# Of value and valuation, risk and return

Three fund managers, a banker and a lawyer: our UK roundtable discussion couldn't help but be engaging. **Rachel McGovern** sat down with five experts to discuss opportunities and pitfalls in the private debt market – in Britain and also continental Europe.

Though the experts ranged around the table for our discussion this year were all very positive about the private debt market, much of the conversation concentrated on risk, and work-outs and restructurings in particular: how a small number can drain resources and wipe out returns clearly weighed on the minds of the managers at the table. The commoditised nature of the syndicated loan market also bothered several members of the group – the illiquidity premium, or current lack of it, is damaging for the market, they concluded. And while the managers in the room do not lever their funds themselves, they all admired the business model of the banker. There was no denying that there is lower risk and attractive returns on offer when lending at the fund level to alternative credit providers.

Malcolm Hassan, the banker in question, is head of funds and asset management sector at Royal Bank of Scotland (RBS). As well as providing general services to funds, his team provides credit lines to debt funds looking to lever-up to boost returns. "We'd rather go and lend indirectly to access a different part of market with a different risk return profile from the bank," said Hassan.

Unintentionally, the discussion also mirrored a trend in UK politics – Europe bashing – but with a crucial difference: everyone at the table wanted more to do with Europe, not less.

The UK is the largest market for non-bank lenders in Europe. None of the managers in our discussion limit themselves to lending within the UK, but the nature of the market means that it is the main source of dealflow for almost every European alternative lender. Similarly, though Royal Bank of Scotland is a UK-based bank, it services private funds across the continent as well as non-European funds looking to do deals in the region. And for our legal expert, Michael Crosby, a partner with US-headquartered law firm, Orrick, Herrington & Sutcliffe, he may be the head of the English law practice, but that's because it's the legal standard used by private funds investing across Europe and the US funds that are the majority of his clients want to use the UK courts when they come into European transactions.

## LEGALLY SPEAKING

And it was the approach to creditor rights and enforcement in most European countries that bore the brunt of any anti-European sentiment expressed.

Bluebay's head of direct lending, Anthony Fobel, recounted one experience in France's Massif Centrale where anti-capitalist political sentiments made the enforcement claim he was then involved in particularly painful.

Given France's position as the second largest market for private debt, it is somewhere that lenders want to be, but parts of the legal code do not support the creditor-friendly rules and rights that reassure investors used to UK and US legal systems.

"We're seeing quite a lot of interest in


From left: Alex Schmid, ESO Capital, David Allen, CPP Investment Board, Anthony Fobel, BlueBay Asset Management, Michael Crosby, Orrick and Malcolm Hassan, Royal Bank of Scotland

France. As a senior lender, it's not a bad place to be particularly given the ongoing evolution of French insolvency laws to a more creditor-friendly environment. If a 'double luxco' structure is part of the deal, for the junior lender it can still be problematic given the potential to end up in enforcement with a mere contractual right to eventual proceeds with no political rights and the senior lenders holding all the cards," said Crosby.

Germany's enforcement laws have improved a lot, said ESO Capital's chief executive Alex Schmid, but between language and law, the last place any investor wants to end up is seeking the support of the local court in any claim in most European countries outside the UK.

"THERE'S A DOWNSIDE TO TARGETING THE SYNDICATED OR BANK LOAN MARKET IN THAT THESE LOANS TEND TO BE MUCH MORE COMMODITISED, HIGHER LEVERAGE AND AT LOWER RETURNS"

**Fobel, BlueBay Asset Management**

## REASONS TO BE CHEERFUL

Though Europe has its issues, from both a lending and a fundraising point of view, current market conditions are very encouraging.

"The big word for me is choice," said Hassan."Finally the corporate world has choice about what type of institution to marry up with."

Bluebay's Fobel noted the retreating of bank lenders and the more generalised acceptance of non-bank lenders as the two key factors driving the benign conditions. "Banks are lending but I think it tends to be very cautious vanilla stuff at low leverage levels which opens up a large universe of potential mid-market deals," he said.

ESO's Schmid echoed Fobel. He

# UK ROUNDTABLE

explained that most of the borrowers that his firm targets and deals with are not private equity-owned. "It has almost taken the career I've had in private debt, which is almost 15 years, for the private individual to accept a non-bank financial partner in the form of debt," he said.

