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Q&A

European Mid-Market Borrowers Starved of Financing; Credit Investors Position for Recovery

High-yield asset manager **Alcentra**, with $22 billion in loan and bond assets under management, sees opportunity in European debt, particularly direct lending and CLOs, according to Chief Investment Officer **Paul Hatfield**. Money should continue flowing into both leveraged loans and high-yield bonds, as both are attractive in a rising-rate environment, Hatfield told Bloomberg Brief's David Holley.

Q: You issued your first European CLO since 2008 this year. Are more coming?

A: There isn't a huge amount of new issuance in Europe at the moment so size is very important. You need to be a large player to get good access to collateral in the loan market and you need to be large to get good execution in the loan market. You need to be large to get good execution in the secondary market as well. You have seen these skin-in-the-game rules come in Europe. It looks likely that they will come in to the U.S. next year. That inevitably has put a little bit of a brake on CLO issuance in Europe. Plus, the arbitrage is not as attractive as some people might like. You need to have a strong capital parent behind you. We've got BNY Mellon, who have been very supportive of us. That enables us to put the requisite 5 percent in European issues. We will continue to issue.

Q: What will risk-retention mean?

A: You'll see smaller managers who don't have the access to capital to put skin in the game, that's going to have more impact on them in terms of CLO issuance. You've seen some consolidation in Europe because of constraints on capital. You need to have somebody with deep pockets behind you.

Q: You started a 500 million euro fund for direct lending this year in Europe. Why?

A: We've seen huge withdrawal, retrenchment in mid-market corporate lending. Banks are facing new constraints in terms of regulations about getting balance sheet in order. They've had to raise capital, make asset disposals, to get their balance sheets in order for the new rules. One thing they've really withdrawn from is mid-market lending. There's a very pronounced lack of supply in the European market for mid-market corporate lending. I consider mid-market an enterprise value of $500 million euros. You don't have BDCs, and you don't have big retail funds to fill that gap. There's a big opportunity for managers like us.

Q: What kind of lending do you do?

A: There will be opportunities in senior, mezzanine and unitranche. For the illiquidity premium and the European premium, you're getting quite well paid. You're getting a couple of points at the senior level and perhaps a couple more in mezzanine. Without leverage you would expect to target low-double digit rates of return.

Q: What is the market capacity?

A: You've got us and a few other managers entering the market. The demand looks to be far outstripping the supply at the moment. As an individual manager you would constrain your fund at certain levels if you didn't feel you could properly ramp up while still being selective on what you put in the fund on a credit analysis. At the moment, we face many more opportunities than we can give full due diligence to.

Q: What are your investors asking for?

A: They are saying, I like the credit asset class. I want to play the European recovery. They say deliver us low-double digit returns by putting a chunk of bonds and loans in some liquid elements. We cover special situations. We have this direct-lending strategy. We have a structured credit fund. They leave it to us to determine the asset allocation. We can customize the solutions to be flexible to what investors want. We're seeing a lot of demand for that, particularly as people want to play European recovery. By that, I'm referring to Northwestern Europe which is where our exposure is focused. Really we're talking about Germany, which has done well throughout the crisis. France is an interesting market, [but] it's not enormously creditor friendly.

Q: What kind of demand do you see in Asia?

A: On the investor side, people positioning themselves on floating rates. If interest rates rise, people are wanting to access that opportunity through loan funds. We've had strong demand for high-yield bond funds out of Asia and we're starting to see some inflows again as they're looking for yield. Yield is driving the demand.

Q: What is your outlook for flows into loan funds?

A: There are still very strong inflows to retail funds. I see those continuing because so many people like the asset class. The volatility historically is lower than U.S. corporate investment grade bonds. You're getting paid a higher yield. You have this much reduced interest rate risk. I think that will prove attractive to investors throughout next year as well.

AT A GLANCE

Where you grew up: Chester, northwest England

Where you live now: New York most of the time, but I also spend time at my homes in London and East Sussex.

Favorite type of music: My children say "appalling." I prefer "eclectic."

Recommended reading: Three Cups of Tea – Greg Mortensen

If you could have another career, it would be: Formula 1 racing driver

Favorite food: Asian fusion **Favorite drink**: A pint of bitter in my local pub

Favorite restaurant in the city you live: Buddakan, New York

Favorite restaurant elsewhere: Le Manoir aux Quat'Saisons, Oxford