

EUROPE



BONE



CLOAKE



MCDUGALL

Riding the bumps

Competition is tough and deal terms are raising eyebrows. But Europe's private debt professionals are also seeing opportunity in specialisation, regulation and the growth of markets outside the besieged UK. **Andy Thomson** reports



EUROPE

It's a sign of confidence in the private debt market that, while PDI's European roundtable discussion opens with talk of competition, it quickly turns to opportunity. Plenty of fund managers are throwing their hats into the ring and deal structures are becoming the subject of much scrutiny. But players are still finding enough niche areas and favourable regulation to keep them happy.

Adrian Cloake, group chief investment officer at London-based fund manager LCM Partners, says multi-strategy hedge funds have increasingly been seen on his radar since 2010, especially in the Spanish and Italian markets. However: "Only a certain number succeed. When you're buying loan portfolios you need a track record and experience and it's telling that we're now picking up secondaries from them as some fail and retrench."

Cyril Tergiman, a partner at EQT Credit in London, says people need to be careful about the highly competitive sponsor-led direct lending market in particular – especially with the political turmoil currently enveloping the UK, Europe's largest private debt market.

"It's not a mature market in Europe as a whole, with the UK and France leading volumes," notes Tergiman. "The UK is a consumer-driven opportunity and, because of Brexit, there is weakness in that space. People should be worried



CHRISTOPHER BONE

Managing director and head of European private debt business, Partners Group

- Based in London and a member of the firm's private debt investment committee
- Has been with Partners Group since 2010 and has 17 years of industry experience
- Previously with AlInvest Partners, RBS, PricewaterhouseCoopers and Ernst & Young
- Partners Group has over \$12bn AUM in private debt and has invested over \$18bn globally in credits since 2003

"IF THERE IS UNCERTAINTY, THE BANKS GET NERVOUS AND PRICE IN MORE RISK"

about having over-exposure to it." But Tergiman also notes pockets of value, including in special situations.

Luke McDougall, a partner in the finance and leveraged finance practices at law firm Paul Hastings in London, cites regulation as providing increased opportunity outside of the UK.

"The regulators are opening up to non-bank lending and traditionally creditor-unfriendly markets, such as France, are becoming more benign," he says. "The outlook has changed and the demand for lending opportunities in France is there as well."

NERVOUS BANKS

Christopher Bone, managing director and head of private debt in Europe at private markets firm Partners Group, also

acknowledges the potential for regulatory changes to bring benefits. "If there is uncertainty, the banks get nervous and price in more risk," he says.

"In 2011 there was the trouble in Spain and Greece and, when the market is like that, we tend to find the most interesting opportunities, with a good example being the Securitas Direct mezzanine deal. However, while there is quite a lot of political and regulatory uncertainty these days, things haven't frozen as much as we'd like."

While competition is acknowledged to be at a high level in many areas of the asset class, it is also clear that new entrants are still keen to try to grab a slice for themselves. "We have seen interest from US fund managers trying to break into Europe," says Dila Minott, a partner and colleague of McDougall in the corporate department at Paul Hastings.

"There are more options for fund structures now, it's not as constrained as it used to be. It used to take a long time to set up private debt funds as the track record was not there but regulatory change has made things easier. US firms in Europe are less nervous than they used to be."

In an asset class where there are so many different strategies, with a range of risk and return profiles, the ability to be flexible is cited as a key differentiator.

