

ALIXPARTNERS MID-MARKET DEBT REPORT H1 2023

At the start of 2023, many industry participants were expecting more stable market conditions in the year ahead, in anticipation of an easing of the pressures applied by soaring inflation. However, continued interest rate rises by central banks to mitigate inflation has ensured a continuation of an uncertain – and in many cases, extremely challenging – outlook for businesses. This has also significantly muted M&A (and therefore LBO lending) activity for a longer period, driven by overall macroeconomic uncertainty and higher cost of debt finance.

The 19th edition of AlixPartners' bi-annual Mid-Market Debt Report covers more than 75 bank and non-bank lenders active in the UK and European mid-market (debt transactions valued up to €400 million).

INFLATION PERSISTENT, BUT SLOWING, AFTER LARGE INTEREST RATE RISES

- Inflation across Europe remains at elevated levels, applying continued pressure to consumers and businesses alike, creating a challenging financial environment.
- Annual Euro area inflation to June 2023 was down to 5.5% (from 8.6% a year earlier, after peaking around September / October 2022). In the U.K., core CPI fell to 6.9% in the year to June 2023.
- In mitigation, central bank interest rates have increased significantly, with ECB marginal lending facility rates rising from 2.75% in December 2022 to 4.25% in June 2023. BOE base rate increased from 3.5% to 5.0% over this period.

SOME STABILITY RETURNS TO DEBT MARKETS IN H1...

- Markets appeared steadier following years of major shocks from COVID, the war in Ukraine and major supply chain issues, with secondary pricing less volatile as central banks pursue consistent rate rises and inflation falls.

BUT UNCERTAINTY HAS STYMIED H1 2023 M&A ACTIVITY

- Mid-market deal-making continues to suffer as sponsors find it hard to close deals due to ongoing macro uncertainty, although slightly more resilient than large-cap M&A activity.
- LBO activity in H1 is down c.63% vs 2021, and 56% vs 2022¹, with valuation mismatches between buyers and sellers being a key driver in this regard, alongside debt market pricing volatility.
- Non-bank LBO lending activity in our survey fell to only 50 deals, the lowest level ever reported in this survey.
- The U.K. has lagged Europe on deals in H1, given greater exposure to economic headwinds and a slower return towards acceptable inflation levels.

1. LCD European Weekly – 23 June 2023
2. Credit Suisse Western European Leveraged Loan Index, hedged to Euro, and constituents, as of 31 May 2023
3. Fitch Ratings: EMEA Leverage Finance Mid-Year Outlook 2023
4. Moody's BvD, S&P Global Market Intelligence, BoE

PRIVATE CREDIT IMPACTED BY INFLATIONARY PRESSURES

- The collapse of SVB in March created more volatility for banks, and saw a platform for direct lending to continue its growth trend and opportunity to take activity. However, in the inflationary environment experienced through H1, credit funds have focused on existing portfolios and struggled to deploy dry power in new deals, with a significant reduction in activity since H2 2022 (37% down in H1 2023).

