Breedon + 2 years: where are we now?
Current non-bank lending options for UK corporates

The Breedon review group reported in March 2012 (“Boosting Finance Options for Business”) on increasing the range of non bank lending options available to small and mid-sized UK corporates. This briefing considers whether, two years on, the non bank lending landscape has evolved to better serve the needs of UK corporates.

SPEED READ

• Developments in non-bank lending since the Breedon report have been evolutionary rather than revolutionary.

• Private placement markets, retail bond markets, and partnerships between banks and institutional investors have all gathered momentum in Europe over the past two years and are now a useful complement to traditional bank lending for corporates.

• The winding up of the Government’s Funding for Lending Scheme, recent changes to Solvency II, and initiatives to standardise documentation and processes in the European private placement markets, are likely to sustain this momentum in the medium term.

THE PLAYERS

Banks. Bank lending remains suppressed compared to historic volumes, as banks deleverage against a background of increased regulation and higher capital requirements, including under Basel III. Last year, according to European Central Bank data, net loan issuance to corporates in the Eurozone was negative for the second consecutive year.

The Government. Since the financial crisis, governments throughout Europe have recognised that the promotion of non-bank lending is a necessary complement to traditional bank finance. In March 2014, the European Commission announced that it is investigating the non bank lending market as a source of funding for long-term economic growth in the Eurozone.

Non-bank lenders. Non-bank funding sources include insurance companies, pension funds, asset managers, hedge funds, and sovereign wealth funds. These institutional investors have funds to deploy and are keen to seek yields in a low interest rate environment. This is reflected in both the development of direct investment products by institutional investors and their increased participation in the syndicated loan market. The same appetite for yield also exists for private investors, as seen in the enthusiastic take up of retail bonds.

SMEs. Evidence suggests that it is the small and medium sized companies (SMEs) which have felt the effects of the tightening of banks’ purse strings most acutely. Without ratings, they are unable to access the public bond markets. Whilst large corporates are also looking to diversify their funding sources, it is generally the SMEs who have the most to gain from improved access to the non-bank lending market.
NON-BANK LENDING PRODUCTS

Private placements
Private placements are privately placed debt instruments issued directly to institutional investors.

Product pros and cons
The private placement product offers corporates a number of benefits over bank and/or wholesale public bond debt, including:

• increasingly competitive pricing (often at a small premium to the public bond markets);

• longer tenors (banks currently prefer 3 to 5 year tenors, whilst private placement maturities are often upwards of 7 years);

• no public ratings requirements (unlike the wholesale bond market);

• investors are not looking for ancillary business, unlike banks; and

• flexible issuance size.

There are, however, some drawbacks, which any corporate contemplating a private placement should consider. These include:

• prepayment charges: in the bank market, debt (if it is floating rate) can usually be repaid at par on interest payment dates. In contrast, in many private placement markets a "make-whole" to maturity applies. The amount of the "make-whole" will depend, amongst other things, on the circumstances of the prepayment, but is invariably expensive, particularly in the context of falling interest rates; and

• less flexibility to effect amendments and waivers: the covenant package is usually substantially similar to the terms a corporate achieves with its banks. However, institutional investors, in some instances, may be less well equipped than banks to respond to amendment requests, making it important to achieve a covenant package on day one that will give the corporate the strategic flexibility it needs over the life of the debt.

It is also advisable for a corporate that has issued private placement debt to engage actively with its investors to develop an ongoing relationship. In the absence of ancillary business and/or frequent refinancing discussions, this can take greater effort to sustain than a bank relationship.

US private placements
These potential drawbacks have not deterred companies from issuing in the US private placement market. The benefits of the product have meant that, since as far back as the 1930s, private placements have been an important source of funding for companies in the United States. Consequently, the market in the United States is by far the most developed and the investors (some fifty plus US insurance companies and pension funds) have many years of experience of purchasing private placements, and have extensive and highly trained credit review functions. A handful of UK insurance companies also operate as investors in the US private placement market.

