

**DLA PIPER**  
**EUROPEAN ACQUISITION**  
**FINANCE DEBT REPORT 2012**



EVERYTHING MATTERS

# FOREWORD



The European acquisition finance market began 2011 with signs of real promise and opportunity regarding the prospects for deal activity. The optimism that had returned to the market towards the tail-end of 2010 appeared well founded. Instead, a turbulent second half year in 2011 characterised by the closure of the high-yield bond market, sovereign debt concerns in the Eurozone, economic uncertainty and stagnant growth contribute to the much more unsettled picture portrayed by our third annual Report.

Our 2012 Report provides a number of interesting insights and by comparing these against findings highlighted in our two previous reports a more sophisticated understanding of future trends is made possible. The results of this year's research reflect concerns that the global market may freeze again and tighten its grip on lending, which would have a dampening effect on deal activity worldwide with many companies choosing to sit on the sidelines with their cash.

The Report outlines a number of challenging conditions, in terms of liquidity, pricing and changes to capital structure requirements for new deals. The results also highlight the extent to which the risk averse nature of banks and the predicted rising cost of debt funding are steering the markets toward alternative funding sources, alternative funding structures and own-cash/equity reserves.

Profitability in many sectors remains tight and debt markets are expected to continue to struggle, with many companies pushed into abnormally conservative positions in the shadow of the Eurozone crisis.

However, the economic rationale to consolidate will only intensify in the coming years and this together with need for the refinancing wall to be addressed and private equity houses needing to exit investments and raise new funds will continue to drive opportunities for growth in 2012. Our Report suggests sectors such as business and professional services, healthcare, TMT and manufacturing will be preferred by well-capitalised corporates and cash-rich private equity houses confident in their long-term strategy and their desire to make prudent acquisitions in 2012.

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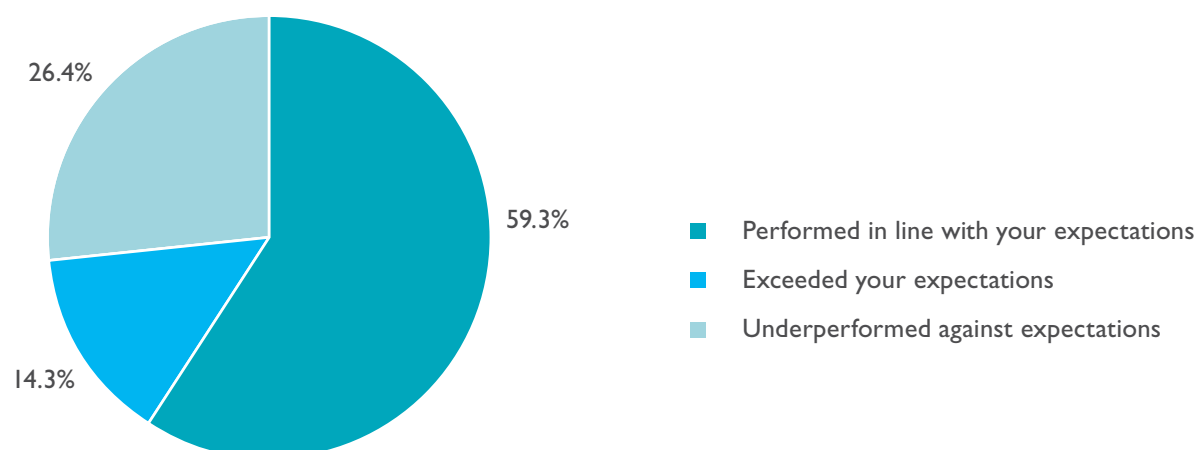
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# REVIEW OF MARKET ACTIVITY IN 2011

In our 2011 Report, just 6% of respondents found that market activity in the acquisition debt market in 2010 underperformed against expectations. One year later, this figure has more than quadrupled as tough market conditions in 2011 put a stop to a predicted recovery in acquisition finance activity. In corroboration with this trend, the number of respondents who stated the market activity exceeded their expectations also fell sharply (from 41% in 2010 to just 14% in 2011).

At the start of 2011, activity in the M&A arena seemed undeterred by the tsunami in Japan and began with an optimism that fuelled the expectation of an increase in deal activity. The high-yield bond market was open to a growing range of credits and banks had cautiously started to talk of taking underwriting risk. However, the Eurozone crisis and a prolonged economic stagnation outside of Europe has led to a marked slowdown in activity and a freeze on liquidity. Renewed pessimism across the banking sector about the prospects for acquisition finance is likely to add further pressure to a market already under strain.

