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How direct lending is opening up new opportunities for private debt investment

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The evolution of Europe's lending landscape over the past two decades has created opportunities for institutional investors to expand their presence in private corporate loans. The post-financial crisis shift by borrowers from traditional bank funding towards alternative lenders has been particularly rapid in mid-market direct lending.

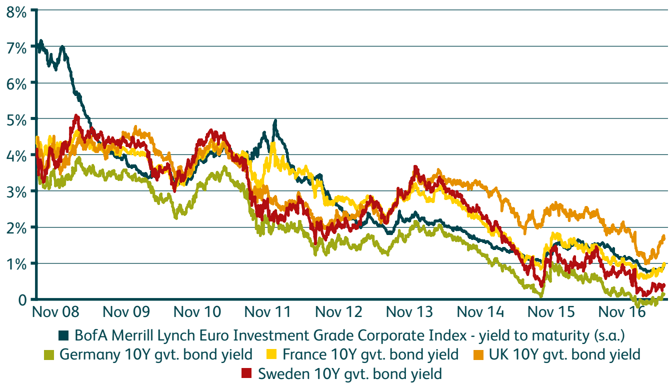
A significant influx of institutional capital into direct lending strategies over recent years has increased competition among lenders in parts of the market, leading to pressure on transaction structures and margins, and heightening the prospect of mispricing risk. At the same time, certain areas of direct lending remain underserved and offer attractive value in comparison. This paper explores where and how such investment opportunities exist today.

Hunting yield: the rise of demand for private debt

Low yields and bouts of volatility in Europe's public bond markets in the years since the financial crisis have prompted pension schemes, insurance companies and other institutional investors to look at private debt as a valuable source of additional returns and diversification benefits.

The years of ultra-loose monetary policy in the UK and Europe following the crisis have resulted in sustained declines in government, and consequently, also corporate bond yields. This has been most acute in Europe where an increasing volume of debt trades at negative yields. Subsequently, this has put increasing pressure on institutional investors to seek higher yields in alternative assets, including private forms of lending that compensate for factors such as their illiquidity and complexity.

Figure 1: Ultra-low yields on European government and corporate bonds



Source: Bloomberg, BofA Merrill Lynch Euro Corporate Index (Ref. ER00) data as at November 2016

Private debt is a sweeping term that encompasses lending to corporate, financial and asset-backed borrowers provided by non-bank lenders. It ranges from companies looking to fund business growth or refinance existing loans and seeking alternatives to funding from banks, or public debt offerings to real estate owners seeking mortgages and infrastructure providers that require long-term capital. Broadly, private debt is a confidential and relationship-driven area of debt finance that requires excellent networks of relationships and specialist expertise and resources to participate in.

The private debt market in Europe is evolving and maturing as investors that have a tolerance for illiquidity recognise the long-term potential for the market to help them meet their investment goals.

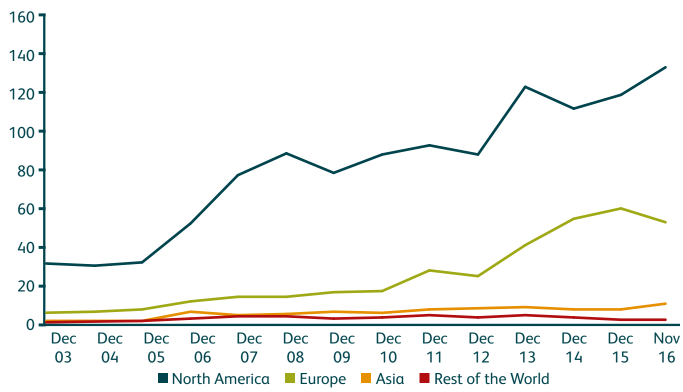
The benefits of private debt extend beyond higher risk-adjusted returns as these debt instruments can play a variety of roles in an institutional investor's portfolio. They can generate specific kinds of contractual cashflows, such as floating rate or inflation-linked coupons, which can insulate investors in the event of rising interest rates or from inflation. Furthermore, they can often provide security over assets and typically incorporate attractive features, such as strong covenants that can offer downside protection and enhance potential recovery values should the investment not perform as expected.

