EXPERT Q&A

Tom Stein, head of private debt Americas, and Chris Bone, head of private debt Europe, at Partners Group discuss the opportunities and challenges facing direct lenders in Europe and the US


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Q Where did you see the most activity in mid-market European direct lending last year, and how has 2022 started? How does that compare to the US market?

Chris Bone: The start of 2022 was shaping up to be much the same as last year, certainly until mid-February. We had witnessed a remarkable increase in activity in direct lending in Europe, particularly in the second half of 2021 and into the beginning of this year. Then, with the onset of war in Ukraine, as well as the combination of more pronounced inflationary pressures and market uncertainty, we saw a number of widely syndicated financings, particularly at the larger end, either being accelerated if they were quite a long way down the line or being postponed if they were not fully underway.

Looking at the broadly syndicated loan market in Europe for a moment, we saw a notable increase in volumes of CLO formation and demand during 2021, which ate into the upper end of the private debt market. For us, that meant the sweet spot where we saw the most interesting value was typically a bit below where a CLO might invest, so a term loan size of about €150 million-€250 million.

At this size, there is not enough liquidity in the loans for a CLO investor and public ratings are punitive. However, as we look forward today, we see the syndicated loan market as a less reliable source of financing, with sponsors increasingly looking at the direct lending market for financing even at the larger end.

Tom Stein: In the US, the market for direct lending is a lot more mature in terms of both size and scale. Over the last few years we have seen more and more $1 billion-plus unitranche transactions, and there are several reasons for that, including the ability of direct lenders to provide certainty of execution, flexibility of terms and a willingness to support long-term buy-and-build strategies. The product is being used to support both large-cap investments and the mid-market, and we are active in both.

CB: If you look at the average EBITDA of direct lending loans in Europe compared to the US, it is notably smaller, maybe half the size. There are similar dynamics across both markets but we don't have nearly as many multi-billion-dollar unitranche transactions in Europe. That might be coming, especially with the uncertainty in the broader market, but the largest sponsors in Europe still go, at least initially, to banks to underwrite and distribute their loans, whereas in the US they more typically call on direct lenders.

The role of intermediaries – debt advisers – is also significant in Europe. It is quite normal for a sponsor, particularly in the lower mid-market, to ask an agent to help place debt. This is partly because sponsors often don't have the in-house capital markets capability or bandwidth to do that.

Those intermediaries have their own favoured direct lenders and that process naturally favours a small number of key players. With increased sophistication and transparency, the role of those intermediaries may be diminished over time at the mid to larger end of the market, but it is different to the situation in the US where sponsors have more capability in-house and the norm is to arrange the financing without an adviser's help.

Q What will be the biggest challenges facing mid-market borrowers this year?

TS: The biggest challenges impacting borrowers, in the near-term, revolve around inflation, whether that is escalating labour and import costs, supply chain challenges and/or rising interest rates. We therefore need to think about the ability of our borrowers to influence pricing and pass on some of these increased costs to their customers. Whether inflation is temporary or permanent, it is going to impact all portfolio companies in one form or another. We need to put considerations about the ability of a business to withstand these inflationary forces, such as rising oil prices, labour, supply-chain challenges and increased capital costs, at the heart of our underwriting decisions and our modelling.

We are now past most of the covid impact of 2020 and 2021, but supply chains are something we are increasingly talking about. The next potential impact for us to think about is China and Russia. We have very little, if any, exposure to Russia, but China is much more embedded in manufacturing and the trading of goods around the world. There could be a knock-on effect from the war in Ukraine that involves China, and everyone should be thinking about that now. The fact that EU countries could come together and impose sanctions so quickly against Russia is remarkable, but anything similar involving China would have a much larger global impact.

Some of the challenges facing borrowers present opportunities for direct lenders. In the face of inflation and macroeconomic volatility, the direct lending market can provide certainty where the markets might otherwise be uncertain. But we still need to be thoughtful about the businesses that we would like to underwrite and invest in and how they might be impacted by these macro and geopolitical challenges.

CB: In Europe we perhaps feel closer to what is going on in Ukraine. Everyone is diving into their portfolios and working out their exposure to Russia, which is small for us and probably for

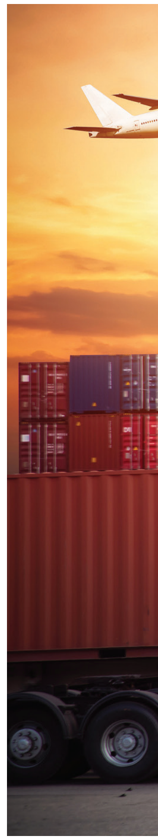
Q Which sectors do you expect to be focusing on in 2022?