Schmid also highlighted that from a fundraising standpoint, there is now a bucket for private debt to go into. ESO Capital was founded in 2006. The firm is currently raising its sixth fund, as reported by *PDI* in February, and Schmid said that the difference between this time round and gathering cash for their fifth fund is striking – he no longer has to explain what private debt is, because investors recognise and understand it.

"THE POINT IS THAT THE FOUR OR FIVE THINGS THAT ARE MAYBE 'NICE TO HAVE' RATHER THAN A 'MUST HAVE', ARE NOW OFTEN BEING GIVEN UP AT THE TERMSHEET STAGE"
**Michael Crosby, Orrick**

### POTENTIAL PITFALLS

That private debt is still a developing market is clear however. There are almost as many strategies as there are funds and for the three investment managers in the discussion, some of the approaches to direct lending taken by some providers raise the all-important question of risk versus return.

David Allen, a managing director at CPP Investment Board (CPPIB), one of Canada's largest pension funds, explained that the European syndicated leveraged loan market does not supply the kind of value-added transactions that his team is seeking out.

"For the straight down the fairway deals, banks are happy to lend. Leverage is high, spreads are low. If UPC does a leveraged loan, everyone in the market is going to want to buy [it]," he said laughing as he asked the table what letter term loan the popular PE-backed cable TV and internet credit is on at this point.

CPPIB is convinced about direct lending, so much so that it likes to by-pass the middle-man and lends itself. But for Allen, the syndicated market that finances the buyouts, refinancings and dividend recaps of the large-cap sponsored transactions is not the best source of deals.

The pension fund prefers contrarian situations where there are almost no other lenders competing because the situation is complicated or the borrower has been hit by negative headlines.

Fobel also has little time for private debt managers who source large volumes of dealflow from the leveraged loan market.

"There's a downside to targeting the syndicated or bank loan market in that these loans tend to be much more commoditised, higher leverage and at lower returns. This is reflected in certain funds where they are targeting net returns of 6 to 8 percent for their investors in a seven to 10 year structure on a relatively low fee base," explained Fobel. "If you're going to invest $3 billion over three years, you can't shoe leather originate enough deals, you're going to have to be playing in that bank syndicated market."

With competition among banks and debt funds to provide cash, sponsors have been able to drive down pricing and loosen covenants with the syndicated market over the past two years. But what's worse, our conversation partners said, is that if something goes wrong, creditors take a big hit if they want to trade out of those deals.

"People don't really price the illiquidity premium that they should. There's a huge premium for not being able to sell something that you own," said Allen.

For the funds at the larger end of the scale, tapping the syndicated market is necessary. It's the best source of deals to meet their large investment requirements. And with lower return targets, the margins and fees earned, though under pressure, are enough to get them across their hurdles.

But it is those low return targets that the managers taking part in our roundtable were concerned about. "The illiquidity premium is very significant, it cannot be priced enough," said Schmid.

# UK ROUNDTABLE

"FOR US IT'S A VERY SIMPLE STORY OF BLOOD, SWEAT AND TEARS OVER 10 TO 15 YEARS TO DEVELOP YOUR 200 TO 300 GOOD RELATIONSHIPS"
**Alex Schmid, ESO Capital**

Fobel suggested that with carry hurdles of six percent, most of these funds are not targeting carry and so the managers' interests are not aligned with those of their investors. Instead, these managers are targeting fees – it's an AUM play. But with paper that can go from sellable to totally illiquid in a very short space of time, investors' returns are at risk with even just one or two sour deals in a fund, he went on.

Orrick's Crosby said that illiquidity in the European market, which is much more marked than in the US, is one of the biggest concerns for his US clients. "When they look at the wider market for distressed European debt assets – the inevitable big gap-down in pricing when something goes wrong means they're likely stuck in their stressed European deals (in contrast to the US where the liquid secondary market for distressed assets often allows them to trade out of their problems for a reasonable cost) so robust legal documentation with real hold out value, is incredibly important to them," he said.

For Allen, recent deals that went bad, including Towergate and Phones4U were counter-intuitively good for the market. "The great losses that some people took in the credit markets are a sobering reminder of the risks that need to be priced into spread premia. This should make for a better priced and better functioning market," he said.

## ORIGINATION

Given their views on the commoditised nature of the syndicated loans market, it wasn't surprising to hear Allen, Fobel and Schmid talking about their preferences for trying to add value elsewhere.

ESO Capital concentrates on smaller mid-market borrowers and although Schmid says the firms' fifth fund included more sponsor-backed deals than is typical for the firm, private equity-backed companies make up a small minority of their lending.

