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European Direct Lending Perspectives

Issue 2 – Q1 2019 Review

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Contents

Brexit hasn’t put the brakes on direct lending

Welcome to the second edition of the Creditflux and Debtwire *European Direct Lending Report*, which investigates deal and fundraising activity in the first quarter of 2019

Mariana Valle
Co-deputy editor, head of primary markets
Debtwire Europe

With Brexit creeping ever closer, the first quarter of 2019 started tentatively. But, while volumes dropped significantly when compared to a record-breaking 2017, UK direct lending activity in Q1 2019 was only slightly behind the same period last year. Indeed, the biggest ever UK unitranche, backing the refinancing of UK telco company Daisy Group at around £1 billion from Ares, was clinched in the first quarter.

Certain sectors such as casual dining and consumer retail, which are getting hammered by industry-wide headwinds, are being avoided due to the current volatility. But traditional sectors including business services, technology, media and telecommunications (TMT) and healthcare, which always attract the attention of direct lenders, continue to see activity.

In fact, the total volume of direct lending deals in the first quarter in Europe reached €2.5 billion across 79 deals (68 mid-market, 11 large cap), which is over three times higher than the €701 million achieved across 60 deals in Q1 2018.

This trend is also evident when we look at how much money direct lenders are raising.

In the first three months of 2019, €10 billion was raised by funds in Europe, which is more than the whole of 2013, 2014 and 2016. It could well be that 2019 beats 2017’s total of €32.1 billion. While uncertainty is causing a degree of nervousness in the market, Brexit has definitely not brought direct lending to a standstill.

Some funds such as BlueBay and Tikehau have even doubled their target amounts - with all the top five largest funds in the first quarter raising more than their targets. And investors are gravitating towards larger managers, which you can read more about on page 12.

Our league table shows Ares continues to top the bill, with a 14.1% and 18.8% market share in Q1 2019 in the mid-market and large cap spaces, respectively, based on number of deals. It is followed by Permira and Pemberton in both tables.

The deal count and fundraising totals across Europe in the first half of 2019 show that direct lending is still in rude health despite the threat from Brexit and this is likely to continue for the foreseeable future.

Creditflux and Debtwire report on the biggest stories in the world of direct lending. Breaking exclusives and reporting on launches, strategies, hires and much more make these must-have services for a market hungry for news. Below are a selection of stories from 2019 so far

Creditflux News

Muzinich launches multi-strategy fund

Muzinich has teamed up with Unicredit's wealth management arm Cordusio SIM to launch a multi-strategy credit fund, which will allow retail investors to access institutional asset classes in a closed-ended fund. The vehicle, known as Muzinich Firstlight Middle Market ELTIF, will invest in a mixture of European syndicated loans (60-80%), private debt (10-30%) and high yield bonds (5-10%).

The six-year fund is structured as a European Long-Term Investment Fund (ELTIF). Established in December 2015, the ELTIF structure was considered a milestone in the development of the cross-border European long-term funds, and helped finance SMEs after banks delevered.

ELTIFs are highly regulated, and a manager must comply with strict diversification rules and limited leverage. They must also invest at least 70% of their capital in eligible long-term investments. ELTIFs also allow investors to invest a minimum of €10,000, allowing a greater number of clients access to these asset classes.

UK pension fund goes big on private debt

Strathclyde Pension Fund's committee has awarded £900 million to three private debt managers and one real estate debt manager.

Alcentra, Barings and Partners Group were all selected to manage a portion of the £21.97 billion pension fund's corporate private debt portfolio, with initial £250 million, £250 million and £200 million target allocations, respectively. The mandates are anticipated to help the pension fund achieve its 3.5% corporate private debt target allocation. Meanwhile, Intermediate Capital Group was awarded a private real estate debt mandate with a 1% (£200 million) initial allocation of the portfolio. The pension fund does not have any exposure to real estate debt.

EC relaxes rules for easier investment

The European Commission has amended Solvency II rules to make it easier for insurers to invest in private debt and private equity.

The regulator announced in a report in March that the adopted new rules will effectively lower the capital requirements for groups of investments in unrated debt, private placements, alternative investment funds, long-term equity and unlisted equity. This removes "unjustified disincentives to shifting more capital into equity and unrated debt without jeopardising the risk-sensitivity of the framework", according to the EC.

One such amendment enhances the appeal of unrated debt to insurance companies by changing the treatment of unrated exposures. At present, bonds or loans that are unrated are assigned to a 'residual' category, leading to those instruments capturing a capital requirement equivalent to rated corporate bonds that have a below investment grade credit quality.

Goldman Sachs lands big hire from Alcentra

Patrick Ordynans has joined Goldman Sachs Private Capital, after six years at Alcentra, to lead the firm's mid-market lending effort in the DACH (Germany, Austria and Switzerland) region.

The move signals Goldman's intent to push further into direct lending in Germany, where the capital market has traditionally been dominated by banks.

Debtwire News

Direct lending co-investments on the rise

In our monthly commentary, Debtwire looked at the rise in co-investments in the direct lending space. After becoming commonplace in the equity space, co-investments are now increasing in the direct lending market, with both sides of the table seeing the benefits.

Managers say LPs are becoming more sophisticated and requesting more opportunities to co-invest. GPs are also waking up to the benefits, such as giving them more firepower to go larger, or mitigating portfolio concentration risk.

A recent example is that of UK telco Daisy Group, which reached the £1 billion mark in the direct lending space. Co-investments appear more prevalent at the larger end of the market, as there is more money to go around. Some LPs also require a minimum co-investment amount of between €25 and €30 million, so deals need to be large enough to accommodate that.

BlueBay take charge of UK data firm EDM

In February, Debtwire revealed that BlueBay had taken control of the EDM Group, a UK data management and storage business, from sponsor LDC. The business was initially levered at 5.5x with £100 million of financing provided by BlueBay and Lloyds.

The business needed cash following a fire in one of its facilities in January 2019. This was coupled with a downturn in performance following an onerous contract in the US. EDM had to reset covenants and secure a £10 billion cash injection by advancing an undrawn loan facility.

