

A full-page background image of a swimmer in motion underwater, creating a sense of fluidity and movement. The swimmer is in the foreground, with their arms extended forward, and their reflection is visible on the water's surface above. The water is a deep blue, and there are bubbles and light reflections around the swimmer.

# FUNDING THE HEART OF THE UK ECONOMY

**Lower mid-market M&A debt**



## Lower mid-market M&A activity surges

The first six months of 2021 has seen a strong rise in M&A activity with alternative lenders playing a leading part in those transactions that have involved debt funding. Trends that were emerging pre-pandemic have been accelerated as mainstream banks have retrenched. The rise of alternative lenders represents a changing of the guard in the sourcing of debt for lower mid-market M&A deals.

THE TOTAL VALUE OF UK DEALS IN THE FIRST SIX MONTHS REACHED £150 BILLION, UP 12% ON THE SAME PERIOD IN 2020

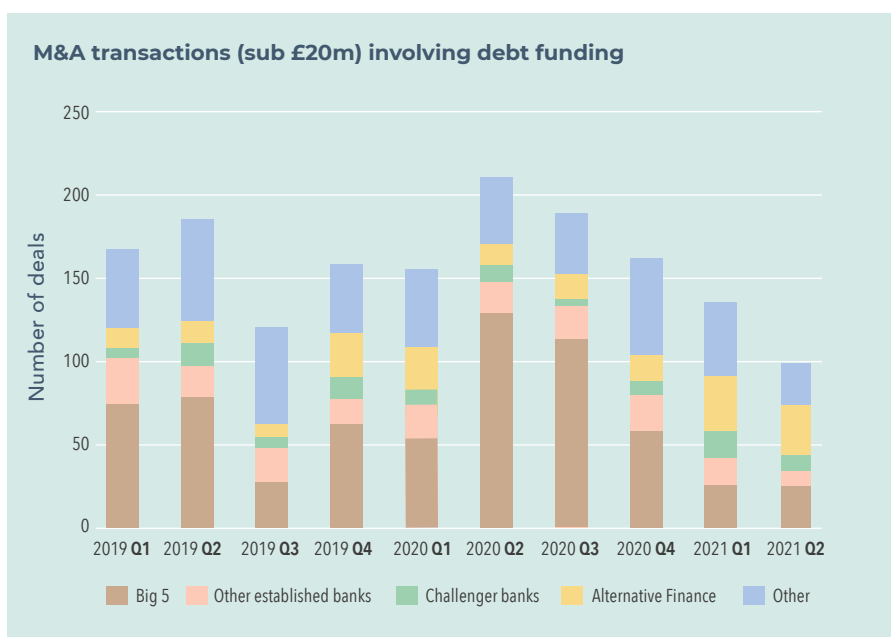
The total value of UK deals in the first six months reached £150 billion, up 12% on the same period in 2020. Volumes were also up at 3,385, a 16% rise on the previous year, according to Experian's latest M&A Report. (Source UK & Republic of Ireland M&A Review – Experian Business Research H1 2021)

Pent-up demand following the slowdown caused by COVID in 2020 played a major role, as corporate activity put on hold during lockdowns bounced back. At the same time, the pandemic forced many businesses to re-appraise their strategies and business models. Some firms struggled and owners have sought an exit, but many owners and management teams saw their business thrive or identified new and changing opportunities.

Four trends were particularly pronounced in the Experian report:

- A strong increase in M&A activity among mid-market businesses
- Rising activity by private equity groups
- An increase in the number of management buy-outs to levels not seen for 10 years
- The alternative finance sector saw its share of M&A financing jump significantly

The graphic below shows the volume of debt funded M&A deals since 2019 illustrating the rise of alternative lenders both in absolute terms and market share. The contraction by the Big Five banks (HSBC, Barclays, Lloyds Banking Group, NatWest and Santander) and other established traditional lenders, is particularly marked.



