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The COMPASS

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Private Debt

Christopher Domenghino takes a look at the emergence of private debt as a new asset class in Europe

Industry Insight

Etienne Haubold discusses direct lending, realistic IRRs and how to add value post-investment

DEAR READER

Peter Derendinger, CEO
Alpha Associates

Welcome to the autumn edition of The Compass. This issue looks at Private Debt, which over the past year has emerged as one of the most sought after illiquid investment themes. In particular, we will look at the corporate private debt market, which is a key focus of Alpha Associates.

Alpha Associates has been investing in private debt strategies since 2006, when we first allocated to private debt funds in the U.S. At that time the corporate lending markets in Europe were still dominated by the banks. This changed dramatically with the 2008 financial crisis and ensuing regulation, which drastically curtailed bank lending and marked the arrival of private debt funds as alternative lenders in Europe. Investors are now presented with a universe of European private debt funds, providing ample investment opportunities.

In this issue of The Compass, Christopher Domenghino from our team of Private Debt specialists takes a look at the emergence of private debt in Europe and what private debt funds can offer. You will also find a personal view from Petra Salesny, Partner, on the merits of private credit strategies for investors looking for yield and capital-efficient returns. The Industry Insight in this issue is provided by Etienne Haubold, Managing Director for France at unitranche lender European Capital, who shares his views on developments in the current lending markets.

Finally, the Figures & Facts section provides you with some interesting statistics for this emerging asset class in Europe.

I hope you'll enjoy the read and we look forward to your feedback. α

PRIVATE DEBT HAS ARRIVED

Alpha Associates Vice President Christopher Domenghino takes a look at the emergence of private debt as a new asset class in Europe

"Banks' reduced lending capacity has enabled private debt to establish itself as an asset class"

Christopher Domenghino
Vice President
Alpha Associates

The aftermath of the global financial crisis has seen legislative action put into place that has transformed the regulatory framework for large lending institutions across Europe. These reforms, aimed at reducing banks´ balance sheets, have had the desired effect: Not only have banks reduced trading risks but also their lending to corporates.

Previously, banks had often viewed senior secured lending, especially to SMEs, as a way to generate additional lucrative business from clients who they had often known for decades. While capital was cheap, the bank balance sheet was at times seen as a conduit to foster core client relationships. Needless to say, credit quality assessment was not always the main driver of terms. Borrowers happily benefitted from this benign lending environment. Thus European lending has been traditionally dominated by banks as other pure lending houses could not compete on price with the incumbents.

In the run-up to the financial crisis, first green shoots of non-bank lending emerged in Europe. Applying financial technology already established in the U.S. market, alternative lenders and securities firms began trading in syndicated loans, which unlike bank loans were typically non-amortising. The first open-ended funds were raised and securitisations issued (CLOs), effectively pooling such loans. This allowed institutional investors to access the market - albeit mostly with exposure to large corporates, typically with enterprise values of €500m and more that can support debt issuances allowing for adequate liquidity. Institutional investors flocked to such products, especially as rating agencies rated the senior capitalisation of these vehicles, inferring a high degree of asset security. Furthermore, junior capital was available at premium pricing from dedicated mezzanine investors.

Reduction in Bank Lending

The ensuing financial crisis put the stability of these popular new structures to the test. With mark-to-market losses accumulating, open-ended funds were facing redemptions from investors and were forced to sell in an already falling market, exacerbating the drop in valuations. Issuance of such structures halted in 2008 and has only re-emerged recently, however, almost exclusively for the upper end of the syndicated loan market. Mezzanine funds generally did not perform well and issuance has yet to recover.

While large companies were able to benefit from the appearance of CLOs prior to the financial crisis, the bank market remained the main source of senior funding for SMEs. This has all but changed as the fallout of the financial crisis has led to a continuous tightening of bank capitalisation requirements, raising the cost of funding and therefore limiting the banks' capacity to lend to SMEs. Consequently, European SMEs' access to credit

has been materially constrained. What's more, while banks remain open for some business their reduced lending capacity has enabled private debt to establish itself as an asset class.

