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DEBT FOR DEALS

BEST-PRACTICE GUIDELINE 67

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In this guideline, we have segmented the debt market as follows: 1) Public company and large cross-over transactions; 2) Large leveraged finance; 3) Mid- to lower mid-market leverage finance; 4) Mid- to lower mid-market 'sponsorless' transactions; 5) Specialist sectors including asset based lending, specialty finance, development finance and venture debt.

For the purposes of this guideline, we have used the following thresholds to define market segments: 1) Large market – enterprise value greater than £500m / debt requirement in excess of £250m; 2) Mid-market – enterprise value of £100m to £500m / debt requirement of £50m – £250m; 3) Lower mid-market – enterprise value of £10m to £100m / debt requirement of £5m – £50m; 4) SME – enterprise value of less than £10m / debt requirement of up to £5m.

Foreword

Welcome to *Debt for deals*. This guideline, which outlines the main features of the UK's debt market, explores how it has developed since the start of the financial crisis in 2008 and offers guidance to corporate finance advisers and executives of companies on how to access the right kind of debt finance for deals and to help a business grow.

Debt is a fundamental element of most corporate finance transactions and a lynchpin for economic growth. Lending provides funding for investment in business expansion and innovation, which indirectly leads to employment creation and therefore increased demand. It is a vital part of the financing landscape that, in response to regulatory change and market forces, has developed considerably over the past ten years in the UK and other G7 economies.

The most significant change over that period has been the increased diversity of lending sources. New entrants in the banking market and the private debt space and the development of new technologies that enable smaller players to lend to business, including peer-to-peer lenders, have led to a dynamic market. This change has led to a more fragmented landscape than was the case before 2008, offering borrowers a greater variety, if not greater number, of lending options.

Yet even with this expanded universe of providers, some companies still find it a challenge raising debt finance. This guideline aims to help advisers and businesses tap into the market, by exploring how these changes affect the availability of debt and the terms on which borrowers can access it, while also outlining many of the areas that borrowers should consider when looking at raising debt to fund their deals. With greater understanding comes the ability to realise greater potential through debt finance.

Of course, reading this guideline and contacting lenders directly is only part of the story. The UK's highly skilled corporate finance and debt advisory community, from those in the large professional services firms through to smaller, independent firms, are well equipped to assist and guide ambitious companies through the process of raising debt. Legal advisers also play a highly important role in ensuring the terms agreed with lenders are appropriate for a company's needs, both now and in the future.

I would like to thank Clydesdale and Yorkshire Banks for the insightful commentary produced for the Corporate Finance Faculty. As with all the guidelines commissioned and produced by the Faculty, the contents of this publication have also been peer reviewed by our Technical Committee, which includes representatives from each of the UK's major professional services firms.

I hope you find this guideline useful and informative.

David Petrie
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1. Introduction

Debt finance is an important means of fuelling business expansion and a competitive lending market is central to economic growth. With a lower cost of capital than, for example, equity finance, it can provide cost-effective funding for acquisitions, management buy-outs, expansion into new product or geographic areas, the development of new projects or facilities, dividend recapitalisations, and even the acquisition of positions from shareholders seeking to realise their investment.

This guideline describes the debt market in the UK and highlights significant changes since the global financial crisis of 2008-2012. It also sets out the principal flows involved in the application and lending decision process.

Debt can be used in addition to equity (for example, in a private equity-sponsored management buy-out) and can now be sourced from a wide variety of different types of lender. Each of these lenders will have different risk appetites and return objectives so that, in today's market, the vast majority of businesses should be able to source debt finance that is suited to their requirements and appropriate for their future strategy.

Indeed, the years since the financial crisis have seen the debt financing market undergo something of a revolution. Where once leveraged finance and debt for deals more generally were largely advanced by a small group of banks, today's CFOs have an array of choices to consider when raising debt funding. In the UK and other G7 economies, these range from traditional banks and, increasingly, challenger banks, through to rising numbers of private debt and direct lending funds, specialist and FinTech lenders and other peer-to-peer platforms.

These changes have been driven partly by greater regulation for banks aimed at financial stability and increased requirements for capital adequacy in banking organisations. This has led to many traditional lending institutions scaling back some of their lending, trimming their loan portfolios and taking a more cautious stance on loans perceived to be at the riskier end of the spectrum. At the same time, the regulatory framework has encouraged the development of challenger banks and alternative sources of finance, such as funds and FinTech lenders.

The UK now benefits from a diverse lending ecosystem, which has, over recent years, been boosted by investors' quest for yield in a low interest rate environment. Europe-focused private debt funds (which include direct lending funds) raised a record $33.1bn in 2017, up from $22bn in 2016. The UK accounts for the largest proportion of investment by these funds, with a 39% share of activity by number of deals in the mid-market between 2012 and 2017 (followed by France with 25%). In addition, the number of challenger banks has increased rapidly – over 50 institutions were granted a banking licence in the UK between 2008 and 2017 – while the annual volume of peer-to-peer business lending in the UK rose by just over 50% in 2017.

Bank lending has generally been the most significant source of debt finance for businesses in the UK and for European SMEs, but the diversity of sources in the market today means that companies have more options than ever before when raising capital to fund deals. In many ways, this makes it easier for businesses to find the right finance that offers the flexibility they need to continue growing and to service their day-to-day capital requirements. Yet it also means that company executives and corporate finance advisers need to keep an eye on how the market is developing to ensure they secure the best available funding package for their deals and remain competitive.

2. Key trends in UK banking terms

The highly competitive nature of today's financing landscape has inevitably led to a shift in the terms on which borrowers can secure debt funding. With rapid growth among challenger banks and the development of private debt funds and FinTech lenders, plus the prolonged low interest rate environment, many UK businesses have been able to benefit from what has become a borrower's market in certain parts of the debt landscape over the last few years.

Another key trend affecting the debt markets is the weight of equity capital in the UK. Private equity funds based in the UK and Ireland raised around €47bn annually in both 2016 and 2017, much higher than the €23bn raised in 2015. With so much equity capital to be deployed over the next four to five years – much of it in the UK – returns for debt providers are likely to be lower, with terms remaining in borrowers' favour.

Returns are likely to be lower because equity providers usually need to invest their funds within a specified timeframe. As a result, they may be more inclined to invest more equity into a business than they would otherwise have done had they raised smaller funds, or invested more through quasi-debt structures, such as loan notes. This has the potential to reduce the quantum of the finance gap that debt has traditionally filled. However, debt will remain an important component of the deal funding landscape as it helps to boost equity investor returns, a key measure for any equity provider.

The increased use of debt advisory services by businesses has added to the competitive nature of the market. Previously, debt advisers might only have been brought in on large transactions backed by private equity sponsors. However, the years since the financial crisis have seen a marked growth in many medium-sized and larger businesses employing the services of these advisers when securing debt finance. This phenomenon has also led to many of the lending terms that in the past were reserved for larger credits filtering through to the middle market. Nevertheless, terms do vary according to business size and ownership type; for example, private equity-sponsored versus private and publicly-listed companies.

LARGE MARKET: LARGE COMPANIES AND CORPORATES

This part of the market (enterprise value > £500m; debt requirement > £250m) can be split into three distinct categories: public limited company (plc) lending; cross-over lending; and large leveraged lending.

The large leveraged lending space is setting the tone for the rest of the market. This finance is agreed for private equity sponsor-backed deals, where debt advisory services are most used and where sponsors are well versed in negotiating leverage finance documents. Such a scenario enables sponsors to take full advantage of what has become a highly liquid debt market over recent years.

Public companies (largely investment grade with low leverage multiples that more usually tap capital markets for deal funding) and the cross-over market (ie, no private-equity sponsor but at higher leverage approaching 4x, or a sponsor-backed transaction at a lower leverage of approximately 3x), are also benefiting from some of the terms below when raising debt for deals.