Foundry sale heats up UK market

In February, the sale of UK special effects software business Foundry laid bare lender appetite for software companies, drawing pitches up to 7x of leverage.

Debtwire revealed that lender education run by Deloitte introduced the £23 million-EBITDA business to lenders who were keen on its stable revenues from recurring licensing agreements.

Ultimately, the asset was acquired by trade bidder Roper Technology in a £410 million cash acquisition.

European Sperm Bank proves attractive

Although it's small and potentially faces regulatory issues, the Danish-based European Sperm Bank saw a tightly fought competition for financing, Debtwire reported earlier this year.

Some banks pushed leverage as high as 5.5x on an all senior basis, with unitranche also in the mix with 6x offered off EBITDA of around DKK 48 million (€6.5 million).

Cartonplast capex spend troubles financiers

In late January, Debtwire investigated the sale of Cartonplast, revealing how the packaging company's capex spend had made financiers nervous as information memoranda for its sale went out.

According to sources, its capex amounts to around a third of the company's EBITDA, which is being marketed at €38 million, and is mostly growth-related. Financiers had to better understand the capex budget and how much additional growth they would get for every euro invested. While investment needs are substantial, Cartonplast can still be more comfortably financed than other capex-intensive businesses because cash is only going in when revenues are already contracted.

With details on the group's figures pending, financiers have yet to develop solid debt indications. Based on preliminary views, banks are likely to pitch all-senior financing packages at just below 4x leverage. Funds are expected to offer a broad range starting at 4x and possibly going as high as 5.5x for unitranche in some cases, according to sources.

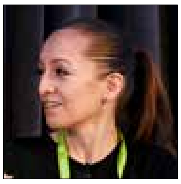
Steering clear of the B word

Ahead of what was the original deadline for the UK to exit the EU, direct lenders gathered in London for Creditflux's European Direct Lending event in March. And, despite the proximity of the exit date, panellists at the event seemed at pains to avoid mention of the B word

Back in mid-March, London's County Hall welcomed direct lenders, advisors and fund financiers from across Europe to Creditflux's European Direct Lending event debate, where they discussed the segments of the market that offered the best risk-adjusted returns.

During the keynote interview between Cheyne Capital's Anthony Robertson and Diala Minott from Paul Hastings (pictured below), it took a full 20 minutes before the pair conceded that it was time to address the elephant in the room when Robertson was asked about struggling UK high street names. "This is obviously your subtle way of not mentioning Brexit," he said.

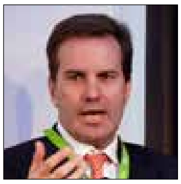
Brexit avoidance was not exclusive to this keynote interview; throughout the day speakers were keen to address other key issues, such as larger deal sizes, distressed opportunities and the syndication of loans and fund financing facilities.



Diala Minott
Paul Hastings

They're supposed to be all singing, all dancing multi-asset funds — and it's quite often a single investor.

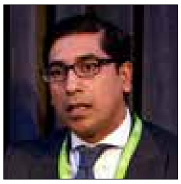
Insurance regimes have changed recently, encouraging these firms to allocate across various markets in single-investor funds. The investor then places each investment into one of its own buckets, be it private equity, alternatives or fixed income.



Anthony Robertson
Cheyne Capital

Investors will continue to allocate with reckless abandon.

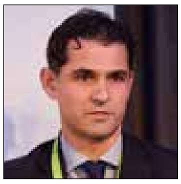
"Brexit absolutely represents an opportunity. The current circumstance is a debacle, but does present opportunities because some of these businesses [high street companies such as House of Fraser, New Look and Patisserie Valerie] have a viability." Robertson went on to say that there has been a rush to allocate to traditional credit markets, despite the uncertainty the UK faces and consequently CLOs, loan funds and bond funds will feel the pain.



Zeshan Ashiq
Barclays

A term sheet in the US can be summarised on A4 paper.

In contrast, a European direct lending term sheet can run to 20 or 30 pages.



Arun Cronin
Credit Suisse

Syndication of [fund financing] risk is coming.

A middle-market European CLO isn't coming any time soon, but syndication of fund leverage could become more prevalent.

Neale Broadhead
CVC Credit Partners

The banks, I think, ultimately will be the losers.

He feels banks are the ones that tend to run away quickest when there's any adversity.

Edward Eyerman
Fitch Ratings

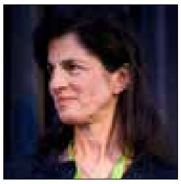
New money wreaks havoc on recoveries.

In restructurings, if sponsors have to inject capital into businesses then lenders can lose out if new debt ranks senior in the capital structure, with New Look being a prime example.

Graeme Delaney-Smith
Alcentra

We might start teaming up a bit more.

Larger deals might start to become difficult for a single fund to absorb and still maintain diversity. In which case, teaming up may solve the problem.



Cécile Mayer-Lévi
Tikehau Capital

Just providing money is not the only added value that you can bring to a transaction.

For newcomers, simply writing cheques might not be enough. Mayer-Lévi suggests that having a speciality, such as focusing on specific industries, could be a better entry point.

David Hirschmann
Permira Debt Managers

10 years ago, if you were managing €1 billion in direct lending, you were a significant player. Today, we're talking about €1 billion loans.

Over the last decade, the direct lending industry has grown rapidly to the point where a loan of €1 billion is no longer out of reach for funds.

Regional view

Views from attendees from all across Europe

Germany

"You have to be careful the structure does not turn upside down." — Klaus Petersen, Apera Capital

Unitranche facilities are typically structured with a super senior portion of 30%. But these have to be structured with care. You don't want the super senior to say, "Guys, pay me back and unravel the structure."

"They always resisted debt funds, but they ended up doing their first deal with us. I think they are all opening up." — Theo Weber, BlackRock

BlackRock's Weber describes how a market-leading German bank was sceptical of direct lenders, but ended up partnering with BlackRock.

