

**Private Debt
Investor**

Europe report 2019

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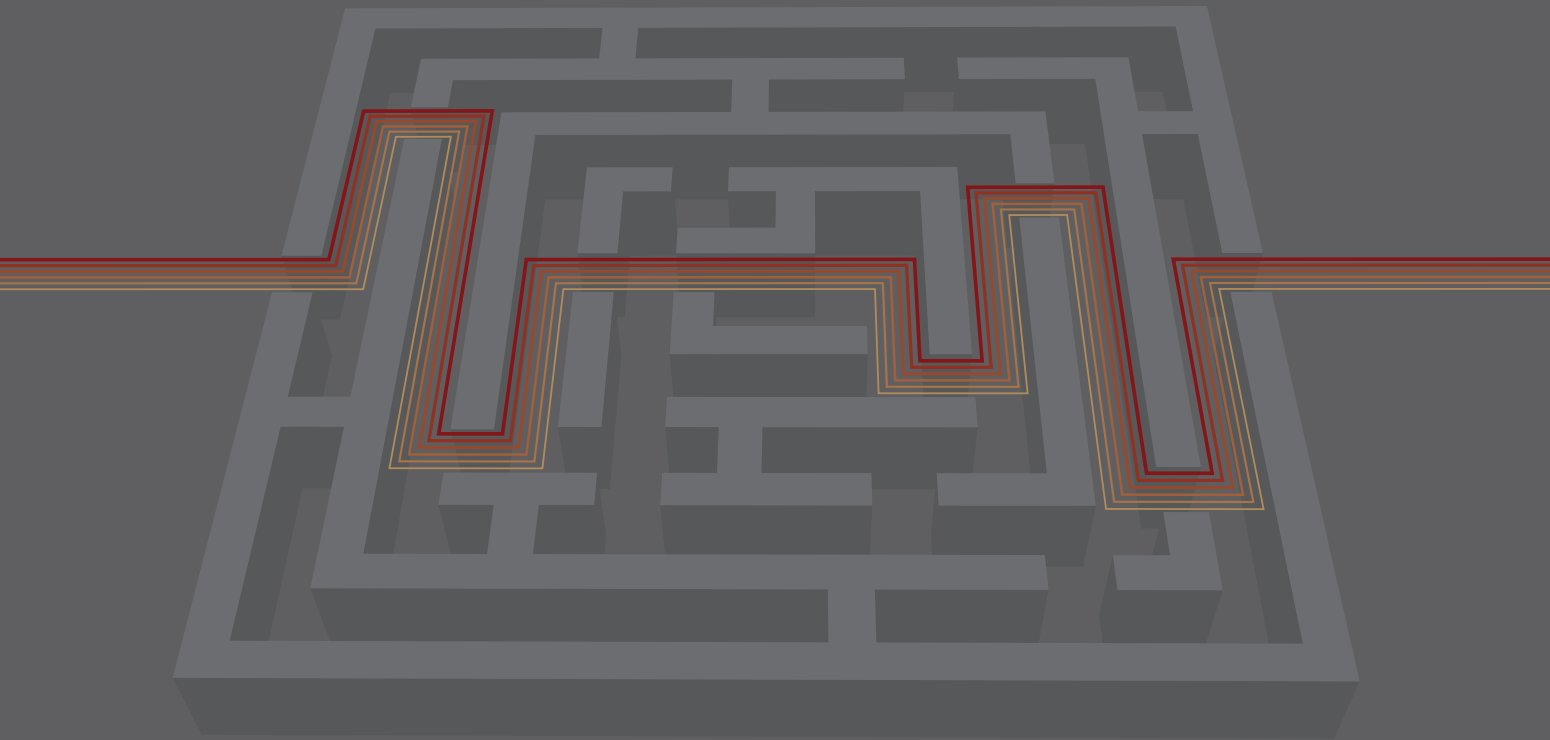


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How to avoid hitting the rocks
as the cycle turns

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Private Debt Investor

Europe report 2019

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Insight

European private debt Amid a strong appetite for its strategies, we identify six trends driving Europe's private credit markets

Buoyant. It's not the word we necessarily expected to use to describe the European private debt markets when we compiled our last Europe report in autumn 2018, *writes Graeme Kerr*. Then the talk was all of the ending of the cycle and fears about what happens next. A year on and guess what? The talk is still on what's coming down the track but there's a new maturity in the discussions, as if participants have got their houses in order for a possible downturn and are now prepared to make the most of the opportunities. Here are six trends that we have identified over the last 12 months.



Europe is bucking the global trend

Global private debt fundraising declined last year but the European market has held up well. Almost 30 percent of private debt capital raised in 2018 was for funds with a sole focus on Europe – the first increase in funding for the region, relative to the rest of the world, since 2014. That confidence was on display at our *PDI* Germany Forum in June where 55 percent of delegates said they planned to increase their European exposure over the next 12-18 months, compared with only 30 percent who intend to increase investment in the US. One factor is the increased willingness of European managers to offer leveraged options at the fund level, sources say, which is at least partly due to the growing presence of US-based managers in Europe. Ares Management, for example, closed its fourth European direct lending fund last year on €6.5 billion, which rose to €10 billion including leverage.



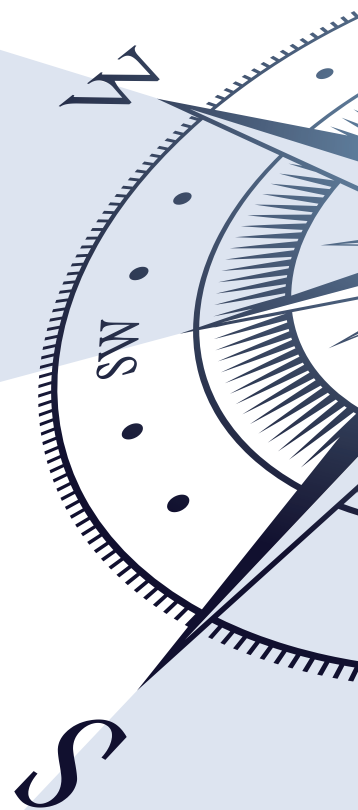
Asian investors are targeting Europe

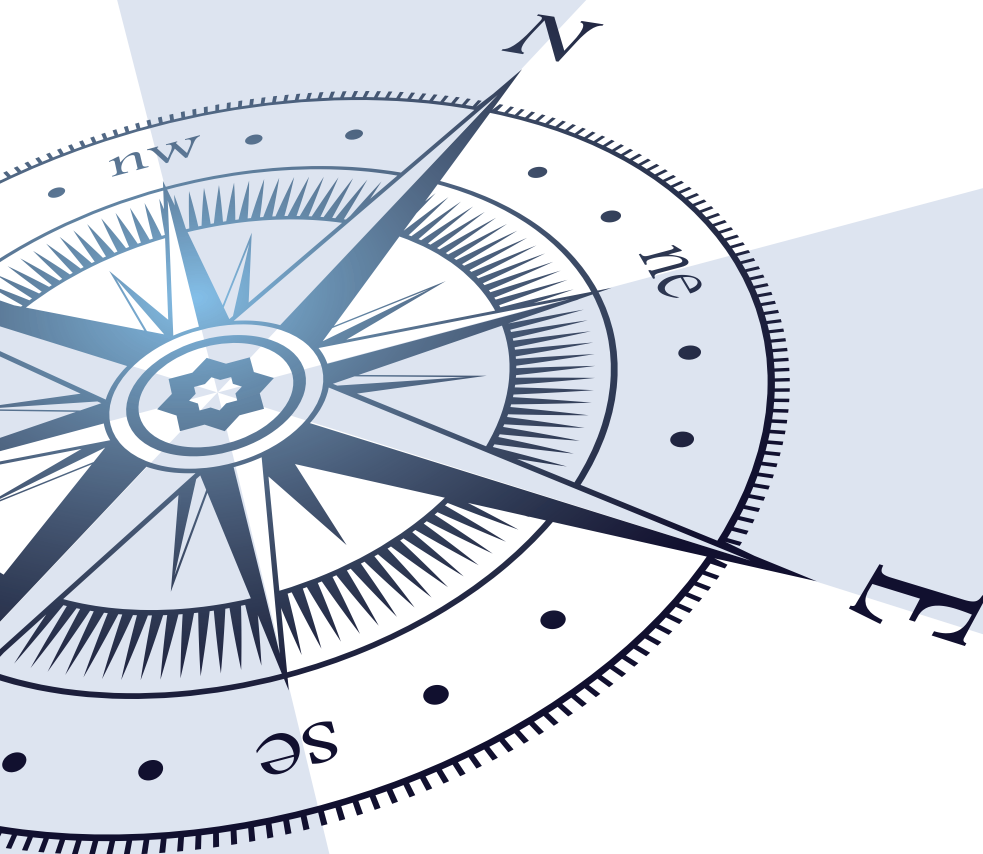
This willingness to embrace leverage is attracting more US LPs to Europe: "European private debt is a nice diversification strategy for US investors, and they are aware of all the opportunities that exist and the decent returns on offer," says Spencer Wells, country executive, UK, at Alter Domus. But US investors are not the only ones newly targeting the region. One of the big talking points of our European Roundtable (p. 16) was the influx of Asian investors. "In Japan, the regulator's understanding of CLOs and private debt funds is now more aligned with that of the European regime and that is translating into Japanese investors becoming more comfortable with European funds," says Diala Minott, a structured credit partner in the London office of Paul Hastings. "We're also seeing a similar pick-up in appetite for Europe among Korean investors."



But there are growing signs of strife ...

That's apparent with the rising popularity of funds targeting distressed debt. Two funds targeting 'challenging' conditions in Europe closed in June alone. HIG Bayside Capital, the Miami-based distressed debt and special situations manager, closed its latest European fund on \$1.5 billion. The HIG Bayside Loan Opportunity Fund V (Europe) will focus on investing in small-cap, special situations credit opportunities in the region. "Economic conditions in Europe remain challenging, especially for





smaller businesses," said John Bolduc, executive managing director and head of HIG Bayside Capital. "Our pan-European credit team is well positioned to address this need and capitalise on the compelling investment opportunities available in the European credit markets."

Earlier the same week, London-based fund manager Cheyne Capital Management closed a European fund on €1 billion that it said would "seek to take advantage of increased dislocation and heightened illiquidity in sub-investment grade credit markets as the current late-stage credit cycle advances".



... especially in the retail sector

Unsurprisingly, perhaps, retail is one of the hardest hit sectors, with sales of distressed UK retail loans – and particularly those on shopping centres – expected to begin this year, according to Anurag Sharma, head of loan advisory at CBRE. "Retail is going through structural changes in the market, which is affecting the values of certain retail assets in the UK, particularly those in the secondary town locations," he told sister title, *Real Estate Capital*. "This will ultimately impact loans secured against these assets,

as loan-to-value covenants will be in breach."

This does, though, throw up opportunities. "Retail is the bad press story but the broad brush the industry applies to it hides areas of potential value," says Beatrice Dupont, partner at Venn Partners, pinpointing how the change from pure retail to mixed use properties can be an attractive investment.