Private debt funds come in numerous forms and pursue a wide range of strategies with different risk/return profiles. Such funds issue new loans or specialise in the purchase of already existing positions, provide senior secured lending, subordinated and unsecured financing instruments or mezzanine lending. A rather newly established investment style termed unitranche or unirate lending designates the issuance of financing by a private debt fund across various layers in the capital structure, from first lien to subordinated, thus making the private debt fund the only source of debt to a business. At the high end of the risk/return spectrum private debt funds apply distressed-for-control-strategies, or invest in other complex situations.

Private debt investments are typically privately negotiated loans to non-public companies that are neither traded nor rated. Private debt funds are closed, illiquid funds with a typical investment period of 2 to 3 years, a term of 5 to 7 years and an annual management fee of 0.8% to 1.5% on invested capital. Depending on the strategy and resulting risk/return profile, private debt funds generate a current yield of up to 5% p.a. to investors and have total return targets between 5% p.a. for strategies with a focus on large senior secured loans and 20% p.a. for complex and distressed-for-control strategies.

These return targets imply that SMEs accept significant changes in pricing compared to the friendly credit environment prior to 2008. The pricing is substantially above what the public markets suggest is the current cost of credit. This begs the question why SMEs would accept such expensive sources of funding.

First and foremost, the only competitor in the SME credit market are the banks, whose lending capacity is substantially reduced. As a result a large gap has opened up between the financing demand of SMEs and bank financing supply. Banks have become inflexible on terms and typically require a higher degree of amortisation and shorter maturities than private debt funds. Additionally, private debt funds have significant advantages with respect to analytical skills, decision-making speed and flexibility on terms and conditions. This allows funds to design customised credit instruments that address the maturity and liquidity profiles as well as specific needs of the borrower. This flexibility, however, comes at a higher price.

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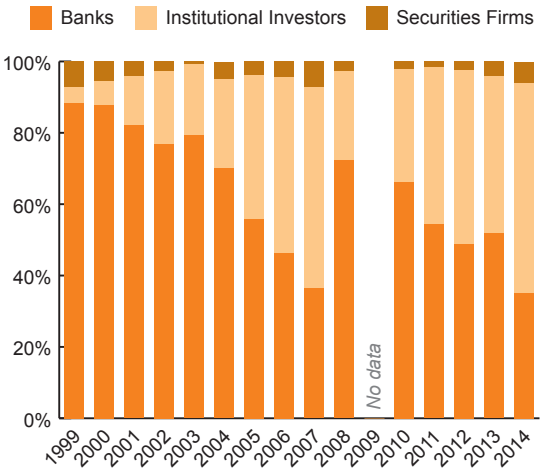
To the borrower, flexibility is not the only benefit private debt fund managers bring to the table. Private debt fund managers conduct a far more detailed due diligence, often comparable to the extent of due diligence carried out by a private equity investor, which allows funds to lend also in complex situations that are usually dismissed by banks. The focus of funds is far more on the company's future profitability than on attachable assets.

Rise of Alternatives

European Primary Market for Leveraged Loans by Broad Investor Type



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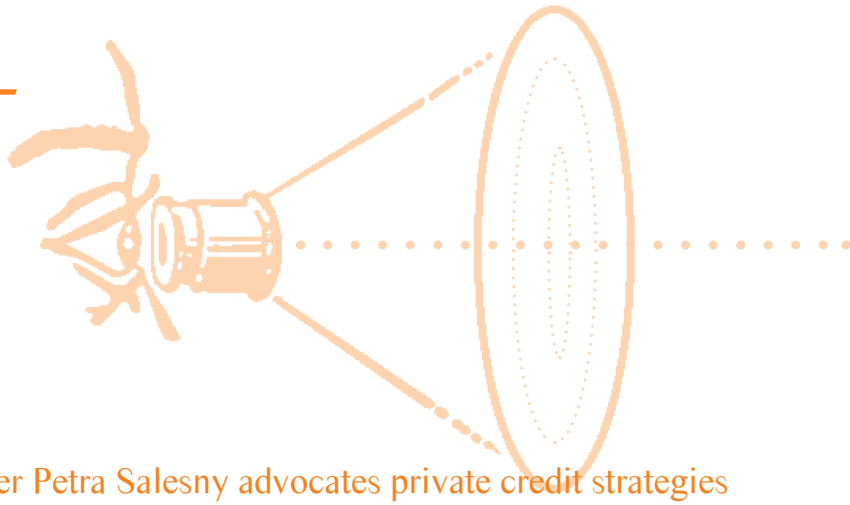
What's more, private debt funds can act faster than banks in executing lending to companies due to their smaller size and leaner internal processes - a key competitive advantage. Finally, if remediable action is required, private debt funds can react faster than a large lending consortium consisting of a number of institutions. This alone can potentially save companies, especially given the complicated and partially untested nature of European bankruptcy laws. In the lower SME segment private debt fund managers frequently take observer positions on the borrowers' boards and provide valuable support and advice as professional investors.