Nordics

"There is a red light/green light mentality."
— Mikkel Sckerl, Capital Four Management

Banks can move together in the Nordics. So if the red light comes on, then it's open season for fund managers.

"When we see a supposedly good Nordic asset, but for some reason the local sponsors aren't interested, you have to ask why?"– Andrew Cleland-Bogle, EQT

Domestic sponsors shying away from a company can be a red flag for a lender.

Italy

"The banks didn't notice that things were going wrong."
– Barbara Ellero, Anthilia Capital Partners

Loan covenants are critical. In a portfolio of 30 loans, one went wrong and Ellero says that covenants provided an early indication, allowing Anthilia to remedy the situation.

"The majority of deals we see are sponsorless."
– Alexandra Gropp, Banca Finint

Italian SMEs are smaller than those in the Nordics, Germany or France. The vast majority of lending opportunities therefore centre around family-owned businesses.

Record-breaking Q1 sees fundraising hit new heights

This year's Q1 total could point to a very happy year ahead for Europe's direct lenders

By Paul Tilt
Head of fund research
Acuris

The first three months of 2019 have seen European direct lenders raise a combined €10.8 billion across six fund final closes – the strongest ever start to a year, according to Creditflux data.

To put this figure into perspective, the amount raised in the first quarter has already surpassed the full year fundraising figures for 2013, 2014 and 2016 and continues to build on the momentum of 2017 and 2018, which saw a combined €57 billion raised.

Although headline statistics can be skewed by fundraising cycles and distorted by a few large closes – BlueBay's Direct Lending Fund III pulled in €6 billion or 55.5% of all capital raised in Q1 2019 – market sources are in bullish agreement that 2019 is shaping up to be a stellar year for fundraising.

"I would expect fundraising to remain buoyant," said one pan-European GP. "As the private debt markets develop and new strategies are launched to capitalise on different parts

of the market, we feel there is demand given the increasing risk in public markets and the difficulty in extracting risk-adjusted value from them."

In another sign of investor appetite for European direct lending, of the funds closing in Q1, all beat initial fundraising targets by amounts ranging from 15% to 100%.

Big might be better?

A closer analysis of funds closing in the period such as BlueBay, Muzinich and Tikehau highlight a trend of pan-European, larger managers securing the capital. One source cautions that "fundraising is increasingly focused on the bigger managers, with wider platforms and established track records. Newer managers may be able to raise capital for niche strategies; however, we believe there is a gravitation towards the larger managers, not least because of the re-upping that occurs, and clearly larger managers have the best scope to capitalise on that."

This gravitation to larger managers is echoed by Creditflux data, with numerous large managers securing recent big-ticket commitments from prominent international institutional investors including MainePERS' €100 million to Ares Capital Europe IV, New Mexico Educational Retirement Board's €100 million to BlueBay Direct Lending Fund III and Strathclyde's £250 million into Clareant European Direct Lending Fund III.

However, smaller managers and country-specific GPs tend to target a different sub-set of investors and investments for their funds compared to their larger peers, and so it is not wholly a zero-sum game. Investors in these funds are typically local institutional investors, family offices and high net worth individuals, while the managers seek deals with debt tickets of €5-€25 million, especially sponsorless deals, where there is less competition and potentially higher returns compared to a vanilla, sponsored mid-market deal.

Pan-European approach wins

As this report covers the period in which Britain had been due to leave the EU, it would be remiss not to touch upon the impact this political uncertainty has had on fundraising.

According to sources who are currently, or have been recently on the fundraising trail, there are investors who are actively seeking UK exposure, but these are the exception to the rule. Many LPs, particularly those based in continental Europe, are specifically looking to limit UK exposure.

One manager said they took advantage of being perceived as a pan-European player as opposed to a UK fund in their recent fundraise as they experienced LPs freezing commitments towards the UK for the time being.

While the appetite for UK exposure and sterling-denominated funds over the past 18 months has dropped off, LP appetite towards the country over the long term is unlikely to diminish significantly, according to sources. However, with the deadline for a Brexit agreement postponed until 31 October, the uncertainty is likely to persist through 2019.

A record year ahead

Delving into the data, Creditflux anticipates a further €15 billion to be raised in the near term with Alcentra, Permira and Hayfin all set to close off sizeable fundraises. A further 35 managers are in the market, with many of these expecting to wrap up fundraising this year.

With the insatiable appetite of investors for direct lending showing little sign of abating, it is highly likely that 2019 will challenge the record figures raised in 2017 and 2018.

Largest European direct lending funds closed in Q1 2019

Fund Name	Target	Amount Raised
BlueBay Direct Lending Fund III	€3bn	€6bn
Tikehau Direct Lending Fund IV	€1.2bn	€2.1bn
Apera Capital Private Debt Fund I	€650m	€750m
Muzinich Pan-European Private Debt Fund	€500m	€706m
Kreos Capital Fund VI	€600m	€700m

Select funds set to close in 2019

Fund Name	Target
Clareant European Direct Lending Fund III	€5bn
Permira Credit Solutions IV	€2.5bn
Pemberton European Mid-Market Debt Fund II	€2.5m
Hayfin Direct Lending Fund III	
Bridgepoint Credit II	€750m

LPs seeking opportunity from uncertainty

Investors are focusing on direct lender behaviour ahead of an expected downturn in the competitive US market

Mariana Valle
Co-deputy editor, head of primary markets
Debtwire Europe

Competition for funds from LPs is fiercer than ever, according to speakers at this summer's Debtwire and Creditflux Mid-Market Forum held in New York. With the market becoming more mature, LPs have become more sophisticated and are starting to put pressure on managers to stay away from aggressive lending practices when it comes to leverage or covenants, with a view of assessing how they will fare in a downturn.

LPs are not only looking at where they could lose money, but also who could actually be in a position to benefit from a dislocation.

"What we see more commonly is that they expect there will be a period of downturn and they are assessing who they want to partner with," said a US direct lending fund. "Those are the most frequent questions - how are you structuring your deal? Are your covenants lite? And, if there is a dislocation in the market, how are you prepared to capture it as an opportunity?"

