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European Private Debt And Lower Middle Market Direct Lending Opportunities

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Private debt markets are attracting increasing interest from investors, who are actively seeking alternative ways of yield-producing strategies in a low-yielding traditional market environment. Following Preqin's classification of private debt strategies, there are six strategies in which investors can allocate: mezzanine, distressed debt, special situations, venture debt, fund of funds and direct lending. The downside protection and the diversification offered to investor portfolios make the asset class enticing, which already accumulated assets under management of more than $500bn. The 2008 crisis constitutes the milestone for the surge of private debt markets and the allocations are expected to rise significantly over the coming years.

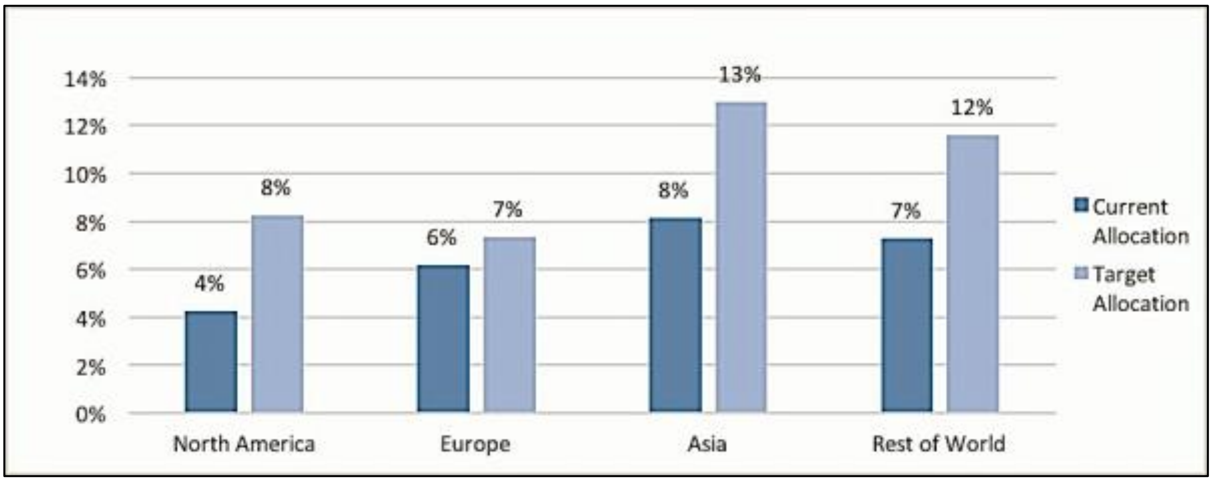

Figure 1. Global Target Allocation In Private Debt Source: Preqin Private Debt Spotlight June 2016

Among the aforementioned strategies, the most intriguing and appealing seems to be direct lending and the reasoning behind this trend has a solid rationale. The shrinkage of banks' balance sheets due to higher capital requirements under Basel III combined with negative rates from major economies due to extensive QE programs shaped the environment for the growth of direct lending markets. Direct lending constitutes an asset class, which provides attractive risk-adjusted unlevered returns and a better diversifier than theoretically low-correlated equities strategies. Institutional investors such as insurance companies, which face Solvency II solvency capital requirements, and pension funds, which search for robust yield with a better asset-liability management in the long term, appreciate the stable and low volatility returns direct lending offers.

By referring to direct lending, we exclude the online marketplace lending, which is a different story to what discussed in this perspective. Direct lending appears to rank highly among other strategies in the credit spectrum, offering investors with liquidity/illiquidity premium compared to public markets. The position of direct lending is not only a product of reduced bank lending activity, but other factors contribute to their appealing profile, such as the reduced liquidity in bond markets provoked by the Volcker rule and the upside potential provided in a potential increase in interest rates.

