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**┌ In the Know:
Leveraged Finance
Annual Report 2022 ┐**

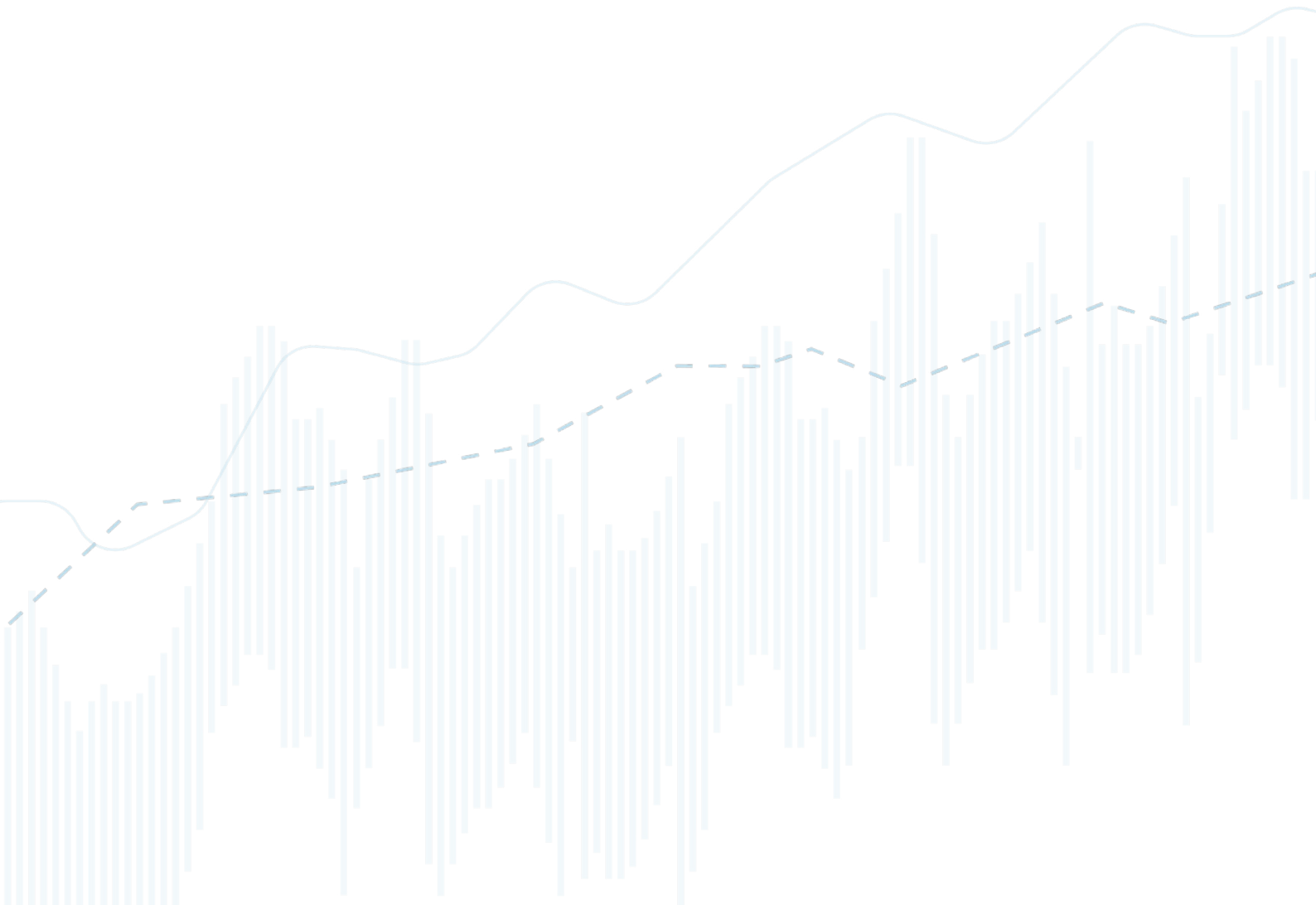
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Contents

