EFFICIENT CAPITAL MARKETS ARE ESSENTIAL TO THE CONTINUED GROWTH AND DEVELOPMENT OF PRIVATE DEBT AND, IN PARTICULAR, DIRECT LENDING IN THE EUROPEAN MARKET

Introduction

Private Debt and particularly Direct Lending is making waves in the traditionally conservative bank dominated sub-investment grade debt market and is leading a revolution in the way corporate borrowers and private equity sponsors approach the question of debt financing.

In our opinion, as private debt asset managers increase investment capacity via larger funds; and as investors increasingly view private debt as an attractive investment opportunity, the market for private debt direct lending will continue to expand and ultimately split into a smaller group of arrangers of private debt transactions on the one side and a much larger group of participant lenders in such deals on the other.

This in turn will bring about a need for the emerging group of market leaders, the tier one arrangers, to recruit capital markets professionals to increase fee income and return on risk assets as well as improve portfolio diversification by reducing total exposure to borrowers through efficient primary market syndication.

Direct lenders continue to take market share from traditional bank lenders, and investors continue to see private debt as an attractive investment opportunity.

However, as a result, market participants are coming under increasing pressure to deliver against investor return expectations, whilst simultaneously mitigating against the risk of portfolio concentration; and all against the backdrop of increased market competition, which is impacting yields, driving leverage up and reduced lender protection through weaker documentation.

Therefore, in similar fashion to the leveraged finance banking market of the 1990's, developing efficient capital markets (in other words, an ability to sell risk to other market participants and increase liquidity in both primary and secondary markets) is essential to the continued growth and development of the global direct lending market.

Life before private debt: A brief history of leveraged finance

If you've ever visited the elegant mahogany panelled offices of Henry Kravis at the West 57th Street headquarters of KKR, you will no doubt have spotted some of the many reminders of the success of this titan of the global Private Equity market.

Tombstones documenting the many successful deals completed by KKR from over 40 years of investing in, and buying, both private and publicly listed companies, serve as a reminder of the evolution and growth of the global buyout market.

Whilst the original pioneers of Private Equity did much to help popularise the concept of the leveraged buyout in the later 1970's and 1980's, the success of private equity as an asset class could not have been achieved without access to efficient debt capital markets.

The debt financing, provided initially on a bilateral basis by a single bank and then more commonly by a group of banks in a syndicate, supports the acquisition of a target by a private equity sponsor.

It is this leveraged debt finance which allows private equity to buy a company without needing to invest 100% of the initial capital and consequently allows the sponsor to sell the business at a multiple of the original equity invested.

The global leveraged finance market has of course evolved and matured dramatically since the early pioneers of the leveraged buyout market first emerged over 30 years ago. In fact, private equity and leveraged loans are now such commonly utilised financing solutions, that some commentators even suggest they no longer merit being categorised as part of the 'alternative' assets universe.

To put the market in context, ***Prequin*** estimates that at end June 2018 there was in excess of $2tn in Private Equity "dry powder" available globally, which in turn would suggest (assuming a conservative 2:1 debt to equity ratio) that there is a need for at least $4tn in debt financing to service the private equity market.

Whilst the largely unregulated global private equity market has continued to grow unfettered by the shackles of regulation, the traditional sources of leveraged finance for private equity - regional and international banks - have not been so fortunate. A combination of regulation, consolidation, bankruptcy and nationalisation, exacerbated by the Global Financial Crisis ("GFC") in 2008, resulted in a rapid, disorderly and painful retrenchment of many banks from the leveraged finance market, leaving a vacuum to be filled as financing demand continued to grow.

However, even as regulators and legislators find creative ways of controlling capital markets, financial markets push back, finding new and creative ways of solving financing problems for their clients.

To borrow and expand on a phrase used by Benjamin Franklin "in this world nothing can be said to be certain except death and taxes….and that efficient capital markets will always find a way!" Step forward a new breed of alternative asset managers providing private non-bank lending solutions for borrowers.

What is Private Debt direct lending?

Over the last twenty years, direct lending has emerged as an attractive asset class for institutional investors (delivering superior risk-adjusted returns and mitigating the effects of the investment j-curve); and as a flexible capital substitute for traditional bank loans.

In the broadest sense, direct lending is a term used to describe a financing solution where a lending source directly provides a loan to the borrower without the use of an intermediary. Direct lending was originally seen as a vehicle for lending to companies who couldn't get bank financing, but is now seen as a credible, flexible and stable alternative to bank lending. Direct lending is accomplished by going directly to private equity sponsors or owner/operators of middle market companies, commercial projects or commercial real estate to originate loans for a variety of purposes including acquisitions, management buyouts, financing capex or working capital requirements.

The evolution of private debt and, in particular, direct lending as an alternative to bank loans

Right now we will focus on non-bank corporate lending, but our market analysis does include loans provided by banks.

