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Direct Lending

A new asset class in Europe?

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<content type="text">Notwithstanding the recovery of public markets, the financing environment for businesses in Europe continues to remain difficult. In particular, the situation facing small and medium-sized enterprises, or SMEs, that form the backbone of the European economy is very challenging. Over the past twelve months, most were unable to access bank, bond or equity markets for working capital or growth capital. The prolonged and severe contraction in lending to this sector is becoming a major political and commercial risk to Europe given the sector's contribution to European GDP. To a large extent this environment is caused by structural changes in the debt markets for European SMEs.

The credit expansion of 2004-2007 was marked by a significant increase in the availability of capital from a variety of lenders to large, medium and small companies across the capital structure. These lenders were almost always leveraged and pricing was based more on what the market would absorb than on fundamental credit criteria. At the time, many hedge funds were active in the credit markets and commercial and investment banks aggressively grew their loan portfolios. After four years of accelerating loan growth, the syndicated loan market collapsed in mid-2007 and the suppliers of debt capital that fed the expanding credit cycle retreated or completely abandoned the lending space.

As a result, commercial banks are now faced with tighter regulatory oversight and limited capacity for new loans and are focusing on their existing corporate and sovereign credit exposure. Hedge fund redemptions have forced funds that offered their investors short-term liquidity to side pocket assets related to the less liquid loan portfolios, which often made up a significant portion of their books. In an attempt to restore the confidence of their investors, these funds are now focusing on their respective core strategies and (quite rightly) are no longer active in the illiquid space.

Credit constraint has been a particular problem in Europe, with many countries experiencing an on-going decline in the volume of loans provided to middle-market companies.

As an example, the situation in Germany reflects the general problems faced by SMEs across Europe. Companies have increasing difficulty in getting loans because the lending criteria requirements of local German banks on equity capital, covenants, transparency and documentation have grown far stricter

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capital, covenants, transparency and documentation have grown far stricter over the last two years. KfW, a leading German government-owned development bank, expects declines in lending to this space of approximately 19% in each of the first two quarters of 2010.
In addition to bank lending, European companies are struggling with a tough macro environment. For example, recent data shows that European debt write-offs due to non-payments have reached a record level of €300 billion, a figure that is equal to Greece's total national debt – and like Greece's debt, it too has not yet necessarily peaked. SMEs are hardest hit by the rise in non-payments. The European Commission claims that this is the cause of one out of four corporate insolvencies leading to the loss of 450,000 jobs each year.

Maturing mezzanine programs are also putting pressure on companies: 760 mezzanine financings with an aggregate value of over €4 billion are coming due between 2011 and 2014 in Germany alone. At the same time, a number of traditional mezzanine investors have withdrawn from the market over the past six months, in many cases due to excessive involvement in highly-impaired, and poorly structured, LBO mezzanine debt.

In summary, with over €400 billion in European leveraged loans maturing before the end of 2014 and traditional lenders suffering from continuing capital constraints, there is no quick solution to the contraction in bank financing for small to medium-sized companies in Europe through traditional credit channels.

Key aspects of direct lending
The target market for a direct lending strategy is positioned between those companies with financing (typically larger capitalisation) and the distressed sector. In Europe, this frequently involves privately-owned middle-market companies with a good fundamental business model, but which are frustrated by their inability to grow or defend their market position due to the absence of working or growth credit.

Whereas this strategy is relatively well established in the United States with many alternative asset managers active in the space (Blackstone/GSO, D.E. Shaw, FrontPoint/Gottex and Silver Point Capital), it is largely unheard of in Europe. Historically this has been to due to challenges associated with sourcing and managing transactions without a strong and trusted relationship network.

Direct financing providers aim to provide capital solutions that meet the unique requirements of borrowers using debt or hybrid debt and equity solutions. The willingness on the part of lenders to share in some of the company's business risks creates more flexibility and options for companies in need of non-traditional financing. Traditional banks, on the other hand, are usually unwilling to work on innovative structures, particularly post-crisis. Often, non-traditional lenders are also able to execute more quickly and reliably than traditional sources of capital – a significant advantage in many situations.