USING A DEBT ADVISER

A deal's success relies on strong, long-term and collaborative relationships between key stakeholders, including the debt provider. If using a debt adviser, borrowers need to ensure they are fully involved in the lender selection process and select lenders who not only provide the best terms, but who will also be supportive throughout the life of the deal, including during more testing times. A debt adviser can help with this selection process, and update management on the flexibility shown by each lender through the debt raising process and the lenders' flexibility on previous deals.

Many corporate finance advisers and debt advisory firms now have specialist teams organised by sector, deal type or company stage, which means they have a good understanding of their target market's risks and opportunities. This can be helpful in securing a debt facility that is best suited to a borrower's needs.

Large leveraged lending shifting terms
The shift in lending terms across the market has been driven by debt packages agreed in larger leveraged lending situations (ie, for large business backed by private equity sponsors). There is a high level of competition in this part of the market. Banks, private debt funds, collateralised loan obligation (CLO) vehicles and, in some instances, direct lending from large institutional investors, such as insurance companies and pension funds, are all vying to provide leveraged loans to large, private equity-backed businesses. With so much competition and high liquidity in this part of the market, terms are often driven by borrowers and sponsors rather than the lenders, with debt advisers pushing for increasingly flexible debt packages for their clients' benefit. Many of the terms we now see in the larger UK leveraged lending space are historically features of the high yield bond market and of the US leveraged space, with greater convergence between the two forms of finance and geographic markets when it comes to documentation.

Cov-lite now the norm
One of the biggest trends since the financial crisis has been the increasing prevalence in the large leveraged lending space of cov-lite loans. These made up 86% of new institutional loans issued in Europe in the first half of 2018, up from just over 8% in 2007. While these packages do not feature traditional maintenance covenants (which are tested at regular intervals), they can still have springing revolving credit facility (RCF) covenants and incurrence covenants attached. Looser terms mean that lenders do not have the quick access to control they would have previously had in these scenarios. In exchange, lenders have the liquidity that larger deals and broader syndicates should provide.

Increased leverage multiples
Competition has also led to a trend towards increased leverage, though not to the levels seen just before the crisis. Leverage multiples have been influenced in part by US and European leveraged lending guidelines issued since the crisis, which recommend that leverage is capped at a maximum of 6x EBITDA. While not binding, these guidelines serve as a brake on the market, with prudent lenders and sponsors continuing to observe the cap even in the face of increased asset prices.

Pricing, maturity and other features
Most larger leveraged loans today have little amortisation and are mainly bullet packages, with repayment loaded towards the end of the loan tenor (typically between five and seven years). Pricing has reduced since the years following the crisis (although still higher than pre-crisis levels) as a result of the prolonged low interest rate environment and competition. However, pricing is usually higher when advanced by funds along with higher leverage multiples and greater structural flexibility. Amend and extend features are now commonplace, allowing borrowers to extend the maturity of their loans before repayment. Most borrowers are also seeking committed acquisition facilities and uncommitted accordion facilities to gain confidence that they can raise finance in the event of an acquisition. This is particularly prevalent in today's fast-paced and highly competitive M&A environment in which buyers must move swiftly to secure deals.

LOWER AND MID-MARKET SPONSORED DEALS

Mid-market private equity-sponsored deals with a £50m-£250m debt requirement will now often feature the involvement of debt advisers. This is largely because of the vastly increased choice of debt providers, achievable terms and liquidity in the market. It is also, to a degree, the result of many larger private equity houses, which have historically been the largest users of debt advisory services, dipping down into mid-market deals to execute buy and build strategies.

Mid-market terms
The involvement of advisers is leading to a number of the terms from the large leveraged lending space filtering through to the mid-market. Key among these are the trends towards bullet repayment as opposed to largely amortising debt, a move away from covenants towards more cov-loose (and in some cases cov-lite) documentation, and often, lower pricing than has historically been the case. The covenant typically agreed in cov-loose deals is leverage. The average leverage being deployed in this part of the market is around 3.0 – 4.0x sustainable EBITDA, although this can, and should, vary according to the size and stage of development of the company. There is also a move towards negotiating accordion facilities, similar to the large leveraged space.

COMMON TERMS IN LOAN DOCUMENTATION

Acceleration (and enforcement). This term is designed to protect lenders in the event of a default and brings forward (or accelerates) the repayment date. Under this term, a lender can enforce its security, including through the sale of assets secured for the loan, to recover the full balance of debt owed.

Accordion (also known as an **incremental facility).** Allows a borrower to add a new term loan or expand a credit line, increasing its debt commitment, without the need to undertake a lengthy amendment and/or consent process with existing lenders. This can be helpful for borrowers if they are seeking to expand through M&A deals. It should be noted that, while this facility is an agreement in principle to provide funding, lenders are not obliged to do so.

Amend and extend. This is a feature where a CFO will approach their banking group well ahead of the facilities expiring and seek to extend the tenor to match the originally agreed period. This is with the intention of locking in the pricing at that time as well as potentially amending any other bank agreement clauses.

Assignment. This clause allows the assignment or transfer of a lender's rights under the loan agreement to a new lender (or assignee). Borrowers can impose restrictions on assignment to allow them to have more control over the composition of the debt syndicate.

Basket. Usually expressed as an amount, a basket is a carve-out to a restriction under the loan agreement. It can offer the borrower operational flexibility and avoids hair-triggering undertakings in the loan agreement.

Clean-up period. This is a timeframe in which a borrower acquiring a business or businesses can remedy issues that arise within the acquired entity (or entities) on acquisitions that breach the leverage finance agreement. This is often used when companies are acquiring a public company or when only limited due diligence on the target(s) can be undertaken, or when security is being taken.

Cov-lite. An abbreviation of covenant-lite, this refers to a loan facility issued to borrowers with fewer restrictions on collateral, payment terms and level of income. These facilities typically have no maintenance covenants (which are tested at regular, pre-determined dates), but do feature incurrence covenants.

Cov-loose. A loan facility issued to borrowers featuring only one to two covenants.

EBITDA cure. This is an extension of the equity cure term (which allows an injection of capital to repair a breach of a financial covenant and increase cash flow). Under an EBITDA cure, borrowers can apply an equity cure to increase EBITDA as a means of remedying a breach of the leverage ratio, as opposed to reducing the debt, and therefore get a leveraged benefit from the equity cure.

Equalisation. A mechanism that ensures equal loss-sharing across a pool of (usually) senior creditors.

Incurrence covenants. These are covenants tested only when the borrower takes a specific and voluntary action, such as incurring additional debt or selling an asset (which would have an impact on leverage ratios).

Revolving credit facility. A line of credit agreed between a lender and a borrower that a business can use when needed, often for operating purposes. The amount drawn can fluctuate each month according to the borrower's cash flow needs.

Springing covenant. This is a covenant that becomes effective on the occurrence of a certain event in the future. This effectively creates less onerous loan agreements as it replaces ongoing covenant tests.

Development of unitranche

Another key feature of this part of the market is the emergence of unitranche debt as private debt funds have developed. This is a hybrid loan structure that combines senior and subordinated debt in a single package from either a group of lenders or, in some cases, a single loan provider. The borrower pays a blended rate on the loan (blended senior and junior rate) and these facilities are commonly accompanied by a super-senior RCF from a commercial bank (see box-out on this page).

Unitranche is often agreed on many of the same terms as above (ie, cov-loose, bullet repayment, and five to seven-year maturity) and has the benefit of eliminating syndication risk and the need to negotiate on multiple documents. In many cases, lenders will require only a leverage financial covenant and can provide greater leverage than banks will typically provide. Nevertheless, borrowers pay for this convenience and flexibility through higher margins and stronger non-call or early pre-payment protections for lenders in the first one or two years.

