

ROUNDTABLE

UNSPONSORED LENDING



From left:
James Newsome, Arbour Partners;
Daniel Heine, Patrimonium;
Symon Drake-Brockman, Pemberton;
Timo Hara, Certior Capital;
Nick Fenn, Beechbrook

The biggest opportunity of all

Lending to companies without a private equity sponsor bears some resemblance to skydiving – the vast open space is impressive but without a sponsor, are lenders forgetting their parachute? **Rachel McGovern** gathers a group of managers, investors and advisors to discuss the pros and cons of taking the leap

Five lending experts in a room with another dialled in from Chicago. Roundtable discussions are always a great opportunity to batter out the issues, even more so when it's possible to narrow the conversation down to just one juicy topic.

And this time round, we asked our panellists to razor in on one of the biggest topics in private debt – sponsorless lending.

Private debt investment, as a function of both its origins and the difficulties of accessing a private market, is focused on leveraged finance. Many debt managers can trace their origins to private equity firms, which spied an opportunity to make money on both sides of their market. The

leveraged loan and high-yield bond markets also offer a combination of greater returns and more liquidity than most debt.

But as private debt has developed into a distinct asset class, managers branched out into a range of niche strategies and an increasing number are deliberately structuring their businesses to lend to a greater proportion of unsponsored borrowers. Not that non-sponsor backed companies are a niche – there are far more of them in the mid-market than private equity-owned firms.

And internal infrastructure is an essential part of lending to independent businesses. Without the safety net of private equity due diligence, managers need to do

that hard graft for themselves while sourcing is another much more labour intensive task versus the leveraged loan market. But rather than describe the topics, you can read our experts' own views.

Q Talk me through why you view unsponsored lending as a strong opportunity?

Symon Drake-Brockman, Pemberton: [The leveraged lending market in] Europe is relatively small in comparison [with the US]. And as we've seen from the last couple of quarters, it's a shrinking market by volume. Looking at overall European lending volumes, the sponsorless market is four to five times larger than the sponsored market. For the industry to

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JAMES NEWSOME

Managing partner, Arbour Partners

It's no wonder that James Newsome is so well-known in the market, he has been in alternative credit for 17 years. He worked at Merrill Lynch before co-founding Arbour Partners, an advisory firm that supports asset managers seeking to raise capital for mid-market strategies.

Spying a gap in the market, Newsome and his team are now expanding their range of activities. They recently set up Arbour Capital which rather than helping alternative lenders raise money, will support them in deal sourcing. The new venture will establish a platform to link SME borrowers with alternative lenders expanding into sponsorless transactions. The firm will source and do initial suitability checks on companies seeking credit before passing them along to lenders that could potentially be interested in the deal.



really grow and to be successful, you've got to be able to tap the largest pool. If you're only covering 20 percent of the market, it means that the investors are getting concentration risk across CLO managers, liquid leveraged loan funds and debt funds, because they're all lending to the same small group of borrowers across a relatively small number of deals.

Banks are going to have a number of challenges over the next three or four years, with the introduction of solvency ratios and also Basel III, which means that term bullet financing is not particularly attractive to banks.

Nick Fenn, Beechbrook Capital: Well, picking up on the same theme, in the SME part of the corporate spectrum, the proportion of companies that are not private equity-owned is even higher and the absolute number of such companies is huge.

Banks and non-bank lenders like lending to private equity firms; they sanitise the process of lending, to a certain extent. They screen companies, they perform due diligence, they provide corporate governance. Lots of people are attracted to that kind of lending business; not so many are prepared to lend to unsponsored small corporates. So if you take those supply and demand dynamics together, that's an attractive proposition.

Q Daniel, when was the last time you guys actually lent to a sponsored company?

Daniel Heine, Patrimonium: A couple of years ago. And the reason for that, just speaking now for the German market, is a bifurcation of the market. You have the Mittelstand companies with flawless balance sheets, and they are chased by the traditional lenders, like the Landesbanken and [that market] is swimming liquidity which comes at hideously low rates. Rates, which do not justify the risk.

