Direct Lending: The Making of a Market

By James Newsome 21st August 2017

Ten years after the start of the global financial crisis there is no sign of banks returning to their all-dominant position in the economy. New capital markets have sprung up and are themselves now experiencing growing pains. Can one of them - the institutional 'direct lending' sector - now reach its potential and become a permanent option for Europe's capital-hungry companies?

Crowd-funding and P2P lending arrived on the financial scene with an almighty splash soon after the financial crisis. At the same time quieter but perhaps equally significant waters have been starting to flow deeper in the financial system. The ‘direct lending’ sector – where large savings institutions channel credit to companies via expert asset managers and SME lending platforms but without the involvement of banks – has grown steadily but significantly since 2008. Direct lending funds are now raising about $100bn per year globally from pension funds and insurance companies, about eight times the amount of 8 years ago. Low interest rates have made the corporate debt funds being offered by these lenders an essential allocation for increasing numbers of institutional investors, despite their lack of liquidity. Regulators have embraced the emergence of the direct lending managers as an opportunity to shift some financing activity from a crisis-ridden and systemically threatening banking sector to patient pension funds. Some governments, including the UK, have even made seed money available to stimulate the launch of new direct lenders, such is the desire to nurture that elusive creature - a large and stable credit market.

But still, the direct lending market hasn’t yet worked out as some of its participants and promoters hope it will. This is because still only a fraction of the expert lending funds now raising capital from big savings institutions will lend direct to firms for growth or refinancing purposes – what’s known in the market as ‘sponsorless’ lending. The overwhelming majority of the $700bn in direct lending capital raised since the 2008 crisis has been lent to private equity firms – ‘sponsors’ - to carry out leveraged buyouts. While the sponsors point to evidence that they most often improve companies’ performance and create jobs, the sector understandably sticks to its favourite industries and is highly cyclical. Moreover, private equity sponsors will tend to use their financial firepower on larger deals, or to buy familiar firms being recycled through the market by their peers. Some of the larger European direct lending funds raised in the past year have been providing individual loans of over €200m per clip to private equity buyouts and refinancing. The $100bn annual global private debt raised is so concentrated in buyouts that it is not registering as even the tiniest blip for the broad mass of small and medium-sized firms in Europe. Credit provision is still way down on pre-crisis levels and Europe has stumbled along with sub-par growth.

It is not that there haven't been notable past successes to build on in 'sponsorless' lending. Asset management groups like Harbert Management in the USA and MML Capital in Europe have been successfully running sponsorless lending funds for their investors since the early 2000s. However, these firms and their peers typically offer high-interest growth capital (known as variously as mezzanine) to entrepreneurs and family-owned business keen to keep their equity intact. This is a niche play therefore, suitable for certain types of borrowers and for certain types of investors looking to invest in niche funds for higher returns. These sponsorless mezzanine funds have also been far smaller than the multi-billion mega-funds now offering senior credit to the big buyout deals. Some of the most successful sponsorless lending funds have been set up in one country where the expert manager feels comfortable investing in niche sectors. These country funds are typically less than one twentieth of the size of the big debt funds now being raised.

What is holding back the big new direct lending funds from now scaling up their direct corporate lending activity? Why are they not reaching out to the tens of thousands of middle market companies across Europe seeking financing options? Firstly there is the justifiable consideration of risk in the smaller SME deals. However, industry analysts point to compelling data that shows owner-managed or sponsorless companies carrying less leveraged balance sheets than private equity-backed firms. Lenders are often able to negotiate more favourable terms – and higher returns – where a firm is independently owned and operating well. There is also an element of the 'path of least resistance' at play. A manager can deploy a 2 billion fund in 20 buyout debt deals at $100m each where a private equity firm has done the due diligence in each case and provided them with all the financial data in tidy packets. Otherwise the debt fund manager would need to do their own due diligence on large numbers of borrowers where data is relatively scarce and financial sophistication is potentially low. Faced with these two alternatives for a similar level of fees to earn – between 1% and 1.5% per annum and a performance fee – it is hard to argue against the buyout option - *as long as it is available.* And this is a paramount question at this stage in the credit cycle. Participants in the sponsorless lending sector stress that they would rather not take the risk of being beholden to a highly competitive and cyclical M&A and LBO market. They also argue that the two options are not 'apples to apples': the higher return and lower leverage in the sponsorless sector outweigh the greater difficulty of accessing suitable borrowers as they build their asset management firms.

From here I see four clear requirements for the direct lending market now to break out of the private equity trench and start to connect meaningfully with small and mid-sized companies. Some of these are indeed already in train and the prospects look fair. But without each of these four things happening the big, profitable and sustainable direct lending market that many have envisaged may never emerge.

