Finding Your Niche

December 2017

VIEWPOINT

By Kirsten Bode & Rafael Torres

With challenges in origination and pricing highlighting growing pressure in the direct lending market, is it still a viable alternative for investors seeking higher yields in an illiquid product?

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

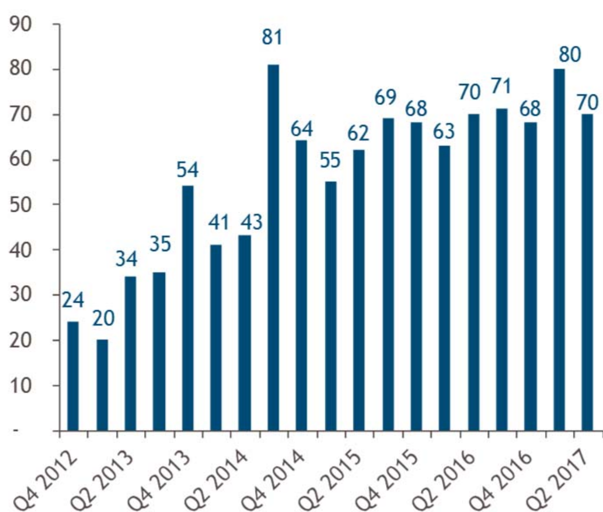
However, against a backdrop of a maturing opportunity set investors are increasingly concerned that the market could be nearing saturation. In some quarters origination is becoming more difficult while pricing pressures are increasing. Are these concerns justified and if so, what implications do they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

A Multi-Faceted Landscape

The European lending market, which involves more than 80 participants, can be split into three categories: upper mid-market, large cap and lower mid-market.

The upper mid-market (€25mm-€75mm EBITDA) and large cap (>€75mm EBITDA) are sited in an increasingly competitive landscape. The asset class is also continuing to see inflows as more investors look to increase their exposure in the ongoing low-yielding environment.

Fig. 1 – Alternative Lending Deals in Europe Have Increased



Source: Deloitte Alternative Deal Tracker Q2 2017.

Kirsten Bode

Co-Head of Private Debt, Pan Europe

Before joining Muzinich, Kirsten worked as a Managing Director in the principal debt investing team at Macquarie, responsible for sourcing and executing transactions ranging from leveraged senior, unitranche and mezzanine debt to equity in the UK, Germany and Benelux. Previously, she worked for Silver Point Capital, a U.S.-based credit/distressed fund, in the 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 B.A. (Hon) in European Business Administration.

Rafael Torres

Head of Private Debt, Iberia

Before joining Muzinich, Rafael was a partner at Hutton Collins Partners LLP, a €1.4 billion primary subordinated debt/preferred equity investment firm. Previously, Rafael held a number of positions in middle-market investing, lending and credit. He spent two years at Mercapital, a middle-market private equity firm and five years at Merrill Lynch in their credit team and later in leveraged finance, originating and executing senior and subordinated debt investments. He started his career at Chemical Bank/Chase Manhattan Bank in Madrid. Rafael graduated from ICADE in Spain and Groupe ESC Reims in France with a B.A. (Hons) in European Business Administration.

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 a compression on pricing 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 very different. This segment is largely underserved from a lending perspective and offers a diverse opportunity set without many of the challenges facing the upper-mid and large cap markets.

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

The lower mid-market is rich in opportunity, so 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.

"The lower mid-market is largely underserved from a lending perspective and offers a diverse opportunity set without many of the challenges facing the upper-mid and large cap markets"

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 a provider willing to go where other managers fear to tread (i.e. the lack of a local presence across European jurisdictions) can benefit from attractive, un-tapped 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 to ensuring successful deal origination.

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 can also generate higher yields and better lending conditions than sponsored deals, which tend to be more competitive. While 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 is very satisfying from a lender's perspective and offers them the possibility of supplying help 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.

It is essential, however, for a lender to obtain a thorough understanding of a company's business model to be able to follow it as an outsider, highlighting the necessity for detailed due diligence.

