EUROPEAN BANKING CHANGES CREATE NEW OPPORTUNITIES FOR DIRECT LENDING TO MID-SIZED COMPANIES

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As regulations prompt European banks to reduce their lending to mid-sized companies, Graeme Delaney-Smith, Alcentra's Head of European Direct Lending and Mezzanine Investments, describes the new opportunity for non-traditional investors to lend directly to those companies at attractive levels of risk-adjusted return.

EXECUTIVE SUMMARY

As regulations prompt European banks to reduce their lending to mid-sized companies, Graeme Delaney-Smith, Alcentra's Head of European Direct Lending and Mezzanine Investments, describes the new opportunity for non-traditional investors to lend directly to those companies at attractive levels of risk-adjusted return. For institutional investors, the opportunity is especially compelling, as lenders to mid-sized companies are able to demand more attractive terms than in the broadly syndicated loan and high yield bond market, where increased demand has compressed margins and weakened financial covenant protection for lenders. However, lending directly to these mid-sized companies comes at the expense of liquidity and, given the private nature of this market, Graeme argues that the expertise of a specialist manager is likely needed for investors seeking to preserve capital and maximize returns.

THE CHANGING FACE OF EUROPEAN CREDIT

European banking is in the process of long-term structural change. New regulations in the wake of the financial crisis require banks to maintain higher capital ratios and to de-risk their balance sheets.[1] As a result, many banks have reduced their levels of corporate lending. This has become a serious problem in Europe, where mid-sized companies have traditionally been far more dependent on bank financing than in the US with its more mature debt markets.

This process of de-risking means that European banks will likely favour traditional retail banking activities such as mortgage lending, while reducing long-term assets on their balance sheets, with a preference for lending to larger companies whose credit default risk is more transparent.

1 "Briefing: Non-Bank Finance," *The Economist*, December 15, 2012.

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Since the financial crisis banks have been torn between the pressure from governments to lend to businesses and consumers, on the one hand, and the regulatory compulsion to deleverage substantially, on the other.

Between 2007 and 2011, German banks' ratio of regulatory capital to risk-weighted assets has increased by 3.2 percentage points to 16.1%, and that of Belgian banks by 8.1 percentage points to 19.3%.[2] Central banks have kept monetary policy loose in recent years, with real rates close to zero. While loosening monetary policy might encourage consumers to borrow more, evidence suggests it will boost lending volumes only where banks are unconstrained by capital-to-asset ratios.[3]

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In Europe banks account for around 75% of corporate financing, compared with about 30% in the US.[4] To put this in perspective, in Europe there is €8 trillion of corporate debt on bank balance sheets, and only €1.3 trillion in the bond markets.[5] Unlike in the US where, starting with the Glass-Steagall Act, banks have long helped companies to borrow money through non-bank lending channels, European banks served to both underwrite and lend meaning that an institutional market was never formed to the same extent. Retrenchment in European bank lending is therefore likely to result in a decrease in the amount of corporate credit available.

Deleveraging in European banking has not yet happened to the extent prescribed, which suggests further reductions in capital available to lend in future. Total bank assets as a percentage of GDP are still in excess of 360% for the eurozone and circa 480% for the UK.[6] It is estimated that €5.1 trillion of further deleveraging is needed in Europe to reach levels similar to that of Australia or Japan,[7] let alone the much lower levels in the US.

THE MIDDLE MARKET GETS SQUEEZED

As European banks begin to lend over a shorter tenor and to larger companies, the gap in lending is most keenly felt by middle market companies and small and medium-sized enterprises (SMEs), especially those that require long-term financing to fund their operations. There is clear consensus that liquidity for bank loans to mid-sized companies in Europe is becoming scarce and that banks are failing to meet the demand for financing, although it is difficult to accurately measure the reduction.[8]

2 "European Banking Sector Facts and Figures 2012," European Banking Federation, October 2012.

3 J. Peek & E.S. Rosengren "Bank Lending and the Transmission of Monetary Policy," Boston Federal Reserve, 1995.

4 "European Banking Sector Facts and Figures 2012", European Banking Federation, October 2012.

5 "Briefing: Non-Bank Finance," *The Economist*, 15th December 2012.

6 "2013: Seeking an Oasis in a Yield Desert," RBS Macro Credit Research, November 2012. Data as of 31st December 2011.

