FOCUS
Capital Partners

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OH DEBT,

WHERE ART THOU?

Sources of Debt Finance by Michael Lalor

The debt lending landscape continues to evolve with lender appetite becoming more nuanced, specialised and increasingly focused on lender returns. Debt sources are coming from a much wider range of providers. However, assessing available options and terms can be difficult and time-consuming.

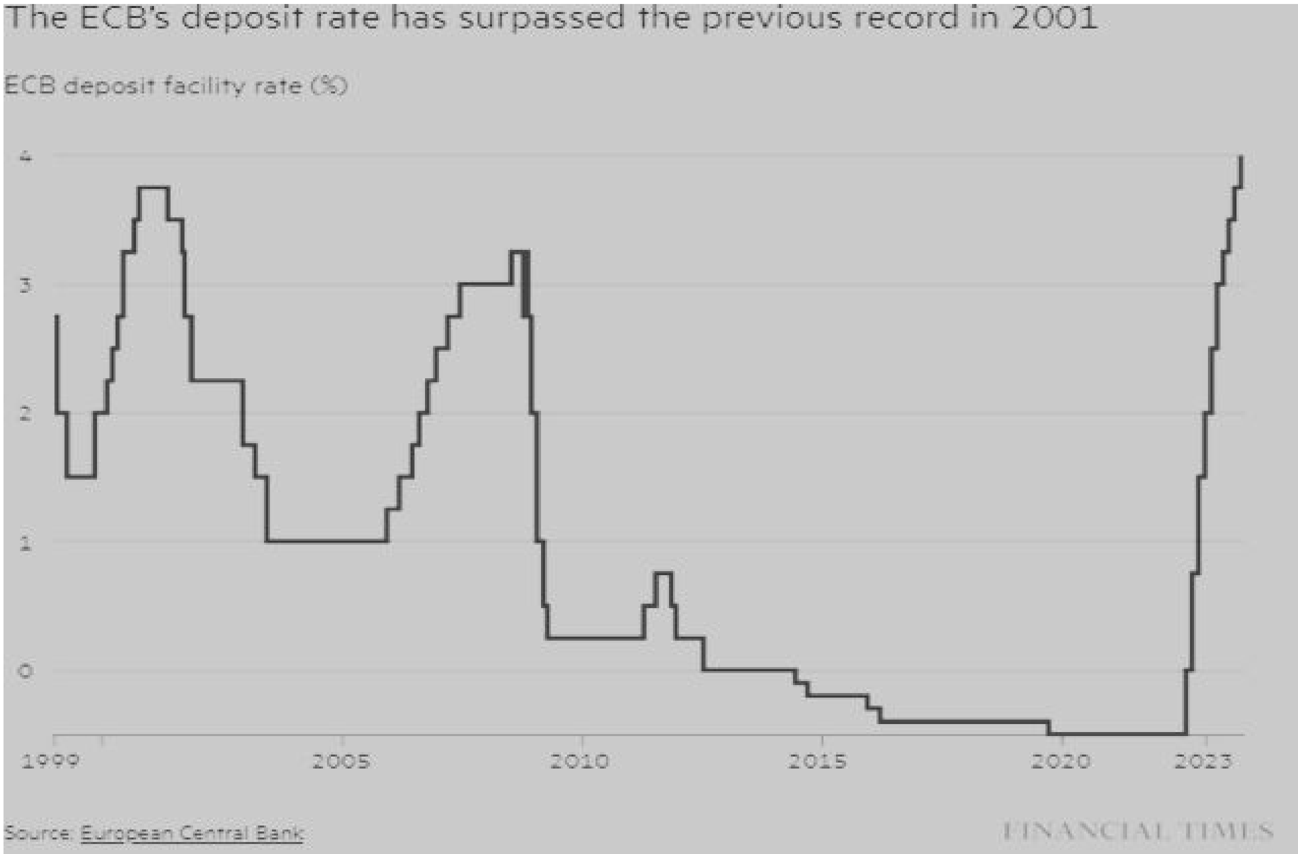
Background

Despite global macroeconomic and geopolitical risks, the Irish economy has performed strongly when compared to international peers on important metrics such as employment and unemployment levels, economic growth and tax receipts. The economy has benefitted largely from strong trade corridors and particularly from US Foreign Direct Investment. While Ireland is an open economy tied to global economic performance, it has performed well on a consistent basis rebounding from Covid-19.

Irish Corporates have also performed well and have largely proven to be resilient to external shocks. The aftermath of Covid-19 has left several significant residual issues to resolve such as the realignment of supply chains, heightened inflation and the need for some businesses to adjust their models to cope with the new environment. Inflationary pressures once thought transitionary have proven to be sticky at their core, despite an easing in energy costs. Central banks have hiked rates accordingly to curb.

