PEMBERTON

Private Debt in the UK

A LONG-TERM PARTNER FOR COMPANY GROWTH

GEOGRAPHIC SERIES

Introduction

The UK is one of the largest, most developed, and most attractive markets for direct lending in EMEA, facilitated by a robust economy and a largely consolidated banking sector. Current threats such as the Covid pandemic and Brexit will have limited or temporary impact, making the UK a hotspot for new direct lending investment opportunities over the months and years to come. In this piece, we explore why.

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Why invest in the UK?

The UK is a G-7, key global economy with a track record of economic growth supported by very low unemployment rates. Three key factors make the UK particularly attractive for direct lending in 2021 and beyond. First, the sector mix that fuels the economy is heavily skewed towards the services sector, which typically lends itself well to cashflow-lending. Secondly, the UK is well on the way to vaccinating its way out of Covid, which should lead to a big economic bounce-back in 2021-22. Thirdly, Brexit appears to have been a non-event economically after all. This all means that the UK offers stability and attractive investment opportunities for institutional investors like Pemberton and the LPs backing such institutions.

A fundamentally strong, service-based economy

The UK is the fifth largest economy in the world by nominal GDP, ranking only behind Germany in Europe[1]. Before Covid, the British economy had been growing between 2.3% and 1.3% annually since 2015, but the impact of the pandemic meant that the UK economy shrank by 9.9% in 2020. Buoyed by one of the world's most successful vaccination programmes - which saw 52% of the population receive a first dose of the vaccination by 30 April (34.6 million doses) - the UK is forecast to grow by 4.7% in 2021[2] and has experienced sequential growth of 16% (Q3 2020) and 1.3% (Q4 2020) in the last two fiscal quarters[3].

Unemployment was historically low before the pandemic, at 4% in February 2020. Thanks to an extensive furlough programme to protect jobs during the crisis, it rose to only 5.1% by Q4 2020[4]. It is expected to rise to 5-6% in 2021 as the furlough programmes end and companies consolidate jobs in response to changed industry conditions in certain sectors[5]. However, unemployment is expected to remain well below the average level of unemployment in the EU before Covid (7.4% as of December 2019[6]).

Compared with Germany, for example, the UK economy is skewed more towards services (79%) than industrials (20.3%). That skew lends itself well to direct lending, as such businesses will tend to be less cyclical, have lower capital expenditure requirements, higher free cashflow, and are less exposed to fluctuations in raw material or commodity prices than industrial manufacturing businesses. About 40% (372) of all UK direct lending deals since 2012 have been in the services sector. This stands in stark contrast to the 44 transactions completed in the manufacturing sector and 20 completed in the Energy & Resources sector[7].

1. IMF estimates List of countries by GDP (nominal), wikipedia.org
2. Average forecast: Forecomp_March_2021.pdf, publishing.service.gov.uk
3. GDP quarterly national accounts, UK: October to December 2020, Office for National Statistics
4. Unemployment rate (aged 16 and over, seasonally adjusted), Office for National Statistics
5. Unemployment rate forecast UK 2021, Statista
6. https://ec.europa.eu/
7. Deloitte H2 2020 Alternative Lender Tracker; Services includes Financial Services, Business, Infrastructure & Professional services, Public sector and Human Capital

Brexit has so far had limited impact on the direct lending market

The UK officially left the EU in January 2020, and the post-Brexit transition period ended on 31st December 2020. Against the backdrop of the pandemic it has been difficult to establish the specific impact of Brexit on the UK economy. Government support programmes including the furlough scheme may also have softened or postponed the impact of the new arrangements. However, the impact on M&A and by extension on direct lending has been short-lived. We saw a 79% uptick in M&A activity by value from H1 to H2 2020[8]. In addition, direct lending deal volumes remained broadly flat in H2 from those seen in H2 2019 (91 deals vs 93[9]).

The impact of Brexit on Pemberton's portfolio companies has also been limited. As Cassandra Rivilla-Lutterkort, UK Executive Director at Pemberton, says: "As part of our ongoing dialogue with portfolio companies, we have remained vigilant about any possible challenges being faced as part of Brexit. A significant part of our UK portfolio relates to businesses based in the UK and serving customers in the UK as well, and therefore Brexit was not a relevant consideration.