7 *Ibid.*

8 European Banking Federation, "European Banking Sector Facts and Figures 2012," October 2012.

The proportion of bank loans as a means of external financing to eurozone SMEs has fallen since 2009,[9] with 22% of those surveyed by the European Central Bank (ECB) identifying a further deterioration in the supply of bank loans as well as "a strong decline in the size of the loan or credit line".[10] A survey of SME managers showed that of those who applied for bank loans, only 60% said they had received the full amount requested, compared to 72% for large firms in the same survey. In the UK alone, it is estimated that by 2016 the gap in financing could be between £84 billion and £191 billion, of which between £26 billion and £59 billion relates to smaller businesses.[11]

An SME, according to the European Union, is a business with fewer than 250 employees, €50 million or less in turnover, and €43 million or less on the balance sheet.[12] Middle market businesses are those with £500 million or less in global consolidated turnover, according to the UK Government's Business Finance Partnership scheme.[13] Market practitioners, however, tend to define middle market businesses as those with up to £500 million (or equivalent in another currency) of Enterprise Value (EV).

Middle market and SME borrowers in Europe often cannot turn to the bond markets as an alternative source of financing. Although the European high yield bond market expanded by €36.4 billion in 2012,[14] investors prefer large issue sizes for liquidity reasons as well as a minimum level of credit rating, both of which favour larger issuers. While an initial public offering can provide external equity financing from a broad base of investors to larger companies, European middle market businesses often struggle to receive any external equity contributions. Moreover, issuing public stock is expensive; as a result, only 3% of middle market companies in the UK fund their operations through external equity.[15]

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FILLING THE BANK FINANCING GAP

The middle market companies and SMEs are key to many European economies in providing employment and growth. Together they make up over 99% of companies in the EU by number of firms.[16] According to the European Commission, SMEs alone employ 72% of the workforce and generate 85% of new jobs.[17] A recent British government report noted: "these smaller businesses often need significant capital injections to achieve their potential and may often be deemed inappropriate for bank finance alone due to their innovative nature."[18] In our view, middle market companies and SMEs can be flexible and innovative, with an impressive potential for growth, provided sufficient financing is available on appropriate terms.

9 European Central Bank, "Survey on the access to finance of small and medium-sized enterprises in the Euro area – April to September 2012," November 2012. Data as of 30th September 2012.

10 *Ibid.*

11 HM Department for Business Innovation and Skills, "Boosting Finance Options for Businesses," January 2012 (known as the "Breedon Report," after the committee's chair Tim Breedon).

12 European Commission, "Key figures on European business – with a special feature on SMEs," 2011.

13 HM Treasury, "Business Finance Partnership: Request for Proposals," January 2012.

14 Standard & Poor's, LCD News, 3rd January 2013.

15 HM Department for Business Innovation and Skills, "Boosting Finance Options for Businesses," January 2012.

16 European Commission, "Key figures on European business – with a special feature on SMEs," 2011.

17 European Banking Federation, "European Banking Sector Facts and Figures 2012," October 2012.

18 HM Department for Business Innovation and Skills, "Boosting Finance Options for Businesses," January 2012.

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These efforts, however, are meant as a catalyst to promote non-bank lending from private institutions and their relatively small budgets are unlikely to materially address the financing gap left by the banks.

THE OPPORTUNITY FOR INSTITUTIONAL INVESTORS: WHERE, WHY AND HOW TO INVEST?

We believe the greatest opportunity for institutional investors is direct lending to middle market companies in a broad range of industries across Europe. Lending to SMEs is a very specialised, often riskier, activity than lending to the middle market, and transaction sizes can be prohibitively small for the amount of detailed credit analysis required. Many SMEs are new and operate in highly competitive markets. We believe middle market companies offer greater stability and a lower risk profile, as they are more established in their respective markets.

Middle market lending is characterised by participants lending directly to businesses rather than as part of a deal where banks underwrite and widely syndicate the debt, either as the sole lender or as part of a small group. Lenders in this market must undertake highly detailed credit analysis of the borrower before investing; they cannot rely on supplementary information provided by third parties, such as banks and private equity sponsors, which are readily available to lenders in syndicated markets. It is worth noting that this kind of financing often suits the needs of these companies better, as lenders tend to be more flexible to negotiate with the borrowers and allocate capital accordingly.