Lower vs mid-market

The lower mid-market is widely recognised as meaning lending of between £5m and £50m for transactions. Debt provided by commercial banks above this range is likely to be arranged through club deals (where banks work together to provide a portion of the debt facility each). Alternatively, debt funds can often provide most or all of a facility, with an RCF provided by a bank, or club of banks.

Many deals in the UK's mid-market include higher leverage ratios and features such as accordion facilities and this can make it more difficult to fine-tune the margin pricing of loans. These deals are often subject to strong competition to provide leveraged finance, which can lead to lenders being brought in at a later stage of the deal process.

By contrast, the lower mid-market will tend to be less competitive. These smaller deals are often run from the closest regional hub to the borrower, which can be helpful for borrowers to form stronger relationships with local advisers and funders, and to negotiate more tailored terms.

AGREEMENTS BETWEEN ABL/SSRCF AND UNITRANCHE

Unitranche facilities supplemented by a super-senior RCF (SSRCF) have become a core feature of mid-market transactions. There is also a trend towards supplementing unitranche with asset-backed lending (ABL). Below are some of the agreement features.

SSRCF

SSRCF facilities tend to rank equally with other senior debt in terms of security, but SSRCF lenders will be paid in priority to the other lenders from the proceeds of enforcement. Unitranche lenders generally have control of the timing and method of enforcement.

ABL

Unitranche, supplemented by an asset-backed facility, is beginning to appear in the marketplace, but relatively few of these deals have been done to date. As such, there is no 'market norm' as yet, but below are some of the common features of the UK market:

- ABL intercreditor agreements can have a split collateral structure, under which the ABL lender and term lender each take first fixed security over different pools of assets.
- It is also possible for ABL lenders to share security with unitranche lenders, for example under a first out/last out structure.
- ABL intercreditor terms tend to be more complex than with an SSRCF. In the event of default, ABL lenders expect to stop funding and collect on those assets already funded, which creates a cash flow problem for the company.
- The problem above may be aided by a standstill, which prevents subordinated lenders from taking enforcement actions. However, standstill terms continue to vary on a deal by deal basis.

LOWER AND MID-MARKET 'SPONSORLESS' AND SME DEALS

Debt advisers are currently less frequently used in this part of the market, although a small number of debt advisers have established teams focusing on the sponsorless market. A number of the larger banks, with a heavy focus on returns and risk-weighted assets, are also more reticent to lend to these types of business: they may have lower hold thresholds or may decline even high quality credits if they do not meet a hurdle return.

As a result, newer players and challenger banks have been looking to enter this part of the market over recent years. And, while most debt funds tend to focus on the larger and/or private equity-sponsored deals, a handful of private debt funds that either target the sponsorless market specifically, or that can lend to businesses not backed by private equity under certain circumstances, has emerged. In the year to the end of March 2018, 15% of the volume of UK direct lending deals were sponsorless transactions. However, to date, most of the lending continues to be advanced by banks, whether the larger, more established institutions or challenger banks.

While some of the terms from the large leveraged space are filtering through to sponsorless packages (such as amend and extend agreements, fewer covenants and, to some degree, accordion facilities), most key terms, such as the amortisation profile and leverage multiples, will tend to be markedly more conservative than in other areas of leveraged finance. In fact, most terms will be specific to the transaction and so there remains little homogeneity in this market.

IN SUMMARY

The high liquidity and low interest rate environment has created a debt market in the UK that is more borrower-friendly on the whole. Specifically, terms have loosened in the years since the financial crisis, pricing has fallen and the number of lenders has increased, offering companies significant choice when it comes to arranging debt for deals. Still, there remain some notable differences between each of the debt market sub-sectors.

Many of the other terms we see today, such as cov-lite, cov-loose and bullet repayment, may have longevity should the diversity of options now available in the debt market remain. However, such competitive tension is likely to reverse if the number of participants were to reduce significantly, either because of a contraction in credit or sustained market consolidation. In addition, at some point, interest rates will most likely rise, leading to increased costs of debt funding in the future.

LENDING TERMS AVAILABILITY HEAT CHART

	Public companies and cross-over (debt >£250m)	**Large leveraged lending (debt >£250m)**	**Mid- to lower mid-market sponsored (debt £10m-£250m)**	**Mid- to lower mid market - sponsorless and SMEs (debt up to £250m)**
Cov-lite	Medium	High	Medium to low	Low
Cov-loose	Medium	Low	Medium	Low
Accordion facilities	Medium to low	High	Medium	Low
Amend & extend	Medium to low	High	Medium	Low
Low pricing	High	High	Medium	Low
High leverage multiples	Medium to low	High	Medium	Low

Key (incidence/availability): High | Medium | Medium to low | Low

NB: This chart shows terms that are generally available to these types of business from lenders. However, terms may vary according to the business and lender.

SPONSORED VS SPONSORLESS DEALS

Private equity investment in the UK is among the most active and sophisticated in the world, offering businesses the opportunity to raise capital and undergo change through management buyouts and expand using growth capital. These are some of the key distinctions between deals backed by sponsors and those raising capital without private equity backing.

SPONSORED	SPONSORLESS
Exit within a specified timeframe, usually 3-5 years.	N/A
Plan usually involves professionalisation and upgrade of company systems, reporting, and close monitoring of key performance indicators (KPIs).	Less focus on professional reporting systems, fewer KPIs that are less routinely monitored.
Will conduct thorough due diligence ahead of investment, often including all or some of the following: commercial, financial, legal, IP, technology and environmental. This can be burdensome, but it can also provide insight to management on new courses of action/strategies.	Due diligence requirements will vary significantly from deal to deal. To the extent that it is undertaken, it will typically focus on specific areas, such as ensuring that financial information is robust and that the projections are credible.
Sponsors may bring sector expertise to an investment, which can provide considerable benefit in strategy identification and contact introduction.	N/A
Sponsors will put in place non-executive directors, some of which will be from the private equity house. They usually also appoint a non-executive chairperson.	Composition of boards remains under the company's control.
Debt packages often highly competitive – lenders appreciate the financial rigour brought to companies by private equity owners and their terms reflect the fact that sponsors can provide follow-on equity in the event of underperformance.	Less competition among lenders in the sponsorless space and less comfort for lenders without an equity cushion in the event of underperformance can make raising debt capital more challenging.
Risk of over-leverage. Sponsored companies tend to have higher leverage multiples than average.	Lower leverage multiples may make it easier for companies not backed by private equity to service debt in the event of a downturn.
Risk of management change in the event of underperformance or a change in market conditions.	Management teams more likely to remain stable during unforeseen events.

