation.

If you have finished with this document, please pass it on to other interested parties or recycle it, thank you.

www.dlapiper.com