Lead Left Interview – Ned Music and Fenton Burgin (Part 2)

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This week we continue our conversation 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]. ***Second of two parts – View part one***

The Lead Left: Where's bank pricing shaking out?

Ned Music: The first out piece is typically priced at L+350 and the second out piece is at L+700. The blended cost is lower than where unitranche pricing is.

TLL: How do you compare the relative merits of lending in Europe vs. the US?

NM: Structures are more flexible and pricing is currently better in the EU than in the US. The market is more competitive in Europe, and some lenders are less disciplined on credit controls than in the US. Some newer funds try to be more competitive with elements such as covenant flexibility.

Recently we've also seen European banks expanding their US teams.

TLL: I would assume cross-border deals are becoming more prevalent as well.

Fenton Burgin: There's definitely a push from European private equity to look for opportunities and deals in North America. Portfolio companies are asking the sponsor, "Can you get us access to the US market?" One good example is EQT expanding its North American PE operations. And you can add at least five to ten firms seriously thinking of opening their offices in the US.

TLL: But deal flow seems to be down overall so far this year.

FB: The US is improving, though high yield issuance is still tough, so loans can step in. Bigger deals are getting done by direct lenders. Normally, direct lenders are more expensive than the liquid market. But when liquidity dries up opportunities get bigger.

TLL: The relative economies are still not in sync.

NM: The fundamentals of the US economy are pretty robust. The EU has growth issues, along with Brexit worries. Very few economies are doing well at the moment.

TLL: Do you think there will eventually be a convergence?

NM: Some asset managers with global direct lending funds are reallocating funds from Europe to the US where they can earn better risk adjusted return. For example, M&A is relatively subdued in Europe so any decent credit should get good terms. Many smaller funds are being cut out of the market by larger funds and as a result they are trying to compete on flexibility. Increased competition will likely accelerate that trend. Scale and diversity typically benefits the larger firms.

TLL: What about cross border deals for middle market companies?

NM: Middle market companies are more international than five or ten years ago. More cross border deals are sought as the need grows to have operations on both sides of the Atlantic.

TLL: What about jurisdictional issues? We're told there's no such thing as "European lending."

FB: Absolutely correct, though Northern Europe has coalesced around some standards. Hungary, Turkey and other esoteric countries are still more complicated relative to the UK.

TLL: What's the long-term trend for banks?

NM: There's been real structural change. That will likely keep banks constrained. Pricing will likely continue to decrease. Direct lenders will likely continue to grow share. Many direct lenders are capped at 1:1 leverage while banks are 10:1. So we have a long way for pricing yet to drop.

TLL: How about default rates?

FB: It's hard in this ultra-low rate environment to think that default rates are going to spike meaningfully any time soon.

TLL: What's been your biggest surprise in the past twelve months?

FB: The pace of market developments. At the end of 2014 there were twenty mainstream direct lenders in London. Now there are over fifty institutions targeting European middle market deals. The scale of fundraising also caught people by surprise. If you had said 18 months ago there would be $40 billion dry powder among all these firms, not many would have believed you.

NM: It's a year now that the European market has generally been more attractive for borrowers than the US. How long will that last? It'll be interesting to see how long it takes markets to converge.

FB: There's also a greater range of banks willing to engage with direct lenders. Currently pricing is down and covenants have weakened to levels that would have been reserved for larger borrowers.

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