TYPICAL DEBT FINANCING PACKAGE FEATURES

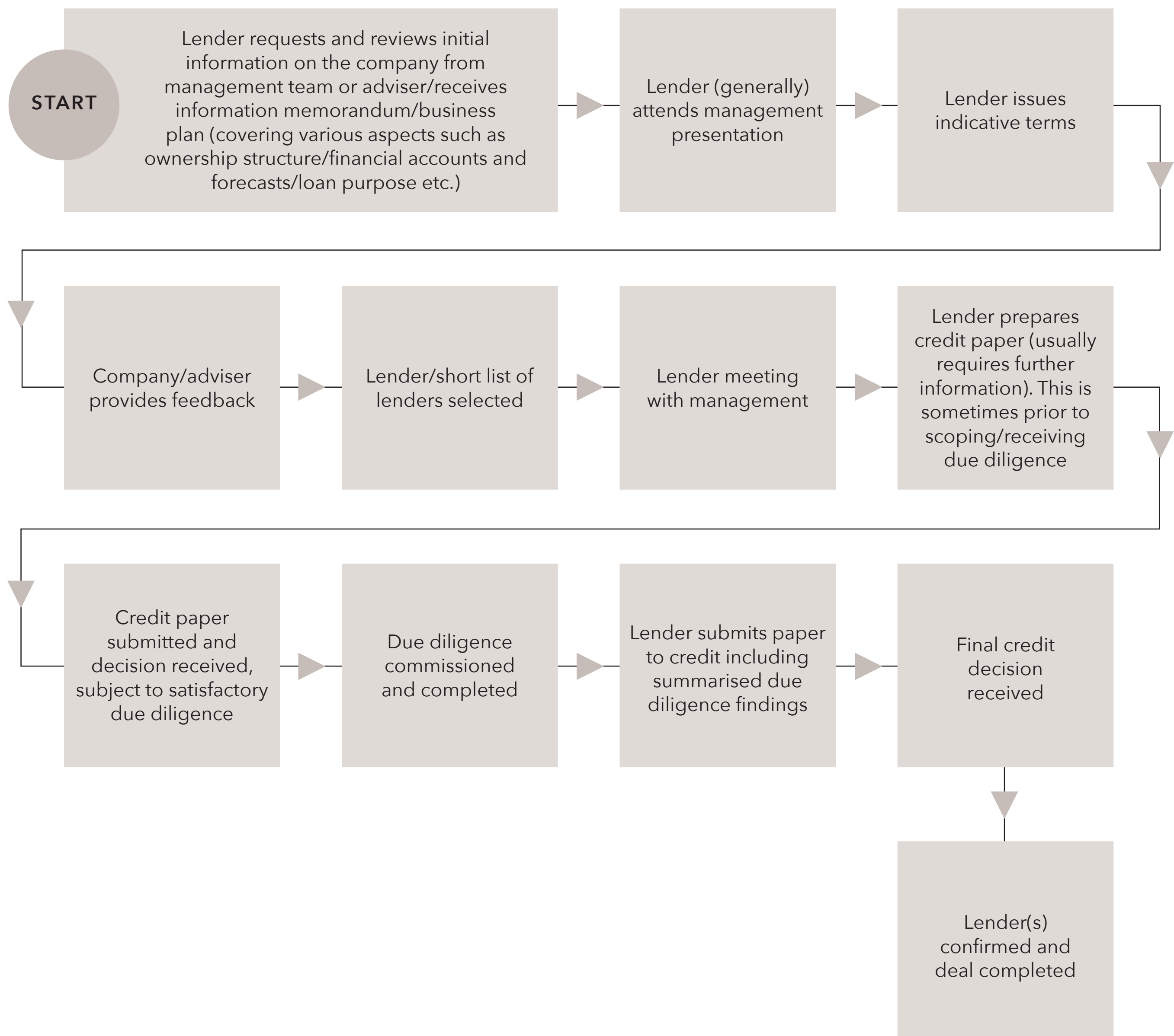
The following provides a simplified overview of the market. Not all debt packages will fall into these groupings and the features are illustrative for comparison purposes.

	TERM DEBT (BANK)	ABL** + TERM (BANK/FUND)	SENIOR & JUNIOR DEBT (BANK & FUND)	UNITRANCHE (FUND)
Structure	TLA and TLB*	Receivables or stock Term debt	TLA/TLB Junior/PIK	Unitranche term loan
Amortisation	TLA: Amortising TLB: Bullet	ABL: Nil Term debt: Amortising/ bullet	Amortisation in TLA tranche	No amortisation
Covenants typically attached	Debt service cover Interest cover Net leverage	Fixed cover charge or debt service cover Interest cover Net leverage	Debt service cover Interest cover Net leverage	Debt service cover Interest cover
Advantages	Lower cost of capital No prepayment costs Leaves headroom for future debt requirements Develops strong relationships with lenders	Lowest cost of capital Simple to execute No prepayment costs Facility can be sized to allow financing to grow in line with assets	Prepayment costs on junior only Develops strong relationships with lenders Option for PIK interest to retain cash in the business	Higher leverage than banks More flex on terms than traditional senior lenders Minimal or no amortisation Maximum covenant headroom
Disadvantages	Lower leverage Typically some amortisation, although all-TLB structures now available More restrictive documentation Minimum covenant headroom	Greater operational reporting requirements (to ABL provider) Financing availability can fluctuate	Maintenance covenants still required Less headroom for future funding requirements Some amortisation likely Intercreditor agreement required (see box-out, page 9) More expensive cost of funding	Pre-payment costs in first 2-3 years Bank still required for SSRCF Some maintenance covenants likely More expensive cost of funding Early repayment protection required in first 1-2 years

*TLA = term loan A, which is amortising and shorter duration TLB = term loan B, bullet repayment and longer duration
** ABL = asset-based lending (see chapter 4 for more information) Adapted from the original source (EY)

TYPICAL LOAN APPLICATION PROCESS

The following is a general outline of the process borrowers can expect when seeking debt funding. While it provides a helpful guide to many of the steps involved; in practice, the process for different types of lending and different institutions can vary.



3. Challenger or challenging?

The post-crisis era has seen a structural shift in the debt markets, driven by regulatory and government initiatives and technological innovation. New entrants are disrupting the prior status quo and creating greater competition among funders. This is good news for companies in the UK seeking funding to engage in M&A, refinance, fund buy-outs and grow their business.

REGULATORY SUPPORT

The UK's debt space is a highly dynamic market that is still evolving, particularly in the small and medium-sized enterprise (SME) space. One of the main drivers has been a regulatory framework designed to increase competition in the UK banking sector following the consolidation that took place in response to the effects of the 2008 financial crisis. Lending to SMEs has been a key element of this effort by the government and regulators, as this was previously highly concentrated among a small handful of large banks. The alternative remedies package, which emerged from the government-backed restructuring of Royal Bank of Scotland, is designed to further facilitate the creation of competition for SME lending through the provision of grants for eligible institutions to encourage customers to switch and to develop new services and products for business customers.

TECHNOLOGY-DRIVEN DISRUPTION

The other key driver has been the development of new technologies that are now being deployed in the FinTech space. These include crowdfunding platforms and other peer-to-peer lending, but also start-ups seeking to reach new customers through online platforms and, to some degree, automate the credit decision process. These tend to operate at the smaller end of the market, offering niche products and services.

PRIVATE DEBT FUNDS RISING

At the same time, private debt funds have become an increasingly important part of the funding landscape. Most funds focus on providing debt to private equity-backed companies, but also increasingly, to sponsorless transactions given the competitive environment for private equity deals. In 2016, there were 133 UK-based private debt firms. These include some established US and UK players that have raised increasingly large funds, institutional investors with direct lending capability, private equity firms that have established private debt arms as well as new independent entrants. These players have been able to target gaps in the market as some of the larger banks retrenched post-crisis. They have also benefited from increased appetite among institutional investors for private credit strategies; globally, private debt funds raised a record $107bn in 2017.

WHERE NEXT?

As a result of these trends, competition in the UK currently falls into four main camps:

- existing banks challenging the big five lenders (Royal Bank of Scotland, HSBC, Lloyds Banking Group, Barclays and Santander);
- new banks established since the financial crisis;
- private debt funds; and
- emerging lenders, including FinTech players such as Funding Circle, that specialise in smaller, niche products enabled by new technologies.

While the big five banks have, for the most part, maintained their market share in the large business space, challengers are increasingly vying for private equity-backed leveraged loans and SME business, which accounts for the majority of commercial loans by number.

As is often the case in markets where there is disruption, the aforementioned four groups of challengers are likely to shift over time. Banks and funds will generally continue to fall into two camps, although there are some strategic alliances between the two that have developed over the last few years. Some funds have joined forces with banks to gain access to their distribution and origination capability. The banks involved see benefit, for their part, in providing ancillary

services to borrowers or offering to provide part of the senior debt package with the majority of debt provided by the partner fund.

