Private Debt Investor

Europe

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Shifting landscape

The opportunities and challenges in a rapidly changing continent

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REACHED
$34+ B
IN COMMITMENTS ACROSS THE GLOBE

$13.9 B
DEPLOYED CAPITAL

#1
MOST ACTIVE LENDER TO NORTH AMERICAN PRE-OWNED COMPANIES[1]

#2
MOST ACTIVE LENDER TO EUROPEAN PRE-OWNED COMPANIES[1]

CLOSED ON
127
NEW PLATFORMS

EXECUTED
125+
ADD-ON TRANSACTIONS

INVESTED IN COMPANIES IN
14
COUNTRIES &
7
CURRENCIES WITH
110
PRIVATE EQUITY SPONSORS

CLOSED
ESG-FORWARD
UNITRANCHE DEAL IN THE EUROPEAN MIDDLE MARKET IN 2020

12
ADDITIONAL ESG-FORWARD DEALS CLOSED IN 2021, IN BOTH EUROPE AND NORTH AMERICA

1. Sources: Pitchbook for North America, GCA Altium MidCap Monitor, Debtwire rankings for Europe

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Europe

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Insight

Analysis

Regional Guide

Insight

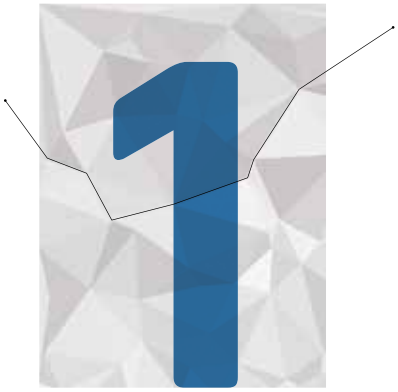
Key trends **The shifting landscape is throwing up a set of openings for European investors**

Times are a-changing in Europe. The macroeconomic shocks of the past six months – the energy crisis, the inflation spike, rising interest rates and continued supply-chain disruption – are forcing private equity sponsors to re-evaluate their funding options, ***writes Graeme Kerr***.

"The syndicated loan market and the high-yield market are both effectively shut in Europe right now," says Luke McDougall, co-chair of the global finance practice at law firm Paul Hastings.

"There are some limited circumstances in which someone would go to market, but generally speaking, as of early September, it is not a feasible option for leveraged buyouts."

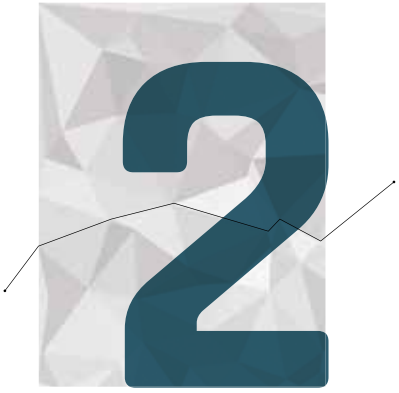
And yet it's not all doom and gloom – far from it. The shifting landscape has thrown up a set of opportunities for European debt investors that make market participants quietly confident that growth will continue. Here are seven key trends that we identified in European debt market while compiling this report.



Direct lenders are gaining ground

Europe's direct lenders have profited in the absence of syndicated lenders, and are unlikely to look back, says Adam Wheeler, co-head of global private finance at Barings.

"The syndicated loan markets and the high-yield markets remain basically shut at the moment, which means a lot more transactions are coming to the private markets," he says. "Private markets... saw an extraordinary number of deals done and dollars deployed in the second quarter of 2022, in both Europe and the US. In Europe, in particular, we compete against the banks, who remain a large part of the mid-market leveraged finance world, and they have pulled back quite a bit."



Current conditions could prove favourable

Providing investors make the right investment decisions, today's market could prove beneficial, says David Hirschmann, Permira Credit's head of private credit: "The sort of companies that we tend to support have high EBITDA margins on average, a good level of pricing power and high cashflow generation capacity, which positions them well in a more volatile environment."

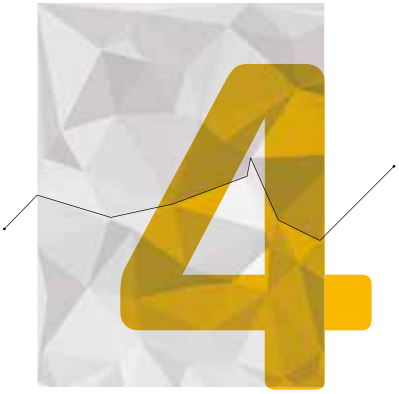
The current environment presents a number of attractive opportunities: "We want to make the right investment decisions and deliver the best outcome for our investors. As always, maintaining our credit underwriting discipline is fundamental."

Smaller cap deals have come into their own

The lower mid-market, defined as transactions with less than €100 million and more than €15 million of debt, offers compelling opportunities, argues Klaus Petersen, founding partner, at Apera Asset Management

"The lower mid-market is structurally different from the upper mid-market because the main provider of financing is the banks, who have de-emphasised the space, creating a demand-supply imbalance. There is more demand than private debt providers can supply, which means there are better credits in terms of leverage levels, lower loan-to-value and stronger covenants," says Petersen.

With around 700 investment opportunities a year, Petersen says the lower mid-market has some tempting traits: "The ability to choose and select the best credits is a massive advantage, as in markets with lower transaction numbers you may be forced to finance marginal deals."



Credit markets are trying to find their balance

The public markets have been largely shut since March, says Andrew Konopelski, managing partner at Bridgepoint Credit, whose owner Bridgepoint is the owner of *Private Debt Investor* publisher PEI Media. This has led to new issuance volumes being down 70 percent year-to-date in the leveraged loan and high-yield bond markets. "This has created many different and interesting opportunities for private credit. The clear trends in Europe have been a return of risk premiums, a return of base rates and a very large shift to private markets," he says.

> "There is more demand than private debt providers can supply"
>
> Klaus Petersen, Apera

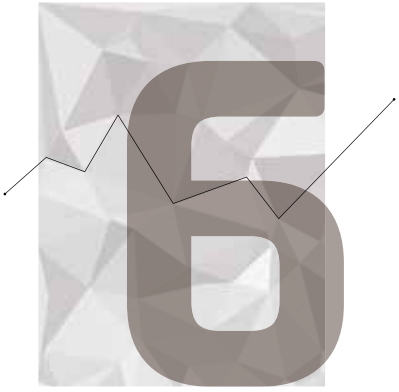
"Q2 was our busiest quarter ever... everything found its way to private markets: a large M&A pipeline, new credits and many European markets that to date have not favoured private credit all turned to it."

Opportunistic credit also saw an uptick, which "is proving to be a very good partner and able to deliver attractive financing solutions for sponsors in times like these".

European debt markets can withstand an economic shock

Private credit, compared with other asset classes, continues to have several advantages that mean it is relatively well positioned for macroeconomic challenges, says Keith Miller, global head of product – private debt at Apex Group.

"Those include the fact that instruments are generally of shorter duration with floating rates, benefit from an amortising position and generate higher yields that offer a bit of a buffer. So, while there are challenges, in the second quarter of this year we have probably seen an uptick in deals getting done, and that is especially true in the core European direct lending markets of the UK, France and Germany," says Miller.



Southern Europe is a bright spot

Spain and Italy are both seeing record transaction levels, but there

are hopes, too, that Portugal is on a growth trajectory for private debt.

"We've just been visiting some of the sites that we own in Portugal and it's hard not to feel optimistic," says Zach Lewy, CEO and CIO of European fund manager Arrow Global. "In the hospitality sector, there's a backlog of people who want foreign holidays. That demand is already pushing activity in Portugal beyond pre-pandemic levels."

John Calvao, fund principal at the firm, is similarly optimistic. "The Portuguese business is one of our more robust businesses. I think we're approaching a thousand employees in Portugal. We're a major, major player in that market."

Nordics remain well-placed

The Nordic region provides a huge market for private debt investors, says Capital Four CEO Sandro Näf. "We are, of course, facing a global slowdown. That means that we're more selective, and we're more conservative on leverage," he says. But Scandinavia has certain advantages which should ensure continued growth: "The Nordic economies are generally less vulnerable to the energy supply crisis because they produce energy domestically and are leaders in renewables." ■

Renewables reassessed **Eyeing the energy opportunity**

With energy security top of mind, the opportunity set for private credit in green energy generation across Europe has moved up the agenda for both funds and their investors.

Jerome Neyroud, head of infrastructure debt at Schroders Capital, says concerns around security of supply have created opportunities on the generation side, especially as Europe seeks alternatives to fossil fuels in the form of renewables. "We continue to see a huge opportunity in energy storage, but remain cautious around retail due to its exposure to price volatility, and around newer technologies like hydrogen where business models have not been tested yet."

Investors, Neyroud says, are very keen on the opportunities on offer from energy assets in Europe but cautious about price volatility. "We need to take time to explain the complexities of the sector and the fact that some segments will benefit while others may suffer. That is where our investment expertise comes into play, allowing us to make good investments in the context of a rising tide that may not benefit all boats."

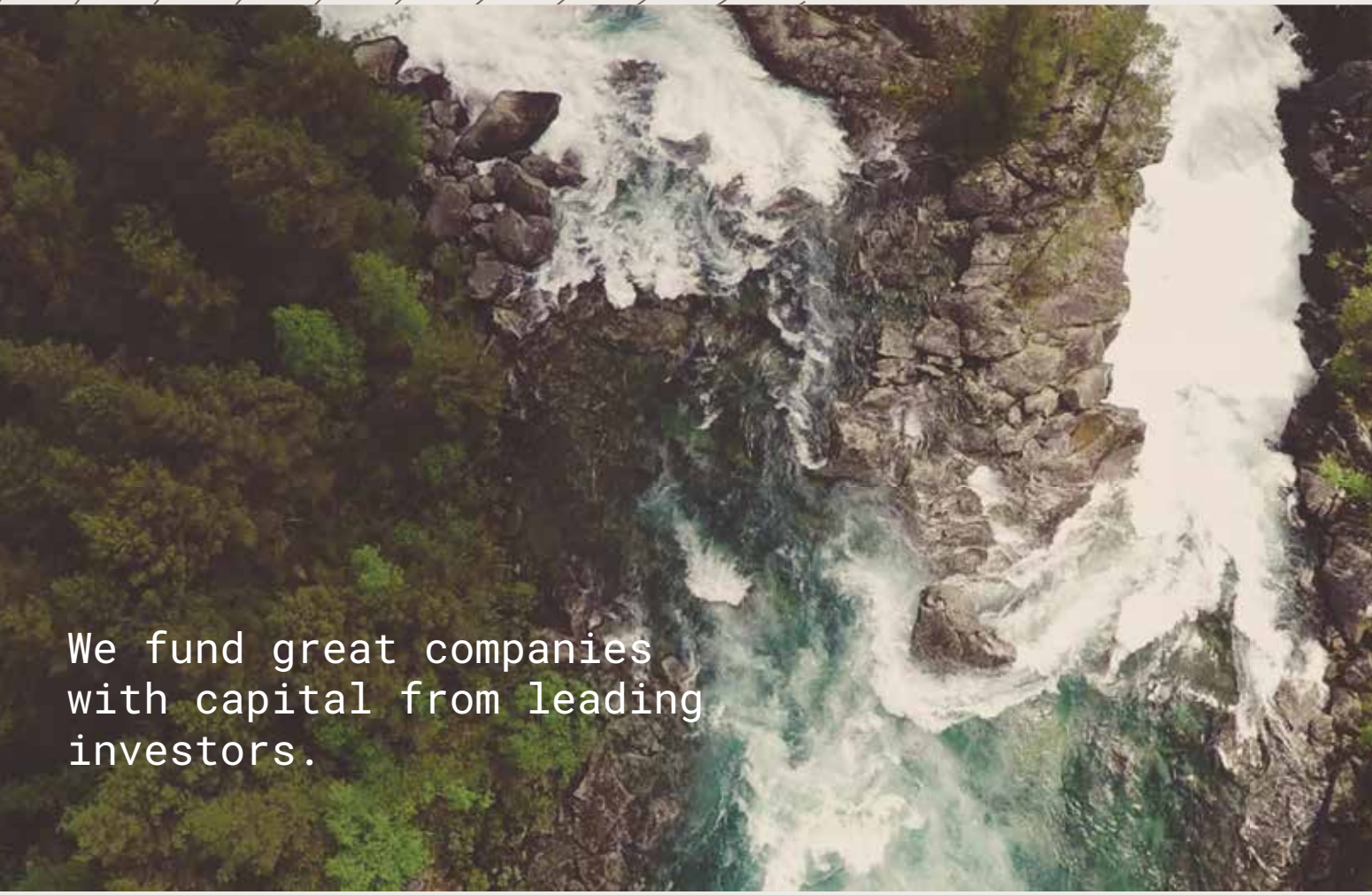
Derwin Jenkinson, London partner in the energy and infrastructure finance practice at law firm Paul Hastings, says there is growing appetite for private debt in energy financing: "The data suggests that in the last two years, non-bank private has put around $12 billion to work investing in energy assets in Europe, with just over half of that by value, and around two-thirds by transaction volume, going into renewables.

"Within renewables, the most active sectors are onshore wind, solar and energy from waste power generation. In the broader energy sector, by contrast, it is almost all invested in oil and gas storage and district heating and cooling, rather than conventional power or upstream oil and gas."

Tom Van Rijsewijk, a managing director within the private credit team at Macquarie Asset Management, says the banks are very active and "really keen to drive this". "Most private credit lenders are trying to play in parts of the market where the banks are less competitive," he says. "This might be when there's an extra layer of junior debt being put on top, where the tenure is very long or where the banks perhaps have quite a lot of exposure to a certain offtaker and private credit can offer some extra liquidity.

"Private credit can also sometimes be very competitive at the very stable end of the market, which can sometimes almost be too low risk for the banks." ■

CAPITAL FOUR



We fund great companies with capital from leading investors.

Editor's letter

A little local know-how goes a long way

Graeme Kerr
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Talk to anyone involved in Europe's expanding private debt market and one thing becomes clear: local knowledge counts. That's partly for structural reasons. Only 1 percent of asset finance is cross-border, as Zach Lewy, CEO of European fund manager Arrow Global, said during our recent podcast *The European Debt Opportunity*.

That means Europe's 44 countries are effectively "44 local markets in which lenders, or in this case, private credit operators, need to create the credit products that people need", Lewy explained. So, whether it's bridge, construction or agricultural lending or loans to small businesses, it takes local expertise to understand the activities that are core to those economies, Lewy said.

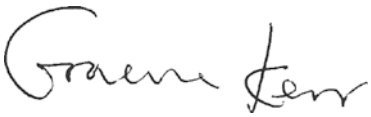
That's why our second annual European Regional Guide (from p. 21) is so instructive. We examine Europe's shifting debt landscape, including the leading markets (the UK is still number one, but France is gaining) and which of the smaller markets are growing fastest: Spain (p. 38) is a notable standout with many of the leading European fund managers setting up shop in Madrid. That helped push Spanish private debt deal levels to new records in H1 2022, per the Deloitte *Alternative Lender Deal Tracker*.

> **"The macro challenges seem... to be contributing to the growth of Europe's debt market"**

The macro challenges seem, if anything, to be contributing to the growth of Europe's debt market, as banks retrench and reduce their appetite for leveraged finance transactions, opening up opportunities for direct lenders.

No one's getting too carried away. Stephan Caron, head of European mid-market private debt at BlackRock, says he would like to see more concrete data that the trajectory will be sustained before putting boots on the ground in Spain.

But the direction of travel in Spain – and Europe's other smaller markets – is clear. There are deals to be done and financing to be arranged, if you know where to look. And that's where local knowledge really is invaluable.



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EXPERT Q&A

With prudent investment strategies, Permira Credit's David Hirschmann argues that private debt can be a bastion of resilience during the economic downturn

Private debt draws on record of resilience

Europe is preparing for a cold winter. The continent's energy security crisis threatens to inflict major economic hardship over the coming months as inflation continues to spiral. But the continent is, at least, used to dealing with macroeconomic turmoil, after a 15-year period that has seen one crisis after another.

