Research Update:

Sherwood Parentco Assigned Preliminary 'B+' Ratings On Close Of Arrow Global Acquisition; Outlook Stable

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Overview

- Sherwood Parentco Limited (Sherwood) has acquired distressed debt purchaser, distressed asset servicer, and fund manager Arrow Global Group PLC (Arrow). The acquired assets and Arrow servicing platform are well positioned in a growing market for European distressed assets, and the acquisition comes as Arrow has successfully pivoted toward asset-light servicing and fund management over the past 18 months.
- We forecast a stable, if slow, earnings and EBITDA recovery after a difficult 2020 for Arrow. The deal close is funded by around £1.2 billion equivalent of new senior secured notes. When combined with sluggish earnings and the new capital structure, we expect S&P Global Ratings-adjusted leverage above 5x over the remainder of 2021 and through 2022. The group's ownership by a private equity sponsor (TDR Capital or TDR) is an additional weight on the rating.
- We assigned our 'B+' preliminary long-term issuer credit rating to Sherwood. The stable outlook indicates that we expect Arrow's steadily improving balance sheet business performance, and continued growth in its servicing and fund management business will support solid earnings performance and a gradually reducing, though elevated, leverage profile over the next 12 months.
- We assigned a preliminary rating of 'B+' to the new issuance by Sherwood, in line with our 'B+' preliminary rating on Sherwood.
- We expect to convert the rating to final from preliminary at the settlement of Sherwood's bond transaction. Our final rating is subject to a review of the finalized bond documentation.

Rationale

Sherwood is now the owner of Arrow Global Group's operations, and Sherwood's ownership by private equity sponsor TDR is an important rating constraint. Sherwood is a BidCo, fully owned by TDR, and it purchased Arrow for a total consideration of £563 million. Arrow's operations will continue to operate under the same branding, and the management organization of Arrow is substantively unchanged following the deal's closure. Although TDR is experienced in the operations of European financial institutions, we remain cautious regarding the group's financial policy over the first 12 to 18 months of the new group. Our base case remains for relatively prudent financial management, but we see a remote risk that TDR could consider deploying further leverage for mergers and acquisitions in the European market, or to accelerate purchases in the group. Actions like these could meaningfully dilute our generally favorable view of Arrow's solid liquidity under our base case. Over the next 12 to 18 months, at least, TDR's ownership of Arrow will be an important rating constraint. Thereafter, we could consider a more favorable view of TDR's ownership if the group can demonstrate a stable financial policy and good financial discipline. The group's new capital structure contains significant financial flexibility to proactively repay debt, and if such an event came to pass, we could view Sherwood's financial sponsor owners more positively.

Our revised base case assumes a subdued recovery in the group's earnings and performance during 2021 and 2022. Stable, if subdued, performance improvement, elevated costs, and a refreshed capital structure are at the core of our base case for Sherwood over the first 12-18 months of its ownership of Arrow. We now expect collections to remain below 2019 levels until 2023, at the earliest. This is partially offset by quicker growth in servicing revenue, which proved resilient in 2020 and was ahead of our expectations, and good fund management income growth for the period. When we combine this uneven earnings outlook with an increased cost base after the deal closes, we do not expect EBITDA to reach pre-pandemic levels on a cash or statutory basis before the end of 2023. Specifically, within our cost forecasts, we expect a one-off restructuring expense of £10 million-£20 million in 2022 and 2023.

The new capital structure of the group is broadly leverage neutral. Sherwood has launched three tranches of senior secured bond financing (totaling roughly £1.2 billion) to repay the bridge facility used to repay Arrow's existing £990 million of senior secured notes at its acquisition. The quantum of these bonds is greater than the previously outstanding senior secured notes issued by Arrow Finance PLC, and surplus issuance via the bridge has been used to reduce the outstanding balance on the group's £285 million revolving credit facility (RCF). At year-end 2020, total drawing on the RCF was roughly £200 million. As such, the refinancing of the deal will be broadly leverage neutral on a gross debt basis when accounting for this repayment. We assigned a preliminary rating of 'B+' to the new issuance by Sherwood, in line with our 'B+' preliminary rating on Sherwood. This rating reflects our '4' recovery rating on the bonds, indicating an expected recovery of 40% on the senior secured bonds in the event of default (see recovery analysis, below).

