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'You're left wondering what's around the corner'

Has the European private debt market had it too good for too long? There are no signs of panic, but nerves are jangling a little as loose structuring, leverage, competition and political volatility compete to be the asset class's chief bogeyman. **Andy Thomson** reports

Maybe it was just relief that the photography session was over, but Andrew Konopelski, partner and head of the advisory team at EQT Credit Strategies, was in a positive mood as he reflected on the state of play in European private debt.

"We are seeing expansion in direct lending, subordinated debt and special situations and a lot of capital continues to be committed. Over the last three or four years we have also noted that you now get paid appropriately for coming up with

creative solutions in a market that used to be very 'cookie cutter'. The economic backdrop is pretty good too."

Konopelski was one of eight private debt professionals gathered at the London offices of law firm Paul Hastings for the latest version of our annual Europe roundtable – a chance to reflect on key trends impacting the region's private debt market. It's not that he is seeing sunshine everywhere he goes. Konopelski was among those who headed to our recent New York Forum and heard "talk of late-cycle

pressures". But in Europe, by contrast, he predicts "good tailwinds for the next two years".

Mind you, that last comment begs the question as to what happens once those two years are up. Moreover, you get the sense that there are other market participants who fear the good times may not last as long as that.

"The drivers of credit pricing and terms are still the banks, and we have been handed market share through regulation which has curtailed the banks' ability to



From left:

- **Paul House**, managing partner, Venn Partners
- **Andrew Konopelski**, partner and head of EQT Credit Strategies, EQT
- **Luke McDougall**, partner, Paul Hastings
- **Jaime Prieto**, founding partner, Kartesia
- **Christopher Bone**, head of European private debt, Partners Group
- **Diala Minott**, partner, Paul Hastings
- **Alex Schmid**, founding partner and chief executive officer, ESO Capital
- **Laurent Benard**, managing partner, Capzanine

lower pricing and weaken credit standards to drive loan volume growth. That has been, and continues to be, a positive dynamic,” says Paul House, managing partner at Venn Partners. “But the macro trends and the weight of capital I would say are a bit less positive. Are we in the fifth, the seventh or the ninth inning? That’s hard to predict, but it’s getting tougher to find value.”

Alex Schmid, founding partner of ESO Capital, is also wary of where things are headed. “When investors pour money in, you have to be careful. It feels slightly too good and you’re left wondering what’s around the corner. It’s the best fundraising market for a long time in special situations, but we are cautious in how we

deploy our capital and still very much disciplined during the investment process. What people are doing looks quite stretched in my view.”

AGAINST THE GRAIN

An important point to consider is that, even should volatility strike in the private debt market, it does not spell doom and gloom for everyone. Indeed, in a benign and highly competitive market, it can be very difficult to pay an appropriate price and also differentiate yourself from the crowd. When conditions are less predictable, there may be greater opportunity for those who claim to add value to actually do so.

“It feels late innings, but we are

prepared for a bit of stress,” says Christopher Bone, managing director and head of private debt, Europe, at Partners Group. “When you hear some bad news, it’s not necessarily bad news for us on the debt side. At this stage in the cycle, we are adding new credits to the portfolio, which we have stress-tested under the assumption of another crisis. We could be presented with new investment opportunities.”

There is acknowledgement that while pressures may be building, the positive characteristics of private debt – together with a favourable regulatory environment – will enable it to cope well with whatever challenges come its way.

“The private credit market deploys more flexible and global capital than the banks,” argues Luke McDougall, a partner in the corporate department at Paul Hastings. “There’s a huge range of institutions serving sub-investment grade debt and different businesses get different results. This set of investors is much better placed for any downturn compared with how the banks were placed for the crisis.”

Adds Diala Minott, also a corporate partner at Paul Hastings: “From a regulatory point of view, we have seen the culmination of 15 years of lobbying with France, Germany and Italy all allowing direct lending. Direct lenders and special situations investors are more able to deploy cash because the regulators have given them a framework they can operate in.”

Jaime Prieto, founder partner of Kartesia, agrees that European private debt now finds itself in “a very good situation”, not only because of greater regulatory support but also because owners of businesses are increasingly seeing private debt firms as desirable partners. In Prieto’s view, this is allowing fund managers to move from the more crowded private equity-sponsored market to the non-sponsored space, which

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Laurent Benard, managing partner, Capzanine

From 2001 to 2004 Benard worked as an analyst in the LBO department of Bank of Scotland in Paris. He joined Capzanine in 2004 and became a partner in 2011.

"FRANCE IS QUITE A DEEP MARKET BUT THERE IS MORE AND MORE COMPETITION"

for Kartesia now represents over 50 percent of its portfolio. "If you're only operating in the sponsored mid-market, you will feel the heat," says Prieto. "You have to look at where the market is growing and that is the non-sponsored, lower mid-market. It allows you to be more selective and also avoid the competition."