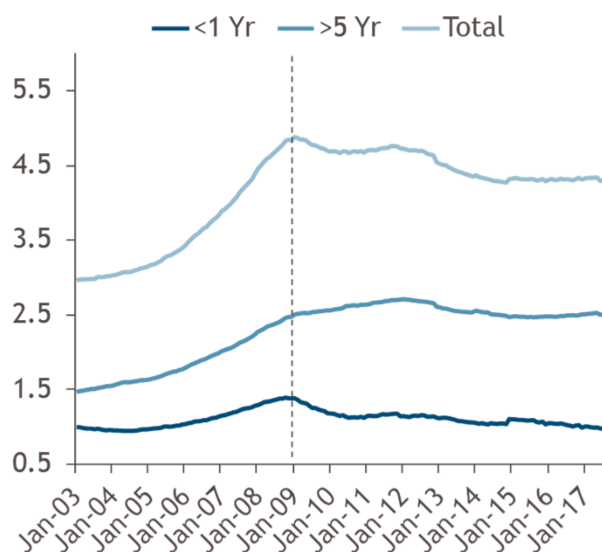
Risks Ahead

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, 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: ECB – June 2014 consolidated banking data and earlier editions; ECB - our statistics, banks balance sheet – total loans to corporates, from January 2003 to August 2017.

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.

There are also organisations such as the British Business Bank which work with investors to provide funding. These organisations are likely to continue to remain supportive of lenders to the lower end of the SME market.

> *"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"*

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.

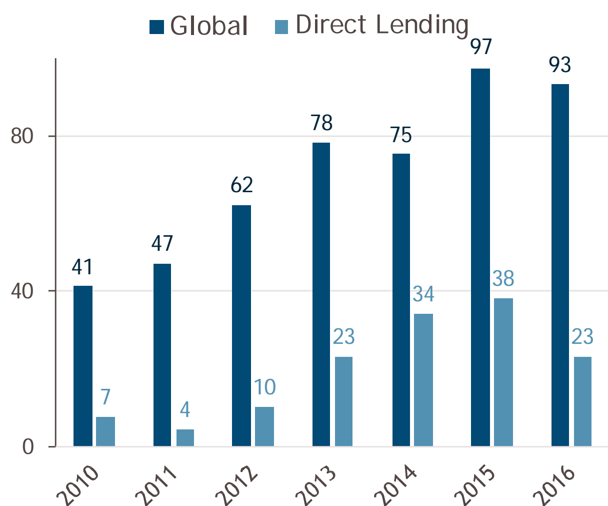
Direct lending is an illiquid market for which investors are compensated with an illiquidity premium.

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.

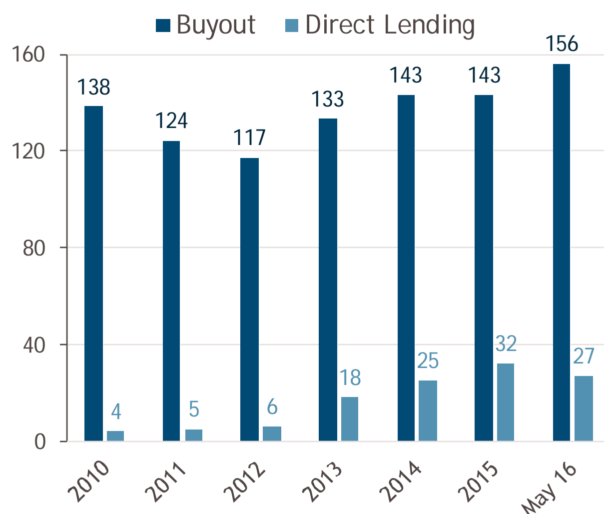
Yet, as Fig. 3 shows, dry powder in the direct lending sphere has actually stabilised. This is in sharp contrast to the private equity market where numbers are still rising (Fig. 4).

Fig. 3 – Private Debt Fundraising over Time ($bn)



Source: 2017 Prequin Global Private Debt Report

Fig. 4 – Europe Focused Dry Powder ($bn))



Source: 2017 Prequin Global Private Debt Report

> *"The European direct lending opportunity set is diverse enough to support a range of lenders with different offerings"*

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.

Ensuring a focus on conservative structuring with maintenance covenants should provide insulation from default risk.

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.

In our view, 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.

Important information

This document has been produced for information purposes only and as such the views contained herein are not to be taken as investment advice. Opinions are as of date of publication and are subject to change without reference or notification to you. Past results do not guarantee future performance. The value of investments and the income from them may fall as well as rise and is not guaranteed and investors may not get back the full amount invested. Any research in this document has been procured and may have been acted on by Muzinich for its own purpose. The results of such research are being made available for information purposes and do not constitute investment advice. Opinions and statements of financial market trends that are based on market conditions constitute our judgement as at the date of this document. They are considered to be accurate at the time of writing, but not warranty of accuracy is given and no liability in respect of any error or omission is accepted. Emerging Markets may be more risky than more developed markets for a variety of reasons, including but not limited to, increased political, social and economic instability; heightened pricing volatility and reduced market liquidity. Issued in Europe by Muzinich & Co. Ltd, which is authorised and regulated by the Financial Conduct Authority.