The debt is typically structured as notes, to avoid the higher capital charges that loans attract under the National Association of Insurance Commissioners’ (NAIC) risk-based capital rules. The debt is often given an NAIC Designation (either by the Securities Valuation Office of the NAIC or self-assigned by the insurance company if the
debt of the issuer is publicly rated). This is a regulatory requirement for insurance investors in the United States. NAIC ratings, together with the model form note purchase agreements produced by the American College of Investment Counsel, have undoubtedly been instrumental to the success of the market.

The US private placement market’s appeal is not restricted just to US borrowers. Lending to European borrowers has increased dramatically and now represents a sizeable proportion of the overall market. US$50 billion of debt was issued in the US private placement market in 2013, of which approximately one third was from European issuers. UK companies accounted for half of that European total. Traditionally, US investors targeted larger investment grade corporates, but the low interest rate environment has opened up the market to a broader spectrum of issuers. The increasing presence of European issuers has resulted in US investors becoming more accommodating of their needs, with transactions denominated in not just dollars, but also euros and/or sterling, and governed by English law.

One of the reasons that European, and in particular UK, corporates turn to the US private placement market, is that the European private placement markets are generally less developed or deep. However, recent years have seen significant progress in the well-established German market and a nascent French private placement market.

**German private placements**

The German *Schuldschein* market is the most established private placement market in Europe. Issuance in this market takes the form of a privately placed, unlisted, unregistered, floating or fixed loan instrument governed by German civil law (a *Schuldscheindarlehen*) for which a separate borrower’s note (*Schuldschein*) may be issued. Tenors are 3 to 10 years (but flexible), with 5 and 7 years currently standard. A public credit rating is not required.

Annual corporate issuance in the *Schuldschein* market for 2013 was €7.7 billion (down 45% from €14 billion in 2012), and 2014 got off to a relatively quiet start. However, since the financial crisis, there has been a marked increase in overall volumes and interest in the product from both issuers and investors. Indeed issuance peaked in 2008 (at around €18.9 billion) when the bond markets were closed following the collapse of Lehman Brothers.

Traditionally a source of long term capital for German Mittelstand companies, *Schuldschein* has become increasingly popular with non-German companies, across a range of sectors, who accounted for 38% of issuance last year. French companies in particular have increased their share of the *Schuldschein* market to an all time record, from 9% in 2012 to 14% in 2013. This was boosted by the issuance of the largest *Schuldschein* of the year: the €535 million issue by aerospace company Zodiac (the largest ever issue of a *Schuldschein* outside of Germany and Austria). Other non-German issuers in 2013 included Swiss retail company Valora, French seed producer Vilmorin & Cie, French cheesemaker Fromageries Bel, and sports equipment company Amer Sports of Finland. Whilst issues in Euro are most common, other currencies are possible, such as US Dollar, Pound Sterling and Swiss Francs.

Investors include banks, savings banks (Sparkassen) and co-operative banks (Volks- und Raiffeisenbanken), as well as an increasing number of insurance companies and (to a lesser extent) pension funds. Institutional investors took up around 12% of 2013 issuance. Whilst the majority of the investors are German, there is an increasing number of European and Asian investors. 60% of the Zodiac’s *Schuldschein* issuance was placed with investors outside of Germany.

Whilst there is no standard form, documentation is light and standardised. Many of the contractual provisions which are necessary under the laws of other jurisdictions do not need to be included in the documentation as they are part of the German civil code framework.
There has been a tendency in recent years to migrate structural elements and documentation standards from syndicated loans (for example, representations and warranties, covenants, events of default, conditions precedent). That said, there remain notable differences to the syndicated loan product, for example there is no “Majority Lender” concept and no concept of pro rata sharing between lenders.