David Hirschmann, Permira Credit's head of private credit, points out that private debt has gone from strength to strength during this period. With traditional capital providers less willing to lend in the current environment, he tells *Private Debt Investor* that private debt can continue to thrive. The key to success, he says, is maintaining discipline in underwriting and lending to market leading, PE-backed companies in resilient sectors.

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Q What are the key drivers behind demand for private debt in Europe?

Clearly, there's been very significant growth over the past decade. Private debt funds have been able to fill the funding gap that has opened up due to bank retrenchment and the continued regulatory pressure on bank balance sheets. The asset class has provided solutions on the one hand for sponsors and borrowers, who are seeking long-term partnerships, and on the other hand for LPs who are seeking attractive and consistent risk-adjusted returns.

The larger, well-established managers have now raised and deployed multiple funds, and have proven they can deliver strong performance and stability in a volatile and uncertain market environment. Private debt-funded transactions now represent the majority of European financing in the

mid-market, and recently we've seen the rise of larger transactions and club deals as an alternative to capital market solutions.

Q Why do you think many European PE firms nowadays favour private debt funds over traditional bank financing for mid-market buyouts?

There are a number of reasons. Private debt funds offer certainty and reliability with a tailored approach, which can suit the needs of a PE sponsor, particularly in competitive auction processes. Speed of execution, as well as ticket size, mean this is sometimes the only way to meet a seller's deadlines and make a transaction possible. And in a buy-and-build context, the availability of follow-on capital is a key success factor. From a shareholder's perspective, buy-and-build situations call for financing partners that can act quickly and have a commercial mindset, in addition to being flexible in terms of the debt quantum involved.

Private debt funds such as Permira Credit are in a position to deliver just that. Our private credit funds have repeatedly backed companies' growth strategies over a number of years, from the low end to the upper end of the mid-market. This is why we see a high level of repeat dealflow from our existing sponsor relationships and also from within the existing portfolio.

Q Over the longer-term, do you expect to see significant growth in private debt in Europe?

Definitely – the European market remains a very attractive market to invest in. High-quality assets continue to come to market and there is room for further growth. Even in the more mature markets of Western and Northern Europe, private debt only represents around 60-70 percent of the financing for European mid-market buyouts, versus roughly 90 percent in the US.

Issuance across leveraged loan and high-yield bond markets declined sharply in the first half of 2022. That helps to create white space for private debt funds. In fact, more recently we have seen the rise of larger transactions and club deals as an alternative to capital market solutions. This increasing deal size extends the opportunity set for direct lenders by effectively raising the ceiling for larger private debt funds.

Q As a private debt manager, how have you been able to ensure resilience through the various macroeconomic crises in Europe over the past 15 years?

Over this period, we've been through the global financial crisis, the euro debt crisis, Brexit, covid-19 and now the war in Ukraine. There's been a great deal of volatility in public markets, as well as in the syndicated loan and high-yield bond markets. But private markets have shown much lower volatility compared to public markets strategies, whether debt or equity.

"The European market remains a very attractive market to invest in"

At Permira Credit, we support high-quality, performing businesses that are backed by blue chip private equity sponsors. And we underwrite transactions with conservative leverage structures and significant downside protection. This consistent approach has delivered resilience in our

funds' portfolios over time.

In our core, senior secured direct lending funds, we've always been highly selective in the companies we choose to support. We've built portfolios that are highly diversified, by the number of borrowers, by industry and by jurisdiction, backing businesses that are relatively unaffected by market cyclicality. These are typically in the technology, business services and healthcare sectors, which have proven to be resilient and benefit from a high level of recurring revenue.

So, to answer your questions, resilience is underpinned by rigorous asset selection, a thorough due diligence process and significant experience of investing through multiple crises.

Q And as we head into another period of economic hardship, are you confident that you can weather the storm?

Yes, absolutely. Pre-global financial crisis, European mid-market buyouts typically had higher leverage multiples. Financing structures often included various tranches of senior and subordinated debt, together adding up to roughly 7-8x leverage, and with a relatively small equity cushion. By contrast, in today's market, we see more conservative debt structures, higher interest coverage ratios and equity cushions of more than 50 percent, alongside a bias towards defensive, non-cyclical industries.

In our own direct lending funds, the portfolio has limited exposure to raw material prices or energy costs, which are experiencing levels of inflation not seen for the last 20 years. Naturally, all businesses are exposed to labour costs and we expect there is going to be inflation there, and that is something we factor into our analysis. The sort of companies that we tend to support have high EBITDA margins on average, a good level of pricing power and high cashflow generation capacity, which positions them well in a more volatile environment.

"The current environment presents a number of attractive opportunities, but equally we are not under pressure to deploy capital. We want to make the right investment decisions and deliver the best outcome for our investors"

Q Could the current conditions in the market actually prove favourable for private debt managers overall?

Yes, providing that we make the right investment decisions. The current environment presents a number of attractive opportunities, but equally we are not under pressure to deploy capital. We want to make the right investment decisions and deliver the best outcome for our investors. As always, maintaining our credit underwriting discipline is fundamental.

Q How do you differentiate yourself in this market?

We are often asked this question and I always point to two key things. Firstly, we are differentiated by our due diligence capacity and our approach to credit analysis, which is enhanced by the fact that we are integrated within Permira, a global private equity firm with vast resources and a large network. Our core sectors – technology, healthcare and business services – are also key sectors for Permira, so we benefit from the deep sector expertise that the firm has built over nearly four decades. This helps us to make more informed investment decisions.

Secondly, as a firm, Permira Credit now has 15 years' experience in this market. We have been one of the few managers to be active in the space since the emergence of private debt as an asset class. This has allowed us to build strong relationships and trust over a number of years with key private equity sponsors and debt advisers.

Q What role does ESG play in your strategy?

The rise of ESG has been an important element in the growth of private debt over the past decade. The introduction of sustainability-linked loans, ESG margin ratchets and ESG ratings are all major developments in the evolution of the asset class more broadly. We aim to ensure that the management of ESG risks is at the core of how we operate at Permira Credit, both in terms of investing and as a business.

Although people often suggest that private debt is behind private equity when it comes to ESG risks, it's worth pointing out that we often have similar expectations to consider ESG risks as the sponsors t hat we work with. We tend to work with top-tier private equity sponsors which have a similar focus on ESG risks as we do at Permira and Permira Credit. We have a dedicated ESG team sitting across both parts of the platform and we integrate ESG risk analysis into our investment decision processes. In that sense, I find a lot of similarities and alignment in approach with the sponsors that we back. ■

Europe becoming a priority

Firms are increasingly looking to the continent as a region of opportunities, as demonstrated in our roundup of stories from the past year

Blackstone plans to double private wealth team, eyes Europe expansion
Blackstone announced plans to double its private wealth staff of 160 professionals. The firm hopes to reach the target by the end of next year and intends to open offices in Germany and Italy. In Europe, the unit has opened presences in Paris and Zurich, which both have roughly half a dozen staff.

Arcmont closes senior debt fund at €5bn hard-cap
London-based manager Arcmont Asset Management closed its latest debt fund above target at €5 billion. The vehicle, Senior Loan Fund II, reached a first close in March 2020, as the covid-19 pandemic hit. Its initial target was €4 billion but in August it held a final close at its hard-cap.

Pemberton secures €1.75bn for strategic credit fund
Pemberton closed its second Strategic Credit fund on €1.75 billion, according to sources close to the company. The vehicle reportedly closed in October, with significantly more raised than for its predecessor, which closed on €1 billion in 2017. The fund launched in Q1 2020 and will follow the same strategy as its predecessor, investing in performing credit throughout market cycles.

SEP 2021 | OCT | NOV | DEC | JAN 2022 | FEB

Amundi holds first close of senior impact fund on €650m
Amundi launched the fourth vintage of its senior debt strategy with a first close on €650 million. Amundi Senior Impact Debt IV will follow a similar strategy to its predecessor fund, offering investors exposure to private senior corporate debt financing for mid-cap companies based in France and Europe. The fund is targeting €1 billion and expects to hold a final close in 2022.

Rothschild & Co raises €1.4bn for third direct lending fund
Rothschild & Co held a final close for its third European direct lending fund on €1.4 billion. The vehicle, Five Arrows Debt Partners III, is significantly larger than its predecessor, which raised €655 million in 2018. FADP III will provide finance for European mid-market companies across the capital structure.

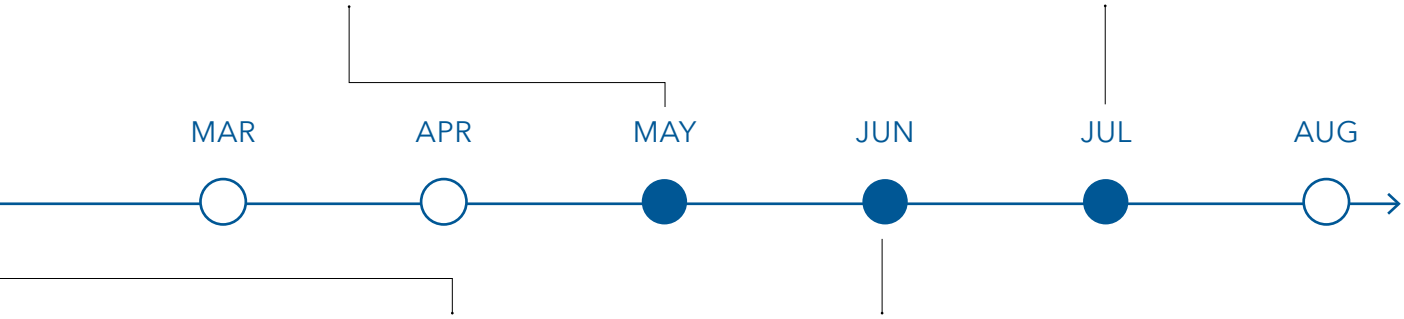
Kinetic Capital, Kayne Anderson launch European PBSA debt venture
Kinetic Capital, a Vancouver-based specialist lender in the purpose-built student accommodation sector, and Los Angeles-based Kayne Anderson Real Estate joined forces to launch Rhize Capital, a debt platform focused on the European student housing market. Kinetic launched the venture after identifying a gap in the market.

HSBC raises $1bn for UK direct lending

HSBC raised commitments of $1 billion for its direct lending strategy in its first year of operation, the firm announced. The direct lending strategy was set up by HSBC Asset Management in early 2021 with a UK focus and uses HSBC UK Bank's origination capabilities. HSBC AM launched direct lending as part of its ambition to grow its alternative assets business.

Apera closes second fund above target on €1.7bn

European fund manager Apera held a final close of its second private debt vehicle on €1.27 billion. Apera Private Debt Fund II exceeded its initial target of €800 million, with capital raised from a range of existing and new investors including pension funds, insurers and endowments from both North America and Europe.



Ares assembles team to provide real estate loans in Europe

Ares Management Corporation launched its first European real estate lending strategy. The Los Angeles-based organisation, which has a 10-year track record in US real estate debt, announced the hiring of a team of property finance specialists and the close of a first loan for the strategy, with €113 million provided in the Belgian market.

Invesco opts for open-end structure with debut European credit fund

Invesco Real Estate launched its first property debt fund in Europe after acquiring the real estate financing business of Swiss asset manager GAM in 2020, with an open-end vehicle for which it is targeting an initial €1 billion of capital. The US-based firm has already committed to €150 million of loans from the fund, Invesco Commercial Mortgage Income – Europe FCP RAIF (CMI Europe).

JPMorgan secures $2.4bn for special situations

JPMorgan Asset Management held a final close on $2.4 billion for its second special situations fund, surpassing its $2 billion target. The fund, Lynstone Special Situations Fund II, is investing in stressed, distressed and event-driven situations in European and North American private and public markets across the capital structure, the manager said in a news release.

EXPERT Q&A

There are many reasons to favour the smaller cap deals in times of economic uncertainty, argue Klaus Petersen and David Wilmot, founding partners, and Louis-Matthieu Heck, partner, at Apera Asset Management

The lower mid-market offers compelling opportunities

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Q Where do you currently see the most compelling investment opportunities for credit funds in Europe?

Klaus Petersen: We are looking at a unique investment environment because of the economic downturn. Rather than looking at any specific industry or geography, we are seeing that the normal providers of capital across Europe are going off risk, reducing their commitments and getting out of the market, which means the supply of capital is massively reduced. M&A volumes are down as well, but that creates a highly attractive environment to invest because the terms for debt transactions are improving, both with respect to credit structures and pricing.

The best time to invest a senior secured strategy is during these down-cycle periods, because you can reduce your risk through more conservative credit structure, and while credit terms are improving the supply dries up, which means you also can demand a premium. At the same time, only the strongest credits will come to the market, as weak credits will not find buyers or financing. Marginal deals will not be completed in a downcycle market where credit quality is one of the main concerns.

David Wilmot: In terms of execution of credit strategy, you need to be keeping to good credit fundamentals, which means businesses with non-discretionary demand and visible, recurring revenues that have limited correlation to downward economic cycles. You want to focus on businesses with limited non-controllable risks, with limited or no exposure to raw material input costs and energy costs, and where margins are not being squeezed.

Louis-Matthieu Heck: Private debt investments are predominantly floating rate instruments, which means that in a rising rate environment they will benefit from enhanced returns. Legal

deal documentations and term sheets will see the reintroduction of substantial floor levels, which is something we have not seen for a while. They enhance returns, so are another positive development for lenders.

Q What does Apera find particularly attractive about the lower mid-market opportunity?

KP: The reason why the lower mid-market – defined as transactions with less than €100 million and more than €15 million of debt – is so interesting is that it offers the largest pool of investment opportunities; around 700 per year. The ability to choose and select the best credits is a massive advantage, whereas in markets with lower transaction numbers you may be forced to finance marginal deals.

In addition, the lower mid-market is structurally different from the upper mid-market because the main provider of financing is the banks, who have de-emphasised the space creating a demand-supply imbalance. There is more demand than private debt providers can supply, which means there are better credits in terms of leverage levels, lower loan-to-value and stronger covenants.

DW: These dynamics leave us with a long-term, structurally under-supplied market for debt transactions in the lower mid-market. That was one of the key reasons for us setting up Apera in the first place. Banks have been reducing their exposure and the larger cap funds have been compelled to move to the higher end of the market. There is an opportunity cost to big funds of trying to stay in lower mid-market deals because each deal doesn't really enable them to deploy sufficient capital relative to the size of their funds.

There is a broad scope of investment opportunities in the lower mid-market with no single dominant debt finance provider, which makes it a very positive environment for selective portfolio construction.

> *"The banks are under pressure and that is probably going to increase"*
>
> **DAVID WILMOT**

L-MH: The debt providers are also simply closer to the client and the borrower in this market than they are in the larger cap segment, both in the deal phase and during the life of the deal. In the large-cap market, lenders have limited say in term sheet discussions because there is so much competition between lenders. Across our portfolio, we have the opportunity to participate regularly in board meetings, which is something you don't have in the larger cap space. In France, for example, we sit on the board of 90 percent of our portfolio companies.

Q How competitive are the banks in the lower mid-market?

L-MH: Banks are still there in the lower mid-cap space; in very national markets it takes just one bank to make a situation competitive. But we certainly see that they are retreating, largely because of increased regulatory costs.

KP: Originally, before the financial crisis, around 60 percent of the leveraged loans that banks did in Europe were in the lower mid-market. Today, that is down to 8 percent, so they have massively reduced their exposure and this year there has been almost no issuance. There is some variation across jurisdictions. In the UK, non-banks have been able to provide finance for a long time, whereas that has been different in the rest of the continent. France and Germany have the highest numbers of banks still active and non-banks were only allowed to provide direct lending in these countries from 2013 with the introduction of the Alternative Investment Fund Managers Regulation.

DW: The banks are under pressure and that is probably going to increase, because it is almost inevitable that they haven't yet been able to fully reflect the impact of non-performing loans as the macroeconomic conditions worsen. Their provisioning does not cover their NPL exposures, instead covering only about 50 percent of non-performing loans. That is only going to become more inadequate, because those portfolio pressures will likely intensify for them in the immediate term.

Q How is this part of the market likely to respond to a more challenging macroeconomic environment?