The underlying goal in any direct lending transaction is to see borrowers overcome their temporary challenges regarding a lack of capital, grow their businesses and repay the financings in a timely manner with a reasonable return for the lender. This is where direct lending differentiates itself from the "loan-to-own" approach to debt investing typically used to source private equity opportunities.

For family-owned SMEs, there is a deep fear of losing control of the equity in a business which almost always has emotional as well as financial links to the owner. This means that sourcing transactions in that segment is virtually impossible without a deep network of trusted existing relationships. Firms that are perceived not to share the same cultural approach towards partnerships are mistrusted.

Direct financing investments are generally for a term of two to three years and are secured by strong collateral support in the form of physical assets or cash flows. Since the capital infusions are geared towards particular situations, such as growth strategies and acquisitions or working capital shortages, direct lending investments usually do not continue beyond the planned term. The target annualised return is partly achieved via cash coupons and partly in the form of other contractual returns (typically back-ended). For borrowers, this structure also demonstrates a commitment to share in the risks of their business. Since the focus is on corporate loans rather than asset-backed securities, specific covenants and terms to each transaction are used to mitigate risk and, together with cash interest payments, to install cash flow discipline within the borrowing company.

Risk in this investment strategy is primarily managed via appropriate trade sizing and limiting concentrations and correlations among investments. These are usually formulated as restrictions on individual borrower positions, single sector exposure and maximum geographic concentrations.

Direct lending funds

As one of the drivers of returns, direct lending temporarily gives up liquidity and commits capital up to three years or beyond. The illiquidity of the underlying debt investments makes it important to structure funds with a matching liability profile. From an investor's perspective, this means that the time horizon lies somewhere in between traditional hedge fund investments that offer three month liquidity and private equity investments, which often require limited partners to commit their money for more than 10 years.

Direct lending provides opportunities for higher yields, better covenants and more security compared to syndicated credit in return for lower liquidity on the underlying investments. Given the investment horizon, direct lending products typically appeal to investors with a medium-term time horizon who want to diversify their portfolio to include European credit exposure. Since the loan investments generate current income, direct lending products can also distribute income on a regular basis making the opportunity very attractive to pension funds and insurance companies that are interested in receiving a current yield on their investments in addition to longer term capital gains. In addition to the institutional market, private investors with a medium-term investment horizon also fit as natural investors in this strategy.

BLM's strategy

BLM pursues its direct lending efforts as a standalone strategy – it aims to lend and recover capital, not trigger some form of debt/equity restructuring. The extensive network of relationships with companies, entrepreneurs, senior corporate management and financial institutions that BLM's founding partners and professionals have formed throughout Europe allows the firm to source attractive primary investment opportunities. Potential borrowers take comfort from the history that BLM's partners have of working closely with management teams to build successful companies, as well as their extensive knowledge of European corporate markets. The focus on relationships with European borrowers is combined with a rigorous fundamental and structuring approach, combining the best of both US and European private investment approaches.

BLM is positioned as a strategic partner and compared to other firms, engages in a more supportive approach with borrowers (as far as possible). It seeks to bring financial, strategic and operational support to middle-market companies in which it invests. Continual communication with borrowers makes it easier to manage each position in the portfolio and react to problems at an early stage. Typically, BLM will have board rights to provide access, information and a regular forum to discuss a company's performance and future strategy. Working with corporate borrowers rather than asset-backed securities also gives BLM more flexibility when it comes to managing problem situations, more options for recovery and the opportunity to bring BLM's operational expertise to bear.

Conclusion

Direct lendingin Europe has been difficult to pursue as a strategy, even for those firms that are active in the US market. Borrowers here are nervous about purely financial investors and a network of relationships is key to originating attractive transactions. However, direct lending now presents a real opportunity for European SMEs to access much needed capital. With the structural impairment in bank lending markets likely to continue for many years, European investors are likely to see much more of this strategy.

Jason Carley is Chief Investment Officer of BLM Partners, an independent alternative investment firm serving small and medium-sized companies in Europe across various industries through a range of investment strategies. A main focus for BLM is direct lending to small to medium-sized European companies that are looking for growth or working capital.

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