LPs driving a hard bargain

US direct lenders are experiencing very similar challenges to their European counterparts, with increased competition driving aggressive documentation changes.

Despite the pressure from LPs, speakers said EBITDA addback flexibility, cov-lite or 'cov-wide' – covenants set at 35%-40% without a step down - and other cash leakage loopholes, such as shifting assets outside the lending pool from the collateral package, are all working their way into the middle market. The US$20 million to US$30 million EBITDA segment is the most competitive and an area where sponsors have an opportunity to play one fund off against another to extract more flexibility on documents and reductions in price, the speakers noted.

"Trying to balance doing the best deal for the LP but deploying and continuing to do deals in a competitive market at the same time is the biggest challenge," said another US direct lender. "We keep hearing from LPs that it's too competitive but then, hey, [they give us] a 100 million bucks."

Deployment is decent

However, despite competition being the most talked-about topic for the day, speakers said the rate of deployment has been satisfactory, at 18-24 months, driven by a healthy deal flow and the fact that US banks have retreated much more from the mid-market than in Europe.

"Europeans are not deploying as fast as expected. The market is not that big and banks are still operating so it is much more limited. In the US, the rates of deployment are faster," said a third US direct lender.

Another trend highlighted on the day was larger players squeezing out smaller ones, given their ability to deliver scale, speed and reliability.

"You need scale. You need to be able to underwrite at least US$100 million," said a US direct lender. "You need a US$5 billion platform – it doesn't have to be one fund, it can be across funds."

The mid-market CLO industry was also highlighted on the day. Speakers said the industry is on the up, with increased interest from Japanese banks and a wider range of investors.

"Three or four years ago, you'd have three or four investors in a mid-market CLO and now it's not uncommon to have 20 or so," said a CLO expert.

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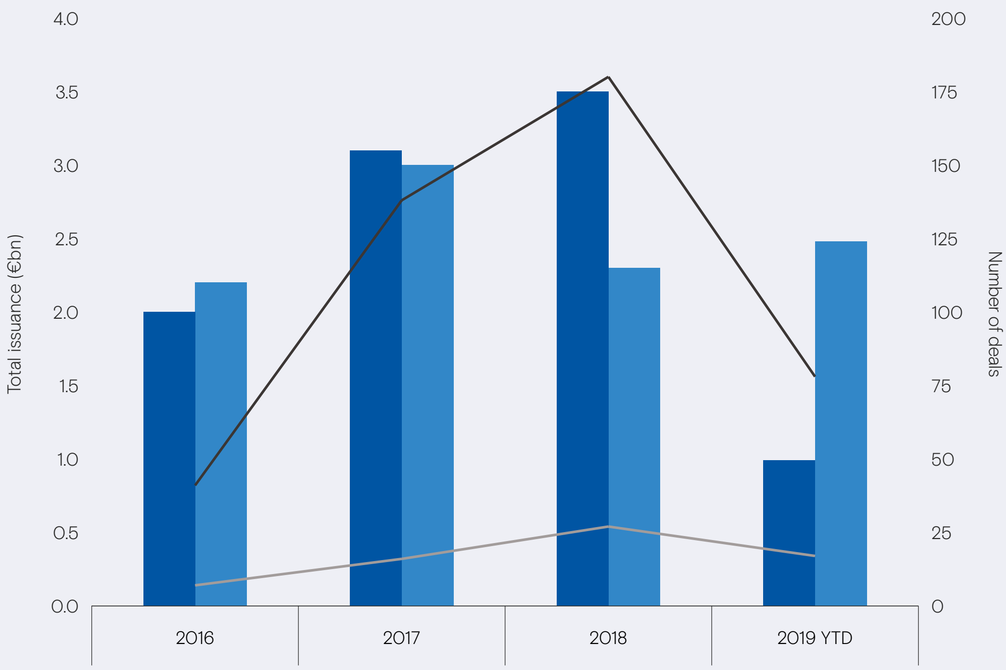
Sky's the limit for direct lenders

Direct lending continues to grow year-on-year as funds persist in stealing territory from banks. This trend continued in Q1 2019, with a flurry of activity in the quarter and funds keen to deploy

By Michelle D'Souza
Reporter
Creditflux

Research by
Darren Maharaj
Manager of EMEA
fixed income data
Debtwire Par

Unitranche volume – large-cap and mid-market



Total issuance (MM €bn) — Number of deals MM
Total issuance (LC €bn) — Number of deals LC

Assumptions:
MM defined as deals <€150m
LC defined as deals >€150m
Senior debt includes 1L & 2L, excludes mezz & PIK
Drawn includes unitranches, term loans
Bank facilities include drawn & undrawn

