PEMBERTON
Connecting Capital Across Europe

Pemberton Perspectives

Discussing some key investment themes in European private debt

True Mid-Market:
The Sweet Spot in European Mid-Market Direct Lending

With over €85 billion of dry powder[1], Direct Lenders have a crucial role to play in financing Europe's more than 25,000 Mid-Market companies[2]. Strong inflows of capital to European Direct Lending funds have created sub-markets within the wider Mid-Market with their own risk-return characteristics.

We believe that most of the Direct Lending capital in the market over the last 12 months has been directed towards the Upper Mid-Market (deals with an Enterprise Value above €500 million), where investment opportunities are readily accessible through investment banks and sponsors. Competition in this part of the market has seen spreads compressed and terms eroded; in our view, medium-sized Mid-Market (deals with an Enterprise Value between €50–500 million) companies offer superior value for investors in the space.

[1] Source: Preqin, December 2018
[2] Source: EVCA "European Mid-Market Private Equity: Delivering The Goods", Eurostat, February 2017

FOR PROFESSIONAL INVESTOR USE ONLY

THE DEVELOPMENT OF EUROPEAN MID-MARKET DIRECT LENDING

The European Mid-Market is a significant and resilient segment within the European economy and a key driver of growth.

There are more than 25,000 European companies with an EBITDA of between €15 million and €75 million[2]. Although this represents a relatively small share of all companies, this segment is responsible for more than 20% of European private sector GDP and employment[3]. The resilience of the Mid-Market sector was demonstrated during the highly stressed economic conditions between 2007 and 2010, when Mid-Market firms in Germany, U.K., France and Italy created 192,000 jobs, in contrast to larger firms that reduced headcount by 1.5 million people[4]. From a growth perspective, Mid-Market firms in Germany have historically outperformed both larger and smaller companies[4].

"There are over 25,000 European companies with an EBITDA of between €15 million and €75 million[2]"

Access to bank financing has been restricted for Mid-Market companies since 2008. Despite political pressure and a range of government initiatives to encourage corporate lending, European banks consistently tightened credit standards and loan terms from 2007 to 2013, with standards easing only very marginally since 2014. The cumulative effect of this tightening of credit standards and loan conditions has been to make access to financing increasingly difficult for Mid-Market companies, which have historically been reliant on banks to provide non-dilutive capital as, unlike large companies, they are typically unable to access the public debt markets for financing.

In response to strong demand from European borrowers for alternative sources of financing for new projects and to refinance existing bank debt, Europe's Direct Lenders launched dedicated funds with strategies to provide the capital needed to finance Europe's Mid-Market. Institutional investors, initially attracted to the asset class as an alternative to volatile investments in European High Yield Bonds or Leveraged Loans, committed more than €600 billion to European Direct Lending funds in the ten years between 2009 and 2018[5]. This inflow of capital established Europe's Direct Lenders as a primary source of finance for Europe's Mid-Market companies and catalysed a process of diversification in the European credit markets that is still ongoing.

"After ten years of rapid development, European Direct Lending funds have grown increasingly larger, as demonstrated by the recent closings of a number of Mid-Market "mega-funds""

After ten years of rapid development, European Direct Lending funds have grown increasingly larger, as demonstrated by the recent closings of a number of Direct Lending "Mega-Funds" with more than €5 billion of commitments. Competition between funds for commitments from institutional investors, coupled with margin pressure as a result of competition for investments, has led to a softening of managers' terms across the board. This has significant consequences for investors in the space: where previously management fees were charged on committed capital (reflecting Direct Lending's roots in Private Equity-style funds) the norm today is for fees to be charged on invested capital. Managers are incentivised to deploy capital quickly, aligning their interests with those of their investors but creating even greater competition for assets.

The emergence of the Mega-Funds, coupled with the weakening in terms across the market, has led to a clear bifurcation of the Mid-Market: the Upper Mid-Market has become highly competitive and Mid- and Lower Mid-Market companies offer better value as a result.