Brexit remains a concern in the UK ...

A strong theme to emerge from this report is just how Brexit is hitting attitudes to investing in the UK. "It has been more than three years since the referendum, but the continued uncertainty means we are cautious around those UK businesses that have, for example, exposure to the high street, and those with input and output costs in different currencies," says Christopher Bone, Partners Group's head of private debt in Europe. Brexit was also one of the key topics of our European Roundtable, with participants agreeing that LPs are becoming increasingly cautious about capital going into the UK.



... yet private debt is taking a greater share in France and Germany

Both markets are showing increased inroads by private debt funds. Capital raised by French private debt funds increased by 48 percent in 2018 to €3.5 billion, compared with €2.39 billion in 2017 and more than three times the €1 billion raised in 2016, according to research by Deloitte and local industry body France Invest.

Meanwhile, in Germany, debt funds are accounting for an ever-larger share of the market and this year have been responsible for one in two deals, according to research by debt advisory firm GCA Altium.

"Germany is also getting considerable attention; with many of the GPs we work with starting to increase their origination efforts here," says Tavneet Bakshi, a partner at FIRSTavenue. "There is increasing room for private debt funds." ■

Editor's letter

Plotting a course that avoids the rocks of uncertainty



Graeme Kerr

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The question got us thinking. "So what lies beneath the surface?" asked *PDI's* art director. We were looking at potential cover images for our *Europe Report* of yachts sailing into the distance. The images were supposed to represent how European private credit was charging on, despite fears of a downturn. But something wasn't quite right. It was all just a little too serene.

That's the paradox of the good ship *Private Debt (Europe)*. On the face of it, everything appears to be plain sailing: fundraising is robust, buoyed by US investors that are switching their attention across the Atlantic.

Dealmaking has more than doubled over the past five years and the recent spate of hires in Germany and the Nordics suggests the market is expanding beyond its existing strongholds in the UK and France.

And yet our art director most definitely had a point. Lurking beneath the surface, there are some pretty dark shadows: not just in the UK, where Brexit continues to weigh on investor sentiment, but in Germany, where the economy is a concern and there are worries about the rise of the far right.

Doubts remain about cov-lite loans and there is the ever-present question of when the cycle will finally turn. The recent hiring spree includes special-situations roles, in a sign that private debt firms are staffing up to take advantage of an expected rise in distressed debt.

Hence the eventual choice for our cover image of a yacht navigating its way over potentially treacherous rocks. There are plenty of opportunities in Europe in both new and established markets, but charting a course through the straits will require some careful pilotage. And there could be some pretty choppy waters as the cycle turns.

So is it time to hoist the mainsail? Yes, but the message that comes through from this report is that you'll need a firm hand on the tiller to ensure you don't run aground.

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Year in review The biggest European private debt stories reported by PDI over the past 12 months

Half of German mid-market deals funded by debt funds

Half of all German mid-market debt deals in the first nine months of 2018 involved debt funds, according to debt advisory firm GCA Altium. In its Q3 2018 *MidCapMonitor* report, the firm said that during the first three quarters, debt fund unitranche financings had accounted for 52 percent of German mid-cap deals, and that 34 deals had been completed by funds, compared with just 31 by banks. This was up from 34 percent in 2017 and 15.6 percent in 2016.

France sees 50% rise in private debt capital

Capital raised by French private debt funds increased by 48 percent in 2018, according to research by Deloitte and local industry body France Invest. A survey of French fund managers and international firms investing in the country found a total of €3.5 billion had been raised by six funds to invest in French private debt. This compared with €2.39 billion in 2017 and was more than three times the €1 billion raised in 2016.



OCT 18

NOV

DEC

JAN 19

FEB

MAR

APR

Mezzanine Management Central Europe raises €264m

Mezzanine Management Central Europe announced the final close of its Accession Mezzanine Capital IV at €264 million, exceeding the fund's initial target of €250 million. The vehicle is the largest ever raised by the firm and counts several central European and Asian firms in its investor base. AMC IV provides flexible growth capital in the form of long-term debt and equity to mid-market companies based in central Europe.



Beechbrook eyes Germany for 'future growth'

Beechbrook Capital, the lower mid-market direct lender, hired Peter Gottron as an investment director to spearhead its push into Germany. He now covers the DACH markets, comprising Germany, Austria and Switzerland. Gottron was appointed to head Beechbrook's new Frankfurt office, having previously been head of corporate banking at Mainzer Volksbank. Beechbrook partner Paul Shea said the decision to open an office in Frankfurt reflected "the importance we attach to the German market in supporting our future growth".



ICG hires ex-Cerberus exec to special situations team

Intermediate Capital Group hired Alan Ross as a managing director in its special situations team. Ross joined ICG after more than a decade at Cerberus Capital, where he was a senior vice-president with a focus on sourcing and executing credit, special-situations and distressed debt opportunities. It is thought ICG is preparing to launch a new special situations vehicle.

Pemberton closes second mid-market fund at €3.2bn

Pemberton closed its second-generation European mid-market fund at €3.2 billion, breaking its €2.5 billion target. The fund manager also raised €1 billion for its first Strategic Credit Opportunities Fund. Pemberton European Mid-Market Debt Fund II was launched in 2018 as a follow-up to the firm's first mid-market credit vehicle, which had closed on €1.2 billion two years previously. It aims to provide senior loans for acquisitions and growth capital and is targeting returns of 7-8 percent.

MAY

JUN

JUL

AUG

EIB announces plans to lend €100m to Dutch and German SMEs via Funding Circle

The European Investment Bank announced that it would lend €100 million to small and medium-size enterprises via online lending platform Funding Circle. The deal aimed to support more than 1,600 businesses in Germany and the Netherlands. It followed a previous partnership in 2016, when the EIB loaned £100 million (\$131 million; €120 million) to UK SMEs via Funding Circle. The EIB said online funding platforms would play an important role in channelling finance to SMEs in the future.

Cheyne Capital Management raises €1bn

Cheyne Capital Management has closed the European Strategic Value Credit Fund at its hard-cap of €1 billion. The fund, which was 40 percent oversubscribed, has an opportunistic strategy that seeks to capitalise on the accelerated sell-down of legacy mid-market corporate loans by European banks. It will acquire the debt of stressed mid-market businesses with average deal sizes of €10 million to €50 million. Texas County & District Retirement System committed \$100 million to the fund in October 2018.

50%

Rise in French private debt capital in the past 12 months

52%

The proportion of German mid-market deals involving debt funds between January and September 2018

\$100m

The amount committed to Cheyne European fund by Texas County & District Retirement System

€100m

Amount EIB is to lend Dutch and German SMEs via Funding Circle

€264m

Total raised by Mezzanine Management Central Europe

€3.2bn

Total raised by Pemberton for European mid-market fund

E X P E R T Q & A

As investors weigh up portfolio resilience ahead of a downturn, Christopher Bone, Partners Group's head of private debt Europe, and Alexander Ott, managing director, examine the key considerations amid uncertainty across the continent



Standing strong amid Europe's ever-shifting market dynamics

Q How would you describe competition in the European private debt market and what is your assessment of bank lending appetites?

Christopher Bone: Ten years ago, private debt was in its infancy in Europe. Today, there are more options for borrowers, but the banks still have restrictions on the amount of illiquid debt they will take and hold on their balance sheets. This means that an owner or buyer looking for financing would need to put together four or five banks to reach, for example, €150 million in a mid-market bank-led lending syndicate.

By comparison, a buyer can go to a single direct lender, like us, and get a solution in one go. Importantly, the banks don't want to underwrite or hold subordinated debt, which also presents an opportunity for alternative lenders. This is particularly relevant

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at the larger end of the upper mid-market, which is a sweet spot for us.

Q Given current market uncertainties in Europe, what is the sweet spot for private debt investment today?

CB: We still see a trend of good risk-adjusted returns for private debt, but we are examining investments closely by region, capitalisation and capital structure. For instance, the immediate outlook for the UK, in particular, has become a lot more uncertain than the rest of Europe.

In Europe, we typically focus on the core countries for private equity including Germany, France, Benelux, Switzerland and

the Nordics. Southern European countries are a smaller market and present, in some instances, a more challenging legal environment. France remains an interesting place for us to invest as we have a strong local presence and track record – it is a difficult market for managers that don't have one. Germany is also an important market for us.

Q How important is experience in the investment team if we were to enter a period of defaults? Can lessons from the last crisis be taught to those who weren't there?

CB: In uncertain times, experience and depth is key. We are one of the larger debt managers out there, with a team of more than 50 private debt investment specialists across our offices. This team is supported by our global in-house legal team, as well as one of the mid-market's largest teams of industry

value creation professionals. Companies don't always perform as expected so we also have a specialist team to help manage more difficult situations. In these cases, you need the expertise and resources to help a company through a rough patch. When we recruit for this team, the backgrounds tend to be those with experience on the legal side. As a debt provider, if things go well, you are refinanced after a number of years, but if things don't, you need the option and resources to be proactive.

Q When you speak to your clients, what are their investment priorities at the moment?

Alexander Ott: Each client will be looking to get different things from their allocation to private debt. You have investors that want to add something defensive to their portfolio, and something that has a cash yield, with a five-year investment horizon. These investors are more focused on investing in senior debt. On a more granular level, there is a distinction between the senior debt liquidity required. Some have more of a tolerance for illiquidity, or are even looking to cash in on an illiquidity premium.

There is a second category of investors, however, with very different needs. They may have a greater risk appetite. This can include appetite, for example, for unitranche, but also directly placed second lien. Mezzanine would also fit within that strategy. Here, the thinking is different. Over and above the liquidity premium, they also want to earn an attractive risk premium.

Q How has Brexit influenced the discussions and thinking at investment committee level?

CB: We are spending a lot of time looking closely at what Brexit means for our companies and for each potential investment opportunity that we look at. It has been more than three years since the referendum, but the continued uncertainty means we are cautious around those UK businesses that have, for example, exposure to the high street, and those with input and output costs in different currencies.

AO: From the investor perspective, I have had many discussions centred on politics and not just on Brexit in the UK. While UK institutional investors are the most bearish, institutional investors in Germany are also cautious due to the uncertainty created by

“There is a real bifurcation among the investors we speak to in terms of their top priorities and concerns”

ALEXANDER OTT

“The immediate outlook for the UK, in particular, has become a lot more uncertain than the rest of Europe”

CHRISTOPHER BONE

the looming end of the Merkel era. In Italy, too, there is caution about political uncertainty. Meeting time at fundraising discussions is increasingly allocated to politics.

For example, I have just returned from a client update meeting where they were keen to know about our UK exposure, and what to expect in terms of the performance outlook given the higher likelihood of a no-deal Brexit. Other discussions with investors and their decision-making bodies are about the potential impact of trade relations with the US, and any ripple effect on the German economy.

Q From your conversations with clients, what are the issues that are front of mind with investors, as they weigh up opportunities in European private debt?