"[Lending to a] private individual owning a business; that market is much, much bigger in terms of opportunities versus the more sponsored market but it is also much harder to find and to access," he explained.

Originating those non-sponsored deals is not a straight-forward endeavour. "For us it's a very simple story of blood, sweat and tears over 10 to 15 years to develop your 200 to 300 good relationships," said Schmid adding that ESO now gets most of its new deals from referrals by previous borrowers: the business owners that ESO deals with are often making a choice between tapping up friends and family for equity or a soft loan, approaching a sponsor or trying to source difficult to access bank debt.

At the other end of the spectrum in terms of commitment size, David Allen's team put up tickets of between $50 million and $150 million. The pension plan will lend in almost any currency, using its triple A rating to hedge the swap at a much cheaper rate than its sub-investment grade borrowers could themselves.

To source European lending opportunities, CPPIB pays a fee to banks that don't have the balance sheet or risk appetite for the deal to bring it to them instead. A cash sweetener guarantees that the traditional lender comes back to his team with other opportunities, Allen said.

"As long as my return, net of that fee, is still attractive, then it's better than not doing deals because I'm never going to have 20 people in the Nordics or France, or Italy or Spain," he explained. And it's by avoiding the plain vanilla, cov-lite, tight spread, syndicated loan deals that earn Allen the returns that enable him to pay that finders' fee.

Hassan described the difference between what bank lenders can do and what private debt funds are open to with a skiing analogy. "Competition – it's like being on a mountain, banks mostly stick to the red and blue runs, but there's a whole massive mountain. There is just so much opportunity for private debt. You don't have to go far off the piste to find great deals," Hassan said, adding that bank credit committees are still somewhat running scared since the crisis.

Allen agreed that his team approaches a new borrower in a very different way from bank lenders: "We start with the questions; what do you need the money for, when you do you need it, when can you pay us back, rather than: 'Here's our standard loan, its $200 million at 700 over at 98 non-call three at 104'."

The mountain analogy fitted so well that Bluebay's Fobel went on to borrow it. He explained that Bluebay's return targets are higher than many other funds focused on providing senior debt, because the firm wants to do the off-piste deals.

Bluebay focuses on event-driven financings and sources opportunities through a network of 320 advisory relationships across Europe. Around 70 percent of Bluebay's borrowers are sponsor-backed and although the firm lends for tenors of up to seven years, the facilities are often refinanced after two or three.

"We did a deal recently with a sponsor for the third time. The last two deals they showed us exclusively," said Fobel. "That's the holy grail for us."

**BRAIN DRAIN**

Originating good deals and basing all decisions on strong credit work are essential when lending. But, inevitably, deals go bad. And though very positive about the market, our roundtable participants all emphasised that for private credit providers, any restructuring situation is a double blow. Along with the potential hit to returns and loss of principal, there is the loss of headcount as people have to follow the situation through to resolution.

It was Hassan who made the point most strongly when he reminded the group that the headcount in RBS's workout group increased from 250 people pre-crisis to over 1,200 at the height of working out its bad assets.

Schmid said his firm spends more on portfolio management than on origination in terms of headcount, a painful decision, but necessary as their assets are higher yielding but risky. "Workouts start with monitoring. If you have true information, rational info, good info on risk, you will be inherently a better workout guy because you will make the decision earlier."

ESO strictly separates origination and monitoring functions as deal makers can get too close to the asset, he added.

At Bluebay, the firm's dealmakers take a 'cradle to (hopefully not) the grave' approach on the basis that the person who led the deal has the most invested in getting the best possible outcome, said Fobel.

And in stressed scenarios, the importance of being paid an illiquidity premium becomes most clear.

"Under what scenario do you value an asset? If all is good – I get to sell a piece of real estate over 12 months' time – that's one value. If I've got to blow this thing out next week, that's a whole different ballgame," stressed Schmid.

"PEOPLE DON'T REALLY PRICE THE ILLIQUIDITY PREMIUM THAT THEY SHOULD. THERE'S A HUGE PREMIUM FOR NOT BEING ABLE TO SELL SOMETHING THAT YOU OWN"

**David Allen, CPP Investment Board**

Fobel, Schmid and Allen were also united in their disdain for the continuing erosion of covenants in loan agreements in the syndicated market. With no opportunity to really negotiate a strong covenant package with the borrower as another lender can usually be found, the commoditisation of the syndicated leveraged loan market continues.

