ESO CAPITAL

Consistency amid changing markets

Private debt in Europe represents a strong investment opportunity. But with loosening structures and increasing leverage, investors must seek disciplined managers, writes ESO Capital's **Olya Klueppel**

ESO Capital has been investing in the European credit markets for close to 10 years. During this period, the direct-lending market in Europe, which barely existed a few years ago, has undergone a profound change. Institutional investors, and in particular those based in Europe, now recognise direct lending as a separate asset class and have allocated substantial capital to the strategy.

In response, new players have entered the market, from global investors active across a variety of strategies to teams specialising in specific geographies and/or segments of the capital structure. Most importantly, borrowers have accepted debt solutions offered by alternative managers as a viable and attractive source of capital.

Alternative lenders have made significant in-roads across Europe. Deal activity has been driven by an active M&A market, need for growth capital as well as changes in regulatory environment and capital constraints on banks.

The sponsor-led model currently dominates direct-lending activity in Europe, in particular for large transactions. At ESO, we have deliberately focused on lower middle market, "direct-to-the borrower" transactions and continue to see attractive opportunities in this space. While these transactions generally require a more hands-on approach and deal creation capabilities, an experienced lender

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can better protect its downside risk by achieving lower leverage, structural seniority and better collateral coverage.

However, as a significant amount of capital has flown into private debt, a number of challenges have emerged. According to recent Altium research, debt funds account for 20-25 percent of deal activity in the German market compared with approximately 15 percent two years ago. Statistics for other major European geographies, such as the UK or France, paint a similar picture. In response, banks – from large pan-European players to small regional lenders – have responded with aggressive structures, leverage and pricing.

In 2015, we have witnessed price compression across all European markets, with borrowers, including those with limited track record, expecting (and often obtaining) low interest rates and aggressive structures. Overall leverage has increased from 3x post-crisis to closer to 5x today, although this is more pronounced for larger M&A driven transactions.

However, the most notable development has been the return of the covenant-lite structures. This has been true both for bank- and fund-led transactions.

RETURN OF COV-LITE

Covenants protect investors by limiting the borrower's ability to incur additional debt, sell assets that underpin the business or divert cash flows from debt repayment. Maintenance covenants, and in particular those tied to cash flow generation, allow lenders to react to a downturn in a business. They are particularly important for lower middle market companies where cash flows tend to be more volatile.

As available debt capital has increased, the balance of power has shifted towards borrowers. Companies and their shareholders naturally prefer covenant-lite financings as it allows them to take greater operational and financial risks.

However, in an environment of compressing yields, covenant-lite structures add another layer of risk. European economies are performing well today, and the market has the wind behind it but managers cannot afford to be complacent about protecting downside. The last financial crisis clearly illustrated the drawback of covenant lite transactions and excessive leverage. Managers unable to protect their investors' capital suffered disproportionately and have exited the market.

Proponents of covenant-lite financings argue that these structures are positive for companies, and thus for lenders, since covenants reduce the flexibility that borrowers might have during a downturn. This might be true for selective large stable companies that have predictable cash flows and low leverage levels. However, the inability of creditors to have a say in difficult situations will normally result in losses for the investors. Today, investors in this asset class might not be fully compensated for the increased risks of covenant-lite structures.

The inclusion of covenants does not necessarily endanger the borrower. The understanding of when, and how, to react in case of covenant breach is crucial to protecting investors' capital. This understanding comes with experience and scar tissue, having invested through multiple cycles. This does not mean that in the case of non-compliance, creditors should immediately seek to default the borrower. Experience shows that a prudent lender would first seek to find an acceptable solution with the shareholders that maximises value.

As SMEs tend to react far more quickly in a downturn than larger companies, the ability to take decisions swiftly is often paramount in ensuring value is preserved when investing in the lower middle market. At the same time, flexibility in working with management teams and owners, both in initially accessing and structuring the financing, devising the appropriate covenant package as well as adjusting to changing conditions during the life of the loan, is another important factor.

Creating an appropriate covenant package is of course just one step of the underwriting process focused on protecting the downside. An experienced investor will recognise that the underwriting of loans to middle market companies differs from typical loan syndication.

The small-cap market, and in particular in continental Europe, tends to be less intermediated, with fully populated investment memorandums on the borrower rarely available. It is critical for lenders to have the skill to create a transaction that both meets the borrower's needs as well as fit the firm's capital structure. This must be buttressed further by the willingness to undertake one's own detailed due diligence, including on-site visits, evaluation of the underlying collateral and understanding of the company's strategy and its impact on cash flow generation.

Cookie cutter structuring does not work because of the wide variety of SMEs and underlying assets of the business. Self-structuring is essential to tailor each structure and covenant package to meet the individual company's needs and to address that borrower's potential weaknesses. These borrowers tend to be less sophisticated when it comes to structures, and the lender's ability to create a structure that reflects the risks of the underlying credit and particularities of the collateral package are key to success.

Further, for SMEs, complexity within the capital structure is a disadvantage. Structural seniority and the ability to exercise control through an appropriate covenant package, reflecting the specifics of the underlying business, allow the lender to effectively monitor the risk of loss and ensure that investors' capital is well protected in a downturn.

While successful SME financing requires critical focus on downside protection through covenants and various structural features, as well as a true understanding of the realisable value of the collateral underpinning the transaction, hands-on monitoring post investment is crucial. This leads to a constant understanding of the changing risk over the life of an investment. Investment managers that have been successful throughout economic cycles share common features: risk management and asset management functions with an active say during the underwriting process and proven experience of selling assets in all markets.

CAUTIOUS OPTIMISM

Overall, we at ESO Capital see significant growth potential for private debt in Europe. Market demand for flexible SME debt continues to outstrip supply many times over. There are over 223,000 SMEs in Europe with turnover of approximately €50 million. In both the UK and continental Europe there is comparably little equity available, with private equity investment in European SMEs approximately a fifth of equivalent US investment. European SMEs have relatively few choices of capital, which bodes well for the development of the private debt market.

Yet, as the environment becomes more competitive, staying selective, focusing on appropriate structures and covenant packages and sticking to a well-defined and stress-tested strategy is key.

We at ESO believe there are three success factors to ensure investors' capital is protected in all market conditions. The first is maintaining discipline on one's return expectations in a market of ever compressing yields. Second, developing deep sourcing networks in local markets so as to identify the most attractive opportunities. Lastly, always focusing on downside protection supported by extensive in-house work-out experience. ■