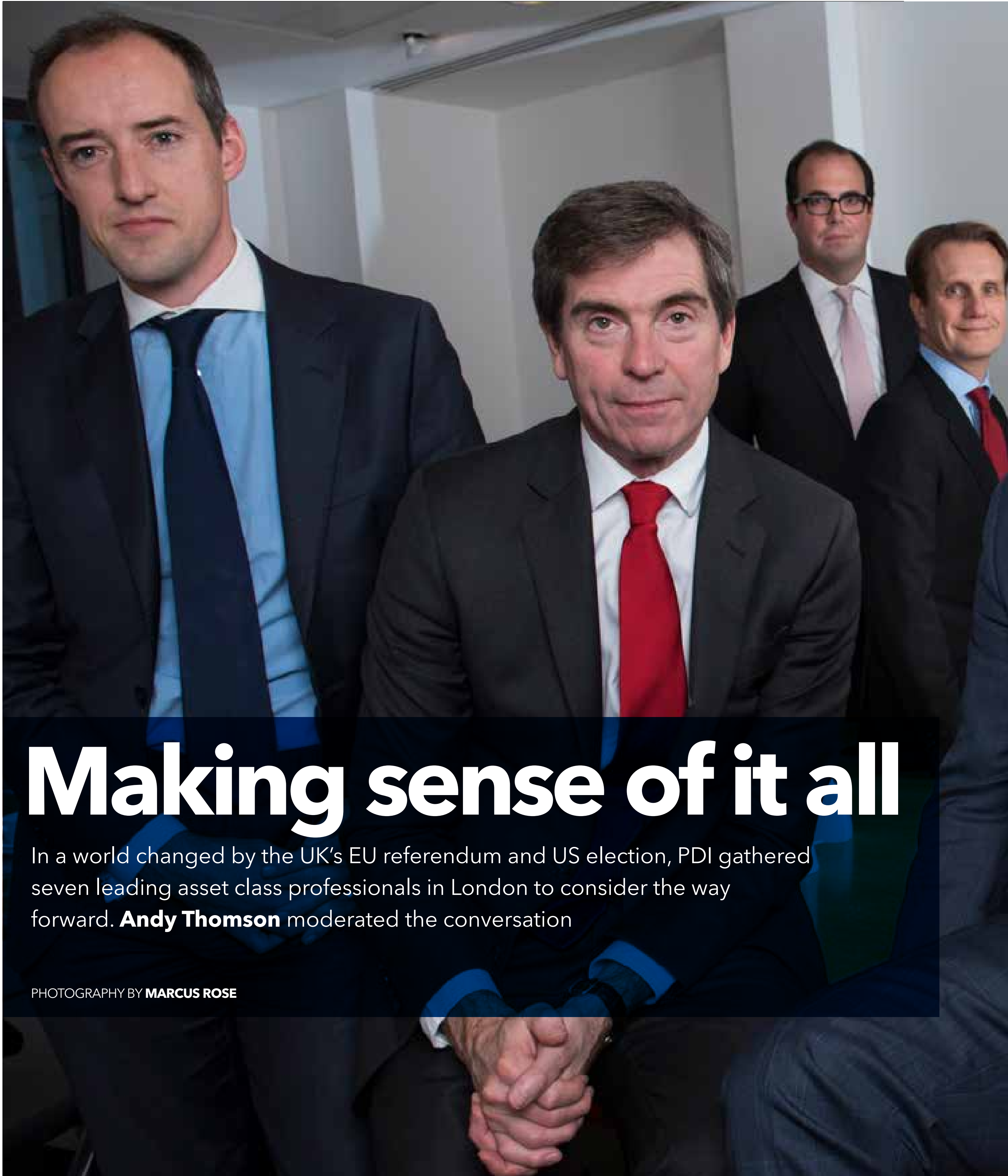
EUROPE



Making sense of it all

In a world changed by the UK's EU referendum and US election, PDI gathered seven leading asset class professionals in London to consider the way forward. **Andy Thomson** moderated the conversation