The direct lending market did not evolve in a linear fashion, originating in the US in the 1990's and only much later in Europe. In each case, market development was driven by a combination of supply and demand factors, with North American direct lending developing for different reasons to European direct lending.

The US direct lending market originated in the 1990's as a result of rapid regional bank consolidation (there has been a 45% decline in the number of banks in the US between 1998-2017, according to the Federal Deposit Insurance Corp.) and a decline in the number of loans offered to commercial and industrial ("C&I") borrowers as banks focused on running more capital efficient businesses.

Further growth in the US direct lending market was driven by the GFC in 2008 which increased bank regulation and reporting requirements and pushed banks up the size curve and away from the middle market (borrowers typically looking for between $10m and $1bn).

By contrast, the European direct lending market evolved primarily due to the dislocation created by the GFC in 2008. As a result of the crisis, the European banking sector experienced fundamental and longstanding changes, including bankruptcy, consolidation and nationalisation as well as foreign bank retrenchment to home markets. Allied to this was increasingly stringent bank regulation (Basel II and Basel III), resulting in banks having to post increasing loan capital charges and reserves. The net effect has been the dramatic and seemingly permanent reduction in the supply of leveraged credit, particularly to European middle market.

The effects of the GFC are still relevant and observable today, in particular as banks experience increased national and supra-national regulatory scrutiny, in turn resulting in declining bank balance sheet allocation to credit (particularly mid-market credit) due to the increased capital cost of holding sub-investment grade debt. This trend is further exacerbated by, for example IFRS9, which will force banks to recognise losses far earlier than was previously the case, meaning that in the next downturn, banks are likely to have little appetite to hold underperforming debt on balance sheet.

This in turn has created a raft of opportunities for a growing group of asset managers who are making loans; for borrowers, including not only mid-sized companies but some big enough to tap the syndicated debt markets if they wanted; and for investors looking for improved returns on investments.

In addition, the transfer of skills and experience, in particular as investment professionals transfer from the European leveraged loan markets, has also played a significant role in helping the market to mature.

The ***2019 Prequin Global Private Debt Report*** stated that "Private debt funds offer investors several advantages: they demonstrate strong, risk adjusted performance over the long term; they provide portfolio diversification; and, compared to other private capital funds, they have reliable liquidity and income streams. As the industry has grown over the decade since the GFC, an increasing number of investors have begun actively allocating to private debt vehicles: the number of investors active in private debt has grown by almost 50% in the past two years."

Asset-management firms such as Ares, ICG and HayFin are raising significant amounts of money from, amongst others, pension funds, insurance companies and other institutional investors that need to deploy cash and find yield in a low-rate environment.

There's also demand for funding from small and medium-sized enterprises (SMEs) that have struggled to get loans from the more cautious banks and are unable to issue bonds.

At the lower end of the high-yield spectrum, direct lenders can be attractive to companies facing business-specific or sector-wide challenges.

The private debt market in numbers

Globally, direct lenders are consistently accumulating large sums of money and pursuing different types of deals.

Roughly a third of investors recently surveyed by ***Preqin*** plan to invest more in private debt in 2019 than in 2018, with nearly half intending to boost their allocation long-term. Capital raised for private debt strategies reached $110 billion in 2018, following a record of $129 billion the previous year, with 41 percent of the money secured to direct-lending funds.

This has taken the industry to almost $770 billion in assets under management as of June 2018, from $275 billion in 2009.

North America is the biggest centre for direct lending, with a 61 percent share of the market, according to ***Deloitte***, with the remainder predominantly focused on European markets.

According to ***Debtwire***, in a recent opinion piece titled ***Perspectives on European Direct Lending***, total capital raised for European direct lending in 2018 was an impressive c.€25bn (albeit down from €32.5bn in 2017), across 21 funds, with an average of €750m deployed per fund across the year.

Recent examples of successful direct lending fundraises include Alcentra's European Direct Lending Fund III raising €5.5bn, BlueBay (now rebranded Arcmont Asset Management) raising €5bn for the European Direct Lending Fund III (soon to become an independent, standalone entity) and Ares Capital Europe IV closing on €6.5bn.

Looking at Alcentra's most recent fund in context, the firm's previous European Direct Lending Fund II secured commitments of €2.1bn, or roughly 40% of the size of the most recent fund. This increase in total fund size in turn translates into greater financing capacity with the capability of financing up to €300m on a single transaction.

Similarly, with the recent financing of UK telecom services firm Daisy Group by Ares, we arguably saw the first example of a direct lender deploying €1bn in a single transaction.

The challenges of portfolio management against a background of increased fund and transaction size

Interestingly, in a recent Private Debt Investor article, published to coincide with the final close on a large European Direct Lending fund, a senior executive stated that at it's very basic level, the firm is "primarily a sole lender to our borrowers", going on to suggest that this offers the twin benefits of certainty and speed of financing, whilst allowing the manager to retain control and oversight on investments.