Schmid agrees that greater acceptability of private debt is the biggest single factor in driving its further growth, and rejects the idea made by a fellow roundtable participant that evidence of improving returns is of most importance.

"From our first fund to our sixth, we've been making more or less the same return," he says. "What's more important is acceptance. That's a much bigger trend — are we seen as relevant and trustworthy? Sponsor-backed businesses took us up first and now we're spreading into other businesses. It won't ever be like the US, where 80 percent of the market is non-banks, but we can certainly take more market share."

ROADS LESS TRAVELLED

Reaching out into relatively untapped areas of the market seems particularly important at a time when there is so much

talk about competition. Laurent Benard, managing partner at Paris-based Capzanine, reflects this sentiment. "France is quite a deep market, but there is more and more competition," he says. "The increase in liquidity is much greater than the number of deals, so there is pressure on pricing, but through proprietary deals we are able to preserve our margins."

Prieto argues that, although pricing is tighter compared with three or four years

ago, it's not as tight as it was pre-crisis. He maintains that pricing is an issue for the "standard, mature LBO market" and also Germany, where only "the odd deal" offers a superior return.

Benard responds that the biggest consideration is not the pricing as many deals have a very attractive risk-return profile, but the amount of leverage going into some deals, and cites examples of firms seeking a 6 percent return from deals featuring 7x EBITDA leverage on the unitranche. It prompts discussion of what one person sat at the table describes as "crazy deal structures".

"What we do see is big deal technology trying to creep into smaller deals," Konopelski observes.

Not all voices are raised in protest, however, and the case is made that covenant-lite may have a beneficial aspect in terms of the flexibility it offers.

There is also a feeling that the constant focus on covenant-lite obscures other more egregious developments. "Covenant-lite is an increasing ask for €150 million-plus deal sizes, but it's not the biggest problem," maintains Konopelski.



Christopher Bone, head of European private debt, Partners Group

Bone has been with Partners Group since 2010 and has 18 years' industry experience having previously worked at Alpinvest Partners, RBS, PwC and Ernst & Young.

"THE DISRUPTION RISK OF EACH INVESTMENT IS SOMETHING WE LOOK AT VERY CAREFULLY"

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Paul House, managing partner,
Venn Partners

Responsible for the commercial real estate business, House spent over 20 years with Citigroup, heading Citi's European real estate business, before joining Venn Partners.

"ARE WE IN THE FIFTH, THE SEVENTH OR THE NINTH INNING? THAT'S HARD TO PREDICT, BUT IT'S GETTING TOUGHER TO FIND VALUE"

"EBITDA adjustments are perhaps worse, as they're fooling people into taking more risk than they think they're taking. With some of these EBITDA adjustments, you are effectively lending forward, so everything has to go well for the next 12-18 months, and how many companies perfectly achieve their original equity plans?"

Achieving those plans is arguably harder at a time when there are so many macro factors contributing to uncertainty. One of these is, of course, the terms surrounding the fast-approaching departure of the UK from the European Union in March next year.

"There will be a softening of the market in the UK because of Brexit," says House. "And Europe has a lot of trade with the UK, so it doesn't get through unscathed. Within that environment, things have to be softening. It's a headwind we didn't have a year ago."

However, Bone believes Brexit is one of those examples of disruption that could also be a gift for debt investors if they scrutinise the playing field carefully enough. "In the UK there is risk but also opportunity," he says. "We are looking to

see where macro risk has led to mispricing. Of course, you do have to avoid getting caught in the middle of the storm in March."

Prieto, however, thinks it will be a case of once bitten twice shy. "When you start losing money in the likes of retail you're a bit less prone to looking out for the interesting deals. How many are capable

of taking losses and still maintain the poise to look forward to the next opportunity? We do see some small weaknesses in the secondary market that could be interesting. I'm not sure that will trickle into the primary market as fast and to the same extent, though."

Benard also thinks factors such as Brexit and the trade war between the US and China will produce opportunities across the risk spectrum, from unitranche to special situations, which helps to explain why Capzantine launched a special situations fund in January this year targeting companies experiencing setbacks. The fund has a target of €250 million-€300 million.

BUILDING SHELTERS

Prieto says he believes the best way of coping with volatility is to identify where there is the broadest possible opportunity. "You need to withstand mini-crises and have downside protections," he asserts. "The lower mid-market may be riskier but only by tens of basis points, and that is negligible compared to the ability to be selective in the segment. There is an



Andrew Konopelski, partner and
head of EQT Credit Strategies, EQT

A member of the EQT executive committee and Credit Partners investment committee, Konopelski joined EQT in 2008 having worked for hedge fund Tisbury Capital.

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Luke McDougall, partner,
Paul Hastings

McDougall is a partner in the finance and leveraged finance practices in London, focusing on UK and cross-border acquisition finance and restructuring. He acts for senior and junior lenders and borrower groups.

