A Review of US vs European Direct Lending

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For the years the US has been by far the dominant supplier of leveraged loans globally (see Exhibit 13), but given similar regulatory environment and regulation of on-balance sheet as banks in Europe, is gaining media attention as a source of debt opportunities for both managers and investors. How should these opportunities be viewed relative to senior credit in the US? Is there something fundamentally different about the direct lending space in Europe, or is it the same set dressed in a different currency?

Lenders to European companies face different challenges than those in the US. In general, and as discussed below, banks in Europe have been aggressive about defending their market share, particularly with relationship sponsors. That has pushed direct lenders to offer non-bank finance as well as more risky lower-capital stack solutions. While sponsors in Europe have pretty much the same variety of financing alternatives, American direct lenders are several years ahead of their European counterparts in both size and sophistication. The lack of maturity has resulted in more competition for fewer opportunities, leading to tighter terms and increasing the likelihood of great concentration in portfolio positions. One further difficulty lies with nation-oriented lending, and as in the US, gives sponsors more flexible coverage ratios. But the total annual volume of new issue leveraged loans in Europe is a fraction of the activity in the US. 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 US for the same period, or almost six times as much.

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Outlook for 2016... and Beyond
As Exhibit 4 shows, European funds have almost $30 billion in dry powder available to support loans. On the supply side, private equity firms have $410 billion available to deploy for investment. That would seem to give direct lenders plenty of opportunity to put money to work. But the total annual volume of new issue leveraged loans in Europe is a fraction of the activity in the US. 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 US for the same period, or almost six times as much.

Plus, as discussed above, banks in Europe have been aggressively defending their market share, particularly with relationship sponsors. That has pushed direct lenders to offer non-bank finance as well as more risky lower-capital stack solutions. While volume information on this activity is not readily available, Progin estimates that 23% European private equity deals have been closed in the past twelve months with a total valuation of $80 billion. One concern is that this will result in more competition for fewer opportunities, thus increasing the likelihood of great concentration in portfolio positions. Meanwhile, deals with bid-to-last between $30 million and $50 million, is where most players agree the opportunity lies for direct lenders. Above that, most deals are too small to be on the radar. But below that, in deal supply to satisfy all the capital being raised by these banks.

One further difficulty is that European lenders must contend with nation-oriented lending. Each European country has its own unique currency, tax structure, legal, set of relationships and of economic strengths and weaknesses that lenders must navigate.

Finally, noted one top manager, European funds face a potential mismatch between funding costs, which are lower in Europe, and lending spreads, which are higher. There will likely be a shakeout of direct lenders that are not competitive in select private equity-driven transactions. Another source agreed. “Forget about getting a decent allocation if you’re on somebody’s black list. You won’t be allowed to trade in the secondary market.”

That means that “job number one” (as one first fund manager called it) for direct lenders is to get an introduction to the sponsor. Be prepared to explain what you should be allowed to work with them. If you’re lucky, you may get some early bird looks. But understand that this is a small subset of a very small pool of European banks.

Because of fee structures, direct lenders require yields in the 9-10% range. That’s a step or two above the bid market, and as a result, there is a potential mismatch between funding costs, which are lower in Europe, and lending spreads, which are higher. There will likely be a shakeout of direct lenders that are not competitive in select private equity-driven transactions. Another source agreed. “Forget about getting a decent allocation if you’re on somebody’s black list. You won’t be allowed to trade in the secondary market.”

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