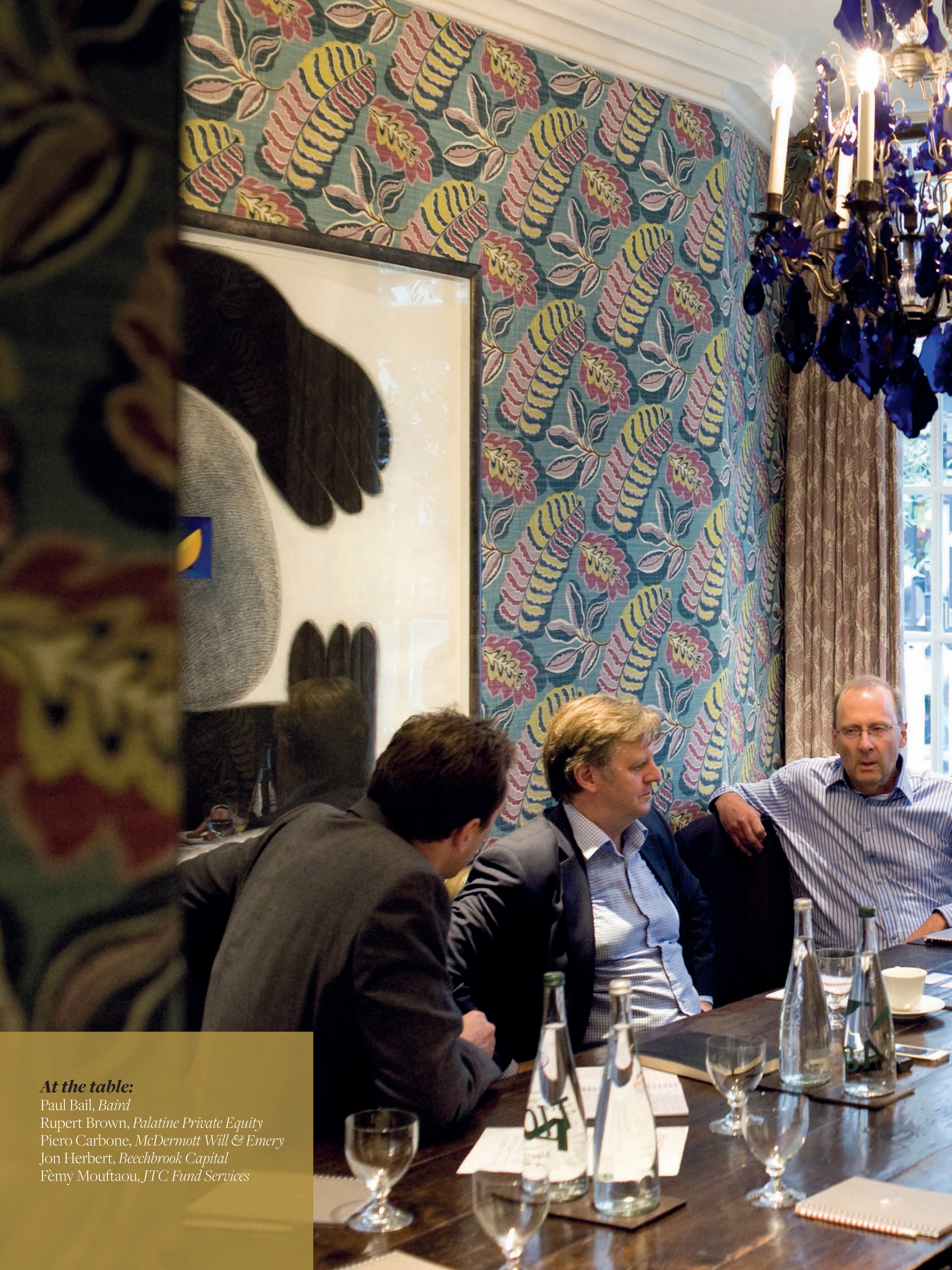
