August 2018

PEMBERTON
Connecting Capital Across Europe

Pemberton Macro View

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Indigestion at the Syndicated Loan Banquet

VIEW FROM ORIGINATION[1]

We are seeing increased competition in the upper end of private debt markets (€200m+). Nonetheless, terms on deals up to €100m remain relatively stable. We expect both PE and debt markets to remain competitive, with PE firms trying to focus on less competitive acquisition processes and buy-and-build. We are seeing larger PE firms dipping down into the mid-market space in their search for deals. We are also seeing sponsors leaving relatively large minority stakes in some deals to incentivise sellers by offering future upside. **We believe competition in debt markets will be most intense for high-yield, syndicated and vanilla senior debt funds, especially in London. We continue to see equity buffers around 40%, offering strong downside protection against fat-tail risk.**

MACROECONOMICS

- ***European Interest Rates*** **– We maintain our expectation of a first ECB rate hike in Q2 2019, earlier than market consensus.** Small probabilities previously assigned to an ECB rate hike in July had dropped to near zero over Q2 2018[2]. This follows the June meeting where the end of ECB bond purchases by year-end was confirmed alongside suggestions that any rate hike was still distant. It is not until Q2 2019 that market-implied probabilities of a deviation from current rates exceed 50%[2]. GDP for the Euro area in Q2 2018 came in at +0.3% QoQ down from 0.4% in Q1.
- ***GBP Interest Rates & FX*** – The Bank of England's Monetary Policy Committee voted unanimously to increase base rates from 0.5% to 0.75% on the 2nd August following a perceived recovery from the impact of the "Beast from the East" in Q1. Separately, Mark Carney commented that there is an "uncomfortably high" risk of the UK leaving the EU without a deal. Despite the rate rise, Carney's comments took Sterling below $1.30 (down 9% since mid-April). **We believe an extension of the hard Brexit deadline is the most likely way to muddle through, but we continue to watch this critical issue.**

[1] Source: Pemberton Head of Origination, Internal Pemberton Pipeline
[2] Source: Bloomberg database, August 2018

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- ***US Interest Rates –*** The day before the dovish tone of the ECB bond buying announcement, the Federal reserve hiked rates by 25bps. Stronger language about economic growth was used as compared to the prior meeting. The market is pricing in a 75% chance of a further hike in September followed by a 50% chance of another in December[3]. Sentiment for sustained rate hikes going forward has strengthened, consistent with our view last quarter that long term rates were underestimating rate hikes. For context US 10yr rates are up 15bps from 30th March as of writing. **In our view the policy outlook continues to point to a benign environment for credit.**

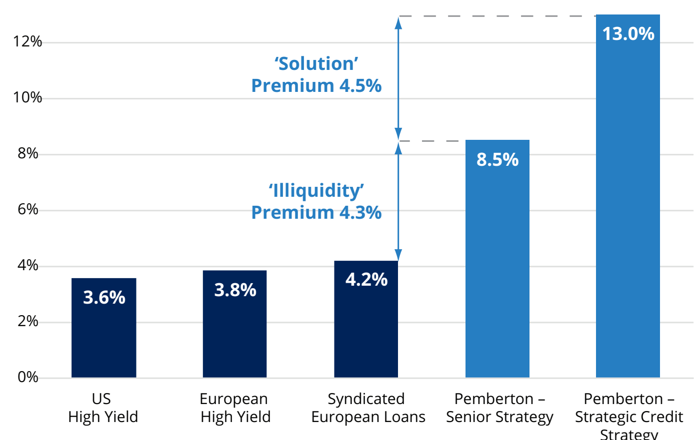
- ***Europe vs US –*** **We maintain our view that European mid-market direct lending remains the best relative value play in credit.** The cross-currency pickup from hedging EUR into USD has risen to 3%[4] and in our view is likely to continue increasing (see above). At the same time credit spreads in Europe have widened relative to the US making European direct lending increasingly attractive for dollar denominated investors. **The spread between US mid-market and syndicated deals is now just 39bps[5]**, extremely tight compared to Europe. Pemberton continues to target a European **direct lending premium of 430bps for illiquidity and a further 450bps for providing solutions** to mid-market borrowers.