AO: There is a real bifurcation among the investors we speak to in terms of their top priorities and concerns. For example, Japanese investors – much like European investors – tend to focus on senior debt and no leverage, prioritising stability and cash yield. They may consider something which is illiquid but only for five years. Contrast that with the US, Asia ex-Japan, or the Middle East, where they are much more focused on the potential size of the return and are willing to accept leverage. Perhaps even leverage on the entire portfolio to get to higher returns. There isn't a right or wrong approach. As investment managers it is our job to accommodate these different appetites, which we do by having a diversified range of product offerings across the capital structure.

Q What is the most important topic in European private debt that the media are not covering?

CB: We are now 10 years on from the last downturn and it is the right time to ask whether private debt managers are set up for the next downturn, both from a defensive as well as offensive perspective. Is there enough flexibility in the funds that are raised and do managers have the in-house capabilities, for example, to take advantage of a drop in prices in the secondary market? It is impossible for anyone to predict when the downturn will come. Hence, it is essential to remain invested in diversified portfolios and at the same time make sure that we have dry powder and the capacity to take advantage of a downturn when it does happen. At Partners Group, we want to be prepared, and so track the market closely in this context. ■

On the minds of managers

European deal prospects remain bright as long as you steer clear of cyclical industries, says our expert panel

Our panel

Ari Jauho

Partner
Certior Capital

Cécile Mayer-Lévi

Head of private debt
Tikehau Capital

Jaime Prieto

Managing partner
Kartesía

Paul Shea

Managing partner
Beechbrook Capital

Q What would you say is the biggest priority for LPs today?

Ari Jauho: LPs should pay more attention to downside protection when making new investments.

Cécile Mayer-Lévi: Allocate to GPs that are able to deploy efficiently in a diversified manner, and stay disciplined so you are not under pressure to invest. Focus on an asset manager who is immersed in the real economy, who knows the companies and their management team and is able to cope with a potential downturn and underperforming companies.

Jaime Prieto: Finding managers that avoid the crowded sponsored mid-market segment, and that can generate consistent returns.

Paul Shea: Maintaining discipline on credit quality, leverage, terms and knowing that the manager has workout experience.

Q Describe a type of deal you would steer clear of?

AJ: Project-based deals in highly cyclical industries, such as the construction business.

CM-L: Very high value from an equity perspective implying a very high leverage – above 6x net debt to EBITDA – in a cyclical industry with a buy-in management team.

JP: Deals with binary outcomes. These could arise due to technological shifts, sudden changes in customer preferences and little or no recovery value in distress. Apparel retail combines all of this: it's great when things go well, but awful when they go bad.

PS: Businesses with no incentive, where management has no skin in the game, or if the business is loss-making or in a dying industry.





Q Where is the best place in Europe for private debt, and why?

AJ: In general, we favour underdeveloped European markets where there is a favourable supply/demand balance of private debt. At the moment these markets could be Benelux, Ireland, and central and eastern Europe. The problem with these markets is that there are not too many managers to invest in.

CM-L: Continental Europe, and more precisely France, where we have been a longstanding private debt player. Italy, Spain, Benelux and France – where we have offices – but also Germany and Scandinavia are among the most attractive markets. The best situations are those of existing portfolio relationships.

JP: Sponsorless deals in the low-mid market segment offer the best risk-adjusted returns (3-6pp for the same risk). The reason being that it is the most underserved segment, and you are rewarded for your origination and structuring skills.

PS: North-western Europe. There is economic activity, clear creditor laws and a stable financial ecosystem.

Q Does private debt's future lie in Europe or Asia?

AJ: We believe in Europe, because in private debt you will need a solid legal framework that is not necessarily in place in Asia. Also hedging costs to the euro dilute the attractiveness of Asian investments from European investors' point of view.

PS: Europe because banks continue to retrench and there is better rule of law and supportive regulation.

Q Tell us when the cycle turns - precise date and time please!

AJ: I think that the cycle turned already, late last year – let us say 27 December 2018. There are many indicators that show that the cycle did peak late last year: things such as the current trading of companies and raw-material price developments.

JP: We are at an inflection point already. The tailwinds are gone, and we still have strong headwinds that make it hard to see when we will regain a solid positive momentum.

PS: It has already turned. Cyclical businesses are pulling back, there are signs of backlogs decreasing and equity return expectations are lower.

Q The 'B' word: What does Brexit mean to you?

AJ: Increased uncertainty with rising hedging costs of pounds to euros. On the other hand, there has been a positive development in terms of underwriting the returns of new deals. We pay a lot of attention to the sectors and avoid UK industrial companies that are dependent on exports.

CM-L: As the British market is contracting, there will be more competition in continental Europe from players who were previously very active in the UK. In general, Brexit is a very grey area and will be a black day for European countries and for the young generation looking for freedom and mixing cultures.



JP: No one is safe from populism, not even the once-pragmatic British.

PS: The downsides are increasing defaults, economic slowdown and the risk for cyclical sectors. The upsides are the new opportunities, given the retrenching banking sector and opportunities in the secondary market as 'weak' funds with limited or no restructuring experience fail. The surviving funds will come out stronger.

E X P E R T Q & A

Investors are increasingly looking outside plain-vanilla direct lending, with the secondaries market of growing interest, say Tavneet Bakshi and Christian Allgeier of FIRSTavenue



Seeking out new strategies

Q Which credit strategies do limited partners like at the moment?

Tavneet Bakshi: We have seen a notable pick-up in interest for higher-returning credit strategies. There are several factors driving this trend, particularly with US LPs and more recently with European LPs. Over the last three to five years, many LPs in Europe have focused on building out their core private debt programmes, and direct lending has formed the bulk of that.

However, some of these portfolios are now extensive, so investors naturally look for something differentiated, and complementary to their overall private credit allocation.

A second consideration, which is probably the stronger driver, is where we are in the cycle. LPs are looking to benefit from opportunities that arise as the cycle begins to turn. This leads to stressed, situational and distressed investments.

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Q Is there much interest in asset-backed lending?

TB: 'Asset-backed' is a real buzzword at the moment for LPs. We have noted particularly keen interest from LPs based in the US, where it is already a well-established strategy. It makes a great deal of sense, because financing is backed by hard assets, including real estate, machinery and telecoms equipment for example. The ability to perfect on tangible collateral should give investors more comfort around the return of principal, if the business itself is unable to make the interest and capital repayments.

Q What other niche strategies are you seeing?

TB: One example is SME lending and wholesale 'lending to lenders'. We are also

seeing interesting opportunities in secondary purchases of non-performing loans, single name or small portfolios rather than the large portfolio acquisitions we witnessed after the global financial crisis in 2008.

Speaking more generally, there is an exciting evolution in private credit at the moment; it is no longer all about direct lending. Private credit strategies in Europe are far more diverse now than they have ever been. One factor behind this is the outpouring of talent from banks or larger asset managers, where managers have gained expertise in particular niche strategies that would have formed part of a wider offering. Some of these strategies were executed in more liquid structures and are now available in more appropriate closed-end structures.

Q At this point in the cycle, what country or regional angles do you see?

TB: Everyone has been bracing themselves

for what Brexit means for UK corporates. However, many funds with diversified geographical exposure are still quite happy to be overweight in the UK, because it is a friendly market for lenders. Having said that, there is a fair amount of competition in the UK between lenders.

Germany is also getting considerable attention, with many of the GPs we work with starting to increase their origination efforts here. Historically it has been quite well-served by its banks, particularly in mid-market lending. However, there is increasing room for private debt funds. On the one hand, the weakening economic health of Germany is getting a lot of press. On the other hand, there are many well-established, well-run companies with a long history that might need some short- or medium-term financing. Non-sponsored opportunities are interesting here. However, originators at private credit funds need to be able to build relationships with family-owned businesses in a non-threatening way, instilling confidence that they are not loan-to-own investors.

Q Are you seeing the growth of country-specific or regional funds?

TB: Local fund managers can achieve good returns. For example, some Nordic and French GPs have done well in their regions. The Nordics are well-served by local banking systems, and France is a 'proximity' market. Interesting deals can be hard to find if you are not on the ground, so I do buy into the idea that there is a role for specialists. However, generally speaking, it is hard to get country-specific exposure of meaningful size outside the UK, France and Germany. Fundraising can be challenging for country or region-specific funds because investors

"There is an exciting evolution in private credit at the moment; it is no longer all about direct lending"

TAVNEET BAKSHI

Opportunities in the secondaries market

Q How do you view the secondaries market?

Tavneet Bakshi: It is still early days for private credit secondaries, especially in Europe where direct lending has only been around for about nine years. However, because of the large amount of private credit dry powder allocated in recent years, there will be more and more opportunities in the future. We think these opportunities have already begun to grow, but do not know exactly when this will accelerate.

Q What are the relative strengths of buyer and seller when it comes to pricing?

Christian Allgeier: It all depends on the reason the seller has for divesting in the first place. An investor who wants to sell due to underperformance of the fund, for example, is more likely to find themselves in a position where they have to accept a large discount due to the time or situational constraints in place. However, if the seller is divesting because of a strategy shift, the discount they would be willing to accept would likely be smaller. Nevertheless, a challenge for the credit secondary market is that because it is still relatively young, the range of possible pricing for any given deal is much wider than for private equity, where the prevailing market price is relatively clear given the high trading volumes over the past decade.

TB: Direct lenders have deployed great sums of money, often at initial leverage levels that are higher than before. There has to be a point at which GP restructurings in private credit pick up and secondary offerings are part of the solution. There should also be plenty of room for plain-vanilla secondaries as LPs seek to restructure maturing private credit portfolios.

often want and need broader exposure and more diversification.

Christian Allgeier: We know one fund of fund with an interesting solution; they invest in smaller, more niche managers as well as specialist regional funds, and thus have created a highly diversified fund portfolio with an almost pan-European focus. Moreover, from a performance perspective, they are able to beat single-focus credit funds with a lower risk profile and despite the double layer of management fees. They are able to do this by getting better economics via first closes, seeding GPs, using co-investments and acquiring private credit secondaries.

Q But are there sometimes advantages in being smaller?

CA: Yes, absolutely. When a manager has a multi-billion fund to deploy it is often not efficient for them to look at deals below €200 million, and given the limited number of deals of this size in the market these larger managers often find themselves either competing for the same deals (and getting less preferential terms/pricing as a result of that competition) or having to follow larger

market trends. This can often lead to their performance being nothing more than a beta play. However, smaller managers with €1 billion or less to deploy can extract real alpha, because they have a wider range of opportunities available to them and so have a stronger negotiating position when finalising deal terms and pricing.

Q Many investors complain about the spread of covenant-lite terms. What is your experience?

CA: The GPs we work with have been very consistent on covenants. One is the minimum they accept, and they may want three or four, depending on the deal. However, in actuality the detail is what is important: how valuable is the covenant? If it contains too much headroom, the covenant can, in a sense, become worthless.