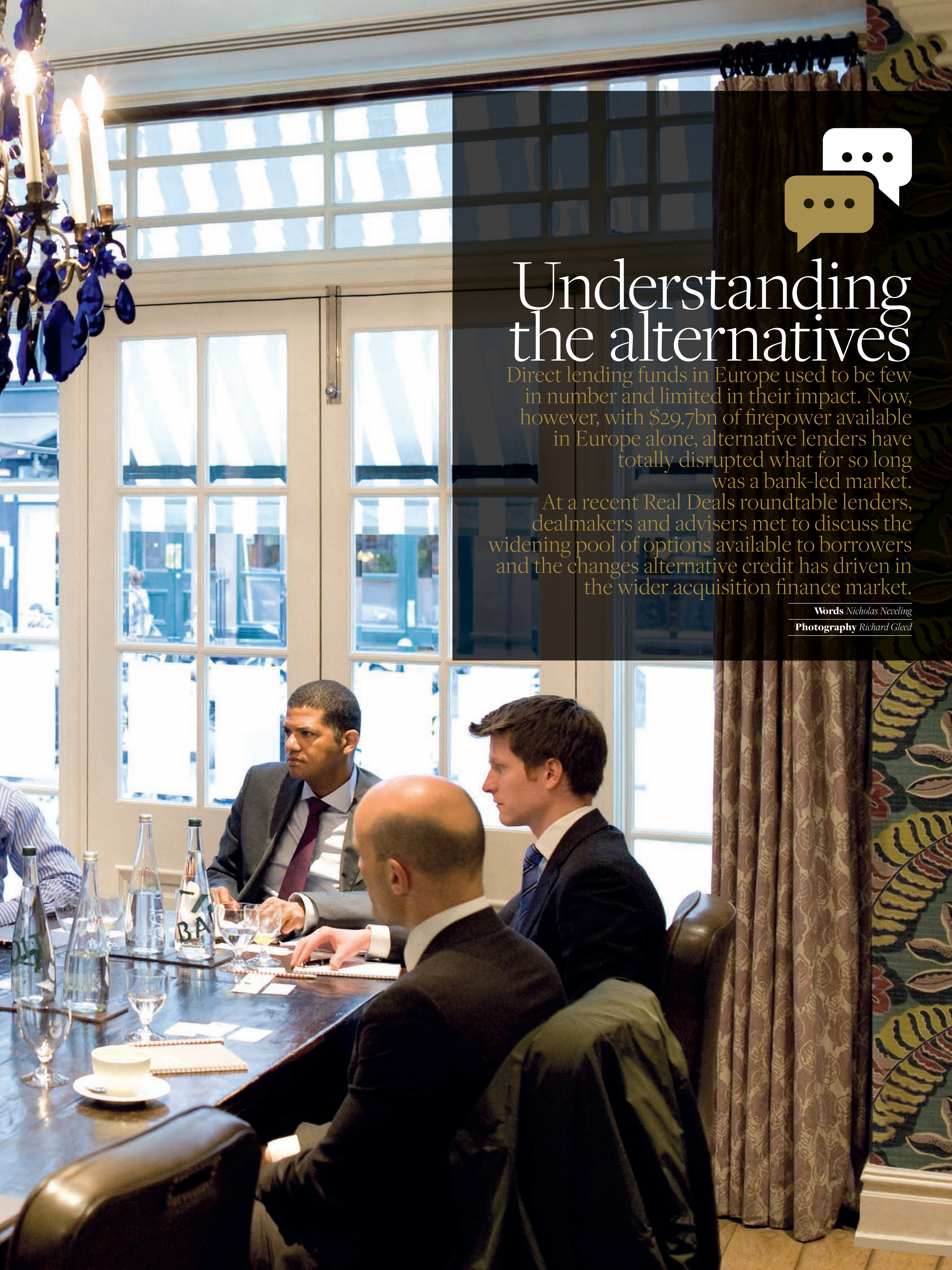