- ***Turkey –*** The Turkish Lira has devalued by 30% against the Euro and 34% against the US Dollar in August. Smouldering concerns about the levels of Turkey's US dollar debt have been growing following a series of tit-for-tat exchanges with the US. **Pemberton's funds do not have any exposure to Turkish corporates. We are watching for potential contagion into the Eurozone, most notably though European banks, and for signs of wider Emerging Market currency weakness.**

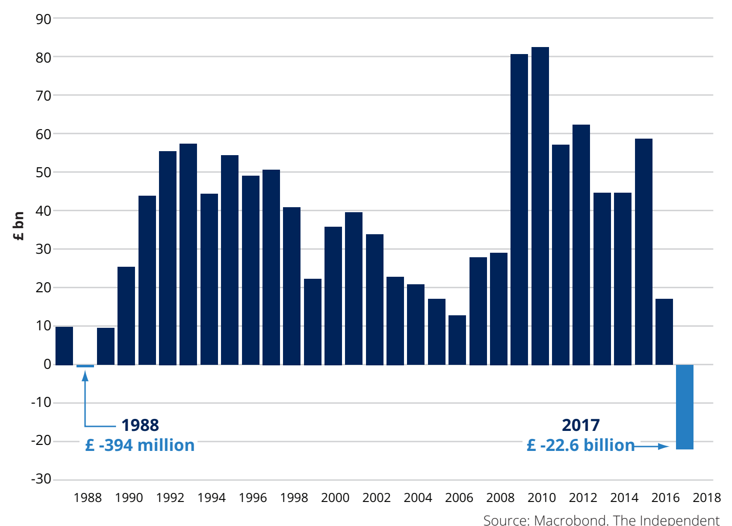
- ***UK Economy –*** UK households collectively spent more than they earned in 2017 for the first time since 1988, apparently confirming that spending has been supported by reducing saving levels and taking on debt. In the 3 years before the 2007 crisis UK household debt-to-GDP rose from 95% to 144% before slowly falling to 121% in 2015[6]. This trend downwards has started to reverse in recent years. Nonetheless, debt-service burdens remain manageable by historic standards. For context 1988 finished with the UK base rate at 13.0% vs 0.75% today following the most recent 25bp hike at the 2nd August meeting. **We remain cautious about businesses that rely on UK consumer spending.**

- ***Public Earnings –*** The early read from Q2 earnings season is mixed with 83% of S&P companies that have reported thus far ahead of estimates. The corresponding number for the Eurostoxx is 40% and FTSE 75% though the majority of companies are yet to report[3]. The read so far, along with 2Q 2018 growth at 4.1% in the US, is supportive of US strength. Coupled with surprisingly weak European numbers this further supports our view of increasing yield pickup for USD investors. **We will have a fuller picture once all companies have reported, but we are not overly concerned by short term fluctuations. Equity indices have not reacted negatively.**

RELATIVE VALUE IN EUROPEAN DIRECT LENDING



UK HOUSEHOLD SECTOR NET LENDING



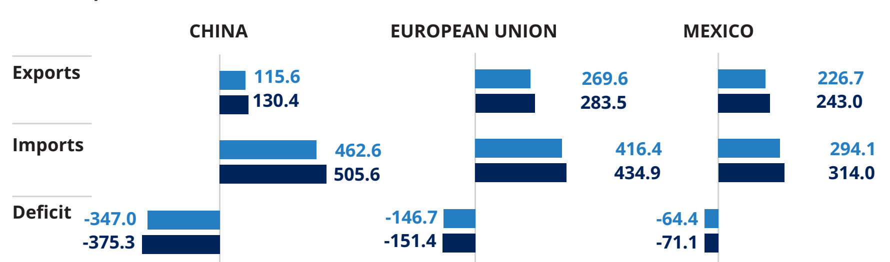
Source: Macrobond. The Independent

[3] Source: Bloomberg database, August 2018
[4] Souce: Record Currency Management, 31 July 2018
[5] Source: LevFin Insights
[6] Source: https://www.independent.co.uk/news/business/analysis-and-features/uk-households-spending-income-borrowing-saving-economy-gdp-a8464731.html