"The emergence of the Mega-Funds, coupled with the weakening in terms across the market, has led to a clear bifurcation of the Mid-Market"

[2] Source: EVCA "European Mid-Market Private Equity: Delivering The Goods", Eurostat, February 2017

[3] Source: World Bank, December 2016, GE Capital/ESSEC Business School "The Mighty Middle" 2012

[4] Source: GE Capital, The Mighty Middle: Why Europe's Future Rests On Its Mid-Sized Companies, 2012. Mid-Market companies defined as having annual turnover of €20 million-€1 billion in Germany and the U.K., €10 million-€500 million in France and €5 million-€250 million in Italy

[5] Source: Preqin, December 2018

OVERVIEW OF THE EUROPEAN MID-MARKET

The Mid-Market in Europe is variously defined but most classifications would include companies with EBITDA of between €10 million and €100 million. We see three clearly defined sub-markets within this definition, each with very different dynamics, driven by both the nature of the borrowers in each sub-market and the sources of capital available to each.

- **Upper Mid-Market:** Companies with EBITDA of €50 million or more and Enterprise Values ("EVs") of more than €500 million. These companies tend to be diversified, pan-European organisations with very substantial debt financing requirements. Such companies are often the largest European players in their respective markets, employing thousands of workers across multiple geographies.
- **Mid Mid-Market:** Companies with EBITDA of €10–€50 million and EVs between €50 million and €500 million. These companies range from established and successful locally-focused businesses to diversified groups of companies, many of which are suppliers to Upper Mid-Market and large-cap companies. With either a regional or a global focus, many of these companies are leaders in their respective markets, employing substantial numbers of workers.
- **Lower Mid-Market:** Companies with EBITDA of less than €10 million and EVs typically less than €50 million. These companies are often relatively new entrants in existing markets or highly specialised companies operating in niche markets. Lower Mid-Market companies tend to have a local focus and employ tens – as opposed to hundreds or thousands – of workers.

FINANCING OPTIONS ACROSS THE MID-MARKET

The financing needs of Mid-Market companies are generally met by banks, Direct Lending funds and, in the Upper Mid-Market, a small number of Mega-Funds competing with the bank-syndicated loan and public high yield bond markets.

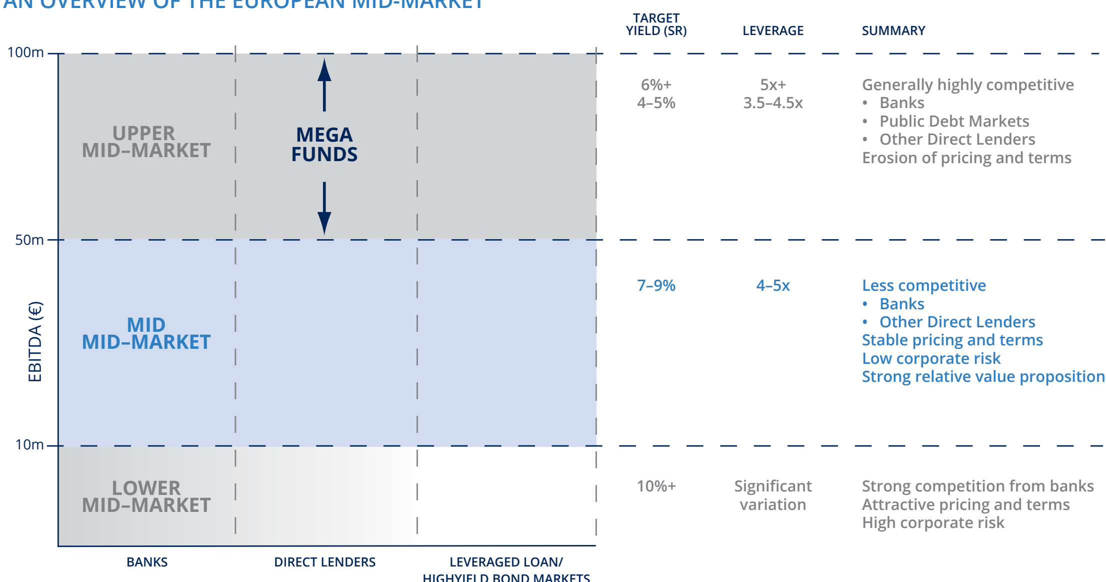
Upper Mid-Market companies can access the leveraged loan and public high yield bond markets for debt packages of €200 million or more (generally considered the lower limit for high yield bond or leveraged loan financings) and it is this access to the public markets that defines the boundary between the Mid- and Upper Mid-Market.

