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European Direct Lending: Opportunities in the Lower Middle Market

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The current market environment is characterised by high valuations in equities and low yields in traditional fixed income markets, urging investors to seek for alternative, diversified and stronger sources of return. Private debt is on its way to becoming an established asset class and falls under fixed income and private equity allocations of institutional investors. There is a broad set of opportunities within the private debt spectrum that spans from investment grade assets (IG CLOs, real assets and real estate senior debt) by lending across capital structure in mezzanine, to equity and first-loss like assets (distressed debt, CLO equity/warehousing/risk retention), depending on the risk-return profile of the institution. Navigating from the investment grade to high yield strategies (direct lending, capital relief trades, distressed debt and special situations) investors identify diversified sources of yield generated from illiquidity, complexity and regulatory premia. The $600bn private debt industry is set to exceed $1 trillion according to a research paper from the Alternative Credit Council.

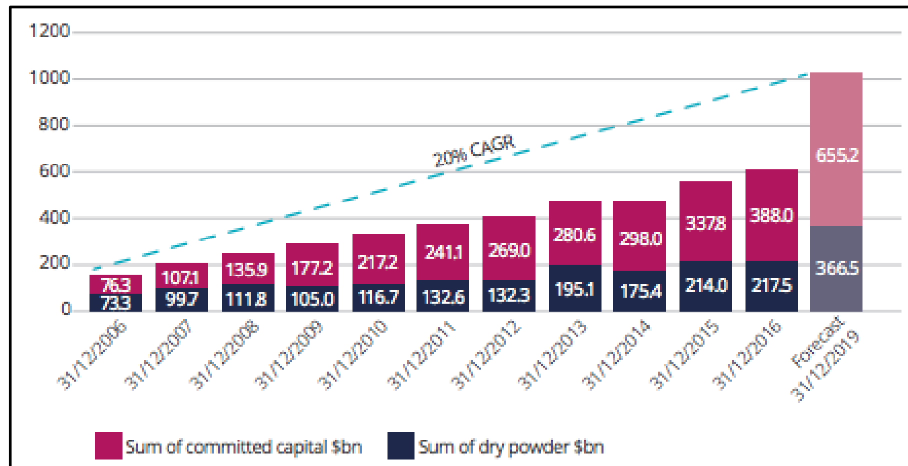

Figure 1. Industry AUM and breakdown of committed capital and dry powder, Source: Preqin, ACC research

The strategy that lures most allocations from institutional investors within private debt is direct lending, followed by mezzanine and distressed debt investing according to a Preqin survey in Figure 2. The opportunity in the direct lending arises from the bank retrenchment due to regulatory requirements. The real risk for direct lending funds capitalising on this opportunity is banks getting back into the game of SME/lower middle market lending, but the triangle banks-lending funds-borrowers is working towards the benefit of everyone. Banks provide funds with leverage and the funds provide financing to the borrowers that could be serviced directly by the banks only by accepting high risk-weighted assets (RWA) charges. The further securitisation and sale of these loans to institutional asset managers could boost the private credit ecosystem with banks relieving their balance sheets. Figure 2 also highlights the fundraising momentum of direct lending funds having raised $186bn over the last decade, constituting slightly over 30% of private debt.

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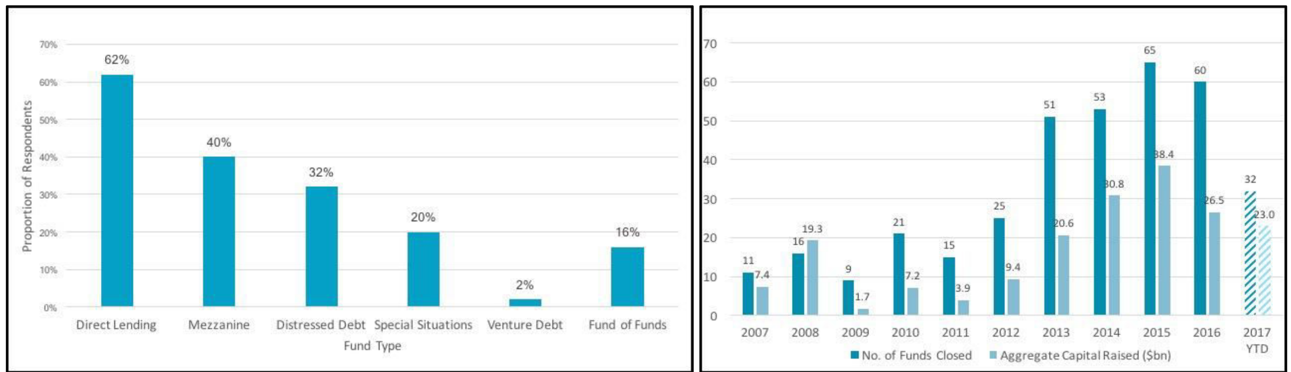