Private debt offers a diverse range of maturities and risk-return profiles. Debt is provided at all levels of seniority in the capital structure (senior, subordinated or unitranche) and varies by borrower type and geography. Some forms of private debt, such as leveraged loans, private placements and infrastructure debt, are relatively long standing, with institutional investors active in these markets since the 1990s. The financial crisis was a further catalyst for the growth of areas such as direct lending, which involves lending to smaller companies with typically less than €200 million total debt.

The availability of more varied sources of funding, often on more flexible terms and longer tenors than bank finance, has proved attractive to borrowers too. Increased demand from borrowers for alternative (non-bank) sources of funding has been a central tenet of the growth in private debt investment strategies in recent years.

The result has been a sustained increase in funds raised for private debt strategies in Europe (and the US) over the past decade. In its "2016 Global Private Debt Report", data provider Preqin found that European dry powder figures totalled $60.5 billion (£47.6 billion*) at the end of 2015 – further highlighting the growth of private lending in the region. The latest data from Preqin shows this figure at $53.1 billion (£41.8 billion*) as at November 2016, as shown in the chart below.

Figure 2: Private debt fundraising has risen sharply since the financial crisis ($ billion)



Source: Preqin, as at November 2016

* Source: Sterling figures converted using a USD / GBP exchange rate as at 13 December 2016

Investing in private debt markets: asset-backed and corporate lending

Asset–backed financing

Infrastructure debt: Loans to providers of essential infrastructure to develop or refinance assets. Infrastructure debt can range from fixed-rate loans to construct schools, hospitals or energy products to inflation-linked notes for economic infrastructure.

Real estate debt: Senior and junior mortgages secured against a commercial real estate asset.

Lending to corporates

Leveraged loans: Syndicated loans to large corporates, typically to finance M&A or leveraged buyouts by private equity sponsors and other leveraged owners.

Private placements: Issued by mid-to-large-sized private companies to a small group of investors. Financing can be structured in the form of bonds, notes or loans.

Corporate direct lending (senior direct lending, unitranche, complex direct lending): Long-term loans to conservatively managed mid-sized companies made on a bilateral basis without the use of intermediaries. Each deal has a unique structure and terms are negotiated as part of the transaction.