19 HM Treasury, "Business Finance Partnership: Request for Proposals," January 2012.

20 European Banking Federation, "European Banking Sector Facts and Figures 2012," October 2012.

21 NPRF, "National Pensions Reserve Fund announces new funds – €850m available for investment in Irish SME sector," 9th January 2013.

The advantages of lending directly to middle market companies, instead of through highly syndicated bond and loan issues, can be higher returns, greater control over the negotiation of terms, and closer relationships with the management teams. In the European syndicated loan market, increased demand has compressed margins significantly from Euribor +5.1% in September 2011 to Euribor +4.4% in December 2012.[22] Syndicated loans can offer total returns of 7-9% per annum, given the manager makes some gains through trading in the secondary markets.[23] By comparison direct lending to middle market companies can offer total returns of 9-12%, with a focus on the primary lending of new capital.[24] In our view, managers with skilful credit analysis may access this greater return profile without a material increase in credit default risk.

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The financing gap caused by European bank retrenchment has allowed lenders to negotiate more effectively with borrowers for greater protection through lender-friendly covenants. At the same time we have observed a loosening of covenants in the syndicated loan market as investors search for yield in liquid credit instruments: in 2012, 9.4% of European leveraged loan issuance was "covenant-lite";[25] the proportion in the US is much higher.

However, the attractive yields in direct lending come at the expense of liquidity. Lenders in this market accept that a longer-term view is necessary and understand that the more illiquid nature of the investment requires very careful credit analysis.

In order to invest effectively in the middle market, institutional investors require in-depth credit analysis and the ability to source attractive investment opportunities. The traditional dominance of banks means that the group of institutional investors in Europe able to analyse investments that are less liquid and less creditworthy is relatively small.[26] Institutions most likely to be able to provide long-term financing through directly lending are entities such as insurance companies, sovereign wealth funds, and pension funds due to the longer duration of their liabilities.[27] However, in our experience, the expertise required to do the corporate analysis necessary to minimise default risk is costly, making direct investments inaccessible to all but the largest institutional investors.

22 Standard & Poor's, "LCD Global Review – US/Europe," Q4 2012.

23 According to the three-year discounted spread (which includes discount to par in the secondary market) of the S&P European Leveraged Loan Index.

24 See, for example, "IPH sponsor bags EUR 180m unitranche for LBO," Debtwire Europe, December 20, 2012; and "Private Equity Enters Banks' Turf in Europe," Bloomberg, February 8, 2011.

25 Standard & Poor's, "LCD European Leveraged Lending Review," Q4 2012.

26 "Briefing: Non-Bank Finance," *The Economist,* December 15, 2012.

27 *Ibid.*

Given the demand for financing among mid-sized companies, lenders now have greater protection through covenants and higher margins than are available in the broadly syndicated market where these are in decline.

Pooled investment funds allow institutional investors to leverage a manager's experience and expertise in middle market credit analysis, across a broad and well-diversified portfolio of investments. They also avoid the need to allocate a substantial proportion of the total portfolio to the middle market and bear the associated costs of establishing a new team of analysts. We believe investing through such a fund will be more cost-efficient for most institutional investors, while the manager's experience should help achieve lower default risk and attractive returns. Established managers have strong relationships with market participants such as financial advisers as well as with the borrowers' management teams, ensuring strong deal sourcing and greater access to information.

INVESTING IN THE NEW WORLD OF EUROPEAN DIRECT LENDING

We believe the scaling back of European bank lending to mid-sized companies offers an attractive opportunity to institutional investors to lend directly. Given the demand for financing among mid-sized companies, lenders now have greater protection through covenants and higher margins than are available in the broadly syndicated market where these are in decline. However, as this is a specialized market, we believe investors seeking to maximize return and avoid default risk should work with experienced managers who can perform the credit analysis and leverage their expertise in this market.

INDEX DEFINITION

S&P Leveraged Loan Indexes (S&P LL indexes) are market value weighted syndicated loan indexes based upon market weightings, spreads and interest payments. The S&P European Leveraged Loan Index (ELLI) covers the European market back to 2003 and currently calculates on a weekly basis. The index is a trademark of the foregoing licensers and are used herein solely for comparative purposes. The foregoing index licensers are not affiliated with The Bank of New York Mellon Corporation and do not endorse, sponsor, sell or promote any investment strategies mentioned in this paper and they make no representation regarding advisability of investing in any strategies described herein.

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