A&Es DOMINATE ACTIVITY, WITH ABL ALSO ROBUST

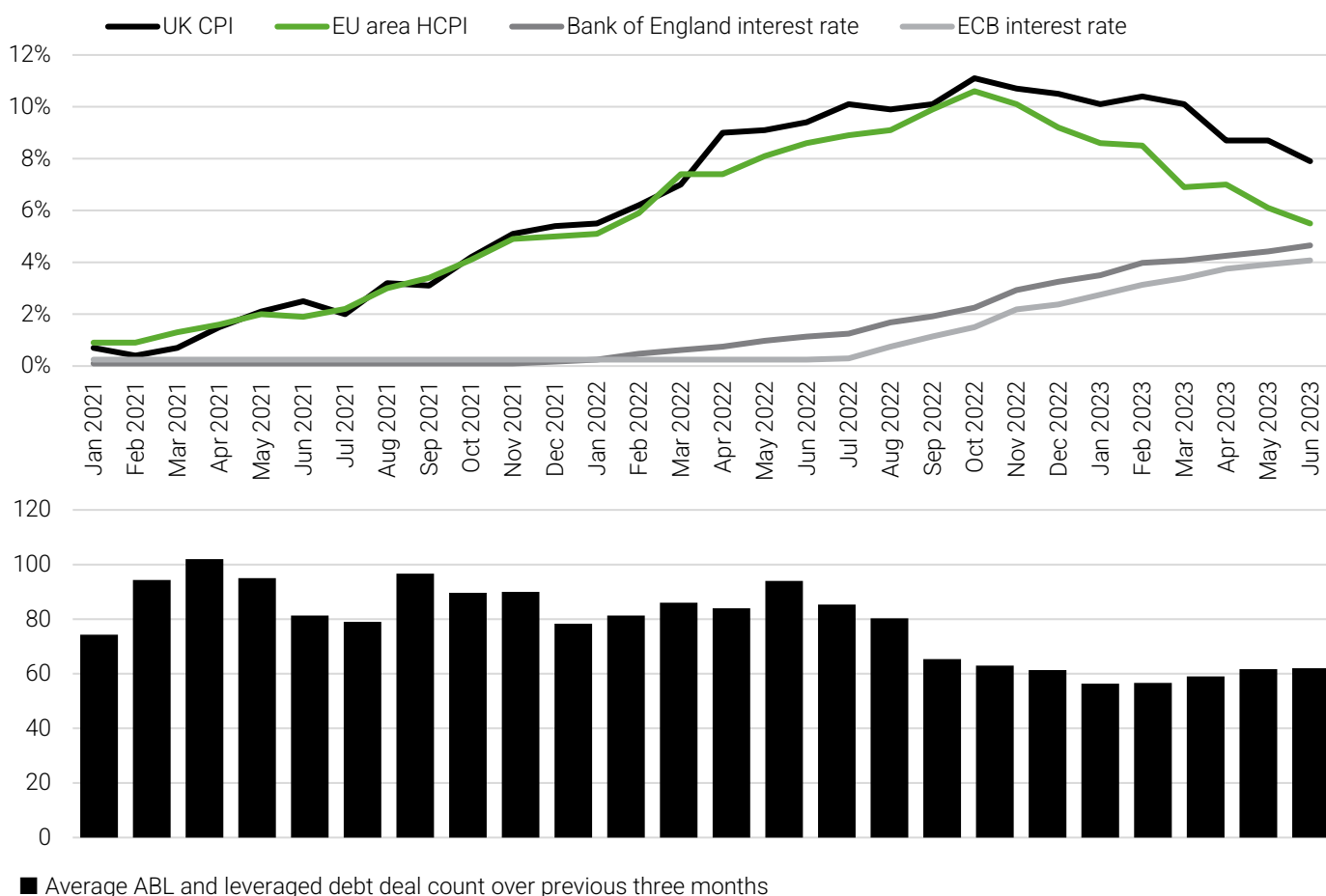
- Extensions are dominating loan activity, given refinancing challenges and LBO softness, leaving few maturities remaining in 2023/2024 across European syndicated loan markets (0.4% in 2023 and 3.2% in 2024)².
- However, these are resulting in significant premia on legacy rates creating pressures on borrower cash flows in the medium term. Fitch concludes that default rates for high-yield and leveraged loan issuers will increase to c.4%³.
- ABL has seen a c.7% increase vs H2 2022 in our survey as Lenders seek security and borrowers look to reduce pricing.

H2 OUTLOOK UNCERTAIN, LEAVING MARKETS SENSITIVE

- Recent consumer confidence data and economic indicators have driven market expectations on future rate rises, and this will be a determinant of future activity.
- Recession risk remains in the short term for the U.K., as mortgage rates filter through and real wages fall. This will likely dampen deal appetite for a while yet.
- There are clear signs that sponsors are handing over the keys to Lenders, as unhedged interest rate rises make portfolio companies unviable.
- 70% of medium-sized businesses are expected to experience balance sheet stress by the end of 2023⁴, which may see restructuring activity increase.