So where does this leave investors? The financial crisis was ultimately caused by superfluous availability of leverage, which led to the mispricing of economic risk and is now being corrected: credit has become more expensive. Regulatory change curtailing the banks' lending activity implies that in a few years from now we can expect an even broader and deeper universe of private debt funds. Companies must come to accept the new market realities and in time will accept the terms they now face. In 2015, private debt has certainly arrived in Europe and is here to stay. α

PERSONAL VIEW



Alpha Associates Partner Petra Salesny advocates private credit strategies as a viable option to increase yield and generate capital-efficient returns

With expansionary monetary policy driving down returns on traditional yield-generating assets, investors with fixed liability schedules, such as pension funds and life insurance companies, are facing growing challenges. The current low-interest environment is a big concern for institutional investors, who previously could rely on well-diversified fixed-income portfolios to deliver the necessary returns.

Investments generating a predictable, mid-single-digit cash return annually are hard to find these days or carry substantial risks. A number of investors have flocked to emerging market assets in their "hunt for yield". This has, however, not only left them exposed to possibly violent market corrections when sentiment changes but also to credit risk that is difficult to understand and assess. High-yield bonds, another asset class that investors have allocated significant amounts to following the financial crisis, have an unattractive risk-reward profile today.

There is an asset class investors can turn to in order to ease this pain: private credit strategies. After the dramatic reduction of lending by the banks following the financial crisis, a deep funding gap has opened up in Europe. Demand for credit financing, in particular by SMEs, significantly outweighs supply, which means attractive pricing for investors. Investing in private debt strategies may require an effort as investors will need to learn about this new asset class and understand the benefits and pitfalls of the different strategies deployed by different managers in different market segments. Also some adjustments may be needed within the internal organisation: the alternative and fixed-income teams, who may have had little interaction so far, now have to stick their heads together. I believe the potential benefits outweigh the costs. Of course, many strategies require intense due diligence and therefore specialised resources; however, this can be outsourced or addressed by investing in diversified products managed by specialised managers.

One common concern often voiced about private debt structures is that they are illiquid. I believe such concerns are undue, in particular for buy-to-hold investors. Investors often want liquidity to serve as a "security valve" in times of strong market corrections so portfolios can be rebalanced. However, the financial crisis showed that extended times of illiquidity exist even for products which are highly liquid in normal trading environments. In such situations, funds with liquidity rights become forced sellers, thereby exacerbating the problem. Never catch a falling knife, as one says. Illiquid private debt structures on the other hand compensate with higher returns.

Regulatory changes not only affect banks and their ability to lend, but also investors' ability to allocate to illiquid investment strategies. In Europe insurance companies and pension funds face increasing capital charges and other regulatory restrictions, making investing in illiquid assets expensive or impossible. Fortunately such hurdles can be addressed by appropriate product structures, which have become equally important for investors as the merits of investment strategy and manager quality.