2021: The Year in Review	4
<hr/>	
2022: Ten Predictions for the EMEA Leveraged Finance Market	8
<hr/>	
Contributing Authors	14
<hr/>	



2021: The Year in Review

The leveraged finance market in 2021 saw record breaking levels of activity, mainly driven by private equity M&A and LBOs, comprised mainly of opportunistic deals or ones which had previously been put on hold. As market participants became more mindful of ESG factors, the use of sustainability-linked instruments became widespread throughout the markets with an increase of almost 50% annually over the past decade.

The first half of 2021 saw the largest jump in transactions, with a sharp increase from Q4 2020 in both high yield bond and Term Loan B borrowings. The remainder of the year softened slightly, especially the end of Q4, mainly due to investor fatigue and broader market volatility from inflationary and interest rate pressures as well as the Omicron variant. Product mix between high yield and Term Loan B borrowings remained in line with 2020, with high yield bonds continuing to rebound as a source of funding. 2021 also marked the end of LIBOR as borrowers and lenders phased out the benchmark by the end of the year.

Although many industries were heavily impacted by the pandemic, we did not observe a significant increase in the number of companies formally restructuring their capital structures. Economies weathered the storm and equity markets saw record-breaking growth. Capital structures under strain were able to turn to alternative or more bespoke sources of funding such as direct lending or government relief programs, which also saw a large increase in both volume and value through the year.

Driven by an increasing appetite of U.S. and European investors seeking greater yields, low interest rates and a market flush with liquidity created fierce competition within the acquisition and leverage finance market in 2021; a boon to sponsors who were primed to take advantage of flexible, sponsor-friendly terms.

While large corporates in hard-hit sectors drew down on available revolving commitments in the U.S., borrowers overall engaged in constructive dialogue with their lenders in assessing their perceived liquidity needs. Several borrower-friendly trends arose in the form of COVID-19-related adjustments, including covenant holidays or level resets. Default rates were lower than during the Great Financial Crisis due to the liquidity available in the debt capital markets, the intervention of the Federal Reserve to support fixed income markets and the equity contributions provided by both financial sponsors and owners of corporate borrowers

2021 was also a record year for special purpose acquisition company (SPAC) IPOs, setting the stage for a wave of M&A in coming years and through a new and expedited way to deploy capital in the market. We explore these trends in greater depth below.



2021 by Product

In 2021, the EMEA bond market grew significantly as we saw a large number of transactions come to market, while the loan market saw a spike in activity in the first quarter and progressively slowed over the course of the year. Strong M&A activity was the main driver throughout the year, although refinancings and other transactions, which had previously been put on hold due to COVID-19 volatility, also came back to market. The last quarter of the year saw a slight dip which we expect to see continue into 2022 as central banks firm up their monetary policy decisions in light of the increasing inflation.

Similar trends were seen in the United States, which in 2021, saw the strength of leveraged loan, high yield bond and private debt markets remain resilient. Fierce competition among lenders for Dollars and league table recognition culminated in transactions being not only large in size, but also complex and aggressive in respect of their terms.

The charts below show deal volume and value of high yield debt and loans by quarter since 2019:



Source: Refinitiv

2021 by Industry

Transactions by industry saw continued volatility through 2021 due mainly to the COVID-19 pandemic, but as the new reality settled in and markets stabilized, opportunities arose in certain industries and transactional activity resumed.

Broadly, loan financing across the board continued to be more negatively impacted by the pandemic, contracting (in terms of volume and value of transactions) in telecom, industrials, financials and energy/power. We observed fewer loan financing transactions in the real estate and materials industries as well, although value still grew due to a few jumbo deals in the market. The financial industry continued to look to bond financings and remained the industry raising the most leveraged bonds in the market in terms of both volume and value. Volume of bond transactions broadly increased throughout the market, other than in the telecom industry which saw a slight contraction in terms of volume of deals in the market (although value remained stable year-to-year). As an expected consequence of the pandemic, healthcare and products and services industries saw increases across loan and bond borrowings in terms of both volume and value over the year.