Our updated base case and the new group capital structure leads to S&P Global Ratings-adjusted leverage above 5x for much of the next 12 months. Although the new capital structure is leverage neutral, in the first instance we expect the group's leverage position to weaken on the back of our revised expectations for performance. Following 2020's leverage spike, we would expect the group's leverage to end 2021 at about 5.3x, and move below 5x only gradually through 2022, ending the year at 4.7x-5.0x. Taken together, this points to a highly leveraged adjusted debt to EBITDA profile, and the direction of travel is similar on an unadjusted basis. This consistently high adjusted and unadjusted leverage drives our highly leveraged financial risk profile assessment.

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Sherwood Parentco Limited--Key Metrics

	2020a	2021e	2022f
Debt to EBITDA (cash adjusted)	5.9x	5.0x-5.5x	4.7x-5.0x
Debt to EBITDA (not cash adjusted)	>6x	>6x	>6x
EBITDA interest coverage (cash adjusted)	4.0x	~5x	~5x
EBITDA interest coverage (not cash adjusted)	4.0X	~2.5x	~2.5x

a--Actual. e--Estimate. F--Forecast.

Despite elevated leverage, the group's interest coverage remains solid and its liquidity profile flexible, and we expect the group's liquidity uses to remain low. Although our financial risk profile is led by the combination of Arrow's leverage profile and financial sponsor ownership, broad strengths remain to the group's rating. The group will continue to operate with a solid cushion of earnings above interest expense, with our expected interest coverage ratio of about 5x sitting at the upper end of the peer set. At the same time, we expect the group to operate with significant liquidity, characterized by near full headroom in its RCF, we expect a small draw of £40 million-£50 million at deal close, and a modest level of annual portfolio purchases under our base case. Indeed, we expect the group to purchase at or around its replacement rate, or the level required to hold its estimated remaining collections flat--a level that should be covered by free cash flow generation. This latter point should support a stable gross debt profile and leave room for excess cash generation in the group. If the group elects to deploy this cash for proactive debt repayment, we could consider altering our assessment of its financial sponsor ownership in due course, although this is unlikely in the next 12 months.

Despite a weaker financial position, prospects for the group's core business lines remain favorable. We see Arrow's core balance sheet business as well-positioned in the European market, with good asset diversification across Europe and stable local franchises. Combined with the resilient servicing business and the growth and success of the fund management business, we see Arrow as well-placed to generate stable earnings and profitability over the medium term, while moving away from its previously aggressive capital deployment.

Outlook

The stable outlook reflects our expectation that Sherwood, through its Arrow operating subsidiaries, will operate with gradually reducing, though elevated, financial leverage over the next 12 months. Notably we expect average adjusted debt to EBITDA to hover around 5x over the next 24 months. We expect this trend to be supported by the group's continued pivot toward fund management and asset servicing in the European distressed debt market, with a continued stable, profitable performance in the group's balance sheet business.

Downside scenario

We could lower the ratings by one notch following a period of sustained underperformance or significantly accelerated capital deployment that undermined our broad view of the group's financial stability. This would include adjusted debt to EBITDA persistently above 5x beyond 2022. This could be precipitated by rapid, material drawing under the group's RCF, likely to fund mergers and acquisitions or significant portfolio purchases, which would increase leverage and worsen the group's liquidity position.

Upside scenario

We believe that an upgrade in our ratings on Sherwood or its debt instruments is unlikely over the next 12 months. In the medium term we could see upside in the rating if the group can reduce its leverage effectively, with its cash adjusted leverage around 3.5x on a sustained basis, while demonstrating stable financial discipline. Under our base case, we do not expect this before 2023 at the earliest.

Ratings Score Snapshot

Issuer Credit Rating: B+(prelim)/Stable/--

Business risk: Fair

- Country risk: Intermediate
- Industry risk: Moderately High
- Competitive position: Fair

Financial risk: Highly Leveraged

- Cash flow/Leverage: Highly Leveraged

Anchor: b

Modifiers

- Diversification/Portfolio effect: Neutral (no impact)
- Capital structure: Neutral (no impact)
- Financial policy: FS-6 (constrains FRP at Highly Leveraged)
- Liquidity: Adequate (no impact)
- Management and governance: Fair (no impact)
- Comparable rating analysis: Positive (+1)