And the other group is the companies where the bank internal rating doesn't qualify them for a lender solution. And here, the market becomes very inefficient and very price insensitive. And as a consequence, we find relatively speaking better risk return profiles, in that very price insensitive market.

Q Ted, you've been doing sponsorless deals in the US for years. Can you talk us through how you source transactions?

Ted Koenig, Monroe Capital: The reason why not many private lenders in the US do non-sponsored transactions is because they are very difficult to source. Private equity funds are very good at sourcing debt whereas non-sponsored companies do not have the same database of lenders or access to advisers to assist them.

In addition, these deals are much more

difficult to underwrite because a lot of the third-party analysis that the private equity funds do in putting a transaction together is not there. So we, as private credit managers, need much more infrastructure to do these transactions.

Years ago, the banks operated more decentralised; lots originators out in the market. So we've adopted a bank organisation mentality; we have eight offices located throughout the US with 20 professionals that do nothing but originate deals for our platform. In the US, the company target pool is very deep. There are probably 200,000 companies with \$20 million of EBITDA and below that are worth looking at.

DH: I think those figures, if you scale them down to our size, it's pretty much the same. We focus on sourcing directly. We are, today, receiving between 150 and 200 proposals a year and we try to do 10-15 transactions from these proposals. We adopted the same approach as banks have adopted in the past: sourcing, underwriting and monitoring are the core functions within the firm. It is a very hands-on business.

Timo Hara, Certior Capital: Where the European market separates from the US market, is, in addition to the sourcing operations, the different underwriting, credit analysis and regulatory frameworks across the different European jurisdictions.

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So the thesis that we have been discussing with our investors is to build them a portfolio of dedicated managers in a specific country who know their market and do the both sourcing and underwriting on the domestic level. We try to find local managers to cover the different countries.

James Newsome, Arbour Partners:

We've set up something called Arbour Capital. And what we want to do is marry the best of everything we've just been talking about, which is the due diligence, the negotiation, the direct sourcing of transactions, with the opportunity to scale-up.

We will address the transaction size gap between the peer to peer lending platforms and traditional corporate finance intermediaries, while combining the best elements of each of these business models. That central platform will do the first processing that Nick and Symon and Daniel are too busy and experienced to spend their time on. Arbour Capital will have a web-based solution and hand over a pre-screened set of opportunities the funds.

So somebody, like Nick, would get probably 30 or 40 deals from us per quarter. He's already seeing lots of deals anyway, but for me, the solution is that we will pre-screen them, we will get financials, we'll have a look at the business model.

DH: At least, for Germany, I would say sourcing is not the bottleneck. We

experience enough proposals. The bottleneck is the underwriting, doing the contracts, and negotiating the transaction. So I think that this is what makes sponsorless lending difficult. I would love to do a few more sponsored deals, because they're easier. Unfortunately, the risk return profiles are not that good. It's a trade-off.

SDB: With a private equity[-controlled] company, the benefit is the moment a buyer has it, they're trying to set it up for a sale. So they are very conscious, from the moment they buy in, of getting the information into a format that makes an easy exit for them. So therefore, they tend to focus on companies that are a long way down that path. They don't really want to start with a basket case and spend the next five or 10 years sorting them out.

DH: I'd like to throw an example on the table. In a typical sponsored transaction, the private equity fund buys the company and seeks debt. And if you provide that, you base your decision on the ready due diligence, and the negotiating private equity firm, the terms and conditions, and some covenants.

Now, in the situation I often encounter, I enter a room of typical Mittelstand companies, where already, there are three lenders at the table and a credit risk insurer. One of the lenders, for example, an Italian bank, needs to retrench. So the question is, "Who is taking over the exposure? What

collateral do you get as security?" So it's a completely different environment, where you have to negotiate with other lenders and look what your position is, and this puts a completely different angle on the legal side of the due diligence. Because you're not, in many situations, alone.

Q Nick, is the situation similar in the UK?