Inflation and interest rate fluctuations dominate the U.K.'s economic outlook, against a backdrop of continued Eurozone conflict

- 24 February 2022:** All domestic legal COVID restrictions are officially lifted in England.
- 24 February 2022:** Russia launches invasion of Ukraine, with Russian troops quickly reaching the outskirts of Kyiv. FTSE 100 falls by more than 7% in the following 2 weeks and oil prices reach over \$120 per barrel.
- 24 March 2022:** COVID moratorium on commercial rent eviction ends.
- 5 May 2022:** With surging energy and food prices driving CPI up to 9% in April, BoE raises base rate to 1%, marking an increase above 0.75% for the first time since 2009.
- 21 September 2022:** Vladimir Putin announces partial mobilisation of Russian civilians to support Russia's war effort. The official decree targets military reservists, but allows any citizen to be conscripted.
- 23 September 2022:** Kwasi Kwarteng delivers his mini-budget, announcing the biggest set of tax cuts for 50 years. The pound subsequently drops to a 37-year low.
- 28 September 2022:** The Bank of England announces it will begin temporary purchases of long-dated U.K. government bonds in an attempt to stabilise the gilt market.
- 20 October 2022:** Liz Truss resigns after just 44 days in office.
- 25 October 2022:** Rishi Sunak appointed PM.
- 16 November 2022:** October 2022 CPI figures show U.K. inflation peaking at 41-year high of 11.1%, with EU inflation peaking in the same month at 10.6%.
- 31 March 2023:** The Eurozone slips into recession in Q1 2023 after two consecutive quarters where GDP fell by 0.1%. The U.K. saw marginal growth of 0.1% in Q1 2023.
- 25 May 2023:** Ofgem announces a reduction in the energy price cap to £2,074 per year from July 2023 onwards (when the U.K. Government's £2,500 energy price guarantee expires), down from a peak of £4,279 from January – March 2023.
- 22 June 2023:** The Bank of England warns businesses and households that the cost of borrowing will remain high for at least the next two years as it raises interest rates for the 13th consecutive time to 5%.
- 24 June 2023:** The Wagner group's short-lived mutiny against Russian government forces ends after President Lukashenko of Belarus brokers an agreement with Yevgeny Prigozhin.
- 30 June 2023:** The tech-heavy Nasdaq index closes the first half of the year up 32%, its strongest start for over 40 years, driven by surges in AI-related stocks. The pan-European Stoxx 600 index rose by 7.5% in the same period, while the FTSE 100 was flat.
- 19 July 2023:** CPI figures for June show that U.K. inflation fell sharply to 7.9%, driven by continued falls in petrol and food prices. However, U.K. inflation remains the highest in the G7. For the first time in nearly two years wage growth is above inflation, increasing pressure on the BoE for further rate hikes.



Average deal counts have been consistently at subdued levels on a trailing three-month average for 12 months. This tracks alongside the series of interest rate rises by the Bank of England and European Central Bank throughout the same period, in an effort to pull inflation back into line. Since the turn of the year, this appears to be having the desired effect, with inflation decelerating during the first half of 2023, albeit at a slower pace in the U.K. However, such elevated interest rates have intensified the pressure on companies approaching maturities, as credit markets tighten and the cost of capital increases.

UK Banking activity in H1 2023 falls by 7% on previous half-year, as interest rates continue to rise to combat stubbornly high inflation