Figure 2. Fund Types Investors View as Presenting the Best Opportunities and Direct Lending AUM, Source: Preqin Private Debt Spotlight September 2017

The question is why do investors eye on direct lending and what is appealing to adding direct lending strategies to an institutional portfolio? Figure 3 highlights the access to credit across the corporate capital stack and the enhancement of a portfolio's risk-return profile. There is yield compression in private credit strategies, especially in high yield bonds, but, despite that, there are attractive opportunities in direct lending, CLOs and in typical, more illiquid private equity strategies.

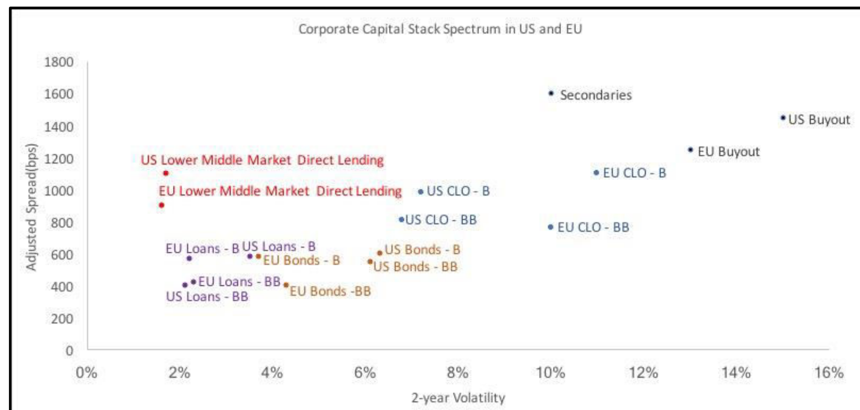

Figure 3. Corporate Capital Stack Spectrum in US and EU, October 2017, Source: Barclays Research, Moody's, Stone Mountain Capital Research

Direct lending strategies, both in the US and EU, provide steady, low-volatile income combined with diversified sources of returns. While direct lending in the US has been a developed asset class, established a decade ago after the financial crisis, in Europe, it remains underdeveloped. ECB's buying program for corporate investment-grade bonds has created demand in the lower middle market space, where banks do not operate, as we can evidence in Figure 4.

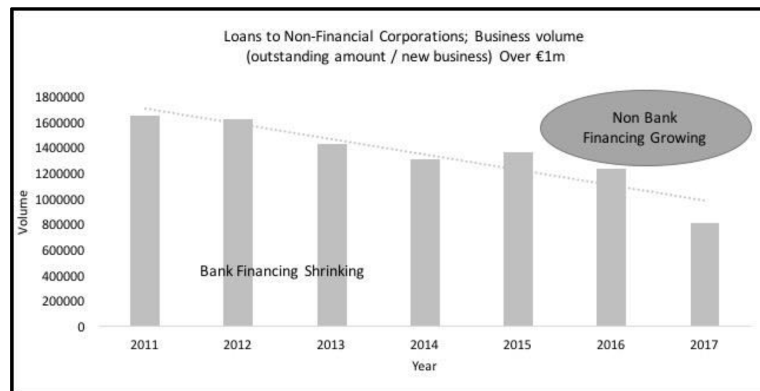

Figure 4. Loans to Non-Financial Corporations Over €1m as of 30/9/2017, Source: ECB Databank

Loans in Europe can represent good value for investors subject to proper selection criteria and market segmentation. The lower middle market in Europe constitutes one of the most important segments both in the European and global economy. The segment remains underserved from banks, which focus on the smallest firms and smaller loan amounts and larger corporates enjoy capital market access via bond issuance. A GE Capital report showed that middle market companies in the top 4 European economies (UK, Germany, Italy, and France) generate about one third of each country's private sector earnings and employ the same percentage of each country's workforce. According to the July 2017 ECB's bank lending survey (BLS), loan growth continues to be supported by increasing demand across all loan categories and by easing credit standards on loans to enterprises, while there is a further increase in net demand for loans. Furthermore, according to S&P European corporate defaults rates are set to stay low, even below historic averages, with problems being generated mainly by the energy sector. This shapes a very promising environment for lenders in Europe.

