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NATIXIS INVESTMENT MANAGERS

MV Credit

Is this a good time to be investing in private debt in Europe and how does it behave through the cycles?

Interviewer

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Interviewee

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SUMMARY

- *Whilst the retrenching of banks from the leverage loan and private debt markets has had positive implications, the gap has been filled by several unitranche lenders which has led to a tightening of pricing and loosening of terms, but we are seeing moves back in the right direction*
- *Solid underlying fundamentals of the European market, low default rates and relative expensiveness of the USD make European private debt an attractive proposition*
- *Investors with the right manager who has rigorous standards in the types of credits that they select as well as strong monitoring and restructuring capabilities, will find private debt performs incredibly well through the cycles*
- *Having been through multiple cycles provides an understanding of how to choose the right partners, the ability to be more selective, as well as ample experience of restructurings*

Zoi Fletcher: What long term macro changes to fundamentals are we seeing in Europe compared to the more short-term economic cycle?

Nicole Downer: The main macro change that we have seen since the last recession has been quite a secular one in Europe. This has been the move in the leverage loan and private debt markets from a predominantly bank underwritten market to more direct relationships between non-bank lenders and the ultimate borrowers. Before the last recession banks underwrote all parts of the capital structure; from senior debt all the way down to the more subordinated debt tranches. And they did this for all sizes of companies. Over the last few years, changes in regulation have led to banks retrenching from various parts of the market. They retrenched almost completely from the subordinated debt markets which has been positive for subordinated lenders like us.

The other area where we saw a large retrenchment by the banks was from small cap companies, basically companies who have a profit of less than €30 million. This is where we have seen the emergence of a number of direct lenders or unitranche lenders in Europe over the last few years to fill the gap that the banks have left. This long-term change is a positive one for third party lenders such as ourselves: what it means is that the traditional form of supply for loans is contracting, which has positive implications on pricing, structure etc.

In the short-term, however, we have seen a bit of the opposite phenomenon, where the gap that has been created has been more than filled, especially in the small cap market, by a number of unitranche lenders who have been raising significant funds over the past 2-3 years. This is a market that only started in 2011 and so the unitranche lending by non-banks hasn't gone through a credit cycle in Europe. We have seen a number of new entrants who have rushed into this market, creating more supply than demand in the short term. In the medium to long term there are still some very strong fundamentals for this market but in the short term the fundraising seems to have gone faster than the rising demand for the product.

As a result, in the unitranche product space, we have definitely seen a significant tightening of pricing and we have seen a loosening of terms. To be fair, this loosening of terms has occurred across the market, so cov-lite transactions are very much a feature of the European market which is an import from the US and bond documentation more generally. We have also seen some levels of price reduction on the mid, upper mid cap and large cap but this hasn't been as noticeable as in the small-cap space.

This came to a head in Q3 and Q4 of last year and since then we have started to see more positive pricing and pushback on documentation etc. I would say that the market was at its lowest in terms of being borrower friendly and lender unfriendly at the end of last year and we are now seeing it move in the direction we, as lenders, like.

> IF YOU ARE AN INVESTOR WHO HAS SOME FORESIGHT INTO YOUR CASHFLOWS OR YOU ARE MATCHING YOUR LIABILITIES TO YOUR ASSETS OVER A FIVE TO TEN YEAR PERIOD AND YOU DON'T NEED THE FLEXIBILITY TO PULL OUT OF YOUR INVESTMENTS VERY QUICKLY, THIS ASSET CLASS IS ABSOLUTELY THE RIGHT ONE FOR YOU, BECAUSE THE PREMIUM THAT YOU GET IS ABSOLUTELY WORTH IT

A small side-bar on loosening of terms: a number of investors express concern about the trend towards cov-lite in the European private debt market. In our view, this risk is one that can be contained by getting sufficiently detailed and regular information from the borrower and having a robust in-house monitoring policy. Other documentation trends which to us are more concerning include EBITDA adjustments, dividend policies and re-cap policies.

These short-term dynamics aren't really a feature of the macro economy in general because we have seen the demand side growing in this market. But it just hasn't been growing as much as the short-term supply. So, the features of this market in the short term have been more of a function of the short-term supply and demand issues rather than something that is driven by macro-economic issues.

Zoi: How does Europe compare to other markets in terms of relative value?

Nicole: Europe has a lot to offer investors because, firstly, as an economic block we are a huge part of the global economy. Thus, this asset class provides exposure to some very strong companies, which have a pan-European and even global reach, especially when you are looking at the mid-market and large-cap markets in Europe. It provides an opportunity for investors to get exposure to this economy.

Since the last recession, Europe has been relatively flat to growing in a very moderate way. This means that the concept of a cycle, downturn or slowdown is less likely than in the US, for instance, where there has been some very stellar growth since the last recession. This has certainly been helped by the QE measures that the US took very early on in the last recession, whereas in Europe it took a number of years before it was finally implemented in 2015.

European Private Debt offers good relative value because the underlying fundamentals of the market are strong and default rates continue to be very low in Europe. We see in this specific market that interest cover, i.e. the leverage that is appropriate for the companies that we are investing in, is stronger than in the past. Spreads have been fairly stable, and we see this continuing with growth from the demand side with more M&A activity and a lot of dry powder from equity sponsors, which is where we originate our investments.