FIGURE 1: U.K. MID-MARKET BANK DEAL COUNT

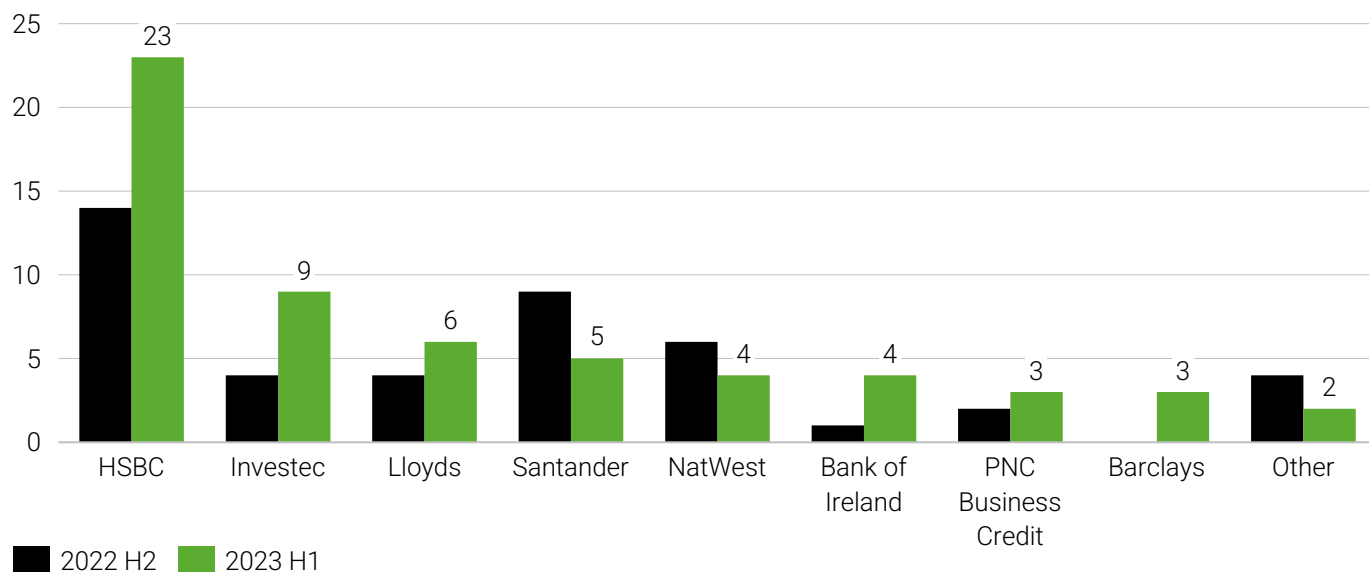
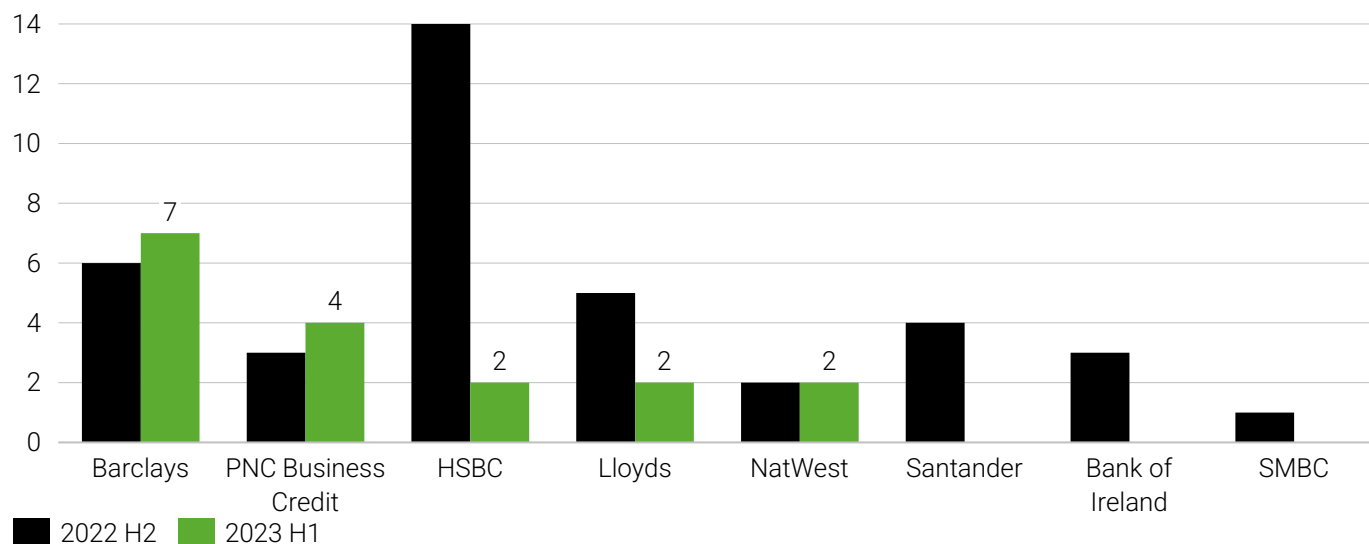


