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

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So far in this series we've covered the unique lending characteristics of European jurisdictions as well as the inherent advantages held by European banks. This week we look closer at the opportunities presented to non-bank direct lenders.

Selling high-yield bonds in Europe has generally been unchanged over the past five years. It's still a public market with the same investment bank underwriters, trading dynamics, and investors. By contrast the landscape for loans has seen an influx of funds from global asset managers, investment firms, and private equity sponsors.

But as we've highlighted, banks still have the upper hand as arrangers of middle market senior debt. This is particularly true for private equity backed borrowers. The manager at one leading European fund put it this way: "As is increasingly true in the US, sponsors in Europe control every aspect of deal structure, who's invited into the financing, even who trades the paper. If you're a bad actor, it's tough to break in."

Another source agreed. "Forget about getting a decent allocation if you're on somebody's black list. You won't even be allowed to trade in the secondary market."

That means that "job number one" (as our first fund manager called it) for direct lenders is to get an introduction to the sponsor. Be prepared to explain why you should be allowed to work with them. If you're lucky, you may get some early bird looks. But understand that this is a "small subset of a very private market."

Because of fee structures, direct lenders require yields in the 8-10% range. That's a step or two above the bank market. Rather than migrating towards second lien, which has effectively disappeared from both sides of the Atlantic, direct lenders are seeking these returns from unitranche financings. But these carry a higher level of credit risk.

And it's an expensive proposition to market effectively. "You need to knock on all the doors in Europe," our second source told us. "It's really Middle Market Lending 101. While the majority of sponsors are in the UK, you still need to have experienced executives in every major city who have a strong Rolodex of PE relationships."

Not to say unitranche isn't popular with PE. According to Deloitte, roughly half of all debt structures are single-tranched, with less than 40% involving some mix of senior and mezzanine. As in the US, the one-stop gives sponsors more flexible covenant packages, more accommodative debt baskets, and, of course, higher leverage.

One major difference in Europe is that unitranche is structured with 50% cash-pay and 50% PIK. All-in yields also vary widely, depending on the credit – ranging from 6-11%.

Ironically, after so much media focus on direct lending in Europe, what's attracting investor attention at the moment is secondary trading in the US broadly syndicated market. As our *Chart of the Week* shows, prices have fallen well below their European counterparts. So much so that some credit teams in London are, temporarily at least, relocating to New York to take advantage of this cross-border arbitrage.

Nest week we look at what it takes to be an successful direct lender in Europe.