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

THE LEAD | March 16, 2016

How much has been raised to support non-bank direct lending in Europe? Figures are often cited in the media without asking related questions such as "What are they raising?" or "What's their strategy?" Preqin recently reported about €31 billion was raised last year for "private debt." Of that roughly 60% was for direct lending, with the rest going to junior capital, distressed, and special situations (see *Chart of the Week*).

Well-regarded platforms like Blue Bay (a subsidiary of RBC) and Hayfin (backed by Towerbrook) have recently raised about €2 billion each. ICG, a global mezz fund, is said to have raised €3 billion for senior debt. Other large investment managers in the mix include Ardian (formerly AXA Private Equity), Ares, Alcentra, Apollo, BlackRock, and Guggenheim. But given, as we've demonstrated, how banks have remained at the center of gravity for leveraged lending, what's the path to success for these firms?

One route in the US oft-followed by opportunistic credit is to take advantage of pricing discounts in the secondary loan market. We certainly saw that in spades with select US buyouts that got caught in the 4Q market downdraft. Indeed, some European direct lenders bought into these deals. But, as one top manager told us, it's too early to tell if prices on these assets will hold, or if buyers are sitting on mark-to-market losses.

In general, European loan prices are less subject to technical swings. For one thing, as our friend pointed out, there are no retail loan funds in Europe. Mutual funds, so-called "UCITS" (Undertakings for Collective Investment in Transferable Securities), cannot hold loans directly. That means there's no need for daily liquidity, no wild swings of cash coming in and out of accounts, no relative value players driving prices up and down. This results in a much more stable market overall in Europe.

CLOs also aren't trading assets, and banks don't trade, so it's less of a liquid market than in the US. That also means less volatility, and more inefficient pricing. One outcome is that smaller loans tend to be priced lower than larger ones. As we've stated earlier, Europe is most certainly a club market, with banks as the club members and sponsors taking advantage of this in terms of tight pricing and loose structures.

As we've discussed, direct lenders have made definite inroads with sponsors for one-stop financings. Funds originally targeted for mezzanine or second lien investing have been repurposed as unitranche providers. While this makes sense given the market opportunities, it may result in lower fund returns relative to the original strategy.

Mid-sized deals, with ebitda between €30-50 million, is where most players agree the opportunity lies for direct lenders. Above that, most deals are getting clubbed up. But will there be enough deal supply to satisfy all the capital being raised by these lenders?

One fund manager notes that scale is essential. "Direct lending is hard to just start up," he told us. "Some American funds are saying: 'Hey, we'll just start with a €200-400 million investment.' You can't even get one CLO done with that."

He continued. “The key to direct lending in Europe is you have to get the ingredients and make it. You can’t just buy it.”

Next week we wrap up our series on European direct lending with an outlook for 2016…and beyond.