Within the challenger banks, there will also continue to be full-service providers targeting all areas of SME finance needs, including clearing and other ancillary services, while others (most likely the new entrants) will be more niche players specialising in certain parts of the SME lending space, particularly at the smaller end of the market.

Yet, in the area of the technology-enabled specialists, there could well be a material shift. Banks are increasingly investing significantly in their digital platforms in a bid to make it easier, quicker and more efficient for SMEs to access debt finance, with some even claiming to offer decisions within minutes. Some are teaming up with existing FinTech players to achieve this, while others are developing their own technology platforms to improve efficiency internally and for borrowers. Indeed, many of the developments seen in the retail space are transferring to the SME lending market.

There is clearly room for FinTech specialists to develop further, but it is likely that some will find it difficult to build up market share in the face of competition from banks that invest sufficiently in new technologies and have existing customer relationships, as well as access to cheaper funding from a large depositor base.

WHAT THIS MEANS FOR UK BANKING

There is a clear government agenda to open up competition in the SME lending market, evidenced by initiatives such as the establishment of the British Business Bank, a state-owned financial institution that provides funding for small and medium-sized businesses through its partnership network. As a result of this drive, the UK's debt funding landscape is likely to become still more diverse, with pressure on the big five lenders coming from a variety of sources.

The US debt funding market is often used as a point of comparison, where the majority of SME debt funding comes from non-bank sources. Yet it seems unlikely that this shift will be replicated in the UK for the foreseeable future given the dominance of the banks as the primary source of lending in the UK market. Instead, a more likely outcome is that borrowers will be able to choose from a larger number of banks (big five, medium-sized full-service and smaller specialist challengers), funds, and more niche lending platforms.

BANKS VS FUNDS: DIFFERENT BUSINESS MODELS

The growth of direct lending and other forms of private debt has created genuine competition for banking organisations, particularly in event-driven situations, such as a change of ownership and M&A deals. The two sources of funding have very different business models, however, and it is important to understand the distinction between the two when considering a financing package, as this can lead to different views on credit decisions and on how lenders may behave if funding terms are breached.

BANKS	PRIVATE DEBT FUNDS
Banks perform an important role in the economy as their actions affect money supply. They essentially create money (or deposits) when they lend by creating a credit in the borrower's account (in the form of a deposit) that can then be spent. The lending decisions by a bank are dependent on the availability of profitable lending opportunities, which in turn is dependent on the interest rate set by the Bank of England. As providers of capital from their balance sheet, banks are highly leveraged organisations, but have limits on how much they can lend in the form of regulatory policy. The regulations aim to prevent a build-up of risk. The banks apply risk-mitigation techniques to ensure lending is prudent in terms of quantum and the risk-profile of borrowers. Banks also need to ensure they are able to attract stable deposits to reduce liquidity risk.	Private debt funds have a very different model in that they are deploying existing capital. They raise capital largely from institutional investors, such as pension funds, insurance companies, family offices and sovereign wealth funds, though they occasionally also approach high net worth individuals for investment. This capital is usually raised through a closed-ended vehicle akin to a private equity limited partnership fund. The fund's investment strategy is determined at fund-raising stage and a target return is pre-agreed with its investors. The limited partnership fund model is subject to fundraising risk. Managers must continue to attract capital from investors for each fundraising effort and they are only likely to be able to do so if they can demonstrate strong prior returns.
Given these characteristics, banks may have an appetite for the following: • at least some element of amortising debt, given the need for higher liquidity than funds; • lower risk-return profile because of the bank's leverage position and capital adequacy requirements (see section 6); • lower-priced debt, in part because of leverage, but also because banks have access to cheaper funding from their depositor base and can generate additional fees and returns on ancillary services that they may provide to borrowers; • hold sizes of between £15m–£100m in the large corporate market (requirements above this will be club deals or syndicated); in the leverage finance markets, hold sizes are more likely £15m–£25m; or • both sponsored and sponsorless deals as well as non-event-driven finance.	These characteristics mean that private debt funds often have an appetite for: • longer-term, non-amortising debt – so that they return capital to investors in bulk; • more non-call protection as funds generally want their invested capital tied up for a minimum amount of time, usually one to two years; • higher risk-return profile as funds must meet a minimum hurdle before receiving any performance payment (however, this profile varies so that some may focus on more junior, subordinated, and more risky, forms of debt for a higher return, while others may provide senior debt or a blend of the two to reach their return targets); • bi-lateral transactions with hold sizes up to £250m (for larger funds up to £500m), thereby competing with the largest banks; and • mainly sponsored deals and event-driven situations ie, M&A, MBOs.

4. The rise of specialisation in the debt market

As sections of the UK's debt market have become more competitive, so many lenders, independent firms and wider corporate finance departments have built specialist teams and created niche products in a bid to fill gaps in the market and differentiate their offering. This provides a more tailored package to customers. Such development in the provision of debt is particularly true in the SME market. Enabled by technology and a deeper understanding of the business issues in specific sectors or stages of growth, specialist teams are increasingly offering innovative solutions to help companies grow.

This innovation stems from the increased disintermediation of banks in the UK as private debt funds and new entrants seek to gain market share. These alternative finance providers, which often benefit from more modern IT systems, a lower operating cost model and, in some instances, a more specialist approach, may present a threat to more traditional banks. Part of the response among some of the nimbler banks, particularly those focused on SME markets, has been to develop their own specialisations across products and sectors to grow and retain market share.

There are now many specialist approaches to lending, but below is an outline of some of the areas that have developed in recent years.

DEVELOPMENT FINANCE

This type of finance is often used in healthcare and hotels and other property sectors to fund the construction, development and refurbishment of assets. Following the crisis, these markets experienced a significant contraction in bank lending as many projects and businesses had been over-leveraged and entered distress.

However, the development of specialist lending in this area among some funders has enabled a more finely-tuned and prudent approach to financing that takes into consideration some of the unique characteristics and risks these sectors face.

Given the different dynamics present in, for example, healthcare and other property-related sectors, lenders often have distinct sub-sector teams with experience in, for example, funding care homes in the case of healthcare deals, and funding hotel or student accommodation development in property development finance lending.

Lending is typically structured to enable the development to be paid in stages. Once the development has been completed and signed off, the facility can be converted to a term loan (with the possibility of a capital holiday to bridge the period between completion and income generation), transferred to an investor purchasing the asset or fully repaid if the asset is pre-sold or re-financed.

MANAGING DEBT

Debt can provide a relatively low cost and flexible way of financing growth, particularly in today's liquid and competitive market. However, there are clearly risks involved – over-leverage was one of the main contributors to business failure in the recession that followed the financial crisis. Borrowers should always approach the market with a realistic view of their ability to repay, taking into consideration an appraisal of risk and the effect a downturn may have on their ability to service debt. Performing a 'What if?' analysis should be the starting point for informing a company's debt appetite.

For their part, lenders will expect to see a business plan that is achievable and backed up with robust figures and assumptions. They will often be more focused on past performance than future projections (with the notable exception of the venture debt market) and therefore the plan presented to a lender may be different from that compiled for an equity investor. If raising leveraged finance, lenders will consider the amount of debt being raised versus the price paid (transactional gearing) and will expect high quality due diligence to be performed on the target. It will also be keen to understand how an acquisition will be integrated and the costs involved. In a management buy-out, lenders are also likely to examine how much owners and/or management teams are cashing out and the extent to which they are willing to re-invest in the business post-deal.

Lenders will look for specific attributes when assessing the suitability of finance in these sectors.