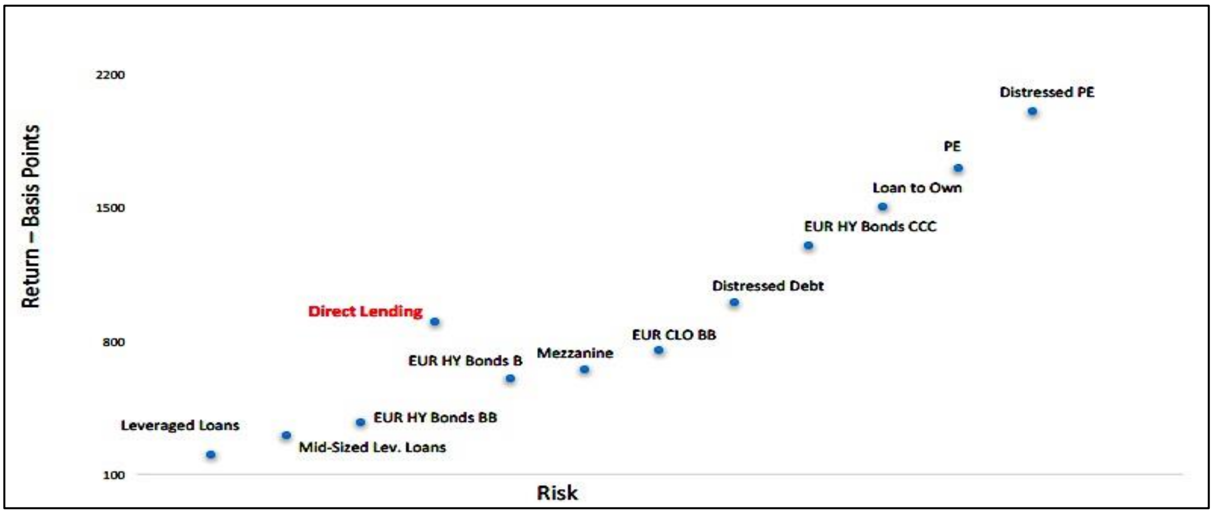

Figure 2. Credit Spectrum Risk-Return Profile, Source: Stone Mountain Capital Research, Citi Velocity

Europe is proving to be a "fertile land" for lending with the fundraising for Europe-focused funds exceeding the respective on the other side of the Atlantic as shown in figure 3 below.

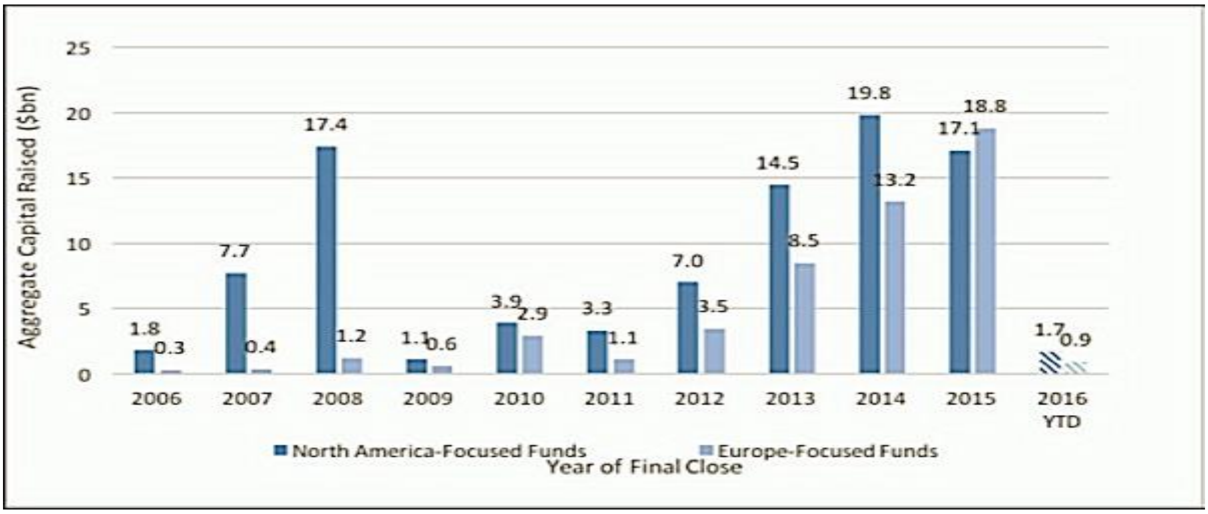

Figure 3. Direct Lending Fundraising: North America vs. Europe Funds, Source: Preqin Private Debt Report 2016

But what makes Europe so special about direct lending and where should investors and managers concentrate their focus. The answer is in lower middle market and SME lending. European central bank through extensive QE and LTROs is looking to boost liquidity to markets and politicians are trying to incentivise banks to lend more, so as to contribute to the economic recovery in the European territory. Despite, the incentives from authorities, the regulations make the access to finance extremely arduous especially for SMEs, which is evidenced below in figure 4.

