Viewpoint

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For Professional Clients and, in Switzerland, Qualified Investors

BNY MELLON

DIRECT LENDING: AN ALTERNATIVE FOR INSTITUTIONAL INVESTORS

Pascal Meysson, managing director at Alcentra, a BNY Mellon company, talks about investment opportunities in direct lending and the latest trends and developments in the sector.

WHAT FORCES ARE CREATING OPPORTUNITY FOR INVESTORS IN DIRECT LENDING?

A growing imbalance in supply and demand for loans to middle market companies in Europe is a key driver of investment opportunities in the sector.

We believe that about €30-35 billion of capital has already been raised for direct lending in Europe but we assume that the demand for middle market corporate loans is much larger than this. Since the financial crisis of 2008/2009 the lack of debt supply has been partly driven by new regulation which has increased the cost of capital for banks.

Given this pressure, many banks have redirected their resources towards lower risk assets. Direct lending managers have stepped in to bridge that gap to supply institutional debt capital. Demand has also been augmented by significant private equity 'dry powder', higher mergers and acquisitions (M&A) volumes and significant refinancing events across the corporate world.

WE OFTEN HEAR THAT DIRECT LENDING IS AN ATTRACTIVE ALTERNATIVE TO PRIVATE EQUITY. CAN YOU ELABORATE ON THE MAIN DIFFERENCES BETWEEN THE TWO ASSET CLASSES?

The key difference centres on their specific liquidity. Private equity funds are usually locked for a 10 year period, while direct lending funds have shorter lock in periods of about six years, which makes them less illiquid.

Direct lending is also an asset class which has current income, allowing investors to receive dividends on a frequent basis from the interest and fees they receive on their loans. Private equity doesn't offer these types of income stream, with revenues coming through primarily from asset realisations.

There are also differences in the management fee structures for debt and private equity funds. In private equity funds, fees are usually charged on the capital that is committed whilst in debt funds, management fees are generally charged on the capital that is invested, which in turn eliminates or strongly mitigates the J-curve effect.

In terms of yield, private equity investors usually target returns of about 20%, whilst private debt investors generally aim for returns in the 5 to 15% range (depending on their investment strategies and use of leverage). There tends to be significantly more volatility in private equity fund performance across the cycle than in private debt funds that benefit from higher downside protection at the level of their underlying assets.

WHAT IS YOUR PROCESS FOR SOURCING AND EVALUATING OPPORTUNITIES AND RISKS?

Our main sourcing channel is private equity funds - which normally drive about 80% of the volumes in direct lending in Europe.

To successfully exploit opportunities in this area you need a very close network of relationships across Europe, including private equity firms and financial intermediaries you have been working with for a long time.

It is important to have genuinely local representatives who have in-depth knowledge of markets and companies they are dealing with and who speak the local language. Having a large existing network of portfolio companies that can yield new opportunities for refinancing and for new leveraged buy outs (LBOs) is also important.

To evaluate opportunities and risk we have a dedicated investment process and our platform has maintained and improved its credit selection structure for more than 10 years. When considering opportunities we adopt a two stage investment process involving a two week initial assessment of any given transaction. Deal teams then carry out a due diligence process that can last months, before making a final recommendation to our internal investment committee, and making a formal financing proposal to the company.

IN WHICH COUNTRIES AND SECTORS DO YOU IDENTIFY THE MOST COMPELLING OPPORTUNITIES? CAN YOU GIVE US ANY RECENT EXAMPLES OF FUNDING MADE BY ALCENTRA?

The markets where we currently see the most opportunities include the UK, France, Germany, Spain, Scandinavia and the Benelux countries.

We currently see significant opportunities in the healthcare sector and in other non-cyclical industries. We tend to avoid any sectors we feel are too cyclical in nature and are very cautious on the retail and chemicals sectors. We are not exposed to real estate, shipping or corporates linked to commodity prices.

As an illustration of recent deals in France, we recently provided unitranche financing for Siblu, a French company operating mobile home holiday parks, to support its acquisition by Stirling Square Capital. This year we also provided unitranche support for the specialist financial data provider Altares, in the context of its refinancing.

WHAT TYPE OF INVESTMENT VEHICLE IS AVAILABLE TO INVESTORS INTERESTED IN DIRECT LENDING?

Alcentra has investment funds focused on lending to businesses located in Europe and which provide senior secured, unitranche and junior debt financing to middle market businesses. These funds are Luxembourg-based, with a 6-year maturity period.

WHAT WILL THE IMPACT ON DIRECT LENDING BE WHEN INTEREST RATES START TO RISE?

The impact when interest rates start to rise is likely to be very positive because 100% of our loans are Euribor plus a margin so as soon as the Euribor goes up nominal returns increase for our limited partners (LPs). There is generally no negative impact on underlying companies which are hedged against an increase in base rates.

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