DW: The larger cap transactions will be suffering more from the downward correction that is going on in enterprise value levels in the M&A market. There is a bigger impact on larger cap portfolios because high leverage has driven high enterprise values there. There will also be more financial covenant issues arising in that part of the market.

We don't think there is going to be the same impact in the lower mid-market, because there hasn't been those debt-driven enterprise value levels, and traditionally the transactions have been financed prudently and consistently with lower loan-to-value and lower leverage levels.

On top of that, the structural features in the lower mid-market space mean you have maintenance financial covenants in transactions that enable you to react more quickly to worsening

financial performance. That allows you to have a discussion with the management team and PE sponsor about how the situation can be dealt with at an earlier stage.

KP: In our portfolio, the normal leverage level is around 3.5x, LTV is around 40 percent, so there is an enterprise value multiple of roughly 8.75x. The leverage covenant would typically breach around 5.4x at a 35 percent headroom, which represents 60 percent of the enterprise value.

By contrast, in the upper market you typically have leverage of 5.5x and a loan-to-value of around 55 percent and an enterprise value multiple of 10x. In this case, the leverage covenant typically will breach at around 9.2x at a 40 percent headroom or circa 90 percent of enterprise value, so you are really at the cusp of enterprise value when the covenant breaches and closer to a real problem where there is little value left in the business.

Overall, that explains why we expect lower defaults and better recovery rates in the lower mid-market.

L-MH: In the larger cap segment, higher enterprise value multiples and higher leverage multiples mean there are higher covenant levels, so once you get a decrease in the underlying enterprise value it feels like you are burning the candle at both ends. You can't just wait until your covenant breaches because that is set at a very high level, but at the same time you can see asset prices are melting down. That is definitely a place you would like to avoid and that is less likely to happen in the lower mid-market. Generally, players in the lower mid-market have a more prudent approach, so the risk of asset price deflation is significantly lower.

Q Which geographies are most appealing as you look across Europe?

L-MH: Globally, across the geographies in which we are operating, most countries tend to be impacted similarly by the economic backdrop. We see interesting opportunities across the board. At the end of the day, in shaky markets it is probably the better performing companies that are still coming to the market, and these companies will still be able to command good terms. However, even on these deals, private debt lenders should be able to achieve better yields.

DW: Looking at the geographies we focus on – the DACH region, the UK and Ireland, France and Benelux – we are looking to have a broad pool of opportunities to select from. It is critical to maintain a high level of selectivity in your deployment. So, the appeal is not so much about the location of the businesses, but the earnings visibility and stability of business models and a limited exposure to uncontrolled risks.

KP: We want to avoid the weaker countries and focus on the strongest economies, like Germany, France, the UK and the Nordics. These countries also have the strongest lender protections, which matters in a downturn. These four geographies represent circa 80 percent of European dealflow, so they have the largest pool of assets, which is what we focus on.

> *"What matters most is experience"*
>
> **KLAUS PETERSEN**

Q How can managers differentiate themselves to take advantage of the lower mid-market opportunity through a downturn?

DW: We are emphasising and continuing to prioritise the importance of prudent capital structures, low leverage, strong operating cashflows and strong equity support. These have not been features of all large-cap transactions. Having just raised our second fund at a total of €1.27 billion means we have capital to deploy in the lower mid-market in times like these, which is a great advantage and there are certainly good deals to be done.

History strongly indicates that in times of macro uncertainty it is overwhelmingly true that cash is king. That's cash to enable businesses to trade through difficult times and cash for fund managers to deploy well in new investments.

L-MH: Another way that managers can differentiate is to have a sophisticated reporting system – a point where Apera has a significant advantage. It is really important to closely monitor the portfolio in a downturn, both to make sure there are no challenges creeping up that you're not aware of and to price and structure new transactions accurately. You need a system that works and allows you to really monitor companies and detect any deviations early on – managers without those strong reporting systems will struggle to keep track.

KP: What matters most is experience. The three of us have each been in this market for more than 20 years, and to be able to demonstrate that you have invested through these market cycles provides reassurance and support to those seeking finance. ■

European debt: Opportunity beckons as banks retrench

Record deal levels in Europe point to a market that is rising to the macroeconomic challenges, reports Claire Coe Smith

Despite unprecedented macroeconomic uncertainty, private credit funds in Europe enjoyed the busiest Q2 on record this year as they executed 216 deals, compared with 154 in the same period of 2021.

This 40 percent increase, recorded in Deloitte's *Alternative Lender Deal Tracker*, is matched by a 16 percent increase in the half-year tally, as alternative lenders stepped into the gap left by banks and public markets and took on bigger and bigger deals.

"The private debt market has picked up transactions that would probably have been done in the public markets under normal circumstances," says Robert Connold, partner in debt and capital advisory at Deloitte.

While leveraged buyouts remain the key drivers of private credit activity, accounting for 48 percent of European deals in Q2, refinancings are on the increase. Connold says: "We have seen an uptick in refinancings, which weren't happening two years ago during lockdown when a lot of debt funded transactions were either M&A or bolt-ons. People have pushed those facilities out because they were happy to stay put, but now those deals need to be refinanced."

Connold highlights the largest-ever private debt financing in Europe in June by The Access Group, a leading software provider. Undertaken by a large group of lenders, the refinancing continued a trend that has been gathering pace over the past few years and has only been accelerated by dislocation in the public markets this year, he says.

Market share growth

The market volatility fuelled by rising interest rates, burgeoning inflation, supply-chain issues, energy cost hikes and conflict in Ukraine has also served to drive banks out of European lending. Mark Brenke, head of Ardian Private Debt, says: "Activity across our core markets in Europe – France, Germany, the UK, Benelux, Scandinavia and increasingly southern Europe – has been very strong in H1. We have seen deals being driven by an acceleration of bank retrenchment over the last 18 months.

"This acceleration has been most pronounced since the covid-19 pandemic and amid the current market volatility," says Brenke. "Our view is that ongoing bank retrenchment will only drive more opportunities for direct lenders in the coming months."

The absence of bank competition across Europe has led debt funds to swallow up market share, with investors attracted to the private credit asset class as a result.

Jeffrey Griffiths, co-head of global private credit at Campbell Lutyens, says: "The European private credit market is still viewed as underdeveloped, with more growth potential and some attributes that make it more attractive than the US to investors."

European deals are still slightly more bank-like in their documentation,

with more creditor protections, which are important in this type of climate, he says.

"In Europe, you tend to see less of a syndication model and more managers doing deals where they are taking down the whole thing rather than sharing with others," says Griffiths. "In the US, it is much more common to have clubs of two or three players, and what that means is that in Europe the lender generally has a bit more power when it comes to documenting terms and it is more of a winner-takes-all market."

Griffiths notes that investors are much more cautious on Europe right now, given the macroeconomic outlook being compounded by concerns over energy security, but he says fundraising is still getting done for the right managers.

Ardian's Brenke says there have been a number of new entrants to the market in recent months, "particularly traditional asset managers looking to diversify into direct lending".

In contrast, there have been few new private debt funds emerging, he says. "Ultimately, investors are focused on managers that can present a strong track record, especially during volatile periods like the pandemic. Those without historic returns to point towards will find it challenging to attract capital.

"It is also difficult for new lenders to differentiate themselves, both for investors and sponsors. On the flip side, market incumbents who have performed well are set to benefit from this period of dislocation as investors place their money with funds they can trust."

"The European private credit market is still viewed as underdeveloped"

JEFFREY GRIFFITHS
Campbell Lutyens

Diversification play

At London-based Sona Asset Management, which specialises in investing across the credit spectrum, CIO John Aylward says: "We find there are pockets of the markets where capital remains scarce due to factors such as complexity – and, consequently, premiums can remain high. These less-competed pockets are often only available to more flexible investors who can solve this complexity with bespoke solutions, creating value. The majority of capital in private credit remains constrained in strict lanes – once you step outside these lanes, premiums can move up aggressively.

"We find there is also benefit of being a resident, not a tourist – satellite teams from US firms, who do not have as long a history of investing in Europe, may struggle to understand the multiple ways that idiosyncratic credit stories can unfold with the equivalent speed of European experts."

The Deloitte data shows that half of all the private debt deals done in Europe in the second quarter of 2022 were unitranche deals, with a further 30 percent being senior loans. PIK deals, mezzanine and stretched senior transactions accounted for 7, 4 and 4 percent of activity respectively, as managers saw an opportunity in more opportunistic strategies.

Eric Capp, partner and head of origination and co-head of direct lending at fund manager Pemberton, says:

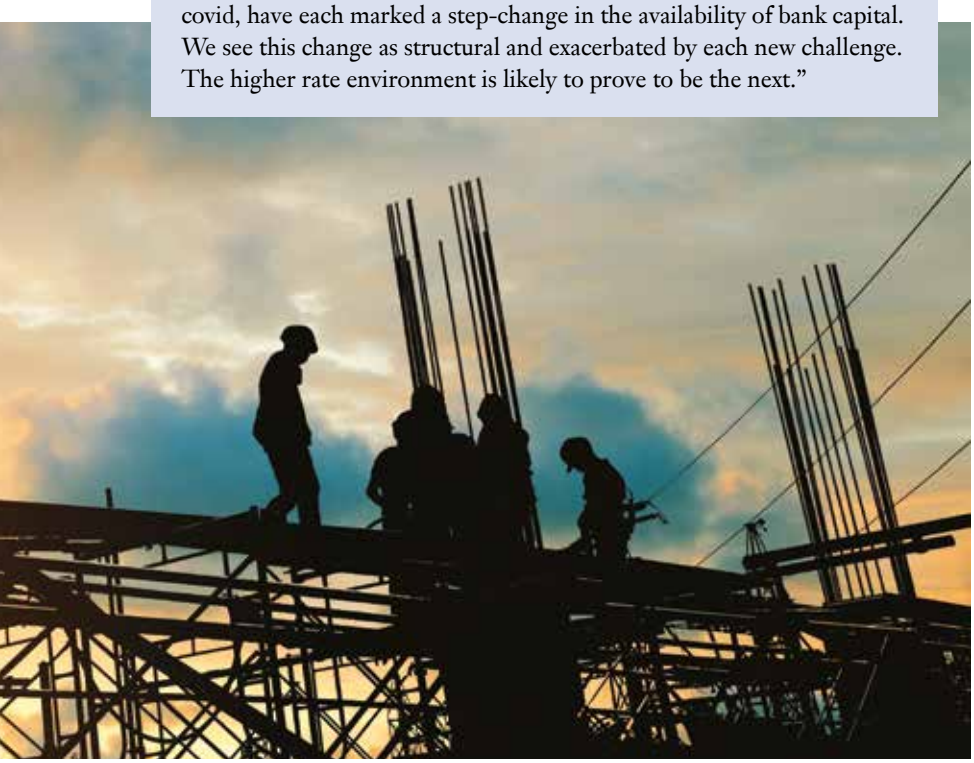
Real estate: 'It's a great time to be deploying capital'

The impact that the looming recession might have on portfolios is front of mind.

However, the shift in the cost of capital creates opportunities, according to Natalie Howard, Schroders Capital's head of real estate debt.

"There are definitely challenges in legacy real estate debt portfolios," says Howard. "Certain sectors have structural challenges, albeit there can be opportunities here to cherry pick opportunities that others may pass over. At the same time there are the sectors which have been the darlings of the last cycle, and which have been acquired on stretch valuations. The fundamental shift in the cost of capital will challenge many of these business plans. It's a great time to be deploying capital rather than managing a legacy portfolio."

She points out that the macro shifts will nevertheless tend to favour private credit: "Banks continue to retrench from the real estate lending markets. Significant market events, such as the global financial crisis and covid, have each marked a step-change in the availability of bank capital. We see this change as structural and exacerbated by each new challenge. The higher rate environment is likely to prove to be the next."



"Pemberton's Strategic Credit Fund is finding opportunities to support incomplete syndications and provide financing solutions to high-quality companies and our banking partners where the syndicated market is not open.

"We're also seeing an uptick in proprietary transactions, where private equity sponsors have acquired in secondary buyouts Pemberton portfolio companies. In these transactions, Pemberton has provided the new LBO financing on a proprietary basis."

Another developing opportunity, he says, is the growing demand for complex first lien financings; "These are often bespoke transactions where the sponsors are merging multiple founder companies in buy-and-builds and require the flexibility offered by our strategic credit funds."

Amyn Pesnani, who heads up Triton Debt Opportunities, the debt arm of European mid-market investment firm Triton Partners, tells a similar story: "As an opportunistic investor, the current freeze in the overall European syndicated and loan markets has created a range of exciting pull-to-par opportunities for us. Mid-market borrowers are struggling to secure financing, so we can step in via opportunistic primaries in addition to secondary markets."

The second quarter of 2022 was Triton Debt Opportunities' most active period of capital deployment ever, he says. "Our deal pipeline is strong. Continued market dislocation and stressed balance sheets will only increase the pool of fundamentally sound mid-market businesses experiencing issues."

Private credit assets tend to benefit from seniority, strong covenant protections, solid equity cushions and the backing of long-term investors, so are well-positioned to weather a recession.

That means that while there are choppy waters ahead for Europe's debt funds, at the end of H1 2022 the story remains one of opportunity just as much as challenge. ■

EXPERT Q&A

The private credit markets in Europe are in good shape to withstand an economic shock, with technology set to reduce risks and increase efficiencies for managers, says Keith Miller, global head of product – private debt at Apex Group

Tough times present opportunities as well as threats

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Q What are the biggest challenges that private debt managers in Europe are facing today, from both a macro and regulatory perspective?

Beginning with the macro perspective, at the start of the year it is true that European dealflow slowed down due to multiple economic factors. Obviously, the cost of raw materials and energy has impacted underlying companies, just as global supply chains have tightened and we have seen high inflation, rising global interest rates and the uncertainty caused by the war in Ukraine. That all had a significant impact on deals getting done in Q1.

Despite that backdrop, private credit, compared to other asset classes, continues to have several advantages that mean it is relatively well positioned. Those include the fact that instruments are generally of shorter duration with floating rates, benefit from an amortising position and generate higher yields that offer a bit of a buffer. So, while there are challenges, in the second quarter of this year we have probably seen an uptick in deals getting done, and that is especially true in the core European direct lending markets of the UK, France and Germany.

At the same time, the banks are naturally struggling to add either new transactions or add-ons to existing facilities, which presents further opportunities to credit funds. That has created new openings for private credit at a point when the funds have probably had a bit of time to absorb the macro consequences and as such have been able to be a bit more conservative on leverage and pricing to take into account the economic landscape.

Economic factors have also created opportunities for private debt managers against the public markets, which have been relatively closed out for much of the first half of 2022. Private credit managers have followed the

"We are starting to see new funds coming through in markets that have traditionally been bank-led"

trend towards investing in larger-scale investments – now regularly hitting the $1 billion-plus mark – and that looks set to continue.

So, there are challenges but there are also opportunities. If we enter a prolonged recession, we are likely to see increased default rates, which have been relatively low for some time, but there will also be opportunities for other strategies that debt funds have in place around distressed or special situations. Similarly, the challenges of inflation are huge, but managers can alter their strategies to invest in assets that are more inflation resilient or where costs can be more easily passed on to final consumers.

From a regulatory perspective, there are not many changes coming through that will have an immediate impact, with the biggest directive on the horizon being the new Alternative Investment Fund Managers regulation, or AIFMD 2, which will impact loan origination. That's a challenge but also presents progress in terms of creating harmonisation in the European framework around loan origination. The published directive so far does not really impact how funds currently operate, but it does remove some of the barriers to transacting across Europe.

Q What role can technology play in helping managers address those issues and remain compliant?

The role that technology can play really comes down to data. We saw during covid that in times of systemic stress there is a naturally enhanced focus on due diligence and on the existing portfolio. That is where service providers, like ourselves, can really provide a fund manager with support, working on everything from engaging with borrowers directly as facility agent to providing information to LPs through investor servicing and all aspects of the administrative workflow in between.

We are generally the first port of call to receive information on underlying investments, whether that is through a GP portal where the managers can get real-time breakdowns of their portfolio, or for tools that we can provide to track covenants on underlying investments. The role of technology in providing that data to managers

"The role that technology can play really comes down to data"

Q What types of requests are coming in from investors in the current environment?