Source: Debtwire Par

€2.5 billion

The amount direct lenders originated in Q1 2019 – 3x higher than Q1 2018

League Tables

2019 YTD mid-market unitranche and senior

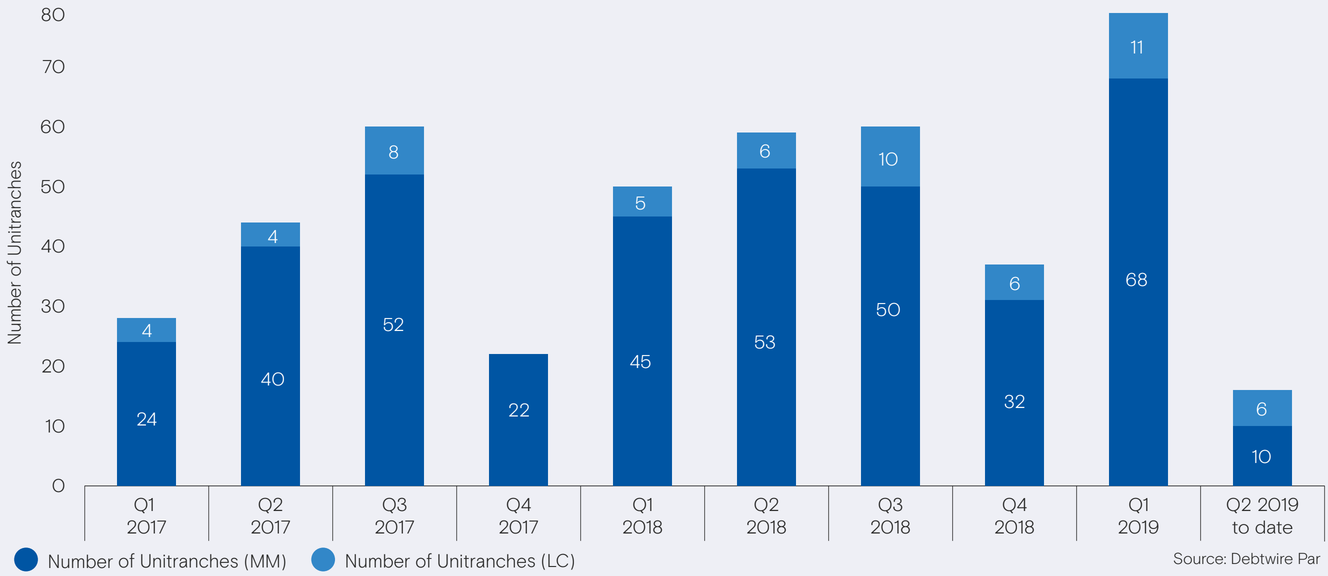
Rank	Direct Lender	Number of deals	Market Share %
1	Ares	15	13.6%
2	Permira	13	11.8%
3	Pemberton	11	10.0%
4	NEOS	10	9.1%
5=	Muzinich	6	5.5%
5=	Alcentra	6	5.5%
6=	Apollo	4	3.6%
6=	Hayfin	4	3.6%
6=	Ardian	4	3.6%
6=	Shard Capital	4	3.6%

2019 YTD large-cap and mid-market unitranches

Rank	Direct Lender	Number of deals	Market Share %
1	Ares	28	21.1%
2	Permira	15	11.3%
3	Pemberton	11	8.3%
4	NEOS	10	7.5%
5=	Muzinich	6	4.5%
5=	Alcentra	6	4.5%
7	Hayfin	5	3.8%
8=	Apollo	4	3.0%
8=	Ardian	4	3.0%
8=	BlueBay	4	3.0%
8=	Shard Capital	4	3.0%

Source: Debtwire Par

Number of unitranches – large-cap and mid-cap

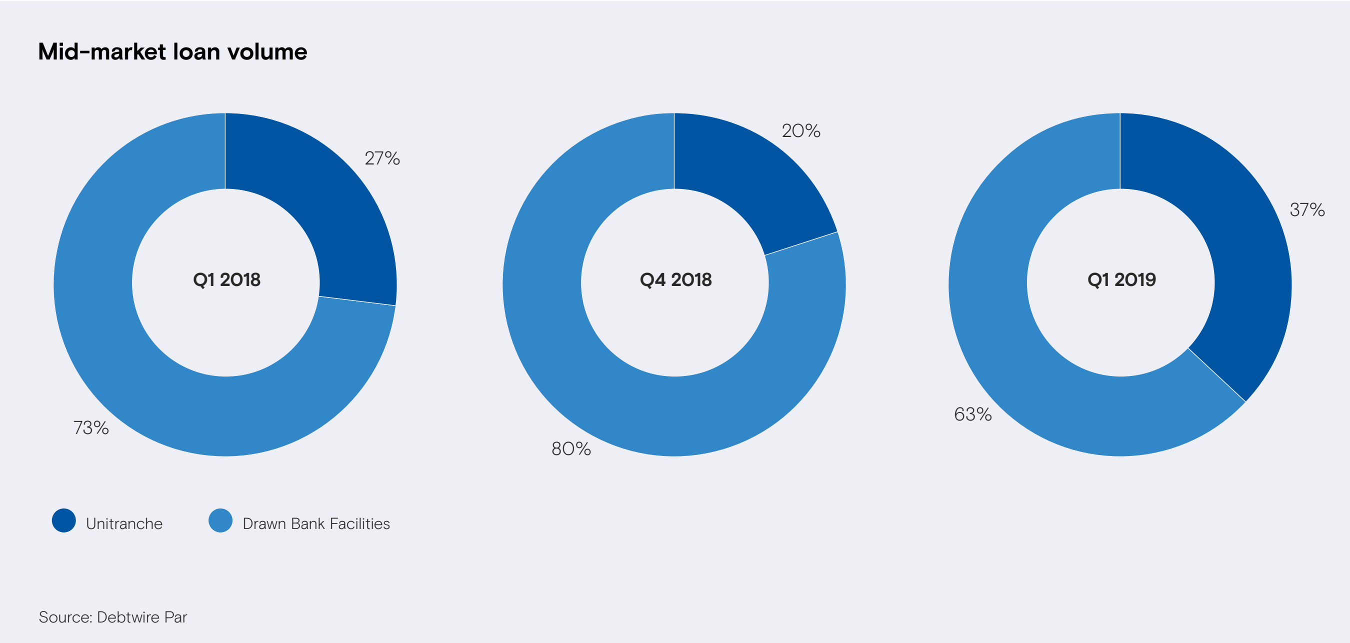


Source: Debtwire Par

Unitranche deals remained strong in Q1 2019 for both large cap and mid-market, with a record number carried out in the quarter. Direct lenders originated a total €2.5 billion across 79 deals (68 mid-market, 11 large cap) — over three times more than the €701 million across 60 deals in Q1 2018.

Large cap on the rise

With greater levels of fundraising and significant firepower to deploy, the number of large cap unitranche deals increased significantly. A total of 11 deals valued collectively at €1.75 billion occurred in the quarter, compared to just four deals in the previous quarter and five in the same time period last year. Ares Management, for example, refinanced UK telecoms services company Daisy Group in January in a €1 billion headline-grabbing deal. However, it was roughly split into £130 million second loss piece, £650 million first loss unitranche piece and £195 million PIK debt.