**French private placements**

France’s private placement market has developed quickly over the last few years. Total issuance for 2013 was €3.9 billion, up from about €3.2 billion in 2012. French corporates who have issued in the last year include Ubisoft, Neopost, Sodexo and LISI Group. Whilst larger issuers represented 96% of the total volume in 2012, this was down to 84% of the total in 2013, suggesting that an increasing number of smaller issuers are entering the market. Deals are typically structured as French law governed listed bonds, although private placements in the form of unlisted loans have developed over the last few years. Although French companies and French institutional investors dominate, borrowers from outside of France are entering the market. Last year, Belgian real estate company Codic Group and Italian utility group Iren SpA both issued bonds in the market.

A charter of good practices (the Euro Private Placements Charter) has been developed by the Banque de France and the Chamber of Commerce and Industry of Paris with the aim of encouraging the development of a non-binding framework of best practice for the Euro private placement market. The Charter, published in February, includes guidelines for the negotiation of documentation, with a focus on issues such as confidentiality, information undertakings and ranking. It includes sample documents, including an information memorandum, a non-disclosure agreement, a set of terms and conditions for a bond form private placement, and a due diligence questionnaire.

**UK private placements**

There are a number of significant institutional investors, such as M&G Investments (the asset management arm of insurer Prudential) which have provided UK style private placement offerings to UK companies such as Barratt, Taylor Wimpey and Drax in recent years, but as the Breedon Report concluded, the UK does not have an established private placement market. In 2012, the Association of Corporate Treasurers (ACT) was asked to look into why the UK private placement market remained a nascent one. The ACT highlighted a number of issues which were holding the market back, including regulatory uncertainty; the absence of a rating system equivalent to US NAIC ratings; no standardised documentation or processes; lack of experience amongst UK corporates and institutions; pricing pressures; and the Government’s Funding for Lending Scheme (discussed further below).

Since the ACT report, whilst significant steps have not yet been taken to remove such barriers, there has, particularly in recent months, been increasing momentum behind developing a recognised market in the UK. Large insurers, such as Legal and General, have announced their intention to participate in the market and some of the uncertainty around the treatment of different debt products for insurers under Solvency II has been resolved (in particular, enhancements have been proposed to the capital advantages for insurers who are able to match liabilities to long term assets). In addition, UK market participants are integral members of several pan-European working group initiatives (including the Loan Market Association’s and the International Capital Markets Association’s working groups) which have been set up with the aim of facilitating further development and standardisation of a pan-European private placement market. It is hoped that with increasing focus from industry participants, political support for non-bank funding and greater regulatory certainty, there is now an impetus to create a more established private placement market for UK investors and issuers to participate in.

**Other forms of direct lending**

Direct lending from alternative lenders involves the direct provision of debt finance to corporate borrowers.
Long term returns, such as those to be found in the infrastructure and real estate sectors, are of particular appeal to institutional investors who in turn have long term liabilities. Earlier this year, six UK insurers recently announced their commitment to investing £25 billion in UK infrastructure by 2018.

Alternative debt providers are also playing an increasingly prominent role in acquisition debt products such as unitranche, mezzanine and high-yield. For example, in February, Barclays and BlueBay Asset Management announced their intention to provide unitranche debt (which combines senior and subordinated debt into a single debt instrument) in partnership for mid-market private equity deals.

There remains a long way to go before non-bank bilateral (or club) lending becomes as common place in Europe as it is in the US. At the moment, there are only a few institutional investors with an established private lending culture. However, the funds that are in the market provide significant opportunities for established corporates looking for longer term funding.

*Joint initiatives with banks*

Non-bank entities may choose to lend alongside banks (or other non-bank entities), sharing both risk and reward accordingly.

AXA’s mid-cap initiative is one illustration of this. AXA has entered into joint ventures with each of Société Générale, Crédit Agricole, Norges Bank, and Commerzbank, in order to provide mid-sized corporate loans both inside and outside France. A number of hedge funds have also been active in setting up mid-market direct lending platforms over the last 12 months.

The key advantage of these initiatives is the ability to leverage the partner’s client relationships, deal identification capabilities and credit expertise, together with the potential to learn from the partner and develop in-house expertise. It can facilitate investments in large-scale assets, where one party cannot meet the minimum investment requirement alone.