**Figure 1. Market activity levels in 2011**

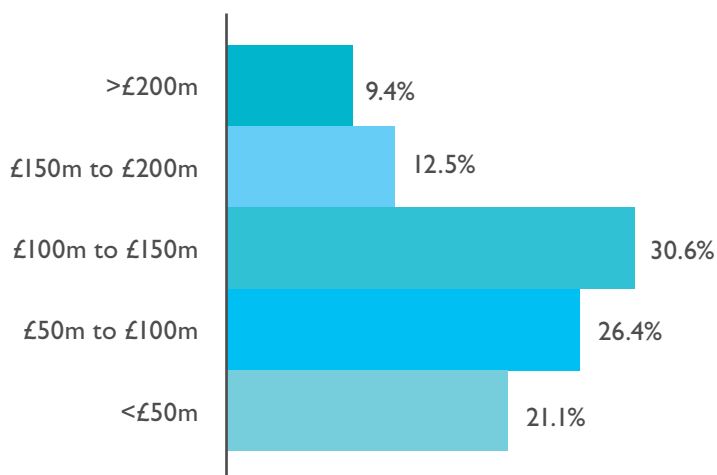


**Paul Scott**  
Chief Investment Officer  
Head of Sponsor Coverage EMEA  
GE Capital

"I think we may be witnessing a profound structural change in the acquisition finance market. As commercial banks retrench to core markets driven by deleveraging of balance sheets and compliance with new capital requirements, new non-bank players are stepping up to fill the liquidity gap. As a consequence, while still more credit focussed, we could see the European market become more akin to the US model with greater risk adjusted pricing and leverage levels. High yield is likely to become more commonplace, although during 2012 this will be sporadic and leveraged loan underwriters will need to be smart and dip in and out of the market when liquidity generated by high yield repayments becomes available. The outlook for the market in 2012 is perplexing; with a fair wind volumes could be comparable to 2011 albeit a quieter H1 this year and a busier H2 which is a reversal of what we saw in 2011. Liquidity is there to get mid-market deals done but for larger transactions we are seeing an increasing short term trend to tap the US market for businesses with dollar exposure due to the excess liquidity there. Equally important will be creativity around deal structures as the dangers of a price expectation disconnect between vendors and buyers emerges due to uncertainty around future profit performance of target companies. Vendor loan notes and earn-outs are likely to feature more heavily. Clearly, what I've just said is predicated on an orderly solution to Greece's sovereign position and no further contagion within the Eurozone which cannot be taken for granted."

In our previous Report, respondents predicted that in 2011 there was likely to be more activity in transactions with values under £150 million (59%). One year later, our Report reveals that a markedly higher number of businesses found that to be true, while the number of transactions over £150 million (22%) was significantly lower than the forecast made 12 months ago, reflecting the slower-than-anticipated recovery in the market.

**Figure 2. Expectations for most active deal values in 2012**



In agreement with predictions made in our previous Report, this year's respondents believe that the traditional markets of the UK and those outside of Europe continued to be preferred by investors in 2011 and that this trend would continue into 2012. To a far lesser extent, France, Germany, and Scandinavia were then ranked as having been the next most active in 2011.

**Figure 3. Most active jurisdictions by volume in 2011**

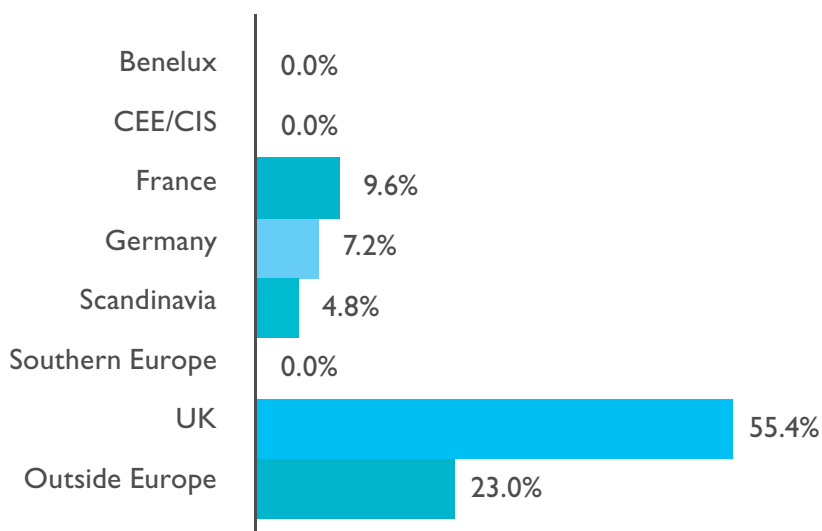
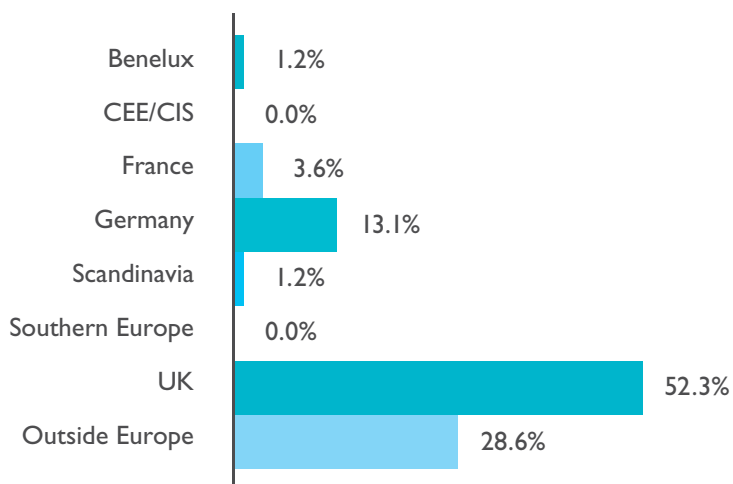