At the table:
Paul Bail, *Baird*
Rupert Brown, *Palatine Private Equity*
Piero Carbone, *McDermott Will & Emery*
Jon Herbert, *Beechbrook Capital*
Fèmy Mouftaou, *JTC Fund Services*



Understanding the alternatives

Direct lending funds in Europe used to be few in number and limited in their impact. Now, however, with $29.7bn of firepower available in Europe alone, alternative lenders have totally disrupted what for so long was a bank-led market.

At a recent Real Deals roundtable lenders, dealmakers and advisers met to discuss the widening pool of options available to borrowers and the changes alternative credit has driven in the wider acquisition finance market.

Words *Nicholas Neveling*

Photography *Richard Gleed*

If we reflect on the emergence of alternative credit in Europe in recent years, has the market matured or is it still in a "growing up" phase?

Paul Bail: I would say that it is fairly mature but there is still a way to go. There have been a number of funds that have been raised in the last few years. The funds themselves are trying to find the particular areas that they want to invest in. There are some niche firms focused on the smaller end of the market and then there are funds playing at the £100m-plus range.

Investors making allocations to private credit funds are looking carefully at where they invest their money and the strategies that funds have adopted are more diversified. The industry is only five years old, give or take, so it will be interesting to see how it does evolve.

That said, we are seeing signs of maturity in terms of pricing. It's tending to come down a bit. Some of the bigger funds are offering senior, stretch senior and unitranche to try and differentiate themselves and find more opportunities.

Piero Carbone: Paul makes some interesting observations on how funds are seeking out niches as the market matures. Some lenders were trying to do a bit of everything at the beginning, but now funds are offering certain products that they think will make them more competitive. Some funds will offer synthetic unitranche, others will look at senior and there will be a lot of other options in between.

Jon Herbert: Lenders are trying to find relevant niches to develop their businesses, but I'm of the view that until we go through a full cycle the funds can't claim they're mature.

We've been in a fairly abnormal world with things like quantitative easing and very easy money. That has driven some of the growth in my view. Only when we get back to fairly normal monetary policy and a normal credit cycle will the market start to refine the business model.

In the meantime, people are trying to get on and develop interesting differentiated strategies. Bigger funds will go out and do B-loan type deals and others will seek to carve out market niches. In a world where there's lots of money, people will try to find different debt packages that appeal to different borrowers. But I still think it has quite a long way to go to become mature.

"We have seen some funds double in size after just three or four months on the road. Now they have to find a way to deploy that money"

Rupert, as a financial sponsor and borrower, what are your observations? Have you noticed a change in the way private debt funds are positioning their offers?

Rupert Brown: From what I have seen the debt fund market has matured, but it has mostly been at the larger end of the market. There are the bigger debt funds, that will lend down to £20m on day one, however they typically operate above where we play, and then there are a few below us doing very small loans. Where we sit, in the lower mid-market if I can call it that, there actually aren't that many debt funds focusing on our deal sizes so there is certainly room for the market to continue maturing and finding new areas of specialism.

There certainly do seem to be more new funds coming into the market. Is it indeed the case the number of managers coming to market is going up? Is the market much bigger than it was five to ten years ago?

Fèmy Mouftaou: The market is much bigger than it used to be, but it is still very young.

When I compare what is happening in the US with what is happening in the UK and the rest of Europe, you see that we are in a market that is still growing up and early in the cycle.