**Retail bonds**

In recent years two developments have made it easier for companies to issue bonds directly to retail investors in the UK. The first is the launch of the London Stock Exchange’s Order Book for Retail Bonds (ORB) for listed low denomination bonds aimed at retail investors. The second is the genesis of its unlisted cousin, the so-called “mini” bond.

Both listed and unlisted retail bonds, in addition to allowing access to an additional source of capital, also help raise an issuer’s profile among retail investors, and may therefore offer a marketing opportunity to issuers that are household names. Both listed retail bonds and unlisted mini-bonds also allow an issuer to raise smaller tranches from a broader investor base, whilst unlisted mini-bonds also allow greater flexibility on maturity and terms.

**Retail ORB**

The London Stock Exchange launched the ORB in 2010 in response to growing private investor demand for easier access to tradable bonds. The ORB now lists over one hundred corporate bonds, helping a number of SMEs to diversify their funding strategies by tapping into that demand. Whilst the wholesale bond market has been relatively cheap for those larger corporates who can access it, ORB has been keen to attract small and medium sized issuers.

Recent issues on ORB have ranged from £20 million to £300 million, with several issuers such as Tesco Personal Finance, International Personal Finance and Premier Oil returning to the market to capitalise upon the success of
their initial offerings. Certain institutions, including Numis, Canaccord Genuity and Barclays, have become frequent lead managers on ORB issues.

In 2013 issuance declined for a number of reasons. Market factors included expectations of increasing interest rates, the recovery of equities and the improved performance of the wholesale and institutional markets. On the regulatory side, amendments to the European prospectus regime under the PD Amending Directive resulted in increased disclosure requirements for retail bonds from July 2012. This, coupled with the drive to ensure “plain English” drafting in retail prospectuses from October 2013, has increased the time and cost of prospectus approval. The bank market has also been more liquid for shorter maturities than was the case at ORB’s launch.

Challenges for the ORB to resolve include pricing and timeline differentials with the wholesale markets, and how to attract both a wider range of issuers (issuers remain skewed for the most part towards the financial services and property sectors) and a wider investor base. On the positive side, as market practice consolidates, the approval process for retail prospectuses has started to become more certain, the ISA eligibility of certain retail bonds has become more attractive in the context of the recent increase in the ISA allowance, and the London Stock Exchange is seeking to support market makers in boosting liquidity and price transparency on the ORB.

**Mini bonds**

Another impact of the PD Amending Directive requirements for prospectuses has been the development of so called “mini” bonds, which are unlisted retail bonds.

Recent high profile issuers include John Lewis, Hotel Chocolat, Nuffield Health, and The Jockey Club. They are typically marketed by large well-known issuers with a strong brand and loyal following (for example retailers) looking to tap a loyal customer, client or employee base. Investors receive an attractive interest rate and/or other customer benefits (for example, vouchers and loyalty points). They can be as much a marketing opportunity as they are a funding exercise.

As mini-bonds are unlisted and non-transferable, they do not require the issuer to publish a prospectus or comply with ongoing disclosure requirements, which can make issuance both cost- and time- efficient. Mini-bonds are typically unrated, issued covenant-lite and may be subordinated to other issuer debt.

The lower regulation of mini-bonds, compared with those retail bonds listed on the ORB, does however remain an area of concern for many investors.

**Government initiatives**

The UK Government has launched a number of initiatives (such as the Business Finance Partnership, Business Bank, Infrastructure UK, and Green Investment Bank) aimed at encouraging private sector investment, from non traditional sources where appropriate, to SMEs. Conversely, other initiatives (in particular the Enterprise Finance Guarantee and Funding For Lending schemes), although a welcome development for borrowers in principle, have undermined the development of the non-bank lending market by stimulating cheaper liquidity from traditional bank sources. The unwinding of the Funding for Lending Scheme over the course of this year may prompt some corporates to revisit alternative sources of finance.