Figure 3: Different risk / return profiles*

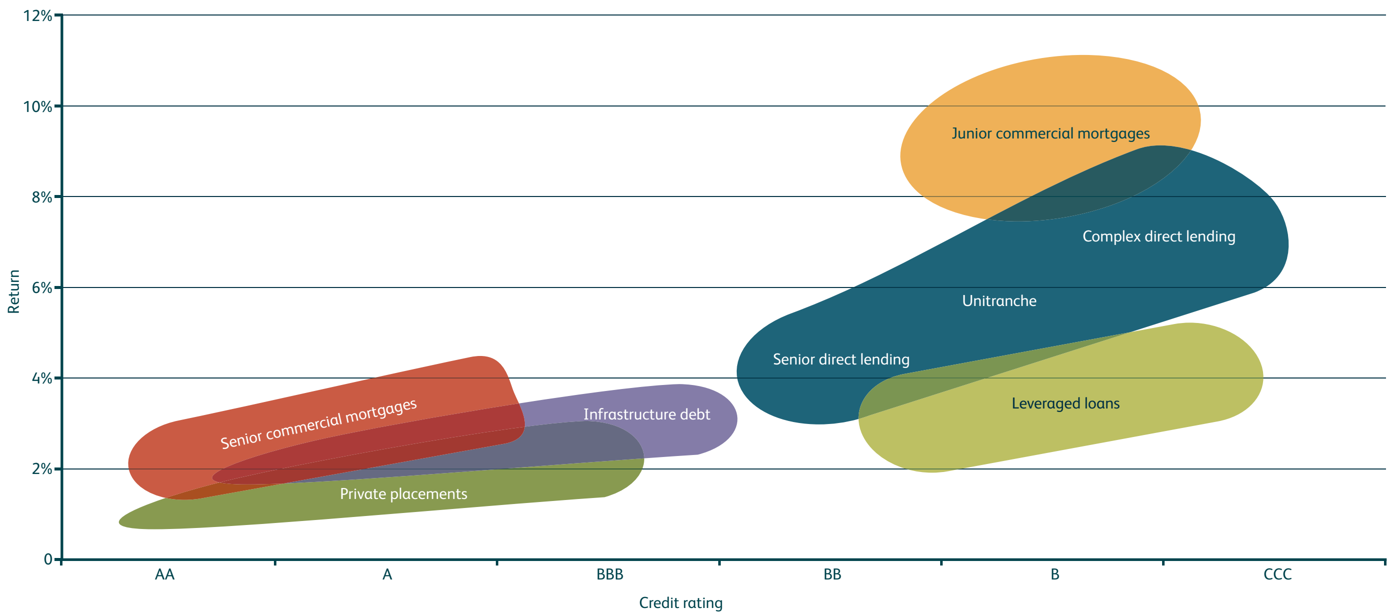


Figure 4: Key characteristics at a glance*

	Leveraged loans	Private placements	Corporate direct lending	Infrastructure debt	Real estate debt
Interest rate basis	• Floating	• Typically fixed	• Typically floating	• Fixed • Floating • Inflation-linked	• Fixed • Floating
Security	✓	×	✓	✓	✓
Tenor	• Legal life is typically 7-8 years, but many repay early at an average of 3 years	• Typically 5-12 years	• Typically 3-7 years	• Typically 15-25 years	• Typically 5-7 years
Credit risk	• Sub-investment grade	• Investment grade	• Sub-investment grade	• Sub-investment grade	• Investment grade • Sub-investment grade
Covenant protection	• Typically at least one maintenance covenant	✓	✓	✓	✓

* Source: M&G Investments, illustrative

The growth of the mid-market

Direct lending is perhaps the most rapidly growing and evolving area of private debt in the past decade. Much of this growth can be attributed to the economic, regulatory and policy changes during and since the global financial crisis. A short-term freeze in bank lending to the economy in the crisis period itself was followed by a prolonged period of retrenchment by banks, particularly from longer-dated or riskier lending, in order to deleverage and meet stringent new capital requirements imposed by regulators. This created opportunities for non-bank lenders, such as asset managers, to lend institutional capital directly to mid-market corporate (and non-corporate) borrowers; a market that has grown significantly, particularly since 2012.

Institutional asset managers have been well-placed to plug this funding gap, particularly for smaller and non-rated companies, by offering longer-term debt, flexible terms and swift deal execution. While banks' appetite for corporate lending has largely returned in certain areas of the market, non-bank direct lenders are now an established part of the European investor base and continue to compete in all areas of the mid-market. A further trend has been the emergence of a thriving market for the provision of acquisition capital to leveraged mid-sized companies acquired by private equity companies in leveraged buyouts (LBOs). This has effectively expanded the large-scale European leveraged loan market to smaller 'sponsored' corporates, providing additional investment opportunities for direct lenders.