In the United States, leveraged lending was particularly active in certain industries which were seen as resilient to the effects of the COVID-19 pandemic, including computers and electronics, healthcare and professional and business services.

The chart below shows deal volume and value growth from 2020 to 2021 of high yield debt and loans across EMEA broken down by industry:



Source: Refinitiv

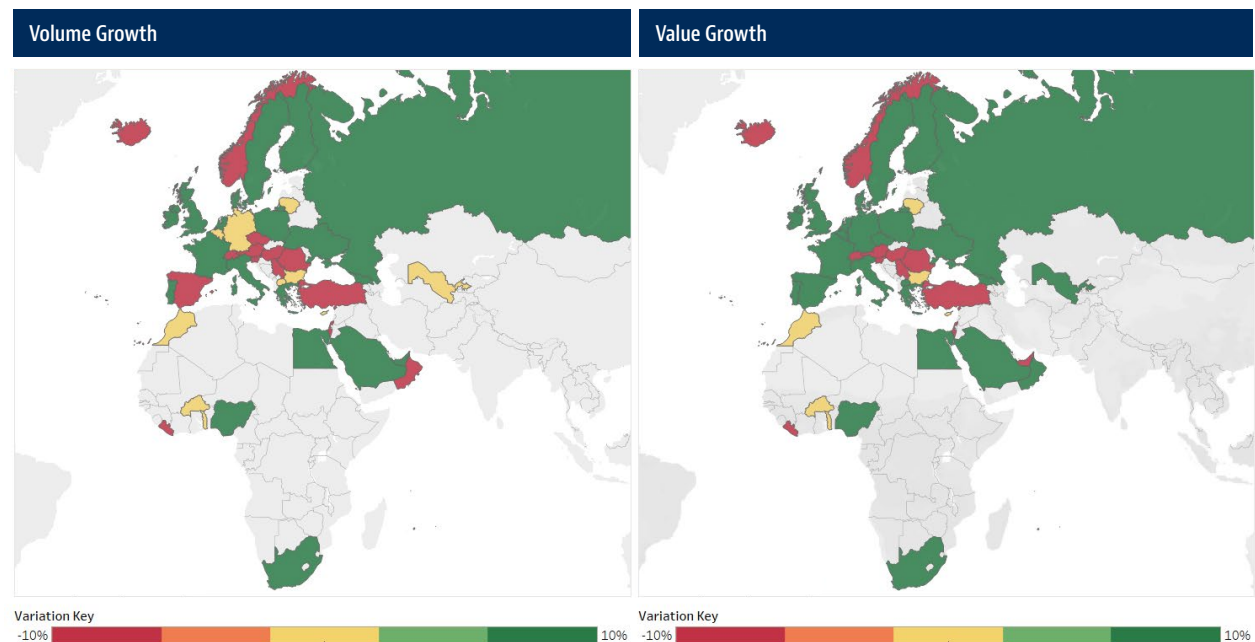
2021 by Geography

Although the market across the globe saw a flurry of activity in 2021, in terms of product mix, the loan market continued to be the most heavily impacted by the pandemic, while bond market activity boomed across EMEA. The second half of the year was slower generally, but still hit record-breaking levels despite levelling out by year end. Western Europe and the United Kingdom continue to be the most active leveraged finance markets in EMEA, both in terms of volume and value of transactions.

