THE EUROPEAN ROUNDTABLE

Point, counter point

A year on from Private Debt Investor's inaugural European roundtable ('Brave New World'), we pulled together five of the private debt industry's leading figures to debate the merits of the asset class, the challenges it faces, and its progress over the last 12 months. **Oliver Smiddy** reports.

It's fitting that the location for *Private Debt Investor*'s European roundtable this year was law firm Latham & Watkins' (newly-refurbished) London office. The firm's transatlantic connections – like those of this publication – mirror the close relationship between the two continents' debt capital markets.

Europe remains very much the junior sibling to its big brother across the Pond, however, as far as private debt is concerned. At PDI's European roundtable discussion in London in October, some of our participants reflected wistfully on the merits of the loosely-covenanted structures that have long been a feature of the US market.

But even if the US private debt market is far further along its development trajectory than its European counterpart, how much progress has the latter made in developing a genuine alternative to traditional bank-derived debt financing? And what has that meant for people in the market on a day-to-day basis?

A DIMINISHED BANKING LANDSCAPE

S&P's Hugh Baxter pointed out that banks were still a substantial part of the market in Europe, despite having reduced their lending activity; he cited a Bank of England report showing that bank lending has fallen by 20 percent in the last three to four years.

"What we are seeing is a 'squeezed middle'," Baxter said, defining the mid-market as companies that have less than €1.5 billion in turnover and with debt requirements of less than €500 million. "That is where we see companies having a problem raising debt, despite growing interest from institutional investors investing in that space. There is demand from issuers to raise money and there is interest from investors to supply it, but bringing the two together is a problem. In Europe there is still a long way to go

> "WE ARE TRYING TO CHANGE A LONG HISTORY OF VERY CLOSE RELATIONSHIPS WITH BANKS"
> **Calum Mcphail, M&G Investments**

"SPONSORS HAVE BEEN EXPERT AT CHERRY PICKING ASPECTS FROM US PRACTICE AND BRINGING THEM TO EUROPE"

James Chesterman, Latham & Watkins

to get to the point where companies have access to the sort of funding options that US companies typically have."

But why does that disconnect still exist? Information flow is a barrier, he contended. "One of the biggest issues is information sharing. Medium-sized companies have to get used to the idea that they have to divulge information and be more open. At the same time, investors need to know these medium-sized companies are willing and able to supply them with information on a continual basis so they can have an on-going awareness of any potential credit risk," he said.

S&P has recently launched Mid-Market Evaluation (Baxter made clear it's not a rating), based on a new scale, which it hoped would give investors an independent view of a company's risk and help them benchmark that risk, and also help mid-market companies communicate better with investors.

Calum McPhail, head of corporate private placements at M&G Investments, welcomed that move but said it was challenging to try and overcome ingrained scepticism.

"I think there is still a cultural shift that needs to take place," he argued. "It's true that companies are beginning to recognise

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WHO'S WHO

KEN GOLDSBROUGH, HOULIHAN LOKEY

Goldsbrough is a managing director in Houlihan Lokey's European capital markets group. He has more than three decades of investment banking experience specialising in corporate lending, leveraged finance and debt capital markets and is based in the firm's London office. Before joining Houlihan Lokey, he worked for Greenhill as head of European debt advisory. Prior to that, he held senior roles at GE Capital, Barclays Capital and Paribas, where he was head of UK corporate banking.

HUGH BAXTER, STANDARD & POOR'S RATINGS SERVICE

Baxter is a vice president and head of client business management at S&P's, and is a member of the executive committee for the 'corporates & governments' rating business. He has been at Standard & Poor's for more than 10 years, and has worked with rated and unrated enterprises discussing changes in the debt and capital markets and how ratings can help achieve their goals. Before joining Standard & Poor's he spent 15 years in corporate banking with both European and Asian banks. He was primarily involved with lending relationships in the corporate sector.