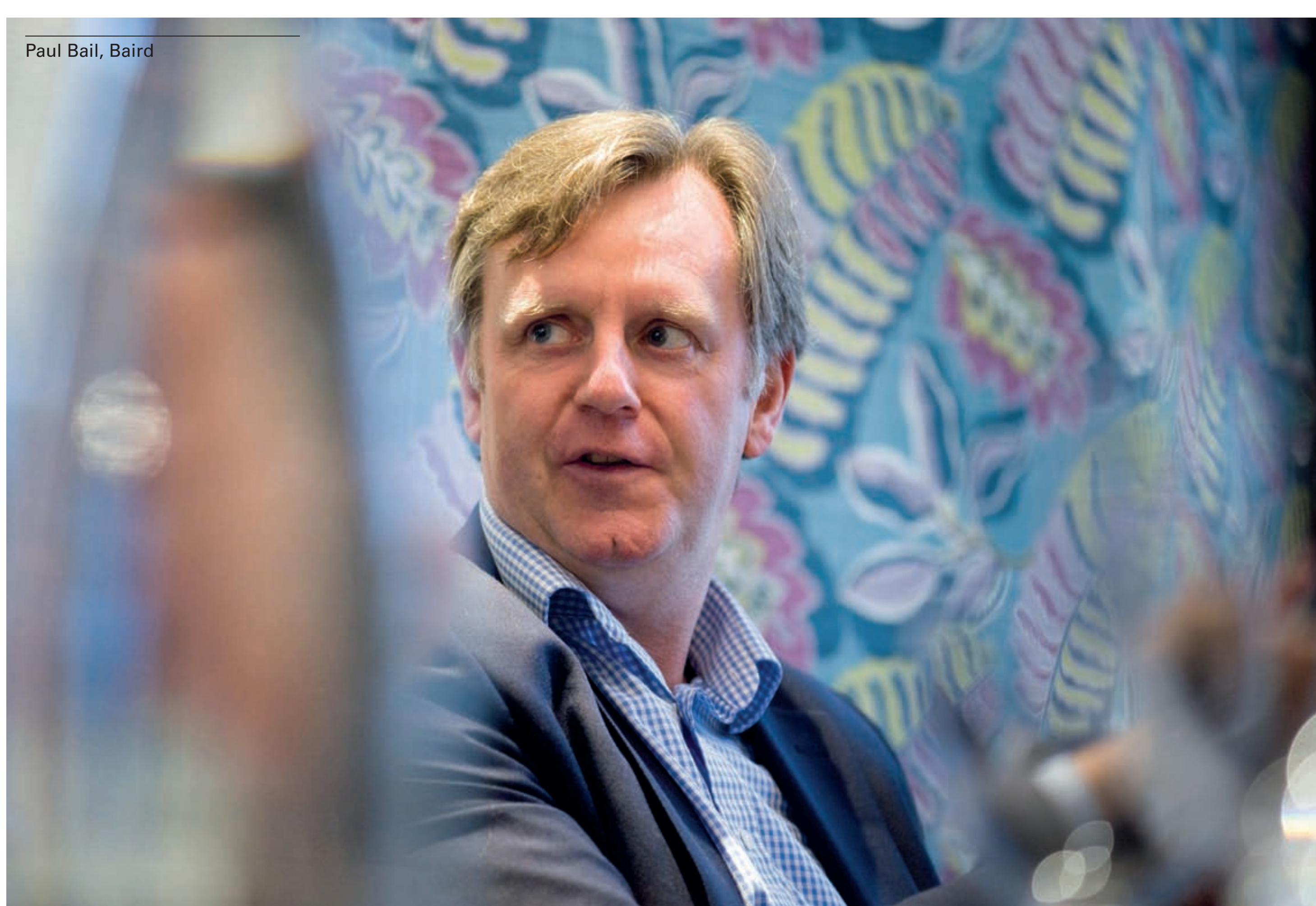
We have reached a level of maturity, but there is still a number of deals in the pipeline to pursue. My feeling is that we will continue to see a number of new funds emerge and offer new strategies.

On that point about private credit still having room to grow, are there concerns that the space is already saturated and that deployment is becoming a problem in market awash with liquidity where M&A volumes are still flat?

