

Find Your Niche

August 2018

With growing pressures in the direct lending market, is the asset class still a viable alternative for investors seeking higher yields?

From its emergence out of the financial crisis, today the European private debt (direct lending) market has become an embedded part of the lending landscape (Fig.1).

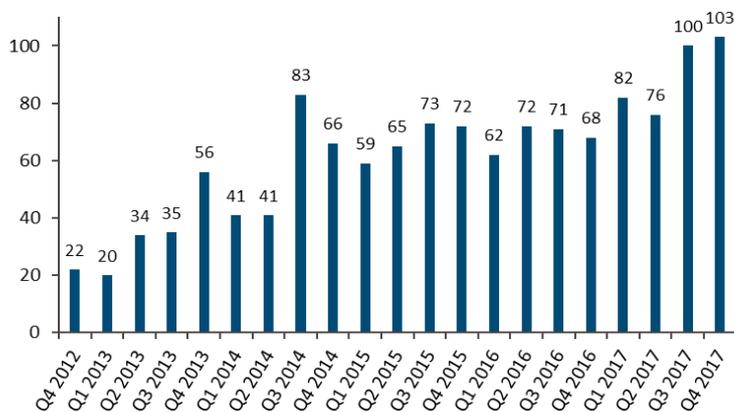
However, against a backdrop of a maturing opportunity set, investors are increasingly concerned that the market could be nearing saturation. In some segments of the market origination is becoming more difficult while pricing pressures are increasing. Are these concerns justified and if so, what implications do they have for investors?

A Multi-Faceted Landscape

The European lending market can be split into three categories: large cap, upper mid-market and lower mid-market.

The large cap (>€75mm EBITDA) and upper mid-market (€25mm-€75mm EBITDA) segments are sited in an increasingly competitive landscape. The asset class is also continuing to see inflows as more investors look for yield with minimal duration risk.

Fig. 1 - Alternative Lending Deals in Europe Have Increased



Source: Deloitte Alternative Lender Deal Tracker Spring 2018. Covers 63 alternative lenders (primary mid-market UK and European deals). Data in the Alternative Deal Tracker is retrospectively updated for any new participants.

Viewpoint



Kirsten Bode
Co-Head Private Debt, Pan-Europe

Prior to joining Muzinich, Kirsten worked for six years as a Managing Director in the principal debt investing team at Macquarie, responsible for sourcing and executing transactions in the UK, Germany and Benelux. Previously, she worked for Silver Point Capital's private debt team in Europe. Kirsten started her career at Morgan Stanley in 1999, working in the generalist M&A and Leveraged Finance teams in Germany and London. Kirsten graduated from ESB Reutlingen and Middlesex University London with a BA Honors in European Business Administration.



Mark O'Keeffe
Global Co-Head Private Markets

Prior to joining Muzinich, Mark was a Partner at York Street Capital. Before York Street, he was Chief Credit Officer of CIT's Sponsor Finance Group (2005-2007) and Group Head (2002-2005) where he helped build the group from 4 to 18 professionals and grow assets from approximately \$200 million to over \$1 billion. Over his leveraged finance career, Mark has been involved with closing over 285 transactions for \$4.0 billion of funded senior and junior debt. He earned a BA in Economics and History from Hamilton College and holds the Chartered Financial Analyst designation.

More providers, combined with an increasing pool of capital, is translating into growing challenges in deal sourcing and capital deployment, which is in turn leading to pricing compression in some areas of the market.

It can be argued that these larger segments appear to have become victims of their own success; the limited number of deals is resulting in more aggressive leverage and weaker structures as lenders compete for the business.

In the lower mid-market (€5 - €25mm EBITDA) the story is different. This segment is less well served from a lending perspective and offers a diverse opportunity set without many of the challenges facing the upper-mid and large cap markets, in our view.

There are an estimated 100,000 businesses in the European lower mid-market, but fewer lenders. Such a sizeable opportunity set comes with multitudinous risk profiles and differing capital requirements - from growth and acquisitions through to refinancing and restructuring.