PATRICK MARSHALL, TIKEHAU INVESTMENT MANAGEMENT

Marshall, who heads Tikehau's credit business in London, has more than 17 years of experience in credit, risk management and loan portfolio management, including leveraged loans and distressed debt. Prior to joining Tikehau, he was a partner at WCAS Fraser Sullivan Investement Management, a leading debt fund manager. He began his career in 1995 in London at PWC then Société Générale and N.M. Rothschild & Sons. He joined Lehman Brothers in January 2000, where he was head of European and Asian loan portfolio management, as well as being portfolio manager for two CLOs.

JAMES CHESTERMAN, LATHAM & WATKINS

Chesterman, a partner, has a wide range of experience in finance matters, including asset-based lending, leveraged acquisition finance, workouts and restructurings, and media and telecommunications finance. He also represents a range of US and European institutions and investors in their restructurings of private placement notes. His clients include Bank of America, Barclays Bank, Credit Suisse, GE Capital, GSO Capital, JP Morgan, Morgan Stanley and Schoeller Arca.

CALUM MACPHAIL, M&G INVESTMENTS

Macphail joined M&G Investments in 2000, and is head of corporate private placements. Prior to M&G, he worked in the credit department of Dresdner Kleinwort Benson. Previously he worked as a supervisory analyst at the Bank of England within the UK Banks Division. He started his career at the Bank of Scotland.

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the need to develop other sources of funding. But we are trying to change a long history of very close relationships with banks, where the pricing in those relationships has been driven by the 'relationship banking' model – [so] companies [get] cheap debt, but the banks [provide] all the ancillary services as the compensation for that. So having to go to a market where they're having to pay something like the true economic cost of borrowing can be a bit of a shock as to what that actually entails."

Baxter agreed. "I think they [corporates] tend to be relatively conservative in nature. So stepping into a new world is actually a big step. There are lots of corporate treasurers out there who feel very uncomfortable about moving away from that traditional bank relationship. They know they have got to do it, but they really don't want to."

There are plenty of other factors that make life tough for European private debt providers. Macphail pointed out that on the investor side, US investors have a much longer history of involvement in private debt and have become comfortable with its illiquidity. "I think in Europe there is still a question mark around how investors want to price that illiquidity. Maybe they are currently placing too high a price on it, which is not helping to bring buyer and seller together."

> "YES, WE ARE COMPETING AGAINST THE BANKS FOR LENDING, BUT WE ARE ALSO WORKING AND HELPING THEM WITH SOME OF THEIR TRANSACTIONS"
> **Patrick Marshall, Tikehau Investment Management**

James Chesterman, a partner at Latham & Watkins, added that banks have traditionally played an important role in bringing borrowers and (alternative) lenders to the same table. So if you disintermediate them from the market, you need other mechanisms to allow the two to connect more easily.

Tikehau Investment Management's Patrick Marshall chimed in, arguing that although in some cases private debt funds compete with banks, in other cases they're viewed as valuable partners. "We have worked with banks where they've had a problem syndicating or there has been an issue with the credit –we are able to come in and do a mezz tranche, or in effect provide the 'harder credit risk' part of the transaction, to enable the 'traditional' banking lenders to have their transaction with a more conservative leverage ratio. Yes, we are competing against the banks for lending, but we are also working and helping them with some of their transactions," he said.

PRIVATE EQUITY PROVES OPEN-MINDED

Sponsors appear increasingly willing to consider non-bank lenders when putting together new deals, or refinancing existing ones. Marshall said many sponsors approach him and ask for bids [to fund their deals] to compare with the termsheets banks will provide. "While direct lenders may be a little bit more expensive in some cases, the more bespoke type of lending that they are willing to do and the way covenants are set up have an attraction to them. The market is now starting to get a little bit better organised in some areas. [But] when it comes to the old 'shoe leather', and finding straight corporates to lend to, you still need to get out and there and find them."

The fact that the pricing differential between traditional lenders and private debt has narrowed has certainly helped sponsors warm to alternative sources of financing . S&P has researched the impact of Basel III on pricing, concluding that when its provisions are fully factored into banks' capital structures, it will probably increase the pricing of speculative grade debt by between 70 and 140 basis points.