Figure 4. Jurisdictions predicted to be the most active by volume in 2012



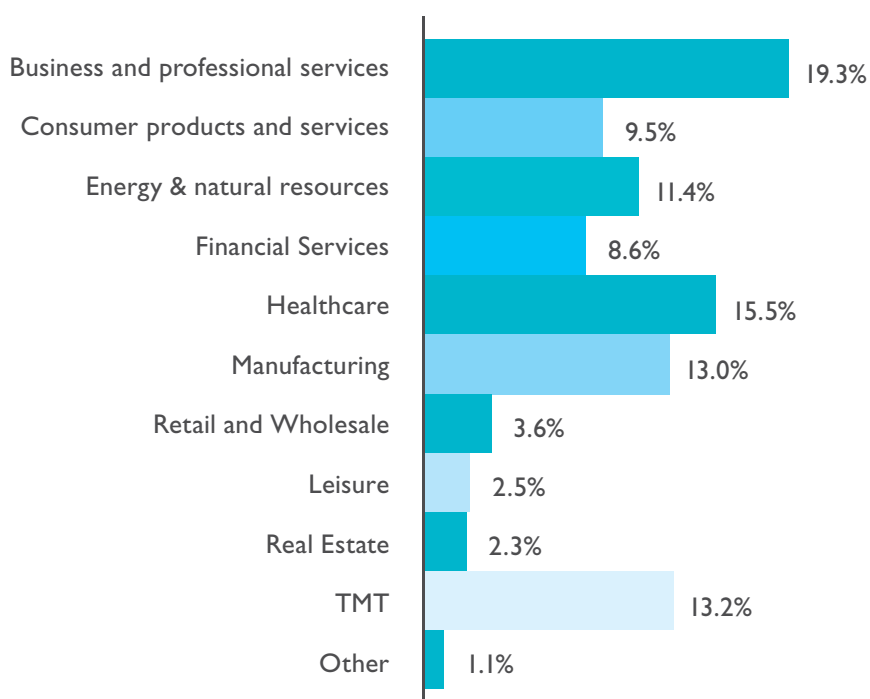
Whilst an uncertain economic outlook has resulted in a more cautious and conservative approach to investment decisions, an increasing number of companies are sitting on large cash reserves. M&A activity in 2012, as a result, is likely to be led by strategic trade buyers flush with cash, with sector considerations continuing to strongly influence support for deal activity.

**Paul Shea**  
**Founding Partner**  
**Beechbrook Capital**

“It is no surprise to us that the UK will continue to be the most active jurisdiction for debt providers in the European acquisition market given the weight of private equity finance dedicated to this country and the large numbers of active intermediaries. Having said that, we have found the Nordic region to have a vibrant lower mid-market and expect this to continue. Germany continues to offer rich potential, with its well-populated Mittelstand, but remains somewhat ambivalent in its openness to the private equity approach.”

Our 2011 Report accurately pointed to hesitation on the part of investors to return to support real estate, whilst actual activity in healthcare significantly underperformed and the number of deals in the financial services sector were almost half the level anticipated. Manufacturing, TMT and leisure, meanwhile, showed better than expected results. Looking ahead to 2012, there is an expectation that sectors such as business and professional services, healthcare, TMT and manufacturing will be preferred.

**Figure 5. Predicted active sectors in 2012**



**Neale Broadhead**  
**Managing Director, Acquisition Finance**  
**Lloyds Banking Group**

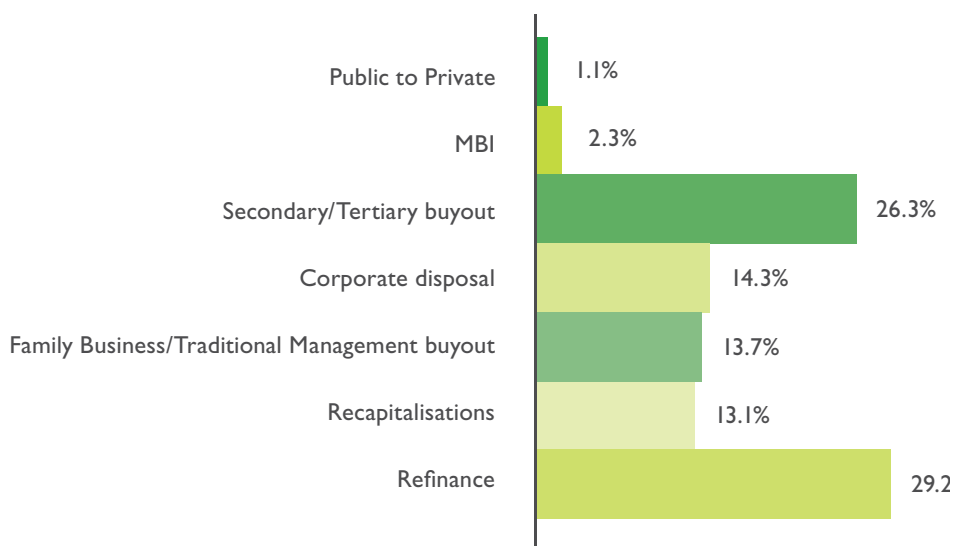
“Business and Professional Services continue to be as popular as ever – value in this sector has been driven by economic conditions that have forced businesses to outsource and rationalise operations. Healthcare (especially within the hardware / devices plus drugs space) should continue to produce stable cash-flows, despite the volatile economic environment. However, we have also seen some Sponsor appetite for less popular sectors such as retail or consumer facing businesses – but unless leverage is low, Sponsors will most likely look to non-Bank lenders to fund such acquisitions, as these newer participants in the market have flexibility on terms and a different attitude to risk and reward compared to the traditional lenders.”