NF: Well, the first point is there aren't many banks here. And there's a lot of pent up borrowing demand in the UK, because the volume of bank lending to UK SME companies has fallen year-on-year for the last seven years.

Banks are open for providing certain types of facilities: overdrafts, a mortgage, other collateralised loans. Do they want to provide five-year term credit to a company, which is unrated, but if it were would be a single B-? Not so much. We believe that there are thousands of companies who have either expansion plans, refinancing needs or maybe an acquisition target. Whatever it is, many of them would like to be able to borrow the money they need rather than going to a private equity firm and facing a loss of control.

If you want to borrow £15 million you've got loads of options. But if you want to borrow £5 million, or £3 million, or £7.2 million, there aren't many people that you can talk to.

NICK FENN

Co-founder, Beechbrook Capital

Fenn is the co-founder of independent debt fund manager, Beechbrook Capital. Between a banking career and his time at Beechbrook, Fenn has 20 years of leveraged lending under his belt. Beechbrook began carving out its own particular niche in the market seven years ago and today has two mezzanine funds and a recently launched UK sponsorless SME fund.

Beechbrook's existing mezz vehicles lend to lower-mid-market borrowers across Northern Europe. The new vehicle will target the same end of the market but is focused specifically on the UK. Fenn and his co-founder, Paul Shea, have opted to create a separate team to run the UK sponsorless strategy and announced in July that Jon Herbert, who head of acquisition finance at UK lender Lloyds for 10 years, would join the firm as managing director.



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TED KOENIG

President and chief executive, Monroe Capital

Chicago-based Monroe Capital's founder Ted Koenig is well known in the private debt market. And his enthusiastic approach – evident in most areas – means that the fact that he couldn't join the roundtable in person ends up of little relevance.

This is because when non-bank lenders extending credit to unsponsored borrowers was virtually unheard of in Europe, Monroe Capital was busy executing such deals as part of their overall private debt strategy.

Monroe manages around \$3 billion and has a 240-strong portfolio of borrowers around half of which are non-sponsored. Koenig's team is spread across the US with offices full of origination experts in New York, Boston, Los Angeles, San Francisco, Charlotte, Atlanta and Dallas. These spokes are supported by more originators as well as the centralised credit assessment hub based in the firm's Chicago headquarters.



JN: This is my point, there are thousands of these companies in the UK. The trouble is, we're sitting in St James's Square, and these thousands of companies, if they think of fund managers in London, they think of hedge fund managers, who go around in helicopters. They are yet to be aware of this kind of capital, which we can provide, which is patient money, match-funded.

Q What about the price sensitivity of potential borrowers used to cheap bank lines?

NF: Well, it depends what your alternative is, doesn't it? If you've got a project that you think's going to generate 20 percent IRR you could take some equity onboard, which is probably costing you more than 20 percent and may involve a loss of control of your business. You could borrow money at around 10 percent from a direct lender (assuming

bank finance isn't available), in which case you're making a nice profit and you get to pursue your project, or you could choose not to do your project.

The other thing, if you take 8-10 percent that sounds quite expensive, but up until the last few years base rate has historically been around 4-5 percent. So most SMEs' historical experience is of borrowing at all-in interest rates of about 7-8 percent. In that context, the cost of finance available from non-bank lenders is not particularly remarkable.

In any case, we don't have to convince everybody that we want to do business with to accept our rates of return. We only have to convince a few a year.

TK: Our direct-lending business is really driven for our LPs. We have to generate this vector of returns and we've been delivering north of double-digit net current returns

now for over 15 years and that's what keeps us in business.

Q I spoke to a borrower quite recently who had just done their first deal with a non-bank lender. I asked about the difference in the way the transaction was handled and they said none, but that since signing, the non-bank lender does less monitoring. Is that particular private lender introducing an extra element of risk?

TH: It's one of the three key issues and questions we are looking at when analysing a manager. As important is screening – there are thousands of potential transactions a year, so which of these is the manager spending time on?

The final part is the robustness of the selection and analysis work, focusing on the quality of the underlying information.