Source: ThinCats /Experian

## The complexity of acquisition finance

Financing businesses for organic growth requires skill and expertise in assessing the borrower, getting to know the owners and managers, understanding their needs and objectives and providing debt at an appropriate price that suits both the borrower and the lender. M&A finance adds a whole extra level of complexity.

The list of stakeholders is much longer. There will be the acquirer, both equity holders and management team and there will be the target, again with both owners and management. The number of advisers involved doubles, two sets of lawyers and possibly two sets of corporate advisers.

Due diligence is required on both target and acquirer and crucially on the prospective merged entity that will be created by the M&A deal. There will be both cost savings to be assessed, growth prospects of the merged entity and potential impacts on existing client contracts.

Attention should focus on where the value lies. In the case of an acquirer buying a company a fraction of its size, diligence may focus more on the acquirer. In a merger of near equals, both sides of the deal may require equal due diligence. There is no single template and assessing where the materiality lies requires an individual approach.

Management should have analysed these issues and have a clear assessment and business plan and the involvement of a corporate adviser helps ensure this work has been done. However, even when such an adviser is on hand, the lender will have to carry out their own due diligence, both for their own business interest and to ensure the lending is appropriate for the borrower.

The complexity of M&A finance also extends beyond the financial numbers – relationships and understanding are vital. The range of stakeholders involved means there will be a range of interests and motivations. The equity holders in the target may wish to exit at maximum value, but they may also have an emotional attachment to their business, which may have been a part of their life for years or decades. Meanwhile the management at the target will have their own interests in terms of continuity of employment and their role in the future merged business.

An acquisition may also involve earn-outs for equity holders or deferred considerations that are dependent upon achieving certain performance targets. These will affect the structure and covenants of the finance and will require flexibility from the lender.

Building relationships with this wide range of stakeholders and understanding their motivations and objectives are a vital part of the process.

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## Private equity transactions bring different challenges

The involvement of private equity in M&A financing can create extra complexity, but may also be a boon in the process of due diligence and in understanding the strategic rationale for the deal.

Acquisitions and disposals are the bread and butter of private equity investors so transactions involving PE backed businesses have an automatic element of corporate expertise built in. At the same time, PE-backed businesses will typically involve more complex corporate structures and a greater number of entities, perhaps to aid tax efficiency or to address complexities in distribution or ownership.

Overall, private equity's corporate expertise more than compensates for any added complexity.

The complexities of lending for acquisition finance alongside the specific needs of funding transactions for private equity backed businesses are well suited to alternative lenders that can offer fast and flexible solutions from people with the necessary expertise. Just as some alternative lenders have made inroads into the banks' previous dominance of small business lending via highly automated online platforms, other alternative lenders have focused on opportunities in the mid-sized sector.

PRIVATE EQUITY'S  
CORPORATE  
EXPERTISE MORE  
THAN COMPENSATES  
FOR ANY ADDED  
COMPLEXITY



## The rise of alternative lenders

The rise of alternative lending, already well under way pre-pandemic has continued as funding needs have changed from working capital for survival to funding for growth either organically or via acquisition..

Traditional banks have found that the risk weighting of commercial lending involves regulatory capital requirements that undermine the economic value of such financing. On top of this, the cost of client acquisition and servicing in the lower mid-market segment have proved onerous for their business models.

Mid-sized SMEs have long been underserved by finance providers and the issue has been acknowledged in numerous studies and government initiatives.

Government action to support business has played a role in the changing shape of the market. Medium sized firms were beneficiaries of the Coronavirus Business Interruption Loan Scheme (CBILS), which was aimed at businesses with a turnover up to £45 million with loans of up to £5 million.

The Covid pandemic may also have contributed to greater recognition of the importance of the mid-sized SME segment to the UK economy and a growing number of private equity groups have identified the lower mid-market as an opportunity.