# DEAL SOURCES IN 2012

There was a strong expectation that secondary and tertiary buyouts would continue to dominate deal activity last year, with 42% of respondents in our 2011 Report focused on this source. Although this phenomenon is expected to continue to play a major role in deal activity in 2012 (accounting for 26% of respondents' predictions for likely deal sources this year), the three-fold rise in expectations shown from 2010 to 2011 in favour of secondary/tertiary deals is unlikely to continue. Instead, refinancing has taken the lead position.

These predictions reflect a continued focus on refinancing debt strategies and private equity "churn" of quality assets that have the potential to continue to increase in value in this difficult economic environment. Corporate disposals, meanwhile, are expected to continue to hold their position in third place, narrowly ahead of family business/traditional management buy-outs and recapitalisations. Public to private transactions appear to be of little interest to respondents.

**Figure 6. Deal types expected to be most prevalent by volume in 2012**



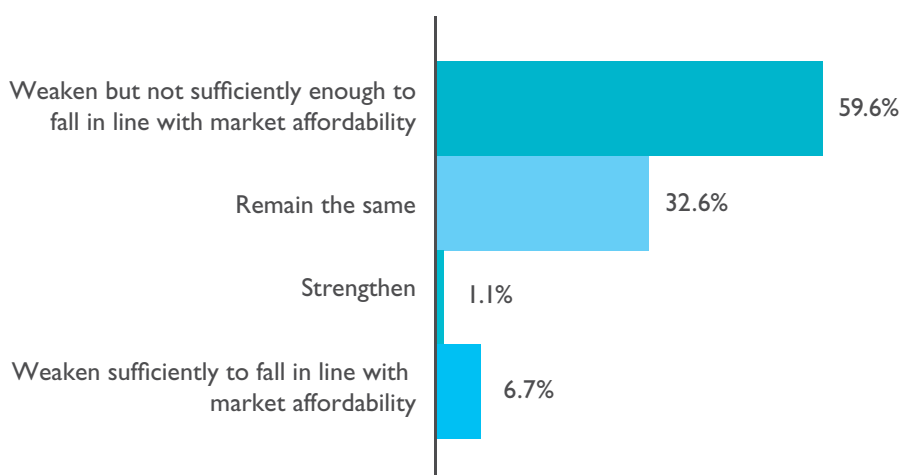
**Richard Roach**  
Managing Director, Financial Sponsors UK  
The Royal Bank of Scotland PLC

"We are not surprised that respondents predict that refinancings will sit at the forefront of deal activity in 2012. This has been the case for some time now and will likely continue as the "refinancing wall" looms. What is more interesting is the drop in secondary and tertiary activity – stresses on the market such as the Eurozone debt crisis have had a downward effect on valuations which has in turn made it increasingly challenging for Sponsors to achieve adequate returns. In such circumstances it is possible that some disposals by Sponsors will be postponed until markets and liquidity stabilise. That said, we would expect overall volumes to hold up relatively well in the circumstances as a range of sellers look to rebalance their private equity portfolios going forward."

# VENDOR PRICING

In contrast to our 2011 Report, when 25% of respondents thought that vendor pricing expectations would strengthen, barely 1% now expect this to be true for 2012. Another strong shift in sentiment is also evident in those who expect vendor pricing expectations to remain the same or weaken only slightly, with nine out of ten respondents now sharing this view for 2012 compared to just six out of ten for the previous year. This signals an unambiguous retreat to the more cautious and less optimistic position that reflects similar market sentiment recorded in our 2010 Report.

**Figure 7. How will vendor pricing expectations in 2012 compare to 2011?**



**Jonathan Guise**  
**Partner**  
**Marlborough Partners**

“It is clear that towards the end of 2011, a significant number of sale processes were pulled or postponed due largely to volatile credit markets and high vendor pricing expectations. We think that 2012 may bring vendors a better chance of achieving their price expectations as credit markets slowly recover, demand from Private Equity buyers is enhanced by a significant number of funds nearing the end of their investment periods, and many trade buyers looking to deploy cash surpluses. However in order to get to the prices demanded by some vendors, many buyers will need to dig deep into the debt markets and consider alternative sources of liquidity. Unless vendor pricing demands soften, a lot more assets will end up with trade buyers if lenders cannot get to the leverage levels required by private equity buyers.”