Spain, Italy and Turkey saw the largest drop in loan volume and value over the past year, while bond volume and value in these countries remained fairly stable and even increased. There were less loan transactions in Germany over the course of the year, but aggregate deal value still rose due to few jumbo deals. The United Kingdom remained the most active market across product classes and saw an uplift across the board both in terms of volume and value during the year. The leveraged financing market in Spain was extremely active over the course of the year, especially in the real estate industry, which saw many debut bond issuers come to market, although most significant was the shift away from loans towards bonds as the loan market contracted significantly. Nordic countries had a mix of activity with a significant amount of transactions (both in terms of volume and value) in Sweden, but we observed a slowdown in transactional activity in Norway. Markets in Russia and Eastern Europe were also quite active, despite headwinds in the second half of the year due to inflationary fears and the continued strain of the pandemic. Green and sustainability-linked instruments came to the forefront of the market as well, as volumes increased by more than 50% year-to-year.

Relative to this record-breaking year, in EMEA we expect to see a relative slowdown in the year ahead, but we still expect an active market buoyed by continued M&A activity and refinancings.

The charts below show movements in combined bond and loan volumes by jurisdictions comparing 2020 to 2021:



Source: Refinitiv

In the United States, leveraged loan, high yield and private debt markets are robust, with fierce competition among lenders to win mandates for large financings. Default rates are forecasted by ratings agencies to remain low in 2022 for leveraged loans and high-yield bonds. The percentage of leveraged issuers on watch-lists is currently in line with pre-pandemic levels. Private equity sponsors took advantage of depressed valuations to and liquidity in the debt capital markets to drive M&A activity.

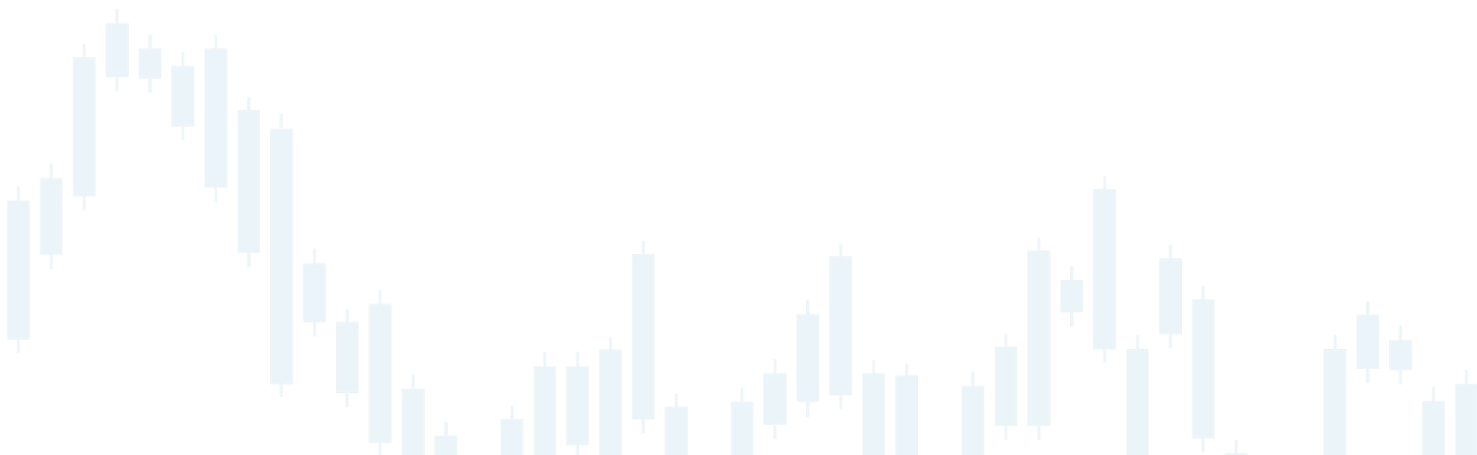
2022: Ten Predictions for the EMEA Leveraged Finance Market

01 Continued growth of sustainability-linked products

Volume and value of green and sustainability-linked debt financings has increased more than 50% annually over the past decade, as ESG factors are becoming paramount to stakeholders across the market. As a result of this increased focus, certain debt instruments have started mandating green use of proceeds (green bonds) or even going a step further by linking the cost of capital to sustainability targets (sustainability-linked bonds). Deals in the market over the past year included mechanics such as interest rate ratchets or one-off premium payments, in each case tied to sustainability targets.