Interest Rates

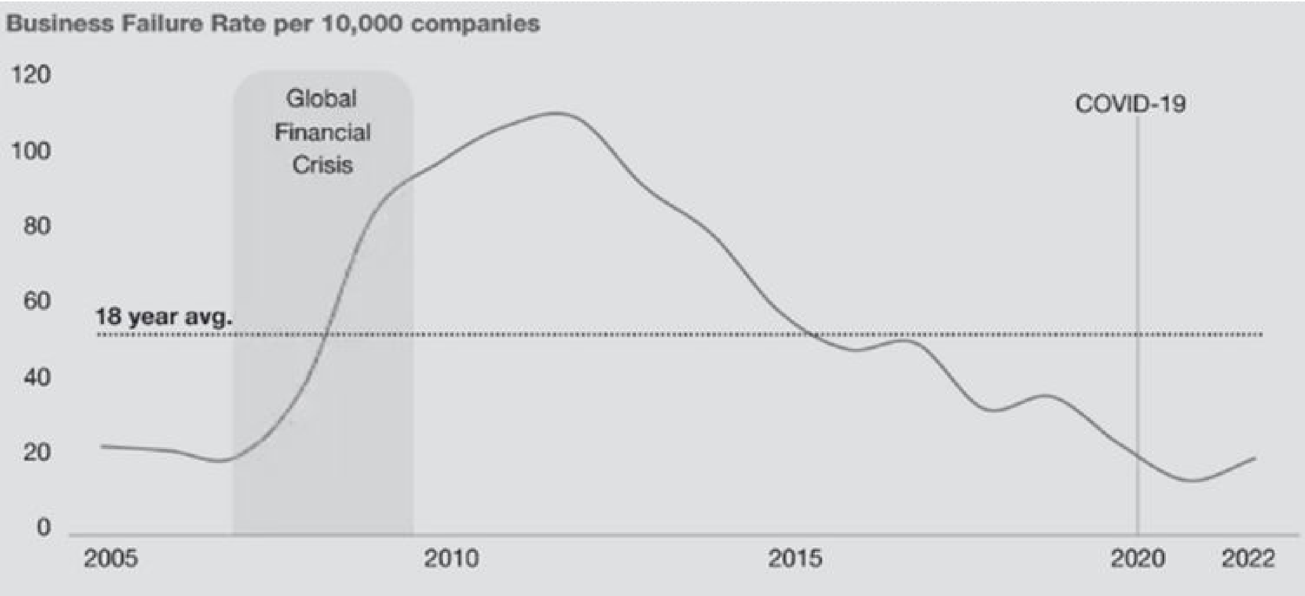
From a debt financing perspective, the pace and scale of interest rate rises have been a significant issue to manage. The sense is that we are nearing peak with possibly one more increase by the ECB, but the key question is when will rates start to fall.



Source: European Central Bank, Financial Times

Most affected are businesses that significantly levered during the 2021 M&A boom, business models that were still scaling and yet to reach a strong cash generation profile and businesses that had an inability to pass on increased costs due to customer price sensitivities/competitive landscape. Inflationary pressures and increased input costs (particularly those sensitive to energy and commodity price movements) also compounded the issue.

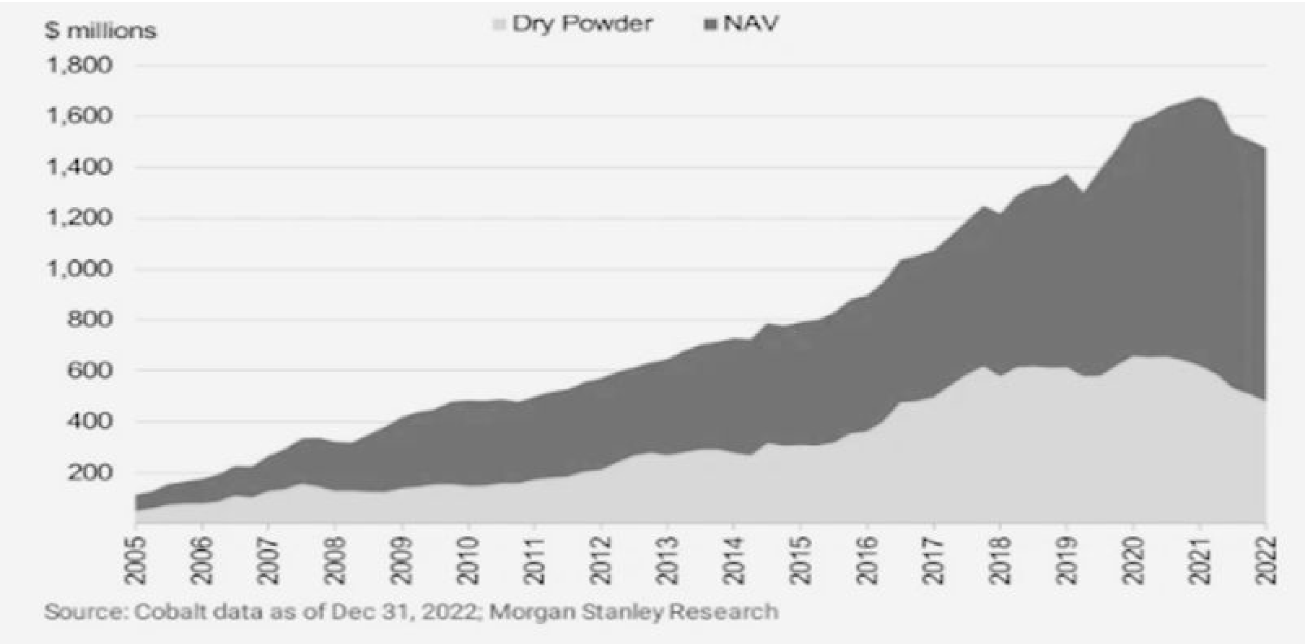
Corporate insolvency levels for Q3 2023 are 48% higher than Q3 2021, however, are down 16% from Q2 2023 and for 2022 are running at 18% of the 2012 peak. So despite challenges, corporates are still in good shape to date in the main.