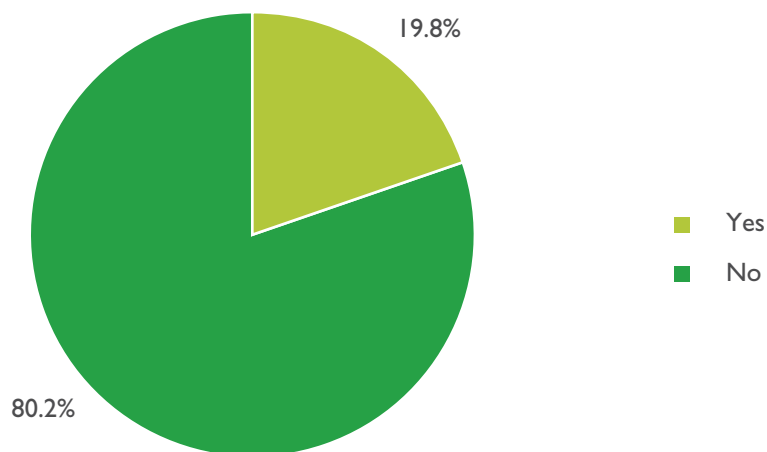
# WHAT DEALS WILL LOOK LIKE IN 2012?

Our research explored a number of questions about the likely structures and cost of capital of deals in 2012.

## LIQUIDITY

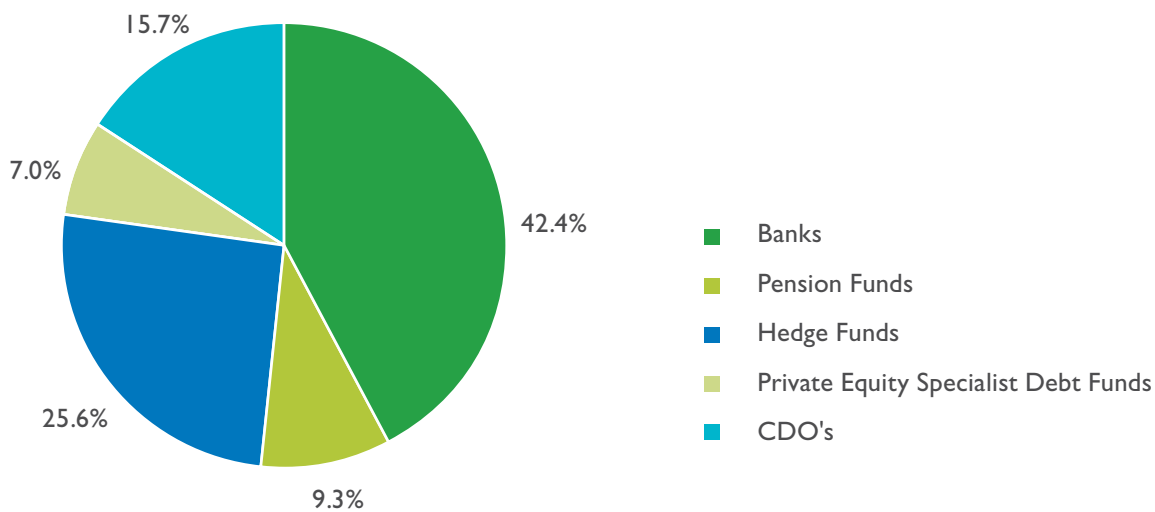
The view of respondents in our 2011 Report revealed liquidity levels were not expected to return to pre-September 2007 levels in the near future. Twelve months later, this view has strengthened with over 80% of respondents now feeling they would never return to this level. The number of participants that share this sentiment has increased by 10% since our 2011 Report.

**Figure 8. Will the syndication market for senior debt ever return to 2007 liquidity levels?**



Interestingly, the dominance of banks in the senior debt market is expected to be considerably diluted by an increase in activity of both CDOs (from 3% in 2011 to 15% in 2012) and hedge funds (from 7% in 2011 to 25% in 2012). The activity of PE debt funds, however, is expected to shrink by more than half in 2012.