TB: The competition is perhaps less in the lower mid-market, and this may help to keep documentation tight. However, at the larger end of the market, there has certainly been some loosening of covenants. The coming years will unearth more evidence of where deployment haste has won over credit discipline. ■

Europe overcomes its leverage stigma



Expert analysis by **Andy Thomson**

A willingness among funds to offer leveraged options is enticing more investors from the other side of the Atlantic

It's often said you should never rush to conclusions. Was the decline in global private debt fundraising a sensible pause for breath by investors that had committed unprecedented sums to the asset class the previous year? Or was it more a case of investors taking fright because of concerns about economic and political volatility – as well as increasingly questionable deal structures?

It may take a while before answers to these questions become apparent, but one thing that can be seen clearly from the fundraising data we compile is that Europe bucked the trend. Almost 30 percent of private debt capital raised in 2018 was for funds with a sole focus on the continent – the first increase in funding for the region, relative to the rest of the world, since 2014.

Delegates at our *PDI* Germany Forum this summer were upbeat about the continent's appeal: 55 percent said they planned to increase European exposure over the next 12-18 months compared with just 30 percent who projected higher investment in the US.

Sources have told us that one factor relevant to the region's growing popularity is the increasing willingness of European managers to offer leveraged options at the fund level. Leveraged private debt funds have long been a part of the landscape in the US, where investors have become entirely comfortable with the role of leverage in enhancing returns. In Europe, until recently, this has not been the case.

Part of the reason behind the cultural shift in Europe towards embracing fund leverage may be the growing presence there of US-based managers. Ares Management, for

example, has been going gangbusters on the fundraising front. This included closing its fourth European direct lending vehicle last year on €6.5 billion, a figure that rose to €10 billion when leverage was factored in. Not bad for a fund with an initial hard-cap of €4.5 billion.

To lever or not to lever?

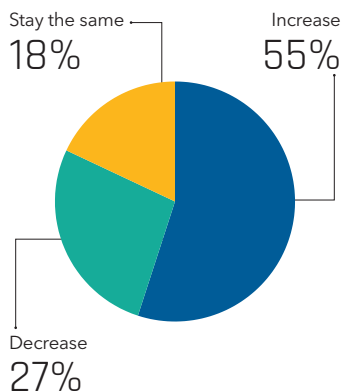
Of course, not everyone has the pulling power of the big brand names. As one market source pointed out to us: "There are still plenty of direct lending funds offering unleveraged only. Ares and others are able to offer levered and unlevered options and ask investors which one they want. In the end, it boils down to your view on the manager. How good will they be at choosing the right credits and making sure the right protections are in place?"

There can also be concerns over how the leverage might be used – just for deals, or areas such as manager compensation or hedging? Another focus is how the leverage is put together, which is normally by way of a bank facility with appropriate security. If it's not structured correctly, it could fall foul of regulations, such as the EU's Alternative Investment Fund Managers Directive.

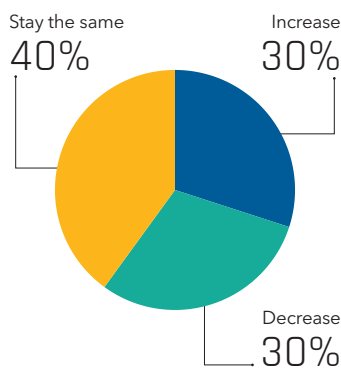
But what does appear to be changing is the perception that relatively low-risk strategies, such as direct lending, should of necessity be unleveraged because of leverage's association with high risk. The boundaries of risk appetite are being tested in Europe in the way they already have been in the US – and it's a development US LPs appear happy to support. ■

Europe's growing appeal

In the next 12-18 months, how do you expect your European exposure to change?



In the next 12-18 months, how do you expect your US exposure to change?



Source: PDI

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On an even keel

As Europe's private debt market continues to mature, investors are looking to capture opportunity and manage challenges. But how can the industry weather the next downturn when it finally arrives?

Even as economic growth has slowed in some of Europe's key economies, the continent's private debt market has maintained its strong momentum. In 2018, deals continued to flow, with Deloitte's most recent *Alternative Lender Deal Tracker* showing a 9 percent increase over the previous year in the volume for direct lenders.

And although fundraising was down last year on 2017, Europe's 29 percent share of the capital raised globally was just shy of the 31 percent peak in 2014, according to *PDI* figures, which suggests there remains a strong appetite for European private credit strategies.

Against this backdrop, we invited a panel of five top private debt professionals to discuss how the European industry is shaping up, new developments they are seeing in the market and what we are likely to see over the next 12-24 months.

Q How would you characterise the investment climate for private debt in Europe?

Daniel Heine: We are starting to see investors become more cautious in their commitments as there are concerns around whether the credit cycle is coming to an end. However, if you look at the actual market, the opposite appears to be true. There is still interesting and good quality dealflow coming through and, even with a bumpier economy ahead, this will help us in continuing to make sound investments, particularly in the special-situations universe. I am actually looking forward to the next few years.

Symon Drake-Brockman: Private equity across Europe remains active. In some markets, such as Germany, you're seeing more activity than has historically been the case. I'd say the demand side for finance remains reasonably robust. If there is a global slowdown, you just need to be more selective

and more mindful of stress-testing opportunities.

Andrew Konopelski: If you look at direct lending – which sits in the middle of what has become quite a wide definition of private debt – it's still quite attractive when compared with other fixed-income and yield strategies. It now makes up quite an important part of limited partners' portfolios as they recognise that they receive a good pick-up in returns in exchange for only an incremental pick-up in risk. Being a sole lender in structures, as opposed to being a participant in syndications, is an attractive space to occupy from a returns perspective.

We certainly take the view that we're now pretty late in the credit cycle, but then I've been calling the top of the market since 2015. We've perhaps been a little overcautious for a couple of years now, but you do have to be mindful that, during your investment period, you are likely to see some kind

PHOTOGRAPHY: RICHARD DAWSON


Symon Drake-Brockman

Founder and managing partner, Pemberton

Drake-Brockman leads the development and execution of the firm's long-term strategy, takes an active role in the selection and structuring of investments, and oversees the ongoing management of funds. He was previously global head of debt markets at RBS.

Daniel Heine

Founder and managing director, Patrimonium

Heine is managing director of Patrimonium's private debt business as well as adjunct lecturer at the University of St Gallen Executive School. He was previously a financial consultant for Merrill Lynch International and a management consultant at AT Kearney.

Dalia Minott

Partner
Paul Hastings

Minott is a structured credit partner in the London office of Paul Hastings. She specialises in structured credit finance transactions, including CLOs, CDOs and bespoke hybrid mid-market CLO-type funds as well as debt and credit funds, with a particular focus on direct lending.

Andrew Konopelski

Partner
EQT

Konopelski is head of credit strategies at EQT. He is also a member of the firm's executive committee and of the credit partners investment committee. Before joining in 2008, he worked for Tisbury Capital, where he helped manage its \$1bn-plus credit portfolio.

Luke McDougall

Partner
Paul Hastings

McDougall is a London-based partner in the finance and leveraged finance practices. He focuses on UK and cross-border acquisition finance and restructuring and has experience acting for senior lenders, junior lenders and borrower groups as well as debt portfolio acquisitions.



“There is a lot of focus and scrutiny on UK-headquartered companies”

ANDREW KONOPELSKI
EQT

of recession or slowdown. We’re definitely seeing more interest in special situations now – whether that’s structuring solutions for companies looking to refinance debt or restructuring balance sheets. These strategies are coming into their own for LPs now.

Luke McDougall: In the work we’re doing, we’re definitely seeing a pick-up in restructurings of private debt deals, although this is primarily in the US so far. We’re not seeing so much restructuring work in Europe, but where we are, it’s mainly focused on syndicated loans and high-yield deals that are struggling rather than on large volumes of mid-market private debt deals.

Q What happens in the US often migrates over the Atlantic, so do you think we’ll see more restructurings in Europe?

SD-B: There is a huge difference between the type of company that uses private debt

in the US and that in Europe. In the US, all the first-tier suppliers – the ones that are integral to their customers’ supply chains – are big companies, and they therefore tend to go to the capital markets for finance. It’s mainly the third- or fourth-tier suppliers that sit in private debt portfolios in the US.

In Europe, by contrast, the first-tier suppliers are much smaller and so are highly relevant to the private debt market. Overall, the quality of business in European private debt portfolios is that much higher. If you talk to US players, they’re likely to agree that some of the businesses they’ve financed are marginal companies that have kept going because of the reasonably strong economy.

Q What trends are you seeing in LP appetite for European private debt?

Diala Minott: We’re seeing some interesting developments in a number of markets. There has been a relaxation of the laws governing limited partners’ investment scope in countries such as Argentina and Brazil, and I think that will benefit private debt generally.

But we’re definitely seeing more Asian interest in European private debt. In Japan, the regulator’s understanding of CLOs and private debt funds is now more aligned with that of the European regime, and that is translating into Japanese investors becoming more comfortable with European funds. This has taken some time as LPs in Japan tend to go through highly detailed processes up to a year in advance of committing. But the general feeling is that once they are locked in, it’s the start of a long-term relationship.

We’re also seeing a similar pick-up in appetite for Europe among Korean investors. In the past it had been difficult to structure investments to comply with the Korean regulatory regime and there were issues around accounting system clashes, but these have been worked through. You now have single investment mandates that then invest in the pooled funds – this gives them the control they need.

Overall, we’re now in a situation where most regulators understand how asset managers work and they no longer see private debt funds as shadow bankers. That’s very helpful. And with the rise of co-investments, there’s more understanding among LPs and more faith in the managers.

DH: We're seeing a lot more momentum, in particular from Asian investors. That appetite wasn't there before. Among Korean investors, you're seeing appetite develop along the same lines that the private debt market developed. They are experienced investors that have invested in the US for some time. The European market is clearly much younger, but Korean investors are now following the growth here. For managers in Europe, it is a relatively new phenomenon to go to Korea for fundraising, but it will become much more commonplace.

SD-B: The US market appears to be slowing down and that is affecting the appetite for Europe. Many US LPs are now fully allocated to US managers and so they are cautiously looking to Europe for opportunities, as are Asian investors, which are currently under-allocated. European investors are still actively investing in European private debt and, with yields continuing to be low, I can't see that changing over the short term. So, the overall appetite remains pretty strong for European private debt.

Q With continued opportunity and growing appetite among LPs, the European market is clearly on an even keel. But what surprises have you had over the past 12 months?

DH: I bet two years ago that interest rates would rise in Q3 2019 because I reasoned that the US economy would continue to improve. But, as we've seen in the US and Europe, that's not going to happen. But I was right about one thing: I agreed with the view that 2019 would be the year that the car industry model would change in Europe as we saw a move from the combustion engine to electric. That is clearly happening. In Europe, and in Germany in particular, that is having a tremendous effect on the auto supply sector – a large sector in Europe. It's definitely getting more bumpy.