For those with cross-border supply chains, during Q4 2020 and early 2021 we heard anecdotal complaints of slower than expected deliveries or increased freight costs. In response, these businesses stockpiled certain supplies ahead of the end of the transition period to ensure there were no shortfalls on 1st January. So while there is still an increased administrative burden for certain parts of trade, we have not seen any financial impact across the portfolio."

In the UK, the sector mix that fuels the economy is heavily skewed towards the services sector, the country is also well on the way to vaccinating its way out of Covid, and Brexit appears to have been a non-event economically after all.

8. Freshfields, Global M&A in 2020 – and what to expect in 2021
9. Deloitte H2 2020 Alternative Lender Tracker

The growth of direct lending in the UK

A consolidated banking market and the strong presence of PE sponsors has put the UK at the forefront of direct lending in Europe. That looks set to continue, with the market increasingly dominated by a limited group of leading firms.

Direct lending is well established

The UK was the first European market in which direct lending established a foothold, encouraged by the example of the US and a post-Global Financial Crisis backdrop in which consolidation and increased regulatory and capital constraints on banks reduced their lending appetite for mid-market businesses. This left a gap that has been steadily filled by direct lending funds such as Pemberton. Since 2012 (when direct lending started to become established in Europe) there have been 978 direct lending deals in the UK (to December 2020), compared with 643 in France and 351 in Germany. In 2019, the last full year of activity pre-Covid, the UK accounted for 162 deals, compared with 122 for France and 67 for Germany[10].

A shrinking banking sector has contributed to the rise of direct lenders

Direct lending has been driven, in part, by the fact that there are fewer banks than elsewhere in Europe. A consolidated banking market means less competition and more scope for institutional lenders, and this has allowed direct lenders to take a big slice of the UK lending market.

UK banks have further refocused during Covid, with much of their effort in 2020 linked to the delivery of government programmes (CBILS, CLBILS and the CCFF) to keep SMEs and larger corporates afloat. This has left little time, appetite or balance sheet available for banks to support mid-market lending. In addition, much of that market segment is private equity sponsor-backed and has not been a beneficiary of the aforementioned government programmes.

All of this has led to a definitive coming-of-age for direct lending in the UK, and in H2 2020 non-bank lenders accounted for 77% of UK mid-market loans, compared with a historic level of 60%[11]. At the same time only a handful of UK banks are now active in this market segment and their level of participation in the mid-market space is on the decline. For instance, in 2020 HSBC (historically the leading bank in this space) only completed 11 transactions, excluding super senior RCFs, a sharp contrast with the 71 deals in 2019. This drastic reduction has been seen across all bank lenders[12].

According to Eric Capp, Head of UK at Pemberton: "The stark reduction in banks' appetite for mid-market lending, together with what we expect to be a strong bounce-back in the UK economy in H2 2021, is setting the stage

10. Deloitte H2 2020 Alternative Lender Tracker
11. Duff & Phelps European Mid-Market Update, Spring 2021
12. Alix Partners Mid-Market Debt Report, H2 2020

for an exciting period of growth for the UK direct lending market. Institutional lending will be able to support the upward trajectory of the economy and at the same time offers institutional investors the opportunity to participate in the recovery of the UK economy."

An increasingly concentrated direct lending sector

With this positive backdrop, one would expect the UK direct lending market to be fiercely competitive, and on the face of it things may look that way. During 2019 and 2020, 45 direct lenders completed investments in the UK. However, only 11 direct lenders completed 10 or more UK investments, and together they accounted for over two-thirds of the UK market. In fact, only two lenders – Pemberton and Ares – have completed over 20 deals in the UK over the last two years, accounting for just over 30% of deal flow between them[13].

"With the top UK players dominating much of the market, we see limited new entrants but rather a growing ambition from the top 10-15 institutions that, through scale, are able to absorb the growth in the UK direct lending market," says Richard Meehan, UK Executive Director at Pemberton. "Given the importance of scale, we predict that we will see consolidation in the market."

An example of such consolidation was Bridgepoint Credit's acquisition of EQT's direct lending business in October 2020.