"We use our flexibility to address the best opportunities at each point in the

ADRIAN CLOAKE

Group chief investment officer, LCM Partners

- A British national based in London, Cloake has 20 years of industry experience
- He was previously at Arthur Andersen Corporate Finance
- LCM invests in performing, rescheduled and non-performing loans
- The firm's loan servicer, Link Financial Outsourcing, has over 550 staff across 10 European offices



"INVESTORS ARE ALSO LOOKING CLOSELY AT THE TEAM AND INCENTIVISATION LEVELS, NOT JUST FOR THE SENIOR MANAGERS BUT ACROSS THE BOARD"

EUROPE

LUKE McDUGALL

Partner, corporate department, Paul Hastings

- Based in London, a partner in the firm's finance and leveraged finance practices
- Practice focused on UK and cross-border acquisition finance and restructuring
- Experience in acting for senior lenders, junior lenders and borrowers on capital structures, portfolio acquisitions and specialist financing transactions



"THOSE WHO WANT TO BE ARES SIMPLY CAN'T BE, AND YOU CAN'T BE A BOUTIQUE UNLESS YOU'RE VERY SMART IN A PARTICULAR SECTOR"

cycle," says Jaime Prieto, managing partner at pan-European fund manager Kartesia.

"We invest across Europe, targeting different markets that are at the right point in the credit cycle and when we see less competition. We lend directly to companies with growth plans and also buy loans from lenders exiting companies and markets when they move away from the original lender's standard loan parameters." By doing so, Kartesia aims for a 15 percent target return.

A NON-STARTER

Prieto adds that the non-sponsored market is another area where Kartesia sees opportunity at the current time. "The development of the non-sponsored market will take time as you have to establish credible relationships," he says. "Around 30 percent of our portfolio is now non-sponsored and over the next 10 years it will continue to be a significant part of our portfolio."

But while Kartesia's focus is on the medium and smaller end of the market in terms of deal size, Partners Group is looking for larger tickets. "We put a premium on size and think bigger companies are generally higher quality," says Bone. "It's more aggressive on deal terms at that end but we like repeat dealflow and if we can be seen as a solution provider for sponsors we know they will work with us again."

All those around the table acknowledge the strength of the fundraising market,

with Bone making the point that increasing interest in Europe from Asian sources of capital has added even more momentum. The concern is whether there is the demand to meet the supply of capital coming into the asset class.

"There is not a direct correlation between capital raised and investment opportunity," suggests Tergiman. "In 2008 the investment opportunity was great but you couldn't get capital from investors. Now you can get the capital, but can you spend it wisely? You need to stay disciplined and rigorous on sourcing, stay disciplined on risk and relative value, and fight for the deals you believe in. I sense there is a degree of discipline slippage in risk management."

Conscious of that need to maintain discipline and not get drawn into scrapping furiously for every deal that comes along,

fund managers appear to be looking for ways to buy themselves more time. "We have seen a spate of investment periods being extended for firms that have struggled to get the money away," says Minott. "Investors have pushed back but ultimately conceded as they want quality deals."

She adds that extensions are typically 18 months but sometimes as much as two years on top of original investment periods of between three and five years.

STUCK IN THE MIDDLE WITH WHO?

There is a sense that some funds may be finding themselves stuck in the middle of the larger players and niche boutiques and are struggling to justify their place in the market.

"In direct lending, there is an emerging split," says McDougall. "There are the dealflow players such as Ares, Alcentra and ICG which have the geographic coverage, track record and resources which act as a multiplier effect, and they can easily raise money and deploy it. Then you have the boutiques which can only operate in certain sectors such as technology and software, where they have an advantage over the dealflow players."

"But if you have no particular way of providing a better offering and you don't have scale, then it's tough. Managers should be mindful of this emerging split. Those who want to be Ares simply can't be, and



DIALA MINOTT

Partner, corporate department, Paul Hastings

- A corporate partner based in London
- Specialises in structured finance transactions including CLOs, CDOs and bespoke hybrid mid-market CLO type funds
- Her practice covers debt and credit funds with a particular focus on direct lending, CLO equity and risk retention funds
- Covers regulated and unregulated funds, both onshore and offshore, with a particular expertise in Luxembourg funds

"THERE ARE MORE OPTIONS FOR FUND STRUCTURES NOW, IT'S NOT AS CONSTRAINED AS IT USED TO BE"

EUROPE

you can't be a boutique unless you're very smart in a particular sector."