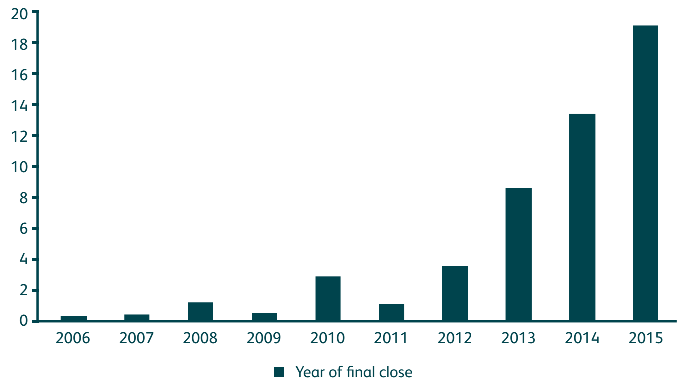
It has also led to innovations in capital structures, such as the development of 'unitranche' or whole loan investment, in which a non-bank lender provides the entire leveraged debt structure for a smaller borrower as a single loan. Unitranche lending contrasts with capital structures in which senior and subordinated credit risk are tranched separately and has grown rapidly in popularity among many non-bank direct lenders. Still, while unitranche loans, where as much as 6-7x leverage can be funded, have become common in the UK, and to a lesser extent in France and Germany, senior loans are still the most frequently used source of liquidity in most of continental Europe, according to industry publication Private Debt Investor.

Today, the European direct lending market serves mid-sized companies both with and without private equity sponsors and encompasses a wide range of target returns and risk appetites through the tranched (senior and subordinated) and unitranche loan structures. The UK, France and Germany are Europe's largest direct lending markets. In particular, the UK's legal jurisdiction is supportive of higher recovery rates in circumstances where debt restructuring is required.

Current market dynamics

Europe has experienced an influx of capital into direct lending investment strategies over recent years, with close to $19 billion (£14.9 billion*) raised by direct lending funds in 2015, a 42% increase on 2014, according to Preqin as shown in Figure 5.

Figure 5: Capital raised by European-focused direct lending funds ($ billion)



Source: Preqin "Private Debt Spotlight May 2016", data as at end 2015

The growth of direct lending funds is having a disruptive impact on supply and demand dynamics. The significant volume of dry powder in a relatively small market has led to a crowding effect in certain areas with a consequent impact on lending margins and structures.

The large, stable sponsor-less mid-market is dominated by banks, supported by a ready supply of available funding arising from quantitative easing and other government schemes, and pricing is typically unattractive for non-bank lenders unable to supplement returns in the same way that banks can. In some instances, lending margins can reflect the quality of the bank / borrower relationship rather than credit risk alone, leaving limited value for direct lenders.

Competition for unitranche and LBO opportunities has also intensified, particularly in the most developed European jurisdictions. Lenders have expanded both up and down the size spectrum to compete. Direct lenders can provide single loans of as much as €300 million, providing borrowers with simple execution but requiring very large funds in order to achieve diversification.

Finding attractive value therefore requires non-bank lenders to be both flexible and innovative. One example is for institutional asset managers to develop innovative partnerships with banks to originate assets. By taking a collaborative approach to lending activities, asset managers are able to draw on strong sponsor relationships and focus on credit provision, but care must be taken that the bank is not simply offloading unattractive risk.

Pricing credit risk across the capital structure

Since mid-market direct lending is both private and illiquid with loans held to maturity, given a lack of secondary market it is vital that an asset manager fully evaluates and prices the credit risk associated with the borrower to ensure investors are compensated for the risk they are taking on. Intensive due diligence and, often, negotiation is also required to ensure the structure and terms of a deal provide sufficient security and a strong suite of covenants to create reassurance of recovery in the event that an investment does not perform as expected.

Yet in the most highly competed areas of the direct lending market, margins can tighten or structures weaken with increasing leverage multiples becoming the norm. A fund with fixed return expectations is more likely to accept weaker structural protections or higher leverage multiples.

* Source: Sterling figures converted using a USD / GBP exchange rate as at 13 December 2016

For example, although a senior loan tranche may be fully secured on borrower assets and therefore justify being classified as both senior and secured, a 'stretched senior' or 'unitranche' loan may incorporate several turns of leverage beyond what would be covered by available assets. In such situations, we would be wary of viewing the loan as 'all-senior' or 'all-secured' and would aim to receive a return well in excess of typical senior margins for accepting the additional credit risk. It is also important to understand the status of banks' revolving credit facilities, which can often rank super senior to unitranche (as opposed to ranking pari passu alongside senior secured) – albeit the unitranche provider retains control.