In hotel development finance, for example, lenders will look to back propositions that:

- are well equitised;
- are put together by experienced operators;
- benefit from a strong team running the hotel on a day-to-day basis;
- are well located; and
- have a strong brand proposition.

In the care homes and sheltered accommodation space, lenders will look for:

- management teams with strong operational experience and track record (given the importance of service quality and reputation in this market);
- teams able to handle the complexity of developing a new product or service while also being able to achieve good occupancy rates early on, recruit staff and fulfil regulatory requirements;
- the right location; and detailed consideration of target customers.

ASSET BASED LENDING

Asset based lending (ABL) – including invoice financing – has been a feature of the lending market for decades in the UK, though the last few years has seen some evolution. No longer viewed as finance of the last resort, many businesses now see the benefit of being able to borrow against unpaid invoices and receivables in the case of invoice financing, and against stock, inventory, plant and machinery in the case of ABL. Invoice financing is typically more suited to smaller businesses, with a £2m+ turnover, while ABL is more usually employed in businesses with a turnover of £20m or more.

This form of finance has grown over the last ten years, with UK advances totalling £23.4bn in 2017, up from £15.8bn in 2007.

Banks and non-banks (including some funds) now provide this form of finance and the types of assets against which lending can be advanced have broadened, including, in some cases, intangible assets such as IP and brands. For those with fast-moving stock, ABL can even provide full-cycle financing, as assets are turned into receivables, creating a revolving facility.

There are certain considerations borrowers should take into account when arranging an ABL facility.

The business's cash need. ABL facilities can be costly upfront as there will be system and reporting set-up expenses, but these products can unlock more capital than other funding methods.

Regular, detailed reporting. Before advancing funds, the lender will conduct due diligence on debtors, stock or other assets to be lent against. After that, the lender will need to keep track of the assets against which the finance is advanced, which requires regular reporting, usually monthly, but sometimes more frequently.

Other forms of finance already arranged. ABL can sit alongside other forms of debt and equity finance and, for borrowers with strong capital structures and sufficient free cash flow, a further cash flow term loan can be offered. This can reduce the amount of equity required in a private equity deal.

SMALL CAP PROJECT FINANCE

This type of finance has been prevalent in the energy sector in recent years. It is extremely well suited to projects that use proven, reliable technologies (such as wind, solar and hydro) and in situations where future cash flows can be forecast with a high degree of certainty.

Project finance loan sizes are typically based on achieving a minimum level of debt service cover against a conservative (base case) set of cash flows and are typically profiled over the life of the asset less three to five years. Relative to other types of debt, commitment periods are normally long, at between 10 and 15 years. Historically,

these loans have achieved loan to cost ratios of up to 85%, making them attractive to the majority of borrowers, particularly SMEs, which often have limited access to equity.

Facilities of this type are often used to provide development finance, structured on an interest-only basis initially, with repayments starting six months after completion of construction.

The covenant package tends to require borrowers to provide information relating to asset performance on a regular basis and periodic testing on the actual level of debt service cover achieved.

Loans of this type are classified as single exit or unsecured, which means that the due diligence process is thorough, can take three or more months to complete and often involves significant cost. For the same reason, banks typically do not provide project finance loans of less than £3m and some larger banks have a minimum requirement of £25m. Nevertheless, there is a question mark over whether the due diligence approach is always commensurate with the relatively low risk characteristic of this sector and it is possible that due diligence requirements may relax in the future.

In recent years, this type of finance, in an energy context, has benefitted from highly predictable revenues in the form of government-backed subsidies. However, most subsidy schemes have now been removed or materially reduced, so that new projects must depend on prices achieved through market mechanisms. To continue deploying capital in this area, lenders will need to develop their processes and find ways of valuing revenue streams with reduced levels of certainty.

SMALL CAP STRUCTURED FINANCE

This type of finance is suitable for SMEs with strong cash flow. However, it can offer little security to a lender, such as those in the knowledge and service sectors. Given their lack of hard assets, these businesses can often struggle to raise other forms of debt when they are seeking to grow or when owners are seeking to reduce their shareholdings. Starting at around the £500,000 EBITDA level, these businesses are also often too small to be of interest to private equity investors.

Loans in this part of the market are based on cash flow and will be typically advanced to businesses that are at least three years old, profitable and are looking to accelerate their growth. For example, they may want to establish new operations, open new offices or look to rationalise shareholdings in a bid to move to the next stage of their development. A lender will look at a company's record of profit generation to appraise debt capacity and at projected cash generation to arrive at a repayment schedule. The debt can be structured as a term loan with a tenor of up to five years and/or working capital facilities.

SPECIALTY FINANCE

A highly niche area of structured finance, specialty finance is focused on the financial services sector. It involves the provision of wholesale debt facilities to support the financing activities of non-bank financial institutions, which lend to consumers and SMEs. Non-bank financial institutions are typically

POSITIVES AND NEGATIVES FOR BORROWERS OF SPECIALIST DEBT

Positives	Negatives
+ Tailored lending that can be fine-tuned to meet a company's specific needs and arranged relatively quickly.	− Specialist lending may be restrictive if a company shifts strategy after financing has been agreed.
+ Lending teams have expertise and a deep understanding of nuances in a particular sector or stage of a business's development – they will have in-depth knowledge of risks and opportunities in a sector.	− Borrowers should ensure that they are able to access as bespoke a deal as possible from a specialist lender.
+ Lenders can sometimes provide access to valuable contacts or networks that could help a company grow and share best practice.	

CONSIDERATIONS WHEN CHOOSING A DEBT FINANCE PROVIDER

Choosing the right lender is critical to a deal's success. Borrowers need to consider which factors are most important to them, such as flexibility, structuring considerations or the type of relationship the borrower is seeking with a lender. Advice from a corporate finance adviser or debt specialist can help with making the right decision. Key factors include:

Type of lender. In some cases, businesses may need to maintain existing relationships; in others, the finance required may be best suited to an alternative lending group; and, in other cases, it can be a combination of both. The debt options offered may vary: for example, a debt fund will not prescribe the use of ancillary business whereas a bank's trade finance credentials may be essential.	**Lender reputation and behaviour.** Lenders can react differently to unfortunate circumstances. There is a perception that banks traditionally take a more long-term view, whereas certain institutional lenders can be more aggressive or simply seek to exit with the result that debt can be sold on to other parties. It is worth asking a lender about their track record in the specific market and taking references from other borrowers to understand a lender's approach and assess how they might behave in more difficult times.
Freedom to operate. Increased flexibility, whether through looser covenants, bullet repayment or delayed drawdown, can come at a cost, but may be valuable to borrowers looking for a more tailored financing solution. For some, it may make sense to pay for cov-lite terms.	**Risk assessment.** Before the structure has been agreed, the business should undertake a sensitivity analysis covering a range of forecast outcomes, including how an unexpected event could impact compliance with the terms proposed. This should inform negotiations so that terms can be tailored accordingly.
Structuring and terms. Borrowers should consider where the debt sits within the capital structure: for example, is it junior or senior? Secured? Amortising? The quantum, maturity, repayment terms, baskets and covenants then need to be set at levels the business can sustain with sufficient headroom for growth.	**Deliverability and sustainability.** Will the lender do what they say they are going to do? The last thing any business wants is for a deal to abort because a funder has walked away or substantially changed their terms. Borrowers also need to look at how sustainable a lender's position is in the market – after the financial crisis, some lenders withdrew from certain markets, forcing borrowers needing to refinance to look elsewhere.

not permitted to take deposits and must find other means of funding their operations. This provides an opportunity for traditional banks to fund these finance companies on a selective basis.