There is a view that, in the direct lending market, you would expect firms to naturally gravitate to the larger end. However, Prieto questions how effectively you can maintain relationships with advisors and borrowers as you move up the deal size spectrum. "It's easier to do a €100 million-plus deal and get fees at the beginning, I understand that," he says. "But we want to focus on the smaller end and we think that will pay off in the end. In debt, when you go too large, you end up competing with other instruments."

As competition at the larger end heats up, movement from sponsors is tending to be in the opposite direction as many larger players dive down into the mid-market. What they do not seem to be changing as they migrate down the deal size ladder is their attitude to deal structuring.

"Sponsors are going down to the small end of the mid-market and imposing the same terms you'd find at the larger end," says Bone.

"Some of the terms in the mid-market are more aggressive than at the large end," adds McDougall. "The ability to say what is market standard is less clear than it used to be because there are so many sponsors and so many strategies. Plus, there are some very aggressive lawyers and they are pushing at an open door."



JAIME PRIETO

Co-founder and managing partner, Kartesia

- Based in London, was a founder of the firm in 2013
- Previously worked at French private equity firm LBO France and ICG
- Also had spells at McKinsey & Co and Lucent Technologies
- Kartesia recently closed its fourth fund on its hard cap of €870m, raising 70% more capital than its predecessor

"THE DEVELOPMENT OF THE NON-SPONSORED MARKET WILL TAKE TIME AS YOU HAVE TO ESTABLISH CREDIBLE RELATIONSHIPS"

"Where does that leave private debt funds today? There are barriers to entry on anything competitive. Terms are more aggressive than they ought to be for the size of deal, and there is more aggression in the mid-market in Europe than there is in the US."

THERE MAY BE TROUBLE AHEAD

Tergiman sees warning signs. "Some companies are disconnecting from budgets and business cases. We see some that may encounter cash issues early next year – and those cash issues will be seen before covenant problems given how loose the covenants are. I think there is some risk amnesia around."

However, while there are obvious worries around deal terms, there is also a view that mitigating factors should be taken into

account. "It's sometimes made to look like a gloomy picture but equity cushions are substantial and put the sponsors on the hook," Bone points out.

McDougall adds that "leverage has not stretched very high. You see deals being done at around 5.5-6 times EBITDA compared with the 7.5 times we were regularly seeing in 2007. So there is some discipline in that, even though I'm concerned that discipline is being tested in other areas."

At the fund level, leverage is now being increasingly used by providers of credit. "We are seeing more and more leverage in funds," says Minott. "It used to be a dirty word, but in the last 18 months we have seen leverage pre-consents being built into documentation. European investors are still fairly nervous whereas US investors are not. Nonetheless, we are seeing investors getting more and more comfortable with AIFMD because they feel that AIFMD provides a lot of investor rights and protections that will ultimately get them more comfortable with leverage."

"Investors are comfortable with leverage as long as it's properly used," adds Cloake. "So we do not think that the leveraging of non-performing loans is appropriate, for example."

With so much talk – whether justified or not – about the 'end of the cycle', how are those around the table planning for different circumstances? "You need to be very

CYRIL TERGIMAN

Partner, EQT Credit

- Joined EQT in 2008 and is a partner based in London
- Member of EQT's Credit Partners Investment Committee
- Previously worked in the leveraged finance teams at Citi and BNP Paribas in London
- Has experience in structuring and negotiating financing for leveraged buyouts, levered corporates and restructurings



"THERE IS NOT A DIRECT CORRELATION BETWEEN CAPITAL RAISED AND INVESTMENT OPPORTUNITY"

close to management so you don't need shock therapy when things turn down," says Prieto.

"You also need tools to help the company whether that's additional capital, extra equity, buying out one or two creditors or corporate governance – and you need to stay put for three to five years to see things through to recovery.

"I don't think there will be a crash like 2012-13 but we will have some underperformance. Some lenders have not built the technical solutions that would allow them to help companies."

