ALCENTRA

Going direct

Active in direct lending in both the US and Europe for over a decade, Alcentra has a unique global franchise. Global chief investment officer, **Paul Hatfield** discusses opportunities and risks in direct lending with **Graeme Delaney-Smith**, managing director and head of European direct lending, and **Paul Echausse**, chief executive and president of Alcentra Capital Corporation.

Paul Hatfield

Hatfield: *In each of your regions, to what extent is growth in Direct Lending due to market growth versus the banks' retreat?*
Echausse: If one assumes that commercial and industrial loan portfolios grow in proportion to GDP growth rates, direct lending has been growing much faster. While the growth rate for alternative lending has started from a smaller base, flexibility and customization benefits have shifted the advantage to non-bank lenders. This is particularly true in the U.S. lower middle market (EBITDA under $25 million).

Delaney-Smith: In Europe, growth is driven strongly by both. Banks have pulled back dramatically since the crisis due to credit issues, but also due to regulatory capital pressures which now reflect the holding cost of loans. There's also demand from issuers to diversify and grow the lender community. Alcentra can originate and hold large deals without using leveraged capital which is better for the borrower and the market. Activity is growing in deal volume and total capital and we expect to increase our investments and market share as part of a long term trend.

Hatfield: *Does the regulatory environment on either side of the Atlantic support or suppress the growth of non-bank lending?*
Echausse:Whether it's the Federal Reserve, OCC or State banking authorities, increased regulatory scrutiny of highly leveraged transactions has put traditional banks under the spotlight. By necessity, banks are carefully allocating capital and managing the size of these portfolios. Alternative lenders have significant opportunity to increase market share.

Delaney-Smith: In Europe, Basel III capital requirements and the historical lack of non-bank lenders strongly support the development of alternative lenders. For example, in Europe there are no business development companies (BDCs) or bank loan mutual funds. Direct lending supports a lower-levered environment of real money investing. This leaves the banks to focus their deposit funds on more suitable areas, such as providing shorter term credit and working capital financing.

Hatfield: *What is the mix between private equity firm sponsored and non-sponsored deals? Are there recognizably different characteristics to each type?*
Echausse: Forty percent of the deals we do are non-sponsored, in which we are lending to family offices, entrepreneurs and family-owned businesses. We have been lending to these market segments for more than a decade, and believe that they provide a good balance to sponsor-backed transactions. Non-sponsored deals typically have a higher yield than sponsor-backed transactions and total leverage can be as much as 0.50x lower, thus providing attractive risk-adjusted return.

Delaney-Smith: There are differences for both economic and legal reasons. We've invested across Europe over the last 20 years and developed significant experience and knowledge. The majority is weighted toward sponsored deals currently, but we expect and hope this changes as the market develops and non-sponsored corporates move towards non-bank lenders. We have several sponsor-less investments doing well and seeking further capital for growth which we are happy to supply.

Hatfield: *In Europe, are there jurisdictions that you are more or less comfortable investing in?*
Delaney-Smith: In Europe, you need expertise to know which countries to avoid completely, and within the countries where you want to do business, you need experience with local conventions, laws and risks. On top of that, you need experience understanding the differences between working with private and family-owned businesses as compared to sponsors. These issues require a customized due-diligence process, and country-specific structures and documentation. Europe is a series of sub-markets versus the US.

Hatfield: *At what size of debt package or company does the direct market overlap with the syndicated market?*
Echausse: There is a syndicated market in every part of the private debt markets. The lower middle market (EBITDA below $25 million) functions primarily on a club basis. In the upper middle market for credits in the $25 million to $50 million level, the market is deeper for syndicated loans. I would say that the cross-over point for the larger market is at the $50 million to $75 million EBITDA level.


Paul Echausse

Delaney-Smith: The crossover in Europe is a deal size of about €200 million currently, but the private debt market can handle larger transactions on a club basis. Alcentra has underwritten a number of €100 million transactions this year.

Hatfield: *Where are terms (leverage, spreads, floors, fees, covenants) today versus 12 and 24 months ago?*
Echausse: Given the geo-political risk that currently exists, and the volatility in equity markets, there is an element of selectivity in the US market. High quality names continue to benefit from strong interest. In the upper middle market, you see some market pressure: 90 days ago I would have said there was rate compression of about 50 to 100 basis points for subordinated debt on a year-on-year basis, and we do see some covenant-lite activity. But leverage continues to remain reasonable and credit discipline is the mantra for the moment.

Delaney-Smith: Terms aren't that different from 24 months ago. Compression has come in differing forms, say the removal of a floor, or limited tightening of the margin but retention of the floor. Fees are not under pressure, and nor should they be in the context of getting the transaction completed by a credible lender acting as lead arranger. We are seeing some shift to unitranche structures as compared to traditional senior debt and mezzanine. There haven't been any covenant-lite deals in the European mid-market.

Hatfield: *What government or agency actions could threaten these market opportunities?*
Echausse: We live in an environment where governmental/regulatory actions and oversight are a significant and increasing fact of life. Managers that embrace and master regulatory changes as opportunity can survive and thrive. We have chosen to embrace and master these opportunities. For example, we manage both private funds and a BDC, and are originating vehicles specifically designed to address different segments within the middle market and the needs of different investors.

Delaney-Smith: The social and moral hazards demonstrated by the crisis must encourage actions to regulate banks and ensure they never again prove too big to fail. This will facilitate structural change in the banking markets and hopefully allow banks to start paying meaningful deposit rates to their customers. The banking model should return to its roots of retail and community lending based on relationship.

Non-bank, specialist lenders are better equipped to assess and price risk and return. Importantly, their ability to act as managers for long term, patient capital allows non-bank lenders to provide longer-term and more junior capital giving companies a better asset/liability match so they can pursue growth opportunities with financing customized to their business, industry and situation, versus a bank's shorter-term, cookie-cutter approach. Our performance is evaluated by our investors, who make sensible decisions based on our returns.

Hatfield: *Given the attractiveness of the opportunity, how crowded is the space, and what are key criteria for investors to evaluate managers?*
Echausse: Investors should look at the risk-adjusted returns generated by a manager over a long period of time. We have been investing in lower middle market companies for over 15 years through a variety of economic cycles. We have seen competitors come and go. Longevity and patience is what business owners want to see. Longevity and strong risk-adjusted returns is what investors want to see. Fortunately, we've proven capable of delivering both.


Graeme Delaney-Smith

Delaney-Smith: The market in Europe is in the first stages of development. Managers with a track-record of sourcing relationships and with credibility are to be favoured. Many are trying to enter the market but whether they have true capability remains to be seen. Investors must look at whether they have sourcing credibility, and experience as lead arrangers. Managers able to demonstrate that they have deployed capital as a lead arranger in new transactions are limited to a few key players and this is likely to continue.

Hatfield: *Thank you gentlemen.* ■

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