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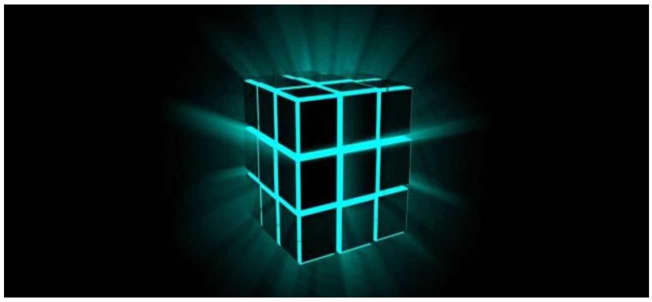
European Direct Lending III: Opportunities In The Lower Middle Market

Oliver Fochler
Managing Partner, CEO
Tel.: +447922436360
oliver.fochler@stonemountain-capital.com

Alexandros Kyparissis
Analyst Hedge Funds
Tel.: +447843144007
alexandros.kyparissis@stonemountain-capital.com



Lending has always been the core banking business over centuries until the great financial crisis hit in 2008, which gave birth to a new asset class: private debt. For years, private markets were dominated by funds focusing on equity and banks on debt. The regulations that came into force in the aftermath of 2008 financial crisis created a funding gap for a specific market segment. Large corporates can finance themselves via debt and equity public issuance or bank lending, but funding middle market and SME corporates remains a challenge. The rise of debt funds together with fintech firms' efforts to revolutionise alternative credit are shaping the current private debt environment, which is still enjoying a strong fundraising momentum. The 2023 forecast shows an increase for private debt AuM to $1.4 trillion, while assets have doubled since 2008.