DM: The rise of fund finance and fund leveraging hasn't been a surprise, but the levels we're now seeing are concerning. You have to ask how these funds will perform in a credit crunch. When you look at the borrowing base and asset base, it is interesting to see how different banks take different approaches. The new regulations on securitisations are affecting funds – they are now subject to regulations and have certain obligations, so it has been challenging to

“We’re definitely seeing a pick-up in restructurings of private debt deals, although this is primarily in the US so far”

LUKE MCDUGALL
Paul Hastings

structure around this. The US is a bit more developed when it comes to fund leverage and their structures have been tested. European ones haven't and I do wonder how robust they are.

LM: This has largely happened because the community of banks that will lend to funds has multiplied. That will inevitably lead to keener terms and pricing. Ten to 15 years ago, you might have had banks insisting on asset vetoes, for example, and their own valuation methodologies, but these are being eroded because it's so competitive. Banks are having to trust the asset managers.

Q So should this be a cause for concern?

SD-B: Well, you're seeing more banks come to funds to provide leverage and then syndicate it to a large group of institutions sitting behind the banks and taking on the risk. Fundamentally, they're buying AAA at 200 over, which is a lot more than you get in the CLO market and the equity under you is much larger, so the risk you're taking is better.



Q It's hard to have any discussion about Europe without addressing the B word. How is Brexit shaping your thoughts and planning?

SD-B: LPs are becoming increasingly cautious about capital going into the UK. Every manager in Europe is being asked about their exposure to the UK and there is now a tightening of lending going into the UK market. Any deal that does get done has to be justified. That is not positive for the UK market over the medium term and it's compounded by the fact that uncertainty – which is reflected in consumer confidence and, in particular, in retail numbers – continues to be a drag on the UK economy.

DH: I fully agree. We're all facing that question: what's your UK exposure? And, of course, we're trying to keep it as small as possible at the moment. As a trend, this isn't great for the UK economy.

Andrew Konopelski: There is a lot of focus and scrutiny on UK-headquartered

companies – and that's as it should be – but we're trying to help LPs understand where the actual risk lies. If you tell them you have an international business that happens to be based in the UK, they tend to look fearful, but then you have to demonstrate to them where the sales are so they can see where the real risks are.

There are still deals being done, but actually private equity firms have dampened their interest in the UK until they have more certainty around what will happen. So there is not unmet demand and margins haven't increased. The spread between sterling and the euro is widening as much as you might expect at a time of potential crisis.

DM: One thing we're seeing is more interest in speciality funds where the British Business Bank or insurers are trying to support the UK through, for example, UK real estate funds. The government has been looking at potential tax changes or measures on the fund side and now would be a good time to do this. Other jurisdictions

“Most regulators now understand how asset managers work and they no longer see private debt funds as shadow bankers. That's very helpful”

DIALA MINOTT
Paul Hastings





have been looking at their fund regimes as a result of Brexit to make them more competitive. There is scope for the UK to have a different type of fund structure. That would be helpful for the market.

Q Beyond UK exposure, what would you say are LPs' main concerns?

SD-B: Investors are cautious about credit, but they are in a bind. You're getting a negative yield on A-grade European corporate risk, yet you still need to reach your return target. And if you're nervous about credit, then you should probably be nervous about stock markets. Where can you put your capital? That's positive for private debt because LPs are largely underweight in the asset class. As much as there is talk of risk, there is demand because of the yields offered. But all this is leading LPs to focus on the scale of platforms because they want to manage that risk.

AK: One of the biggest changes over the past 12-24 months has been a shift of focus among LPs. Previously, they wanted to know about deal sourcing, convergence and deployment – they wanted to be sure you could get capital out the door. Now they assume you have all this. The focus now

is on the quality of introductions and diligence and, increasingly, on monitoring and restructuring. Do you have the capabilities and talent you need to deal with problems? Because even if you don't have issues now, you could in one to two years.

LPs now know the managers, they have a big dataset and they know the market much better. They're asking more sophisticated questions and digging into individual credits. Their knowledge has increased substantially. It means they're investing less thematically and more according to who the runners and riders are and who has the right skillset to manage through the crisis.

Q So how well prepared is Europe's private debt market for a future downturn and how is this informing your strategy?

DM: One of the big lessons from the credit crisis is the need for mixed teams with a mix of skill sets. Restructuring expertise is now a must-have rather than a just-in-case. Vehicles will be much more robust this time. There is so much regulation and legislation now. AIFMD and securitisation regulation, for example, have yet to be tested in a downturn, but I think they will help stabilise the market in more difficult times.

“As a lender, you need to understand societal changes and what the implications are”

SYMON DRAKE-BROCKMAN
Pemberton



“We’re working on the assumption that the economy will turn”

DANIEL HEINE
Patrimonium

AK: The bar is high for cyclical businesses – even those that are good and that will almost certainly come through the cycle. That’s because we know we’ll have some heartache somewhere in the middle. You have to ask how much you want your team to be spending time dealing with issues when you’d prefer them to spend time looking at new investments.

In a downturn, you want to continue moving forwards.

DH: We’re working on the assumption that the economy will turn. There is a manufacturing recession looming over Europe. You can still finance manufacturing businesses, but then it becomes more of a special-situation or opportunity credit than in the past, when many of these businesses would have been in a more plain-vanilla lending situation.

When it comes to how well-prepared funds are for a downturn, it’s largely a resource question as to whether you can manage through difficult times. Larger managers typically run different strategies in addition to direct lending – they’ll have credit opportunity and special-situations teams as well. The day-to-day business of these teams is restructuring work and so, should things go bad, you already have the resource internally.

SD-B: Leading LPs expect you to have strong monitoring and restructuring capability and they want to know you have the scale of resource internally to manage difficult situations. We’ve had this in place for five years. LPs have got to the point where they are saying that if they are going to give you capital to manage, you have to have the full set of equipment.

But on the manufacturing side, we take a slightly different view. If you are a first-tier supplier, you’re unlikely to default; if you’re third- or fourth-tier, you’ll get hammered in a downturn. Customers move their order book up to the first-tier suppliers to keep them going because there’s such an interdependency between them. And, as I said earlier, the first-tier suppliers in Europe are still very much of the size to be in private debt territory.

I’d also say that we’re going through huge shifts at the moment with electric cars, WeWork, Amazon, etc, and these shifts are changing society and people’s spending habits. As credit managers, we spend a lot of time talking about where we are in the cycle, but the reality is that a lot of industries are going to be killed by technology regardless. As a lender, you need to understand societal changes and what the implications are. ■

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How European funds are evolving



Expert comment by **Alex Amos** and **Ceinwen Rees**

Two Macfarlanes partners look at recent trends in European private debt fund structuring

A number of managers have established so-called ‘hybrid’ funds/accounts, which invest in illiquid debt but adopt both closed-ended and open-ended fund structures. This is a response both to investors’ demand for vehicles into which they can deploy capital without having to make a new allocation decision every few years, and to managers seeking to avoid repeated fundraisings.

These vehicles tend to be tailored and are harder to set up given the predominance of pure funds and managed accounts. They might take the form of a hedge fund-style product or an evergreen investment period terminable on notice with a traditional run-off period. Alternatively, a hybrid might include defined vintages within one and the same fund, with each vintage having its own investment period, term and waterfall for the purposes of the performance allocation.

Occasionally there may be some form of limited redemption right if an investor specifically requires it for liquidity purposes. Hybrid vehicles often make greater use of working capital facilities, particularly to manage the timing or profile of investments.

In order to improve the return profile of private debt funds and against the backdrop of continuing low interest rates, some managers have established levered funds with security at the asset level and using concepts from structured financings.

Within private debt and other alternative asset classes, there is an increasing interest in structures that enable investment in private assets by ‘retail’ investors. These are typically ‘mass affluent’ or direct contribution

pension schemes rather than true retail investors, though they nevertheless fall short of being classed as institutional investors.

These are usually regulated funds, such as European long-term investment funds, UK non-UCITS retail schemes and Luxembourg Part II funds. However, there is no perfect solution that enables such vehicles to be marketed to retail investors wherever they may be domiciled. Furthermore, the restrictions on permissible assets and other operational requirements can prove challenging for many managers.

Tax trends

Typically, European debt funds hold their investments through Luxembourg holding structures and manage tax payable in the structure by offsetting interest expense against interest income (while retaining a margin in Luxembourg). In the past year, Luxembourg has undergone one major change in law and is in the process of implementing a second. Both are having a significant impact on the structuring process for debt funds.

“There is an increasing interest in structures that enable investment in private assets by ‘retail’ investors”

Pursuant to the European Anti-Tax Avoidance Directive (ATAD 1) Luxembourg has implemented an interest limitation rule. This restricts deductions for interest expenses where those expenses exceed interest income. Debt funds holding discounted debt or distressed debt, which can result in the fund holding minority equity positions, have been particularly affected because returns from such investments are not necessarily ‘interest income’.

This means traditional structures that repatriate realisations via debt instruments leave the Luxembourg holding company exposed to high taxable profits if some of the interest expense is not permitted as a deduction.

Luxembourg has been slow to issue guidance on these rules and there is not yet a consensus in the local market about the best way to respond. Many funds have therefore faced difficulty determining how to restructure their funding arrangements in order to minimise their tax requirements while satisfying the new rules.

ATAD 2 will be implemented in Luxembourg from 1 January and funds, as well as Luxembourg advisors, are grappling with what this will mean for fund structures. The ATAD 2 rules seek to limit interest expense deductibility in circumstances where hybrid entities or instruments are used to obtain tax advantages.

The remit of the rules is currently unclear. Most funds are not making structural changes at the moment, and are instead giving themselves flexibility in their LPAs to restructure if needed. ■

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E X P E R T Q & A

The hardest thing for investors is to gauge where they should be on the risk spectrum, say Paul House, managing partner, and Beatrice Dupont, partner, at Venn Partners



Seizing opportunities in commercial real estate debt

Q What is the immediate outlook for private commercial real estate in Europe?

Paul House: We are cautiously optimistic. If you look at transaction volumes, there is a healthy interest in commercial real estate. The driver of cashflow is the occupational market, which is in pretty good shape, with the exception of the retail sector. Recent months have shown continued positive GDP growth in Europe, with July's figures confirming that the UK posted growth after data from the country's Office for National Statistics had suggested a contraction in the second quarter. Earnings multiples are not overheated against historic metrics and we don't have an overleveraged market.

That said, we are certainly cautious because these are uncertain times. The political situation concerns us and one has to consider the impact of rising trade barriers on the underlying economies and the com-

mercial real estate sector. Against this backdrop, investing in real estate private debt has the advantage of predictable income while also benefiting from downside protection against potential property value declines.

Q What impact will the current political environment have on private commercial real estate lending in both the UK and Europe as a whole?

PH: Political volatility should have a negative impact on bank funding that still dominates CRE lending. This will mean the supply of credit will be in check. On the demand side, the key is the impact on the underlying economy and on the underlying CRE equity market returns. Real estate is the infrastructure of society, so we naturally follow the

stats on white collar job growth, business confidence, manufacturing, consumer confidence and anything which shows the demand for wider business services. Thus far, these figures are holding up.

