Aon's Investment Research and Insights

Understanding European Direct Lending

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By beginning to identify investment research and communicate ideas before they are needed we can shorten the implementation times for our clients and act in a timely way when opportunities are correctly priced.

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Summary

The direct lending market, a form of private debt, has increased in popularity with investors in Europe since the Global Financial Crisis due to European banks' reduced ability to lend to mid-market companies following changes to regulation. As a result, direct lending firms have bridged the gap in providing capital to businesses with earnings between €10m and €500m. This area of the market is often referred to as the 'middle market'.

A holding in a direct lending fund can make an attractive addition to a portfolio due to the relatively high return in an otherwise low yielding environment. This paper will provide a high level overview of direct lending in Europe and introduce key concepts when considering its inclusion in a portfolio.

Clients interested in an allocation to direct lending should consider their ability to lock-up capital. A direct lending fund is a closed ended structure with a typical life of 5-7 years. Investors will not be able to redeem their holding until the end of the life of the fund. Capital is committed (a formal guarantee to invest) and then called (taken by the manager and invested).

What is direct lending?

Direct lending provides capital to mid-market businesses in the form of a loan secured against the company's value, but is often not collateralised by specific assets. Returns are driven by an upfront fee and repayments which are made at a margin above Libor, also known as the spread. Since loans are floating rate, the repayments are set at a percentage above Libor (e.g. Libor +7%). Hence if interest rates rise, so will the loan rate and consequently returns will increase as interest rates rise.

Who are the borrowers?

Borrowers are typically non-financial corporates seeking additional funding for the purposes of: buyouts, acquisitions, growth capital or refinancing. Companies are usually sponsor-backed (firms with Private Equity capital behind them). However, there has been a recent rise in sponsor-less deals, notably within the lower middle market space.

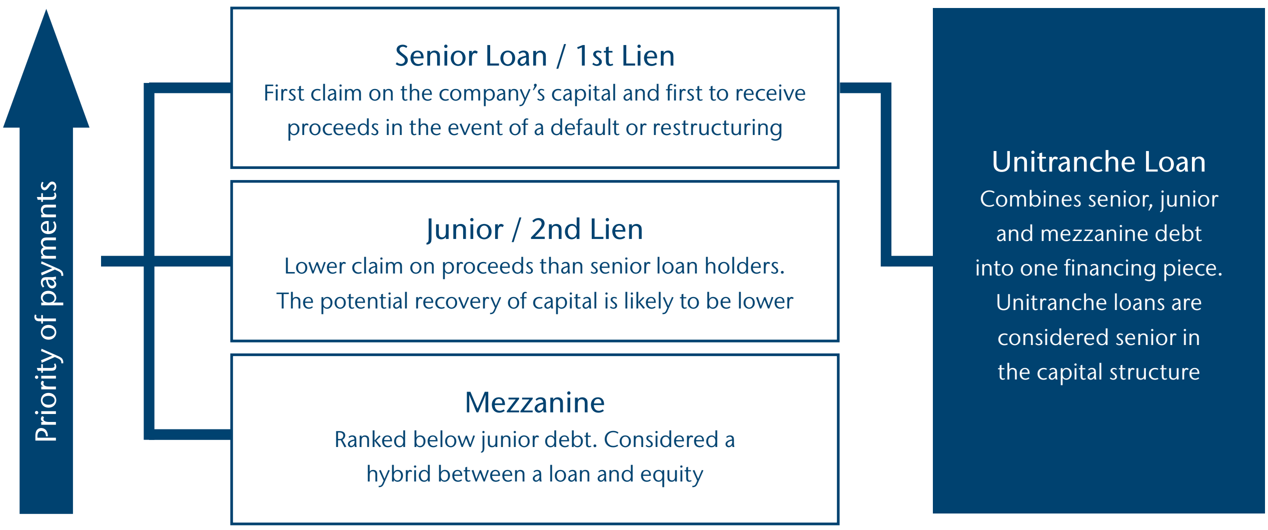
Typically sponsor backed deals are viewed as being less risky than sponsorless deals as the sponsors can provide additional financial injection and expertise in restructuring scenarios.

Are all loans the same?

Loans will vary in risk and return characteristics depending on where they sit in the capital structure of a company i.e. the layers of debt and equity that make up a company's borrowings. In the event a company faces bankruptcy the capital structure determines which lenders will get paid first.

Loans can be made throughout the capital structure. The seniority of a loan in the capital structure determines the inherent risk and thus the required return to compensate investors for risk taken. It is not related to the creditworthiness of the underlying company. Generally, the lower in the capital structure a loan is, the riskier it is perceived to be due to the potential impairment to interest and return of principal in the event that the company faces difficulties. In the event of a bankruptcy a company will repay debt to the most senior debt holders first and then follow a waterfall of payments down. As a result, those lenders at the bottom of the structure may not be repaid.