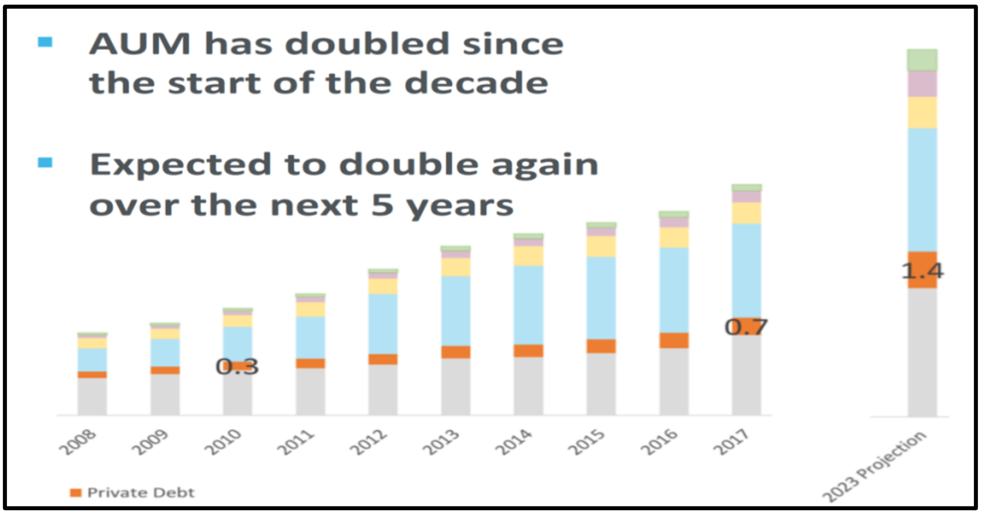


Figure 1. Private Debt AuM, Forecast 2023, Source: Preqin

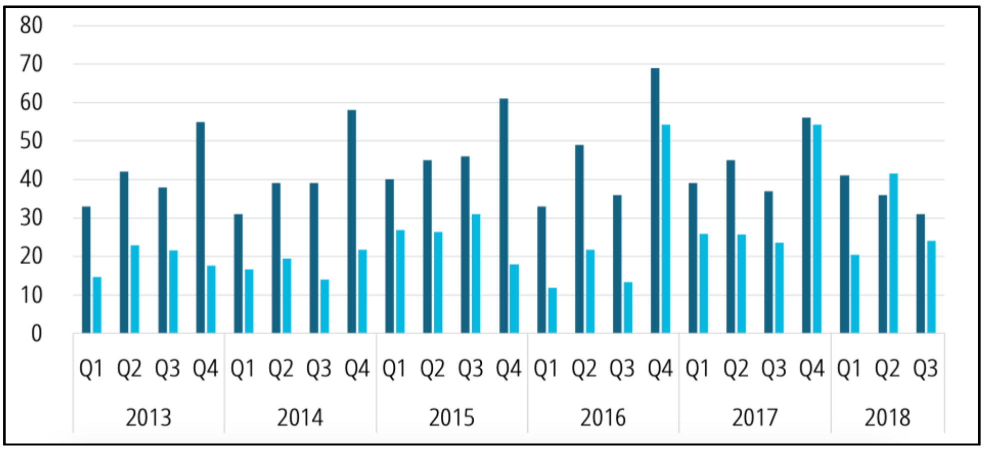


Figure 2. Private Debt AuM, 2013-3Q18, Source: Preqin

Banks have not exited the mid-market or SME space, but are following a different route to access this lucrative market segment. Banks provide private debt funds, fund of funds and fintech lenders with asset-backed facilities and warehousing lines. The leverage facilities are structured like private CLOs without tranching and include the setting up of an SPV with terms: advance rate, deployment and amortization periods, final maturity date, financial and performance-triggered covenants (performing loans and deployment percentage), eligibility of receivables, diversification requirements, regulatory trigger events and risk retention requirements. Interestingly enough, banks remain the main player for lending in Europe as shown in Figure 3, whereas alternative lenders have substituted banks on the other side of the Atlantic.

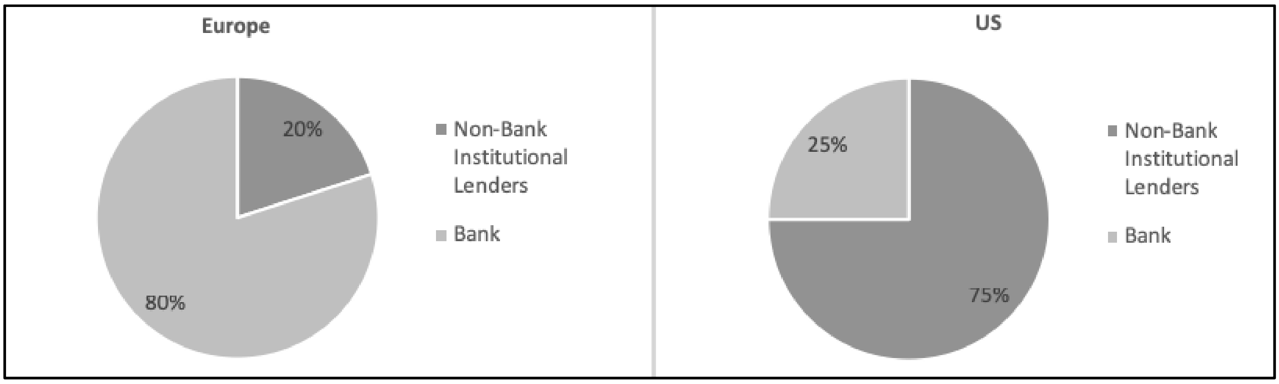


Figure 3. Proportion of Bank vs. Non-bank lending in Europe and US, Source: ECB, Bloomberg

The room for bank substitution compared to the US combined with the reduced lending activity from banks as shown in Figure 4, highlight an opportunity for alternative lenders to become the stepping stone for funding the mid-market, lower mid-market and SMEs. The European Union and European Commission are considering SMEs to be the backbone of the real economy and are focusing on funding this segment of market.

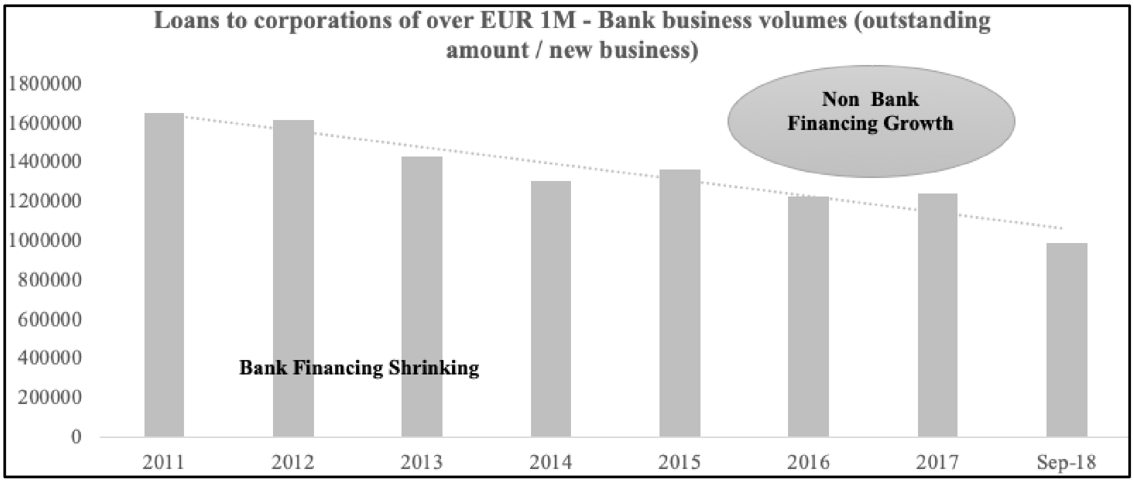


Figure 4. Loans to European Corporations Over €1m as of October 2018 Source: ECB Databank, Stone Mountain Capital Research

