Certior Capital

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## An Emerging Niche: European SME Private Credit Continues To Offer Attractive Risk-Adjusted Returns As Institutional Investors Start To Move Into The Sector

- **SME private credit across Europe can offer attractive returns**
- **Actual risks are likely to be lower than many institutional investors perceive**
- **Positive risk-return dynamics are driven by the low amount of capital flowing into the segment, especially when the size of the European investment universe is considered**

**At the recent Certior Capital European SME Private Credit Round Table at SuperReturn International in Berlin an audience of leading institutional investors and fund managers active in the sector discussed the favourable dynamics of the market. As Ari Jauho, Chairman of Certior Capital, a leading fund-of-funds manager focused on SME private credit, concluded: "SME private credit investing can offer attractive returns to investors with significant downside protection that comes with being a senior lender. The size of the opportunity across Europe is enormous - in the UK alone there are some 40,000 companies with GBP 5-50m of revenues - and yet to date relatively little institutional money has focused on it. That is slowly changing, however, as institutions look to broaden their private credit exposure away from the large cap segment which has become increasingly overheated and competitive".**

Returns available to investors in the SME private credit sector compare favourably to many other private and public asset classes. Johan Kampe, a Senior Managing Director at Harbert Management in London, believes you can safely lend to businesses which are rapidly growing but not yet profitable, and in doing so achieve strong, risk-adjusted returns. "Our typical investee companies have raised one or two rounds of venture capital funding but they are not yet being targeted by the banks. Revenues are typically in the EUR 5-50m range and our funding is often a bridge between rounds of venture funding. Returns to date have been attractive at up to 20% IRR, made up of 12-14% in a contractual element plus fees and in all cases an equity kicker". Beechbrook Capital is another firm active in the SME private credit space which has taken advantage of the lack of bank lending available to smaller European businesses. "Our original focus was on mezzanine, unitranche or subordinated loans in private equity sponsored buyouts in Northern Europe where typically there might be a EUR 5-10m gap in the capital structure", commented Paul Shea, Co-Founder and Managing Partner at the firm. "However, we soon began to be inundated with enquiries from companies in the UK who wanted to borrow GBP 5-10m and so we then set up a sponsorless UK SME fund which raised GBP 150m. It typically provides unitranche or senior loans to family businesses. Most banks are reluctant to provide five year bullet loans but that is exactly what many growing companies are looking for. For a senior loan we are typically targeting a 10-12% contractual IRR plus around half of the deals we execute involve equity kickers". Other European private credit strategies have also produced interesting risk-adjusted returns at a time of historically low interest rates, as explained by Martin Pommier, a Partner at Incus Capital, which manages EUR 600m across several strategies. “We focus on asset-based lending to the Iberian SME sector with local offices in Madrid and Lisbon and offer an alternative to the banks, based on speed and flexibility. Our main strategies include special situations lending, real estate credit, receivables, distressed debt and leasing with targeted IRR returns above 15%. We operate in a low competitive environment for the types of capital solutions we offer companies”.

While the common assumption is that investing and lending to smaller companies involves higher risks than dealing with larger companies, risks can be significantly lower than what investors perceive. David Bateman, a Senior Managing Director at Harbert Management, is clear on this point. "If you are operating in this niche most deals are a result of bilateral negotiations. If you are a venture capital business there is a lot more competition for capital but in debt there is only one senior lender and they really hold the reins. Being the senior lender in a bilaterally negotiated deal is a great place to be". Paul Shea at Beechbrook Capital goes further. "Interestingly, we missed out on a couple of commitments due to the perceived risk associated with the higher returns we are targeting. There is more specific risk with a smaller company; however, there are many mitigating factors which we believe work to reduce the risk in lending to smaller companies compared to larger businesses. Leverage is generally lower and there are many more companies to choose from, for example. There is no broad syndicate of lenders, there are rarely vulture funds to consider and no-one is seeking to syndicate a tranche of their loan. We don’t believe these mitigating factors are always taken into account when considering SMEs and the lower mid-market".

In spite of the lower level of competition for deals - in stark comparison to the larger lending segments or the broader private equity market - institutional money in Europe has been slow to focus on SME private credit although this situation is now changing. Timo Hara, a Partner at Certior Capital, underlines one of the factors behind the historical lack of capital. "While in private equity there are many well established fund-of-funds in private credit there are few similar sources of capital. We are one of very few sources of funds who is happy to potentially back emerging teams of experienced managers". Catherine Lewis La Torre, Chief Executive Officer of British Business Bank Investments, concurs that there is limited institutional capital available for these types of opportunity today which is why BBBI has been a very active investor in this part of the market in recent years. "Small-cap debt funds sometimes struggle to raise capital from institutional investors for two reasons. Not many institutions have dedicated in-house teams evaluating private credit opportunities and so this often falls under the private equity umbrella where private debt fund proposals will be in competition with higher returning strategies. Another barrier may be structural as it is sometimes inefficient for many institutions to make commitments below a certain size, given the level of capital they have to deploy. At the same time these institutions may have restrictions on the percentage of the fund that they wish to own. SME credit funds therefore looking to raise £100-200m, which may be the right fund size for the opportunity set, can be ruled out for investment if, for example, an investor’s minimum investment size is £25m and the maximum percentage the investor can hold in the fund is 10%".

<u>About Certior Capital</u>

Certior Capital is a value-add focused private equity and private credit advisor and alternative investment fund manager. The firm's core experience and expertise is in European lower- and mid-market private equity and credit markets, where the team's experience is one of the longest in Europe. Over the years Certior team members have closed over 180 primary fund, secondary and co-investment transactions. Certior Capital currently manages two funds. Certior Credit Opportunites Fund invests in opportunistic private credit and SME private credit funds and makes investments directly in loans while Certior Credit Investments invests in European mid-market direct lending transactions. Certior Capital is a registered AIFM and supervised by the Finnish FSA.

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