FIGURE 2: U.K. BANK SUPER SENIOR RCF COUNT



INSIGHTS

- Overall mid-market deal activity (excluding super senior RCFs) increased by 34% in H1 2023 versus H2 2022, with 59 deals completed. HSBC led the way with 23 deals, some way ahead of Investec with nine deals and Lloyds with six.
- Bank of Ireland, PNC Business Credit, and Barclays all registered an uptick in activity during the latest six-month period, while Santander and NatWest saw declines from nine deals to five and six deals to four respectively.
- Banks share of activity of deals covered by this survey increased to 40%, the highest level since 2019. Banks continued support for consumer facing businesses, accounting for 17% of bank deals, up from 8% in 2020.
- It was a very different picture for super senior RCF deals, however, which fell by more than half in the first six months of this year (55%), from 38 deals to 17.
- HSBC's high deal count in H2 2022 (14 deals) dropped dramatically to just two, accounting for the lion's share of this overall slump in activity.
- Deals by Lloyds also fell from five to two, while Santander and Bank of Ireland did not complete any deals, after registering four and three respectively in the previous six months.
- Barclays and PNC Business Credit saw their deal activity increase slightly on H2 2022, up from six to seven, and three to four.

Non-bank activity plummets by 37% in H1 2023, driven by LBO activity, which has fallen to below one third of deals associated with a soft M&A market