Beatrice Dupont: One of the benefits of CRE lending, particularly in the more value-add space in which Venn Partners operates, is that we can adapt our portfolio to changing market conditions. Our loans are typically repaid over a two- to three-year period as we lend against assets that are repositioned from value-add to core, and therefore we recycle capital at least once in our funds. This means we can react to macro events and vary our exposure accordingly. As an example, our investments were initially more weighted towards the UK as this was the most attractive market in Europe. But with Brexit and an increasing demand for alternative lending in continental Eu-

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rope, that dynamic has shifted and we have now rebalanced our portfolio accordingly.

Q How do you characterise the differences between sectors, such as business parks, offices, logistics hubs and retail?

PH: There are some marked differences both between the sectors and between geographies. Venn Partners' mandate is to identify the best place to deploy capital in sectors with high relative performance while avoiding those that underperform, and we have to date managed to do just that.

Take UK retail. Until 18 months ago, it wasn't necessarily the dirty word it is today. Properties that traded in 2014 and 2015 are now trading at prices that are up to 50 percent below those levels – and this has happened quickly due to the repricing of retail rents and substantial changes to the occupational market. For investors that went long on retail, that is going to impact them significantly. We avoided pure retail loans that were most exposed to these downward trends.

Retail is the bad press story, but the broad brush the industry applies to it hides areas of potential value. The transactions we review and track illustrate some important anomalies, such as retail properties that have sometimes been hit so hard on value that they are close to residential or last-mile industrial land values. Furthermore, rent is repricing inside those two asset classes in select sub-markets. This presents a unique opportunity to benefit from the change from pure retail to mixed-use properties.

As another example, Venn Partners focused on alternative asset classes, such as hotels and pubs, before it became more mainstream, and we were able to capture superior returns as a result.

Looking to differences across geographies, the benefit of being exposed to both the UK and continental Europe is that although the occupational market impacts can differ across jurisdictions, they can follow the same trend. This is something we follow closely for our investments. Student accommodation, for instance, is only emerging in Spain but is a very established asset class in the UK.

Q What do you consider to be the main issues for clients weighing up the opportunities in private commercial real estate lending?

PH: Commercial real estate debt is no longer a new asset class, as was the case

“The political situation concerns us and one has to consider the impact of rising trade barriers on the underlying economies and the commercial real estate sector”

PAUL HOUSE

“If things go wrong, we need to have the necessary measures to protect the capital of our investors”

BEATRICE DUPONT

when we started the real estate lending platform at Venn in 2013. Today, investors are well versed with the benefits of investing in real estate debt and like the predictability of the income and the protection that comes from having security over a tangible asset. That said, real estate debt is not a ubiquitous asset class and it can be difficult for investors to compare investment opportunities as presented to them. One of the hardest things for investors to gauge is where they should be on the risk spectrum, as the market and the risks within it are difficult to compare given its fragmented nature.

Q How is the growing investor interest in sustainability manifested in the commercial real estate lending market?

BD: The equity sponsors we lend to increasingly understand that they have a responsibility to take on the sustainability challenge, and many are doing so. As a lender, Venn Partners is one step removed from this. However, there is a natural sustainability impact from our investments because a large part of the lending Venn does supports borrowers that are transforming older unproductive buildings into state-of-the-art, environmentally efficient assets.

Q How important is depth of knowledge in the investment team and what happens if we enter a period of defaults?

BD: One cannot underestimate the importance of experience in a team, particularly in the private lending space. We are creating bespoke loans which are tailored to each client's business plan. Obviously, we want our clients to make money. However, if things go wrong, we need to have the necessary measures to protect the capital of our investors. We do this by underwriting our loans against scenarios which may turn out to be worse than predicted but still result in capital preservation, thus mitigating the risk of things not going according to plan.

PH: Venn Partners has the benefit of having experienced three different real estate cycles in three different global markets. While history can never be the guide to the future, the experience of the team plays a critical role in avoiding trouble in the first place, but also in enabling us to emerge from difficult positions that inevitably happen during more economically challenging environments. ■

How Europe's deal volumes stack up

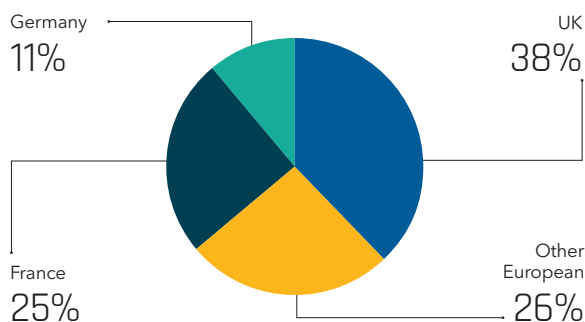
*The number of European private credit deals have more than doubled in just six years, writes **John Bakie***

Deloitte's data on mid-market deal volumes reveal how European private debt has evolved since 2013. There has been an expansion of activity across the continent, though the region is still far behind the US. The most notable jurisdiction over the past six years has been France, which has rapidly become Europe's second most popular location for private debt investment.

Although Germany has grown more slowly, it is also expected to become a major source of deals in the near future, as more private debt funds open offices and hire specialists in the country.

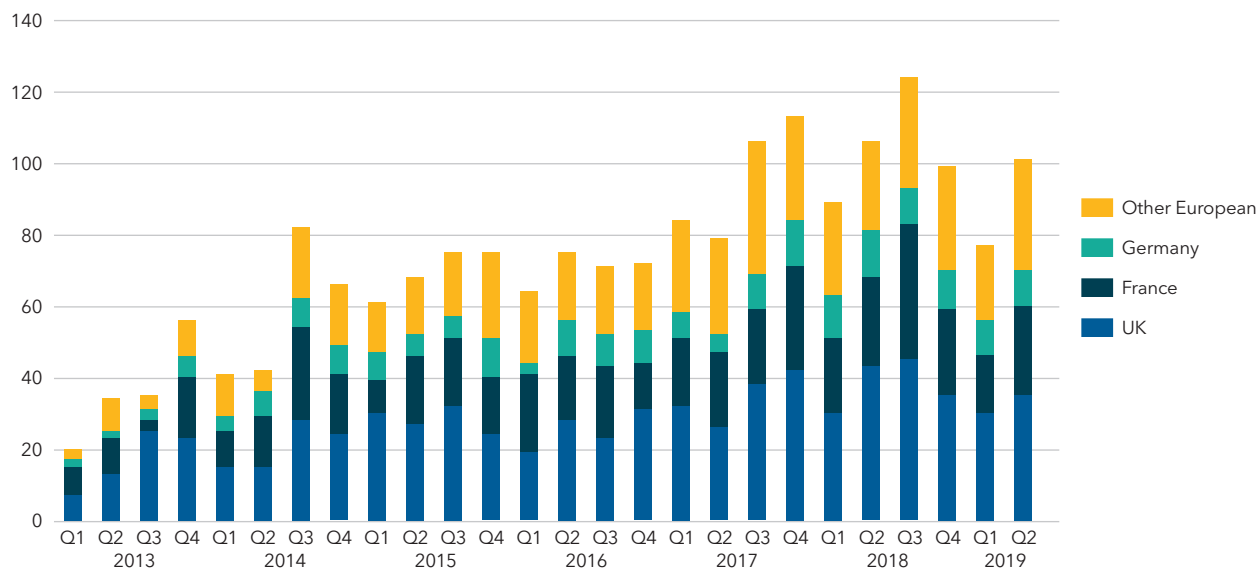
Deal activity in the UK has proved resilient, notwithstanding the uncertainty surrounding the country's impending exit from the EU. After a small decline in 2016, when the country voted to leave the bloc, private debt activity increased in both 2017 and 2018. ■

Between Q4 2012 and H1 2019, a total of 1,937 deals were recorded in Europe

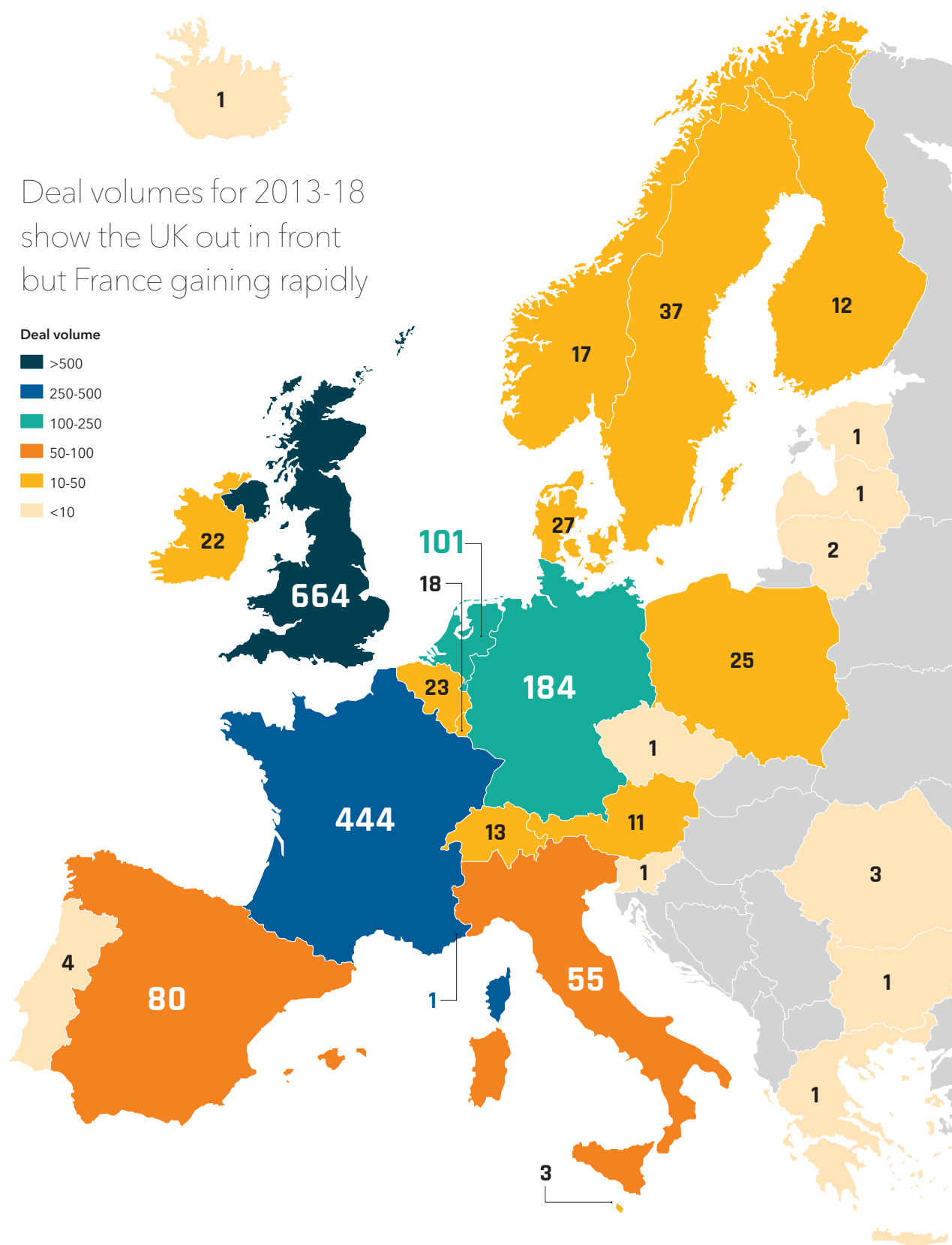


Source: Deloitte

European direct lending deals by country (2013 to H1 2019)



Source: Deloitte



Source: Deloitte Alternative Deal Tracker Spring 2019

E X P E R T Q & A

*With LP demand for private debt at an all-time high in Europe, managers can afford to look further afield to broaden their investor bases, say **Spencer Wells**, country executive, UK, and **Patrick McCullagh**, head of sales EMEA, at Alter Domus*



Booming investor demand creates fundraising opportunities

Q What fundraising trends are you seeing in European private debt?

