European direct loans: A familiar asset dressed in a different currency?

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Executive Summary

- Investors seeking illiquid alternatives to traditional fixed-income are finding new opportunities to generate higher yields and cash flow through European direct lending strategies.
- An evolving financial and regulatory landscape in Europe has reignited non-bank lending, attracting strong interest from investors around the globe over the last few years.
- While European loans may offer compelling investment opportunities, the market is nascent, dominated by banks and characterized by patchwork regulatory oversight across borders, creating a complex web for investors.
- While European direct loan investing has generated significant flows and attention, investors should carefully consider the risk and return attributes of these assets, which are fundamentally different than similar U.S. loans.

Institutional investors have scoured the global landscape for income opportunities and higher-yielding alternatives to traditional fixed income over the last several years. Flows to alternatives including private credit, hedge funds and real assets have outpaced traditional investments during this period as investors seek more income, higher returns and assets that better match their long-term liabilities and funding obligations. Growth in these asset classes has underscored that institutional investors have been willing to trade liquidity for a yield premium and to generate long-term steady cash flows.

Most recently, institutional investors have turned their attention to Europe, where there is a growing number of attractive investment opportunities in illiquid loans. The market had been dominated by banks, which have historically provided nearly all financing to European middle market companies. In recent years, however, a changing regulatory and financial landscape has led banks to scale back lending in some areas, creating opportunities for non-bank entities, such as institutional investors, to enter the market. The European lending market is

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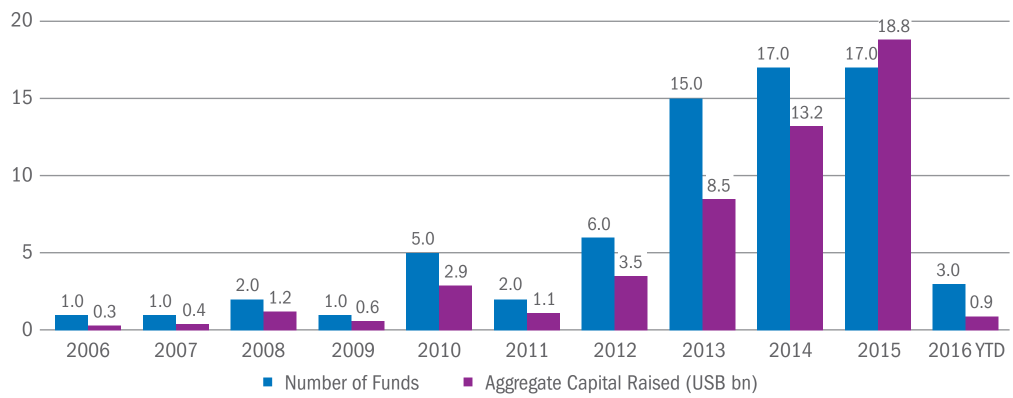
Exhibit 1: European focused direct lending fundraising 2006–2015



Source: Preqin

growing fast and many new investment funds have launched seeking to put investor capital to work alongside private equity investors (see Exhibit 1).

How should these European loan investments be viewed relative to similar opportunities in the U.S.? Is there something fundamentally different about direct lending in Europe, or is it the same asset dressed in a different currency? We would urge investors not to view U.S. and European loan investing opportunities as the same—they are not. While the terminology might sound familiar, and private equity is an important component in both the U.S. and Europe, the two markets are varied and different. In this paper, we will review some of the key features of the European market and provide some analysis of the current market opportunities there.