FIGURE 3: EUROPEAN MID-MARKET NON-BANK DEAL COUNT

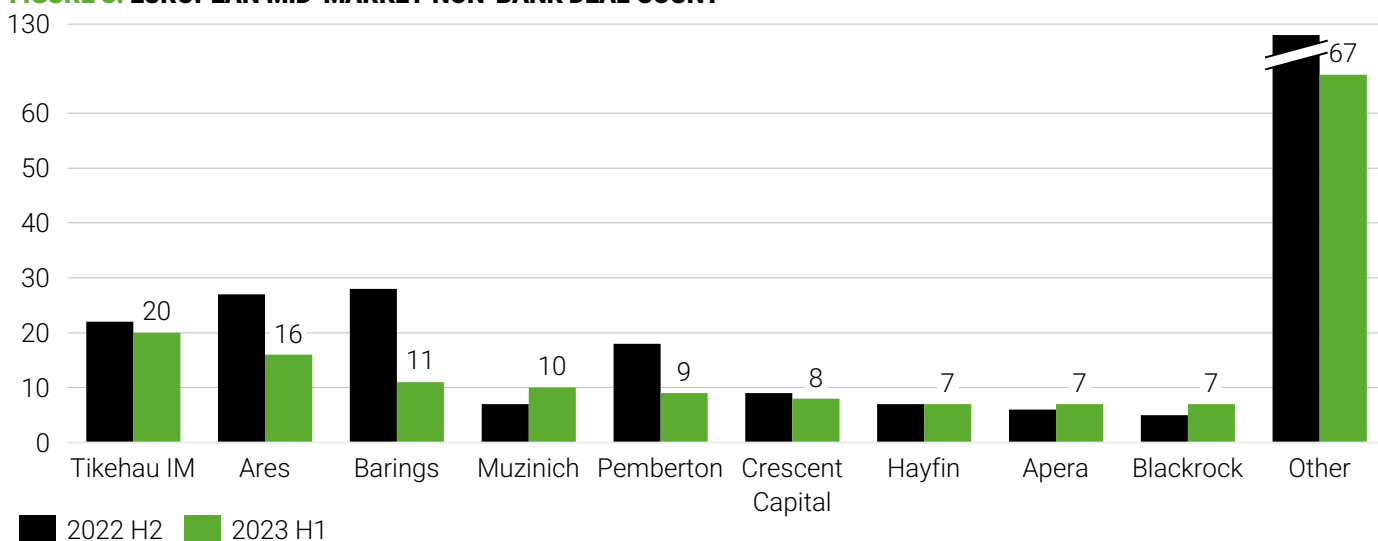
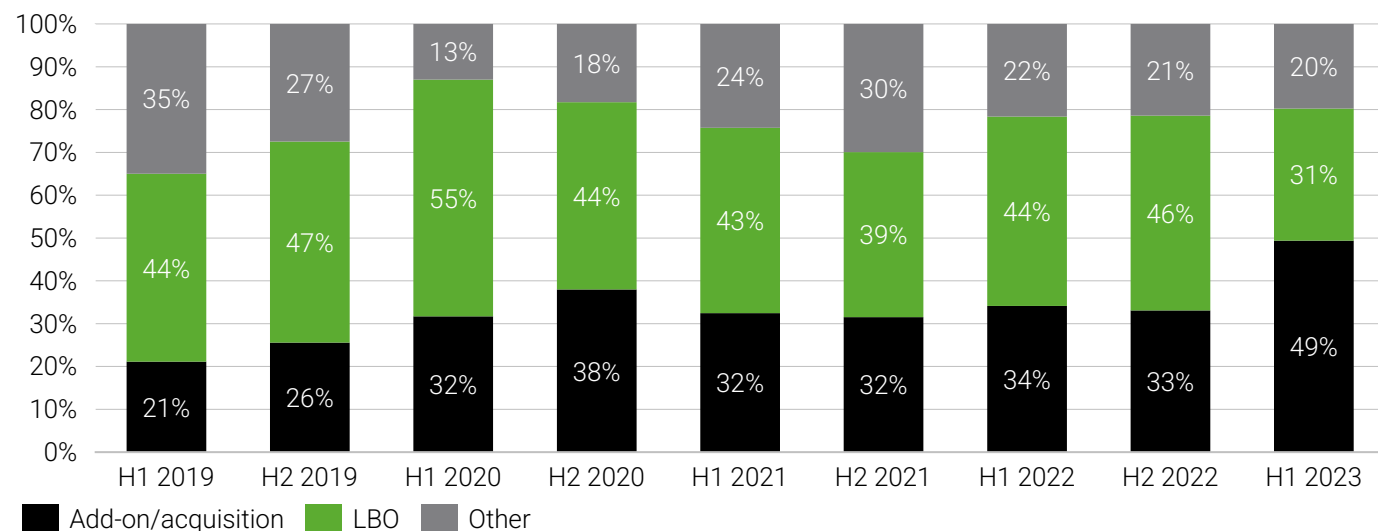


FIGURE 4: NON-BANK ACTIVITY BY DEAL PURPOSE



INSIGHTS

- 162 European non-bank deals were completed in the first half of 2023, a fall of 37% from 254 in H2 2022.
- Tikehau completed the most deals in the latest six-month period, completing 20 deals, down from 22 in H2 2022.
- Ares, Barings, Pemberton, Crescent Capital and Arcmont all saw falls in activity, with just Muzinich, Apera, and Blackrock increasing their deal count in H1 2023. Other deals fell sharply by almost half (48%).
- Deploying capital in an inflationary environment is challenging for credit funds, and whilst inflation poses a risk to dry powder, lending is also made riskier. Add-on/acquisition activity was more resilient than LBO deals, and accounted for 49% of activity, a significant increase compared to the trend over the last four years. Additionally, the number of lenders per transaction fell to less than 1.08, the lowest level recorded in this survey, and a decrease from 1.23 in H2 2022. Both of these statistics support the fact that funds have focused activity on their existing portfolios.
- The mark of the economic downturn continues to be illustrated in sector-based activity. Those on the front line with regards to consumer confidence and the spiking cost of living – consumer, leisure, retail, and financial services – accounted for just 15% of deals in the first half of 2023. This represents its lowest level for more than five years.
- Consistent with the broader reduction in M&A activity, LBO activity fell to only 50 deals, the lowest level ever reported in this survey.
- Funds' share of activity for H1 2023 was 60%, which is also the lowest proportion since 2019. Many credit funds have not experienced a period of high interest rates, which could impact their access to capital. However, there is still significant dry powder, so the market for securing strong credits remains very competitive.