**Figure 9. Anticipated active participants in relation to the syndication of senior debt in new deals in 2012**



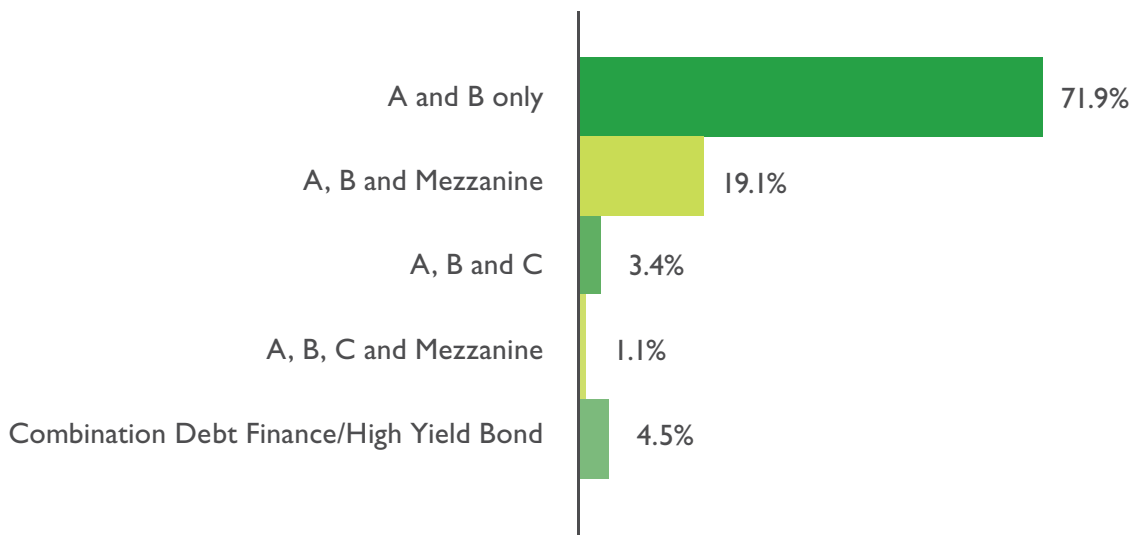
**Dan Roberts**  
Managing Director, Debt Finance  
Barclays Corporate

“Banks are finding loan profitability more challenging in the current economic climate for a variety of reasons, including the impact of the Eurozone debt crisis on their funding costs and longer term additional regulatory costs. We do expect a shift in composition of participants in debt markets towards non-bank providers of debt. However this diversification in the market will play to the advantage of financial institutions that have strong distribution and coverage platforms – and as such we welcome it.”

## DEBT STRUCTURES

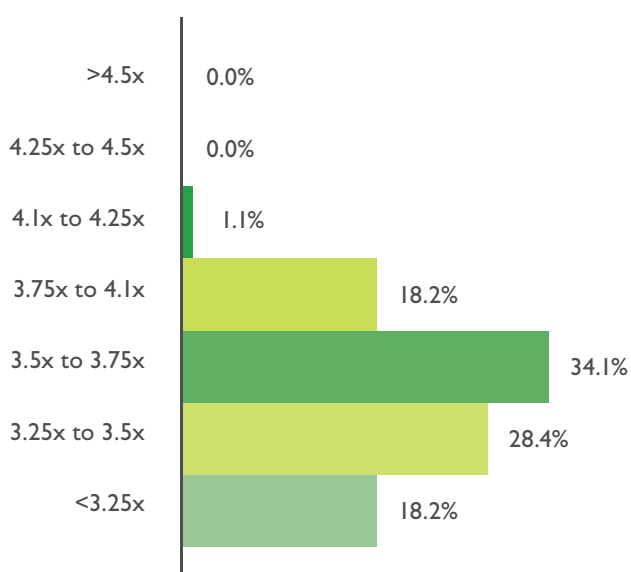
The most typical debt deal structures in 2012 are expected to continue to be the amortising A loan and bullet B loan. Support for the idea that mezzanine tranches of debt will feature this year continues to waver, reflecting an ongoing trend previously highlighted in both our 2010 and 2011 Reports. Fewer than one in five respondents now predict mezzanine forming part of the capital structure.

**Figure 10. Predicted typical debt structures in 2012**



Respondents sent a clear message that they expect senior debt leverage levels to stay below 4x. The significant rise we saw last year in the number of respondents anticipating senior debt leverage above 4x (from 0% in 2010 to 20% for 2011) has been virtually wiped out with hardly any respondents now making this prediction. Perhaps not surprisingly, a corresponding increase in respondents expecting senior debt leverage below 3x was also noted.

**Figure 11. Expectation for average senior debt on transactions in 2012**



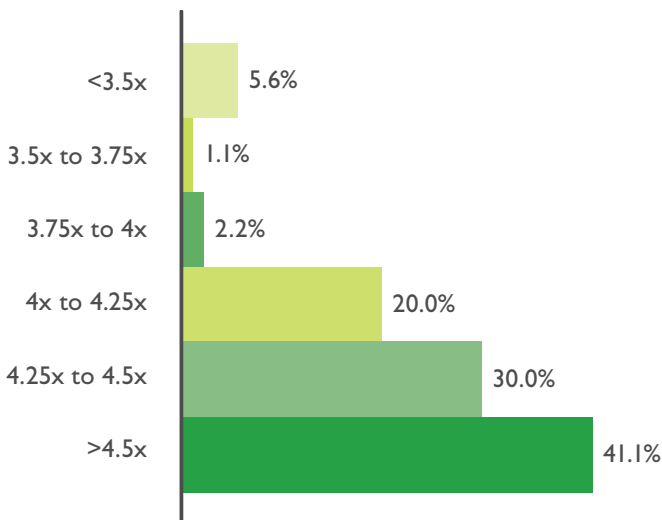
**Ian Crompton**  
Deputy Head of Leveraged Finance, London  
HSBC Bank PLC

“Very few senior lenders have appetite for deals with a senior debt leverage beyond 4x. There will always be exceptional credits in certain sectors that achieve higher leverage but in order to get a club of lenders interested, such deals will need a large equity underpinning and a strong relationship between Sponsor and funders.”