According to ICG data, European private companies' fundamentals remained strong in 2Q18 with high interest coverage and senior debt rising as evidenced in Figure 5. Both senior debt and interest coverage are at all time high since the financial crisis, a statistic which is very supportive of the economy's outlook despite the current late credit cycle. As we start to observe more defaults and delays in payments in the credit market, we need to stress the importance of seniority and experience in distressed situations. We expect senior lending and distressed debt closed-ended strategies to perform better during the current cycle in case funds are raised at this stage and capital deployment starts early in 2019.

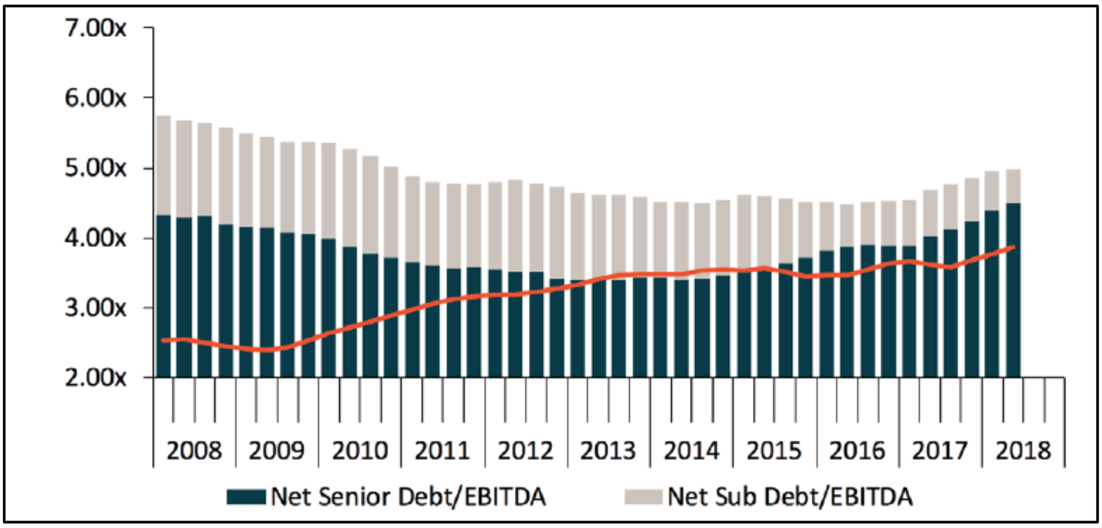


Figure 5. Leverage and interest rate coverage of European corporates, 2008-2Q18 Source: ICG

Senior lending remains very attractive on a risk-return basis, providing institutional portfolios with uncorrelated sources of income compared to other private and public fixed income/credit strategies. There is embedded complexity and an illiquidity premium that investors can harvest with very low volatility and predictable cash flows. Lending funds have simpler and quicker credit and execution processes that justify higher pricing than banks and can invest across the capital structure. Senior secured and unitranche are the most common structure within debt funds, with unitranche being used by the same lender to enhance the returns with higher EBITDA multiples or higher LTV, but still being the most senior or sole lender in the capital structure.