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"That brings them much more into line with the pricing levels that investors are looking for," Baxter added. "I think banks economically will be forced to charge more. That price differential between the loan market and the capital markets will over time disappear, but it will require change for people to get comfortable with that."

Macphail took up the baton. "In many cases private equity houses have long-standing banking relationships and can bring a number of parties to the transaction. At M&G, in direct lending, we are looking at the corporate space – either a smaller listed company or a company that may be in private family ownership, where again they typically don't have the same level of banking relationships. Indeed their access to advice on what the alternatives are is more limited. Therefore the chance of them being able to find alternative sources is more difficult." It's easier in the sponsor space, he added, because Europe has a longer history of institutional investors being involved in that market.

Ken Goldsbrough, managing director at Houlihan Lokey's European capital markets group, said "We work a lot with private equity sponsors, and they're all saying the market has developed quite significantly, even in the last year, reflected by your [i.e. PDI's] emergence as well."

> "MID-SIZE SPONSORS ARE INCREASINGLY INTERESTED IN DIRECT LENDERS"
> **Ken Goldsbrough, Houlihan Lokey**

Asked how his clients tend to approach financing their deals, he responded: "With sponsors, it's horses for courses. Some of them, probably the ones with a strong name, can still get good deals out of the banks and they are still slightly wedded to that route. But that's generally just at the upper end of the market. Mid-size sponsors are increasingly interested in direct lenders, unitranche providers and the like. They are calculating the premium over the all-in cost of bank money has come down as the market has evolved and some of the new lenders have slightly adjusted their return expectations downwards. The premium is now a couple of percent, and when you trade that off against the greater flexibility on covenants and amortisation, higher leverage possibly, longer maturities... They're taking the view that that's not a bad deal and I think we are going to see it develop more as time goes on," he added.

But it's not just the economics that make sense; the flexibility offered by private debt funds is also a draw, he reckoned. "I spoke to one sponsor recently and he said: 'Don't even show me the bank deal; I am only interested in the new lender approach'," Goldsbrough added. "They had made the transition. They wanted more flexible, non-amortising, covenant-loose structures. I think it depends on the investing style. If you are buying companies that might need a bit of operational turnaround or capex, you want that freedom to reinvest the cash flow rather than have to worry about amortisation. The classic bank style of shrink-wrapping the covenants around the business plan has proved quite tough for many borrowers."

'Knowing your lender' swiftly became a key theme. Marshall pointed out that there were "direct lenders and direct lenders" – his point being that some groups have

small teams and have to deploy capital quickly so are less concerned with pricing, for example, whilst others are more considered and have the resources to tailor a truly bespoke financing solution. There's also the question of whether having a distressed debt unit within the firm could spook potential borrowers.

Debate raged on this point. Chesterman believed borrowers could be put off if a firm has a distressed debt component, whilst Goldsbrough reckoned it wasn't a factor, as any firm that made a loan and then invested in that credit using its distressed debt team would go out of business in short order. The consensus seemed to be that having both a lending business and a distressed debt business was a risky path.

CHALLENGES TO PRIVATE DEBT

Alternative lenders face a challenge from the US and European high yield markets, however. The US Term Loan B market has been thriving, Chesterman pointedout, and high yield has been a popular tool, particularly for refinancing. Goldsborough criticised the way high yield has been pushed to investors by some banks, and also questions whether the small issues (in the €100 million range) that have been seen periodically this year "made sense" and will continue to be a factor.

> THERE IS DEMAND FROM ISSUERS TO RAISE MONEY AND THERE IS INTEREST FROM INVESTORS TO SUPPLY IT, BUT BRINGING THE TWO TOGETHER IS A PROBLEM
>
> **Hugh Baxter, Standard & Poor's Ratings Service**

"Not every borrower wants the disclosure that comes with a public bond issue and although you have a lot of flexibility in terms of lack of maintenance covenants and amortisation, they are not always flexible in terms of being able to do things afterwards, such as repay early," he adds.