PHOTOGRAPHY BY **MARCUS ROSE**

From left: Christopher Bone, Paul House, Clark Coffee, Jakob Lindquist, Max Mitchell, Paul Shea and Alex Schmid

EUROPE

Christopher Bone
Managing director, head of private debt Europe, Partners Group

Partners Group

- **$7 billion total AUM in private debt**
- **Over 350 credits invested globally since 2003**
- **Focus on downside protection and attractive returns**
- **Targets whole debt structure ranging from senior loans to mezzanine finance**
- **Investment themes include attractive niches, creative structures and add-on financings**

On the US market

"IT'S MORE TRANSPARENT, PROCESSES ARE QUICKER AND MORE EFFICIENT, AND PRICING ADJUSTMENTS ARE MADE MORE QUICKLY"

St Paul's Cathedral has seen some history in its time. Created as part of the major rebuilding programme following the Great Fire of London, in more recent years it is often associated with the Second World War Blitz through images of the cathedral's dome ringed by smoke and fire.

In the wake of the UK's Brexit vote and the election of Donald Trump as the incoming president of the US, it seems somehow appropriate that St Paul's looms large from the windows of Intermediate Capital Group's offices – the location for the latest iteration of our European roundtable. This, after all, feels very much like another significant historical moment – even if not quite as dramatic as those earlier events.

Drifting into the room to take their seats are: Christopher Bone, managing director of private debt at Partners Group; Clark Coffee, partner and head of Tyndaris Real Estate; Paul House, managing partner at Venn Partners; Jakob Lindquist, co-managing partner at CORDET Capital; Max Mitchell, head of direct lending in Europe for Intermediate Capital Group; Alex Schmid, chief executive of ESO Capital; and Paul Shea, co-founder at Beechbrook Capital.

Coming just a day after the result that rocked the world, the US election seems a natural starting point for the conversation once pictures have been taken and caffeine boosts delivered. There is an amusing pause following an invitation for comment, as no one seems particularly keen to take the lead on such a thorny subject.

Eventually, Coffee ventures the following: "There is a common theme emerging with the US election, Brexit and what may yet happen in forthcoming European elections – it reflects a disgruntled populace and an objection to the status quo. Technological advancement has for some time been chipping away at the blue-collar workforce, and it's about to start impacting white-collar jobs in a big way. We are now living and investing in a world with heightened geopolitical risk and need to incorporate this into how we conduct our business."

Lindquist then reflects on the likelihood of greater isolationism, reversing what was assumed to be the unstoppable rise of globalisation. "Before the crisis, banking was more international in nature. Post-crisis there has been retrenchment and Balkanisation of European banking. An eventual reversal of that retrenchment now seems less likely, in light of Brexit, the US presidential election and various upcoming EU country elections. We had got used to seeing US and European banks expanding across Europe and there will be less of that now."

It's a theme also taken up by House, who adds: "The regulatory frameworks within which asset classes operated around the world were becoming increasingly uniform. Post-crisis there have been differentiating regulatory regimes emerging across various countries. Going forward, it will be interesting to watch the approach that the Trump administration will take and to what extent it will emphasise this trend further."

But while these initial reflections are largely downbeat, private capital managers also tend to have an ability to see an upside in any situation – and today is no different. Coffee predicts that the uncertainty will further reduce the risk appetite of traditional lenders and thereby create opportunity for alternative lenders; Lindquist believes that fund managers that can operate across borders will be well placed due to the lack of other financing options; and House thinks that, as markets become more distinctive and less homogenous, the chance to play a

relative value game increases. Shea says he is worried by the "direction of travel" with the upcoming constitutional referendum in Italy in December to be followed by elections in Austria, France, Germany and the Netherlands within the next 12 months. "The downside could be challenging," he says, reflecting on the possibility of nationalist and potentially isolationist triumphs.