## PRICING

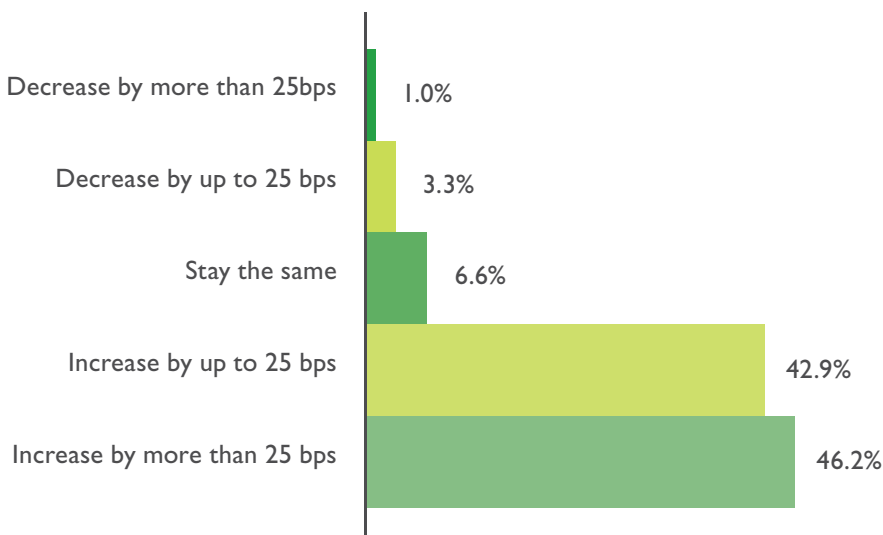
The cost of debt funding, according to the Report, looks set to change dramatically from the findings recorded in 2011. Last year, over three-quarters of respondents (77%) believed that arrangement fees would remain in the range of 3.5% to 4.5% of total commitments for 2011. At the time, this supported the prevalent trend of continued caution in the debt funding market. It also suggested that growth strategies in the market would need to be adapted to accommodate what could be a sustained period of low growth in Europe. One year later, just over half of respondents still share this view and the number of those who expect arrangement fees to exceed 4.5% of total commitments has surged from 9% in 2011 to 41% in 2012.

**Figure 12. Expectations for typical arrangement fees in 2012**



In contrast to the 2011 research findings and reflecting continuing market trends highlighted in this report, the number of respondents who believe that senior A margins will remain at current levels has dropped from 59% in 2011 to 6% in 2012. Also, in marked contrast to findings 12 months earlier, the majority of respondents in our latest Survey now fully expect senior A margins to increase by up to 50bps (from 6% in 2011 to 89% in 2012).

**Figure 13. Expected changes to Senior A Tranche margins in 2012 compared to 2011**



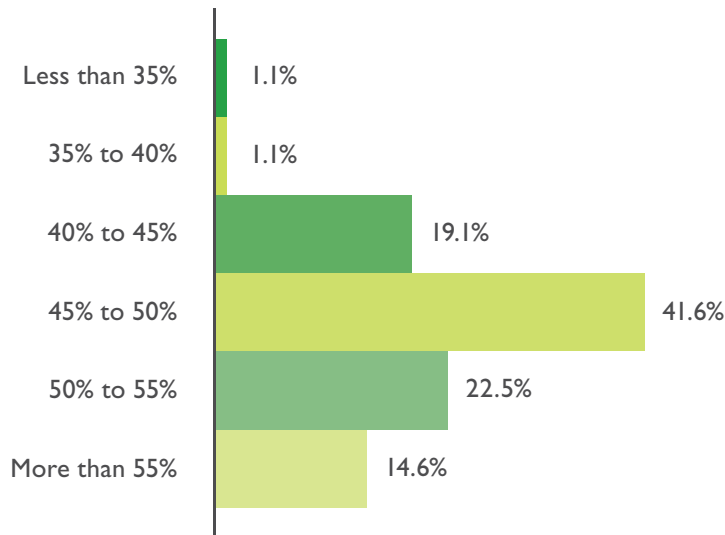
**Andrew Tully**  
**Head of Corporate and**  
**Structured Finance, London**  
**Santander UK plc**

“Competition amongst banks for the best mid market deals is still strong however rising bank funding costs and the potential impact of further recession on target businesses means deal execution in the current climate has been likened to pitching a tent in a hurricane.”