Piero Carbone: There's a lot of liquidity in the market and certainly people are under pressure to put money to work. We have seen some funds double in size after just three or four months on the road. Now they have to find a way to deploy that money. There is that pressure to deploy.

That is not to say that funds won't be able to find enough deals. Funds are deploying. But we will have to wait for a few years to see whether risk has been priced correctly.

Paul Bail: From a fund perspective the pressure to deploy is acute, because you've raised the fund on the premise of making certain returns, so you can only push so far.


Paul Bail, Baird

> When your model is based on fees only for deployed capital, then if you don't deploy you can't pay the salaries. That can drive more marginal deals

Jon Herbert, Beechbrook Capital

I think what we've seen is a recognition from the funds that if you take the unitranche to the far right in terms of leverage and the pricing, it becomes difficult. What we are starting to see is what's called stretch senior at a lower price point. That is likely a reaction to them not getting enough money out of the door with the unitranche product, hence, they're taking the leverage down, they're taking the pricing down and finding a mid-point that they hope will compete with the bank alternatives.

That said, the funds have been able to deploy. That has been surprising given that the premise for these funds coming into the market was that the banks wouldn't be there and the funds would take all the volume. That hasn't really happened. The banks have been extremely competitive and aggressive and have stepped up. The syndication market has been open and deals have been done. When we look at that market, some of the bank terms are actually more flexible than some of the terms the debt funds can give at the moment for the bigger deals.

All those factors are at play, but the funds have been successful in deploying a lot of capital. I think they got in on the back of recapitalisations, where they were prepared to allow sponsors to take more money out than the banks were.

However, when we look at new deals and new lending, and I work on a majority of Baird's M&A transactions running lender processes, it is the bank-led deal structures that are generally winning out on new deals.

So it's a real mix, but there's certainly pricing pressure in the market evidenced by funds offering stretched senior at lower margins than traditional unitranche.

To what extent is the fact that many credit funds only receive fees on deployed capital driving deployment rates? Are there any concerns that this is leading to bad decisions?

Jon Herbert: It is a key issue. When your model is based on fees only for deployed capital, then if you don't deploy you can't pay the salaries. In a very liquid market that can drive more marginal deals. If there is a big stock of new transactions coming down the pipeline it is not much of a problem. In a world where a lot of the transactions are repricings or recaps, that's not a particularly healthy market.

At Beechbrook our fee structure is based on a blend of deployed and committed capital and we think that is essential.

Fèmy Mouftaou: It comes back to the point I made earlier that the debt fund market still has to go through a cycle. Until this happens we cannot foresee what is going to happen. Right now there is a lot of liquidity and deployment levels are up, so it all looks good. It is only after the market has gone through a crisis that we can tell whether the debt funds have made mistakes, whether the regulators will react and what position the banks will be in.

There are many questions, but we won't know the answers until the market goes through a crisis.

Rupert Brown: My hope is that funds, given the way they are structured, will be able to take a long-term view. There's less pressure than with traditional lenders. The private debt managers have a fund structure and they can look at longer term picture. We will see.

Picking up on that, are the funds actually in a better position to serve the financial sponsor market given the fact that they do have longer term money and don't face the same internal corporate pressures that the banks do? Over time are the funds going to gradually take a bigger share of the market as a result?

Piero Carbone: I think that is what they would like to do, but I am not sure if that is going to happen. What I think is going to be interesting to see is if we have more banks and funds working together on the same deals. How is the inter-creditor relationship going to work when the senior, or part of the senior, is provided by the bank and the remaining part of the structure is provided by the fund? From the work I have done, borrowers are thinking about how to make these relationships work rather than what it will be like if the market is dominated by funds.

Piero raises the point about different kinds of lenders working together. About 18 months ago there was a lot of talk that everybody would team up and share the capital structure. Has that happened?