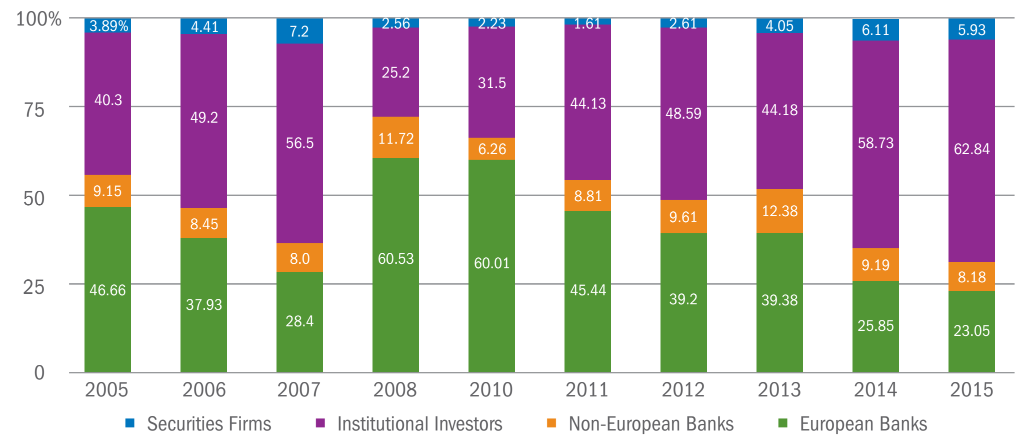
Europe's leveraged loan market makes a comeback

Over the years the U.S. has been by far the dominant supplier of leveraged loans globally. But given changing market dynamics, Europe is gaining attention as a source of debt opportunities for both managers and investors. Where European banks are scaling back, asset managers have been eager to move in and tap a growing market opportunity on behalf of their yield-hungry clients.

In some ways, Europe has been ripe for non-bank middle market lenders for a while, and the market was trending that way since before the financial crisis. The fabric of the European landscape is mostly small and medium-sized companies, and it has fewer large companies than the U.S., making it a natural fit for non-bank lenders, specializing in loans to middle-market and unrated companies. According to S&P LCD, Europe was a €15 billion loan market in 1998. Before that, deals were executed among an informal club of banks, which worked together to provide loan packages to businesses. Things remained clubby through the early 2000's, but a growing pool of institutional buyers seeking leveraged loan opportunities pushed the market to over €100 billion. It peaked during the bull loan market of 2006–07 at €165 billion. As cash flowed into loan funds and collateralized loan obligations (CLOs), the sell-side friendly features of the U.S. broadly syndicated market had crossed the Atlantic. But the market seized during the credit crisis and loan volume collapsed after 2008.

Banks continue to have a significant share of the European loan market.

Exhibit 2: European banks still have a large share of the market



Source: S&P Capital IQ; Primary Market by Broad Investor Type, 2009 date not meaningful

The market recovered and grew again mostly through bank lending, but the imposition of new regulatory frameworks, including Basel III, has curtailed bank loan activity. Non-bank lenders have been filling the void, seeking to deploy capital on behalf of institutional investors.

Banks still have clout in the European loan market

Today the European loan market is where the U.S. was in terms of development a decade ago. Unlike the U.S., disintermediation of regulated lenders in Europe by non-banks has only occurred since 2009. European banks have historically played a central role in corporate lending, and while their share has recently declined, it's still well over the 10% market share that U.S. banks have (see Exhibit 2).

Europe is a much more efficient bank market for loans compared to the U.S., and banks still hold sway in many regions. This is particularly true for the middle market. Even smaller deals—those made to companies with earnings before interest taxes, depreciation and amortization (EBITDA) below €25 million—are attracting bank attention, and spreads are falling, indicating increasing demand. This has proven challenging for non-bank lenders including asset management firms seeking to deploy capital in the region.

While European banks are more active in leveraged loans than their American counterparts, middle market borrowers—those with credit facility sizes less than €250 million—tend to fall below the radar of most corporate lending teams. Instead, regional, or "country" banks often support Europe's smaller companies.

Another bank-friendly element in the market is Europe's quantitative easing program. Unlike the Federal Reserve, the European Central Bank (ECB) is still lowering rates. Europe's banks are flush with cash. Funding costs in Europe are cheap right now—the three-month Euribor[1] is negative 20 basis points. In that context, 475 basis points in spread plus a 1% floor for a single-B credit looks good. That means owning paper is a powerful strategy for banks. By being buy-and-hold players in the European market, banks are competing with funds. A recent example is Carlyle's increased leveraged buyout (LBO) financing for Comdata, an Italian company. According to S&P LCD, Carlyle, a private equity firm, had nine banks involved in a €210 million package to finance the deal, and later brought in three more to raise the total to about €300 million. This included a seven-year "term loan B" (TLB) tranche that in the U.S. would typically be distributed exclusively to funds, not banks. European LBOs are also typically smaller than U.S. deals which means banks are still able to club some deals amongst themselves, rather than distributing to non-bank institutional accounts.