13. Deloitte H2 2020 Alternative Lender Tracker

The growth of direct lending in the UK (continued)

Private equity remains the main driver

The sponsor community is larger and more robust in the UK than anywhere else in Europe, and UK-based funds continue to take a large share of newly-raised funds – 42.8% in 2020 and 52.4% in 2019[14]. UK direct lending is highly dependent on private equity activity, with 80% of transactions linked to borrowers backed by PE sponsors. If we consider the period 2019-2020, this increases to 85%[15].

During 2019-2020, 118 unique sponsors were involved in UK investments where direct lenders also played a role. In contrast, only 69 unique sponsors were involved in German direct lending transactions in the same time period – partly a reflection of the smaller market in Germany.

If we consider the make-up of the UK sponsor community, the vast majority are UK-founded mid-sized funds, but we also see a very significant presence of US-founded PE firms with a longstanding track record in the UK and a local presence since the 90s and 2000s, such as Carlyle, KKR and Blackstone. We see limited inbound activity from Continental European PE firms into the UK, given the depth and strength of domestic firms.

PE deal volumes have held up well over the past year, showing that private equity sponsors are continuing to focus on the UK despite the pandemic. The monthly number of PE deals has risen steadily since November 2020, reaching 62 in March 2021[16]. Private equity sponsors have also remained supportive of their existing portfolio companies. Unlike prior crises, the vast majority of the UK mid-market is now financed by direct lending funds and typically these will act as sole financiers of a given business, making way for direct and transparent dialogue between borrowers, lenders and shareholders alike.

“Covid has been the first real test for the direct lending market in the UK and Europe overall,” says Cassandra Rivilla-Lutterkort, UK Executive Director at Pemberton “Direct lenders will tend to have patient capital and operate as very lean institutions, which is completely different to how banks are set up and this has allowed for a far more thoughtful and considered approach when businesses have run into trouble. The partnership-like relationship between direct lenders and private equity sponsors has put everyone at ease and allowed for constructive solutions to be put in place, protecting our LPs' interests and mitigating downside risks.”

Levels of direct lending dry powder remain robust

European private debt funds' 'dry powder' stood at US$105bn as of December 2020, the second-highest level since 2018[17]. “Whilst direct lending dry powder may not be at an all-time high, capital available for deployment is still vast and we see many funds out in the market, including Pemberton – we raised €3.5bn of capital in 2020 in spite of the pandemic, and aim to raise a further €3-4bn in 2021,” says Antoine Josserand, Head of Business Development at Pemberton.

And as dry powder continues to grow, the expectation is that deployment opportunities will continue to expand in the UK. To that end, Pemberton investment introduction data indicated a strong bounce-back in Q4 2020 and in Q1 2021, with over 100 new UK investment opportunities reviewed during those six months – well above levels seen in Q2 and Q3 2020[18] .

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14. Preqin
15. Deloitte H2 2020 Alternative Lender Tracker
16. Mergermarket
17. Duff & Phelps European Mid-Market Update, Spring 2021, page 5
18. Pemberton internal data on introductions, i.e. deals seen

Pemberton's commitment to the UK

Pemberton is one of the leading direct lenders in the UK. Its focus on non-cyclical businesses has made its portfolio resilient during the pandemic and the firm remains very committed to the market.