Source: PwC January 2023

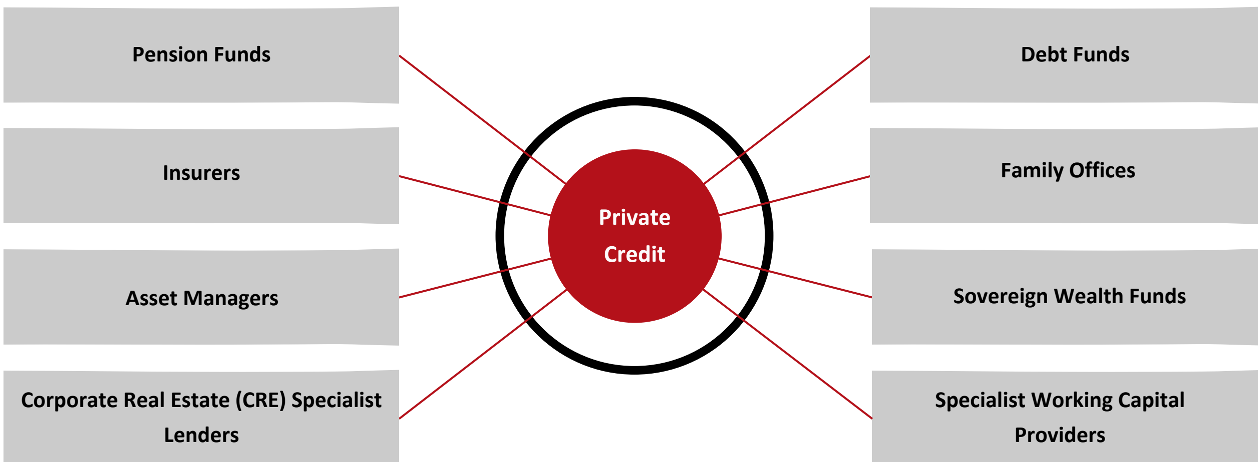
Private Credit Rises

The sources of debt capital have changed considerably over the last decade. The emergence of Private Credit (Non-Bank/Non-Public or 'Private Debt') has been a significant development and is estimated to be currently in the region of $1.5trn. Europe lags the US and accounts for only c$220bn, but is growing significantly.



Source: Cobalt data as Dec 31, 2022; Morgan Stanley Research

Sources of Private Credit include:



Of course, both domestic and international banks still play a very important role in financing, however, their appetite has been constrained largely for regulatory reasons. In July this year, we saw the US regulatory authorities announce increased capital reserve requirements, billed the 'Basel III end-game', which will likely translate into increased loan pricing and challenges when lending.

European banks have similar issues and are adapting business models accordingly favouring low capital-intensive products such as liquidity & cash management, wealth management and distribution of loans to 3rd parties. In fact, banks such as Barclays, Rabobank, SocGen and Deutsche Bank are reported to be considering expansion into Private Credit in conjunction with asset management businesses. (Source: Bloomberg)

Features of Private Credit

As illustrated, Private Credit can come from a diverse range of providers with varying degrees of risk appetite and terms. The following are some features when compared to traditional sources of capital:

Benefits:

Favourable risk appetite and debt quantum.

Structurally flexible providing greater covenant headroom, non-amortising structures, higher leverage and greater ability to pay dividends. Pension Funds/Insurers can consider long-tenor loans in excess of 15 years where the borrower's credit profile is strong.

Can provide a wider range of debt products across the capital stack i.e. senior, unitranche, mezzanine and debt with equity features. Can also take second lien and subordinate positions with other debt providers in situ.