Prediction

2022 will continue to see strong growth in the prevalence of ESG factors throughout the market. As stakeholders' focus on these factors continues to grow we expect the use of sustainability-linked products to continue to develop and become mainstream throughout the leveraged finance market. Although every transaction may not end up down this road, we expect all market participants to consider these factors in deal structuring. As market participants become more savvy and informed, we will see further developments and refinement of the underlying mechanics, with creative thinking from issuers across industries as to how to fit their financings into a sustainability structure.



02 Emerging markets macroeconomic volatility

Many emerging markets had a rough year. Between the pandemic and macroeconomic pressures from rising yields and weaker local currencies, economies and corporates haven't had much reprieve. Inflation rates have been spiking, central banks have been tapering their stimulus and asset purchase programs and economies worldwide are considering interest rate hikes. Turkey was hit especially hard this year as the Lira hit historic lows and businesses fought strong volatility. Certain emerging markets such as the United Arab Emirates and Saudi Arabia were among top performers and withstood the windy year.

Prediction

Emerging markets are looking ahead to another challenging year. Inflationary pressures will lead to global rate increases which will increase the cost of capital for corporate borrowers, in turn exacerbating the ongoing strain of the pandemic. More developed countries have been relatively successful with vaccine rollouts, but as further variants develop and the pandemic continues, emerging markets will likely be hardest hit. As we go to press, all eyes are on NATO and Russian troop build up in the vicinity of Ukraine. Military conflict would create volatility not only impacting the capital markets in that region but globally, and even absent military conflict the signals around sanctions and other penalties imposed on market participants would create EM volatility.

03 COVID-19 — continued challenges and opportunities

Economies and corporates are more resilient and durable to the pandemic than markets had initially feared. Although it has been a long two year period, market participants are weathering the storm. Short term liquidity hurdles were overcome with working capital credit facilities or even more bespoke capital raising options such as direct lending. Lockdowns and pandemic-related restrictions were surmounted by businesses adapting to the new reality and evolving. Restructurings and distressed financings generally were not as prevalent as expected.

Prediction

With new variants emerging despite ongoing vaccine campaigns and herd immunity, we don't yet seem to be quite out of the woods and the pandemic is still raging globally. As the pandemic continues and short term liquidity options come to maturity in the face of inflation and/or higher interest benchmarks we expect to see more a more expensive price tag for many financing alternatives, continued close negotiations with creditors, and potentially distressed financing and/or restructuring of businesses and/or capital structures.

04 Direct Lending - Come for the certainty, stay for the flexibility

In 2021, direct lending, which refers to privately held debt provided by non-bank lenders, cemented its role in middle-market borrowers' post-pandemic recovery narrative, as borrowers obtained access to liquidity while preserving operational flexibility. The US middle market by GDP (\$10 trillion of GDP annually) is the third largest economy in the world; the market share for direct lending and non-bank investors in this space has increased over time.

Prediction

Given the growth of dry powder among direct lenders and committed capital among other capital providers (e.g. captive insurance companies, sovereign wealth funds, etc.), we expect non-bank lending supply to keep up with demand. We predict that the continued retention of maintenance covenants and comparatively less risky deal structures when compared with the syndicated lending market will continue to drive leveraged loan investor demand in this area. We expect default rates to continue to remain at low levels across this asset class. At the same time, the significant competition among direct lenders and traditional bank lenders in the upper middle-market will contribute to financing provisions that, for the most part, reflect pre-pandemic, borrower friendly terms.