But he, too, has a more positive slant, pointing to the checks and balances on Trump and the possibility that the US may have a more favourable trading stance towards the UK, which could help to mitigate the effects of Brexit.

THE BOTTOM LINE

Schmid wonders aloud about the impact of recent developments on return expectations. "A big question for me is how much return we need to be making at higher levels of political risk. Is 8-10 percent enough when you take into account ultimate downside scenarios? The potential for downside could be significantly higher in such a political environment."

Like any good fund manager, Schmid has quickly directed his focus to practical issues – with knock-on effects on fundraising front of mind. "In terms of my business model I'm thinking about capital raising because investors will likely sit and hold. Most of my capital comes out of the US and if people want to hold off and not do much for the time being then that's bad news because there are great things to invest in."

But while investors are unsurprisingly feeling cautious as a result of recent developments, Shea believes private debt is well placed relative to other options. "What asset class would you like to be in at a time like this? You can have secured, yielding assets versus equity markets which are at an all-time high. With its stable risk-adjusted returns, I'd say private debt looks compelling compared to some other asset classes."

Lindquist also sees reasons to be optimistic. "We're in fundraising mode and we're surprised by how much UK borrower demand has picked up post-Brexit. Business owners are seeking further debt capital to support growth and other strategic ambitions."

Clark Coffee
Partner, head of Tyndaris real estate, Tyndaris

Tyndaris
- **Bespoke capital solutions to owners and operators of commercial real estate**
- **Targets mid-market opportunities from €10 million to €80 million in size**
- **Active across the capital structure including senior and whole loans, subordinate and mezzanine loans, preferred and joint venture equity**
- **Likes traditional and alternative classes including transitional and development opportunities**
- **Pan-European focus including the UK, Western Europe and CEE**

On political events

"WE ARE NOW LIVING AND INVESTING IN A WORLD WITH HEIGHTENED GEOPOLITICAL RISK AND NEED TO INCORPORATE THIS INTO HOW WE CONDUCT OUR BUSINESS"

This leads to further reflection about the way in which the unexpected outcome of the UK vote to exit the European Union has impacted day-to-day activities. "How do we view UK risk?" ponders Lindquist. "By last month it had dissipated, but then along came Trump and the prospect of decoupling of economies. You can have euro-based funds with pound sterling returns and so the question is how you factor in currency risk. Hedging became a bit more expensive over the summer. On the other hand, however, into 2017 we can anticipate a scenario with a weakening euro in light of the European elections."

Bone adds: "Currency is the one tangible difference day-to-day. Plus, we're more nervous around the UK in general in the long term than we were before as there could be a reduction in GDP growth."

House acknowledges he has similar fears over the performance of the UK economy: "The UK faces challenges due to restrictions on labour, the need for FDI, and the challenges facing the services industry and multinationals in London. The UK will be resilient, but softer growth should be expected."

However, fund managers often stress that in times of economic difficulty, opportunity is front of mind for many. "There is more uncertainty but opportunities are greater for nimble fund managers operating in direct lending, which continues to represent

EUROPE

an attractive asset class and is recognised as such by investors," House adds.

The roundtable is taking place shortly after the publication of a National Institute for Economic and Social Research study predicting that inflation in the UK would quadruple to about 4 percent in the second half of next year. Those gathered are asked whether this rings any alarm bells, adding to the sense that the economy is heading off-track.

"A slowdown is not necessarily that bad," reasons Shea. "In a strongly growing market, excess liquidity and refinancing mean it can be hard to achieve the risk-adjusted return we want. In a sustained recession it's also difficult due to potential losses. Between zero and 1 percent growth is favourable for building a portfolio of yielding loans and achieving the money multiples we are seeking. High inflation can also be mitigated as our loans are typically floating rate."