A mixed mid-market

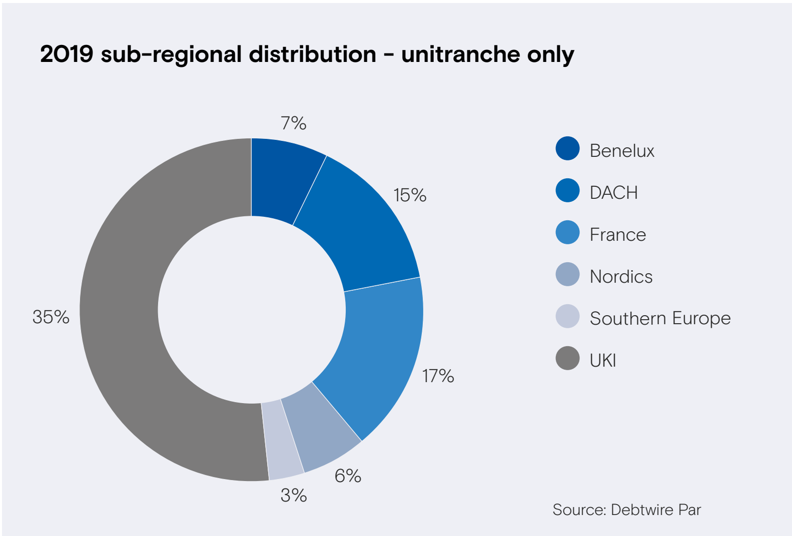
On the other hand, the increased number of mid-market unitranche deals was coupled with a decreased size per transaction. The quarter saw €788 million originated across 68 deals for an average €11.6 million deal size. In Q3 2018, a total of 50 transactions represented €1.4 billion.

Sponsor-backed numbers rising

In the sponsor-backed space, direct lenders continued to gain market share from banks. Mid-market unitranche volumes relative to drawn bank facilities increased in Q1 2019, with unitranche comprising 37% of all mid-market volumes. The market saw 68 deals totalling €788.9 million. In comparison, the percentage of unitranche volumes compared to bank facilities for Q4 2018 and Q1 2018 comprised 20% and 27%, respectively. Direct lenders in the UK and Ireland remained the heavyweights in the region, with the number of unitranche deals surpassing bank deals by 72% in the first quarter.

UK leads the way

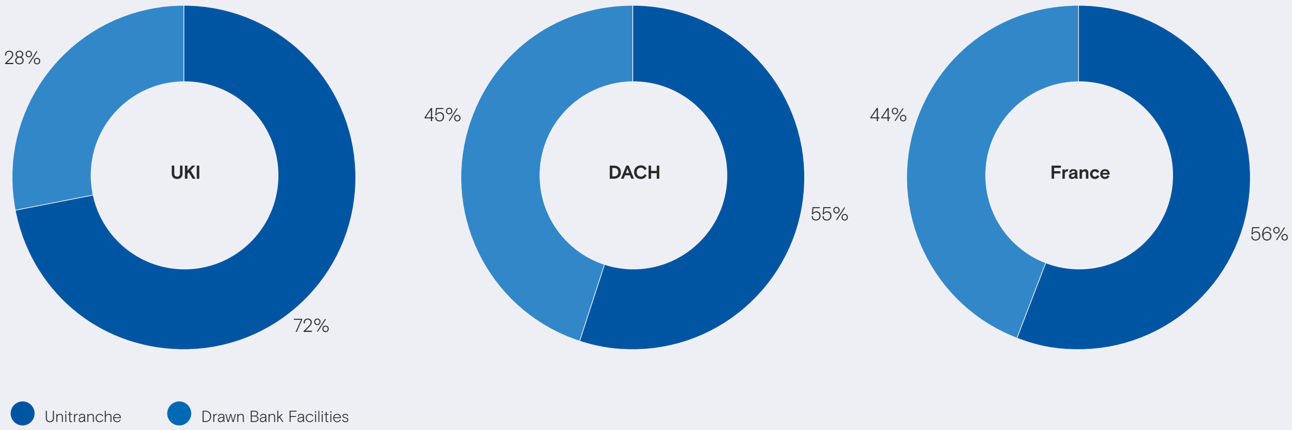
Despite fears that Brexit-linked uncertainty would cause a slowdown, the mature UK and Ireland market grabbed the largest market share for the number of unitranche deals. Unsurprisingly, France and DACH region followed suit as regions with the largest number of unitranche share by deal number. The ever-growing regions of Benelux and Nordics tailed behind.



Services leads sectors

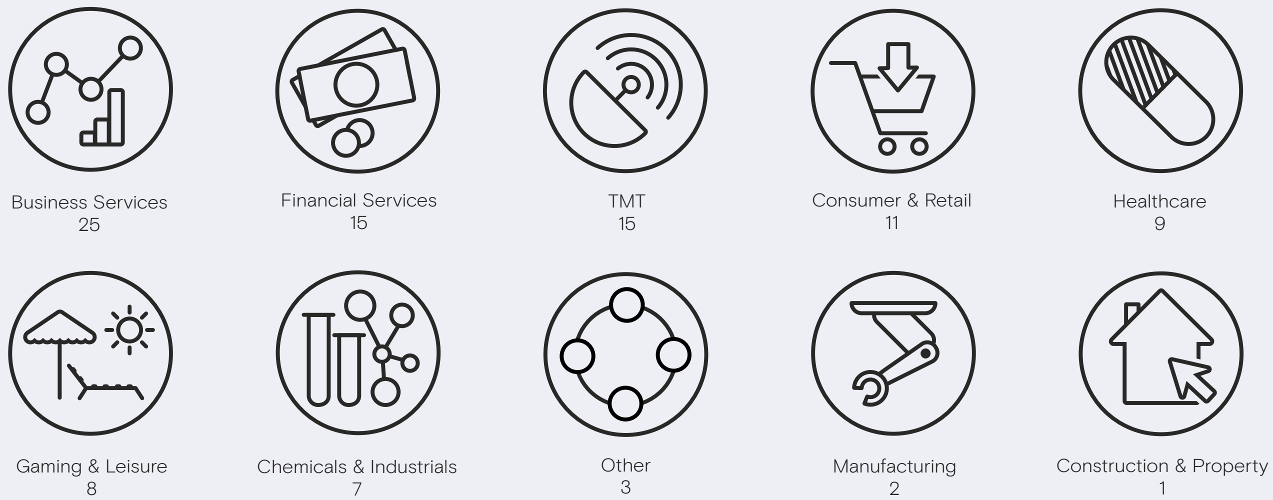
Business services, with more stable cashflows, took the largest share for unitranche issuance for Q1 2019 by number, taking a quarter of all deals. Financial services and technology, media and telecommunications (TMT) came joint second favourable with equal weighting of 16% — but TMT took 48% of deals by volume. Surprisingly, consumer and retail sectors — often cited as distressed opportunities arising from Brexit — ranked as the third most in-demand sectors by unitranche deals.