Broadly, the capital structure can be divided into:

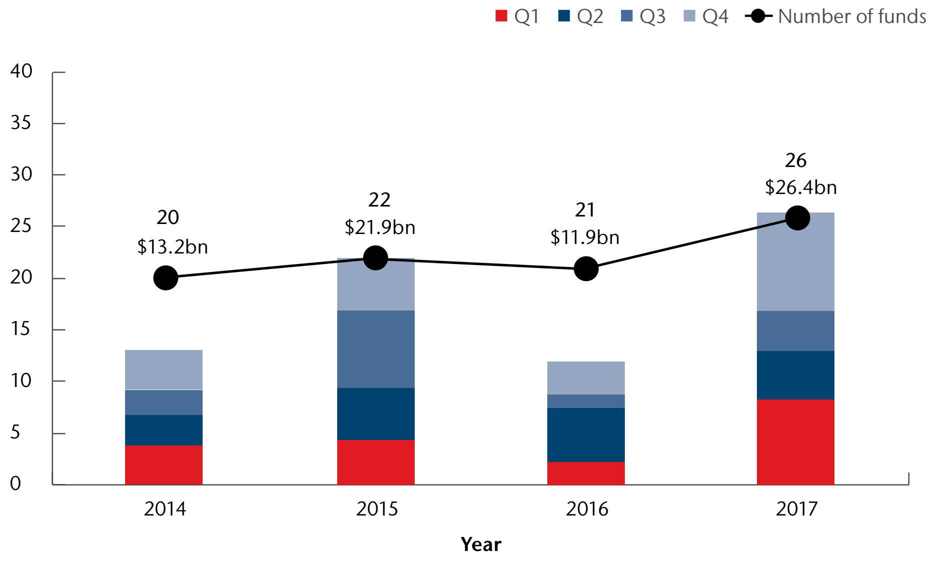


The middle market capital structure has seen changes following the Global Financial Crisis which arguably have simplified and improved the investible landscape. Unitranche loans have grown in popularity amongst borrowers: combining senior, junior and mezzanine loans into a single loan attempting to meet the entire financing needs of a company. Unitranche loans are considered senior in the capital structure (due to the fact no other debt is ahead in the capital structure). These unitranche loans often have a higher margin than senior debt to compensate for the inclusion of mezzanine debt.

European direct lending market

European middle market direct lending has seen significant growth since the crisis, both in terms of capital available to deploy and the number of direct lending firms. In 2017 alone, $26.4bn was raised across senior and junior loan funds. Consequently, the competitive environment is rife with a number of funds seeking to deploy capital in the most attractive deals.

Europe Direct Lending fundraising by quarter



Source: Deloitte Alternative Lender Deal Tracker, Q1 2018

It is worth noting that the UK remains the dominant direct lending market in Europe, accounting for a significant proportion of deal flow, closely followed by France and Germany. However, deal flow in Benelux and the Nordics has seen solid growth in recent years indicating an increase in geographic diversification and potential for development of new markets.

Although the deal flow has the potential to provide adequate opportunities for capital deployment, the heightened competition for deals has resulted in a tightening of spreads (margin above Libor) and downward pressure on upfront fees that borrowers would pay to a lender.

Additionally, there is a trend towards less investor protections which are referred to as covenants. Covenants play a key role in loan underwriting (assessment of the risks inherent in a loan) and enable direct lending firms to impose limits on the borrower in order to protect the lender. This may include required minimum levels of interest coverage (an accounting ratio which measures the ability of a company to meet its loan repayments) or restrictions on the amount of leverage (borrowing) which allows a lender to take control of the situation in the case of deteriorating financial performance of the borrower. Despite potentially reduced lender protections, margins still look relatively attractive when compared to other fixed income assets although there are risks that need to be taken into account.

Mitigating risks associated with direct lending

Risk of impairment

Risk of impairment refers to the risk that debt will not be repaid, or only partially repaid, if a company faces difficulties. Direct lenders have the ability to mitigate impairments by controlling the structuring of the loan and including lender protection in the form of a covenant. Mid-market companies in Europe would not be immune to increased default rates in wider public debt markets. However, due to the control on the structuring of the loan, impairments could be limited by the manager and recoveries could be higher than in public credit markets when defaults occur.

Depending on the deal, a direct lending firm may be the sole lender or co-invest alongside another lender. However, often a firm will look to be the sole or majority lender in order to facilitate underwriting and retain control in a restructuring situation.

Manager risk

Further risks pertain to the pace of capital raising and opportunities in the market. A manager’s ability to source deals relies on reputation hence the larger, well-established players tend to dominate transaction activity.

Furthermore, there has been an increase in the number of direct lending managers and quantity of capital raised. This increase could put downward pressure on pricing and lending standards. This has been prevalent in the European market with the number of covenants, margins and upfront fees being pressured over the last few years.

Therefore we believe that the selection of a best-in-class manager is essential when considering an allocation to direct lending. Aon’s manager research specialists can work with your investment consultants to identify which fund manager would be best suited to achieving your objectives within this space.

Liquidity risk

Investors will be unable to access the committed capital for a number of years, which requires consideration of a number of issues including meeting liability cashflows and access to other market opportunities.

As margins compress in the market we are presented with the risk that the illiquidity premium does not adequately compensate for risk. This is the additional margin demanded by investors for holding an illiquid asset. However, margins still provide a buffer above traditional, more liquid assets and remain adequate given low default rates in the senior European direct lending market.

Conclusion

An allocation to direct lending can form part of clients' allocation to growth assets by offering potential increased returns in a low yield environment.

Locking up capital for a number of years grants managers more certainty and flexibility in their dealings. Investors are potentially rewarded for this with what's known as an illiquidity premium, potentially leading to higher returns than traditional, liquid fixed income assets. Investors may be able to achieve mid-to-high single digit returns, depending on the level of risk taken.

However, potential gains should be weighed against risks of opportunity cost of locking up capital, potential impairment and liquidity profile of underlying assets.

Contacts

John Belgrove
Senior Partner
john.belgrove@aon.com
+44 (0)20 7086 9021

Kate Charsley
Partner
kate.charsley@aon.com
+44 (0)117 900 4414

Tim Giles
Head of UK Investment Consulting
tim.giles@aon.com
+44 (0)20 7086 9115

With thanks to our author

Chelsea Parandian
Principal Consultant

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Registered Office:
The Aon Centre
The Leadenhall Building
122 Leadenhall Street
London EC3V 4AN

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