Investors are increasingly aware of the quality of the information they can receive, and they are becoming increasingly savvy and knowledgeable about investment strategies and underlying portfolios. With the enhanced use of technology, we probably receive fewer direct requests from LPs, but that is because we are working with GPs to significantly increase the information flow to investors from the outset. They are asking for more accessible, quality data and GPs are now actively responding to that.

In times of economic uncertainty, investors will want to scrutinise data far more, so it is more important than ever to have that data readily available in real time.

is key and there is certainly enhanced focus on that across the market.

Technology also plays a part in helping managers get a complete real-time view of their portfolio as administrators such as ourselves can deliver an integrated middle office function. We are building more connectivity with managers and providing more real-time input around the portfolio and pricing.

Q Which areas of fund administration and reporting are now ripe for technological transformation?

Technological transformation is the area in which we see the biggest change in our business as a whole. Historically, fund administrators were quite manual in nature and workflows were fairly siloed. Now we are at a point where the ability to provide a fully integrated one-stop-shop solution for a manager, across the lifecycle of a private fund, is critical. Technology, in line with operational best practice, enables that to be possible.

What that means in practice is that our suite of services covers everything from borrowers through to investors. We sign documents with the deal teams, act as facility agents and hold security on behalf of lenders. All of that information is in our systems so it can feed into an integrated middle office solution that gives managers access to real-time data. That creates efficiencies in operational processes and removes a significant amount of operational risk, and then that information feeds through to fund administration functions and investor services.

Today, information is touched a lot less frequently, but it flows through all the different parts of the operational life cycle, right through to providing investors and GPs with decision-enhancing data on market-leading portals. Technology has made all of that a reality. A career in banking used to be about automating processes and taking risk out of the system, and now we have got to the point where fund administrators can do that for private credit. There are add-ons to that, including technology solutions around ESG reporting on investments and funds, which can now all be integrated into the operational and technological workflows.

> *"Going into 2023, I expect to see private credit continuing to take market share"*

In general, we are now at the point where nearly everything has been transformed by technological developments and the range of solutions available. But, that said, it is still a people business, so while technology provides the ability to achieve these things, we still rely on a personal, tailored solution where our teams become an extension of our clients. And there is still more to do. Thinking about the next areas ripe for technological transformation, our focus is on integration with clients from a data and middle office perspective. That is where we are really going next, as well as being able to provide tailored data points that respond to the needs of an individual manager. Over time the whole process becomes infinitely more integrated and more bespoke.

Q Finally, how do you see the outlook for private debt fundraising and capital allocations in Europe for 2023?

If you look at this year, so far Europe is following global trends, with fewer new funds coming to market, those funds are much bigger in size, and they are able to deploy a lot more capital to investments that are generally global in nature. That is indicative of how the market is developing.

Meanwhile, over the last two years the private debt markets have progressed in Europe from replacing bank lending to replacing public debt markets. So, it is going to be interesting as we come out of this stressed period, depending on when that is, whether that shift is here to stay or the extent to which the public markets are going to bounce back. Going into 2023, I expect to see private credit continuing to take market share.

In addition, we are also seeing the maturing of private debt in Europe leading to enhanced fundraising in new countries. There remains a lot of concentration around the UK, France and Germany, but we are starting to see new funds coming through in markets that have traditionally been bank-led and stepping up to provide some of that smaller mid-cap lending.

We are seeing that in countries such as Spain right now, and that is just a sign of the maturation of private debt in Europe as a whole, so that will continue.

In terms of strategies, we do not see a huge shift in the shape of fundraising, with the only strategy that appears to be growing being funds of funds. Again, that is probably largely indicative of the maturity of the market as there are more funds to invest in.

Generally, we are optimistic going into 2023, with the future of private debt fundraising in Europe showing a good pipeline of larger funds coming to market later this year, and we expect that to continue into next year. There are a lot of challenges, but ultimately they also present opportunities for an asset class that is well positioned to continue expanding and taking market share from both banks and public markets. ■

EUROPE REGIONAL DEBT GUIDE

19-page special report

The shifting European landscape

The UK is still number one but France and Germany are gaining ground, according to *Deloitte's Alternative Lender Deal Tracker* (number of deals in the year through March 2022 vs year earlier figures)

	UK	France	Germany	Benelux	Nordics	CCE	Southern Europe
2021-22	246	160	127	79	66	6	64
	+21%	+100%	+39%	+62%	+32%	+100%	+68%
2020-21	194	80	77	49	45	3	38

Europe's 'incredible' growth

The European private debt market was busier than ever in H1, despite the macroeconomic challenges, writes Claire Coe Smith

When you look at the array of macroeconomic challenges facing Europe, the fact that the private debt market posted double-digit deal growth in the second quarter is a remarkable testament to the resilience of market.

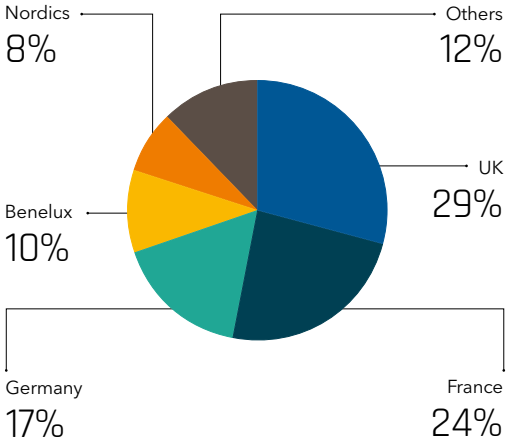
Provisional figures from Deloitte's *Q2 Alternative Lender Deal Tracker*, released as we went to press, show that the number of deals done in Europe in H1 2022 rose 16 percent to 395, from 340 a year earlier. For the second quarter alone there were 216 deals versus 154 recorded in Q2 last year. That's on top of stellar growth in all the major European markets in the 12 months to March 2022 (see map opposite).

The increase in deal volume comes against a backdrop of rising interest rates, inflation hitting levels not seen for decades, supply chains under pressure and energy supplies threatened. Despite all this, Q2 2022 was the busiest second quarter on record, according to Deloitte, as credit funds stepped into a gap left by public markets and banks currently retrenching from corporate lending.

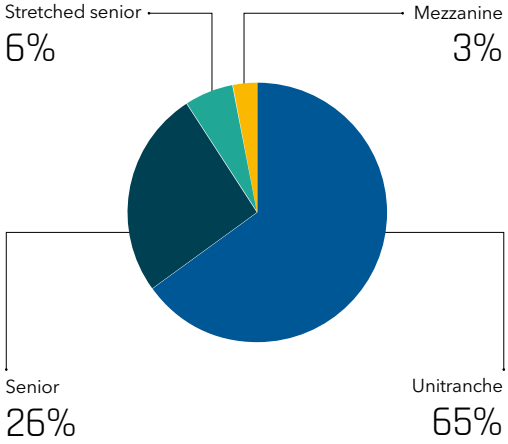
The UK market continues to be Europe's most mature direct lending market and accounted for nearly one in three private debt deals on the continent. The French appetite for direct lending solutions is growing, recording 52 deals in Q2 versus 30 in the same period a year ago. Germany ranked third by deal volume and Benelux was fourth. Private lenders have grown market share at pace in H1 and will keep taking share from banks as both borrowers and institutional investors increase their appetite for their offering, market participants say.

Robert Connold, partner in debt advisory at Deloitte, says: "For the whole of the first half of 2022, the number of deals done in [the] European market is up on a like-for-like basis compared to last year. That is incredible bearing in mind the massive uncertainty going on in the public debt markets during the last six months, since the outbreak of the Ukraine war, and shows how the private debt markets have proved incredibly resilient in times of volatility." ■

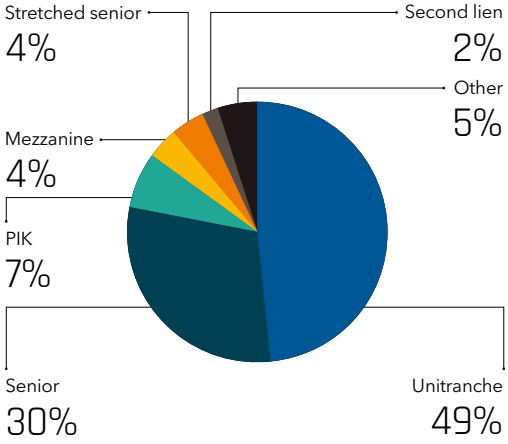
Deal split by country Q2 2002



UK debt deals by structure Q2 2022



EU debt deals by structure Q2 2022



Figures have been rounded
Source: Deloitte's Alternative Lender Deal Tracker

43

Number of funds focused on the UK to close since 2017

$167bn

Total amount targeted by UK-focused funds in market

United Kingdom

While dealflow remains strong, lenders are cautious as we head towards the end of the year

Figures from Deloitte's *Alternative Lender Deal Tracker* show the UK debt market is still the most active private lending space in Europe, accounting for 111 out of the 395 deals on the continent, or 28 percent, in the first half. In all, 65 percent of the UK's private debt transactions were unitranche deals, with 26 percent being senior debt and a further 6 percent stretched senior. The four most active sectors for deal volume were business services, technology, financial services and healthcare, with financial services featuring more prominently in the UK market than it does across the European market as a whole.

Richard Roberts, principal and head of origination and M&A at Arrow Global, says: "Private debt funds have picked up large swathes of private credit lending that was historically provided by UK and foreign banks prior to the global financial crisis. The reluctance of the banks to subsequently increase their lending risk profile as the economy recovered, and the recent reduction of the P2P sector, has increased this trend. We see the UK as by far the largest and most developed private credit market in Europe and the headquarters for most of the US funds that have pioneered some of the securitisation trends that have institutionalised the asset class."

While dealflow remains strong, lenders are cautious going through Q3. Kartesia director Nick Holman, who is responsible for senior opportunities investments across Europe, says that as we go into September 2022, there is not the same volume of deals coming through as there were 12 months ago. "Both lenders and private equity sponsors are being more selective, and I would not be surprised if we see more failed processes on both the equity and debt side because people can't get the leverage, but also because vendors are not willing to lower their price expectations," he says.

"At the moment, there are so many different challenges going on that it is difficult to say with any certainty that you can price risk on certain credits. For those resilient businesses though, in the right sectors, the debt funds will be able to take advantage of diminishing bank lender appetite as we go through the cycle." ■

France

The market in France remains very competitive between banks and credit funds

28

Number of funds focused on France to close since 2017

$11bn

Total amount targeted by French-focused funds in market

France solidified its place in the number two slot in terms of European deal transactions in the first six months of the year. France witnessed 99 private credit transactions in the first half of 2022, a considerable increase on the 65 deals seen in H1 2021. The market accounted for a quarter of all European direct lending deals, up from 20 percent for the same period last year, according to Deloitte figures.

Houlihan Lokey's *MidCapMonitor* report for Q2 2022 records that the deal activity in France has continued to be driven by new financings, which accounted for 64 percent of transactions in Q2, and notes that the majority of closed transactions were in industrials, business services and consumer, showing lenders have appetite for most sectors.

Robert Connold, partner in debt advisory at Deloitte, says: "In France, access to government-backed support schemes was much more readily available to private equity-backed transactions during the pandemic, and as those schemes are rolling off, people are refinancing back to third-party debt, which is driving some of the uptick."

Maxime de Roquette-Buisson, managing director for private debt at Eurazeo, says macroeconomic conditions are not so far causing significant challenges to French private debt portfolios: "Being primarily exposed to service-based companies, we expect a limited impact from energy prices," he says. "However, recruitment is still a challenge when we look to sustain strong growth momentum."

The Houlihan Lokey report notes debt funds recorded 50 unitranche and senior debt deals in the first half, compared to 53 completed by banks: "The market in France remains very competitive between banks and credit funds, with an almost equal share of the market," says the report. "While the credit funds are able to provide more leverage and flexible terms, the banks continue to be able to price much cheaper than credit funds. However, we have recently noticed an increase in margins from banks." ■

EXPERT Q&A

Direct lenders in Europe have gained ground in the absence of syndicated lenders, and are unlikely to look back, says Adam Wheeler, co-head of global private finance at Barings

Structural change in Europe as funds take market share

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BARINGS

Q Given the current macroeconomic landscape, what are the current pressure points for private debt portfolios in Europe? Where are you seeing underperformance or concern from management teams?

Clearly there is a lot of discussion around inflationary pressures flowing through into the real economy, and the impact of higher interest rates.

When I look through our issuers, of which there are almost 100 in Europe and over 350 globally, I have been surprised by how well portfolio companies have held up so far. We don't have a lot of high energy users in our portfolio, so there is not a lot of impact from higher oil and gas prices – but we have certainly seen supply chain issues and wage inflation flowing through. However, where that impact has been felt, companies have generally been able to pass through price increases because demand has remained strong.

The companies that we lend to are generally in more defensive, less cyclical sectors with some pricing power, where demand is still robust. We haven't seen any real margin compression, but as interest rate rises start to bite in the broader economy, we would expect to see some softening of demand and probably some margin compression.

We currently have more equity underneath us than ever before, and that is partly due to the high prices that private equity has been paying for assets. So we have a good cushion. By and large, if you have a high level of diversification across your book at fund level you are going to be okay.

Q How do the challenges differ between syndicated and private markets in times of volatility?

The syndicated loan markets and the high-yield markets remain basically shut at the moment, which means a lot more transactions are coming to the private markets. Private markets as a

whole saw an extraordinary number of deals done and dollars deployed in the second quarter of 2022, in both Europe and the US. In Europe in particular, we compete against the banks who remain a large part of the mid-market leveraged finance world, and they have pulled back quite a bit.

So M&A has been relatively strong given the circumstances, and more of that financing has flowed to direct lenders because of the lack of competition from banks. We have recently started to see pricing move up, leverage come down and terms improving to favour lenders.

My view is that this is a structural shift that will not fully reverse, as the direct lending community now has sufficient scale to start doing large transactions by pulling together clubs of direct lenders. That has been happening in the US for some time, and we can expect more of it in Europe. From a borrower perspective, it provides more certainty of execution, which is why we will likely start to see the private markets replacing at least the bottom layer of the syndicated loan market, and potentially more than that.

Q Given your perspective on both the North American and European investment committees, how do the situations in the two regions differ right now?

M&A activity seems to have slowed down faster in North America than it has in Europe, which is surprising given the geopolitical landscape in Europe. We have also started to see pricing move out faster in North America – it does tend to lead the way, with Europe then following suit.

In terms of relative value, Europe is probably slightly better positioned, but there is a much deeper market in North America, where you can get access to transactions in order to deploy capital at scale and build a well-diversified portfolio. The barriers to entry are higher in Europe because a lot of what is done here is done on a sole-lender basis.

Q Despite these challenges, European private credit markets have seen a number of new entrants in the last 12 months. How has this changed competitive landscape impacted the way in which managers win deals?

The asset class keeps on growing and is one of the few asset classes to which LPs, and pension funds in particular, are looking to increase allocations.

In Europe there are a lot of new entrants, but we have seen a consolidation around a small group of lenders. The whole market continues to expand in terms of both the number and size of transactions, but that small group is doing an ever-increasing amount and taking market share. You then have a long tail of people struggling to get dealflow.

In an environment that is uncertain, private equity firms like to transact with people they know they can rely on. So scale, incumbency and deliverability are particularly important right now.

Most of the transactions we do have some sort of proprietary angle, either because the private equity firm has secured a deal that is proprietary, or because they are trying to secure exclusivity in the auction process. In those circumstances, they need to go to a very small group of lenders to get access to a debt facility, and they are focused on deliverability. It is not about a difference of 25 basis points of margin, or giving ground on some of the terms – it is whether they can get there in the timeframe and have a broad structure that works.

"The barriers to entry are higher in Europe"

You have to be one of the handful of lenders that a sponsor wants to work with to get access to that dealflow. Otherwise, you risk getting stuck with auction processes that tend to go to the lowest common denominator.

Q Finally, how would you describe the outlook for European private credit going into 2023?

The outlook is more uncertain in the medium term, so we have to expect a slowdown in deal volumes. I think we will see private equity firms holding onto companies for longer, because it will be more difficult for them to exit at a price they want to achieve, and there will be fewer refinancings because they will be more expensive – meaning firms will hold onto debt for longer.