Whether the motivation of an investor is to increase yield or to generate capital-efficient returns, I believe that private debt is an attractive choice. Private debt as an asset class deserves to occupy a significant part of a well-managed investor balance sheet. α

"An allocation to private debt can ease the pain caused by the low interest rate environment"

Petra Salesny
Partner
Alpha Associates

INDUSTRY INSIGHT

Etienne Haubold, Managing Director for France at European Capital

European Capital Timeline

2005 European Capital established as subsidiary of American Capital to pursue mid-market debt and equity investments in western and northern Europe

2007 Completes the first European unitranche deal to support acquisition of luggage brand Delsey

2014 Closes £100m fund in partnership with British Business Bank to provide debt finance to SMEs in the UK

2015 Establishes mid-market pan-European private debt fund focused on arranging mid-market unitranche and mezzanine financing. To date, European Capital has invested €1.4bn in 46 private debt transactions

What have been the biggest changes to the European direct lending market over the past decade? Has the behaviour of banks changed during this time and what do you expect from them going forward?

The financial crisis placed enormous pressure on banks' balance sheets, causing them to materially reduce their lending activities from 2008 onwards. This created a large funding gap, which has been filled by the direct lending market. In addition to providing necessary capital, direct lending has also introduced some innovations such as unitranche, and has increased choices for borrowers while making the market more robust. The financial crisis was in a way an important catalyst for European businesses to reduce their reliance on banks, and direct lending funds have so far proven that they are here to stay, even as banks recover and look to increase their own lending activities.

Do you think the markets for direct or uni-rate lending have become too crowded, with established groups raising multi-billion funds? How does this potential capital overhang affect your investment activities?

As a general market observation, competition has increased in direct lending with data showing leverage ratios increasing and equity contribution decreasing. This is particularly true for companies with enterprise values over €250m that can access multiple forms of financing beyond banks and direct lending, i.e. high-yield or private-bond financing.

We focus on lending to high-quality lower-mid-market companies (€50-250m in EV) that are below the radar of multi-billion funds and large banks looking to originate and syndicate. It is still competitive, but in our opinion much less so than at the larger end. Ultimately, we differentiate ourselves via our sourcing effort and adding operational value to companies so that we can better influence pricing and terms.

With regards to achievable yield, do you think a gross IRR close to 14% as promised by competitors is realistic, and where do you see the market developing? What would you say is a "stable" yield within your target space?

Overall, we expect target returns to be moderated, given where the forward yield curve is today. Having said that, we certainly believe that a gross IRR of approximately 14% is achievable with the right mix of assets. For example, funds that invest a meaningful portion in mezzanine and have originated a significant portion of their portfolio pre-2014, when overall pricing was more favourable, could come very close to that target. It may also be achieved through the use of fund-level leverage, though that could materially change the risk profile of the proposition.

One of the appeals of direct lending is that companies can benefit from the experience of professional investors. Can you illustrate how European Capital adds value once invested?

European Capital brings strong operational and managerial expertise to its investment portfolio. We believe in actively engaging with portfolio companies, building a rapport with management and providing industrial and strategic insight.

We have an in-house 20-person operations team with extensive turnaround, restructuring and bankruptcy experience, as well as strong accounting and financial skills. Our operations team members can provide board level advice and get involved with companies on a more hands-on basis if needed, much like a traditional private equity approach. In addition, we offer our portfolio companies unique access to the U.S. for acquisitions or organic development through leveraging our parent company American Capital. As most of our clients generally lack operational resources and international reach, being able to draw on such support is a significant benefit. α

FIGURES & FACTS

93

number of direct debt fund managers in Europe

199

completed European deals in 2014 with debt up to €350m

$192BN

amount being raised by private debt funds as of May 2015

€461bn

amount of reduction in bank lending in the Eurozone since financial crisis

105%

average discount margin increase of European leveraged loans pre-crisis to August 2015

80%/28%

European banks' share of leveraged loan market before and after the financial crisis

66

Unitranche financings in Europe in 2014

1.3%

European leveraged loan default rate in 2015

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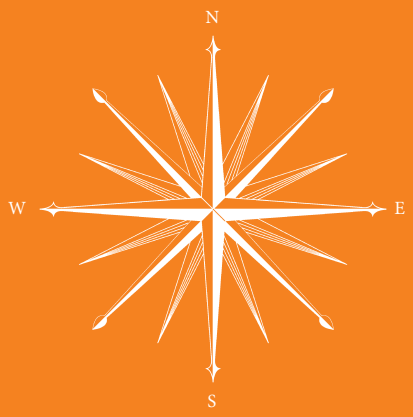

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