As one of the leading alternative lenders to mid-sized SMEs ThinCats has been an active participant. The group leapt into the top 10 M&A debt providers, jumping from 11th in 2020 to 5th place this year in terms of number of deals funded ahead of all but two of the big five high street banks.

GOVERNMENT ACTION  
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OF THE MARKET

### Debt provider rankings by volume: Jan-June 2021

Current rank	Previous rank	Debt provider	Volume
1	1	HSBC	25
2	-	Boost & Co	24
3	4	Shawbrook Bank	23
4	7	Santander	17
5	11	ThinCats	14
6	8	Caple	11
7	6	Natwest	10
8	-	Triple Point Investment Management	9
9	3	Barclays	6
10	5	Lloyds	5
11	18	Goldman Sachs	4
12	16	Arbuthnot	4
13	15	Oaknorth	4
14	-	Bank of America	3
15	22	Dunport Capital Management	3

Source: Experian M&A Report H1 2021





## DEBT FUNDING IN THE LOWER MID- MARKET OFTEN FALLS BETWEEN TWO STOOLS

### “The underserved mid-sized”

Debt funding in the lower mid-market often falls between two stools. Debt providers to smaller businesses tend to be automated in their application and approval processes, because the value of loans is too low to merit close individual analysis or bespoke servicing.

At the same time, the segment above mid-sized SMEs in scale (loans of £15-20 million or more) are well-served by mainstream lenders and banks, since at this scale the value is sufficient to merit the investment in bespoke lending and service.

This has left the mid-sized SMEs segment underserved by both the automated solutions offered to smaller businesses and the fully bespoke personal service offered to larger businesses. A significant opportunity has opened up to lenders that can offer a hybrid approach that combines high quality data, and efficient, technology driven processes alongside the expertise of people-based underwriting.

## The ThinCats approach to M&A finance

Speed and certainty are highly valued by business borrowers of all sizes and particularly in the lower mid-market segment. Flexibility is also essential. With so many moving parts to an acquisition the lender must be able to adapt to many variables and circumstances. Dealing with these issues means relationships are vital – lenders should know their borrowers, be available to them and share an understanding of their motivations and objectives.

The ThinCats approach combines all these important features.


ThinCats operates through a regional network with business development and credit teams located across the UK. Typically, the borrower will meet with the regional business development director and regional head of credit at the very start of the process so ThinCats can understand more about the business, the management team, the purpose of the loan and assess ThinCats' credit appetite. As regional heads of credit also sit on ThinCats' Investment Committee the prospective borrower is immediately plugged into the ultimate decision-making process. If the regional head of credit supports a funding proposal it is likely to be approved by the Investment Committee subject to the appropriate due diligence.

For acquisition finance ThinCats regards itself principally as a provider of transition finance. The target segment is loans of between £1 million and £15 million, with terms of between 3-5 years.

Assessing and approving lending combines elements of automated credit appraisal typical at the smaller end of the market, with the individual loan analysis and relationship-based lending normally offered by banks and direct lending funds to much larger borrowers.

ThinCats' Propensity and Risk Model (PRISM) is a proprietary system to allow rapid assessment of potential borrowers. Using a prospective borrower's Companies House registration number, PRISM draws down credit data and other metrics from publicly filed records to provide an immediate assessment and potential pricing for the required lending. This is not a pricing decision, but it provides an immediate filter to help ThinCats decide whether to progress. It also provides the prospective borrower with an indication of price.