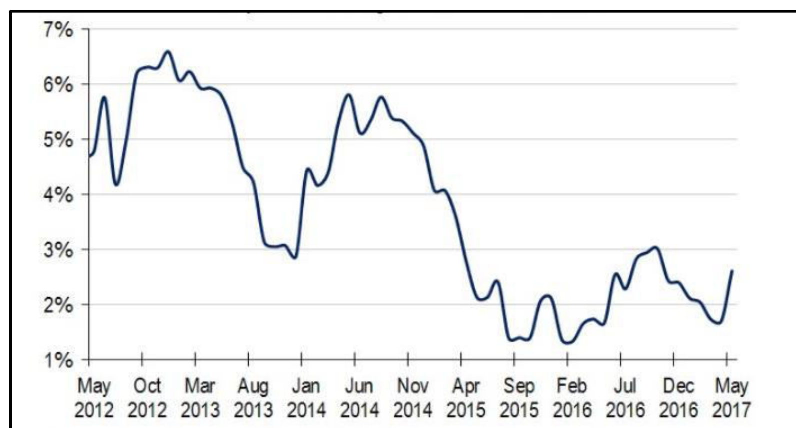

Figure 5. European Leveraged Loan Default, Source: LCD, S&P European Loan Leverage Index

According to Deloitte Alternative Lender Deal Tracker, direct lending mid-market activity in Europe is peaking in the first two quarters of 2017, with the first quarter being the second best since the fourth quarter of 2012. Out of 1082 deals, nearly 40% were made in the UK and the majority of those were used for buyout financing in either senior or unitranche structures. According to the same report, UK, Germany, France, Benelux and Nordics are the most active areas for deal completion with hospitality, healthcare and property being the leading sectors.

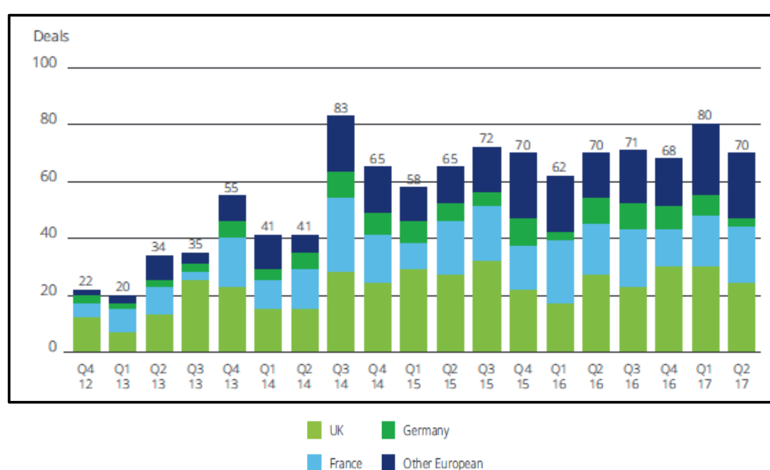

Figure 6. Number of Mid-Market Lending Deals Completed in the Euro Area, Source: Deloitte Alternative Lender Deal Tracker

There are key challenges to mid-market lending, which highlight the importance of robust manager selection for every lending strategy. Credit and structuring risks are mitigated by selecting an experienced team in deal structuring and due diligence and by having in place conservative covenants. Direct Lending managers must have people on the ground in the countries of their lending operations and posses the required language skills and local regulatory, lending and restructuring experience. Access to deal flow from a diversified network of corporations (non-sponsored), sponsors, banks, debt advisors, accountants, and law firms is the key criterion in selection. Moreover, proper underwriting/scoring with standardized lending agreements and or securitization, should be core in the selection process. Given the current stage in the credit cycle, a focus on senior secured, first lien, and stretched unitranche should be targeted in the corporate space. This can further reduce idiosyncratic risks, spanning from fraud and diverted payments to lifestyle changes. Investors should seek illiquid strategies, where the asset-liability mismatch in is favour of the manager (e.g. the assets have shorter maturities than the liabilities) and avoid strategies offering "shadow" or headline liquidity, as they bear more risks, when the credit cycle turns, defaults rise and investors intending to redeem. A very important factor in the manager selection should be the mitigation of country risk, with most European countries having untested or poor bankruptcy regimes e.g. in Eastern and Southern Europe. Western Europe, Benelux and Nordics and particularly United Kingdom, Ireland, Germany, Austria, Switzerland, and Netherlands offer a particularly stable legal and regulatory environment, and European private debt is seeking to capitalise on the opportunities offered. The legal framework for lending favours the lender and debt collection and restructurings are possible timely. Other risks include leverage, currency, concentration and documentation can be tackled by proper manager selection to navigate a complex space. We see major opportunities in European Direct Lending strategies compared to the US, underpinned by less competition in the lower middle market, a higher degree of traditional bank lending replacement opportunity in Europe with 80% for banks and only 20% for alternative lenders (invested from the US with 20% bank lending and 80% from alternative lenders) and yield premia available from illiquidity, complexity and regulation.

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