Goldsbrough said his colleagues in the US were seeing incredibly aggressive terms driven by the weight of money and competition amongst different capital providers.

Baxter weighed in. "The US market is very flexible, very liquid and very deep and requires fewer covenants. But interestingly, although there is an assumption that the price is also lower, if you look at it in terms of the basis points per unit of leverage, there is actually very little difference between Europe and the US."

Macphail acknowledged the US private placement market has been a very attractive source of capital. The difficulty for borrowers is the necessity of being perceived as investment grade, he said. He also believed there was a size bias at the ratings agencies, which limits access to this market for smaller companies.

Baxter in turn pointed out that larger companies generally have a better default record, because they're able to weather difficult periods better than smaller peers.

While the high yield and TLB markets are open mainly to larger companies (and their sponsors), an even more select group have the resource to dual-track financings.

Many large sponsors will run parallel processes, Chesterman explained. "For example, we will have a bond package of senior secured bonds – maybe a super senior revolving credit facility and senior structurally subordinated notes – running in one track, and on a parallel track we will have a US Term Loan B financing. There are situations where we run these processes in parallel for a great amount of time

until the pricing evaluation is made at a relatively late moment. We are one of the few firms that can do it, but we need US banking, US securities and UK banking capability as a minimum, and it's incredibly time- and resource-intensive. So it's not a process that lends itself to the vast majority of the corporates that you are talking about; it's just not available for them."

Traditional bank-derived debt financing remains the biggest competitor to private debt. But banks have become increasingly parochial since the credit crisis. "Banking has become a much more domestic affair," Goldsbrough pointed out, adding there were still a handful willing to do cross-border loans. Their main preoccupation, still, is minimising their own balance sheet exposure; the amount they're willing to hold on balance sheet now tops out in the €15-25 million range, he estimated.

The question is whether banks will return to the underwrite-to-distribute model. The answer is linked in part to the health of the CLO market, which has shrunk significantly since the crisis, reducing liquidity and importantly, the market for syndicated loans.

CAN PRIVATE DEBT FILL THE VOID?

The shrinkage of the CLO market and banks' reduced appetite for lending has left a substantial financing gap; the panel all agreed on this. "It's a question of scale," Baxter said. "If you look at the level of financing that's needed over the next three to four years, if the banks are not actively involved in that, there is a huge gap – and I don't see the alternative sources of funding filling that gap any time soon. That's a problem. If you are a borrower at the moment, you look at the alternative market and you still see it is relatively small."

Goldsbrough argued that if a European borrower needed €300 million of financing, it's achievable to find three alternative lenders who could each provide €100 million. That gives you similar pricing [to high yield], and greater certainty of execution, and you're only dealing with three parties, he added.

Pressed on how many alternative lenders are able to write cheques of €100 million or more, Goldsbrough put the number in the "high single-digits". The rest of the panel agreed.

Macphail also emphasised the reputational hurdle private debt funds have to overcome. "It's all very well saying, 'Our bank has lent to us for a number of years, I am going to go with this new fund'. But if that fund has not got a strong backer or reputation in the market, do you have confidence in its longevity – so that the next time you have to refinance, they are going to be around with a new fund to be able to help you? Or are you just postponing the problem to another day? I think it's a real issue."

One of private debt's key advantages could also be an impediment to rapid growth.

"The teams at alternative lenders are smaller, so even the senior guys are involved in the deep-down due diligence. In a bank, it's a whole lot of signatures and the guy who's got the top signature doesn't really know the detail, to be totally honest," Marshall said.

Tikehau has a team of nine professionals with three working on a deal, together with internal lawyers, before presenting the transaction to the firm's chief investment officer and other senior executives. "It's a very short, but very intense, process," Marshall said. "I come from an investment banking background and we [at Tikehau] go through a deal in much more detail. I was on the steering committee which handled approvals when I was last at an investment bank, and I know much more about the deals now."