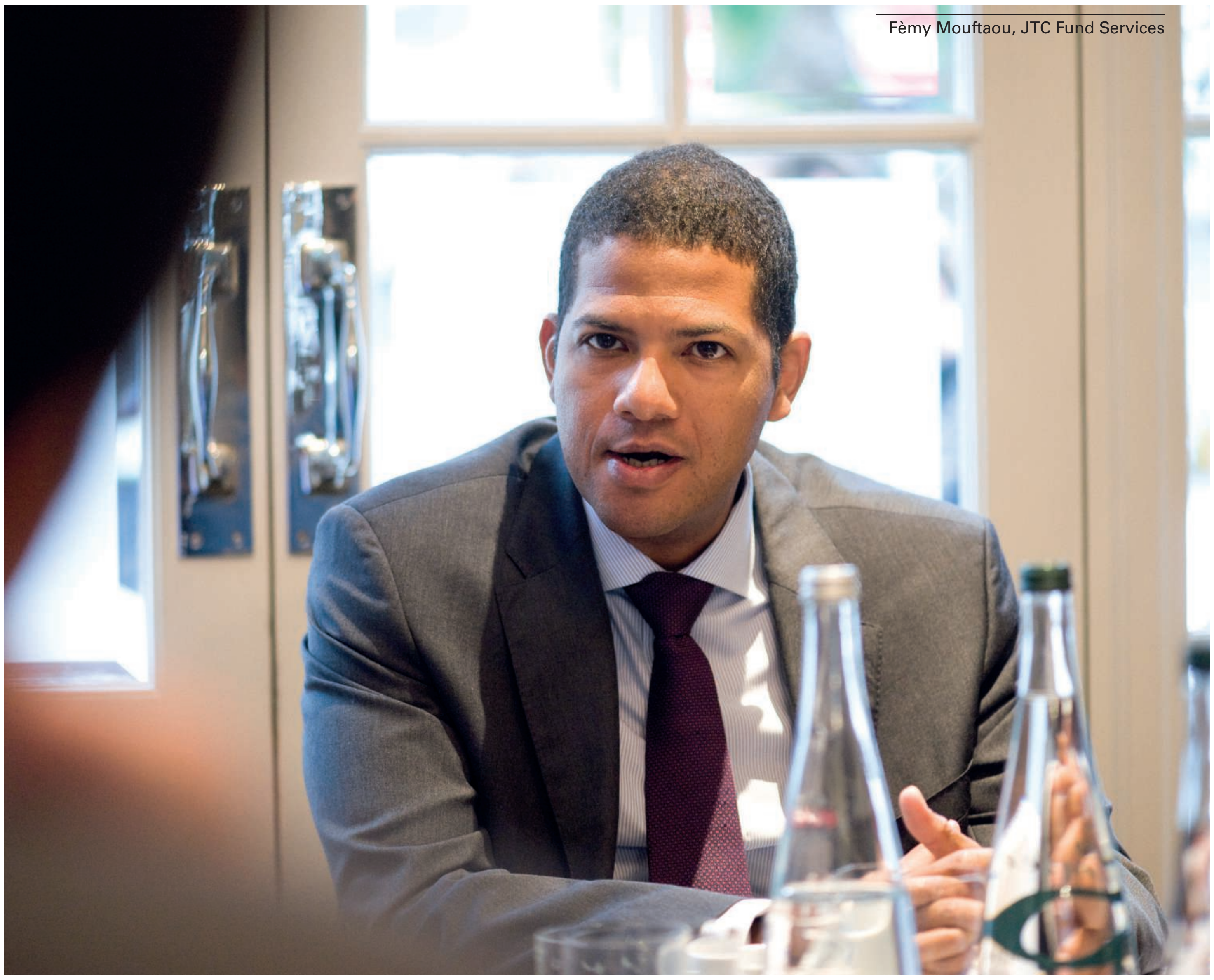
Paul Bail: You do see it but I wouldn't say you see a lot of it. Over time I think it will become more common. It's an interesting dynamic, isn't it? You've got banks competing with funds and also working alongside them in the same deal.

