INTRODUCTION

Contributed by: *Alexandra Grant and Sarbajeet Nag,* ***Milbank LLP***

The Return of Banking and Finance

Buoyed by the emergence of government vaccination schemes and the opening up of many of the world's largest economies, 2021 started with the tailwinds behind it. The last quarter of 2020 had proven the ability of the markets to bounce back quickly from catastrophic global events and in 2021 that trend continued, the new year bringing with it a bull market of exceptional magnitude driven by a combination of unprecedented investor-side demand and a level of M&A activity not seen since the nineties.

As of the time of writing, primary leveraged loan volume for the year to date is the highest it has been since the global financial crisis. More impressive still, just six months into the year, the volume of sponsor-backed high-yield bond issuances had already surpassed any other year on record. And the direct lending market continued to thrive in the first half, reinforcing what prior years had already begun to indicate: that private debt is a now a key and permanent part of the financial eco-system.

Any notion that deal fatigue may set in over the summer was quickly dispelled come July, with a slew of high-profile LBOs (including a number of take privates) bringing some new names to the leveraged market over the past few months and signalling the start of what will almost certainly be another frenzied end to a record-breaking year. While the pandemic still rages in some parts of the globe, there will be scepticism on how long the bull market will last – but for now at least it shows no signs of slowing.

An outline of some of the common themes and trends seen so far this year is set out below.

Leveraged Loans, High-Yield Bonds and Direct Lending – an Overview

January 2021 picked up where 2020 left off: driven by excess liquidity, the desire to play "catch up" after a sharp (albeit short lived) slowdown at the beginning of the pandemic and the subsequent surge in M&A volume, documentary terms not only returned to pre-COVID levels but continued to widen further throughout the year.

As was seen towards the end of 2020, large cap top-tier sponsor M&A and LBOs continued to feature capital structures comprising both leveraged loans and high-yield bonds, with secured high-yield bonds pricing as tight (or tighter) than corresponding loans in several instances, bucking the trend for the last few years when sponsors and borrowers overwhelmingly favoured leveraged loans to high-yield bonds. At the same time, direct lending funds became increasingly relevant in the sponsor-backed space. The private debt market again showed over the course of 2021 to have more appetite and/or patience for COVID-19-affected credits (frequently financed, as seen in 2020, off the back of "normalised EBITDA"). In addition, as direct lending funds crept further into the large cap space, there was a convergence of terms with those offered by the syndicated market, with some funds showing an appetite for "cov-lite" deals and/or incurrence-based terms.

Increasingly, debt funds appeared not only on smaller mid-market financings but also on and around large cap underwritten deals in various capacities – from taking a pre-placed portion of senior or subordinated opco debt at one end of the spectrum (especially on "edgier" structures or less stable credits) to offering bespoke holdco pay-in-kind financings and/or preferred equity (as valuations increased, but senior debt leverage levels remained largely flat year on year) at the other end, debt funds showed themselves to be a genuine alternative – or, in some cases, complement – to more traditional TLB/bank-backed financings, offering, in many respects, a level of flexibility and creativity that would not be possible in the more traditional space.

Ultimately, what is clear is that the global, economic and sociological effects of the pandemic have had little effect on the pricing and/or terms of debt raised in the leveraged finance market (bank or bond) (certainly in the large cap/top-tier sponsor space) – pricing is back to pre-COVID-19 levels, and covenants remain extremely flexible. In addition, having picked up clues from the liquidity crisis in 2020, sponsors (and their counsel) have sought to implement some of the lessons learnt in the form of widening addbacks to consolidated net income or EBITDA for non-recurring, exceptional, one-off and extraordinary costs and losses and/or the ability to add back lost revenues relating to the pandemic or the ability to incur super senior government-backed financing.

Other Notable Trends

Environmental, social and corporate governance (ESG)

There have been murmurs of ESG-based financings for a couple of years now and they were seen sporadically in the market over the latter half of 2020, but until 2021 the inclusion of ESG-based provisions was still viewed as something of a novelty. That has changed quickly over the course of this year, with a significant number of 2021 large cap leveraged loans including, in particular, ESG-based margin ratchets – and with the biggest asset managers having signposted their desire to invest more heavily in ESG-compliant instruments and rating agencies now factoring ESG considerations into their determinations, it seems like ESG is here to stay.

There is, of course, a lot more to be done – as it stands, the eventual impact of ESG considerations on pricing remains low (typically 10-15bps) and the opacity surrounding the determination and measurement of KPIs (most commonly some combination of carbon footprint, water consumption and diversity /governance) has been criticised – but the progress that has been made over the course of this year has nonetheless been encouraging, and given the focus on and investment in the field, there is reason to be hopeful that ESG will have a real and lasting impact on the financial sector.