A close analysis of each transaction is required to establish if the return offered does fully compensate for the risk. Whether lending to corporates or lending against hard assets, such as a mortgage secured on real estate, there are different types of analysis that the lender needs to perform in order to correctly price credit risk. Due to the asset coverage, there is a greater focus on the quality and value of the underlying property when it comes to underwriting commercial real estate loans.

Serving the underserved

Despite the record levels of fundraising and high competition, we continue to see underserved areas of direct lending in which few lenders are active and financing options for borrowers remain scarce.

One area of the market that remains largely underserved is lending to financing companies. These can range from consumer finance companies providing loans to consumers secured against a physical good (for example: houses, cars etc.) to SME lenders, which provide loans to small and medium-sized businesses. These financing companies can have high volumes, strong recurring revenue profiles and fundamental growth drivers, yet often their business model complexity requires additional due diligence to understand and leaves their financing needs beyond the scope of both banks and direct lenders.

To illustrate, we have outlined the key points of a £25 million three-year loan we made directly to a technology-based lender focused on stock finance and invoice advancement for smaller SMEs.

Figure 6: Investment example – marketplace lending

Key terms	**Size:** £25 million loan **Coupon:** Libor + 6% **Expected maturity:** 3 years **Credit rating:** BB+
Investment rationale:	
Senior and secured debt	• M&G provided senior debt with 75% advance rate secured against a pool of loans • 25% credit enhancement provided by junior debt / equity • Short-term loans and strong covenant package combine to create strong credit protection
Diversified pool of borrowers	• Average loan size of £3,000 • Over 5,000 borrowers • Equity sponsor with significant experience in the sector
Strong sponsor	• Management team with experience in underwriting • Scalable origination approach, filling the gaps left by banks

Source: M&G Investments, as at November 2016

Complexity creates opportunity

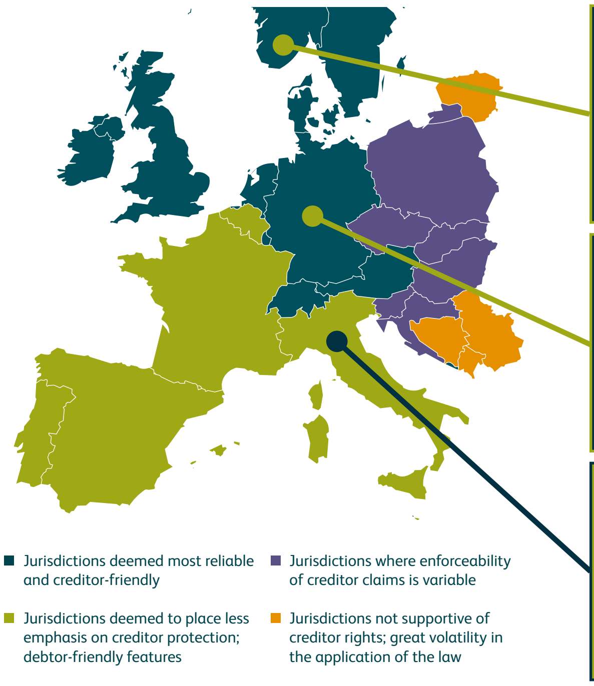
There are a large number of operationally-sound businesses across Europe that need capital to grow and expand their activities. These underserved areas of direct lending typically involve 'complex' situations versus 'off-the-shelf' deals, atypical assets or sponsor-less borrowers, in which greater work and expertise is required on the part of the lender to understand and price the asset, and which offer a complexity premium to compensate the investor for this additional effort.