**Funding for Lending Scheme:** launched by The Bank of England and HM Treasury in July 2012, the scheme is designed to incentivise banks and building societies to boost lending to the UK real economy. It does this by providing funds to banks and building societies for an extended period, with both the price and quantity of funding provided linked to their lending performance. In April 2013, the scheme was extended by one year to allow participants to borrow from the scheme until January 2015, with incentives to increase lending skewed to SMEs.
The Enterprise Finance Guarantee Scheme: the scheme facilitates bank lending by providing lenders with a government-backed guarantee for 75 per cent. of the value of each individual loan, subject to a cap.

The Business Finance Partnership: aims to increase lending to SMEs from sources other than banks. It comprises two funding elements. The first invests in senior and mezzanine debt funds which lend to medium-sized businesses. The second invests in non-traditional lenders that provide an alternative source of lending for small businesses (including, for example, peer-to-peer lending and online receivables platforms). The Business Finance Partnership invests in lenders on fully commercial terms, matched with at least an equal amount from private sector investors. It will be transferred to the Business Bank in due course.

The Business Bank: a new institution intended to address the insufficient supply of debt finance available to SMEs. The bank will not fund companies directly, but will work in partnership with other financial institutions to leverage private capital (for example, by offering lenders low cost funding and/or guarantees). It is due to become fully operational by Autumn 2014 following EU state aid approval. The Enterprise Finance Guarantee scheme, the Business Finance Partnership and the Start Up Loans programme will be transferred to the Business Bank in due course. In February this year, the Business Bank announced a new £40 million investment to be made through peer-to-peer lender Funding Circle, an online marketplace for business loans enabling direct loans to be made to small businesses.

Infrastructure UK: a unit within HM Treasury that works on the UK’s long-term infrastructure priorities and provides credit support for private sector investment. At the end of last year, the Government announced a new national infrastructure plan containing information on over £375 billion of planned public and private sector infrastructure investment up to 2030 and beyond.

The Green Investment Bank (GIB): established in response to specific financing challenges affecting green infrastructure projects. It became fully operational in October 2012 when it was granted State Aid approval by the European Commission. GIB aims to accelerate the UK’s transition to a green economy by investing alongside private sector finance in projects which are both green (i.e. meet GIB’s sustainability criteria) and commercial (providing a financial return), the so-called “double bottom line”.

COMMENT

The two years since the Breedon report have been evolutionary rather than revolutionary, at least in the UK. Although some progress has been made towards a domestic UK private placement market, it has been with small steps and the pace of development contrasts unfavourably with that in jurisdictions such as France.

That said, a steady proliferation of various forms of corporate borrowing from non-bank institutional lenders is observable. The private placement market has seen the entrance of a growing number of UK issuers and investors, and there is increased momentum to standardise documentation and processes in European private placements. The retail bond market, both listed and unlisted, has survived some significant threats at a critical time in its development and is positioned for further growth. Attempts have been made to redress the lack of credit information on SMEs available to non-bank investors, including the use of funding platforms and development of market tools such as Standard & Poor’s mid-market evaluation scale.

There does however remain some way to go. The loan markets have remained competitive as demand for deals outstrips supply, and Government-subsidised funding programmes to encourage bank lending, in particular the Funding for Lending Scheme, have inhibited the further development of alternative markets to some extent. The
expiry of the Funding for Lending Scheme, the increasing cost of capital as banks move to full compliance with Basel III, and recent amendments to Solvency II, all suggest that non-bank lenders will over the medium term become an increasingly important source of corporate debt finance.

*Slaughter and May has a breadth of experience in advising clients on debt financings extended by non-bank lenders, including note issuances into the US private placement market, loans from insurance companies and other institutional investors, Schuldschein, retail bond issues and other alternative sources of debt financing.*

*We have also advised the Department for Business, Innovation and Skills on the establishment of both the British Business Bank and the UK Green Investment Bank, and HM Treasury on establishing the Business Finance Partnership.*

*The Firm is a member of ICMA’s Pan European Private Placement Working Group, set up to propose standard market practice and a framework for the documentation of private placements on a pan-European basis.*