05 Blockchain and Crypto move the market

The wave of new tech finance options changed the finance landscape in 2021, with blockchain and crypto-currency financing options leading the way. These new technologies create a set of challenges for the legacy infrastructures, that were designed to settle and clear for hard currencies through traditional banking means.

Prediction

In 2022, new protocols will emerge to facilitate these new technologies and market participants scramble to take leading positions. In addition, planning for the next wave (e.g., the Metaverse) will get more gravitas as tech pioneers establish new financials systems.

06 Liability Management Transactions: Plugging Loopholes

Over the last several years and specifically after the onset of the global COVID-19 pandemic, there has been significant focus by leveraged lending market participants in "uptiering" and "drop-down" financing transactions. These transactions illustrate the tension between a borrower's desire to manage its capital structure to avoid a free fall when they need to access liquidity to avoid bankruptcy and the senior lenders' desire to maintain their place at the top of the capital structure. J. Crew, Serta, PetSmart, TriMark and other distressed contexts have provided leveraged loan market participants with compelling examples of the necessity of such participants taking a proactive approach to preparing for downside scenarios. These cases illustrate the importance of participants needing to be highly sophisticated to understand the distressed scenario ramifications buried in complex financing documentation.

Prediction

For the middle-market, we expect that lenders will be successfully in "holding the line" in not agreeing to underwrite more risky deal structures. We believe that so-called "J. Crew Blockers", "Serta Protections" and other similar provisions will be increasingly incorporated in the middle to upper-middle market, with private equity sponsors continuing to work with such lenders who are otherwise providing borrowers with operating flexibility, certainty of pricing and smooth financing execution.

07

Refinancing push ahead of interest rate hikes

Inflation rates have been increasing globally over the past year and alarm signals are going off at central banks. More than a decade after the financial crisis, rates remain at all-time lows and inflation is catching up with us. The US Fed has started tapering its asset purchase program and is actively discussing rate hikes.

Prediction

Rate hikes seem all but inevitable at this stage. The question is how much of a hike markets are expecting and whether these are only the first of many. As central banks increase rates, this in turn will put pressure on yields and increase the cost of capital of corporate borrowers. We expect that borrowers have been, and will continue to, evaluate their capital structure in light of these developments and that many will come to market to refinance their current borrowings to lock-in current rates.

08

Recovery of fallen angels: is BB+ the new BBB-?

Traditionally, sub-investment grade (or "high yield") is a credit rating of BBB-, but recent years and turmoil have led a lot of corporates who were previously right on the edge to drop down to BB+ ratings. These are "fallen angels". As corporates weather the pandemic and general market volatility, many of them are teetering around the investment-grade line.

Prediction

As corporates continue to oscillate on the brink of investment grade status (either becoming fallen angels or recovering and getting back into investment grade status), we expect to see more blurred lines in the documentation of their leveraged financing. Historically sub-investment grade financing such as high yield (which includes restrictive covenants) were limited to corporates below the investment grade line and corporates above the line benefited from limited (if any) operational restrictions in their debt documentation.

09 Rise of ESG ratings

Stakeholders throughout the leveraged finance market are increasing scrutiny of borrowers' ESG performance and impact. 2021 saw the rise of ESG ratings (which are distinct from credit ratings of rating agencies) as a useful tool for investors to assess and consider these factors. However, regulatory oversight of these new ratings and service providers have been lagging, mainly due to the rapid development of the ratings and a variety of new market participants offering such services.

