

# E X P E R T Q & A

*As investors weigh up portfolio resilience ahead of a downturn, Christopher Bone, Partners Group's head of private debt Europe, and Alexander Ott, managing director, examine the key considerations amid uncertainty across the continent*



## Standing strong amid Europe's ever-shifting market dynamics

**Q** How would you describe competition in the European private debt market and what is your assessment of bank lending appetites?

**Christopher Bone:** Ten years ago, private debt was in its infancy in Europe. Today, there are more options for borrowers, but the banks still have restrictions on the amount of illiquid debt they will take and hold on their balance sheets. This means that an owner or buyer looking for financing would need to put together four or five banks to reach, for example, €150 million in a mid-market bank-led lending syndicate.

By comparison, a buyer can go to a single direct lender, like us, and get a solution in one go. Importantly, the banks don't want to underwrite or hold subordinated debt, which also presents an opportunity for alternative lenders. This is particularly relevant

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at the larger end of the upper mid-market, which is a sweet spot for us.

**Q** Given current market uncertainties in Europe, what is the sweet spot for private debt investment today?

**CB:** We still see a trend of good risk-adjusted returns for private debt, but we are examining investments closely by region, capitalisation and capital structure. For instance, the immediate outlook for the UK, in particular, has become a lot more uncertain than the rest of Europe.

In Europe, we typically focus on the core countries for private equity including Germany, France, Benelux, Switzerland and

the Nordics. Southern European countries are a smaller market and present, in some instances, a more challenging legal environment. France remains an interesting place for us to invest as we have a strong local presence and track record – it is a difficult market for managers that don't have one. Germany is also an important market for us.

**Q** How important is experience in the investment team if we were to enter a period of defaults? Can lessons from the last crisis be taught to those who weren't there?

**CB:** In uncertain times, experience and depth is key. We are one of the larger debt managers out there, with a team of more than 50 private debt investment specialists across our offices. This team is supported by our global in-house legal team, as well as one of the mid-market's largest teams of industry

value creation professionals. Companies don't always perform as expected so we also have a specialist team to help manage more difficult situations. In these cases, you need the expertise and resources to help a company through a rough patch. When we recruit for this team, the backgrounds tend to be those with experience on the legal side. As a debt provider, if things go well, you are refinanced after a number of years, but if things don't, you need the option and resources to be proactive.

**Q When you speak to your clients, what are their investment priorities at the moment?**

**Alexander Ott:** Each client will be looking to get different things from their allocation to private debt. You have investors that want to add something defensive to their portfolio, and something that has a cash yield, with a five-year investment horizon. These investors are more focused on investing in senior debt. On a more granular level, there is a distinction between the senior debt liquidity required. Some have more of a tolerance for illiquidity, or are even looking to cash in on an illiquidity premium.

There is a second category of investors, however, with very different needs. They may have a greater risk appetite. This can include appetite, for example, for unitranche, but also directly placed second lien. Mezzanine would also fit within that strategy. Here, the thinking is different. Over and above the liquidity premium, they also want to earn an attractive risk premium.

**Q How has Brexit influenced the discussions and thinking at investment committee level?**

**CB:** We are spending a lot of time looking closely at what Brexit means for our companies and for each potential investment opportunity that we look at. It has been more than three years since the referendum, but the continued uncertainty means we are cautious around those UK businesses that have, for example, exposure to the high street, and those with input and output costs in different currencies.

**AO:** From the investor perspective, I have had many discussions centred on politics and not just on Brexit in the UK. While UK institutional investors are the most bearish, institutional investors in Germany are also cautious due to the uncertainty created by

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the looming end of the Merkel era. In Italy, too, there is caution about political uncertainty. Meeting time at fundraising discussions is increasingly allocated to politics.

For example, I have just returned from a client update meeting where they were keen to know about our UK exposure, and what to expect in terms of the performance outlook given the higher likelihood of a no-deal Brexit. Other discussions with investors and their decision-making bodies are about the potential impact of trade relations with the US, and any ripple effect on the German economy.

**Q From your conversations with clients, what are the issues that are front of mind with investors, as they weigh up opportunities in European private debt?**

**AO:** There is a real bifurcation among the investors we speak to in terms of their top priorities and concerns. For example, Japanese investors – much like European investors – tend to focus on senior debt and no leverage, prioritising stability and cash yield. They may consider something which is illiquid but only for five years. Contrast that with the US, Asia ex-Japan, or the Middle East, where they are much more focused on the potential size of the return and are willing to accept leverage. Perhaps even leverage on the entire portfolio to get to higher returns. There isn't a right or wrong approach. As investment managers it is our job to accommodate these different appetites, which we do by having a diversified range of product offerings across the capital structure.

**Q What is the most important topic in European private debt that the media are not covering?**

**CB:** We are now 10 years on from the last downturn and it is the right time to ask whether private debt managers are set up for the next downturn, both from a defensive as well as offensive perspective. Is there enough flexibility in the funds that are raised and do managers have the in-house capabilities, for example, to take advantage of a drop in prices in the secondary market? It is impossible for anyone to predict when the downturn will come. Hence, it is essential to remain invested in diversified portfolios and at the same time make sure that we have dry powder and the capacity to take advantage of a downturn when it does happen. At Partners Group, we want to be prepared, and so track the market closely in this context. ■