Spencer Wells: Europe's appetite for investing in private debt is probably at its highest to date, with an expanded variety of investors coming in with particular interest in the real estate private debt space. Investors are especially attracted to the risk-return profile of those asset classes and the speed with which those returns can be delivered. Real estate assets are highly sought after in the UK and throughout Europe at the moment, with the UK in particular enjoying high demand for investment in development projects such as logistics and student accommodation.

Both banks and private lenders have continued to fulfil borrower needs, owing either to increased demand or easier access to funding sources. We're also seeing ever-more sophisticated real estate and infrastructure debt lenders coming into the space. The industry

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is maturing with both private debt managers and investors boasting teams of specialists familiar with the assets, resulting in a higher frequency of deals coming through.

Patrick McCullagh: Over the last few months we have seen greater activity from CEE-focused managers and debt funds. The rise in the number of portfolio investments made by special situations funds shows a large number of private debt managers are no longer dependent upon a sponsor and can demonstrate their ability to source their own pipelines. Investors still see the market as very strong, so the challenge for managers has shifted away from finding investors and more towards finding good debt to fund or acquire.

Q How are investor attitudes and demands changing over time?

PM: We certainly see an increase in the level of expertise many investors possess, so it's now evident that both investors and managers have a much better understanding of the type of information they need in order to analyse and manage the investments which are being made. Reporting, particularly at a portfolio level, has a much deeper level of detail and granularity, and investors are pushing for still more of ways of collecting, viewing and analysing that information.

SW: The onus is on administrators to be ahead of the curve in providing managers and investors with what they need, according to the profile of the assets they're investing in and the type of asset form. US investors may have different needs to European LPs, for instance, and can find themselves subject to Alternative Investment Fund

Managers Directive regulation, perhaps for the first time, so they need people who are able to guide them through the relevant processes and procedures.

Q What can European managers do to attract US investors?

SW: The key thing when it comes to crossing the Atlantic is making it easy for those investors to come into the fund. European private debt is a nice diversification strategy for US investors, and they are aware of all the opportunities that exist and the decent returns on offer. Despite these major attractions, the managers definitely need the right infrastructure and advice in place to support them with unfamiliar aspects.

PM: As well as seeing US investors coming into European funds, we also see a good number of US managers setting up parallel funds to attract European investors. They often incorporate special structuring or, for example, strategies such as ‘season and sell’ to avoid a fund being classified as engaged in a US trade or business and therefore exposed to unrelated business taxable income. In the case of ‘season and sell’ we often see two parallel funds formed – one in the US and one offshore – with the US fund originating the loan, holding it for a period of time, and then selling it to the offshore fund. Special transatlantic arrangements like this require managers and administrators to be well aligned with tax and legal advisers who can support investors through complex structuring.

SW: It is also important for managers to make their funds appealing from a financial point of view. When trying to attract US investors who generally operate on a tight total expense ratio in the US, you need good terms and cost controls set up in order to attract them. Having the right fund administration and reporting platform and technology in place is key, and so is having staff with a track record of administering similar funds and portfolios. Debt is an asset class that requires fund administrators with specific expertise in this area.

Q Where do you see the European private debt markets expanding in the year ahead?

SW: We are seeing more collateralised loan obligation activity returning after a few quieter years. The big providers are setting up new CLOs to support the increased amount

of private debt in the market and it makes sense for some of that to be collateralised into bigger portfolios. The rating agencies are also much closer to the market. We see a lot of opportunities in the CLO space; where private debt funds may have 30 loans in a portfolio, CLOs might have more than five times that, and as an administrator, we have the ability to service them.

PM: We’re continuing to see new debt managers enter the market too, although the barriers to entry may be getting a bit higher owing to the demands of regulatory and investor reporting. Investors now have more choice about which debt strategies they invest in and are often keen to see a proven track record of loans being created and well managed. Equally, the challenging reporting requirements continue to have a barrier-to-entry effect amongst administrators as well. Administering and reporting on complex real estate and private debt structures requires substantial investment in teams and technology, both of which we’ve seen many administrators shy away from. In fact, only a small fraction of specialist administrators have invested in real value-added middle-office teams and platforms to perform this work. The reality is, the complexity of administering debt assets requires strong, technology-enabled middle office teams. This is something we’ve invested heavily in at Alter Domus because we realise that the asset class requires more than

just debt-focused tools. It requires teams who understand the nuances of the asset class to be able to leverage that technology in ways that ultimately deliver on managers’ and investors’ expectations. Our debt operations expertise is a combination of teams consisting of CFAs, MBAs and professionals with deep experience evaluating loan agreements. Many have learned about the debt market having gained hands-on experience in the field, and then place that expertise alongside our technology tools to provide a seamless service delivery to our clients. It’s that combination of experienced teams and dedicated technology that really helps new debt managers find their footing.

Q Do you see a growing sophistication in performance measurement in private debt?

SW: Yes. You’ve now got specialist private debt teams behind the administrators just as you have behind the managers, because the volume and complexity of the work requires specialists who can aggregate and present the data for investors to be able to adequately monitor portfolio performance. While overall the market performs well, there will still be occasional non-performing assets and it is vital for the manager to be able to show investors what has happened, why, what the work-out strategy is and how that will affect their investment. The increased scale and complexity of debt activity also means that a lack of expertise by a manager or administrator is more easily uncovered and can cause fundamental issues.

PM: Due to the typically shorter fund life-cycles for private debt funds compared with private equity funds, (eg, four to six years instead of eight to 12) we also see many of our debt fund manager clients launching second and third funds more quickly than in other asset classes, with people quickly getting up to three or four funds over a four- or five-year period. That means the market renews quickly and delivers more strategy fine-tuning and diversification, which needs understanding and support from specialist partners, whether they be law firms or administrators for example. It’s certainly an exciting sector to work in and one where continued investment in human expertise, technology and operational scale are vital for keeping pace with the growing sophistication and needs of debt fund managers, investors and borrowers. ■

“When trying to attract US investors who generally operate on a tight total expense ratio in the US, you need good terms and cost controls set up in order to attract them”

SPENCER WELLS

Politics, not economics, is the biggest risk for funds

*Portfolios are strong, but political uncertainty and originating good deals pose risks for private debt providers, writes **John Bakie***

A mismatch between available capital and dealflow is one of the biggest problems facing private debt today, panellists told the *PDI* Germany Forum 2019, which took place in Munich in June. Panellists were of the view that political issues posed threats to the asset class, though some felt these could be turned to the advantage of private markets.

Patrick McAuliffe, managing director and head of direct origination at First Eagle Investment Management, said: “We’re seeing lots of capital coming into the market and not much dealflow, and these are a volatile combination.”

He said the challenge of deploying dry powder was the key issue for industry professionals, rather than underlying portfolio performance and economics, both of which remained healthy.

“American mid-market companies are doing really well,” McAuliffe told the forum. “And while we are seeing some indicators of a market correction taking place, we just aren’t seeing it within our portfolio.”

“Uncertainty right now is very high. Between Brexit and trade wars, it’s a very complex environment”

THIERRY VALLIÈRE
Amundi Asset Management

Thierry Vallière, head of private debt at Amundi Asset Management, agreed that although talk of the credit cycle turning had been commonplace, this had not been reflected in portfolio performance. However, he added there were some political issues that could become economic issues in the near future. “Uncertainty right now is very

high,” he said. “Between Brexit and trade wars, it’s a very complex environment.”

Nevertheless, Jurij Puth, managing director at GSO Capital Partners, believed political crises could be beneficial for private debt providers. “Brexit and trade wars will create pockets of volatility and panic, which will cause the capital markets to shut down,” he explained. “[This] could allow private debt providers to step in and plug that gap.”

Politics has been rising up the private equity agenda in recent months, with S&P Global warning in an analysis that political issues, rather than underlying business performance, pose the biggest threat to European credit markets.

Panellists also cited higher leverage levels and lower covenants as potential risks. McAuliffe said his company’s portfolio in recent years had typically had leverage levels of 3.8-3.9x, but that these had increased slightly, to 4.2-4.3x, since late 2018.

“While leverage levels have increased, they have not grown as much as valuation multiples, so we still have healthy equity cushions,” he said. “Covenants have loosened as well. Where we used to have two covenants, we now typically have one, and it’s a leverage covenant.”

LGT’s head of private debt, Philipp Wagner, added that conditions were still less risky than they had been in the run-up to the 2008 financial crisis. “There is still a healthy equity cushion in the market, with an average of about 50 percent,” he said. “This is far better than we saw pre-crisis, when equity cushions were often just 35 percent.” ■



View from the top: panellists at this year’s *PDI* Germany Forum discussed the way forward for private credit once the market turns

PDI Germany 2020, which takes place on 16-17 June next year, will bring together 150 professionals, from more than 50 institutions, who are primarily focused on private debt investment strategies within the DACH region and wider Europe