With the lower mid-market so rich in opportunity, why are there fewer providers competing to lend? The answer is that this part of the market has a number of barriers to entry that many direct lending operators are unable or unwilling to meet.

Profitable Niches

The sheer diversity is itself a challenge. Lenders arguably need to specialise by sub-segment/country to find the profitable niches where they are best able to operate successfully.

While it is important not to exclude certain sectors outright, some may have more attractive features such as predictable cashflow and higher cashflow conversion.

Meanwhile those in more highly-cyclical sectors such as retail, will provide less predictable cashflow profiles and therefore may not offer the best risk-return profile.

Some countries are also weighted towards specific sectors; Germany and Italy for example have a greater proportion of industrials, while the UK has more professional services businesses.

The specialisation, dedication and focus required to source deals alone has acted as a deterrent to many of the larger managers who can comfortably undertake all their larger transactions from a centralised location.

Yet, we believe a provider willing to invest in a local presence across European jurisdictions, can benefit from attractive, untapped return opportunities within a much less competitive landscape.

With such a diverse pool of investment opportunities, having a localised presence in each market in which a lender operates is vital, in our experience, to ensure successful deal origination.

In our view, specialists within each jurisdiction who have extensive and local fundamental credit analysis capabilities, who understand the culture, language and legal regime and have developed good relationships, are key to a successful investment strategy.

While this platform is more challenging to develop, once established the potential benefits can be significant. Faced with a choice of sponsored or non-sponsored deals, the latter can be more varied and provide the potential for further diversification benefits.

Directly-originated transactions may also generate higher yields and better terms and conditions than sponsored deals, which tend to be more competitive. Meanwhile fewer competitors can mean deal terms offer a higher return on lower leverage.

In addition, non-sponsored deals present lenders with the opportunity to form closer relationships with businesses. This can be very satisfying from a lender's perspective and offers them the possibility of supplying assistance and advice to drive a business forward; many of these firms are founder and family owned and welcome the expertise and input from a lender.

At the same time, a lender with the ability to present a flexible and customised structure to suit a company's specific needs could result in an enhanced risk/return profile for the investor.

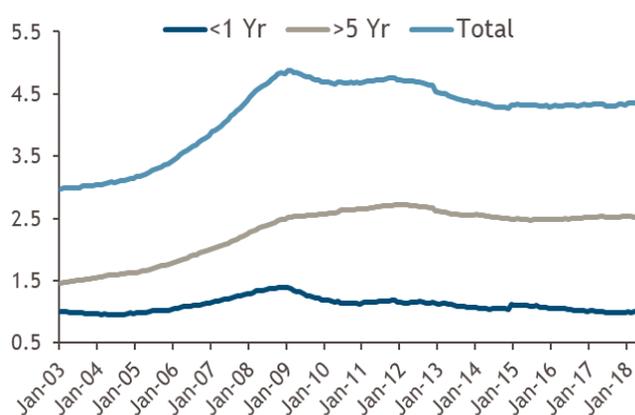
Risks Ahead

Looking ahead, monetary tightening appears to be on the agenda for much of the developed world, although it will likely be at a slow and measured pace. Will rising rates lead to more competition from banks in the lending market?

In our view, this is unlikely to occur. Bank loans to corporates have been in steady decline for some time (Fig. 2) due to regulatory burdens such as Basel III which already make it more difficult for longer-term lending for non-investment grade businesses (likely to be the case for the majority of lower mid-market companies).

Therefore, even in a rising rate environment, we believe banks are unlikely to begin competing heavily with private lenders in this section of the market.

Fig. 2 - Bank Loans to Corporates in the Euro Area (€tr)



Source: European Central Bank - banks' balance sheet - total loans to corporates, from January 2003 to April 2018.

Instead we expect to see an increasing amount of banks acting as deal introducers and partnering on financing. For example, banks and funds are partnering on unitranche transactions and these are becoming increasingly popular as collaborative and cost-efficient methods of financing.

Although pricing pressures have been experienced in some sectors of the market, we believe the bottom has been reached and we do not anticipate any further downward trends in pricing.