All of this underscores the importance of being selective about what you do and the types of companies that you lend to. There will be opportunities, because pricing is still attractive, with base rates increasing and ours being a floating rate instrument, and because private equity has so much dry powder. But protecting the downside and not losing any money will always be key.

As we look across the market today, we see value in being senior in the capital structure and conservative in the way we deploy capital. As we come out of the downturn, opportunities may open up further down the capital stack where there is a shortage of capital, and there may be opportunities to get equity-type returns for that, but we are not there yet.

Right now, our pipeline remains robust and we continue to see attractive opportunities across the private-credit landscape. Some of that is down to the structural shift we are seeing in Europe as banks continue to retreat, which suggests that private credit will continue to gain market share through the cycle. ■

14

Number of funds focused on the DACH region to close since 2017

$3bn

Total amount targeted by DACH region-focused funds in market

Germany

Private debt proved its resilience in the first half, compared with the increasingly volatile public markets

The German private credit markets reported 53 transactions in the first half of 2022, up from 41 in the same period last year and a 13 percent share of the European market, according to Deloitte's *Alternative Lender Deal Tracker*. Debt funds and banks were both pretty active in the second quarter, with 48 percent of the deals done by banks as they confirmed that they remain open for business, shows Houlihan Lokey data.

Mattis Poetter, co-CIO at European fund manager Arcmont, says: "The German private debt market remained active in the first half of 2022. While direct lenders have become more cautious in certain sectors, including consumer and industrials, general activity levels have remained high."

This, he says, could be seen as a "testament to the resilience of private markets" in comparison with the increasingly volatile public markets. Poetter says a particularly active sector for private debt in Germany is healthcare services, which remained the case this year with a number of deals done in the sector in recent months.

"Many borrowers are turning to private debt as a long-term reliable financing partner, which has opened many opportunities for direct lenders to invest in large high-quality companies at attractive terms. In particular, pricing and leverage levels have significantly improved in response to public market volatility and the lack of alternative sources of capital available to borrowers."

Jakob Schramm, partner and head of private credit at Munich-based Golding Capital Partners, adds: "As the liquid markets have been less available to borrowers, a significant market opportunity has opened up for private credit, often at meaningfully better pricing than before."

While Germany is particularly susceptible to the impact of cuts to Russian gas imports, which accounted for 55 percent of the country's gas consumption in 2021, that vulnerability is yet to impact credit portfolios. Schramm says: "So far private credit portfolios have been very stable across the board. Even if some companies are seeing some challenges, most direct lending GPs have structured their loans with sufficient buffer to withstand some short-term softness in operational performance." ■

Benelux

Benelux has built a strong fourth position in European deal volumes, supported by strong fundamentals

4

Number of funds focused on Benelux to close since 2017

$210m

Total amount targeted by Benelux-focused funds in market

In recent years, the Benelux region has gradually emerged as the solid fourth-place market for European private debt, with a growing deal volume, placing it comfortably on the tail of the UK, France and Germany by deal volume. In the second quarter, the Benelux region saw 22 transactions, equivalent to one in every 10 transactions completed in Europe, according to Deloitte's *Alternative Lender Deal Tracker*. That continues the solid growth of the Benelux market where deal transaction volume rose 55 percent to 79 deals in the year ending March 2022.

The market leader is the Netherlands, which is responsible for three-quarters of all Benelux deals. Reza Atighi, CEO of European fund manager Arrow Netherlands, says: "The private credit market in the Netherlands is seeing clear growth, as the incumbent banks continue to retrench from selected segments, and as the underlying demand for credit remains very strong.

He says credit funds are seeing particularly strong opportunities in real estate lending, spanning the spectrum of bridge lending, property development and buy-to-let investments. Alternative lenders are also building up a growing footprint in newer finance areas, such as leasing and SME finance.

Atighi says the economy is holding up well and the universe of private lenders is growing. "So far in the Netherlands the economy has continued to perform well, despite the building headwinds linked to inflation, energy prices and higher interest rates.

"Looking out, however, there is a clear expectation that also the Dutch economy will be impacted, with knock-on effects on asset quality and credit demand."

He says the shift from banks to alternative lenders is gathering pace in the region, and there continues to be healthy interest in the Dutch market from international credit funds. "Probably the key impediment in the Netherlands is the yield levels attainable, which currently make it challenging for certain private debt funds to operate. Given the expected rise in yield levels, and broader dislocation in the markets, pricing levels are expected to adjust to new, more attractive levels." ■

EXPERT Q&A

The Nordic region provides a huge market for private debt investors, says Capital Four CEO Sandro Näf

Opportunities in the Nordics

As winter approaches, Europe faces a grave economic crisis – but the Nordic region looks better placed to weather the storm than most of the continent. Sandro Näf, CEO of Capital Four, a Copenhagen-based fund manager, says that the structural resilience of the Nordic economies, combined with the maturity of the private equity market, makes the region ideally suited to private debt investment. With traditional sources of finance less willing to lend, Näf says that private debt is poised to expand its role, providing much-needed diversity in the supply of capital.

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Q Why do the Nordics present an attractive environment for private debt lenders?

The Nordics have a rich tradition of private equity, dating back to the 1980s. The type of business model that requires relatively high amounts of debt to support concentrated ownership is well established in the region. The direct lending market has been evolving at a good pace, and it has a lot of potential to attract investors that have previously invested in private debt in the US or the broader European market.

On top of this, Nordic economies provide a very resilient economic environment. We saw that during the pandemic, when GDP contracted much less than in other parts of Europe. Scandinavian countries have low debt-to-GDP ratios, so there is more fiscal headroom.

These countries also tend to rely less on industries that are capex-intensive or cyclical, and the sectors where we like to deploy, such as healthcare, technology and business services, are very resilient. Then there are very strong legal protections for property rights and creditors' rights – similar to the UK, and much better than countries such as France or Italy.

Q How is macroeconomic and geopolitical volatility affecting private debt lenders in the Nordics?

We are, of course, facing a global slowdown. That means we're more selective and more conservative on leverage. The changes in pricing in the liquid market have a knock-on impact on the pricing of private debt deals, and the somewhat greater risk backdrop is reflected in the higher spreads in our deals.

The private equity sponsors understand that financing will become more expensive. Many sponsors say they will put less leverage in deals because the interest rate costs are higher and they don't want to overburden the portfolio companies. But, partly because of interest rates increasing, multiples have come down somewhat. So, private equity sponsors can get the same IRRs on less levered companies because entry multiples are lower.

The Nordic economies are generally less vulnerable to the energy supply crisis because they produce energy domestically and are leaders in renewables. When it comes to labour imbalances, the region is in a better situation than the US because we have more surplus labour and a flexible workforce. Inflation has increased, but we think it is close to peaking. Interest rates are not going to explode, and it could be quite positive if they stabilise at a slightly higher but still relatively low level.

Q Are private debt lenders well positioned to take advantage of the reluctance of banks and other traditional sources of debt finance to lend in the current environment?

Yes. We have been very reliant on banks to supply capital or debt funding in Europe, and perhaps for a longer period in the Nordics. To rely on one source of funding puts companies in a difficult position – much like relying on one source of energy makes a country vulnerable. So, we should not have a narrative around banks versus the private debt market. We are not doing 'shadow banking' – we are enabling our economy to benefit from having richer sources of capital. Having alternative sources of funding for companies is fantastic for the economy.

> *"The Nordic economies are generally less vulnerable to the energy supply crisis"*

A lower-middle-market company is not going to be able to access the public bond market or the leveraged loan market. It probably cannot access private debt provided by the biggest players. So, we think there is a particular opportunity for us to support these lower-middle-market companies, of around €10 million to €20 million EBITDA. That's a very interesting sweet spot.

Q To what extent will demand for private debt come from private equity sponsors in the coming years?

There's obviously a lot of dry powder in the private equity community and that will continue to be a driver for private debt. But we don't invest in sponsored deals because we like sponsors. We like to do deals with sponsor-related transactions because of all the ingredients that come with it. The concentrated ownership model, where you have highly incentivised employees, very focused boards, investment horizons of four to five years, and heavy use of consultants, has been extremely successful.

But there is no reason why this model can only be applied by private equity. We could see that playbook being used even in family-owned businesses. We think that direct lending will spread more and more to non-sponsored transactions. Lenders will push down the things they like about the private equity market – good governance, strong business plans – to the owners of other businesses.

We can't just hop onto all the sponsored deals because certain types of sponsors look for high volatility to maximise potential returns. That's something we avoid. We look for companies with high cash conversion and lots of resilience to a recession. Our approach has remained consistent because no matter at what point in the cycle we invest, we have to make recession-proof investments.

Q How can private debt lenders integrate ESG considerations into their investment decisions?

It helps us that Nordic companies have been taking ESG very seriously for a long time. Our own approach is heavily influenced by our exposure to liquid bonds and loans; the approach we've developed in the liquid markets has filtered through to the private debt side.

We've developed a scorecard to assess our investments against ESG criteria. The single most important thing is our fiduciary duty – we believe a strong ESG profile is good business. So, we want to avoid having companies in our portfolio that operate in harmful industries and don't address the problems. Scoring is just the start – it provides a basis for us to enter into dialogue with the borrowers. We find they are very open to that.

The challenging part is implementing Article 8 of the EU's Sustainable Finance Disclosure Regulation in our private debt portfolio. We've spent a lot of time with regulators and legal advisers, and we've developed a solution where we price coupons in relation to KPIs on sustainability. We want companies to be aware of what we want and to collaborate with us. I think that works very well – our next fund will be Article 8 with relevant sustainability linked KPIs on the individual deals. ■

9

Number of funds focused on Nordics to close since 2017

$5bn

Total amount targeted by Nordics-focused funds in market

Nordics

Sweden and Denmark continued to be the main drivers of dealflow in the first half

A total of 19 senior and unitranche deals were reported in the Nordic region in the first half of 2022, according to Houlihan Lokey, and 14 of those deals were done by private debt funds versus banks. That figure of 19 deals in H1 compares to 45 completed in the region in the full year 2021 and 25 in the full year 2020, showing how activity has remained fairly strong.

Sweden and Denmark continue to be the main drivers of dealflow in the Nordic region, with more than seven out of 10 closed transactions in the region emanating from those two countries in the first half of 2022.

Sandro Näf, co-founder and CEO of Copenhagen-based Capital Four, says: "If you look across the market, we have experienced a good first half-year but we expect a slowdown in the second half. The overall professionalisation of the private debt market is developing very nicely, with both institutionalisation of debt structuring and more and more sponsors in the mid-market creating dedicated teams, and the ESG agenda quickly spreading from the private equity community into credit."

In terms of sectors, Näf says: "The biggest areas we are typically engaged in are healthcare, technology and services, and those have actually done well from a deployment perspective. Those of course are areas that have proven over the past decade to be more resilient, and they are becoming more popular as we face more challenging quarters ahead."

Stockholm-based ARCOS Capital launched its inaugural evergreen private debt fund in February this year with support from a small number of large institutional investors, targeting senior loans in the Nordic, DACH and Benelux region for companies with more than €10 million of EBITDA.

Founder and managing partner Johan Hultner tells *Private Debt Investor* that there is an opportunity in the lower risk end of the market where banks have traditionally dominated, applying tight deal terms and modest amounts of leverage: "Investors can already get quite a lot of exposure to unitranche through the direct lending funds but they see us as a way to capture the safe, senior end and diversify their risk-return." ■

Central and Eastern Europe

The retrenchment of banks is proving a boon for private debt markets, especially in Poland

4

Number of funds focused on CEE to close since 2017

$760m

Total amount targeted by CEE-focused funds in market

Almost exactly a year ago, Warsaw-based fund manager CVI achieved a first close on what it claims was the first institutional direct lending fund ever to focus on Central Europe. Today, CVI has the biggest direct lending team in the region, with more than 30 professionals already on board, and partner Marcin Leja says business is good.

"The single most important issue for this region is the further retrenchment of bank financing, especially in Poland," says Leja. "The banks have been hit because when interest rates went up the government decided they needed to subsidise mortgage holders and introduce credit vacations, so every mortgage holder can forego payments for four quarters at a cost to the banks. That hit to bank balance sheets immediately hit credit appetite.

"That hit has created much more room for alternative finance and we already see a clear pipeline, which is much more than we can invest in. That is good because it means we can be selective in the deals we do, and we are not chasing deals, but at the same time if we had more money we could invest it."

He says a growing number of global managers are now looking to do deals in Poland, but it is the outcome of the war in Ukraine that will determine the scale of the investment opportunity for private debt. "We had a huge influx of Ukrainian refugees that created an additional two or three million inhabitants in Poland. Some of those people will return to their homeland once the conflict is over, but the number of people in Poland was going down so the influx creates more consumers and more workers."

In addition to Poland, Leja says Romania and the Baltics are the two markets that are most attractive to debt funds: "They are less developed in terms of capital markets and so the sources of financing available to local companies are even more limited than they are elsewhere." ■

EXPERT Q&A

Portfolio compositions are evolving in Europe to give greater weight to real asset-backed credit. Accessing that opportunity requires on-the-ground expertise, say Arrow Global's Zach Lewy and John Calvao

Why local knowledge counts in Europe

The private debt industry in Europe has historically been dominated by corporate credit. But, as the continent faces the prospects of economic turmoil, credit backed by real estate assets has an opportunity to grow in prominence.

Zach Lewy, CEO and CIO of Arrow Global, and John Calvao, the fund principal at the firm, explain that they have found success by focusing on smaller deals across five European countries. Their approach relies on having large specialist teams on the ground, who can use their local knowledge to assess risks and spot opportunities.

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Q What advantages do you gain by investing in assets backed by real estate collateral?

Zach Lewy: Private credit has historically been dominated by corporate credit, but I think in the future there's also a chance for private credit to be a very influential part of asset-related credit. The typical way that investors build their portfolios in Europe differs from how they actually see the world. Most types of bonds and loans are underpinned by corporate earnings. And if you discuss with investors whether they have confidence in Italian or French corporate earnings, especially heading into a recession, you find that people do have legitimate doubts about the credit resilience.

But people are hugely confident that there's a very sustained base of demand for high-quality real estate in Europe. Who doesn't want to own one of the spots on Place des Vosges or in Sloane Square?

So, I feel like the music will change and portfolio compositions will evolve in Europe to give greater weight to real asset-backed credit. The barrier to that is that to be a good investor in the Place des Vosges or Sloane Square, you need to be a local expert. That's a much more operationally intensive requirement.

Our strategy is to be present in those markets and make the very attractive risk-adjusted return of that local real estate available to investors in those locations. As part of that, we will open up for them more asset credit than they currently have, because the only thing that's been available is corporate credit.

Q How do you assess the quality of collateral?

John Calvao: In our most recent fund, over 90 percent of the investments are backed by real estate, cash in court orother mixed securities. It's central to our investment thesis. And when we're underwriting deals, it's super important to have very good collateral and to have the ability to monetise that collateral in the future, if needed. You might have a piece of property that looks great, but it might have been built without a licence and would probably be worth zero. So, being able to assess the quality of the collateral is at the heart of what we do.

We own multiple platforms across the five countries where we operate, many of which have been operating for 15-20 years, and we have around 2,500 people working for us in total across these 18 platforms. We rely heavily on our local teams to evaluate the collateral and also to understand the market conditions and the legal aspects of deals. There's no way we could do that, especially for the smaller deals that we prefer, without having local teams on the ground.

Q How does having specialist local teams help you identify deals and tap into opportunities?

ZL: We can use our servicing economy of scale to access transaction sizes of as little as €3 million. That allows us to play in areas where the traditional Mayfair-based manager just can't efficiently transact. When you look at a big global fund, they might have raised $5 billion and have 40 employees. We've raised $1.7 billion with 2,500 employees. We are in a completely different category and we can play at the local level.

Being local and having the right local franchises at a granular level across Europe is more compatible with how the European market operates. If you are sitting in London and trying to find a mega deal, you might have to wait a very long time.

JC: Having local platforms allows you to pick the deals you want to do to some extent, as opposed to being shown a portfolio that gets put out to an auction. We have done some very large transactions off market. We do a lot of secondary trades – being local and having the expertise to better understand why assets haven't sold to date enables us to operate in that secondary market very effectively.