There are currently only a handful of speciality finance providers, but with the growth of FinTech platforms and increasing moves among consumers and SMEs towards alternative forms of finance, it is an area set for strong growth. Types of business that would be eligible for this form of finance range from early stage FinTech lending platforms to established regional specialist lenders providing a range of services including consumer finance, point-of-sale funding, secured lending, bridging finance and SME lending.

Wholesale debt facilities are provided against customer loan agreements (or receivables) and are typically structured as committed RCFs provided to a ring-fenced special purpose vehicle (SPV) to segregate the financial assets from the origination and servicing platform of the corporate group. This helps to insulate credit facilities from other liabilities of the wider corporate group.

Lending is usually available to finance companies that:

- have been in operation for at least two/three years (although some younger, high-growth FinTech businesses may be considered);
- have a clear corporate governance and risk framework, with robust underwriting, collection and provisioning policies and practices;
- have a lending track record so that finance can be structured according to risk profile and performance of the loan book;
- focus on near-prime and prime, as opposed to sub-prime lending; and
- have a good reputation in the market and satisfactory history of regulatory compliance.

VENTURE DEBT

Venture debt typically provides funding for young, high-growth, revenue-generating companies that are looking to scale, but that are not yet profitable. It is usually provided to venture capital-backed companies, although in some cases the business may not need to be equity-backed if management can demonstrate that the company has the ability to scale quickly. While venture funding has been in existence for a number of years, it is generally in more recent times that venture capital firms and management teams have become more accustomed to using venture debt in the UK. There is a small handful of providers of venture debt, including both banks and funds.

The finance is typically used to develop a new product or service, open new sales offices and/or to recruit sales people to take the business to the next stage of development. It can also help fund growth ahead of revenue growth. The higher risk involved in advancing the funding means that pricing is at the higher end of debt finance, at over 8%, and it usually features some form or warrant or equity kicker. Lenders will typically consider:

- revenue growth rate;
- quality of equity provision;
- the market in which the business operates to understand its ability to scale;
- quality, background and track record of the management team; and
- intended use for the finance.

5. Mitigating risk

Taking a conservative approach to the quantum of leverage in a business is clearly the first step in mitigating the risks associated with debt. Nevertheless, businesses should also take account of possible future interest rate rises, increasing inflation and, for those with an international element to their company, currency fluctuations. Borrowers can use hedging strategies to mitigate these risks, giving them greater certainty and control over financing costs. They can also seek specialist advice about the most suitable type of debt for their company's needs.

INTEREST RATES

The prolonged low interest rate environment and quantitative easing policies have increased liquidity and reduced the cost of debt. The entry of new players, such as challenger banks, funds and FinTech platforms has created a more competitive market for business finance than was previously the case and this has also driven down financing costs. However, most commentators expect interest rates will rise in the future and so there will be a point at which debt finance costs will increase.

This environment is leading many businesses to consider their interest rate hedging options when arranging debt. There are a number of different areas to consider.

Opting for fixed rates. Companies can select products with a fixed interest rate, including when refinancing, to lock in a favourable rate. These may be more expensive than floating rate or variable rate products, but they provide predictability.

Varying maturities. This allows companies to diversify interest rate fluctuation risk through a staggering of tenors.

Refinancing early if possible. Refinancing while interest rates remain low (if terms allow this) to lock in a lower rate can reduce a company's finance costs. The rate available in the market may depend on desired tenor, however. With the current market expectation of interest rate rises over the medium term, ten-year tenors will be more expensive than five-year terms, for example.

Using interest rate derivatives. The most common of these is the 'vanilla' swap, which is an exchange of floating rate payments referencing LIBOR for fixed rate payments. This can significantly increase the cost of finance in today's low interest rate environment, but is likely to be a more viable option once interest rates start to rise.

INFLATION

Inflation rates in most markets globally have been low since the financial crisis, even with central banks' quantitative easing strategies. In the UK, inflation rose following the devaluation of sterling following the Brexit vote, although it has since fallen back. Inflation hedging strategies have therefore not been widely used by companies for a number of years.

However, inflation remains a risk that businesses should consider, particularly given that some central banks are considering increasing their target inflation rates in the event of a recession, and to counter the threat of deflation. Inflation swaps, where a client can swap the floating rate of RPI or CPI into a fixed rate of inflation using the forward inflation curve, can be arranged to manage future inflation risks.

FOREIGN EXCHANGE

Sterling's fall against the dollar and euro in the aftermath of the Brexit vote has brought into sharp focus the risks of currency exchange volatility, particularly for businesses who trade internationally and have overseas supply chain arrangements. While a lower sterling may provide opportunities for exporters, it clearly increases the costs for those that source goods and services denominated in other currencies.

The most common means of managing currency risk is through the use of hedging products, which include the following.

Forward contracts. These allow companies to buy or sell a fixed amount of currency at a pre-agreed rate for a pre-agreed date in the future, providing certainty over costs and revenue even if currency exchange rates are volatile.

FX swaps. This involves the exchange of one currency into another currency for a specified period of time. At maturity, the currencies swap back at a pre-determined exchange rate into their original currencies. This allows for the better management of currency balances and overdrafts and can minimise costs.

Options. Options can offer businesses currency exchange flexibility. They provide the right, but not the obligation, to buy currency at a specified price by a specified time, and they can be bought or sold by companies.

These products range from relatively straightforward to highly complex, with differing risk profiles. Therefore, companies should take advice before embarking on currency hedging strategies.

A NOTE ON FLEXIBILITY

These options are some of the ways in which companies can mitigate risks associated with fluctuations in interest rate rises, inflation and currency exchange volatility. However, when considering these options, companies need to build in sufficient flexibility to ensure they do not become a constraint on future management decisions, including a future partial divestment. Recent trends include a move to hedging for shorter periods of time and the adoption of policies that set a maximum hedging percentage to give management teams enough room for manoeuvre.

6. Regulation and tax treatment of debt

Since the financial crisis in 2008, banks globally have been subject to a number of new, more stringent regulations aimed at increasing financial stability and improving transparency. The effect on day-to-day borrower relationships with banks and the terms available depends on the regulation and the type, size and complexity of banking arrangements.

These are some of the main recent regulatory changes applicable to banks in the UK and how they affect the market and borrower terms.

BANK BALANCE SHEETS AND CAPITAL UNDER BASEL III

One of the most significant developments in financial regulation to come from the period post-financial crisis was the Basel III accord. Aimed at enhancing the stability of the financial system internationally, it requires regulators to strengthen their supervision and risk management of banks. This has typically led to improvements in the management of risk and an increase in the quantity and quality of the regulatory capital and liquidity held by individual banks. As intended, the regulation has a direct impact on a bank's risk appetite when it comes to lending and partly explains the retrenchment of many banks from some lending activities in the years following the crisis.

When it comes to managing their balance sheet, banks, like any other business, must ensure that their assets (mainly loans) are balanced by their liabilities (mainly deposits owed to their customers). And because they tend to commit to loans over a period longer than the term of their deposits, they need to do that within strict standards that govern liquidity.

The losses expected on the loans are provisioned in the profit and loss account and therefore show up indirectly in the bank's capital position. In addition, the bank must also hold an extra amount of capital for unexpected losses on its loans. The total of this capital is typically only a small proportion of the amount of deposits on the balance sheet, so banks could be said to be leveraged organisations.

Because of this, any small movement in the amount of capital required is magnified in its impact on its 'return on capital', – arguably the key performance metric for any bank. The riskiest loans therefore tend to attract disproportionately more capital following the implementation of Basel III, which is why these loans have become more expensive since 2008.

Another way to look at these changes is through the eyes of the UK's Prudential Regulatory Authority (PRA) and how it delivers its key strategic objectives of:

- promoting the safety and soundness of the firms regulated; and
- facilitating effective competition between firms.