The options for Mid- and Lower Mid-Market companies are less diverse. The public markets are inaccessible to all but the largest companies in this segment. As a result, the majority of capital for financings is provided by (i) banks; (ii) a handful of regionally-focused Direct Lenders with funds large enough to provide the finance needed for transactions of this size; and/or (iii) a small number of pan-European Direct Lenders with local origination capabilities.

This part of the market is not where the Mega-Funds normally invest: with large funds under pressure to deploy quickly, larger opportunities are of greater interest.

The financing needs of Lower Mid-Market companies are primarily served by banks, with any additional financing that the banks are unwilling or unable to provide typically met by locally-based, regional Direct Lenders or by smaller, specialist managers with a mix of debt and equity (usually warrants or preferred shares) financing.

AN OVERVIEW OF THE EUROPEAN MID-MARKET



Source: Pemberton Capital Advisors LLP, January 2019. There is no guarantee that target returns will be achieved.

PRICING AND RISK

As Upper Mid-Market companies can choose between banks, Direct Lenders, the leveraged loan and public high yield bond markets for financing, achieving attractive returns from investments in this part of the market is difficult. Direct Lenders active in this space compete with each other for investments while negotiating terms that can be easily benchmarked against the high yield and leveraged loan markets. Margin compression in the leveraged loan markets (reflected in new issue Term Loan B spreads, shown below) translates much more directly into Upper Mid-Market private debt transactions than lower in the Mid-Market, where there is less competition and direct market comparisons for new financings generally do not exist.

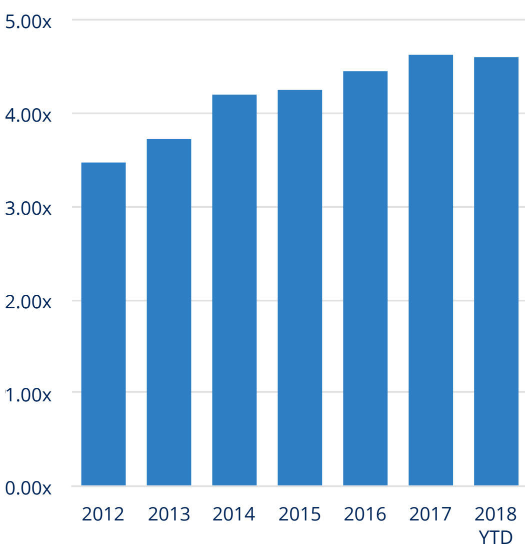
Senior loans in the Upper Mid-Market generally attract yields of 4-5% for companies with leverage between 3.5x and 4.5x and 6%+ for companies with leverage of 5x or more. Investments priced to deliver returns at the top end of this range are contested by Mega-Funds raised by broadly diversified pan-European asset managers in competition with the public markets. Such opportunities generally have weaker covenant packages and increased leverage than can be achieved in Mid- and Lower Mid-Market financings, both of which weaken the lender's position in the event of underperformance.

"Senior loans in the Upper Mid-Market generally attract yields of 4-5% for companies with leverage between 3.5x and 4.5x and 6%+ for companies with leverage of 5x or more."

Because the public markets are inaccessible to all but the largest Mid-Market companies, the public market pricing and terms benchmarks have a much lesser impact on Mid- and Lower Mid-Market companies. In Pemberton's experience, investments in companies of this size can deliver gross returns of more than 7% per year, with early repayment penalties providing further upside. Strong, enforceable covenants offer protection in the event of underperformance.

SYNDICATED LOANS: INCREASING LEVERAGE...