Q One of the countries you focus on is Portugal. What kind of opportunities do you see there?

ZL: We have just been visiting some of the sites that we own in Portugal and it's hard not to feel optimistic. In the hospitality sector, there's a backlog of people who want foreign holidays. That demand is already pushing activity in Portugal beyond pre-pandemic levels.

Q Southern European markets like Portugal are often perceived as riskier. What are the key elements to being able to invest successfully in the Portuguese market?

JC: Portugal is a small country, it has around 10 million inhabitants. It's a country where being local is especially important. You need to be on the ground with people who understand the language and culture, not to mention the courts and legal system.

ZL: In terms of managing risk, the key is simply to have the best assets you can and stay cognisant of the macro picture. The best solution to those kinds of risks is to invest in assets that have relatively short lives. If your assets are paying back, they are amortising, so you are reducing your exposure over time. If you are taking 10 years of risk with no interim return, then clearly, you are far more exposed.

Obviously, you want to maintain a sensible portfolio construction, with sensible exposure to particular asset classes, jurisdictions, or other parameters. At the end of the day, hypothetically, if Portugal were to fall out of the eurozone, that is going to have an impact. But if you have got the higher quality collaterals in that country, you're more immune from that kind of a downdraft. So, it's a combination of asset quality, portfolio composition, having the right limits and keeping duration short.

JC: The Portuguese business is one of our more robust businesses. I think we are approaching a thousand employees in Portugal. We are a major, major player in that in that market.

We have created quite a few verticals there and it puts us in a very strong position in the marketplace. We have an anchor servicing platform, Whitestar, which mostly operates in the residential space, but also covers performing and non-performing loans. Then we have a real estate management company, Norfin, as well as a company that specialises in corporate restructuring, Restart, and we have several assets in the hospitality space in our fund.

Q Turning to migration risks when moving portfolios from sellers to buyers – what are the key things to consider?

JC: In terms of getting a deal right, migration is priority number one. You don't want to get that wrong because it could create a massive problem for you – legal problems, regulatory problems and obviously problems from a performance perspective.

A lot has changed in the last few years. The banks have become much more experienced, and sellers have become much more experienced at moving data. Regulators have also focused on this a lot more. Our platforms have an enormous amount of experience, doing this for the last 15-20 years in some cases. They have ported thousands of different sellers over the years. They have seen every system migration you can imagine. They have done every seller migration you can imagine. Banks even come to us sometimes to help with migrations, because they recognise our capability and our capacity to migrate the relevant data.

Q Are there any other private credit strategies that are particularly attractive in the current environment?

ZL: We are very optimistic about the role that private credit can play in the European economy. We have never been busier across a range of different activities. One of the interesting strategies is bridge lending. There are some long-standing operators whose loss rates are infinitesimal, but are able to charge a large convenience premium for the nature of bridge lending. If you have got a deep origination machine, you get paid very strong returns for that.

Another one to highlight is construction lending. It's got a lot of risk, in the sense that rising costs, rising interest rates and supply-chain disruptions can all bring challenges. So, are banks really going to be the best operator of that risk? I think actually there's a very interesting place for specialist firms in lending to construction. Plus, there's a significant amount of bankruptcy activity in construction – as well as in sectors like transport, travel, retail and offices, so that provides opportunities on the distressed and restructuring side.

Also, more and more investments will go into the energy transition, particularly in asset finance. It's a trillion-dollar theme. As you go building by building, you see so many compelling use cases for energy investments that need to be funded. For example, today not many people in hot countries have air conditioning that gets switched on and off through a motion detector. But five years from now, having air conditioning that doesn't work through motion detectors will probably be seen as unacceptable. So, a lot of these dynamics will go from nascent to mainstream at a very rapid rate.

Going back to our original thesis though, the more local you are, the more you will be able to originate, service and optimise these assets as they present themselves. This local presence has allowed us to generate a strong track record delivering an average gross 18 percent IRR for more than ten years with a sub 1.5 percent loss rate. ■

"We're very optimistic about the role that private credit can play in the European economy"

ZACH LEWY

"The Portuguese business is one of our more robust businesses"

JOHN CALVAO

Southern Europe

SMEs are increasingly keen to work with private lenders, with Spain a standout market

20

Number of funds focused on Southern Europe to close since 2017

$4bn

Total amount targeted by Southern Europe-focused funds in market

The penetration of private credit in Southern European markets continues to gain momentum, with several major lenders opening offices in Spain and dealflow increasing even in the face of economic shocks.

Javier Castillo, who is based in Madrid with fund manager Kartesia and is responsible for senior opportunities in Iberia, says: "Both local and international sponsors have remained quite active in this region, with international sponsors increasingly looking into Spain's mid-market as they diversify away from historically core markets like the UK and France.

"That growing interest, combined with local private equity funds and SMEs increasingly eager to work with private lenders and banks reduced capacity to cover the mid-market space, has led to quite a robust level of activity since September 2020 and so far in 2022."

Tikehau Capital, which has had a physical presence in the Spanish market since 2015, also sees huge growth potential for direct lending. "Although banks remain the main source of debt funding in Spain, there are an increasing number of cases where private debt is the preferred source of financing, either by itself or to complement a bank financing," says Carmen Alonso, head of UK and Iberia at the firm.

In Italy, Arrow Global's head of credit strategy, Daniele Patruno, sees an array of opportunities: "We see space for growth in lending to real estate development projects, mainly residential, hotel refurbishments, office upgrades to ESG standards and logistics." Others include energy and corporate restructuring solutions with capital provided by special lenders, sometimes alongside carefully selected equity partners. "Competition can be fierce, especially in top locations and high-quality assets, but flexible and innovative investors can find space to grow."

Portugal is still at an earlier stage of development: "Contrary to what happens in more established markets, the private credit market in Portugal is still in its early days. That said, we are seeing more activity in the past couple of months as new players have come into the market looking for opportunities, especially in the real estate hospitality finance space," says João Bugalho, CEO of Arrow Portugal. ■

Spain retains allure for private lenders

Spain's private debt market has continued to grow strongly this year, outpacing many other European markets, writes Blake Evans-Pritchard

Spain has emerged in recent years as one of the fastest growing private debt markets in Europe. That's reflected in the number of global lenders that have opened offices in the country over the past couple of years, including Pemberton, Ares and Tikehau Capital. This may be one of the factors sustaining growth in the market.

Pemberton says that, since opening its office in Madrid in early 2020, it has undertaken 14 deals and has invested more than €1.5 billion.

"The Spanish private debt market is less mature than that of other European countries. It has evolved significantly in recent years [but] there is still a lot of potential for the market to grow," says Leticia Ruenes, Pemberton's head of Spain.

"At the moment the majority of our deals have been done with international private equity houses with local presence in Spain – we are increasingly partnering with local private equity funds as well. The financing of these sponsored deals has historically been very bank-driven, but as they have positive experience with private debt funds and our advantages are becoming better perceived by the community, they are increasingly looking to do more deals with funds like us instead of banks."

The latest figures from *Alternative Lender Deal Tracker*, published by Deloitte, show 42 deals completed in Spain the year ended March 2022, up from 26 in the previous 12 months.

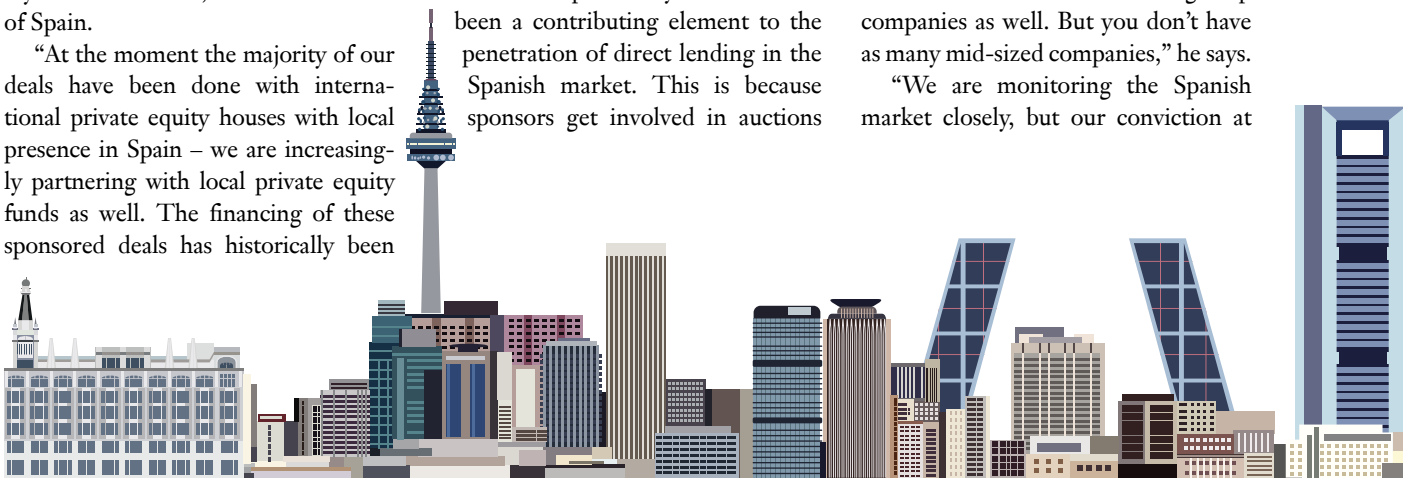
"Since 2014, the Spanish market has witnessed a growing interest in private credit, both from lenders and borrowers, who now understand the products much better and how they can benefit from the flexibility of alternative capital solutions," says Guillermo Ferre, director at Kartesia, which is active in the country.

"Over the past two years M&A has been a contributing element to the penetration of direct lending in the Spanish market. This is because sponsors get involved in auctions and, given the competitiveness of the private equity space, having the speed and certainty of execution is essential. This is something that direct lenders can provide, while banks tend to be much slower."

This is not to say that global players everywhere are quite so eager to jump into the market.

Stephan Caron, head of European mid-market private debt at BlackRock, says that he would like to see more concrete data that the trajectory will be sustained before putting boots on the ground. "A lot of the financing that we do is geared towards mid-market companies that have an EBITDA of between €10 million to €50 million, whereas in Spain you have a lot of fairly small SMEs with EBITDA below €5 million. You have a lot of large-cap companies as well. But you don't have as many mid-sized companies," he says.

"We are monitoring the Spanish market closely, but our conviction at



the moment is not as big as for other parts of Europe. If we see new data that points to a further retrenchment of banks, then we'll revisit our views on the country."

Headwinds

As in other European countries, the private lending sector in Spain has been buffeted by headwinds from the Russia-Ukraine crisis, which has led to surging inflation and increased the dangers of a full-blown recession.

This uncertainty has suppressed lending appetite and narrowed the universe of companies that direct lenders are prepared to invest in.

"Sectors that are proving popular for private debt investment are those that are very cash generative and resilient to the current macroeconomic climate," says Alonso Torre de Silva, managing director in the credit group of Ares. "There should be no surprise that sectors more affected by the current macro environment – such as cyclical companies or companies impacted by cost inflation – may be a bit less popular these days."

He says sectors such as technology, media and telecommunications, pharmaceuticals and business services tend to be the most active in Spain now.

Pemberton's Ruenes says that prices have widened significantly in Spanish debt over the summer on the back of rising risk sentiments, and she expects them to remain elevated for the next six months or so.

A lot of this, of course, will depend on the extent to which banks pull back from the market and create that opportunity.

This is where the jury is still out. Whilst Caron from BlackRock believes there is still not enough data to show categorically that banks are retrenching in any meaningful way, many of those on the market say that they have noticed a growing reluctance of traditional lenders to finance transactions in the current climate.

Torre de Silva says: "Banks certainly seem to be reducing their appetite for leveraged finance transactions, so from that perspective, direct lending funds can certainly replace some of the gap."

> *"If you look at the Spanish economy, there is a huge base of SMEs"*
>
> **GUILLERMO FERRE**
> **Kartesia**

As a specialist lender to SMEs, Kartesia stands to benefit as banks pull back from the market. "If you look at the Spanish economy, there is a huge base of SMEs, many of which tend to be family-owned businesses that in the past have worked only with banks," says Ferre. "The more they understand alternative capital solutions, and the flexibility they can offer, the more they will be in using private debt funds."

The key to working with SMEs is to offer wider value to the business in addition to financial support, says Ferre.

"You will continue to have companies that banks are very well positioned to continue to lend to, but as soon a company has significant growth/restructuring plans or the business is a bit more complex to understand, the required flexibility or level of risk is less palatable for banks."

This structural change in the market also opens up the possibility of more partnerships between private debt funds and traditional lenders.

"Banks may be focused more on working capital or Term Loan A amortising facilities, while funds are comfortable with bullet structures, including Term Loan B, holdco and mezzanine tranches," says Ferre. "Term Loan B funding is likely to be more expensive, but if you combine this with Term Loan A funding from banks, you eventually achieve the same solution for the borrower but at a lower cost."

While not everyone is convinced a structural shift is taking place, the strong growth of the last few years means the country cannot be ignored.

Caron draws parallels with Germany and thinks that Spain could go a similar way. Six years ago, Germany wasn't much bigger than Spain is today, but the market suddenly took off. These things can happen very, very quickly, says Caron. "There comes a point in many markets where an inflection point is reached, and we haven't seen that in Spain yet. I think this inflection point will have to be driven by a wider retrenchment of the banks. Ultimately, if the banks become capital constrained and start pulling back in a more meaningful way, this could drive more private debt opportunities," says Caron. ■

EXPERT Q&A

As public markets adjust and opportunistic credit comes alive, there are plenty of reasons to be excited about private debt, says Andrew Konopelski, managing partner at Bridgepoint Credit

'Q2 was our busiest quarter ever'

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Q How would you describe the current state of private credit markets across Europe? Where are the opportunities and challenges?

The credit markets right now are trying to find their balance. The public markets have been largely shut since March, leading to new issuance volumes being down 70 percent year-to-date in the leveraged loan and high-yield bond markets. This has created many different and interesting opportunities for private credit.

The clear trends in Europe have been a return of risk premiums, a return of base rates and a very large shift to private markets. Q2 was our busiest quarter ever because everything found its way to private markets: a large M&A pipeline, new credits and many European markets that to date have not favoured private credit all turned to it. For example, the Benelux region, the Nordics and Spain were more active last quarter and became increasingly positive towards private credit.

That uptick has not just been in direct lending. Opportunistic credit is proving to be a very good partner and able to deliver attractive financing solutions for sponsors in times like these. Europe doesn't always price risk well in times of change and this is the first time that private markets have been of the size and maturity needed to step in and fill some of the more complex financing needs in the market. Private equity sponsors have been pleased with the result as it has enabled them to continue to complete their transactions, both primary deals and add-ons. Private markets have also been clearing bank risk, something we've seen through our CLO and direct lending businesses with the clearing price almost right on top of direct lending target returns.

Finally, one of the main trends has been the divergence between high-quality credits and those that have been more impacted by the invasion of Ukraine and macroeconomic challenges. You not only see this in pricing, but you also just see very little willingness to finance the most highly impacted or at-risk sectors.

What we have not seen is panic. Covid was a good opportunity for management teams and companies to stress test their processes and hone how they respond to difficult times. It seems to have given them a greater understanding of their businesses and as a result have been better prepared for the recent set of issues they are facing, making them more resilient in the process.

Q It has been an interesting year for European direct lenders – how have GPs responded to the testing macroeconomic environment?

It really depends on the state of your portfolio coming into this. It is too late to pivot or change strategy – in private markets if you don't like your risk at this point, you don't have many options to adjust your portfolio, especially in direct lending. However, if you came into 2022 feeling good about your portfolio, and didn't have too many issues to deal with, then you are ready to step up and continue to do business. If your portfolio wasn't well positioned, you may have other priorities, forcing you to pause on new deals and reflect on those missed opportunities.

We always say that if you only start to take action when you see a difficult market developing, you are already two years too late. Now is the time when you see the better businesses really outperform. They aren't immune to pressures like wage inflation, but they do have a greater ability to pass through cost increases if their market position is strong.