POLITICS

- ***Trade Wars*** **–** The escalating trade wars emanating from the US have started to command increasing attention in markets. The European Commission cut growth forecasts by 20bps to 2.1% for 2018, blaming the threat of a trade war with "no winners, only casualties"[7]. In July president Trump launched what China called "the largest trade war in economic history" with sanctions targeting another $200bn of Chinese exports. The US has now threatened tariffs of 25% on up to $450bn of Chinese exports and enacted 25% tariffs on EU steel (10% on aluminium) among other measures. The Bank of England estimates that a 10% tariff on all US trading partners would dent US GDP by 2.5% and global GDP by 1%[8]. **However, given the importance of trading relationships between the EU and the US we do not anticipate lasting damage to Fund borrowers**. A recent meeting between Trump and Juncker, EC president, appears to have eased EU-US tensions with suggestions the US would be "pleased" if all tariffs, barriers and subsidies could be scrapped.

US TRADE DEFICIT *(billions of dollars)*



Source: US commerce dept

- ***Brexit*** **–** The Prime Minister presented her Cabinet with the blueprints for post-Brexit relations with the EU. These included a legally binding agreement to follow EU rules on goods, a commitment to end free movement and acceptance of the remit of the EC of justice in some areas. Boris Johnson, foreign secretary and David Davis, Brexit secretary quit thereafter claiming betrayal of the 2016 referendum result. There are suggestions that the deadline for Brexit (March 2019) will be extended. **An extension would drag out uncertainty but nonetheless remove a potential near-term hard Brexit outcome.** Recent threats from Trump that Brexit, as proposed, would rule out a UK-US trade agreement represent posturing, in our view[9].

- ***Shanghai Composite Enters Bear Market*** **–** Following weeks of relentless selling, the benchmark Chinese index has dropped 20% from a January high. This is despite stimulatory cuts in the reserve requirement ratio for banks, a form of monetary easing. In the face of a weakening Yuan and escalating trade wars it is hard to attribute a specific cause for the decline, but a targeted deleveraging of state owned banks is one theory. It is worth noting that China has material levers to intervene, including FX reserves of $3.1tn. **Given the limited global impact of the 50% sell off in 2015, we are not overly concerned about recent developments.**

- ***Italian Elections*** **–** The Italian political situation is stabilising, with several statements over the last few weeks from the new government committing to financial discipline. As an example, on July 12th the chair of the Eurogroup finance ministers said that Italy's finance minister has been reassuring regarding the government's intention to respect EU fiscal rules. The latest nation-wide poll at the beginning of July showed that, in a referendum, 74% of Italians would vote pro Euro. **The increasing stability reinforces our view that Italy remains an attractive hunting ground for high quality borrowers.**

[7] Source: https://www.theguardian.com/business/2018/jul/12/trade-war-blamed-fall-uk-eu-growth-forecast-european-commission
[8] Source: https://www.theguardian.com/business/2018/jul/05/carney-tells-trump-escalation-of-trade-war-will-hurt-us-most
[9] Source: https://www.bbc.com/news/uk-politics-44815558

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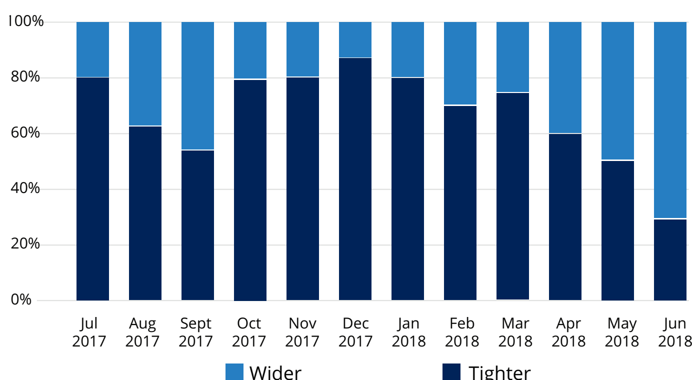
MARKETS