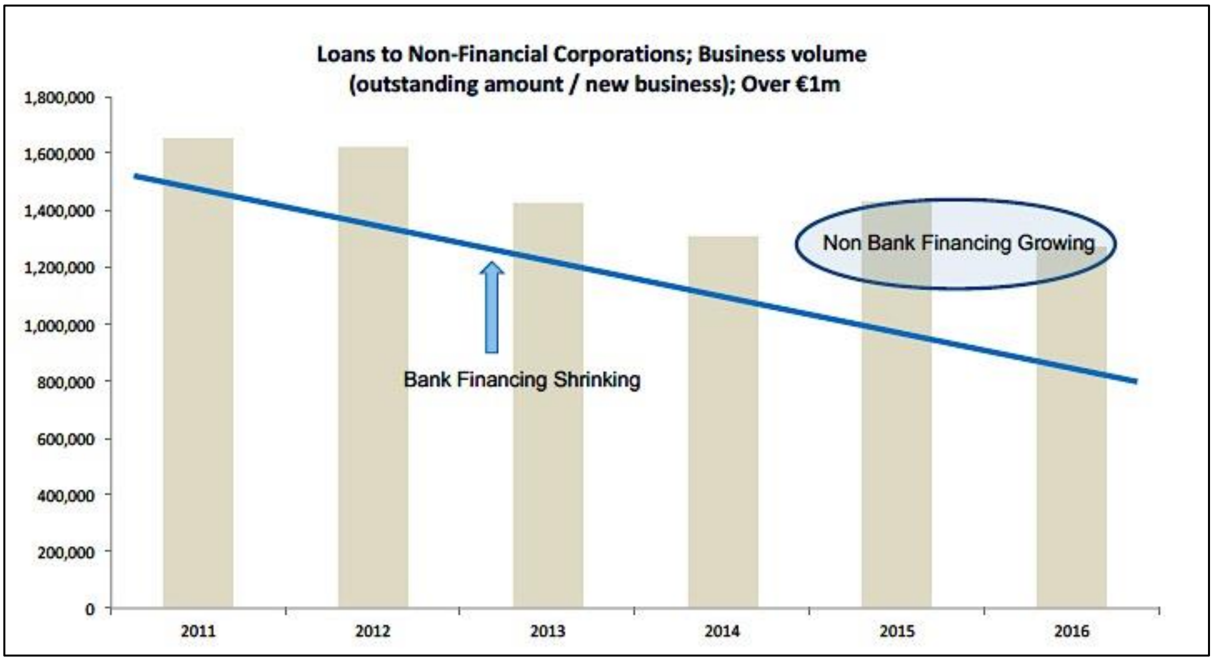

Figure 4. SME Access to Finance, Source: Stone Mountain Capital Research, ECB Databank

The European economy is heavily reliant on SMEs for its growth as evidenced in figure 5, which makes their finance bridging crucial for the sustainability of the European area. Lending to SMEs is challenging due to lack of quality in data and underdeveloped evaluation and scoring methodologies. The risks in investing in European SMEs are higher due to the debt culture, which is prevalent in European corporates, as it discourages investing in companies with high debt ratio. Private debt managers should be cautious and should educate corporates on the management of the company and incentivise them towards more active equity involvement.

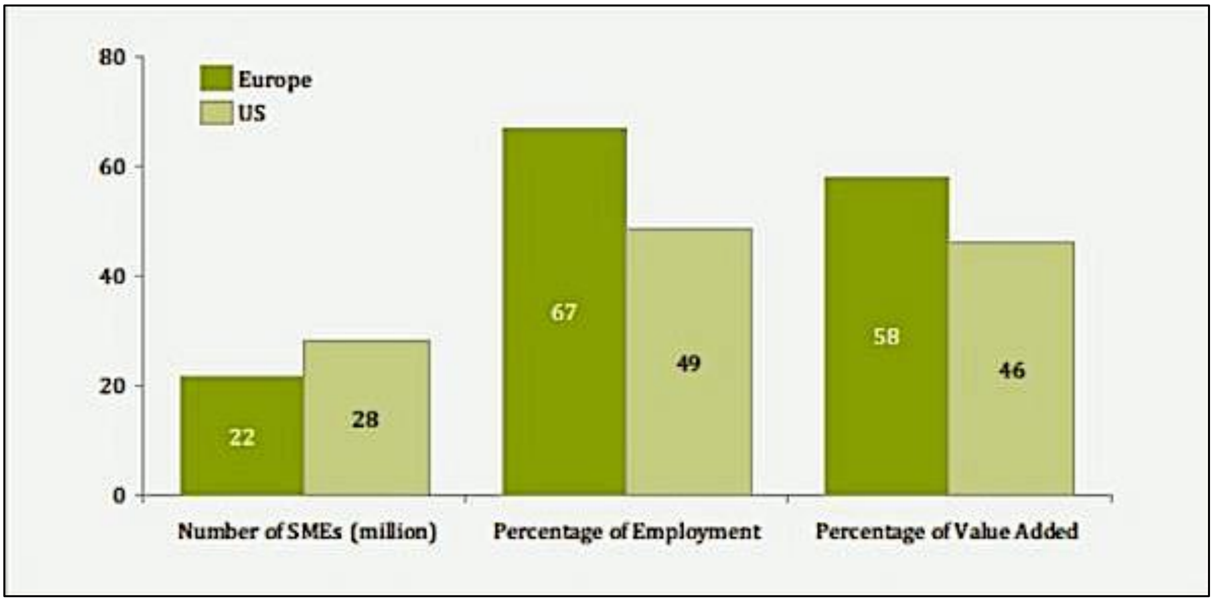

Figure 5. SME Importance in EU vs. US, Source: EC, SBA, AFME

From a practical perspective direct lending with a European focus is one of the most thought after assets classes currently. Institutional investors are being offered low rewards in traditional long only bond and equity markets. European direct lending offers diversification due to a set of different accounting standards across Europe as compared to the US. The market has been growing 100-150% p.a. since the crisis according to research of Morgan Stanley. Returns are generally uncorrelated to traditional long only bond and equity benchmarks and persist with low volatility and close to double digits in the lower middle market and SME segment, which makes those attractive for institutional investors. As the sector has not yet experienced a credit cycle enhanced due diligence on investment and operational level is required from investors.

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