1. Become truly 'investable' for the large pension funds

To attract the big allocators such as sovereign funds and state pensions, the sponsorless lending market firstly needs to offer bigger funds. Few funds making direct business loans have a final size target of more than 400m. This is the actual ticket size of some sovereign funds, which is why they have to allocate to the 2bn+private equity debt funds. What would be the attraction of such funds to these large allocators? Direct SME lenders point to several. The funds offer much-needed diversification for investors from their private equity commitments, which may be exposing them to the same underlying deals across several debt and equity funds. Furthermore, sponsorless fund investors can typically be shown higher

returns than buyout debt funds, while portfolios are themselves more granular than in the debt mega-funds. But these positive investment attributes count for naught if they can't invest for technical reasons because the fund is too small for their ticket size. To run bigger funds, asset managers will need to build out well-resourced, fully AIFM-compliant platforms, so strong backing will be required for new players and new teams. New asset managers-forming who are not blessed with large capital sources of their own to pay for teams and the costs of a large platform have to be prepared to share equity in their platform. Several talented new start-up direct lenders in Europe have done just that and shared what looked like large stakes in their management company with key investors and other backers. One or two have grown to 5bn or more under management in a few short years and bought out their original backers. For some asset managers independence is everything, but independence without options in a competitive market like this is can be a deadly trap.

2. Understand and serve the insurers better

Despite complications associated with their Solvency II regulations, some of the most prominent insurance names in the UK, France, Germany and Scandinavia have begun to allocate small percentages of their vast asset books to illiquid debt funds to enhance yields. In most cases, however, insurance companies have been channelled to the senior debt of the private equity LBO market. To make the sponsorless lending market investable for insurers, three things are required. Firstly, asset managers need to originate primarily senior debt rather than mezzanine or growth capital in sponsorless situations. This means operating alongside banks in Europe and adding extra capital where needed to senior corporate debt transactions rather than being in subordinated positions to banks. Secondly, asset managers will need to establish credit platforms that insurance companies can be comfortable with. This may mean independent credit groups or even ratings assignment processes which insurers can become comfortable with. Finally, these funds will also need to be far bigger than the typical sponsorless offerings. Funds of less than 500m will not be able to take the ticket size of insurers, who do not have the capacity to analyse many different fund managers.

3. 'Professionalise' SMEs and improve the data

The most common reason fund managers cite for not pushing more actively into direct business lending is the lack of professional processes when they deal with potential borrowers. A private equity-backed company will bend over backwards to make it easy for lenders to understand and get comfortable with a credit. In a true direct lending situation the lender may be working from scratch with limited financials and may be working with a management team who have never before worked with non-bank lenders. This provides a big opportunity for advisers to potential borrowers and the fund management community. By providing a professional advisory service to management teams, an advisor can play a useful role. Typically debt advisors have worked to place debt into the private equity community. As more capital comes in to the sponsorless sector, advisory boutiques can gear up to play a crucial role in arranging new deals. Simply modelling a company's past and projected cash flow in detail and providing a detailed professional offering memorandum will make the job much easier for the many direct lenders who have capital available.

Another significant development is the emergence of the data-led market-place lending platforms originating loans to micro-SMEs. Only around $20bn has been provided globally to SMEs through the MPLs so far but the number of companies served is far higher than in the private equity sector. This means that investors with equivalent size are accessing much more

granular credit portfolios. Technology has been key to the process. Unencumbered by expansive branch networks the market-place lenders have managed to build large and powerful sourcing and analytical processes. Machine-learning is being deployed to improve underwriting processes. Insurers have taken notice and have started to invest. The recent commitment by Dutch insurer to Funding Circle is the latest such example. If the platforms can keep their discipline and prepare well for the next cycle (by submitting to severe stress tests and maintaining tight underwriting standards) the MPLs will have built a new bridge between SMEs and global investors.

4. Revive the funds of funds

A crucial catalyst in the early development of the private equity and hedge fund sectors was the development of a large funds of funds market. For a large investor allocating for the first time to esoteric new asset classes an efficient way to get exposed was to park money with a fund of funds who would do the due diligence on a range of different funds. As those markets have matured investors have become less willing to pay the double layer of fees that a fund of funds involves. However, for a large pension investor to access the smaller credit managers who are lending in one country where they have deep local presence, a fund of funds may be the right model. Funds of funds catering to the German market like Yielco Investments and Golding Capital Partners have successfully allocated to specialist debt managers on behalf of their own investor clients. Finnish direct lending and private equity expert Certior is advising clients on how to allocate into single country lending funds. Further development of this sector is required to further boost direct lending.

If these opportunities are grasped by market participants over the coming period there is a good chance that a permanent funnel from the savings system into SMEs will open up. Yes, asset managers will need to work to set up the right systems, advisors will have to retool some of their processes and investors themselves will need to take the time to understand different risks. The upside for investors will be greater diversification and more yield. Asset managers themselves will be able to develop new products and serve new clients. SME companies will be able to access patient and potentially more understanding capital pools. Collectively we will have laid at least one ground-stone for a more resilient, less cyclical credit system.

James Newsome is Managing Partner at Arbour Partners. Arbour, based in London and Berlin, advises global investors in the alternative investment sector. Prior to founding Arbour in 2010, James was at Merrill Lynch's Alternative Investment Group in London from 2000-2009.

About AltFi
Altfi provides market-leading news, insights and data on the rapidly growing alternative finance and fintech world. Our core focus is on alternative lenders, including both peer-to-peer/marketplace lenders and direct lenders as well as investment in alternative credit, equity crowdfunding, challenger banks and robo-advice. In addition, AltFi runs major industry conferences and seminars globally, and our sister company AltFi Data is widely regarded as the premier source of institution-grade analytics for alternative finance.

© AltFi Ltd 2013-2017. All rights reserved.