UK ABL and IDF activity increased by 13% as borrowers raise finance against their assets, whilst inflation clouds cash flow certainty in the leverage market

FIGURE 5: U.K. IDF-ONLY ABL DEAL COUNT

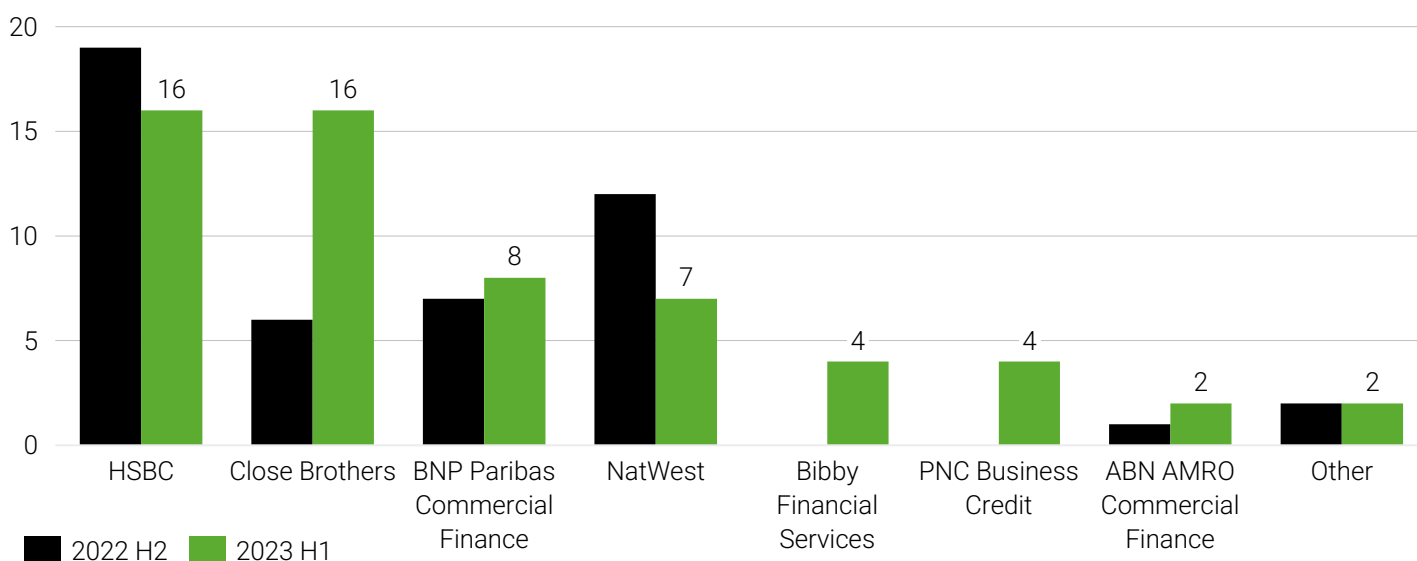
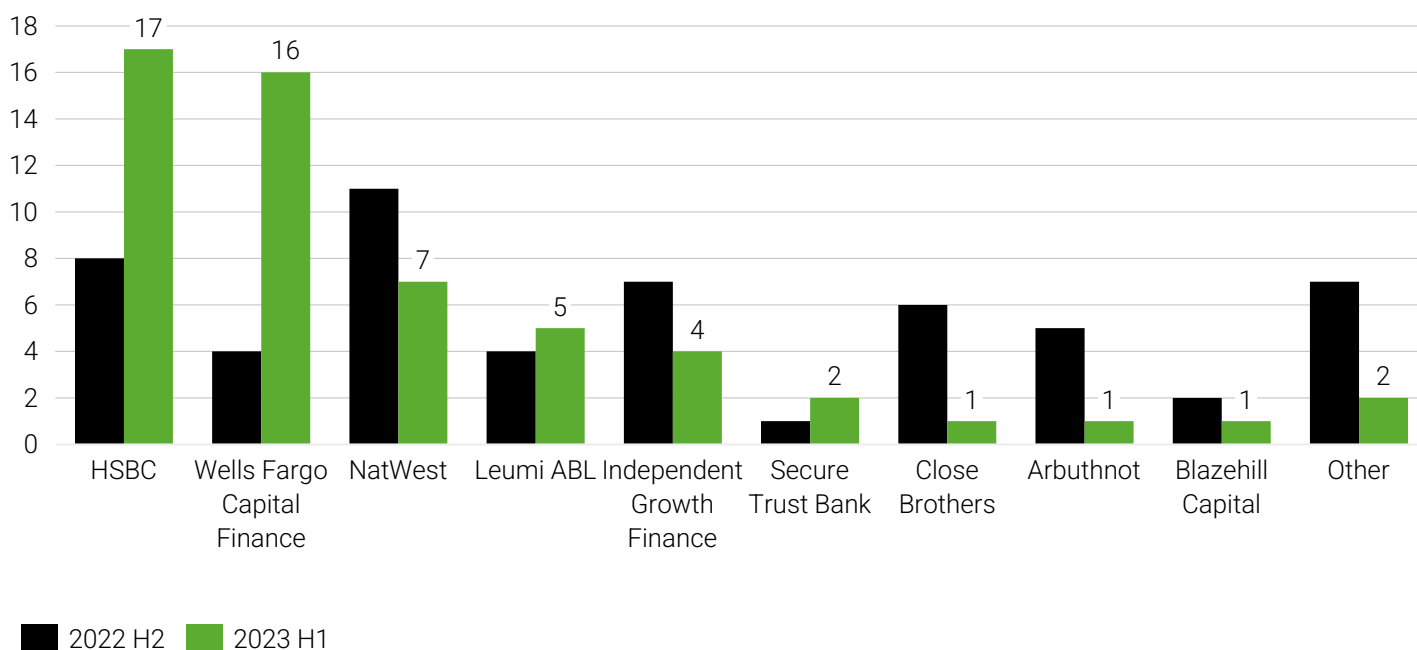