TIMO HARA

Partner, Certior Capital

Helsinki-based Timo Hara has been advising and making investments for clients in the alternatives space for 12 years. Hara's firm looks at private equity and debt and Hara has been active in private credit since it was little more than a few mezzanine specialists. Certior's view on the market has evolved in tandem with the asset class and is focusing more and more on direct lending. Certior focuses on the lower-mid-market and began examining the sponsorless opportunity in 2012.

Hara launched Certior in 2011 with two colleagues and manages fund of fund and segregated investment mandates for Finnish investors as well as advising clients on GP commitments.



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SDB: I think a lot of asset managers underestimate the monitoring intensity that banks do on borrowers, and I think you'll find there's a lot of people who've moved into this industry from the trading or CLO space who have a different perspective of monitoring compared to hardcore lending [veterans] and I think that's important for LPs – to understand the culture of the management team that are managing their money.

We've spent a huge amount of money and time on building a monitoring process because I don't think any bank in the world lends to mid-market corporates without a very sophisticated monitoring process.

JN: If you were to ask the average LP, some would probably say, "Oh, the banks of course did absolutely nothing." Others will probably say: "I'm very worried that the private debt funds are more interested in earning their carry or, well, earning their annual management fee." And it's just because, as Ted said, this is not a mature market yet; there are a lot of opinions flying around.

The question is the integrity: is that what the LPs wanted, is that what the organisation is set up to do, and do you execute well on whatever that business plan was?

TK: What credit fund managers sometimes forget is that it's hard to get money back from a bad borrower. The managers that are going to distinguish themselves are the managers that can get money back when the cycle gets more difficult and the best way

to evaluate that is by looking at history and what happened during the last credit cycle.

And that will happen; it may take a year, it may take a bit longer but the cycle will turn, and at that point, losses will occur and the hardest way to drive returns for LPs is to lose their principal. That is what happened to a number of US private debt managers in the last cycle that didn't build strong infrastructure.

What we've learned is that you need a thoughtful, in-between approach where you are strong enough from a credit perspective, to get your money back but yet not too strong to risk reputational damage in the market.

Q Last question, I'd like you to make some predictions. What is the growth trajectory for your own sponsorless lending business as well as the wider private debt arena?

NF: How many European bank mergers have there been in the last five years? Because I can't think of many.

SDB: Well, there was Bankia in Spain.

NF: Ok, so a little bit in Italy and Spain and through the rest of Europe, next to nothing. I think that some people's expectations of the rate at which the European banking industry will consolidate are overly optimistic. It's likely to be a long, slow process with a lot of embedded political and nationalistic resistance to change. That's why there are still many hundreds of banks in

Europe, a lot of them still propped up by their taxpayers.

I think we have to manage expectations that the European corporate lending market is going to follow the USA and be 80 per cent direct lending in the next 10-15 years; it probably isn't. But then we are not overly concerned how quickly the change takes place. Our objective is that the funds under management at Beechbrook are well-invested in good, diversified portfolios of loans that generate an acceptable yield for [our] investors.

We're expecting to raise £100 million to £200 million into our current fund and to deploy that over the next two to three years into a portfolio of performing UK assets. And if we do a good job then I dare say we'll be able to raise some more money.

JN: I think there's going to be a shake-out. The shake-out will be people who just don't manage to raise the fund size that they needed to pay their people. People will dribble off and join other platforms; they will either be taken over, or more likely the best people will be poached.

I'm predicting in two or three years the number of managers fundraising will fall to 150; but the actual amount of money being raised won't fall by nearly so much.

We will have more capital coming into the market [from two sources]. Firstly, we've got the return of that once dead thing called the fund of funds.

SYMON DRAKE-BROCKMAN

Managing partner, Pemberton

Pemberton's Symon Drake Brockman is another familiar leveraged loan market figure with 28 years of credit experience, 20 of which was in leveraged lending. Before founding Pemberton in 2014, Drake-Brockman was global head of debt at Royal Bank of Scotland until 2009. Pemberton is a relatively new independent asset manager. Insurer Legal & General took a 40 percent stake in the firm last year. The firm reached a €547 million first close on its European direct lending fund in July and has more than €1.5 billion in assets under management.