Non-banks turning to unitranche loans in a borrower-friendly market

Given the recent attention and amount of non-bank money raised, many observers figured European banks would be on the way out of the leveraged loan picture, as is the case in the U.S. Big funds were raised over that prediction. But it has not worked out that way. Non-bank money got raised, but there was nowhere to put it.

Instead, direct lenders have offered private equity sponsors favorable packages such as unitranche financings at six times leverage. Unitranche loans combine senior and subordinated debt into a single package, and typically feature greater leverage than other types of loans such as senior-only structures.

> Extremely low interest rates means owning paper is a powerful strategy for banks. As buy-and-hold players in the European market, banks are competing with funds.

Because of fee structures, direct lenders require yields in the 8-10% range, which is a step or two above the bank market. Rather than migrating towards second lien loans, which have effectively disappeared from both sides of the Atlantic, direct lenders are seeking these returns through unitranche financings, which carry more leverage and a higher level of credit risk. The companies that are in the sweet spot for these packages are not truly middle market—they are less bankable.

And unitranche is popular with private equity. According to Deloitte, roughly half of all debt structures are single-tranched, with less than 40% involving some mix of senior and mezzanine debt. As in the U.S., this one-stop approach gives private equity sponsors more flexible covenant packages, more accommodative debt baskets, and, of course, higher leverage. One major difference in Europe is that unitranche is structured with 50% cash-pay and 50% payment-in-kind (PIK), which is a significantly lower cash component than for similarly-structured loans in the U.S. All-in yields also vary widely, depending on the credit, ranging from 6–11%.

1. Euribor is the rate at which European banks lend to each other.

The patchwork nature of multiple jurisdictions makes loan origination in Europe a real challenge.

As we've discussed, direct lenders have made inroads with sponsors for one-stop financings. Funds originally targeted for mezzanine or second lien investing have been repurposed as unitranche providers. While this makes sense given the market opportunities, it may result in lower fund returns and different types of risk exposure relative to the original strategy.

Europe's patchwork regulatory environment creates additional complexity

In addition to competing with banks and borrower-friendly finance structures, investors in European credit need a strong Rolodex of PE contacts and business relationships. Because each country has a different regulatory framework, economic and legal considerations, solid contacts and relationships are a requirement. The patchwork nature of multiple jurisdictions makes loan origination in Europe a real challenge.

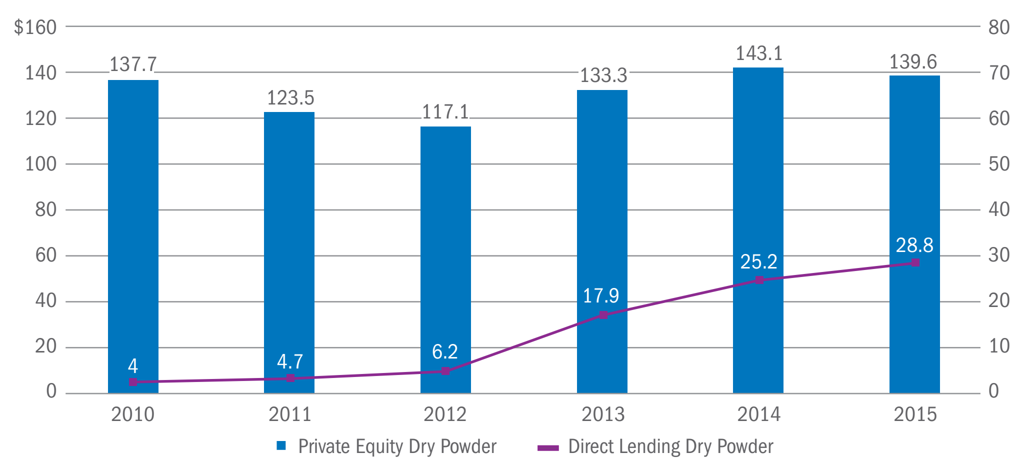
Understanding the nuances of each local market is critical, particularly in a default. For example, default options are different for lenders in Italy versus Spain or France. There's no standard approach. The Scandinavian countries are somewhat similar to the UK. They are supportive of their borrowers. But southern Europe is very different. Each country has its own dangers and dilemmas.