Risk-free rates

While the markets welcomed ESG with open arms, another change that has been slightly less welcome, at least from an integration perspective, is the introduction of risk-free rates (RFR) for sterling loans. It has been a long time coming – anticipated for almost a decade since the LIBOR scandal – and yet it was only after the PRA and FCA's "Dear CEO" letter earlier this year that the market really kicked into gear. Six months after the April 1st deadline, since which no new LIBOR-based sterling loan underwrites have been papered, a clearer path has finally started to emerge on RFR terms and an accepted market position is beginning to crystallise – though practice does continue to differ across markets. For example, while the TLB market is, at least at the large cap end, now largely willing to forgo the credit adjustment spread (which is intended to compensate lenders for the economic impact of RFR being inherently lower than three-month LIBOR), this remains a point of contention in direct lending transactions; and while Europe almost universally relies on compounded SONIA, the US market has become equally tied to simple SONIA.

Some of these differences are, of course, bound to remain, but given that, as the Bank of England website not-so-subtly puts it, (at the time

Contributed by: *Alexandra Grant and Sarbajeet Nag,* ***Milbank LLP***

of writing) the LIBOR transition will take place in 102 days, two hours and 30 minutes, the RFR dust will hopefully settle fairly quickly going into 2022. Well, until the LIBOR transition for US dollar loans in 2023.

Talking of sterling, one could not have missed the demand for UK assets, especially listed companies in 2021. Fuelled by somewhat depressed stock prices for UK listed companies (which have never quite recovered to pre-Brexit levels), significant “dry powder” in private equity, historically low interest rates and investor desire to exit some investments (at high premiums) amidst slightly uncertain equity markets, UK take privates soared in 2021.

Restructurings

But while supermarkets, tech, retail and healthcare businesses thrived in the post-pandemic world, others, such as hospitality, travel and tourism, were left reeling in the aftermath of the pandemic and associated lockdowns throughout 2020. So, while financial markets might have proven to be unexpectedly resilient, the real-world effects of the pandemic nonetheless claimed its casualties and 2020 saw a number of significant and newsworthy restructurings and rescue financings; to some extent, that has continued into 2021. That said, even in this typically pessimistic space, the news has perhaps not been as dire as many as might have expected, with the relative suppression of restructurings in the European market being largely attributed to government support measures.

With restructuring activity now back to pre-COVID-19 levels, it seems these measures have had the desired effect, though their lasting impact is yet to be seen and there is sense among restructuring and insolvency practitioners that there may well be an increase in activity in this field once the support measures expire.

Conclusion

The overarching theme of 2021 was that the debt markets not only bounced back, but surpassed their pre-pandemic state. Having gained momentum towards the end of last year (after stuttering through most of the year prior to that), the markets have continued to pick up speed throughout the year and haven’t looked back. Leveraged loans, high-yield bonds and direct lending all flourished and sponsors and borrowers enjoyed terms (pricing and otherwise) at pre-COVID-19 levels (and, in some cases, beyond) – but all of this while the pandemic looked on. The bull can run fast, but can it run far?

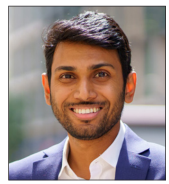
INTRODUCTION

Contributed by: Alexandra Grant and Sarbajeet Nag, ***Milbank LLP***

Milbank LLP has been in London for over 40 years, assisting clients with their most complex, high-profile and ground-breaking cross-border transactional and contentious matters. Now the second largest office in Milbank's global network, the London office has over 160 lawyers providing English and NY law advice on UK, pan-European, Asian, African and other global matters. The strength of its leading UK and US practices provides the firm with a unique ability to handle the most complex and demanding transatlantic mandates for its clients.

CONTRIBUTING EDITORS

Alexandra Grant is a partner in Milbank's European leveraged finance/capital markets group and also a member of the financial restructuring group. She has extensive experience of advising both lenders and sponsors/borrowers on a wide range of complex and cross-border leveraged acquisition, public-to-private, and infrastructure financings and restructurings, across the full spectrum of products (including bank/bond, second lien, private high-yield and holdco PIK).



Sarbajeet Nag is a partner in Milbank's European leveraged finance/capital markets group. Sarbajeet has advised and represented lenders, issuers and sponsors in a wide range of international and domestic transactions, including leveraged acquisition financings, infrastructure financings, financial restructurings and public-to-private buyouts. Sarbajeet has been recognised as a Next Generation Partner for acquisition finance and as “Up and Coming” for banking and finance. He was also awarded a European Rising Star for Banking and Finance.

Milbank LLP

100 Liverpool Street
London
EC2M 2AT
UK

Tel: 020 7615 3000
Email: ACGrant@milbank.com
Web: www.milbank.com

Milbank