A number of those present are keen to make the point that there should always be a margin of safety built into deal structures. As long as this is done, then you should be able to absorb some stress – including of the unexpected variety. Moreover, there is a view that more pressure is likely to be felt in the private equity and public markets than in private debt. Equally, it is acknowledged that while an inflationary environment would be acceptable for a year or two, a long-term inflationary outlook could be problematic.

There are few signs of panic, however, and no sense that a wave of distressed is about to wash up. "The most credit losses are often seen after a big boom, whereas we have seen eight steady, average growth years," reflects House.

Coffee adds that while all-out distress would be an unwelcome development, a bit of discomfort would not be. "Volatility alone does not make an attractive environment to invest. We want to invest in the dislocation which it produces. Post-Brexit we have seen very little distress but a good deal of indigestion across European markets. This is an ideal environment for us to deploy capital. We offer liquidity and certainty where the obvious lower cost option does not have the ability to act."

Paul House
Managing partner, Venn Partners

Venn Partners

- **Manager of European asset-backed loans, founded 2009**
- **In March 2016, launched own Dutch mortgage brand and platform, Venn Hypotheken**
- **Has completed more than £1.2 billion of new lending since 2013 in commercial real estate**
- **In December 2014, mandated by UK government as delivery partner for £3.5 billion PRS Guarantee Scheme**
- **Has proprietary risk analytics and valuation tool (VeRA)**

On the UK outlook

"THE UK FACES CHALLENGES DUE TO RESTRICTIONS ON LABOUR, THE NEED FOR FDI, AND THE CHALLENGES FACING THE SERVICES INDUSTRY AND MULTINATIONALS IN LONDON"

OVERHEATED

This "lower cost option" refers to the banks, who those around the table say are being seen less and less in the mid-market and rarely on cross-border or asset-backed deals. Because of the gap this is creating, there appears to be little problem in identifying good potential dealflow. On the flip side, someone puts forward the view that real estate looks rather overheated.

House, whose firm Venn Partners' investment mandate includes commercial real estate finance, responds as follows: "We don't play in core, shiny office buildings. There are certainly areas in real estate that are overheated, but generally it's a growing economy and there has been a delay in building new stock. For example, there is not enough supply of housing and there is strong demand for financing in the PRS sector, which will go institutional over the next five to 10 years."

Overall, there is confidence in the opportunity set – whether on an absolute or relative basis. "We are seeing six to seven new lending opportunities a week, primarily from the Nordics and the UK, our two home markets," says Lindquist.

"To build a successful direct lending business you need the right focus, the right team and the right processes. The direct lending market is growing quickly, and at the same time maturing with a requirement for lender differentiation. Our focus is local lending to lower mid-market companies in our two home

markets." He continues: "In any given lending process, we ask ourselves: Do we have a proprietary angle on the deal or other advantage of some kind? In a proprietary process, a lender's ability to provide levers of influence are much enhanced."

Adds Bone: "The majority of what we do is private equity-backed, and a huge amount of capital has been raised so there will be lots of M&A."

He continues: "We are committing roughly equal amounts to the US and Europe currently on behalf of our clients and we really like second lien in the US because the banks are highly regulated and can't do much of it. In Europe, it's mainly smaller companies and the demand is more for first lien and unitranche."

Jakob Lindquist
Investment professional, co-managing partner, CORDET Capital

CORDET Capital

- **Founded in 2013**
- **Provides private debt, direct lending and alternative funding to smaller mid-market firms**
- **Targets the UK and Nordic markets**
- **Meets investor demand for attractive risk-adjusted core income-focused credit investment returns**
- **Focus on first lien senior secured debt**

On borrower appetite

"BUSINESS OWNERS ARE SEEKING FURTHER DEBT CAPITAL TO SUPPORT GROWTH AND OTHER STRATEGIC AMBITIONS"

COMPETITION

The conversation moves on to the level of competition being seen in the market today. Isn't private debt its own worst enemy as its apparent attractiveness has fund managers drawn to it like bees to a honeypot, thereby driving up prices?

