A Review of European Direct Lending (Third of a Series)

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“Europe is not a market,” a keen observer of Europe’s debt market informed us. “First of all,” he said, “there’s the difference in legal jurisdictions. These are real hurdles and won’t change anytime soon. If anything, the EU is becoming less unified.”

“Here local teams matter. Even London-based teams have trouble managing deals on the continent. The more complex the structure, the more local the team needs to be.”

Understanding the nuances of local companies is critical, particularly in a default, an attorney specializing in cross-border matters told us. “Your options as a lender are very different in Italy versus Spain or France. There’s no one standard approach.”

He went on. “The Scandinavian countries are somewhat similar to the UK. They are supportive of their borrowers. But southern Europe is very different. Each country has its own dangers and dilemmas. Laws are evolving quite rapidly post-crisis.”

How? Until very recently, non-banks couldn’t technically make “loans” in Italy and France. You have to call them “bonds,” and are not as liquid. To buy them you need to be a qualified investor. This is changing, but the legal environment still favors banks.

Perfecting security interests is also a challenge in Europe. Germany has no standard UCC filings such as in the US. France does not recognize liens on inventory. As one banker friend in London put it, “it’s often said it’s easier to lend in the beer-drinking countries than the wine-drinking ones.”

Another bank-friendly element is Europe’s quantitative easing program. Unlike the Fed, the ECB is lowering rates. That’s made banks flush with cash. Think about how cheap funding costs are right now. Three-month Euribor is negative 20 bps! In that context, 475 basis points in spread plus a 1% floor for a single-B credit looks good.

That means owning paper is a powerful strategy. By being buy-and-hold players in the European market, banks are competing with funds. A recent example is Carlyle’s upsize to its LBO financing for *Comdata*. According to S&P LCD, the sponsor had *nine* banks in the existing €210 million package, and brought in *three* more to raise the total to about €300 million. This included a seven-year TLB tranche that in the US would ordinarily be distributed exclusively to funds.

Many thought European banks would be on the way out of the leveraged loan picture, as is the case in the US. Big funds were raised over that prediction. But it hasn’t worked out that way. Non-bank money got raised, but there was nowhere to put it.

Instead direct lenders have gone to sponsors and offered unitranche financings at six times leverage. But this is not the true middle market. It is the market for less bankable companies with different players, and very different credit fundamentals.

Next week we look in detail at the direct lending market in Europe.