## CAPITAL STRUCTURE REQUIREMENTS

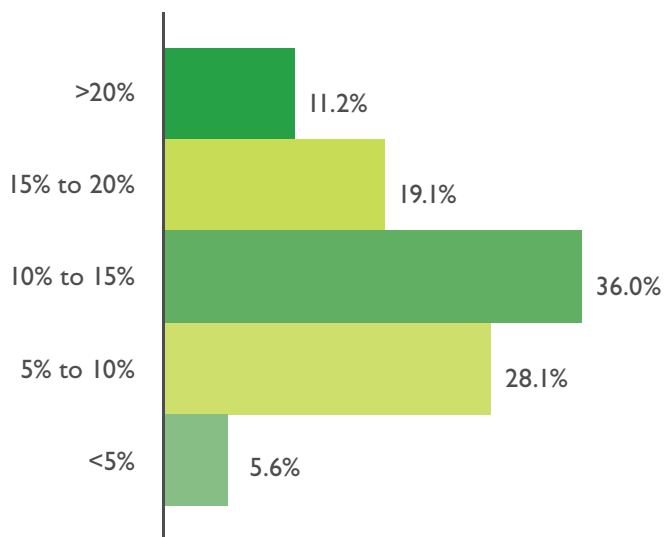
Expected changes to capital structures in 2012 mirror continuing trends observed in 2011. Reflecting the economic influence of recent volatile market conditions, the Report provides strong evidence that the minimum for equity contributions in a transaction is increasingly likely to return to 50% of the capital required (from 12% of respondents in 2011 to 37% of respondents in 2012). Less than two-thirds of respondents now suggest that equity will make up 40% – 50% of the capital structure of new deals in 2012 compared with 80% one year ago.

**Figure 14. Expected equity percentage of capital structure in 2012**



In contrast to figures recorded in 2011, those respondents who agree that the percentage of mezzanine in a transaction will be less than 5% has fallen by more than half (from 11% in 2011 to 5% in 2012) and at the other end of the scale the number of respondents who expect this figure to exceed 20% has risen strongly (from 1% in 2011 to 11% in 2012). The general shift towards the upper end of this range suggests the difficult senior lending environment has created new and larger opportunities for mezzanine lenders in 2012.

**Figure 15. Expected percentage of mezzanine debt of capital structure in 2012**



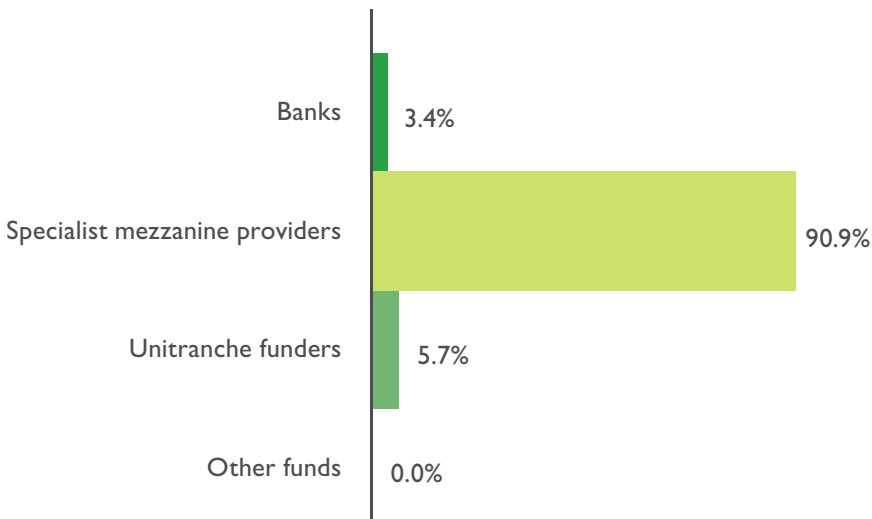
**Mark Wilton**  
Managing Director, Babson Capital Europe

“The reduced levels of senior liquidity in the market is indeed an opportunity for the mezzanine community, and one to which we have responded. The challenge for mezzanine is to develop innovative and creative solutions that address the structuring issues faced by financial sponsors in the current changing market.”

## MEZZANINE FINANCE

Remaining with Mezzanine, it is also clear from the research that specialist mezzanine providers are expected to hold their position in 2012 as the dominant provider of mezzanine finance, with the number of respondents who agree with this view remaining unchanged at over 90%. Other funders continue to show little appetite for arranging mezzanine finance, the only change of note being the view that unitranche funders are expected to become more active than banks in this area in 2012.

**Figure 16. Anticipated active arrangers of Mezzanine Debt in 2012**



**Matthew Robinson**  
**Director, Mezzanine UK**  
**Intermediate Capital Group**

“Specialist mezzanine houses can provide sponsors with more flexibility around their capital structures. They can tailor a junior debt product to the capital structure required – be that straight-forward mezzanine, a unitranche product or something completely unique. For most bank institutions, holding mezzanine is just too expensive an option and CDO/CLO funds are starting to see their investment periods running out – making it difficult to continue to stay in the mezzanine space. In fact our biggest competitor is the private equity sponsor themselves deciding to put more of their own money to work in a deal instead of mezzanine.”



# METHODOLOGY

Our research was carried out through an online survey of the European acquisition finance market. Responses were received from over 30 financial institutions active in the lending community including Alcentra, Ares Capital Europe, Armada Mezzanine, Babson Capital, Barclays Bank PLC, Beechbrook Capital, Caird Capital, DnB Bank ASA, European Capital, GE Capital, HSBC Bank PLC, ING Bank NV, Intermediate Capital Group, Investec Bank PLC, Lloyds Banking Group, Mizuho Corporate Bank, NIBC, Rabobank International, Santander, Société Generale, and The Royal Bank of Scotland PLC.

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. This works particularly well for highlighting which options scored especially low or high.

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