If you know your own mind and stay true to your core investment strategy, know how to price risk, and are willing to be in the market, then you will find attractive opportunities that others won't see. The point of private credit is to be consistent and always open to discussions. Sponsors will remember those that supported them in difficult times. The uncertainty of public markets being open or closed has definitely driven sponsors to the deliverability of private debt. Some of that flow may revert to public markets, but for many sponsors it will remain the primary financing route of choice.

Covid provided some real lessons for management teams, sponsors and credit investors alike. Being tested through cycles and managing stress is something your team needs to experience. It is easy to make money in a bull market but now is the time that will test the mettle.

Q ESG is playing an increasingly important role in financing today. How are European managers responding?

ESG is one of those challenges that we are all incentivised to work on together, we are committed to helping each other and working through industry groups to share best practice. This is all about increasing awareness and improving responsible investing for all of us, so there is nothing proprietary or competitive about it.

Right now, I would say we are at the professionalisation stage of this: at Bridgepoint, we have just hired our first credit-focused ESG professional. While we continue to utilise our fairly extensive firm-wide resources and the ESG ambassadors that we have within our credit team, we hired Katie Cotterell as ESG manager to help get us to the next level in terms of our approach.

We are also in the measuring phase: we have the approach down, we have the investment style and we know what we want to talk about with companies and where we would like to see them headed. Now we are focusing on things like emissions and trying to measure those, because it is remarkable how few companies are doing that.

Q What opportunities are there in special situations, and how can managers position themselves to take advantage of those?

We are finally seeing the market really develop there. It's been a frustrating strategy at times to invest over the last half a dozen years, and a difficult place for many market participants to deliver consistent out-sized returns. At Bridgepoint we invest across corporate credit, from CLOs to direct lending to opportunistic credit, and we often work with the same companies. What we are seeing is a return to the perception of risk, and the proper pricing of it.

There are probably three areas providing interesting opportunities right

now. First is the secondary market, which has been a tricky place to invest for opportunistic credit over the last few years during the bull market. The combination of lower global growth and rising interest rates has resulted in a steep fall in secondary market prices. This disruption is leading to a greater differentiation between credits. If you can understand those companies, what risks they face and how they will perform through a downturn, you can start to identify some very attractive and mispriced risk.

Then there is this primary gap that both of our private credit strategies across direct lending and opportunistic credit have been filling, providing acquisition capital and more creative capital solutions as public markets rebalance. Finally, as mentioned earlier, there is the opportunity to clear overhang from the banks' balance sheets.

An opportunistic credit strategy provides solid upside returns together with downside protection, which we feel is particularly attractive in turbulent and more uncertain times as we are in today. Across the portfolio you can make private equity-like returns out of the opportunity across primary and secondary markets if you know what to look for. In private markets that really comes down to your ability to source deals, thoroughly diligence those opportunities by using your knowledge angles, then pricing and structuring that risk to deliver the right returns.

There is competition – a fair bit of capital raised during covid sat on the sidelines after the market rallied back so quickly. Many market participants anticipated the covid opportunity would last longer than it did and that markets would fall further than they did, causing LPs some frustration that it wasn't put to work as they expected.

We believe the opportunity today is fundamentally different. It is not a short-lived dislocation but a series of macroeconomic headwinds that we are all trying to size up and understand. The one thing that seems pretty clear is that this is not going to be a quick fix. The coming downturn should provide a very attractive investment market for private credit for the coming quarters and years ahead.

"Opportunistic credit is proving to be a very good partner"

"Now is the time when you see the better businesses really outperform"

Q What do you think the next year will bring for private debt in Europe?

The growth of private credit has only been going in one direction for some time now, in terms of size and market share. We expect that will continue and Bridgepoint Credit is very well positioned to continue to grow within it. This economic and geopolitical environment is another challenge that will test the market, but I expect the asset class will come through strongly thanks to the way lenders, such as ourselves, lend, and the ability to interact directly with management teams and sponsors to resolve issues quickly.

There will be some companies with cash needs that face inflationary pressures and issues with their revenue bases and end customers. But for most direct lenders, portfolios are going into this in robust health. The average company that we lend to has a 30 percent EBITDA margin, which implies these businesses are well positioned in their markets and have a reasonable degree of pricing power.

Rates are rising and will begin to have a meaningful impact. With floating rate instruments, that flows straight into returns, although we need to factor that into our underwriting and ensure companies are able to absorb the increased cost. But with an average of around 3x interest coverage ratios in our portfolios today, it indicates a solid cashflow buffer and the ability to absorb a bit of margin erosion.

We might price loans a bit differently today, terms might be a bit different, but I'm expecting more of the same, with a continued growth in market share and a proper opportunistic credit environment delivering good risk-adjusted returns over the next three to five years. ■

How to go green when carbon is back on the menu

The energy crisis facing Europe has shown that fossil fuels are still essential for stable energy supplies, despite best intentions among investors to go green, writes John Bakie

While the ambition of net-zero carbon emissions has seen the investment industry take great strides in ensuring portfolios are greener than ever, recent events have reminded us that fossil fuels are, for now, still essential to the world economy.

The war in Ukraine has heralded a major energy crisis across much of the world, with fuel prices spiking and fears in many countries that rising costs of gas and electricity could force many households to choose between eating and heating this winter. Although much political effort has been expended on the transition to net zero, there is still a great need for fossil fuels to meet the basic requirements of maintaining civilisation.

Private credit providers have recently been taking steps to support green energy through carbon-linked loans. Most recently, Carlyle launched decarbonisation loans, which will link pricing to the achievement of decarbonisation milestones and the achievement of other, related ESG KPIs. Elsewhere we've seen a push for greater standardisation of the way the industry approaches loans linked to ESG criteria by the European Leveraged Finance Association.

These are, no doubt, positive developments that will play a role in incentivising corporate borrowers to step up their efforts to reduce emissions in their business. But realistically, gas and other fossil fuels will be essential for at least the next 20 years, and the recent energy crisis has thrown this into focus.

Flexible approach

Industry players have previously told *Private Debt Investor* that European politicians are considering how to get more capital into important areas such as gas storage and facilities for offloading liquid gas in ports as supplies from Russia dry up. However, infrastructure debt is very long-term, and fund managers need to know that gas projects will receive government support for a decade or more.

Furthermore, fund managers and their LPs might need to reassess how they monitor decarbonisation within their own portfolios. Claus Fintzen, CIO and head of infrastructure debt at Allianz Global Investors, says: "When we look at divesting from fossil fuels, it is tempting to pursue companies that are already green to bring down CO2 emissions in the portfolio, but there is some merit in saying we should invest in 'dirty' companies and invest to allow them to make their business cleaner as this would have the effect of reducing overall emissions within the economy."

The road to net zero is a long one, and in the short-term there can be unpredictable barriers to progress. Taking a more flexible approach that recognises the ongoing need for fossil fuels, which can mitigate the environmental damage they are doing and also support the long-term move towards full renewable energy infrastructure, will be vital for investors hoping to support this transition. ■

Lenders (and investors) take a step into the unknown

As the popularity of technology lending grows, so does the use of ARR financing. But for managers and investors alike, it presents some challenges, writes Andy Thomson

Annual recurring revenue finance, which supports some of private debt's most favoured businesses these days, was a talking point on the sidelines of our 2022 PDI Germany Forum. This is not least because providing that finance involves the possibility of lenders stepping into unfamiliar territory, while also needing to gain the approval of their investors.

Delegates said that they particularly favoured technology businesses such as those found in the software and healthcare sectors. Such firms were certainly on lenders' radars before the pandemic, but during it they started to dominate dealflow. Many of these firms have a strong story to tell, but it's one of future rather than present revenues – jam tomorrow rather than jam today.

This is not necessarily comfortable for limited partners that may only be familiar with cashflow-based lending, as we heard from one direct lender keen to incorporate ARR financing into its mainstream activities but still in the process of trying to win approval from LPs. In most cases, according to our sources, this approval tends to be given but it's not necessarily a quick or easy process.

Gaining traction

ARR finance has only been gaining strong traction in Europe over the past few years (longer in the US). Many funds around now didn't include it as part of investment mandates for the simple reason that it didn't exist to any significant degree at the time. Managers today may need to go back to their LPs for waivers to make investments through their funds – or, alternatively, set up a separate dedicated ARR strategy or perhaps appeal for deal-by-deal support on an ad hoc basis.

One of the considerations for investors is the back-ended repayment of interest, with typically a payment-in-kind element in the early years. This is unlikely to be too much of a problem for LPs since committing to an illiquid asset class implies that they're not necessarily keen to get their cash back in a hurry in any case. Also, there's a perk which may help assuage any concerns: a premium, typically between 50 and 75 basis points, versus a more plain vanilla loan.

Perhaps more unsettling for investors may be the negative sentiment around some of the larger, publicly-listed technology stocks. "Big technology stocks are in the midst of their biggest rout in a decade," as *The Wall Street Journal* put it.

Some of our sources familiar with ARR financing concede that this may indeed be an issue, particularly for consumer-facing tech businesses, but for the time being little impact on valuations was being seen in the mid-market. Furthermore, they point to typically low leverage and large equity cushions as significant safety nets in ARR deals. There is no sense yet of a bubble bursting in this part of the market. ■

Why investors fancy a bet on litigation

The litigation finance market is growing in popularity, with deep-pocketed LPs looking for ways to deploy meaningful amounts of capital. But it's not for the faint-hearted, writes Andy Thomson

A media roundtable staged in the London office of law firm Macfarlanes this summer drew attention to both the opportunities and challenges associated with litigation finance, a fast-growing corner of the private debt universe.

Typically placed in the speciality finance bracket, litigation finance involves third parties unconnected to the litigation bankrolling the legal fees of a court case. If the case is successful, the funder is paid from the proceeds; if unsuccessful, the funder will not obtain any return on its investment.

There are two main reasons why litigation finance has become highly popular. One is the possibility of private equity-like returns of 20 percent or more. Two is that it is a highly distinctive area of investment that fits well with portfolio diversification objectives.

As a result, it is experiencing strong growth. In its early days, funders would typically only back single cases. These days, more and more funders are taking a portfolio approach – backing multiple cases and putting a larger quantum of capital to work. Other ways are also being found to deploy capital, including lending directly to law firms to enable them to fund cases and build their books, as well as financing spinouts from law firms where start-up capital is required to establish litigation finance boutiques.

According to Macfarlanes' litigation finance specialists, there is very significant appetite from investors with deep pockets, including large asset managers, high-net-worth individuals and sovereign wealth funds. They noted that, three or four years ago, single cases proceeding through London's High Court would involve financing of up to £5 million ($6 million; €5.9 million); today, that figure has risen to £40 million. While the published worth of the UK litigation finance market overall is £2 billion-£2.5 billion, Macfarlanes believes this is only the tip of the iceberg.

Reasons for caution

The legal cases being financed range from competition cases, fraud and insolvency to divorces, intellectual property claims and professional negligence. An interesting area that is also seeing growth is the secondary market, where a case needs more capital than that provided by the original funder to proceed further – where that original funder declines further involvement, a different financier may then step in.

While this growth speaks to a market in rude health, there are reasons for caution. One is the prospect of greater regulatory scrutiny. It was back in 2009 that light-touch regulation was first introduced to the UK's litigation finance market. Part of this was the formation of an industry association with a voluntary code of conduct. But there is a question mark over whether simply asking financiers to adhere to a code of conduct provides investors with sufficient comfort. No one is expecting a heavy hand anytime soon – but nor can the status quo be taken for granted.

The other aspect worth considering is the degree of risk an investor is prepared to tolerate. As mentioned earlier, a failed case means no return – but, in addition to that, could also mean paying at least some of the costs of the other party. While litigation financiers are keen to stress that they will only take on the most winnable cases, the Macfarlanes lawyers pointed out that there's no such thing as a slam dunk. And you also have the "judge variable" to take into account – the possibility that a judge will come to an unexpected verdict.

A betting person would probably predict further strong growth for the litigation finance market. But it's worth bearing in mind that a bet is precisely what predicting legal outcomes boils down to. ■

EXPERT Q&A

Dislocation is creating opportunities for lenders and driving changes to fund structures, say Luke McDougall, co-chair of the global finance practice, and Diala Minott, private funds partner, at Paul Hastings

Direct lending: The healthy European outlook

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Q How has direct lending in Europe changed as a result of dislocation in syndicated and high-yield markets in 2022?

Luke McDougall: The syndicated loan market and the high-yield market are both effectively shut in Europe right now. There are some limited circumstances in which someone would go to market, but generally speaking, as of early September, it is not a feasible option for leveraged buyouts. We saw underwriting done over the summer but very little was launched and quite a lot either aborted or switched from an underwriter to a direct lender.

The problem is that the level that the banks will underwrite in the current market is so punitive for the borrower in an LBO that it is better to go for the certainty of a direct lending solution. There is an inversion going on where direct lenders will now do deals at a cheaper price than a syndication.

After the application of market flex, the cost of capital represented by a bank underwrite could be in the 10-12 percent range for debt that would have been priced in the 5-6 percent range just nine months ago. So there has been a significant switch.

There are some circumstances where we have seen banks do a long bridge, but it is a bridge to a better market 12 or 18 months away, hoping for a term loan B take out when things improve. We see people propose that but it is not seen as very attractive.

As a result, direct lenders have had this enormous space to walk into over the last six months, and a number have stepped up really effectively.

While the terms often start from a relatively aggressive position from the sponsor perspective, there are signs direct lenders are chipping away pretty heavily at pricing, terms have got tighter, and lots of documentary flexibility that had crept into the senior loan market over the last two years has reversed out again.

> *"Tech and software businesses are regarded as more resilient and a bit less cyclical"*
>
> **LUKE MCDOUGALL**

Q What has been the response of direct lenders to these new opportunities?

Diala Minott: What I'm seeing is an influx of direct lenders wanting to set up fund vehicles really quickly to take advantage of price dislocation in the loan market and looking at bonds, turning to more liquid asset classes and mixing liquid assets with illiquid assets. They are responding to what they are seeing, which is lots of opportunity, and that is being matched by investors looking for liquidity.

We have seen quite a lot of pressure on some of the closed-end funds to offer some liquidity, plus managers changing their strategies to take advantage of the opportunity in credit while staying within core direct lending, which they know will come back.

Smaller managers are putting in some opportunistic buckets quickly, while larger funds are finding it a bit slower to get the money from investors to match the credit opportunities. They are having difficulties getting money from nervous LPs, some of whom have shut up shop and put funds on hold as they wait to see how markets react. Managers are aware of the new opportunities to fund loans left by the banks but risk losing out on those opportunities because they don't have the requisite funds from LPs.

Q How are regulators reacting to these changed market dynamics?

DM: We hear good noises from the regulators, in that all of them are allowing new structures. They were starting to do that before the macroeconomic challenges hit, so we are waiting for new regulations to be published. Certainly, they are much more comfortable with the current regulation of direct lenders and have started to look at other ways to allow more liquidity into these products. We see them looking at allowing direct lenders to expand their investor bases, potentially allowing open-end funds to do direct lending, and becoming more amenable to retail investors coming into funds.

Because it is so difficult to find the LP base, a lot of managers are turning their attention to retail, starting with high-net-worth individuals but also looking at new fund structures like the UK's Long-Term Asset Funds. There is a real drive now for managers to have one platform that can bring in all these different investors, and regulators are providing that framework to ensure retail investors understand what they are getting into.

Q How are managers adapting to the macroeconomic environment?

LM: From a deployment perspective, the inflationary expectations and recessionary expectations in the macroeconomic outlook naturally cause managers to exercise a degree of caution. We have also seen quite specific problems that have broad application, such as the supply chain problems caused by the pandemic that have affected a great range of businesses and drawn lenders into difficulties with existing credits.

The environment is certainly impacting behaviour. While there is appetite to do deals and lots of value being seen in the market, there are also headwinds that are causing lenders to decline opportunities because of the stresses they see coming. Investment committees face a difficult time right now in selecting where to deploy. Tech and software businesses are regarded

as more resilient and a bit less cyclical, and, of course, credit funds tend to have much healthier and less cyclical portfolios too.

DM: On the funds side, managers are realising that potentially they don't have the expertise to deal with some of the credits that have gone into distress. They are hiring whole teams of distressed credit specialists.