Finally, given where the forward curve is for US dollars versus euros, Europe is a very attractive space for US investors. They will get a 2-3% pick up in returns just because they are US dollar investors investing in Euro products. Also, the opposite is true for European investors, where the US is going to look quite expensive for them.

We have also seen demand from Asian investors into the European market, especially those from Japan, for the reasons I have just mentioned. The solid European fundamentals together with the relative expensiveness of the USD makes European investments an attractive proposition.

Zoi: How does private debt behave through the cycles?

Nicole: Private debt in Europe has performed very well through the cycles, providing consistently good returns with low volatility to investors.

One of the concerns that has been expressed by investors about European private debt is that a lot of the fundraising has occurred for the unitranche product which hasn't actually been through the cycle. This makes it difficult to judge how this part of the market will behave through a cycle. For me, there is a clear differentiation between the unitranche product and the more traditional senior secured loan mainly because we are talking about financing quite different types of companies. The unitranche product caters primarily to smaller and more local companies with quite a lot of exposure to the UK, France and a little to Germany and the rest of Europe, whereas the senior secured product is used to finance larger, pan European companies headquartered throughout Western Europe. So the way that less experienced manager of small-cap funds will react may be different to the space that we are in, which is the more mid- to upper-mid-cap markets. We have been an investor in European private debt through the subordinated as well as the senior tranches since 2000. And we have found that if you are, as a private debt lender, very rigorous in your selection and disciplined in the way that you invest in private debt, you can perform consistently well through the cycles. We have seen this with our own track record.

For us, discipline about the size of the company; the industries we lend to i.e. being rigorous about not lending to more cyclical industries, the private equity partners we do business with and the diversification of our portfolio are key to managing the cycle successfully.

Investors who are exposed to private debt with the right manager who has rigorous standards in the types of credits that they select; whilst also having strong monitoring so that they can react quickly when a company is not performing as well as expected; and finally has strong restructuring capabilities; will find this is an asset class that performs incredibly well through the cycles.

Zoi: Is the illiquidity premium worth paying?

Nicole: You do get an illiquidity premium within this asset class when you compare it to say high yield and I do feel it is a benefit to investors. It is quite hard to measure what the illiquidity premium is, although it is obviously there when you look at the returns of this asset class compared to some others. As important, is that within this asset class, the level of information that the lender receives on the underlying borrower is much stronger than in some more liquid alternatives. This is a contributing factor to the better performance of private debt as the increased information contributes to lowering the underlying risk.

If you are an investor who has some foresight into your cashflows or you are matching your liabilities to your assets over a five to ten year period and you don't need the flexibility to pull out of your investments very quickly, this asset class is absolutely the right one for you, because the premium that you get is absolutely worth it.

Sometimes the perceived liquidity that is inherent in other asset classes isn't there when it matters. The European high yield market is a good example of this, where if everything is going well then, yes, there is liquidity, but if things are going badly in general then there isn't liquidity. So, you end up not getting the premium or the benefit of it when it matters most.

Pension funds, insurance companies and family offices etc. would find that this type of asset class would suit their profile very well.

Zoi: Given that the vast majority of managers in the private debt space have not gone through a cycle yet, how effective will they be on a down cycle and where might the issues be?

Nicole: A lot of the investors who haven't been through a cycle as a direct lender might have been through cycles under different guises, some of them as CLO managers, which is quite a different proposition. And some have operated in different jurisdictions such as the US which works very differently than Europe.

As a result, a downturn could be challenging for a number of the unitranche lenders. Partly this will come from the concentration of their portfolios in two or so geographies, but where we are going to see the difference between good and bad managers with limited cycle experience is in how disciplined they have been in terms of the credits they have selected. When you look at some of the deals that have been funded, the discipline that we feel is so important is less apparent – for instance lending to companies in the retail space or companies with high capex. Some lenders argue that their control, through covenants or being the only lender, makes up for weaker credits. We don't share this view.

The benefit of investing with managers such as ourselves who have been through multiple cycles in the European market, is that we are more defensive and conservative because we know how credits and cycles work, and we have learned from past mistakes. When you are looking at private debt, it isn't about investing with the cleverest manager. It is about investing with the manager who is the most experienced. In determining how to minimise risk, it is obvious, when considering which industry to invest with, that retail is going to be more cyclical than healthcare, but you then have to understand how, within those industries, you choose the right partners. This means a company that is a leader or has a strong position within its field, with a strong management team, a responsible and experienced private equity owner, robust ESG policies within the company, to ensure that you invest with companies with sustainable products, with good corporate practices and positive (or at the very least not negative) influences on the environment.

Another benefit of experienced lenders such as ourselves is we have strong and deep relationships within the market. This means that we get to see many more transactions which allows us to be selective. One of the challenges for newer managers is that they don't have as strong a network or reputation, which means they don't have the luxury of being selective. For instance, in our senior funds, we have originated over 700 loans in the last 3 years but have only made around 90 investments. We have the ability to be selective; saying no a lot more than we say yes. This is key to seeing who the winners and losers will be.

Finally, having been through multiple cycles provides ample experience in how to deal with restructurings. These processes are complex, vary by jurisdiction and are most successful when all stakeholders are consensual and deal with issues early.

Of course, the challenge for investors in unitranche funds will be that they will have to wait to see what happens, because a number of European Private Debt managers just don't have sufficient relevant track records.

Zoi: Thank you for sharing your thoughts on this topic.

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