TAX TREATMENT OF DEBT

The tax treatment of debt is highly complex and companies should seek detailed advice before arranging debt finance, to understand fully the tax implications of any borrowing they undertake. However, there are three broad areas to consider.

1. Withholding tax. This is applicable to loans that last a year or more. The rules require companies making interest payments to deduct withholding tax from the payment at the basic income tax rate (20% at the time of writing). However, there are a number of exemptions, including:

- loans made to and from a UK bank or interest payments made to a UK resident company;
- instances where companies are paying discounts, such as when structured as discounted bonds; and
- where double tax treaties or the EU Interest and Royalties Directive apply.

2. Deductibility of interest. Tax deduction of interest payments can make debt an attractive source of funding. However, over the last few years, the rules that determine deductibility have become more stringent and complex. Companies should consider the following:

- whether the loan arrangement could be perceived as tax avoidance – companies should keep detailed records to support any application for interest deductibility;
- when arranging connected party loans, thin capitalisation and transfer pricing rules apply; and
- there is now generally a cap on deductibility of interest payments in the UK. The cap is 30% of taxable EBITDA.

3. Repayment. If repaying a loan at maturity, there should be no tax impact on the borrower. However, if a borrower repays early and this gives rise to a profit or loss, the profit is taxable, while the loss may not always be tax-deductible.

To deliver these objectives the PRA continually monitors both balance sheets and the models used to predict and measure risk so that the bank's lending stays within boundaries commensurate with maintaining soundness, including in stress conditions. This also provides protection to depositors. In practice, this means there is a maximum level of risk associated with lending beyond which the banking system is not really designed to fulfil. Other legal measures such as 'ring-fencing' (see below) reinforce this approach.

These regulations are constantly under refinement, but the direction of travel is that banks are likely to hold at least as much regulatory capital, if not more, and take an ever more granular approach to assessing risk.

Overall, this means that businesses considered riskier (those considered more likely to be unable to repay a loan through over-reliance on debt, lack of management experience, short track records and, in some cases, those in highly cyclical sectors or with limited assets to pledge as security for the loan) are less likely to secure bank funding. For these businesses, other lenders that are not subject to the same capital rules (because they are funded either entirely or mainly by their investor base) are usually more suitable providers of loans.

MiFID II

The Markets in Financial Instruments Directive II (MiFID II), which came into force in the European Union in January 2018, builds on trading regulations introduced in 2007. It aims to provide more protection for investors and increase transparency in all tradeable asset classes, such as equities, fixed income, commodities, futures, exchange-traded products and retail derivatives. As a result of MiFID II, banks should be establishing best execution framework policies that outline charges, to ensure that customers receive the fairest deal at any given time.

This is a significant change for many banks that have a large product portfolio and execute high volumes of trades for customers. However, for banks catering to the needs of SMEs, which are less likely to be involved in executing trades, the changes are less wide-ranging.

The key points for bank customers are as follows.

- Banks are now obliged to offer best execution.
- If trading derivatives (including interest rate swaps and foreign exchange hedging), the company should have a Legal Entity Identifier (LEI) and it must use this to report the trade(s). In practice, some banks offer delegated reporting of trades, so that customers are not obliged to do this themselves.

RING-FENCING

Ring-fencing comes into force in the UK in January 2019 and was introduced through the Financial Services (Banking Reform) Act 2013. Devised as part of a response to the global financial crisis of 2008, ring-fencing requires UK banks (but not foreign banks) to separate core retail banking from investment banking activities.

While this sounds relatively straightforward, in practice different banks are taking a variety of approaches, depending on their business model, as they have some flexibility as to where the ring-fence is placed. For example, a deal in one banking group may be provided by the ring-fenced bank, while in another, it may be provided by the non-ring-fenced bank, depending on the approach taken by the group (often including the revenue level of the borrower).

This has the potential to affect the terms available to customers, with deals in non-ring-fenced banks priced differently (as a result of a different cost of capital or funding) from those in ring-fenced banks. However, this remains to be seen. Ring-fencing affects a borrower's ability to source multiple products easily across the ring-fence from the same banking group. It may also affect the relationship between the borrower and the bank, as there is likely to be some movement of personnel.

Banks are well prepared at this stage for compliance and have been advising customers on the impact ring-fencing may have on their business and debt facilities. Borrowers concerned about the effect on their banking services should seek information from their bank.

7. Conclusion

The debt market in the UK, as in other G7 economies, has changed significantly over the past decade, with more changes likely to come over the next few years. This is good news for borrowers, who can take advantage of greater competition among lenders to achieve the best financing solution for their business needs and future strategy. It is also good news for the economy as companies' access to affordable debt to fund expansion plays a vital role in driving economic growth and job creation.

The changes outlined in this guideline have helped create a resilient UK debt market. There is often a perception among management and business owners that raising finance can be a challenge and therefore acts as a brake on growth. However, the reality is that the UK debt market now offers a range of funding options for corporate and SME borrowers to help them grow. Indeed, the challenge is more likely to be one of knowing where to look for the right finance for a business than a scarcity of available capital. High quality specialist debt and corporate finance advice can assist borrowers in navigating what has become a more complex and crowded market, choosing the right structure, terms and provider(s), as well as identifying and mitigating risk.

At the core of any successful debt raising is a strong relationship between the borrower and the lender. A lender which is able to identify and even anticipate a borrower's funding needs and respond accordingly is a partnership which will serve the borrower well and is one which a borrower should actively seek.

As the prospect of further interest rate rises approaches, newer elements of the UK's debt market may be tested, but the diversity of options available mean that the sector should remain robust. While some individual lenders may shift strategy and appetite and some may leave the market altogether, the financing ecosystem is now well established. The future looks set to be characterised by further changes, with increasing fragmentation of the lending market as new entrants identify niches and fill gaps in the market. This development will be evolution rather than revolution, but it is almost certain to result in even more debt funding choices for businesses with operations in the UK.

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Head of Business Banking,
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Graeme has been Head of Business Banking since March 2016. He is responsible for leading the evolution of business banking at Clydesdale and Yorkshire Banks, with a core focus on shaping innovative solutions for key financing events that support the growth of SMEs, and those customers that have successfully grown to continue to develop. Graeme joined Clydesdale and Yorkshire Banks in 2006, going on to develop the bank's venture debt offering ('growth finance') and then the wider approach to this industry specialism. Graeme trained as a chartered accountant with PwC, then worked in their advisory practice focusing almost exclusively on the technology sector. This role led to a new role as CFO for a venture capital-funded fintech business, KAL, and then to General Manager of a larger software business, Graham Technology plc, before joining the bank.

SMEs are the engine of the British economy and banks have a critical role to play in providing services for start-ups, cultivating established businesses as they scale up and encouraging sector expansion and innovation. Clydesdale and Yorkshire Banks have a proven track record of fulfilling this role and of being a national and regional economic champion for SMEs. In April 2017, the Banks announced a £6bn lending commitment, making dedicated funding available to UK SMEs over three years to 2019, and are on track to reach this target, advancing over £2bn of new loans and facilities in the first year.

Clydesdale and Yorkshire Banks have a strong heritage of supporting British businesses through the key events in their business lifecycle, including funding their initial venture and growth stages, management buy-outs, secondaries and public listings. SMEs are a key differentiator for the Banks and they have the products, track record and capabilities needed to help SMEs grow and succeed.

The Corporate Finance Faculty's professional network includes 7,000 members and more than 80 member organisations.

Its membership is drawn from major professional services groups, specialist advisory firms, companies, banks, private equity, venture capital, law firms, brokers, consultants, policymakers and academic experts. More than 40% of the faculty's membership is from beyond ICAEW.

The faculty is ICAEW's centre of professional excellence in corporate finance. It contributes to policy development and many consultations by international organisations, governments, regulators and other professional bodies.

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