TS: Part of that depends on what sponsors want to do and what we can get comfortable with. About half of our portfolio build over the last 12 months has been in information technology, healthcare, business services and transportation and logistics. On the flip side, we tend to shy away from more cyclical sectors, capital-intensive businesses, or those likely to be adversely impacted by regulatory change.

We run a generalist approach to credit for our direct lending business and have "boots on the ground" in a number of local jurisdictions, globally. That said, we also have a substantial presence in the broadly syndicated market and have sector specialists who we can leverage for our credit analysis. They offer insight on relative value, sector specific themes and diligence topics that we need to be aware of and focus on.

CB: The logistics space has become a particularly attractive part of the market in the last six months, supporting supply chains in the face of significant disruption around the world. There are plenty of opportunities, in everything from logistics software through to freight forwarding businesses.

Otherwise, we tend to follow the same approach as our cousins on the private equity side of our business, drilling down into our investment giga themes of digitisation, new living and decarbonisation to identify growth trends. Importantly, we try to avoid the icebergs and disruptive changes that certain sectors might see as a result of, for example, technological change. That said, we expect our focus areas this year to be broadly in line with where we have been active over the last couple of years.



most of our direct peers. But secondary and tertiary effects could be pronounced, especially on energy prices if the supply of gas from Russia to Europe is curtailed at a time when prices are already high. Agriculture and related sectors are also impacted.

More broadly, if you are an owner looking to sell your company today, why would you start a process now when there is so much uncertainty? In this context, we expect some M&A processes to be put on hold so there will likely be a noticeable impact on M&A volumes in the short term, although that may simply manifest in more portfolio add-on transactions rather than new platform investments. Conversely, as mentioned before, the uncertainty in the markets could help drive direct lending volumes, as sponsors and borrowers look for certainty of execution.

"Interest rate sensitivity is something we are watching closely"

TOM STEIN

Q Where do you see the greatest opportunities for lenders?

CB: Broadly, we see volatility as creating an opportunity for direct lenders, and a little volatility is no bad thing. The regulatory environment remains relatively benign and we have come through the worst of the covid impact, so we anticipate volatility reducing volumes in the immediate term but improving penetration levels of direct debt over the longer term. More specifically, we expect larger businesses, which might otherwise attract low cost of capital in the syndicated markets, to offer interesting relative value for the direct lending market.

TS: Interest rate sensitivity is something we are watching closely, because typically a borrower has a difficult time changing their capital structure and cost of capital. If the Federal Reserve is going to move six times on rates in the space of 18 months, as has been predicted, that's not immaterial and will create opportunities for direct lenders who benefit from floating interest rates.

Last year, 35 percent of our transactions in the US were add-on volume to existing credits, and, as Chris mentioned earlier, it is possible that volatility will drive discussion away from primary LBOs and increase the focus on existing portfolio investments. That kind of shift will also create investment opportunities for lenders like ourselves, in credits that we already know quite well.

Q How does the competitive environment compare for direct lenders in the US and European markets?

CB: Penetration of direct lending in Europe has been gradually expanding over the last decade as private lenders continue to replace banks as the key providers of capital. Companies are getting more and more used to, and appreciate, direct lenders as their regular source of capital to the extent that over half of mid-market loans are now financed by direct lenders.

At the same time, a lot of dry powder has been raised by our peers and ourselves and we see the same handful of direct lenders appearing on transactions time and again. The intermediaries are talking to the same players and when you go to a presentation by a management team you are sitting next to the same peers each time. Today it remains quite a small market with a handful of players in Europe, though it has got more institutionalised over the past decade.

TS: In the US, we have a much broader pool of direct lenders. There are a few very large players in the market but there is enough opportunity for us to make an impact. We play in the top-end of the market but also in the upper mid-market; lots of firms are focused on one or the other, but we are flexible. We can also be nimble to provide junior capital and thus play up and down the capital structure.

The strength of our underwriting process reflects our roots in private equity. We have an Investment Committee that is very diverse in terms of experience and background and a dedicated restructuring team that could own and run a business, if necessary. ■