Unitranches vs bank facilities - 2019



Source: Debtwire Par

Sector distribution by number of unitranches - 2019



“The impact of Brexit has been relatively small compared to what the market was expecting”

Diala Minott, partner, Corporate Development at Paul Hastings discusses the challenges and opportunities presented by Brexit and how it is affecting the business

Diala Minott
Partner, corporate development
Paul Hastings

How has Brexit affected deal transaction volumes in H1?
We saw a pause while managers decided whether to activate their Brexit contingency plans. Big white label managers did activate their migration plans while smaller managers adopted a “wait and see” approach. Now we have seen more funds being launched with either the ability to flip their Alternative Investment Fund Managers’ (AIFM) Directive into a European jurisdiction or choosing to start up a new AIFM in a European jurisdiction.

Has fundraising been affected by Brexit?
I would say fundraising has been slower as more questions were being asked by investors about Brexit and its impact. However, I believe the impact has been relatively small compared to what the market was expecting.

What opportunities will Brexit provide for direct lenders?
I think there will be some pricing mismatches of underlying credits and so there will be more opportunities for dislocation funds and credit opportunity funds.

Will Brexit affect existing transactions? Have they had to add more legal documentation into the fund structuring/deals to account for Brexit? Do they need to add these for new transactions?
Some funds have had to amend their documentation, especially foreign regulated funds, and it has been interesting seeing countries such as Luxembourg take their time issuing any grandfathering legislation after Italy and France did so.

Has Brexit affected competition?
I think there are now funds that focus purely on UK assets and those seem to be more competitive. We wait to see if the UK will take advantage of Brexit to improve their funds and tax regimes.

We are seeing more levered sleeves in funds and even European investors are getting comfortable with leverage. We have seen some sterling funds come back into fashion with UK pension funds. There has been a migration of funds into Europe but hopefully the UK will start to refresh its current funds and tax regime to provide further opportunities for the market.

> Even European investors are getting comfortable with leverage

“There has been a change in the Nordics… banks can’t lend as much and direct lenders have stepped in”

Robin Challis of Pemberton tells *European Direct Lending Perspectives* about new horizons for direct lending, limited partners focusing on ESG and a bad bet on batteries

Robin Challis
Portfolio manager
Pemberton Asset Management

What was your first job in credit?
My career in credit began just over 20 years ago, working in KMPG’s restructuring team and advising banks on their troubled loans. It was a pretty steep learning curve as every company was teetering on the edge of bankruptcy. But I learned that controlling cash flow is extremely important and how to prioritise what’s most important about a company. I still use those same skills every day.

What is your best investment?
Recently, I made a loan for a roll-up in the European childcare market — a company that operates children’s nurseries. We were lending to a good private equity firm that bought the firm a couple of years ago at a time when the sector was under a lot of stress. The PE house worked with the company, turning it around and getting it back to profitability. Once the business had stabilised, we came in as lenders so they could continue this strategy — and they went on to double their EBITDA and make an effective sale of the company.

And the worst?
Around eight years ago, I lent money to a leading recycler of lead acid [car] batteries. Soon after we made the investment, they fell out with one of their main customers… and that customer then went on to build their own recycling plant. The market was flooded with excess capacity because of the new plant.

Where is the market heading?
Direct lending spreads have been super resilient through the periods of volatility and I expect they will remain the same. For the wider credit market, there are signs of stress in certain sectors. There’s been a few names in the retail space, for example New Look and Arcadia. And the auto sector and casual dining also have seen some stress. Interestingly, European default is tracking half the default of the US market.

What are the main trends in the market?
Over the last couple of years, direct lending has become a mainstay in places like the UK and Germany, where it’s now over 50% of all leveraged buy outs. The banks continue to face regulatory pressures, to reduce their single name exposures and focus on M&A deals — I think distracting them from day-to-day lending.

In Spain and Italy, penetration rates are closer to 20%. But we are seeing a steady increase in acceptance of direct lenders with family-owned businesses.

There has also been a marked change in the Nordics in the last 12-18 months, which used to be an overbanked market where banks would do high leverage and low margins. Now, banks can’t lend quite as much and direct lenders have stepped in.

What is the biggest thing that needs to change about the way your industry does business?
LPs are more focused on ESG, so it clearly drives them and us. The whole market is moving more and more in that direction — and quite rightly so.

Pan-European funds prove popular as Brexit indecision intensifies

The back and forth over Brexit has blunted investor appetite for direct lending funds with a large UK exposure. Sofia Karadima speaks to LPs and GPs to examine investor concerns and evolving strategies

Sofia Karadima
LP researcher
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Acuris

"It's fair to say that, in general, UK-only private debt funds are facing fundraising headwinds owing to the uncertainty [over Brexit] in the market," says Toni Vainio, principal at Pantheon. "And on the margin, continental European direct lending funds are generally benefiting from this shift in investor sentiment."