FIGURE 6: U.K. ABL DEAL COUNT (EXCLUDING RECEIVABLES ONLY/IDF DEALS)



INSIGHTS

- IDF-only deals in the U.K increased by 26% in the first six months of 2023, from 47 deals in H2 2022 to 59 in H1 2023.
- The most active lender in the UK, HSBC, saw its deal count drop by 16%, while NatWest's also dropped from 12 to seven.
- Close Brothers saw a significant uplift in deals, from six to 16, as BNP Paribas, Bibby, PNC, and Wells Fargo all registered a higher number of deals than the six months previous.
- UK ABL deals (exc. receivables only / IDF) were at similar levels as H2 2022 overall, held at this level by large increases at HSBC, from eight to 17, and Wells Fargo, from four to 16. Leumi ABL also increased from four deals to five, while all other firms saw a fall in activity.
- ABL is more secure for lenders than leveraged finance and therefore comes at a lower price for borrowers. ABL and IDF activity accounted for 34% of transactions across this survey (leveraged deals and ABL/IDF). This is the highest level since H1 2020. This trend is not a surprise, given both borrowers and lenders exhibit a preference for ABL during periods of higher interest, higher inflation and when companies are cash flow constrained, as has been seen through H1 2023.

Sources: AlixPartners debt report, Sponsor press releases, Lender press releases
Please refer to the disclaimer at the end of this report for further context on the data

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These are the moments when everything is on the line – a sudden shift in the market, an unexpected performance decline, a time-sensitive deal, a fork-in-the-road decision. But it's not what we do that makes a difference, it's how we do it.

Tackling situations when time is of the essence is part of our DNA – so we adopt an action-oriented approach at all times. We work in small, highly qualified teams with specific industry and functional expertise, and we operate at pace, moving quickly from analysis to implementation. We stand shoulder to shoulder with our clients until the job is done, and only measure our success in terms of the results we deliver.

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