A Review of US vs European Direct Lending

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Over the years the US has been by far the dominant supplier of leveraged loans globally *(see Exhibit 1)*. But given similar regulatory pressure being exerted on overseas banks as here, 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 asset dressed in a different currency?

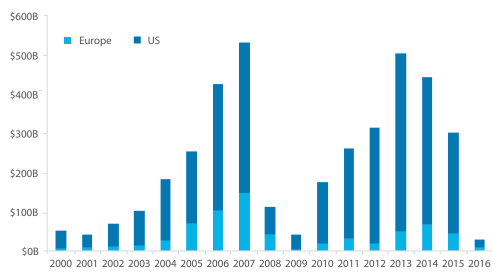
Lenders to European companies face different challenges than those in the US. In general, and as discussed below, banks in Europe have been aggressive about defending their market share, particularly with relationship sponsors. That has pushed direct lenders to offer unitranche financings as well as more risky lower-in-the-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. This 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, where each country has its own economic strengths and weaknesses. Any investor in European lending needs to understand these dynamics before diving into a European private debt fund.

Preqin recently reported about €31 billion was raised last year for "private debt." Of that roughly 60% was for direct lending, with the rest going to junior capital, distressed, and special situations *(see Exhibit 2)*. But given differences in the US and European markets, what's the path to success for these firms?

The Opportunity

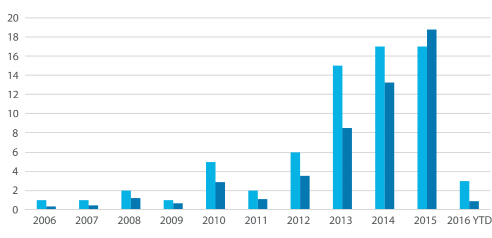
According to S&P LCD, Europe was a €15 billion market in 1998. Before that deals got done among an informal club of banks. Things remained clubby through the early 2000's when a growing number of institutional buyers pushed the market over €100 billion. Then following the bull loan market of 2006-07, it peaked at €165 billion. As cash flowed into funds and CLOs, the sell-side friendly features of the US broadly syndicated market crossed the Atlantic. But that all came to a halt with the credit crisis. Loan volume collapsed after 2008 and was on its way back until 2012, when the imposition of new regulatory frameworks knocked activity down again.

Exhibit 1: Tale of Two Markets



Source: S&P Capital IQ; Annual institutional loan volume in US dollars

Exhibit 2: Europe on $50 million a Day



Source: Preqin

Today the European loan market is where the US was in terms of development a decade ago. Unlike the US, disintermediation of regulated lenders in Europe by non-banks has only been going on since 2009. Banks there have always played a central role in corporate lending, and while their share has eroded, it's still well over the 10% of banks here.

In some ways, Europe has been ripe for middle market lenders for a while. While European banks are more active in leveraged loans than their American counterparts, middle market borrowers – with facility sizes less than €250 million – tend to fall below the radar of most corporate lending teams. For those regional, or "country" banks, that do support smaller companies, their focus tends to be on working capital financing with ABL facilities or lines of credit.

And though some European banks can be competitive in select private equity-driven transactions, in general they are less nimble with comprehensive credit solutions than non-banks.

Banks vs. the Non-Banks

There are fundamental differences between the US and European markets. One is the way each developed alternative lending. The disintermediation of regulated US lenders by non-banks has been going on for twenty years; in Europe that process only restarted immediately post-credit crisis *(see Exhibit 3)*.

"People don't realise that Europe is the much more efficient bank market for loans compared to the US, which is controlled by institutions," one leading UK credit provider told us. "We're beginning to see a shift as leverage comes down and regulations go up," he continued. "But banks still hold sway in many regions."

This is particularly true for the middle market. "Smaller deals – below €25 million ebitda – are attracting bank attention," another private fund head reported. "Libor spreads are dropping, and floors are falling away," he said. Smaller European LBOs mean banks are still able to club some deals amongst themselves, rather than having to distribute to institutional accounts.

"Supply/demand in Europe is relationship-driven," our friend went on. "Private equity sponsors are bringing their lenders to the table. Where there's an opening is in offering up-and-down-the-capital-stack solutions. But that will close when banks come back. It's mostly option value for US firms trying to come into this market."

Another bank-friendly element is Europe's quantitative easing program. Unlike the Fed, the ECB is lowering rates. That's made banks flush with cash. Think about how cheap funding costs are right now. Three-month Euribor is negative 20 bps! 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. By being buy-and-hold players in the European market, banks are competing with funds. A recent example is Carlyle's upsize to its LBO financing for Comdata. According to S&P LCD, the sponsor had nine banks in the existing €210 million package, and brought in three more to raise the total to about €300 million. This included a seven-year term loan B tranche that in the US would ordinarily be distributed exclusively to funds.

Many thought European banks would be on the way out of the leveraged loan picture, as is the case in the US. Big funds were raised over that prediction. But it hasn't worked out that way. Non-bank money got raised, but there was nowhere to put it.