Crosby explained how the starting point for documentation discussions has moved.

"The point is that the four or five things that are maybe 'nice to have' rather than a 'must have', are now often being given up at the termsheet stage and so to a certain degree it does feel a little like we're in 06/07 again, but of course from a very different (and better) perspective. Legal documents, particularly inter-creditor agreements, start from a far better position than those we were presented with back in 06/07 and before which is good for multi-tranche lenders in Europe," he said.

# UK ROUNDTABLE

"FINALLY THE CORPORATE WORLD HAS CHOICE ABOUT WHAT TYPE OF INSTITUTION TO MARRY UP WITH"
**Malcolm Hassan, Royal Bank of Scotland.**

### WITHER PRIVATE DEBT?

Though most of the group agreed that eroding the illiquidity premium paid to lenders is, at the very least, short-sighted, none could outright condemn the low-return target funds as doomed.

Bluebay's Fobel, the most vociferous critic of those kind of strategies, said: "We need to go through a few economic cycles to see which strategies emerge as the best models. It may be that doing 6 to 8 percent deals with some leverage is a completely robust strategy. It may be that you need to target higher returns and do more event driven-type loans but I don't think any of these models has been truly tested yet because in a low interest rate environment no one has been tested on the key question of defaults."

In a similar vein, Schmid said that competition amongst themselves will not be of the utmost concern for alternative lenders for some time to come. "All of us have a long, long way to go before we're competing with each other. Yes, there will be pockets of competition but I don't think that's our issue. Our issue is still the acceptance of the practice of private debt amongst economies and the market participants of those economies."

That the borrowers will make the market seems like a fair point to make about the evolution of private debt, but RBS's Hassan had an interesting point to add – namely that banks can and should also be key to the growth of private lenders.

"I think that [banks directing borrowers to the right alternative lender] is where the evolution of the banking and alternative lenders will come. It will take a sea change in people's ideas but I tell you, in 10 years I think you'll see a significant [change]," he concluded.

In the UK, the government is certainly making noises (and legislative changes) in support of non-bank lending. It remains to be seen if the rest of Europe can catch up with it, and if the national authorities can address the legal frameworks that leave many lenders nervous about their ability to recover debts. ■

## AROUND THE TABLE

**David Allen** is a managing director at CPP Investment Board but rather than making LP commitments for the Canadian pension fund, he lends funds directly. He joined CPPIB from GoldenTree Asset Management where he was a partner and portfolio manager. He founded GoldenTree's London office and was responsible for their European investments. Allen did a 10 year stint at Morgan Stanley where he worked in M&A, investment banking in Hong Kong and finally in fixed income, where he was associate director of high yield research.

**Michael Crosby** heads up US law firm Orrick's English law banking and finance practice. He specialises in acting for lenders and borrowers in leveraged and acquisition finance transactions, with particular experience advising debt funds and other alternative credit providers in structuring and negotiating complex domestic and cross-border multi-tranche finance transactions. Crosby has executed deals across a range of sectors including financial services, energy and technology. He was a partner at Proskauer before he joined Orrick.

**Anthony Fobel** is a partner and head of direct lending at BlueBay. The firm's direct lending team provides senior and subordinated debt solutions to financial sponsors and mid-market European corporates. Fobel was a partner of Och-Ziff Management and head of European private investments from 2005 before he made the move to BlueBay in 2011. Before joining Och-Ziff, he was a director at CVC Capital Partners from 1998. He cut his teeth in the corporate finance teams of Lehman Brothers and Dresdner Kleinwort Benson after qualifying as a lawyer at Allen & Overy.

**Malcolm Hassan** is head of funds and asset management sector at Royal Bank of Scotland. His team provides services to a range of different funds including leverage for debt funds, bridging facilities as well as other cash management services. Hassan moved to the funds side of the business in 2011, he was a senior director in the leveraged finance team for six years before that originating and executing mid-market deals. He was also responsible for helping deliver the UK corporate bank's five year strategic plan.

**Alex Schmid** is chief executive officer of ESO Capital. Prior to founding ESO in 2006, he was managing director and head of Europe at DB Zwirn. He has over 20 years of illiquid investment experience in Europe and more than 15 years in private debt. ESO Capital has just finished investing its fifth fund. It targets lower mid-market companies and concentrates on businesses that are not backed by a private equity sponsor.