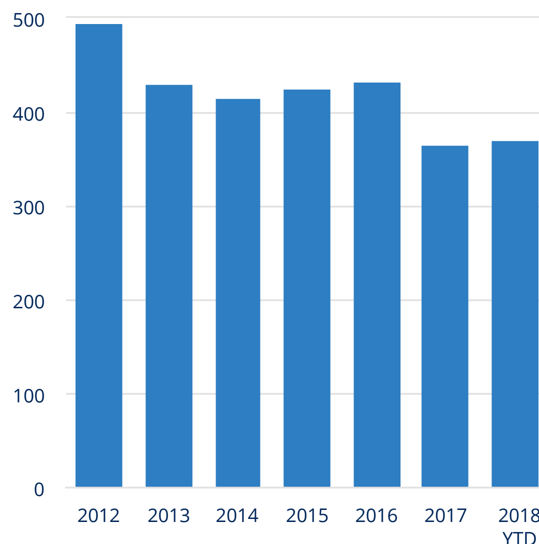
FIRST LIEN DEBT TO EBITDA, 2012–2018



Source: S&P Leveraged Comps and Data, October 2018

... AND PRESSURE ON PRICING

NEW ISSUE TERM LOAN B SPREADS, SYNDICATED LOAN TRANSACTIONS 2012–2018



Of course, there is still competition for investments in companies of this size. Debt packages can be broadly syndicated to Direct Lenders without local origination capabilities ("fly-drive investors"), reducing the terms that can be achieved for these investments. In our experience, the most attractive opportunities never reach fly-drive investors, instead being invested by managers with differentiated relationships and local origination capabilities ("the best deals have no wheels").

In the Lower Mid-Market, the pricing of loans is primarily driven by competition between banks. Investing in loan tranches that the banks are unable or unwilling to provide, Direct Lenders' investments in companies of this size are generally priced, through a combination of debt instruments and equity participations, to deliver returns of 10%+ per year. However, financing Lower Mid-Market companies carries significant risk because of the relatively high degree of uncertainty in predicting these companies' cash flows – a serious problem for lenders. Because of the risk, we would consider lending strategies focused on companies of this size more akin to "Venture Debt" than "Direct Lending".

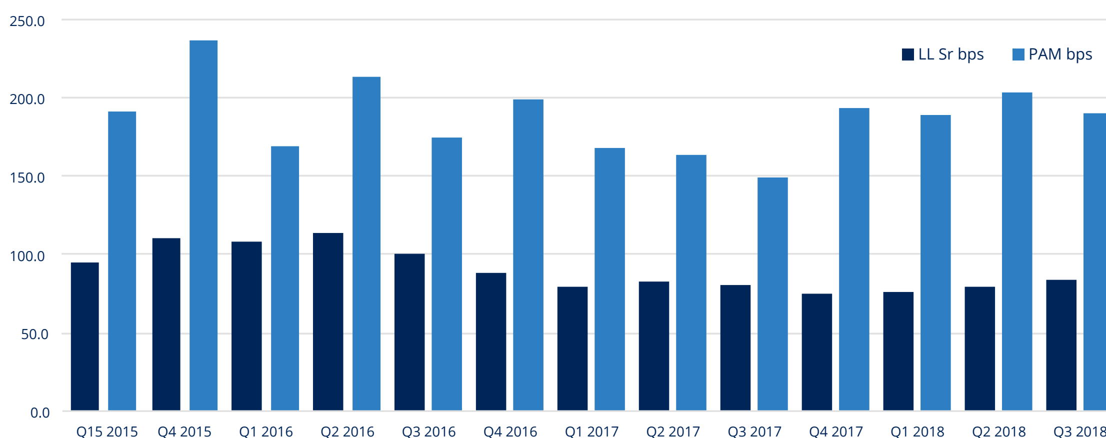
RELATIVE VALUE

The spread per turn of leverage (effectively the price received per unit of risk taken) provides interesting insight into the relative value differential between the Mid- and Upper Mid-Market. Our analysis of the spread per turn of leverage for European leveraged loans and all-in 3-year projected yield per turn of leverage (which includes arrangement fees) for Pemberton's Direct Lending portfolio (below) indicates that Mid Mid-Market senior loans generate on average approximately 100bps of additional value per turn of leverage than European leveraged loans, clearly demonstrating the attractiveness of Mid Mid-Market-focused Direct Lending strategies for investors focused on the space.