Sometimes the terminology also varies between markets. Until very recently for example, non-banks couldn't technically make "loans" in Italy and France. Loans were classified as "bonds," but were not as liquid and only qualified investors could buy them. This is changing, but the legal environment still favors banks.

U.S. offers far more opportunities

There is a growing supply of capital from investors and private equity sponsors. As Exhibit 3 shows, European funds have almost $30 billion in dry powder available to support loans. On the supply side, private equity firms have $140 billion available to deploy for investments. That would seem to give direct lenders plenty of opportunity to put money to work. While

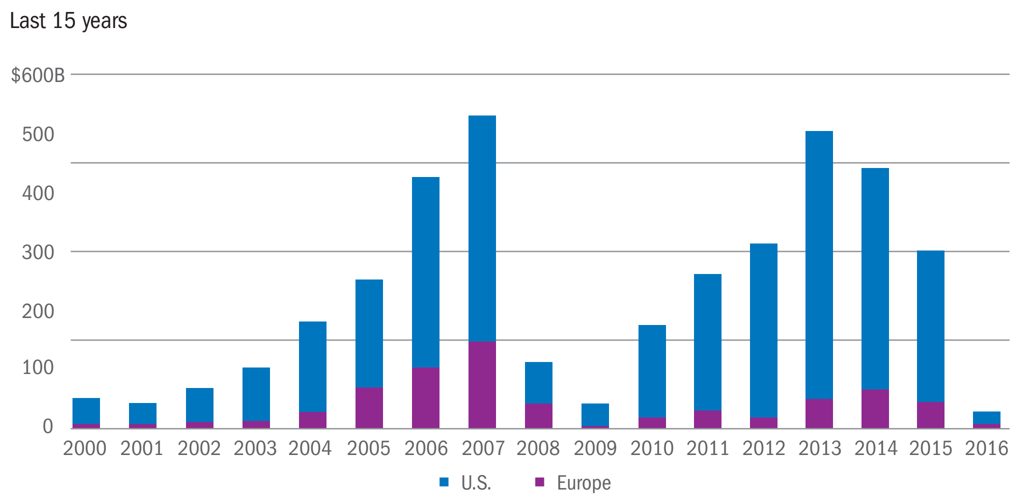
Exhibit 3: European debt funds have growing supply of capital



Source: Preqin

Last year there were $45 billion in European deals compared to $257 billion in the U.S.

Exhibit 4: U.S. loan volume is on average over six times greater than Europe's



Source: S&P Capital IQ; Annual Institutional loan volume in U.S. dollars

funds are raising more capital to put to work in Europe, the total annual volume of new issue leveraged loans there is a fraction of the activity in the U.S. Last year, according to S&P Capital IQ, there was just under $45 billion in new institutional European deals. That compares to over $257 billion in the U.S. for the same period, or almost six times as much (see Exhibit 4).

There are some attractive qualities for investing European loans in the current market environment. In general, European loan prices are less subject to technical swings than U.S. loans. For one thing, there are no retail loan funds in Europe. European mutual funds, known as "UCITS" (Undertakings for Collective Investment in Transferable Securities), cannot hold loans directly. That means there's no need for daily liquidity, no wild swings of cash coming in and out of accounts, no relative value players driving prices up and down. This results in a much more stable market overall in Europe.

European CLOs and banks don't trade assets, so it is a less liquid market than in the U.S. That also means less volatility, and more inefficient pricing, both attractive qualities for investors.

Investors should work with managers who understand the risks and rewards of investing in European loans.

Conclusion: Europe's loan market needs time to mature

While European direct loan investing has generated significant asset flows and attention, investors must carefully consider the risk and return rewards of adding exposure to this asset class. Overall, it is early days for the direct lending market in Europe, which is less mature than in the U.S. What we have seen to-date is significant competition for fewer opportunities, leaving non-bank lenders to offer borrower-friendly deals with relatively higher yields but also with greater risk versus similar opportunities in the U.S. Eventually, non-banks may take market share from banks as leveraged lenders for middle market companies in Europe, but it will take time as the market and regulatory frameworks mature and get settled. Investors should continue to examine opportunities carefully and work with managers who understand the risks and rewards of investing in European loans.

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