Prediction

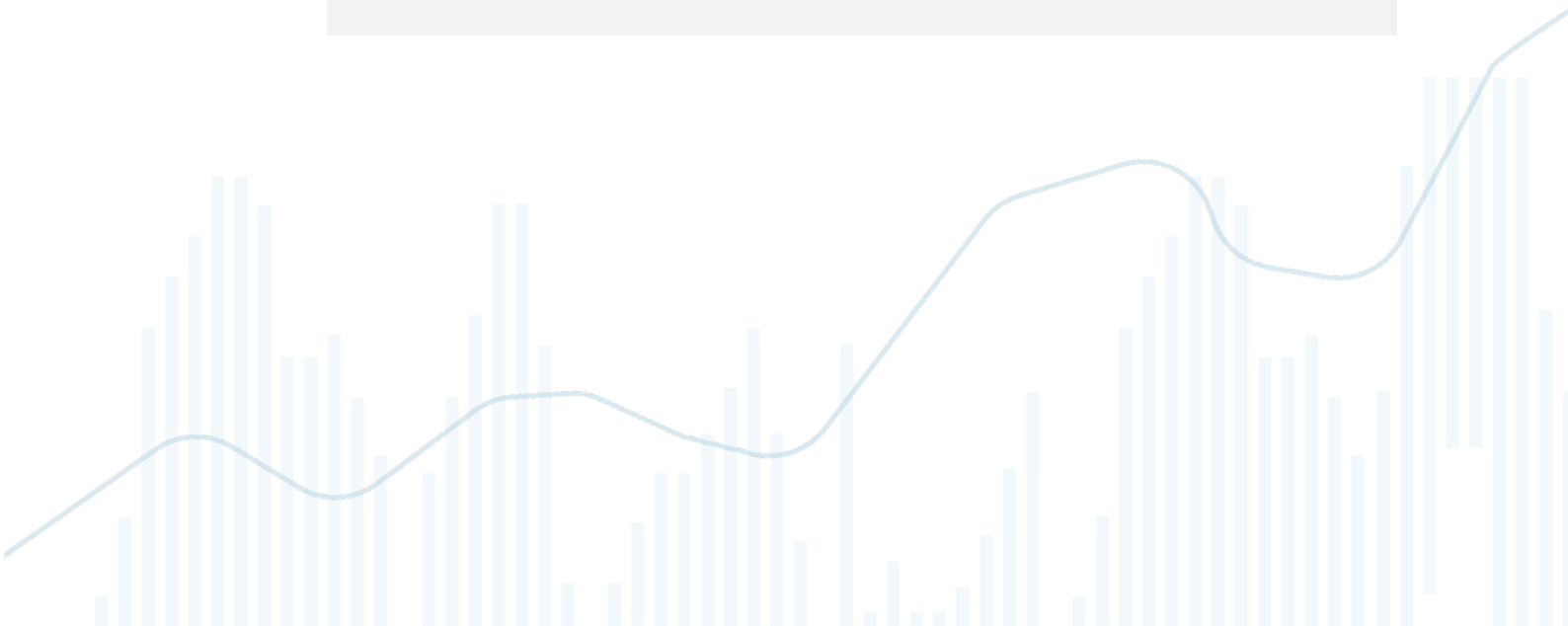
ESG ratings will become more standardized and their use, be it in the context of an offering or more generally, will become more mainstream. As investors focus more on these, their materiality in connection with investment decisions will also increase and the need for transparency and regulatory oversight will become paramount. As scrutiny increases, barriers to entry into the market will increase and we will see a thinning of providers of these ESG ratings.

10 The M&A wave

The EMEA leveraged finance market in 2021 saw record-breaking levels of M&A activity, whether opportunistic or deals which had previously been put on hold. The first half of the year broke records across the board, so much so that as market participants met and exceeded quotas they turned their focus to 2022, which may have contributed to a softening of the market in Q4.

Prediction

We expect M&A activity to continue to be strong into 2022. SPACs will be entering the market and as the pandemic continues to strain corporates we expect opportunistic M&A to continue. Private equity funds also have significant investment capacity which they are actively looking to deploy in transactions. The wild cards will be inflationary and interest rate pressures, which could tip the markets either way (together with tighter macroeconomic policy in the U.S.), as well as geo-political unrest and any disruption that occurs in the upcoming US elections. The use of SPAC financing arrangements should also drive the M&A activity by providing investors with a new expedited channel to fund acquisitions.





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