Is the documentation mature enough to accommodate this dynamic?

Piero Carbone: We are moving towards more standardised documentation. In deals where the business is slightly more complicated, however, and the structure a little unusual then you will have very bespoke deals. I think that's probably the most interesting part of the market, right now, especially in sponsorless transactions.

Rupert Brown: In our part of the market we don't really need these structures very much. We'd probably be less interested because it's very much about building a relationship with the lender for us, and that gets harder when you've got lots of different lenders to deal with.

We are also not trying to squeeze the last bits of leverage out of something, so there is no urgency to try to bring in a big group of lenders and do that.



Fèmy Mouftaou, JTC Fund Services

“” There is still an element of sense in the market. You can pretty much structure it the way you want it, but you won’t get stupid offers

“” The fund manager mindset is similar to that of the borrowers. That could mean that little by little the banks are going to be pushed out by the funds

Jon Herbert: My personal view is that you can pretty much do any deal in any way with any type of borrower these days. It’s all still relatively new, but if you want a fund to do a bank-priced piece of paper then you can get that. From a borrower’s perspective, we’re in unprecedentedly good times. There is also still an element of sense in the market in terms of risk. You can pretty much structure it the way you want it, but you won’t get stupid offers.

Given what Jon has said, is there still a distinction between what a fund will do and what a bank will do? Is it even relevant to still look at the market in this way or should the focus simply be on the term sheets on offer?

Paul Bail: It is an interesting question. In some of the processes we’ve seen that the debt fund has offered less leverage than the bank, which is quite surprising. That is the exception though, because if debt funds don’t offer something different then it is difficult to see how they will win deals. Typically, you will still see the debt fund offer more leverage but at a higher price. Financial sponsors are then asking whether they need the extra leverage and what sort of flexibility they can get.

I think it comes down to that, and if you look at the syndicated bank market right now you can get a good deal in terms of flexibility. In that respect, the banks are as flexible as the funds.

I think one of the questions is whether the funds will take over the syndication market in time. Right now you can’t see it because very few of the funds are going covlite, for example, so the banks have an advantage at the moment.

When you move into the middle market I think it becomes much more blurred. You see different deals, different funds and different banks. There is a wide range of terms and then it just comes down to hammering away at both parties and getting the best deal you can.

Rupert Brown: In our market we still find that the funds are generally more flexible and offer more favourable amortisation, better covenant positions and generally better terms. We are less interested in pushing the leverage and more focused on getting the flexibility to invest in our portfolio companies.

Jon Herbert: I think one of the fundamental differences is that funds are driven by return on capital and banks don’t worry too much about that, particularly where it’s an established relationship with the bank. So banks, generally, are still weaker around their ability to price their capital in my opinion. They are still focused on risk, but once it becomes an acceptable risk it’s more about, “I really like this deal, how do I win it?”

Funds are very, very focused on ultimately delivering, because you know carry is a very important part of their remuneration. If you don’t get hurdle rates on carry, well, that’s a real mugs deal. You’re better off holding off those situations.

Banks are still driven by bonus structures linked to deal fees, deal volumes and deployment of capital. Very little is around the underlying performance of the broad assets. Funds are driven by carry structures. That’s a material difference.

Rupert Brown: Another thing that comes into it is that the people in the funds tend to stay longer because of the way they are incentivised and that does make it easier for us to build longer-term relationships.

Piero Carbone: What is interesting is that the way the fund is structured could change a little bit. If the fee structure is still at two-and-20 or similar the fund can wait more than 15 years to get its cut. In order to find niches within the market, some funds may have to look at changing their internal structures.

Fèmy Mouftaou: The fund manager’s mindset is very similar to that of the borrowers. That is a fact. That could mean that little by little the banks are going to be pushed out by the funds.