Issue Ratings--Recovery Analysis

Key analytical factors

- The preliminary long-term issue rating on Sherwood's senior secured notes is 'B+', in line with the preliminary issuer credit rating. The recovery rating of '4' is supported by the company's asset base and our view of the U.S. and U.K. as relatively favorable jurisdictions for senior secured creditors.
- Our simulated default scenario contemplates a default in 2025, reflecting a significant decline in cash flow because of adverse operational issues, lost clients, difficult collection conditions, or greater competitive pressures, leading to mispricing of portfolio purchases.
- We calculate a combined enterprise value, taking into consideration the different business segments and assuming that Arrow's portfolio of debt receivables would find a potential acquirer. We apply a haircut of 25% to the book value of the debt portfolios. In calculating the assets available to support the group's enterprise value, we deduct the assets pledged to the asset-based facilities from our estimate of the net portfolio. We assume these facilities to be 100% drawn at the point of default.
- In addition, we assume earnings from its third-party servicing businesses will decline and apply a valuation using a 4.0x EBITDA multiple. We assess Sherwood on a going-concern basis, given its long-term contracts and established relationships with customers from Arrow.

Simulated default assumptions

- Year of default: 2025
- Jurisdiction: U.S.

Simplified waterfall

- Net enterprise value (1) on liquidation: £758 million
- Priority claims (2): £245 million
- Collateral value available to secured creditors: £512 million
- Senior secured claims (2): £1,261 million
- --Recovery expectation: 4 (rounded estimate: 40%)
- (1)This figure is net of a 5% administrative expense charge. (2)Includes six months of prepetition interest expense.

Related Criteria

- **General Criteria: Environmental, Social, And Governance Principles In Credit Ratings**, Oct. 10, 2021
- **General Criteria: Group Rating Methodology**, July 1, 2019
- **Criteria | Corporates | General: Corporate Methodology: Ratios And Adjustments**, April 1, 2019
- **Criteria | Corporates | General: Recovery Rating Criteria For Speculative-Grade Corporate Issuers**, Dec. 7, 2016
- **General Criteria: Guarantee Criteria**, Oct. 21, 2016

- **Criteria | Corporates | General: Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers**, Dec. 16, 2014
- **Criteria | Financial Institutions | General: Issue Credit Rating Methodology For Nonbank Financial Institutions And Nonbank Financial Services Companies**, Dec. 9, 2014
- **Criteria | Corporates | General: Corporate Methodology**, Nov. 19, 2013
- **General Criteria: Methodology: Management And Governance Credit Factors For Corporate Entities**, Nov. 13, 2012
- **General Criteria: Principles Of Credit Ratings**, Feb. 16, 2011

Related Research

- Arrow Global Ratings Placed On CreditWatch Negative As Take-Private Deal May Worsen Its Financial Position, April 21, 2021
- Monitoring How Arrow Global's Take-Private Deal With TDR Will Affect The Ratings, March 31, 2021
- Europe's Distressed Debt Purchasers Look To Steady The Ship In 2021, Feb. 12, 2021
- Arrow Global's Bond Tap Shows Funding Position Is Still Supportive, Feb. 1, 2021
- Arrow Global Group PLC, Dec. 2, 2020

Ratings List

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New Rating; Outlook Action	
Sherwood Parentco Ltd.	
Issuer Credit Rating	B+(prelim)/Stable/--
New Rating	
Sherwood Parentco Ltd.	
Senior Secured	B+(prelim)

Certain terms used in this report, particularly certain adjectives used to express our view on rating relevant factors, have specific meanings ascribed to them in our criteria, and should therefore be read in conjunction with such criteria. Please see Ratings Criteria at www.standardandpoors.com for further information. A description of each of S&P Global Ratings' rating categories is contained in "S&P Global Ratings Definitions" at https://www.standardandpoors.com/en_US/web/guest/article/-/view/sourceId/504352 Complete ratings information is available to subscribers of RatingsDirect at www.capitaliq.com. All ratings affected by this rating action can be found on S&P Global Ratings' public website at www.standardandpoors.com. Use the Ratings search box located in the left column. Alternatively, call one of the following S&P Global Ratings numbers: Client Support Europe (44) 20-7176-7176; London Press Office (44) 20-7176-3605; Paris (33) 1-4420-6708; Frankfurt (49) 69-33-999-225; Stockholm (46) 8-440-5914; or Moscow 7 (495) 783-4009.

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