He also pointed out that funds were judged on their track record, so you simply couldn't afford to have a deal go bad. That means due diligence has to be effective, and the team has to be very disciplined about what deals it takes on. Investment banks, by contrast, have other business lines that can make up losses.

However, Macphail argued this enhanced due diligence and involvement from senior executives at all stages could also be a drawback. "It's got to be a limiting factor to the size of the market – as it is, for want of a better expression, a resource-intensive way of doing business. [It's] perhaps not as scalable as other types of lending, where there are more liquid markets and you are able to move in and out; here you have to live with your mistakes."

DEVELOPING DEBT - THE FUTURE FOR ALTERNATIVE LENDERS

Marshall believed private debt fund managers would increasingly look to develop a broader offering to both their investors and borrowers. Picking up on Goldsbrough's mention of how the large US multi-asset managers like KKR and Blackstone provide "flexible capital" across a range from senior debt to equity, he said: "I think you are going to see direct lenders or funds move to be able to match the yield that investors are looking for with the product, and in effect allow corporates to decide which type of product best suits their need."

Private debt funds who do direct lending were also generally much more open-minded about credits, Marshall believed.

"The way banks are lending money now is very much a box – if it fits into the box they're up for it, but if you are in Spain or Italy, or if you've got a business that is a little bit more difficult… Let's take Skrill – a recent syndication – which is in a market segment that is reputationally difficult. A

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lot of people in that syndication did not want to be involved. Now with direct lenders, they are willing to do the more hairy credit risks, [to] look at that and get to know the company better – [whereas] banks would just say as a matter of principle 'I am not in the Spanish market' or 'I am not in the Italian market'."

European private debt funds will increasingly look to import US structures, Chesterman argued, aping what private equity groups have been doing for some time. "Sponsors have been expert at cherry-picking aspects from US practice and bringing them to Europe, and vice versa. I am sure that some of these features, such as springing financial covenants, greater flexibility of negative covenants, will be coming over here in loan products as well. I think it's a very interesting time for everyone in that space."

Discussion turns to the macroeconomic picture in Europe. The panel agreed that while Europe isn't out of the woods yet, the worst was over. "I think the picture is rosier than it was," Baxter said. "Europe is moving forward, albeit in the slow lane. Our view is that things are improving but growth is likely to be sluggish through into 2015."

Asked what keeps him up at night, Baxter cited the on-going fragility that still exists. "Things appear to be getting better in most places, but it's not so strong that another big shock wouldn't cause another huge problem."

Marshall said he's "relatively bullish" that things are getting better, particularly as banks in some jurisdictions have done a lot of the painful work needed to recalibrate their balance sheets. "There is a lot of money around at the moment – it's what happens when that cashflow, that excess money, starts to disappear that worries me," he added.

Chesterman cited the exit from the quantitative easing process as a major cause for concern. "Managing the escalation of interest rates concerns me from a business perspective, because if people get it wrong, it's going to be very painful. Even the indications by the Fed about stopping tapering in the US had ripples around the world. How is it going to be when the ECB and the Bank of England and everyone start doing it?"

Macphail chipped in. "There's quite a lot of liquidity and that seems to be keeping things going. In a world where some of that liquidity starts to be withdrawn, does that create problems that are being hidden? So, whilst everything seems to be sailing ok, is that sustainable?"

Much of the hard refinancing and recapitalisation work has already been done, Goldsbrough argues, so in one scenario, unless M&A picks up, 2014 could be a very quiet year. However, he preferred a more optimistic scenario: "I feel convinced the alternative lending market will continue to grow, as people get more familiarity with these cultural changes. I think we will see more large deals where these alternative lenders start clubbing together to provide some attractive options for sponsors and corporates, potentially in the €250-300 million deal size range," he said.

It was a positive note on which to end. Despite all the challenges, private debt, the panel agreed, has become a vital component of the European market. ■