The UK accounts for 30% to 40% of the direct lending market, followed by France and Germany. However, that percentage has been decreasing over the last two years, creating more space for euro-denominated funds to grow, as investors are taking a pan-European approach.

Continent beats country

The pan-European route gives investors a lot of comfort to source and originate a wide variety of opportunities across the European market, including the UK, according to Graeme Delaney-Smith, managing director at Alcentra.

Pier Luigi Gilibert, CEO at the European Investment Fund, agrees with that assessment. "We have noticed a clear trend towards pan-European funds versus single-country funds across the direct lending market," he says. "This is especially true in areas where the private debt fund market is very active, such as France, Benelux and the UK."

By investing in multi-country funds, investors can benefit from exposure to continental Europe as well as the UK market, even when the country leaves the EU.

"Brexit would mean that the UK would fall out of the European Investment Fund's [EIF] investment focus. However, investable funds typically have a multi-country approach and the EIF's investment criteria are adapted to this reality. This means that, to some extent, lending to UK-based borrowers will continue to form part of the operations in which the EIF is involved," says Gilibert. He adds that funds managed from the UK may well be lending to borrowers in the EU, and as such could be considered for an EIF investment.

Vainio says most pan-European direct lending funds are continuing to provide loans to UK-based or headquartered businesses. This means that any LP wishing to allocate to the European direct lending asset class through pan-European funds is likely to end up with a 20% to 40% allocation to UK-based firms.

Brexit risks spook investors

LPs are more sensitive to certain risks that have risen since Brexit, including around business disruption and FX volatility. Currency risk and the cost of hedging have become more important when analysing a fund's economics.

"From the perspective of an institutional investor focused on supporting UK small- to medium-sized enterprises [SMEs], limited awareness of other SME-focused direct lending funds, as an asset class, is a challenge," says Catherine Lewis La Torre, CEO, British Business Investments.

While investing into GBP-denominated funds is a natural hedge for UK-based investors, it seems like a question of adding extra risk to the portfolio for overseas investors. As a result, some investors are playing a waiting game until there is more clarity as to how the country will exit the EU, either by avoiding UK-domiciled funds or by opting for EUR-denominated instruments.

Non-European LPs in EUR-denominated funds

Institutional investor	Fund backed
Indiana Public Retirement System	Crescent European Specialty Lending Fund II
Alaska Permanent Fund Corp	Permira Credit Solutions IV
Pennsylvania State Employees' Retirement System	Permira Credit Solutions IV
Ohio Police & Fire Pension Fund	GSO European Senior Debt Fund II

One clear example of this trend saw Italian banking group Intesa Sanpaolo's pension scheme recently issue a tender notice seeking direct lending funds but excluding those domiciled in the UK. The Italian LPs' screening requirements included the main geographical focus to be on Europe, and the underlying instrument to be EUR-denominated.

"Continental European LPs have been more focused on the concentration limits to UK exposure. They should look at these from a variety of angles, and not only focus on the number of deals or volume of deal exposure," says Niels Bodenheim, senior director of private markets at the investment consulting firm Bfinance. "You need to look at where the underlying revenues and EBITDA of those borrowers are generated. A UK-headquartered firm doesn't necessarily mean a company has 100% exposure to Brexit-impacted scenarios."

Outside influence

There are also several non-continental European LPs opting for EUR-denominated funds as part of their strategy to gain exposure in the European direct lending market.

Alaska Permanent Fund Corporation and Pennsylvania State Employees Retirement System (SERS) recently backed Permira Credit Solutions IV, where the fund's strategy focuses on primary and senior secured investments in mid-market European companies. Other LPs in the fund include three UK-based pension funds, including Greater Manchester Pension Fund, Tameside Metropolitan Borough, and London Borough of Wandsworth Pension Fund.

"Many GPs are hedging FX to guard against the impact of FX volatility and taking into account potential Brexit risks when underwriting loans," says Vainio. "This means that direct lending funds are generally still investing in UK-based businesses but applying a different lens to analysing potential risks associated with UK investments."

In the case of a hard Brexit, it will be important to look at each deal on a case-by-case basis, run a series of models related to profitability, and assess whether each business will be able to serve its interest, according to Howard Sharp, partner at Park Square Capital.

Bodenheim agrees that disciplined investors will run not only downside scenarios from a potential recessionary impact, but also consider worst case Brexit scenarios to assess if borrowers could sustain their operations through a downturn and if lenders could recover their debt investments.

A ray of light

However, there are some that feel it could be a good time to be lending in the UK, because there has been an increase in deal flow as assets are cheaper due to sterling weakness. "Investors benefit from a sterling premium investing in UK loans," says Laura Vaughan, head of direct lending, Hermes Investment. "There is less competition and they benefit from stronger lender protection rights in a very strong legal environment."

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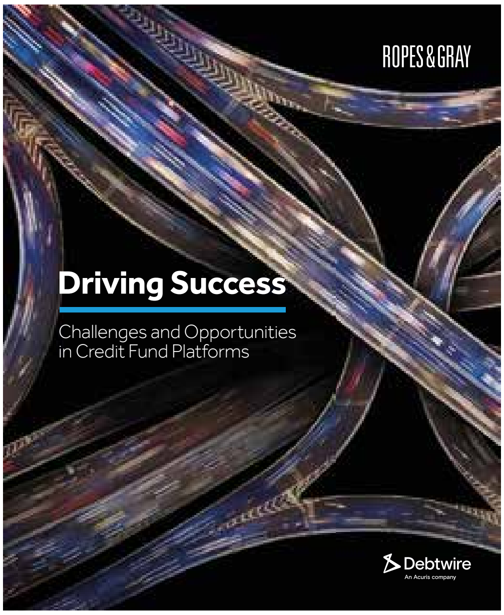

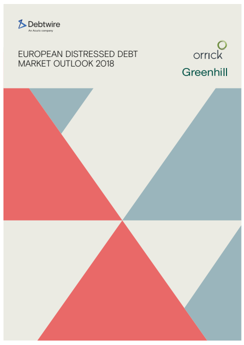

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