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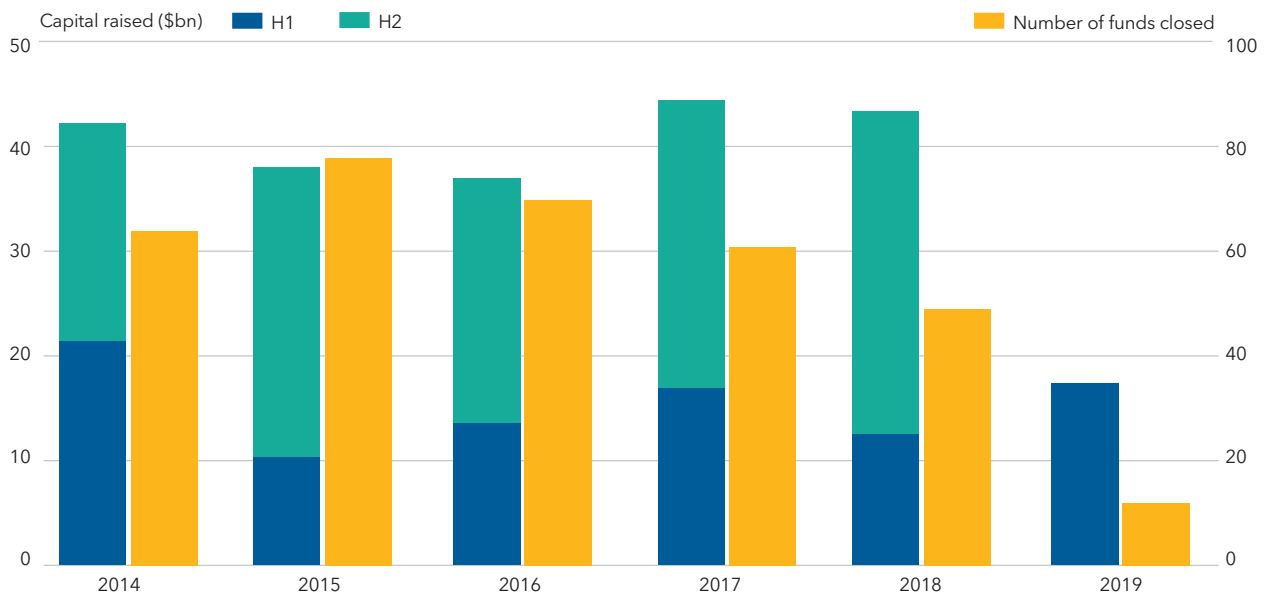
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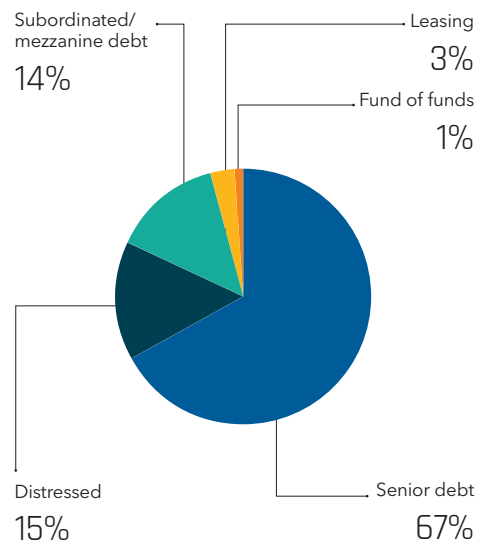
All eyes on Europe

Fundraising remains strong in European private debt, with average fund sizes continuing to rise

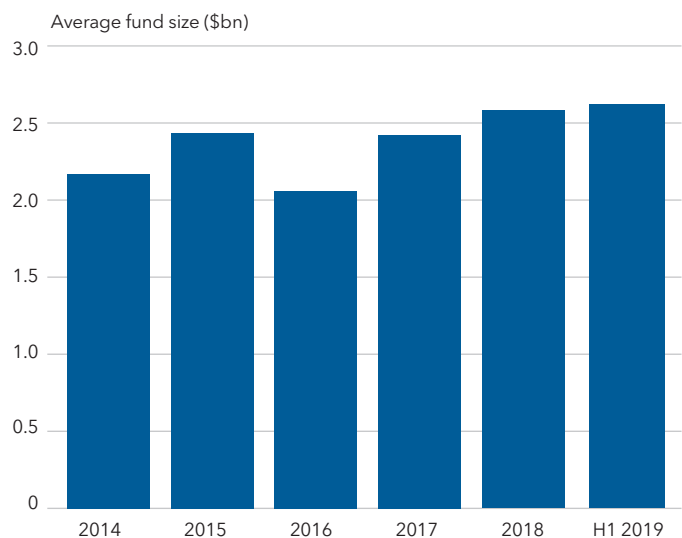
Europe-focused fundraising is holding up well, with the first half of 2019 marking a five-year high (\$bn)



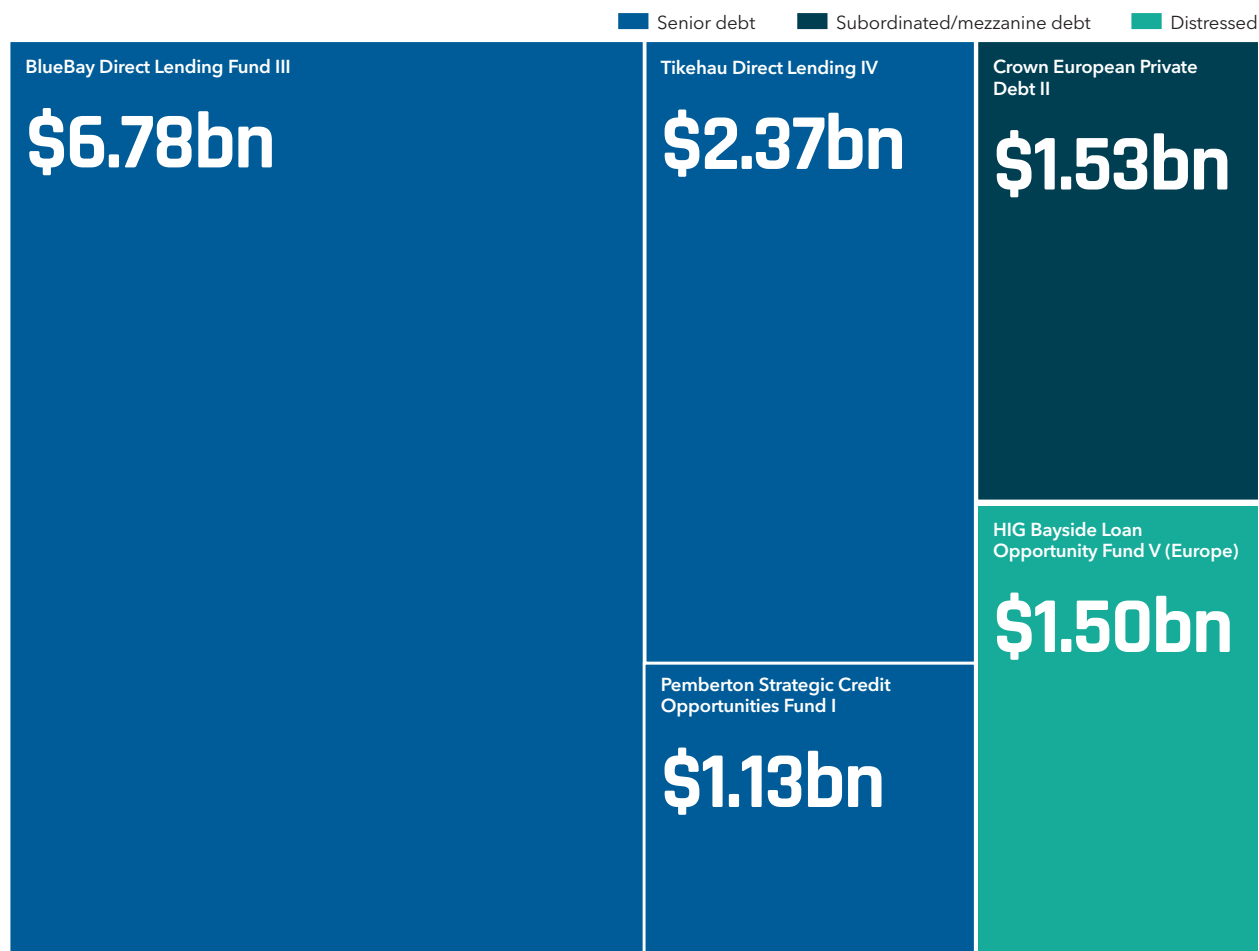
Senior debt remained the most popular fund strategy in H1



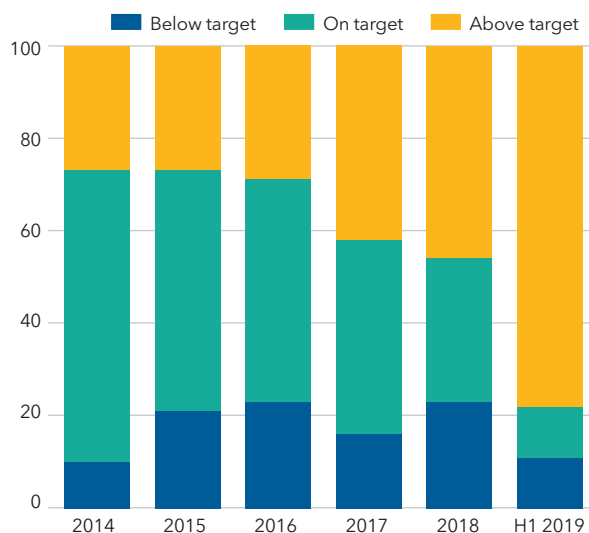
Average fund sizes rose amid the drive towards larger vehicles (\$bn)



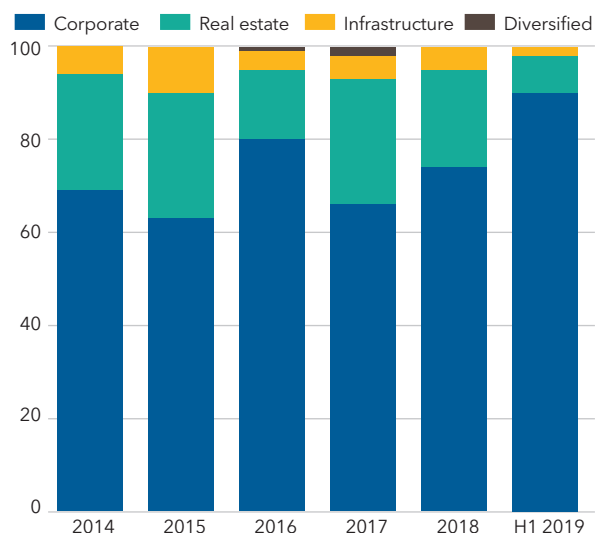
BlueBay's Direct Lending Fund III was comfortably the biggest European vehicle to close in H1



The buoyant fundraising market has seen targets surpassed for most funds (%)



The corporate sector is taking up an ever-larger share of the debt market (%)



Source for all data: PDI

European points of view

“Retail is going through structural changes in the market, which is affecting the values of certain retail assets in the UK, particularly those in the secondary town locations”

ANURAG SHARMA
CBRE

“The global economic cycle is becoming more advanced ... It is the right time to position ourselves for future opportunities”

BENOÎT DURTESTE of Intermediate Capital Group on its decision to add to its special-situations team

“Economic conditions in Europe remain challenging, especially for smaller businesses”

JOHN BOLDUC
HIG Bayside Capital

“Uncertainty right now is very high. Between Brexit and trade wars, it’s a very complex environment”

THIERRY VALLIÈRE
Amundi Asset Management

“Banks in the Nordics aren’t under as much pressure as in other parts of Europe”

Pemberton’s **VICTOR KIHLGREN** on why Nordic countries have seen slower development in private credit than the rest of the continent

“Private debt funds continued to grow strongly in 2018 and we also saw the arrival of new foreign inflows, confirming France’s attractiveness in this market”

GUILLAUME LEREDDE
Deloitte Debt Advisory

“Of the €5.9 billion of European direct lending commitments we made last year, 59 percent involved existing portfolio companies”

MICHAEL DENNIS of Ares says the key to its European strategy is to continue to invest in and support incumbent borrowers

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