> *"The spread per turn of leverage (effectively the price received per unit of risk taken) provides interesting insight into the relative value differential between the Mid- and Upper Mid-Market."*

RELATIVE VALUE IN MID-MARKET LOANS

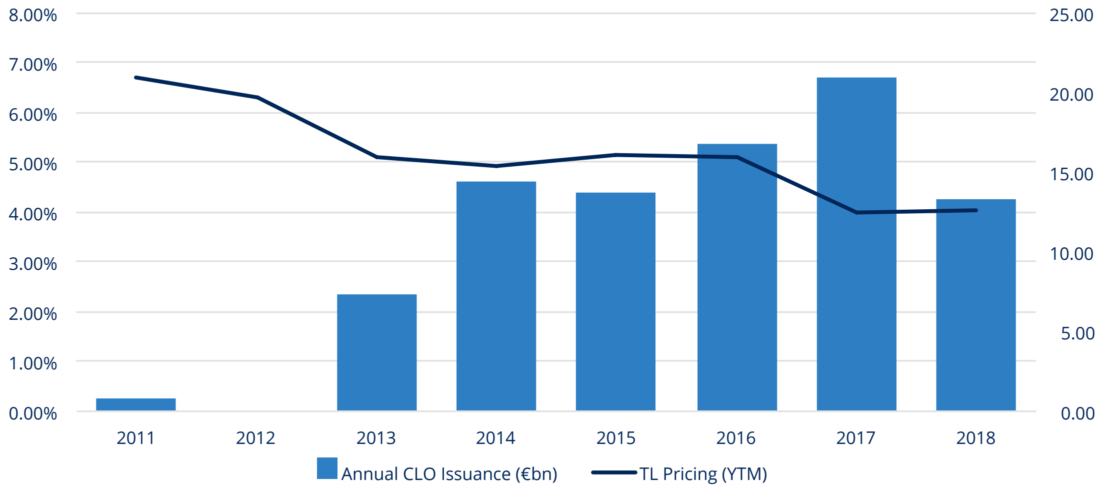
YIELD PER TURN OF LEVERAGE Q3 2015–2018



Source: Leveraged Loan data from S&P Leveraged Comps and Data. "Mid-Market Loans" data from Pemberton Capital Advisors LLP, October 2018

The outlook for yields at the top end of the market does not suggest a significant improvement in this dynamic. Approximately 80% of new loan issuance is acquired by institutional investors[7] and a large percentage of that is acquired for CLOs. Competition between CLO managers for allocations of new-issue loans drives yields lower so CLO issuance volumes can have a significant impact on leveraged loan pricing. And, with a high of more than €27 billion of new CLO issuance in 2018[8], further pressure on margins in the leveraged loan markets – and, by extension, in the Upper Mid-Market – is expected.

6 Source: S&P Leveraged Comps and Data, October 2018
7 Source: S&P Leveraged Comps and Data "LCD European Quarterly", January 2019



Source: Pemberton Capital Advisors LLP using data from S&P Leveraged Comps and Data, October 2018

Combining a compelling relative value basis, stronger covenant protections, lower levels of competition and a more attractive outlook, we believe Mid Mid-Market companies – the "true Mid-Market" – is the sweet spot for investors considering investing into European Mid-Market Direct Lending strategies.

DISCLAIMER

This document is intended only for the person to whom it has been delivered and is solely for discussion / information purposes. The information contained herein (which does not purport to be comprehensive) is provided by us and has not been independently verified. The information contained in this document is believed to be accurate only at the date of this document and does not imply that the information herein is correct at any time subsequent to the date hereof and such information is subject to change at any time.

Pemberton Capital Advisors LLP gives no undertaking to provide the recipient with access to any additional information or to update this document or any additional information, or to correct any inaccuracies in it which may become apparent.

This document has been prepared and issued by Pemberton Capital Advisors LLP. Pemberton Capital Advisors LLP is authorised and regulated by the Financial Conduct Authority ("FCA") and entered on the FCA Register with the firm reference number 561640 and is registered in England and Wales at 52 Grosvenor Gardens, London, SW1W 0AU, United Kingdom. Registered with the US. Securities and Exchange Commission as an investment adviser under the U.S. Investment Advisers Act of 1940 with CRD No. 282621 and SEC File No. 801-107757.

Tel: +44(0) 207 993 9300. www.pembertonam.com

Pemberton is a registered trademark.
© Pemberton.

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 Business Development team on BDgroup@pembertonam.com or +44 (0) 20 7993 9300 with any questions or comments.

www.pembertonam.com