Instead direct lenders have gone to sponsors and offered unitranche financings at six times leverage. But this is not the true middle market. It is the market for less bankable companies with different players, and very different credit fundamentals.

Hurdles: Legal, Cultural, and Logistical

"Europe is not a market," a keen observer of Europe's debt market informed us. "First of all," he said, "there's the difference in legal jurisdictions. These are real hurdles and won't change anytime soon. If anything, the EU is becoming less unified."

This patchwork nature of multiple jurisdictions makes origination in Europe a real challenge. "Here local teams matter. Even London-based teams have trouble managing deals on the continent. The more complex the structure, the more local the team needs to be."

Understanding the nuances of local companies is critical, particularly in a default, an attorney specialising in cross-border matters told us. "Your options as a lender are very different in Italy versus Spain or France. There's no one standard approach."

He went on. "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. Laws are evolving quite rapidly post-crisis."

How? Until very recently, non-banks couldn't technically make "loans" in Italy and France. You have to call them "bonds," and are not as liquid. To buy them you need to be a qualified investor. This is changing, but the legal environment still favors banks.

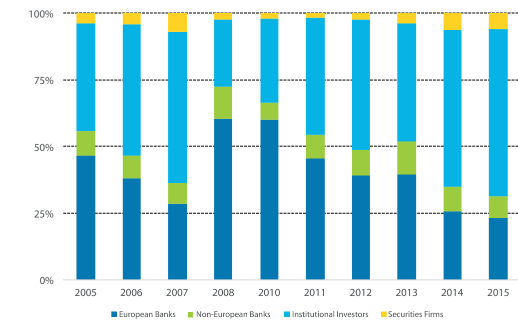
Perfecting security interests is also a challenge in Europe. Germany has no standard UCC filings such as in the US. France does not recognise liens on inventory. As one banker friend in London put it, "it's often said it's easier to lend in the beer-drinking countries than the wine-drinking ones."

It's an expensive proposition to market in Europe effectively. "You need to knock on all the doors in Europe," our second source told us. "It's really Middle Market Lending 101. While the majority of sponsors are in the UK, you still need to have experienced executives in every major city who have a strong Rolodex of PE relationships."

Relationships Count

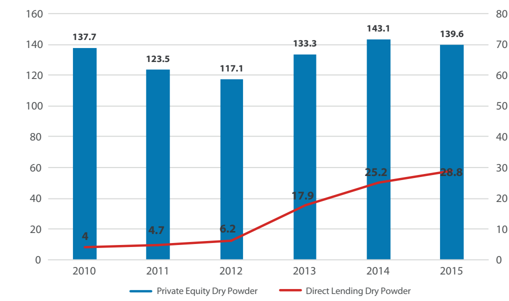
As we've highlighted, banks still have the upper hand as arrangers of middle market senior debt in Europe. This is particularly true for private equity backed borrowers. The manager at one leading European fund put it this way: "As is increasingly true in the US, sponsors in Europe control every aspect of deal structure, who's invited into the financing, even who trades the paper. If you're a bad actor, it's tough to break in."

Exhibit 3: Hard floors



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

Exhibit 4: Deployment Overseas



Source: Preqin

Another source agreed. "Forget about getting a decent allocation if you're on somebody's black list. You won't even be allowed to trade in the secondary market."

That means that "job number one" (as our first fund manager called it) for direct lenders is to get an introduction to the sponsor. Be prepared to explain why 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 private market."

Because of fee structures, direct lenders require yields in the 8-10% range. That's a step or two above the bank market. Rather than migrating towards second lien, which has effectively disappeared from both sides of the Atlantic, direct lenders are seeking these returns from unitranche financings. But these carry a higher level of credit risk, and a major difference in Europe is that unitranche is structured with 50% cash-pay and 50% PIK. All-in yields also vary widely, depending on the credit – ranging from 6-11%. But unitranche remains popular with PE, and as in the US, gives sponsors more flexible covenant packages, more accommodative debt baskets, and, of course, higher leverage.

Outlook for 2016…and Beyond

As our Exhibit 4 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.

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 unitranche financings as well as more risky lower-in-the-capital stack solutions. While volume information on this activity is not readily available, Preqin estimates that 233 European private equity deals have been closed in the past twelve months with a total valuation of $90 billion. One concern is that this will result in more competition for fewer opportunities, thus increasing the likelihood of great concentration in portfolio positions.

Mid-sized deals, with ebitda between €30-50 million, is where most players agree the opportunity lies for direct lenders. Above that, most deals are getting clubbed up. But will there be enough deal supply to satisfy all the capital being raised by these lenders?

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

Finally, noted one top manager, European funds face a potential mismatch between funding costs, which are at rock-bottom, and lending spreads. "There will likely be a shakeout of direct lenders down the road," he said. "The US experienced this in 2009 as poorly performing (or inadequately funded) managers flushed away in the downturn. For Europe, the day of reckoning may still be ahead."

Investors need to carefully explore the European landscape and decide if the risks of investing in European private debt outlined above are justified by the returns. The US is by far the more battle-proven territory today.

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