Drake-Brockman says the firm's book includes a roughly even split between private equity-backed and unsponsored transactions. He believes the private debt market in Europe will go but acknowledges that it is some distance off being classed as mature.



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DANIEL HEINE

Founder and managing director private debt, Patrimonium

Heine is a co-founder of Swiss asset manager Patrimonium and heads its private debt business. The independent firm invests into real estate and private debt and is in the process of expanding its credit business to include real estate finance alongside the existing corporate debt book. Patrimonium has been up and running for more than 10 years and is the second largest provider of mezzanine loans to mid-market corporates in the German-speaking DACHS region of Europe.

Heine's portfolio of corporate debt deals is, currently, entirely unsponsored. He says that the firm has no rules against lending to private equity-backed borrowers but adds that Patrimonium sources more compelling opportunities among unsponsored businesses. The firm has around SFr2 billion (\$2 billion; €1.8 billion) in assets under management.



The other thing is fixed income investment; it is definitely happening on the insurance side, there are at least two, maybe three, people around this table who can tell you that they've managed to get new insurance LPs in the last 12 months and that's because they are able to put it in the fixed-income bucket. So the net amount of capital coming into the market is going to grow next year.

TH: Institutional investors with long-term liabilities are a natural source of capital for longer-term bullet loans. Banks are not a natural source for that type of capital, they have very short-term liabilities. Whereas the other end of the table is eagerly looking for something that provides stable, perhaps high single-digit returns in cash yield and moreover, with a substantially lower solvency capital requirement than equity funds.

Then on the other side of the equation again I'd pretty much follow James' view, the market will polarise. There will be the niche, opportunistic strategies that exploit a certain small part of the market and there will be a consolidated market in the more mid- to upper-mid-market where a pan-European operation is needed. [That end] needs more investment up-front, it has economics of scale but it needs a certain mass to be viable so the number of direct lending managers in the market today is higher than it will be in three years' time.

DH: I believe the German traditional lenders will continue to retrench but at a relatively slow pace. The banks will continue to lend to middle-market corporates but due to regulation, they'll be forced to gradually and slowly give some ground and that will be filled by alternative providers like us. So I agree with Nick; even if retrenchment is on a very small scale, for small alternative providers this is more than enough volume to grow a country or niche strategy. So for us it's more a question of how we grow our organisation, of how we deploy the funds.

SDB: I look at it from a slightly different angle; regulatory change inside of Europe is going to open the door for alternative lenders, and that door is rather similar to what's happened in the US where maturities beyond five-plus years to sub-double B companies are going to be extremely expensive for the banks. The pace of change in Europe will be slower and like any industry there will be a weeding out of managers through either consolidation or performance. In five years' time we will have a much bigger market but a much smaller number of participants.

TK: I have an advantage; I've seen the movie already so I know how it's going to end. What's going to happen in Europe is you're going to see a lot more euros being raised and allocated to this private credit

space. There will be more country-specific funds, just like in the US regions. Borrowers in certain countries are going to want to go to private lenders that share the same language, culture, and thought process when it comes to transacting business. I think you will also see a lot of the larger equity managers in Europe open debt shops; it's an easy transition for private equity to open debt businesses because the fundraising is relatively simple and it is a great driver of additional management fees.

Finally, I think you will see some credit losses in Europe because of all this; firms will be forced to do competitive transactions that perhaps are outside of their comfort zones because they will need to employ the euros that they raise relatively quickly as LPs do not want to see "J curve" effects in this business. That behaviour will lead to underperformance.

The key is to build the best credit and sourcing infrastructure and stick to your core competency. Our market share has continued to grow over the last five years at approximately 25 percent per annum despite all the new entrants because I feel that we have built the best platform in our space. I think that growth will continue for the next few years as there is continued uncertainty in the regulated lending and banking business. ■