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abundance of opportunities with local companies and you can get the downside protection that enables you to ride out the bumps in the road."

Konopelski, however, is not entirely convinced by this argument. "We look at the mid-market too and you don't always have buffers built in. In smaller companies, there can be issues with over-concentration of customers or suppliers and you may also find there is not as much depth in the management teams."

It is also the case that confidence varies greatly from one market to another. Italy is cited as one market where, despite more favourable regulation having been introduced, there are still considerable obstacles to be overcome.

"When a deal crops up in Italy, some investors have a very strong view as to how they would value the collateral," says McDougall. "All jurisdictions have a kind of intuitive weighting as to how easy it is to get your money out. Deals can be done anywhere, but there is more time spent on restructuring in certain places."

Schmid says real life experience can be very different to theory, expressing wariness of any advisors that don't have

the "scar tissue" that some investors have. He provides a stark example of this, again from the Italian market: "On one deal, we've had cash trapped there for eight years and it's still not gone to court."

House, on the other hand, has a pragmatic view of the different European jurisdictions.

"Whether it's the UK or France, both are good markets for us. We've done a deal

in France, the issue is when you lend, you lend a bit less and you do things a bit differently. The most important thing is that you're trying to get that alpha."

Benard makes the point that, however investor-friendly a jurisdiction may seem, that apparent advantage can be eroded by stiff competition. "Maybe the rules are better in the UK, but the level of leverage is higher in the UK than it is in France. In addition, being local allows you to better understand and navigate the local jurisdiction, which is especially important in France."

Schmid believes US investors can sometimes be wrongly dissuaded from allocating to European funds as a result of over-estimating the impact of mini-crises. "Investors got really worried about the Greek crisis, but it made no difference to our deals," he says. "Local markets can play out really well if you know those markets. LPs need to ask us whether we've seen things go wrong and how we've dealt with that. There will always be some losses."

DEMANDING INVESTORS

One thing that's clear, and not just in relation to which markets managers operate



Diala Minott, partner, Paul Hastings

Minott is a corporate partner in the London office specialising in structured finance transactions including CLOs, CDOs and bespoke, hybrid mid-market CLO-type funds.

"INSURANCE COMPANIES ARE INCREASINGLY DICTATING THE TERMS, FOR EXAMPLE ASKING FOR THE PORTFOLIO AS A WHOLE TO HAVE A CERTAIN CREDIT RATING"

in, is that limited partners have become a lot more discriminating. And perhaps the area where this has become most evident is in relation to the type of information they want – and how they have access to it.

“Investors expect much more underlying information on the portfolio,” says Bone. “They want to look at the pricing, the leverage ... they expect a lot more. And they want to see everything in real time on their ipads. Technology risk is a black swan and they are very keen to know how technology is impacting portfolio companies. The disruption risk of each investment is something we look at very carefully.”

Minott believes credit funds may have been behind the curve but are now catching up. “You now have CLO technology built into a lot of credit funds including, for example, cash traps and cash buffers. And insurance companies are increasingly dictating the terms, for example asking for the portfolio as a whole to have a certain credit rating.”

One thing is clear – investor demands in this area cannot be overlooked. “Not being allowed a clear view of the portfolio makes investors nervous,” Benard points out. “It’s almost more important than track record.”



Jaime Prieto, founding partner, Kartesia

Prieto is responsible for overseeing the development and management of Kartesia, particularly in relation to sourcing and trading. He founded the firm in 2013 after 10 years of experience in private equity.

“IF YOU’RE ONLY OPERATING IN THE SPONSORED MID-MARKET, YOU WILL FEEL THE HEAT”

Talk turns to whether smaller private debt houses are at a relative disadvantage compared with the huge budgets that some of the larger players have available for new technology spend. BlackRock is cited as an example of an investment giant that now has a huge information and analytics system at its fingertips in the form of Aladdin.

However, not everyone believes big systems such as this will erode the importance

of human input. “Having the best in-house data doesn’t necessarily make you the best user of that data,” suggests House.

Bone also does not seem unduly threatened by the march of technology: “I struggle to see how artificial intelligence will take away everything we bring in terms of human input. It will make things more efficient, though.”

Konopelski expresses the view that, when it comes to sourcing opportunities, any help technology can bring is welcome. “You want to stand in the middle of the road and be hit by as many deals as possible,” he says. “And then, once you have those deals, you bring your human intelligence to them. Across the firm, we have been exploring ways to use AI to identify, source and diligence deals outside the usual channels.”

While Konopelski’s imagery may have connotations of road accidents, there is no sense of a car crash for Europe’s private debt professionals any time soon. Indeed, confidence appears to be higher than you might expect. But loose structuring does give pause for thought as to what may eventually be lurking around that corner. ■



Alex Schmid, founding partner and chief executive officer, ESO Capital

Schmid has over 25 years of illiquid investment experience across Europe and was previously managing director and head of Europe at hedge fund DB Zwirn (London).

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