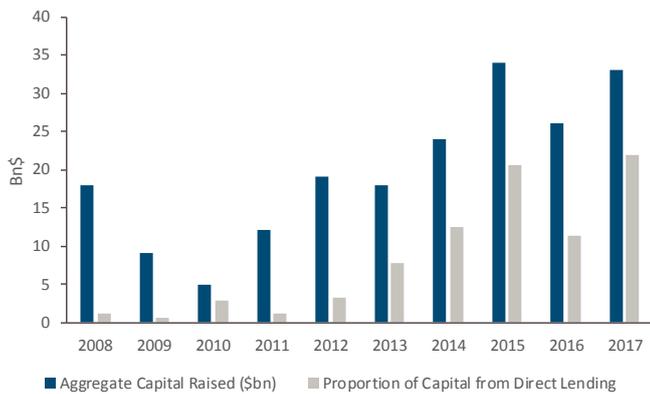
Direct lending is an illiquid market for which investors are compensated with an illiquidity premium.

If prices converged with the liquid markets, there would be no point for investors to participate; hurdle rates have acted as a floor to prices falling any further.

In addition, with the increasing number of market participants comes growing concern that the amount of so-called 'dry powder' (capital raised but not deployed) is rising.

Yet, as Fig. 3 shows, dry powder in the direct lending sphere has actually stabilised. This is in sharp contrast to the private equity market where numbers are still rising (Fig. 4).

Fig. 3 - European Private Debt Fundraising Over Time (\$bn)



Source: "2018 Global Private Debt Report - Preqin" page 31: European Fundraising

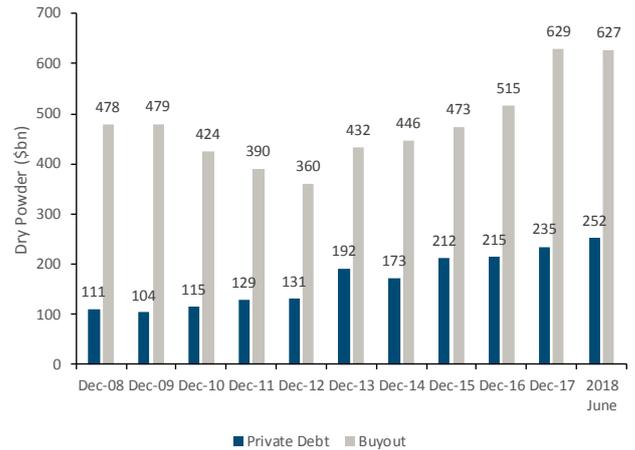
Then there is the fear of a growing number of covenant-lite deals and weaker structures emerging in the market place, which increases risks for lenders in the event of a default.

While these are becoming a bigger feature of liquid markets, they are far less common in direct lending (although there are some) and at the lower end of the mid-market there are even fewer.

Nevertheless, we believe it remains important to avoid the riskier (covenant-lite) deals. The European direct lending market has yet to experience a full credit cycle and, as the cycle turns, defaults in the riskier credits are likely to increase because recoveries are weaker.

In our view, ensuring a focus on conservative structuring with maintenance covenants should provide insulation from default risk.

Fig. 4 - Europe Focused Dry Powder (\$bn)



Source: Preqin Global Private Debt Report - to 30 June 2018

Higher Risk/Rewards

Despite the challenges experienced by some segments of the market, direct lending appears to be here to stay. In the US it is a well-entrenched part of the lending landscape and we believe that pattern will be repeated in Europe, although at a different pace in each jurisdiction.

While we could witness periods of supply/demand imbalances and challenges in the near term - such as the recent pressures on pricing - over time we believe the market should reach an equilibrium.

We believe the European direct lending opportunity set is diverse enough to support a range of lenders with different offerings. But, as the number of participants grows, it is important for a lender to be able to distinguish themselves from their peers and identify that profitable niche in which to operate.

In our view, specialisation is the key to a successful lending model, which in turn offers clients the best return on their investment.

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