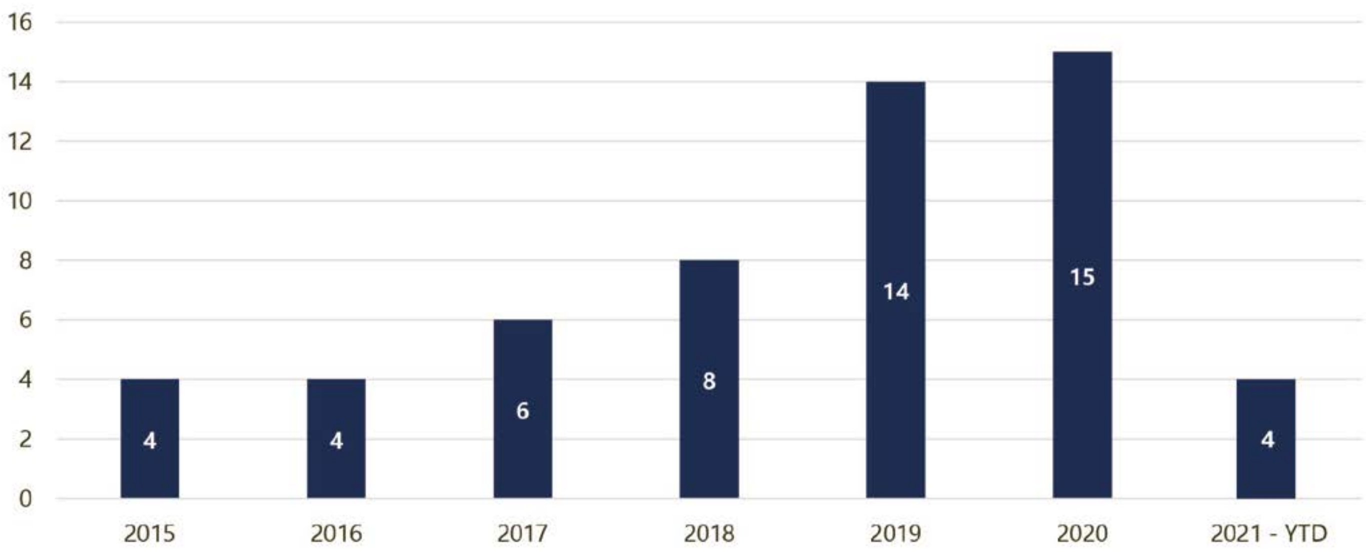
Pemberton has completed 55 direct lending deals in the UK and Ireland (2015-2021 YTD). As Pemberton has steadily expanded across Continental Europe it has remained deeply committed to the UK market, a fact demonstrated by its consistent top 2 position[19].

Pemberton's UK strategy is focused on adding new, high-quality, cash-generative businesses in partnership with its PE sponsor partners, together with providing add-on / refinancing capital to existing portfolio companies.

Since 2010 direct lenders have completed 978 deals in the UK[21]. Business infrastructure & professional services has been the most important single sector over that period with 203 deals (21.5% of the total), followed by TMT with 185 (18.6%) and financial services with 140 (14.9%).

Pemberton's own UK portfolio has historically been skewed towards business services (14 deals to date and 25.5% of the total), food & beverage (10 and 18.2%, respectively) and healthcare (10 and 18.2%, respectively) – all of which have proven resilient through Covid[22]. The firm has made a conscious decision to avoid cyclical industrial businesses and focus on defensive companies.

Pemberton's UK deals, 2015-2021 YTD[20]



19. Deloitte H2 2020 Alternative Lender Tracker
20. Pemberton internal data
21. Deloitte H2 2020 Alternative Lender Tracker
22. Pemberton internal data

Looking ahead

UK direct lending is an established alternative fixed income market which has demonstrated depth in flow of investment opportunities with strong diversification across sectors and an ability, as such, to provide an attractive income vs other credit segments (e.g. IG, leveraged loans) and provide stable returns. The UK economic backdrop and its resilience during Covid and Brexit, set the tone for what we expect to be a buoyant direct lending market in the years to come, and Pemberton plans on continuing to offer investors the opportunity to participate in this attractive market.

Pemberton's UK investment highlights (2020-2021 YTD)

Eat Real Healthier Snacking / PROPER	Merger	Exponent	Term Loan & Acquisition Facilities	February 2021
ipn Inspired Pet Nutrition	An add-on of	CapVest	Term Loan, Acquisition Facilities, HoldCo PIK	December 2020
MVF	A portfolio company of	Bridgepoint Development Capital	Term Loan & Acquisition Facilities	December 2020
Eight Fifty Food Group	A portfolio company of	CapVest	Add-on Term Loan	December 2020
Chamonix Estates	An add-on of	First Port	Term Loan	December 2020
Hermes the parcel people	A portfolio company of	Advent International	Term Loan & Acquisition Facilities	November 2020
OVO energy	Corporate deal		Acquisition facilities	September 2020
frontiermedical group	An add-on of	Vernacare	Term Loan	July 2020
Chill Insurance	A portfolio company of	Livingbridge	Term Loan & Acquisition Facilities	June 2020
Learning Curve Group	A portfolio company of	Agilitas	Term Loan & Acquisition Facilities	March 2020

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