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Pemberton Perspectives

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Discussing some key investment themes in European private debt

Powder Keg or Powder Puff? How to assess if dry powder is an issue

Dry powder – the amount of money raised by fund managers that has yet to be deployed – is an in-vogue topic. According to data provider, Preqin, the amount of dry powder held by private debt funds across Europe stood at €234 billion as at December 2017[1].

Observers who talk of "a wall of capital" waiting to be deployed add to the impression that dry powder has become a significant problem for managers and for investors. No one wants to be sitting on undeployed cash, or worse, to be forced into unattractive or risky deals in order to meet deployment targets.

A manager with a dry powder challenge ultimately has one of two problems. Either they can't find companies who want financing in the first place. Or there are plenty of companies asking for this, but none that look suitable from a risk-return point of view.

In the current European private debt landscape, some managers might feel they're facing both problems at the same time.

In some markets, banks are highly competitive on deal terms, pricing them out or reducing the available pool of companies. In others, the headline economic landscape will put some managers off lending, even to strong companies.

The reality is more nuanced than the headline figures suggest. For Europe-focused managers with the ability to invest across all major economies, attractive origination opportunities can be in fact abundant.

As an existing or potential investor in private debt, there are three key questions to consider when assessing whether your manager could face a dry powder problem:

[1] Source: Preqin www.preqin.com

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1 How many different sourcing channels are in place?

Despite many managers' marketing claims of a pan-European focus, a lot of the time, money is raised in London and stays in London.

Many managers focus on evaluating deals that come to London from continental Europe. Consequently, they try desperately to find a home for their dry powder from a rather limited pool of deals, fought over with fervour by many other fund managers and banks.

As well as relying on the UK market, many managers rely on one sourcing channel as well: borrower companies sponsored by private equity firms with London offices. We believe an ability to source opportunities in local markets across Europe significantly enhances origination capability.

Admittedly, the flow of sponsor-backed deals in London is one of the largest sources in Europe. However, it is also one that an enormous number of people are monitoring, eager to use its flow to dissolve their dry powder.

2 How 'European' are they?

Any manager worth their salt talks about their "pan-European network". But what does that actually mean in practice?

As noted above, good opportunities come from not just understanding a country, but actively participating in it.

A fund manager with a genuine pan-European presence – which we define as permanent boots on the ground in multiple cities – should be able to see deals that never make it to the London market.

The impact of this may sound obvious, but there is a hidden compounding effect to this approach.

Each office has its own cluster of pipelines. Rather than relying on local private equity firms, in-country teams constantly receive information on a wide range of deals from their contacts at local banks and domestic private equity firms.

Connections to the network of local debt advisory, legal and accountancy firms advising potential borrowers further magnifies this effect.

3 How proactive are they in the less well-trodden markets?

A few years ago, the idea of lending money to a mid-sized Spanish or Italian company would have appeared risky. The Eurozone crisis, sovereign debt woes and economic growth concerns, would all appear as flashing warning signs not to lend into those countries.

The problem with this type of assessment is that it often ignores the reality of how good companies perform, even in difficult markets. Hidden gems are by definition 'hidden', but there are clues you (or your private debt manager) can look for, such as medium and long-term strength of the borrower's industry sector, the position of the company in that sector, the threat of technology and other disruptors to it, and the quality of management.

Furthermore, following the global financial crisis, many countries across Europe have enacted lender-friendly changes to their insolvency and restructuring laws, as detailed in our previous Pemberton Perspective: Credit Structuring across European Legal Regimes.

The health of the economy where that company operates is of course important. Ruling out a country en masse is a guaranteed way to remove a lot of strong potential deals quickly. As an example, Spain which has been growing at 3.0-3.5% for the last 3 years[2], has provided a steady flow of high quality mid-market deals.

Finally, diversification is important. Risk has to be spread across the major European economies, and an allocation broadly based on GDP contribution seems sensible.

[2] Source: Instituto Nacional de Estadistica: http://www.ine.es

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

We'd love to hear your views for our Pemberton Perspectives Series. So please feel free to contact our Head of Investor Relations, Mike Anderson on +44 (0)20 7993 9311 or mike.anderson@pembertonam.com with any questions or comments.