Unlocking value in Europe's lower mid-market

European private debt is growing and evolving with more capital being raised for mid-market strategies in the region. **Christian Fritsch**, of ESO Capital, offers insight into the segment that is the backbone of all European economies: the SME market

What defines an SME? Ask the question to 10 different fund managers and you will receive 10 different answers. In reality, distinct differences exist depending on whether one focuses on the upper or lower end of the SME market.

At the upper end of the market – which we define as companies with enterprise values of more than €200 million – significant amounts of capital have been raised for private debt strategies in Europe. These strategies typically lend to large privately-owned companies, deals are sponsor-backed and transaction structure is uniform. This part of the market has grown dramatically post-crisis and is becoming far more institutional.

By stark contrast, the lower end of the market is more opaque, more fragmented and remains significantly underserved and underbanked. Management teams at this end of the market, while strong at running their own companies, tend to be far less experienced when it comes to dealing with finance providers. Deals require a specialist skillset of the fund manager to ensure successful sourcing, structuring, execution and monitoring of transactions.

As more capital flows into the lower mid-market private debt space, it is vital for managers who invest that capital to define the opportunity and, perhaps more importantly, to develop effective downside protection strategies to mitigate against inherent levels of risk. It is equally important for investors to understand the nuances of the different strategies available to them across the various segments of the SME universe.

"FINDING GOOD DEALS IN THE LOWER MID-MARKET IS KEY, BUT EQUALLY, HAVING THE CAPABILITY TO ASSESS CORRECTLY THE RISK AND TO STRUCTURE EACH DEAL APPROPRIATELY IS ESSENTIAL"
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In the post-crisis world, a recurring theme in all asset classes has been an ever greater pool of capital chasing ever diminishing returns. Debt is certainly no exception. According to S&P Global, in 2016 European leveraged loans (ie, public, liquid, rated loans) generated total returns of 5.72 percent. At the time of writing, most new issues are printing at yields below 5 percent for structures where senior leverage now exceeds 4.5x. Weighted average bids in the secondary market have been above 99 percent for most of 2017. In the private debt space, the data are far less transparent, but the sense of crowding remains due to significant inflows of capital, particularly for deals at the upper end of the mid-market. Therefore, as the number of lenders has grown and the level of sophistication of larger SME borrowers in the upper mid-market has increased, larger private debt deals have ever more closely mirrored the institutional leveraged loan market. In such an environment, the role of borrower-side debt advisors in the €50 million plain vanilla private debt space is no longer simply to raise a large ticket for their clients. Their true value-add is now to take advantage of competitive tension, drive down pricing, drive up leverage and create ever more borrower-friendly covenant structures.

In contrast, the lower end of the SME market paints an entirely different picture. Here, there is a greater sense of space due to limited competition for deals and far less capital flooding this part of the market relative to the investable universe of SMEs. Despite UK GDP growth in every quarter from 2011 to 2016, the outstanding balance of loans from banks to smaller SMEs – defined by the British Bankers' Association as companies with less than £25 million ($32.3 million; €29.5 million) in revenue, and arguably the drivers of much of that growth – declined by 5.7 percent over the same period. This highlights the continued scarcity of capital at this level of the market and has resulted in major opportunities for experienced managers to generate deals with very attractive risk and reward criteria.

While this market appears to be an attractive hunting ground for credit managers, lending within this niche is not without its challenges: strongly performing smaller companies are awash with tempting offers from private equity. Owners who are not tempted to sell out, but whose businesses need capital, are often unaware of the range of options available to them. Their advisors (if any) are rarely debt specialists. Furthermore, their need for capital often arises from complex circumstances, which banks are unable, or unwilling, to serve; these can include international expansion, transformational acquisitions or a dip in operating and financial performance.

Therein lies the opportunity. Each situation is different, with its own complexities. Financial metrics can vary widely, but generally the SMEs that we work with have a proven business model with revenues in excess of €10 million backed either by assets or strong cash flows.

Capital providers who can customise solutions to fit these circumstances can achieve attractive returns within deal structures that in terms of leverage and covenant profile are arguably more conservative than those appearing at the upper end of the mid-market.

THE RECIPE FOR SUCCESS

Sourcing is a key skillset for any private debt fund and is especially challenging in the fragmented lower mid-market. As much as we might like to think it, no private debt manager enjoys name recognition amongst all owners and managers of Europe's SMEs. Investment professionals need to be frequently 'on the ground', interacting with advisors and educating the market. More often than not, management will have identified an opportunity or a problem requiring capital but are not aware of the options available to them. A great debt deal can often be the result of a broken process seeking some other outcome such as traditional bank financing or an equity solution. A successful private debt manager in this space needs to show creativity and entrepreneurship across the board.

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Finding good deals in the lower mid-market is key, but equally, having the capability to assess correctly the risk and to structure each deal appropriately is essential. A robust due diligence and credit underwriting process is required. Having the discipline to say no when your credit criteria are not met is vital.

SMEs at the lower end of the mid-market undoubtedly present a degree of business risk. Extremely fast growth can quickly reverse. Expansion to new markets can fail. Less sophisticated reporting and governance structures coupled with less experience in interacting with institutional capital providers mean performance issues can be difficult to identify. A specialist skill-set is undoubtedly required to be successful in this space over the long-term.

First and foremost: know how to get out before you get in. In approaching any situation, ESO seeks first to understand and address the downside so that investor capital is preserved in all outcomes, regardless of capital structure. This approach entails significant up-front work to understand the inherent value of the company or its assets, combined with practical knowledge, shaped by real world experience, of how value can be realised through all scenarios.

Secondly: structuring is vital. Debt solutions must be sufficiently flexible to allow for changing circumstances but sufficiently simple to allow management teams to focus on running their businesses. Deals rarely arrive fully-formed on our desks and the journey from initial idea to final structure can be a challenging one. Experience across the full credit spectrum, including private equity, legal and accounting knowledge is vital to ensure all facets of structuring a good deal are covered.

Finally: asset management. In the lower mid-market, deals rarely go exactly to plan. In our experience, it is essential to have a dedicated team of asset managers who have at their disposal a tool kit consisting of a formal relationship, through board observer rights and reporting, and an objective 'feel' for the business formed through the close partnership they build with the borrower from day one. That objectivity is important and allows foresight, speed and agility in decision-making when things go off-plan and ultimately preserving value for all sides.

The lower mid-market in private debt is opaque. Borrowers in this market do not benefit from the same level of experience or advice as larger companies. Structuring around complex situations means 'off the shelf' solutions do not work and due diligence is time intensive. However, this brings with it significant benefits. Lenders in this space are generally not working in competitive processes; they can design covenant packages which really work and documentation which suits the situation, rather than taking terms dictated by the market. Absolute levels of leverage are generally conservative and risk-adjusted rewards look very attractive in the context of the wider private debt market. As other segments of the European private debt market are looking increasingly overheated, at ESO we see this as an exciting time to be working in the lower mid-market in Europe. ■