Coffee insists that it depends what part of the market you're operating in. "The majority of private debt capital that has been raised in Europe is concentrated in the hands of large funds targeting large deals. Tyndaris focuses on the middle market. We fly below the radar of these bigger funds and as a result compete less often on price. We tend to know in a few days if we're in pole position for a deal or not and, if we're not, we move on."

Lindquist takes up the point, but argues that there is also a significant difference within the mid-market itself. "With bigger deals, where advisors are almost always used, the process is very visible," he says. "The pricing and terms are also very transparent in the core mid-market, where it mirrors the more liquid leveraged loan market. In the lower mid-market, that's very much less the case when you're talking about companies with EBITDA of €3 million-€10 million. When you go above €10 million-€12 million, you start bumping into many more competitors, but the lower mid-market category is not at all as competitive."

A couple of those present reflect on the differences between the US and European markets. "The US is a much larger market," notes Bone. "It's more transparent, processes are quicker and more efficient, and pricing adjustments are made more quickly. It's not so much about competition as the amount you can deploy and having the right relationships."

"The market [in Europe] is well behind the US and doesn't work the same way," adds Schmid. "For us, we are focused on special situations and the only competition is family equity and other private capital sources of that nature."

Mitchell makes the point that many private debt managers are only looking to put to work a very modest amount of capital in relation to the size of the overall market opportunity. "The market is large, fragmented and local," he says. "In senior secured, we have no problem finding deals. If we do 15 deals in Europe, that's a great year. We don't have to buy the market, just invest in 15 great businesses that we like each year. As long as you don't seek

EUROPE

Max Mitchell
Senior managing director – head of direct lending Europe, Intermediate Capital Group

Intermediate Capital Group

- Aims to benefit from dislocation in credit markets and offer attractive risk/reward
- Bespoke private debt, senior, junior/ subordinated debt, mezzanine, structured loans and equity solutions
- Invests in direct lending across Europe, originating, structuring and executing own transactions
- Through ICG-Longbow, targets real estate whole loans and mezzanine
- Alternative credit strategy targets the likes of CLOs, RMBS and correlation tranches

On dealflow and investment strategy

"AS LONG AS YOU DON'T SEEK TO REPLICATE THE BANK MODEL, WHERE IT'S ALL ABOUT LEAGUE TABLES AND VOLUME, THEN YOU'RE FINE"

to replicate the bank model, where it's all about league tables and volume, then you're fine."

Further underling the open nature of the playing field, Mitchell adds: "Bank regulation creates the white space for us to fill. If we were in the US it would be a very different market, but the market here [in Europe] is so young that we're designing it for ourselves."

AROUND THE REGION

Coffee and House respond to a question about where they see real estate opportunity, and which are the less attractive markets. Says Coffee: "We looked at Spain for a long time before the big pools of NPLs were sold and we couldn't find opportunities where we would be appropriately rewarded for the risk. The transfer of these pools into the hands of private equity has acted as the catalyst for borrowers to seek new financings in order to retain ownership of their

FUNDRAISING: LOOKING FOR SOMETHING DIFFERENT

With $67 billion raised by private debt funds to the end of the third quarter of 2016, according to *PDI* data, there is no obvious sign of fundraising having been derailed by the year's extraordinary political events. And if those around the table are worried, they're doing a good job of hiding it.

"The fundraising market post-Brexit has been interesting and fruitful; we've not seen a slowdown," remarks Christopher Bone of Partners Group. "Private debt is still a small part of the pie and people are moving out of equities and high-yield bonds, and private debt is one of the places they are moving to. Just a 1 percent shift in terms of total allocation can be a huge amount. Pensions are looking at private debt more and more. Some of them are now moving out from broad, generalist strategies to more individual, particular strategies."