With greater complexity comes risk. At the senior end of the capital structure, we accept the level of complexity involved and perform the due diligence required to understand the credit risk. Whereas a strategy that focuses on seeking out complexity across all parts of the capital structure requires deep knowledge of the restructuring and legal frameworks of the highly fragmented and idiosyncratic European market. Understanding these structuring nuances while seeking out compelling opportunities higher up the risk curve can reward investors with high total returns.

In the case that an investment does not perform as expected, and to avoid being a forced seller of an inherently illiquid position, we can draw on the expertise of our in-house workout team that incorporates legal and restructuring specialists who can negotiate on M&G's behalf to seek the best possible recoveries.

Limited coverage of SME companies in certain jurisdictions with operational or structural complexities can provide an opportunity to deploy capital at attractive returns with material control over the underwriting process. To illustrate how direct lending can be used in different complex situations, we summarise the main features of some of the sample transactions we have considered across Europe to date:

Figure 7: Investment examples – lending to stable companies with temporary deadlocks



Norwegian fisheries

- Growth capital for niche product
- Small ticket of $15 million
- Banks over-stretched with oil and gas workouts
- Target 12% returns

German automotive

- Business restructured two years ago
- New money required for capital expenditure and refinancing
- €40 million ticket
- Banks looking to exit due to restructuring stigma

Italian kitchenware

- Strong retail platform, online and stores
- €20 million capital required to grow and partly refinance banks
- Banks tired and not supportive of growth plan
- Target 10-12% returns

Source: M&G Investments, as at November 2016. Fitch country recovery ratings criteria, June 2013

Figure 8: Investment example – lending in a complex but solvable situation with material upside

Company overview	Transaction overview
• UK-based aviation services business with EBITDA of $4 million • Owned three planes and held long-term maintenance contracts with third parties • Transformational contract won, but ongoing litigation distracted management and limited ability to raise capital for growth	• Senior loan secured on shares and mortgages over three planes • $15 million ticket size • 18-month facility • 2.9x net leverage • Bespoke structuring to control cashflows and limit material refinance risk • 15%+ returns

Attractive characteristics

- **Complex but solvable problem** – profitable and cash-generative business unable to access capital due to litigation
- **Strong security package** – solving for litigation released valuable security and enabled a refinancing of tired lenders
- **Credible business plan** – refinancing released fresh capital in to the business to fund ramp up of profitable new contract
- **Multiple sources of repayment** – strong cash generation, valuable security and improved access to capital
- **Limited lender appetite due to complexity and size** – bespoke structuring, security, documentation and covenant package at high returns

Source: M&G Investments, as at November 2016

Flexibility, selectivity and discipline

It is in these underserved and complex areas of direct lending that we can often find attractive value opportunities. At the senior end of the mid-market, for example, we are seeing decent relative value right now and are originating a number of transactions.

Fundamentally, it is our strengths in credit research and transaction structuring that provide us with a high degree of flexibility so we can be selective on credit quality, maintain discipline on structures and covenants and, crucially, avoid becoming a forced buyer of assets.

In the same way, taking a flexible approach to private debt markets can enable an institutional investor to identify value and realise the benefits from a range of opportunities across the spectrum.

M&G and private debt

M&G is an established investor in private assets, having invested in the asset class for our parent Prudential plc and our third-party institutional clients over the past 20 years. In 1997, we made our first investment in private placements and were one of the first non-bank investors in European leveraged loans in 1999.

As an early mover in Europe, we made our first commercial real estate debt investments in 2010. We have over £6 billion* invested across more than 70 investments in Europe.

In 2009, we launched a direct lending strategy for mid-sized UK companies, which we expanded with another round of fundraising three years later. We have £21.2 billion** of private debt assets under management, and are ranked the largest private debt investor in Europe and third largest globally according to Private Debt Investor (2015).

* Source: M&G Investments, as at 30 September 2016

** Source: M&G Investments, as at 30 June 2016

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