Speed of execution and access to decision-makers.

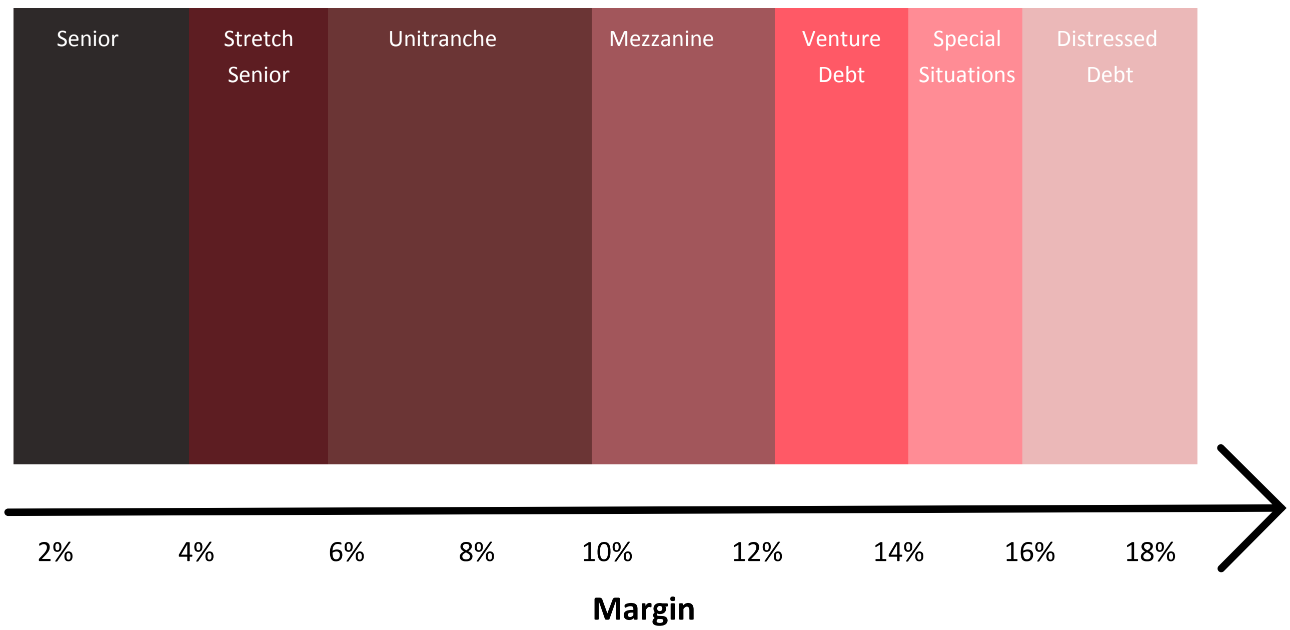
Additional Considerations:

Lenders will price to risk and may have minimum return hurdles to meet reflecting their funding position.

Early repayment of loans can come with exit fees or ‘make whole’ payments.

Some lenders may require enhanced monitoring depending on risk profile.

Pricing



Pricing will naturally vary depending on the risk profile of the client, transaction, sector, geography to name a few. Caution should be exercised when taking on debt to ensure that the business is generating sufficient liquidity and profitability to meet interest repayments. The right type of financing is also important to ensure it meets the objectives of the business, for example matching long-term capex programs with long term debt.

Conclusion

Rising interest rates, sticky inflation and regulatory pressures have made the process of raising debt more difficult. Sources of debt have become more varied and nuanced, in part due to the emergence of Private Credit and new players led by the US. Serious consideration should be given to what type of debt instruments a business takes on and whether appropriate from a number of perspectives in terms of structure, tenor, terms and pricing. Before seeking debt financing, time should be spent preparing a detailed business plan to ensure effective engagement with a prospective lender so that a complete picture of the business is presented. Finally, choosing the right lending partner is of critical importance so that interests are aligned.

If you are considering exploring the potential avenues to optimise debt structures or exploring debt opportunities tailored to align with your specific financial goals, please contact us for an initial conversation today.

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About FOCUS Capital Partners:

FOCUS Capital Partners offers a broad suite of corporate finance advisory and capital raising services, with a focus on Debt Funding, Equity Fundraising, Mergers & Acquisitions, Renewables & Infrastructure, and Tax. FOCUS has expanded into the United States by combining with Washington D.C.-based FOCUS Investment Banking to form FOCUS International, an international Investment Banking services platform. The transatlantic firm provides sell-side, buy-side, and capital raising services to companies in Ireland, United Kingdom and the United States. We are a highly committed, outcome focused team of professionals who bring to each project a powerful combination of technical and financial expertise, extensive commercial experience, strong networks, and an entrepreneurial mindset. We deliver value by working in partnership with our clients and prioritising their needs.

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