In addition, a lot of funds are drawing on their cornerstone investors – either setting up new funds with cornerstone money or calling it down from their group parent because it is so difficult to bring in a diverse LP base at the moment. We are seeing a lot of joint ventures between cornerstones and managers, often with deals in mind that they are warehousing.

Finally, we see some broadening out of strategies and European managers partnering with US managers or US pension plans, allowing them to set up funds quickly and look at opportunistic credit that they might not otherwise be able to do without that financial support. We expect to see a bit more asset manager consolidation as a result and especially as it gets harder for managers to grow their own businesses.

Q How have recent market conditions affected direct lenders raising capital?

DM: There are a lot of delays; fundraising is now taking a minimum of 18 months when it used to be 12 months, and investment periods are shrinking to two or three years. We have seen specialist funds set up really to acquire an asset, turn it around, sell it and then move onto the next vehicle quickly.

We see more evergreen funds, including several small evergreen funds being set up for different assets within the same fund, to save on the cost base. And we are seeing some investors looking for exposure to higher risk assets than straight direct lending, causing funds to set up as a master fund with different classes to track different assets for different returns. Fund administrators are now trying to segment those cashflows, as market conditions are leading this structural change to funds.

> *"Fundraising is now taking a minimum of 18 months when it used to be 12 months"*
>
> **DIALA MINOTT**

Inflation has also changed the return expectations of LP investors in credit funds. The divergence of incentives between managers and LPs has become a bit more acute and is driving investors to really force managers to monitor portfolios and push returns on investments. Some LPs are asking managers to benchmark returns to inflation, and it will be interesting to see if any agree to that.

Q What structural trends in funds are we seeing, particularly new fund structures?

DM: There is more appetite for evergreen funds, including some closed-end funds that are half open and half closed, with a mixture of liquid and illiquid assets, and allowing investors to be exposed to different risks and returns according to their appetite.

Those funds are not fully open-end because many managers don't have the expertise to manage open-end funds and the liquidity needs associated with those. However, LPs are asking for that liquidity premium, so we are seeing these closed-end funds that essentially offer the ability for investors to be bought out at a certain point in time.

These structures are proving to be of interest to some of the UK pension plans, who are actively asking to be bought out of their current investments as they seek to pause and see what happens next within the current market. I noticed that big US state plans are suggesting that they are expecting to see valuations start to drop and so will only look at tier one managers, which creates tensions around the definition of a tier one manager and makes conditions even more challenging for new managers with their new strategies.

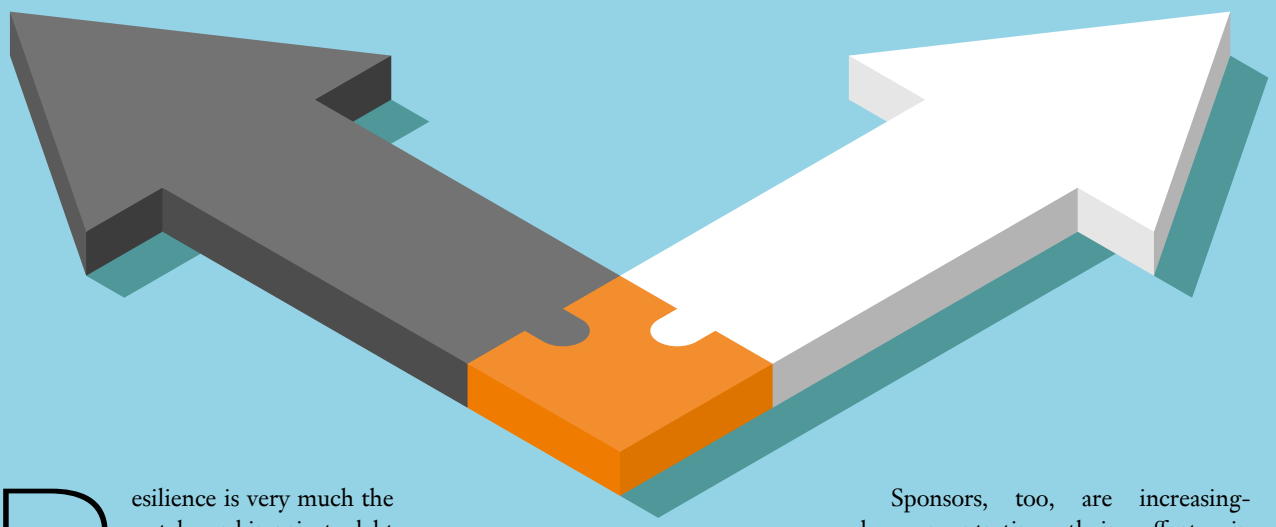
Q Should we expect further tightening of lending conditions as a result of scarcity of debt capital?

LM: The trendline has definitely been tightening over the last few months and we have seen sponsors frustrated by processes where terms have worsened between when they started to negotiate and the point where diligence is done, and they are going to investment committee.

That is in part market driven, but there has also been a degree of market finding recently that large sponsors are less used to. The syndicated market and the high-yield market give them so much data, and the banks were so much more confident of where a credit would price and what terms would be achievable, they are not used to this level of uncertainty.

So, there is a bit of frustration, but credit funds are being asked to deploy significant amounts of money on single name exposures because they are looking opportunistically at larger deals, so their investment committees are, perhaps understandably, back on the terms the investment teams would like to do. ■

The search for stability



European debt activity is consolidating around non-cyclical sectors, as lenders seek out stable revenues, writes Claire Coe Smith

Resilience is very much the watchword in private debt these days. Europe is no exception. Three sectors accounted for nearly 60 percent of all the private credit transactions that took place in Europe in Q2 2022, as debt funds concentrated their efforts around more stable sectors. In all, there were 89 software, healthcare and business services deals transacted out of a total deal volume of 153 in Q2, with technology, media and telecoms once again the busiest sector overall.

In such a challenging macroeconomic environment, it is perhaps not surprising that lenders are favouring businesses with stable recurring revenues, which are more insulated from consumer behaviour, enjoy long-term growth fundamentals and where there is a greater ability to pass on price increases.

Sponsors, too, are increasingly concentrating their efforts in faster-growing, non-cyclical industries, leading to a split in the private credit space between three favoured sectors and the rest of the market.

Recurring revenues

Ben Harrild, partner and co-CIO at fund manager Arcmont, says: "We have concentrated on those sectors for a longer period of time than the market as a whole. When we started doing recurring revenue software deals six years ago, they were not as popular as they are now. Covid was a good test case for seeing how those platforms performed.

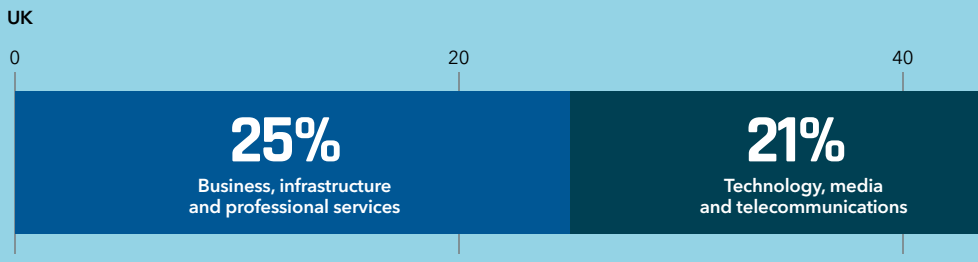
"We were early into those businesses, so we have become known as a lender that understands those businesses and has appetite. Other players have now acknowledged the attractiveness of those sectors, but winning the deals

comes down to credibility and deliverability. If you have only been looking at those sectors for a period of time and your track record is not as strong, it remains challenging."

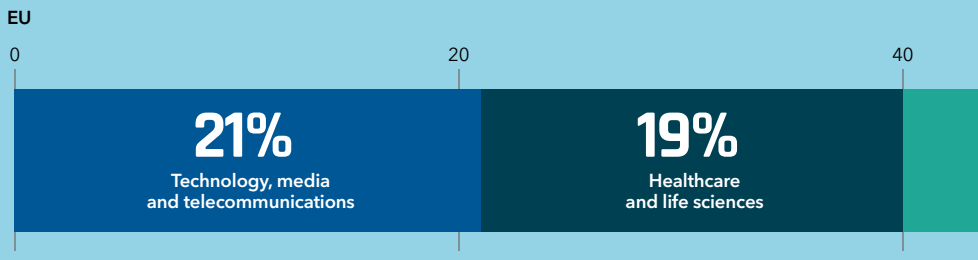
Mark Brenke, head of Ardian Private Debt, says these sectors make sense at a time when lenders are anticipating a difficult period. "Inflation will undoubtedly have an impact on overall M&A volumes, which will in turn drive down certain opportunities for private debt funds," he says. "Companies with particular exposure to inflationary pressures, whether that's rising input cost inflation, high energy bills or reliance to consumers' discretionary income, are likely to suffer. Funds that are overweight in sectors like retail, hospitality, industrials and travel could experience challenges."

Ardian, like others, is putting the spotlight on a small group of industries. "Our strategy focuses on businesses that are largely insulated from such market headwinds," says Brenke. "Our investments are in businesses that have a steady and reliable revenue stream and in sectors that are less affected by input inflation or cyclical trends. This includes software, healthcare, and business services. We are therefore optimistic both about the performance of our existing investments and the opportunities for new deals."

Private debt deals by industry split, Q2 2022



* Others includes leisure; consumer goods; energy, resources and industrials; transportation and logistics



* Others includes energy, resources and industrials; manufacturing; leisure; transportation and logistics; human capital; retail; specialised consumer services; real estate; public sector

Figures have been rounded
Source: Deloitte Alternative Lender Deal Tracker

Better margins

The same trend can be seen across Europe. Jens Bauer, managing director for Permira Credit, notes evidence of a growing shift into those three sectors happening in Germany, saying: "If you look at the deals done in Germany, around 70 percent of activity in H1 was in those three sectors, according to a recent report. If you exclude the deals done by banks, that figure would be even higher.

"Over the last few years, we have seen a real concentration of private credit around robust sectors with highly profitable businesses, and the businesses in those sectors are generally stronger, better capitalised, with better margins, better management teams and a stronger ability to absorb shocks."

In the UK, a fourth sector joins the list, with financial services deals also playing a large part in the market. In the first half of 2022, 86 of the 111 private credit deals done in the UK involved borrowers in TMT, financial services, business services or healthcare.

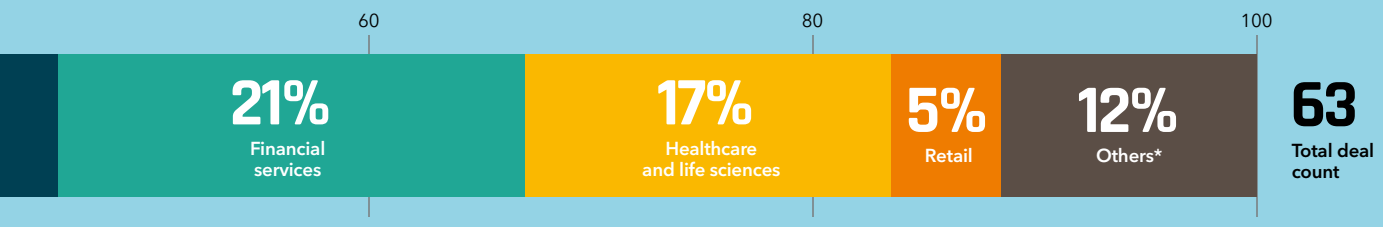
Nick Holman, director with Kartesia in London, says the result is a "bifurcated market" where the stronger, more defensive credits are attracting attention and therefore the flow of capital. "A lot of people are thinking about fixing the risk and so are not willing to take on increased risk even at an increased price," he says. "That leaves people willing to do reasonable amounts of leverage on transactions, but only in defensive sectors.

"In the UK, healthcare, IT and financial services have proved more resilient, and there is still enough appetite to get those deals away. You have more capital chasing fewer assets, and if people are only willing to do one or two deals, they are going to pick the safest ones. Anything marginal is not going to happen right now."

Despite billions being wiped off tech valuations in the public markets through the first half of the year, the focus on enterprise software deals and technologies that cater to medium-sized companies continues to present opportunities in a downturn.

David Flannery, president of Vista Credit Partners, says: "Enterprise software involves a long sales process before a company buys or licenses a product, but once it is up and running that really doesn't come out. Even if a company files for bankruptcy and has to reorganise, it keeps its software running.

"We are in a pretty tough, uncertain economic environment, but that stickiness is why these enterprise software deals hold up and why there will continue to be a market for lending to those deals."



> *"In the UK, healthcare, IT and financial services have proved more resilient"*
>
> **NICK HOLMAN**
> **Kartesia**

> *"Winning the deals comes down to credibility and deliverability"*
>
> **BEN HARRILD**
> **Arcmont**

At Park Square Capital, founder and managing partner Robin Doumar says the firm is focusing in on software, healthcare and business services, with the latter featuring because of its predictable nature. "What we have found, by screening through all the various business opportunities that we look at, is that if we want businesses that are very stable and predictable, a lot of them are in B2B services.

"A good example would be distribution businesses, which is a segment we are very supportive of, as well as testing and compliance. These businesses tend to be growing quite nicely and they are relatively well insulated from economic volatility and stable compared to consumer businesses that can shift on a dime based on consumer sentiment."

Healthcare, too, offers its own non-cyclical, non-correlated returns, with long-term growth underpinned by the megatrend tailwinds of an ageing population and funds pouring into digitisation.

Robert Connold, partner in debt and capital advisory at Deloitte, says the split in the market is not a new one but is gathering momentum through the macroeconomic challenges: "What we have been reporting over the last three to five years is people focusing their lending around TMT, healthcare, business services and financial services," he says.

"Gradually funds have moved away from lending into industrials or consumer retail, and those four sectors have remained incredibly healthy for transactions, with private equity sponsors still deploying quite a lot of capital there and the appetite for financing those deals remaining robust.

"Those sectors are considered recession-resilient, so at a time when private equity funds really need to deploy capital, they are going to focus their efforts into those safer sectors."

Debt funds, in turn, are sharpening their toolkit for deals in just a few popular market segments. ■

Retail investors take their lead from Italy

Attendees at the PDI Germany Forum heard how the country has been leading the way in promotion of the ELTIF vehicle. By Andy Thomson

Launched to much fanfare in 2015, the European Long-Term Investment Fund has struggled in the seven years since to live up to its billing. By October 2021, there were only 57 ELTIFs in the EU and these were heavily concentrated in just four markets: Luxembourg, France, Italy and Spain. Representing €2.4 billion of assets under management last year, ELTIFs are a drop in the ocean compared with the overall €6.8 trillion alternative investment fund market in the EU.

Speaking at the PDI Germany Forum in May, Barbara Ellero, partner and head of private debt at Milan-based fund manager Anthilia Capital Partners, explained how, for the Italian market, the ELTIF appears to have worked well. Helped by capital gains tax and inheritance perks as well as good distribution networks in the country, ELTIFs have provided access for Italian retail investors to the alternative investment market for tickets as low as €10,000.

Ellero reminded us of the ELTIF's potential and provided clues as to why the EU has recently opted to reform it rather than abandon it.

One question posed at the Forum was whether small retail investors should really be dipping their toes into alternative investment at all during a period of so much volatility. Isn't there a danger that they might get wiped out by a downturn? But, with the ELTIF, a lot of investor protection is built in: leverage is limited, diversification encouraged, and only certain types of product given the green light. In addition, investors can only commit up to 10 percent of their total assets.

> *"The momentum seems unstoppable"*

Certainly, attempting to revive the fortunes of the ELTIF is entirely in keeping with the courting of the retail investor base that has been one of the big themes in private debt in recent times. There was a dissenting voice, however, which came from Ari Jauho, partner and chairman at Finnish fund of funds Certior Capital. He recalled raising his first private debt fund in 2015 and not being allowed to take retail money and said that, in his view, the beauty of private markets lay in giving entrepreneurship free rein rather than being guided by regulators. The ELTIF only encouraged more and more regulatory oversight.

But while the debate is interesting, it seems likely that the topic of retail investment will be an even bigger one in future iterations of our private debt events in Europe and elsewhere. The momentum seems unstoppable. ■