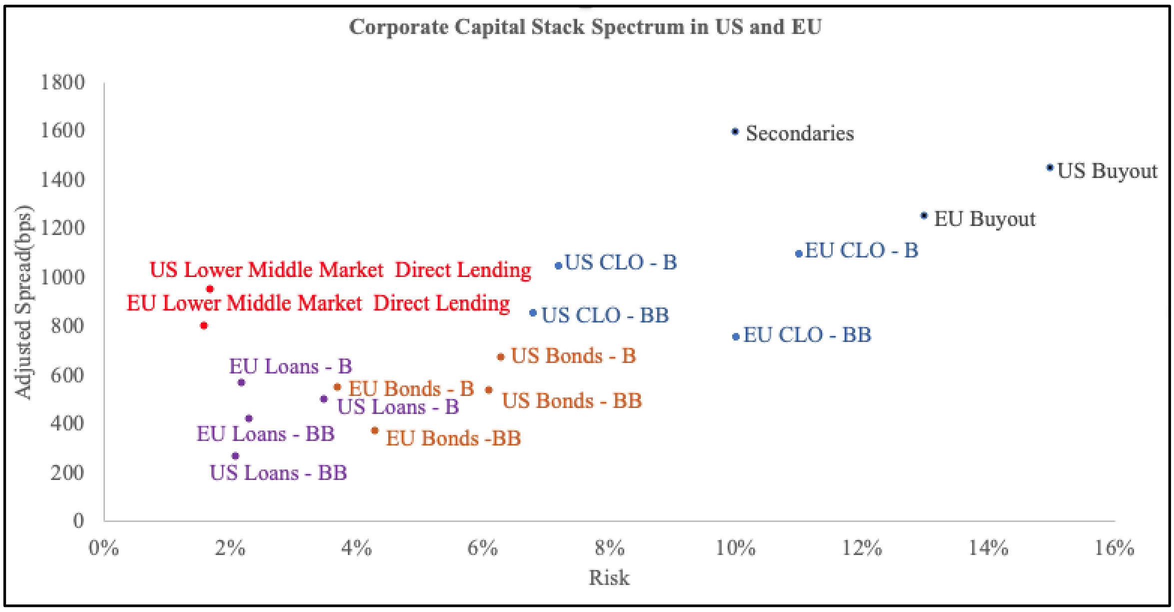


Figure 6. Corporate Capital Stack Spectrum in US and EU, October 2018, Source: Barclays Research, Moody's, Stone Mountain Capital Research

Lending activity in Europe has peaked and 2Q18 was one of the most active since 2012, majority of which was originated in the UK. Since 2012, 1510 lending deals have been originated, 581 of which were based in the UK. Lending deals have increased significantly since 2017, showing signs of strong appetite for debt.

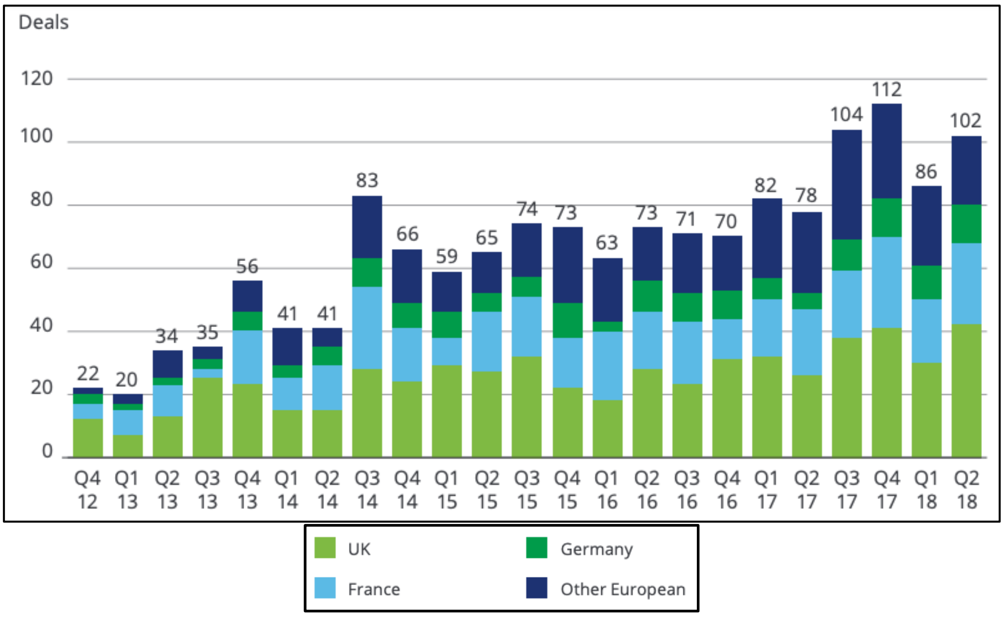


Figure 7. Lending Activity in Europe, Source: Deloitte Alternative Lender Deal Tracker Autumn 2018

There is an interesting distinction between funds that do sponsored deals and those who do exclusively non-sponsored. Investors usually prefer non-sponsored due to higher spread as they usually yield 100-200 basis points higher than sponsored. This premium is essentially the reduced risk as sponsored transactions have usually fully detailed due diligence reports and professional financial reporting systems. The management team should be diligently selected by the sponsor to execute a well-designed strategy. The above factors should be always considered based on the sponsor's savviness and expertise in the industry. We believe that portfolios should have a mixture of both due to deal characteristics diversification but should be mainly non-sponsored with the credit team relying fully on their credit underwriting standards.

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