THINCATS OPERATES  
THROUGH A  
REGIONAL NETWORK  
WITH BUSINESS  
DEVELOPMENT  
AND CREDIT TEAMS  
LOCATED ACROSS  
THE UK

INPUTS	PRISM MODEL PROCESS	OUTPUTS	FIRMS	% OF TOTAL INSOLVENCIES	1 YEAR INSOLVENCY RATE
DEMOGRAPHICS		★★★★★	13%	1%	0.06%
LIQUIDITY		★★★★★	34%	5%	0.19%
DEBT/GEARING		☆☆★★★	28%	16%	0.73%
FILING BEHAVIOUR		☆☆★★★	17%	32%	2.52%
PROFITABILITY		☆☆★★★	7%	47%	8.48%
EFFICIENCY		☆☆★★★			
GROWTH		☆☆★★★			




By combining the initial PRISM assessment with the expertise of the regional business development director and regional head of credit, ThinCats can quickly provide feedback to the borrower on the potential quantum and price of a loan and areas where further information and due diligence may be required. Certainty for the borrower comes from knowing that once the regional head of credit supports a proposal it is very likely to be funded subject to satisfactory due diligence.

Flexibility is built into the ThinCats approach from the outset. Covenants typically have decent headroom for the borrower and, unlike many banks, ThinCats does not automatically tighten the covenants over time, meaning the borrower does not find they are running to stand still.


The lending may also be designed to flex with the structure of the acquisition. For example, if there is a deferred consideration in the acquisition, Thincats can put in place a committed facility that can be drawn down when the relevant performance targets are achieved.

ThinCats typically does not fully amortise the loan from day one and, depending on circumstances, may offer capital repayment holidays in the early months when only interest is charged. This flexibility gives the management of the business breathing space to bed in their acquisition and focus on delivering its value.

In the long run a stronger business is in the interests of both the borrowers and the lender.



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## Case studies

### SUPPLIES FOR CANDLES - CORPORATE M&A

In 2020 ThinCats provided a seven-figure package to Supplies For Candles, a Yorkshire-based distributor of candle and soap making ingredients to fund its acquisition of The Soap Kitchen, a Devon-based market leading supplier of personal care and soap making ingredients.

The acquisition of The Soap Kitchen creates a market leader in the distribution of candle and soap making supplies in the UK and Europe, with combined revenue expected to approach £10million in the next 12 months.

The regional approach and the role of corporate advisers was key to the acquisition and funding. A team of Yorkshire-based advisers from Sentio supported Supplies for Candles' owner and worked closely with ThinCats' Ben Kimball, Director, Regional Business Development, Yorkshire.

Founder of Supplies for Candles, Nicky Story, said: "In the team at ThinCats, we have the support of a strategic funder who share our appetite for growth."



The acquisition of The Soap Kitchen creates a market leader in the distribution of candle and soap making supplies in the UK and Europe



## Case studies

### TRISPAN AND PHO - PRIVATE EQUITY M&A

In 2021 ThinCats provided funding to support the acquisition of Vietnamese restaurant group Pho.

The business – a chain of 30 restaurants and 3 dark kitchens across the UK, was acquired by private equity group Trispan which has a dedicated restaurant fund, Rising Stars, and identified Pho as having a unique selling point and opportunity being the first national chain of Vietnamese restaurants in the UK.

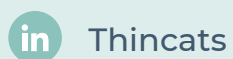
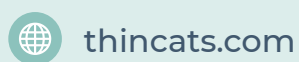
The business was founded by Juliette and Stephen Wall, who opened their first restaurant in London's Clerkenwell in 2005. As a private equity-linked deal the funding came with multiple stakeholders, but also with a private equity partner in Trispan who brought their expertise and familiarity with M&A to bear.

Understanding the details of the business and the founders and management's vision was particularly important. In the wake of the Covid pandemic restaurant businesses were not obviously an attractive market for finance.

However, the founders' vision was for a distinct style, dedicated to fresh cooking avoiding the carbon-copy approach to opening new outlets followed by many popular restaurant chains. Flexibility was important to the deal, since while the bulk of financing was to fund acquisition, a significant proportion was to help fund roll-out of new sites.

The pandemic had also delivered some upsides. Pho had signed up with Deliveroo, which meant its name was promoted by the national food delivery service. Its product appealed to food-lovers in lockdown and had created a pent-up demand from diners keen to visit Pho restaurants.





ThinCats is a trading name of the  
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