Jacob Lindquist of CORDET Capital also makes the point that investors are now on the lookout for niche strategies as the asset class begins to mature. "It was the first movers who built the direct lending market. In this second wave of market development, there is a great opportunity to do something different and proprietary. Both investors and borrowers are seeking differentiation. 'Me-too' strategies are unlikely to be successful."

Clark Coffee of Tyndaris expects to see a big inflow of capital from insurers in future. "Many insurers are still scratching their heads in terms of how best to invest in real estate credit," he says. "We have spent a lot of time reverse engineering the solvency capital requirements of insurers and believe as these institutions get their heads around it, private real estate debt managers will be an attractive solution."

'BIG SHIFT'

Traditionally, one of the biggest constraints on institutional investment into private debt has been illiquidity. However, faced with a sparsity of attractive investment options, investors appear to be becoming more flexible. "Now institutions are coming out of fixed income and they are trading liquidity for the return that they need," says Alex Schmid of ESO Capital. "So they are taking illiquidity risk, and that's a huge change. With US pensions there is a big shift from liquid into illiquid strategies – we've seen some go from 10-12 percent in alternatives up to 40 percent."

assets. As a result, today we see an abundance of attractive lending opportunities."

House adds: "The UK is interesting as the banks were recapitalised post-crisis and had to sell assets. Ireland and the Netherlands have also been interesting for that reason. Germany is well funded and is therefore less interesting from a real estate perspective as there is an aggressive and well-funded bank market."

Shea largely agrees with this assessment: "The landesbanks are in varying degrees of health, but they are still lending freely and cheaply. In the UK there are lots of borrowers, but there is a highly concentrated banking sector. So there is a big opportunity in the UK. The Nordics and Benelux are somewhere in between the UK and Germany – there is some competition from the banks but not too much."

Germany is certainly a hot topic within private debt circles, but often as a source of disappointment. With the UK and France

Alex Schmid,
Chief executive, ESO Capital

ESO Capital

- Founded in 2006
- Special situations investment management group, offices in London and Zurich
- Targets privately originated, "off-the-run" situations backed by the assets of European SMEs, financial assets and real estate
- Deployed over $500 million in capital since inception
- Acquires undervalued and distressed assets and provides capital to SMEs facing liquidity constraints

On Germany

"WE'VE SEEN SOME SMALLER OFF-MARKET DISTRESSED DEALS COMING OUT OF THE BANKS AND THAT'S BEEN INTERESTING OVER THE LAST 12 MONTHS"

It may be only partially true that investors are accepting illiquidity, however. Some in the market say private debt may be attractive compared with other investment options such as private equity because *on a relative basis* it is more liquid. Whereas a private equity fund's life typically extends to 10 or 12 years, private debt funds will often be wrapped up several years quicker.

"Private debt recycles more quickly than other things," acknowledges Alex Schmid of ESO Capital. "We get some coming out of the private equity bucket, which is much slower to recycle capital. So there has been an adjustment out of long lock-up strategies, and that has really helped us."

Some investors may have been holding back from committing to private debt because they thought it would be a case of 'here today, gone tomorrow'. That is also a view that is changing according to Max Mitchell of ICG. "There has been a change in mindset for asset allocators. Private debt used to be seen as tactical and opportunistic because people thought the banks would come back in and therefore it would be a short-term opportunity. Now they see it as a strategic allocation and there are buckets for alternative fixed income. That's because they simply can't hit their return targets with traditional fixed income."

However, Mitchell is wary that it will not be plain sailing for investors and that some will make bad choices. "Some people will get burnt because they didn't allocate to what they thought they were allocating to. So many GPs have been bringing so many strategies to the non-bank lending market under the badge of direct lending. But there is a track record of first and second funds delivering a good return in many cases. Investors are now waiting for those managers to come back to market rather than backing any new one that comes along."

When it comes to the kinds of terms and conditions that investors are wanting to see these days, participants believe it would be very difficult for GPs to be too aggressive in their negotiations. In the early days of the asset class, some funds were charging fees on committed capital, but the view around the table is that it's only possible to charge on deployed capital today.