McDougall ponders whether a downturn would precipitate a division of responsibilities within fund management groups. "We saw a huge internal reorganisation of the banks after the crisis. You can't sweat existing assets at the same time as finding new deals because it sucks up all your time. The banks ended up with separate teams. Will credit funds do the same?"

Tergiman thinks investing in special situations requires an increasingly broad skill-set. "To identify attractive opportunities and execute on them you need a broad sourcing network and be able to operate across the capital structure – you could propose creative financings to solve cash needs and ease companies through difficult periods for example, or in the case of restructurings be able to think beyond the legal aspects and execute on value creation plans."

LPs ON THE LOOKOUT

While they undoubtedly are watching like hawks for signs of a downturn, investor support for private debt appears to be stronger today than it has ever been. But what key messages are those present picking up from the LP community?

"The appetite for private debt remains strong but one LP told me he had had around 300 pitches from private debt managers," reflects Cloake. "Therefore, they have to be discerning and are looking for track record through the last downturn. Transparency is a big issue as are quality of client service and reporting.

"Investors are also looking closely at the team and incentivisation levels, not just for the senior managers but across the board, including support functions. They want to see alignment with the objectives of the fund across the whole firm."

"The way credit funds are incentivised is very important," agrees Bone. "If the incentivisation is not aligned as it should be, in a downturn scenario you could see some unusual behaviour which might lead to some consolidation in the industry."

But while the next downturn could see some major ramifications for the asset class, there is a danger in allowing it to dominate your thoughts. It was economist Paul Samuelson who came up with the quote about Wall Street predicting nine of the last five recessions. The cycle will surely turn, but it still might take a while yet. ■

WHATEVER NEXT?

The roundtable identifies trends to look out for

RATINGS FOR INSURERS

"A LOT OF INVESTORS SUBJECT TO SOLVENCY II REQUIRE PORTFOLIOS TO BE RATED FOR OPTIMAL REGULATORY CAPITAL TREATMENT. CONSEQUENTLY, WE ARE SEEING THE CREATION OF QUITE DIVERSE MIXED POOLS OF ASSETS. IT MAKES FOR SOME INTERESTING STRUCTURES AND GIVES THEM THE RATING THEY REQUIRE."

Minott

MORE NICHE FIRMS

"THERE ARE NOT YET AS MANY NICHE OPERATORS IN EUROPE AS IN THE US. THERE ARE SOME HEALTHCARE AND PHARMACEUTICALS-FOCUSED STRATEGIES, WHICH WILL WORK IN SOME MARKETS BUT NOT IN OTHERS. NO DOUBT THERE IS MORE ROOM FOR GROWTH."

McDougall

THE CHARGE OF TECHNOLOGY (BUT BANKS MAY LEAD IT)

"AT THE SMALLER END OF THE MARKET THERE ARE A MYRIAD OF NEW TECHNOLOGIES EMERGING AND NEW WAYS OF LOOKING AT FINANCIAL SERVICES THAT COULD FEED INTO PRIVATE DEBT. BUT PEER-TO-PEER LENDING, FOR INSTANCE, IS STILL A DOT ON THE LANDSCAPE AND THE BANKS, WHICH ARE ALSO INCUBATING THE NEW TECHNOLOGIES, WILL PROVIDE FORMIDABLE COMPETITION."

Cloake

DEALS UP DOWN UNDER

"WE'LL SEE FURTHER GLOBALISATION OF THE PRIVATE DEBT MARKET. THE AUSTRALIAN MARKET IS ON OUR MINDS - HAVING RECENTLY DONE A UNITRANCHE DEAL THERE WITH KKR - AND WE THINK IT'S QUITE UNTAPPED. CONSOLIDATION COULD ALSO BE A THEME AND THEN THERE'S THE START OF THE DISTRESSED CYCLE, WHENEVER THAT MAY BE."

Bone