In theory this is an attractive narrative. Deep dive due diligence, bi-lateral negotiation on financing documentation, attractive fee income for arranging a financing package and a close on-going dialogue between lender and borrower seems like an attractive, stable basis for building a robust direct lending fund platform. Against a relatively benign economic environment, defaults are low and recoveries high. Fund performance generally delivers against investor expectations and marketing materials.

However, if we add into the equation the twin dynamics of increased market competition resulting in compressed loan yields, higher leverage and looser protection in the form of financial covenants; and increased fund concentration as a result of fewer, larger transactions in a portfolio, the risks become more apparent.

Add a further element such as a general economic downturn, resulting in weaker revenues, lower profits and weaker cash flows and the risk to a portfolio of loans increases significantly.

Thus, taking this theory through a simple worked example, if a fully invested portfolio of €5bn contains 10 direct lending investments of €500m on average, a default on only one €500m investment, with eventual recoveries of 80%, would, in addition to the reputational fallout, result in a capital loss of €100m loss on the portfolio, or in simple terms, a big dent in portfolio returns.

It is our view therefore that institutions providing direct lending facilities are increasingly recognising the risks of portfolio concentration and the impact of a single significant loss on a fund as well as the associated benefits of increasing fee income as a proportion of total fund return by selling down risk via syndication.

Bifurcation of the market in private debt as deal arrangers and deal participants start to emerge

There is a further aspect to the growth in the global direct lending market that we must consider, essentially, the increased split between arranging institutions and those lenders who prefer to participate in transactions arranged by others.

Whilst established market participants are growing rapidly (for example Alcentra now has c.€9bn in AUM across four European direct lending funds and Arcmont has raised c.€14bn for European direct lending), a plethora of new entrants continue to emerge, attracted by returns and an eager investor base. As a result, a two tier market is emerging.

Consequently, we believe that tier one direct lenders such as Alcentra, Arcmont, Ares, HayFin and ICG will increasingly look at arranging transactions, maximising fee income and selling down risk to increase portfolio diversity and return on risk assets.

Taking our rudimentary worked example from above and developing the theme further:

(a) a direct lender typically arranging a €500m loan and charging a fee (for example 3% or €15m) on the deal, is still left with a €500m risk exposure.
(b) If, however, the same arranger rather than holding the €500m loan within the portfolio, instead sells €250m via syndication and in the process pays away 1% in fees for the €250m sold, the total net fee earned by the arranger is €12.5m, whilst total portfolio exposure is €250m.

When comparing case (a) and case (b) whilst fees have dropped by c.17.5% in the latter example, exposure has fallen by 50% and therefore return on risk asset has increased markedly whilst portfolio concentration has fallen dramatically.

Therefore, as a consequence, larger, more established private debt direct lenders who have a greater capacity to source, diligence and lend larger amounts of capital, are concentrating the pool of deals arranged. By contrast, a long tail of smaller, sub-scale and/or niche industry or regional managers are struggling to source quality deal flow and when they do, they find it difficult to lend the capital required.

We believe therefore that by a process of natural market selection, the tier one lenders will continue to win the vast majority of mandates, whilst other market participants will either have to evolve (for example focus on a particular market or sector), or risk slipping further behind the market leaders.

Based on conversations we have been having with managers, we are starting to see some of the largest direct lending participants actively considering making an investment in capital markets (loan syndication professionals) from sell side banks, or moving investment analysts into capital markets roles, in order to manage risk and increase overall return on investment.

This, in many ways, is a replay of the evolution of the global leveraged finance market discussed at the beginning of the article. The evolution of capital markets functions within direct lenders is still very much in its infancy.

Conclusion

In summary, the European private debt direct lending market can be defined as a patchwork of competing challenges, pressures and opportunities, which together make this as one of the most interesting, dynamic and competitive sectors of the entire Alternatives market.

Whilst it's is hard to calculate precisely how many buy-side direct lending investments have been made in the European market and in turn how many have defaulted and suffered a capital loss, it would be hard to argue against the view that the actual number is small. This is a function of rigorous credit selection, strong legal protection, systematic monitoring and good communication between lender and borrower, all set against a background of a benign economic environment.

Notwithstanding the above, as investor demand for the asset class increases; as average fund size grows; as the manager universe simultaneously expands and divides into an arranger and a participant class (as in the leveraged finance market); and finally as the size of loans offered to Borrowers increases, the benefits of having a financing model based on bilateral loans or small clubs of lenders, may well be outweighed by the risk of holding a small number large loans in portfolio.

In our opinion therefore, market participants who display sufficient foresight to recognise the risks as well as the opportunities of this expanding market and as a consequence are willing to arm themselves with the tools required to mitigate such risks, such as primary market syndication capability, will be well placed to manage portfolio risk and as a consequence increase portfolio returns, thus positioning their respective businesses to build long-term sustainable direct lending franchises.

The private debt direct lending market is here to stay and as the market evolves participants must display continued flexibility and be capable of evolving with the market.

End