Moreover, the point is made that, given the difference in returns (whether real or imagined), debt funds cannot stray into equity territory when it comes to economics. "If you're close to a private equity model, you need to deliver a return that justifies it," says Mitchell. "Ours is a fixed-income product. Private equity fees would kill the strategy." ■

EUROPE

holding the status of Europe's biggest private debt markets, Germany plays second fiddle with its still-dominant banks leaving little space for non-bank lenders.

However, Schmid maintains that in certain niches, opportunities may be found. "We're a bit more nuanced on Germany. We've seen some smaller off-market distressed deals coming out of the banks and that's been interesting over the last 12 months. We sometimes play in equity replacement and there have been some opportunities in the country that are just starting to make sense."

Whether the global political environment is starting make sense is another question entirely – and many would probably answer in the negative. But Schmid's concluding remarks are entirely in keeping with private fund managers' determination to spot opportunity wherever it exists, regardless of the background noise. ■

Paul Shea
Co-founder, Beechbrook Capital

Beechbrook Capital

- **Provides debt and equity to SME businesses in northern Europe**
- **Supports the acquisition or expansion of SMEs**
- **Founded in 2008 and made 36 investments to date**
- **UK SME fund provides debt to owner-managed and family-owned companies in the UK**
- **Private Debt Fund provides debt to private equity-owned companies across northern Europe**

On regulation

"WE DO NOT POSE SYSTEMIC RISK AND WE FULFIL AN IMPORTANT ROLE BY SUPPORTING THE GROWTH ASPIRATIONS OF SME COMPANIES, SO I THINK THE REGULATORS WILL CONTINUE TO TREAT US FAIRLY"

REGULATION: NOTHING MUCH TO WORRY ABOUT?

"Don't expect major hoopla," is the initial response of one of the roundtable participants when asked how private debt funds may be impacted by regulation in the years ahead.

Paul Shea of Beechbrook Capital explains why this assessment may be justified: "We do not pose systemic risk and we fulfil an important role by supporting the growth aspirations of SME companies, so I think the regulators will continue to treat us fairly."

For marketplace lenders there may be perhaps be more to worry about. "Consumer lending will be more heavily scrutinised and that will have an impact on P2P SME businesses," says Alex Schmid of ESO Capital. "We think that a lot of these businesses will go away as they are not good, well-regulated lenders."

But for traditional private debt fund managers, concerns are few aside from appreciating the regulatory nuances of different European markets. "Regulation is quite local," reflects Christopher Bone of Partners Group. "You need to understand the regulations in France, Italy, Germany, etc. Brexit hasn't happened yet but it's on our minds. There may be some changes to come but it's not a case of having to make a sudden adjustment."

Jacob Lindquist of CORDET Capital, whose debut fund announced a €200 million first close earlier this year, gives an example of how regulation can be a positive thing when it comes to fundraising. "Having an EU onshore fund with full-scope AIFMD [Alternative Investment Fund Managers Directive] compliance has been a massive benefit with investors. We're a relatively young firm, and with such a comprehensive regulatory structure, this is seen as a big positive. The initial regulatory process was very costly and time consuming but it was worth it."

THUMBS-UP

Another regulation-related thumbs-up goes to a small country which tends to punch above its weight. "Fund managers from all over the world use Luxembourg," says Clark Coffee of Tyndaris. "There has not been over-reach where regulation becomes punitive, which has occurred elsewhere, and Luxembourg has been the clear winner as a result of that."

And a "clear winner" is what many in the private debt market consider themselves to be in an environment where regulatory pressure continues to be directed towards the banks. Shea provides a neat assessment of why firms like his are not in the firing line: "There is a long-term secular shift towards finance provided by private debt managers, despite volatility in markets from year to year…We're not trying to make a quick turn but build a long-term business." ■