Lead Left Interview – Ned Music and Fenton Burgin

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This week we chat with Deloitte's Ned Music and Fenton Burgin. Mr. Music is an SVP in the US firm's Deloitte Corporate Finance LLC Capital Advisory team while Mr. Burgin heads up Deloitte LLP's UK Capital Advisory practice. Capital Advisory has 140 debt professionals in 30 countries dedicated to the middle market. Mr. Music will be a moderator at the upcoming Middle Market Symposium on May 17-18 [link].

The Lead Left: Gents, tell us about your business.

Ned Music: As part of the Deloitte Touche Tohmatsu Limited network of member firms, our Capital Advisory team is one of the biggest and most global practices in middle market debt advisory. We've completed over 100 transactions in the last twelve months.

Fenton Burgin: It's a simple business proposition, really. We focus on $30-500 million debt raises across the full spectrum of the debt markets. We're one of the top debt advisory practices in Europe with a heavy focus on the private equity and leveraged finance market. We have advised on over $6 billion debt in 2015.

TLL: I know you also bought McColl Partners not that long ago.

NM: Yes, in 2013 Deloitte's US investment banking business acquired McColl Partners. The US group now has over 130 professionals, mostly focused on sell side M&A which resulted in over 70 closings in 2015. John Deering heads up our Capital Advisory business from the US platform. Our team has also been successful raising capital for companies outside the US, particularly in Mexico and LatAm where our clients were pursuing capital from the US institutional market.

TLL: Ned, is Europe's direct lending market really fifteen years behind the US?

NM: Yes and no. Europe is going through fundamental change; the pace of that change is rapid.

FB: The EU is moving to US-style financing for the middle market. I spend a lot of time speaking with US CFOs. I have a range of contacts who tell me that only 10% of their financing is coming from banks – the rest comes from funds. But in the EU it's 180 degrees different. Cash is cheap, plentiful and banks are active. However, in the past two years we've seen a withdrawal of bank capital.

TLL: How do you deconstruct that trend?

FB: First there's the obvious regulatory pressures. But it's also the impact of capital adequacy measures due in 2019. Banks need to be compliant with Basel III. Pure play leveraged financing is increasingly less profitable for banks. At least, without ancillary business.

TLL: What themes will you touch on in your remarks at the Middle Market Symposium?

NM: One is the divergence of debt market conditions and monetary policy between the US and EU. Currently, five year US yields are around 1.5% while Germany's are negative around 0.5%. Institutional investors like insurance companies and pension funds have long-term liabilities and they typically look for long-term assets to match, but investors are increasingly finding it difficult to generate positive return with government bonds and as a result more investors are looking for higher yielding assets. That's given rise to direct lending strategies.

FB: In 2014-2015 there was the first big fundraising wave. The second with direct lending funds came in 2015 and 2016, including ICG, Ardian, BlueBay, Proventus, Pemberton and Permira. We estimate there's about $40 billion in undeployed capital committed to European direct lending.

TLL: Not including the banks.

NM: In Europe, many banks are trying to be aggressive to keep market share. The good news is that there are no leveraged lending guidelines in Europe so lenders there can be more aggressive than their US counterparts when providing leveraged loans.

FB: Since 2013, non-bank lenders began targeting the unitranche product. The yield is higher, call it L+700 bps and above. But market development has slowed on the back of competition from banks and funds providing stretched senior product. As Nedim said, a concern for the borrower is the weighted cost of capital of getting to 5.5x leverage vs. 4.5x. That additional turn of leverage costs well above 10%. But now 2015 funds are bigger.

TLL: Which means transaction size is growing.

NM: Currently there are 10-12 funds in the Euro market that can write checks in excess of $200 million. That's a big change – the scale to which funds have grown of late. Larger non-bank direct lenders are more relevant. It's tough for banks to compete if you can only hold $35-50 million per deal. That's compelling for clients in auctions who will pay more for certainty of close. Also many funds have the ability to leverage 1:1 which allows pricing to come down. Eighteen months ago most funds had a minimum return hurdle of L+750-800; now it's closer to L+550. There's still a difference in where banks can price their loans.

TLL: How are banks responding to this competition?

FB: In Europe banks are partnering with direct lenders, moving the same way the US market did three or four years ago. Loans are being structured on a first lien/second lien basis with banks at 3.5x and direct lenders providing an additional turn of leverage. Lloyds, for example, has linked up with AIMCO [Alberta Insurance]. RBS is working with three big direct lenders. So you'll see more first lien/second lien partnerships.

To be continued the week of May 16

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