The funds tend to be closer to their borrowers and the other parties. Banks will work with these borrowers, but only in syndications or on very large deals. So we go into a situation where the market is going to be very segmented, with certain companies using funds and others using banks. My feeling is that the banks are going to become large institutions for large deals and large clients. The rest of the market will be served by private fund managers.

I would also add that the impact of regulation on banks could influence how the market develops. If regulation tightens, it might restrict banks from doing certain kinds of lending.

What about the size of debt funds. Will debt funds have to have the scale to do larger underwrites if they are to survive?

Piero Carbone: I am not so sure. The lower mid-market is quite different from the top end of the mid-market, for example. So I don’t think you have to become bigger and bigger to be more competitive. You could even turn the argument around and say that the larger funds may find it difficult to deploy all their capital. I think there is space for everyone.

Paul Bail: I would agree. If you are a fund that specialises in an area of the market that is underserved you are going to do well. You don’t need to be big to win the day.

The bigger funds, of course, have enormous fire power. We’ve seen some massive cheques being put into deals. If you are a financial sponsor at the upper end of the mid-market and you are looking for £100m of finance or more, you can either go with a club of five banks or a single fund.

If the fund can put that money on the table with decent terms in a competitive auction process, then it is in a very strong position and sponsors will recognise that.

The difficult part will be in that mid-market where you have a lot of funds all squeezed together. They’re all going to have to work out how to survive in that particular area. So there’s a bit of a bifurcation. There are the funds at the smaller end and the really big players. The guys in the middle are the ones who have got to find ways of deploying that capital and that’s tough.

Jon Herbert: If you are one of the established names at the top end of the market, I think you’re in a very robust position. I think that business model is very strong. I completely agree with Paul that the funds that want to do

> Subscription line financing is a pragmatic way of being nimble or flexible around the deal and that's only a good thing

Rupert Brown, Palatine Private Equity

£50m cheques are in a much tougher market. There are a lot of players in that space and the banks are really competing hard there too.

Funds have to try and find niche markets. That's exactly how we see life. We are focused on the SME market and developing niche strategies within that space to give us some pricing power in a market where there's lots of liquidity.

Fèmy Mouftaou: I see the market developing along these lines too. My question is whether the market as a whole can absorb more capital at the same level of risk? This is probably the only limit on the growth of the current debt market. Can the market continue growing at the same rate, while maintaining the current levels of risk and return?

What are the views on subscription line finance? It has generated a lot of interest. Are more GPs using it?

Fèmy Mouftaou: People are asking more and more about subscription lines. What is certain is that this is directly related to the rise of investor and LPs awareness.

A subscription line is a tool that enables you to involve your clients in your process and make the whole capital call process easier to manage. With regards to the clients we have at JTC Fund Services we are seeing more and more subscription lines.

My feeling is that it is GP-led, but when subscription lines are suggested LPs do generally like the idea.

Rupert Brown: We don't use a subscription line at the moment and we wouldn't use it for financial engineering purposes to try to enhance our IRR. But even though we don't use it currently, we can see the benefit. It can be a helpful execution tool.

As a bidder you can move quickly by underwriting the whole deal, with debt to follow shortly after. It also streamlines the drawdown process with your LPs. As things get more competitive it may be something we need to consider, but for now haven't had to use it.

Piero Carbone: To be honest, I actually believe the GPs when they say it is there to make things easier for LPs and give an edge in competitive deals. In situations where GPs have to move quickly, and perhaps in a locked box situation, it's relatively common. When the seller wants to have more certainty, bidders also tend to use these lines.

I think it's more about the practical side of things rather than trying to stretch a better return, in my experience.

Real Deals would like to thank Baird, McDermott Will and Emery and JTC Fund Services for making this roundtable possible.

Piero Carbone, McDermott Will & Emery

> Can the market continue growing at the same rate, while maintaining the current level of risk and return?