- ***Syndicated Market Volumes***[10] **–** 2Q 2018 syndicated loan volumes in Europe were robust, at €26.9bn. Whilst this is down from €35.2 in the previous quarter, it is still the most active 2Q period since 2014. This makes 1H 2018 the busiest first half recorded in 11 years. The share of M&A related financings (an indicator of new supply to the market) hit 84%, the highest since 3Q 2011. **In our view, the high volume of new supply caused market indigestion and the ~75-100bp across the board widening seen in syndicated loan markets.** This shift in price was accompanied by investor pushback on weak documentation (see below). Indeed, the last seven single-B or unrated deals have yielded an average 4.8% all-in, versus 4.2% on average in June. Private debt markets continue to offer substantial pickup nonetheless with YTM for syndicated B-rated TLBs still below 4.0%. We consider the lender pushback healthy and a positive for markets as a pressure release valve that helps stabilise capital markets.

- ***Institutional Market Supply / Demand***[10]**–** Despite near record CLO issuance, there has been a net supply of paper (defined as new issues minus repayments minus CLO issuance) since 4Q 2017, currently standing at ~ €6bn. Accordingly, the share of deals flexed wider has steadily increased over the same time frame from ~20% to ~75% (see chart below). Further, documentation has been materially revised during recent syndications following investor pushback – a phenomenon which has been absent from institutional markets for some time. Examples include Zentiva, ION Trading, MFG and Exclusive. Most recently, AMS Recruitment was flexed by 50bps margin, 300bps OID and now includes a covenant among other lender friendly changes. Whilst there has been some push back on terms and pricing, 80% of syndicated market deals are still cov-lite. **Directly structuring all of our investments ensures materially better terms than those available in syndicated markets.**



(Chart shows what % of all flexes done in each month moved pricing higher or lower)
Source: LCD, an offering of S&P Global Market Intelligence

- ***Leverage Multiples***[10] **–** On a YTD basis total leverage in syndicated markets has averaged 5.3x continuing the steady upward trend that began in 2010 from a 15-yr low of 4.1x in 2009. This masks some of the high clearing leverage in recent transactions: Mehilainen (5.5x / 7.0x), IRIS Group (5.8x) and IGM Resins (6.0x). The Mehilainen 2nd Lien through 7.0x, rated CCC+ / Caa2 and yielding 7.89% provides a great comparable for junior debt in private markets. **In our view private debt remains attractive, particularly with a focus on the "mid mid-market".** For context, syndicated deals of €1bn+ in Europe have cleared at an average multiple of 6.0x YTD as compared to 4.3x achieved for recent senior strategy deployment, with an average of 1.4x covenants per transaction.

- ***Defaults***[10] **–** In June there were no new defaults among loans in the S&P ELLI. Thus, the lagging 12-month default rate by principal amount fell to 0.12%, down from 0.42% the previous month. This is the lowest reading for the default measure since 2008 as compared to a maximum of 10.5% in December 2009. **This continues to support our constructive view for credit risk.** Through the cycle (2007-2015) the annual default rate for the European Leveraged Loan Index (ELLI) was 4.8%. According to Fitch the corresponding number for the European mid-market (less than €500m) was 2.6% between 2011 and 2015.

- ***Dry Powder* –** 2017 was a record year for direct lending fund raising. With several managers currently fundraising, including Pemberton, 2018 efforts are expected to be similarly robust. Recent large fund raises (up to €10bn capital to deploy) are increasingly forced to focus on upper mid-market transactions. **Those able to deploy in the true mid-market (less than €400m EV and €40m EBITDA) enjoy less competitive deal processes.**

[10] Source: LCD

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These are just a few thoughts based on our view of the market.

We'd love to hear your opinions. So please feel free to contact our Investor Relations team on ir@pembertonam.com or +44 (0) 20 7993 9300 with any questions or comments.