BENEFIT STREET PARTNERS Alcentra

FRANKLIN TEMPLETON

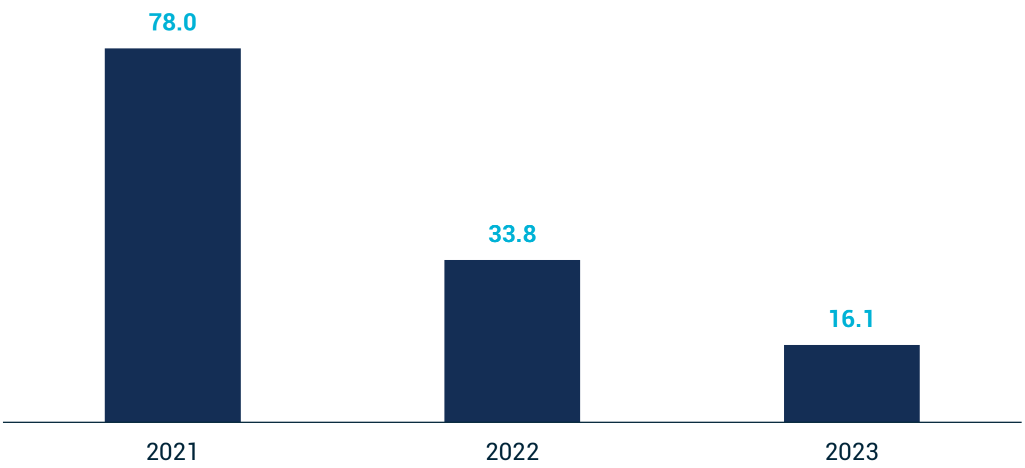
MARKET DYNAMICS CREATE HEADWINDS FOR UPPER MID-MARKET IN EUROPE

1. What is the recent trend in the European direct lending upper mid-market?

Since the end of 2023, a strong trend we have seen in the European private credit market is the refinancing of upper mid-market direct lending transactions by the broadly syndicated loan ("BSL") market. In most cases, these are private equity sponsored borrowers with €100 million+ of EBITDA, originally financed in 2021 and 2022 by direct lending deals. Due to the size of these loans, they were filled by a club of direct lenders in Europe, with each general partner ("GP") taking a slice of these deals which (at the lower end) were €300 million+ per transaction and as large as €4 billion in size.

2. Why is this happening now?

Loans issuance M&A volume (€ billion)



Source: LCD, 31 December 2023.

In 2022 and 2023, global M&A activity was relatively muted and banks underwrote a lower volume of new LBOs, as shown in the chart above. At the same time, we saw a strong trend of fundraising in private credit markets, with several GP's in the space raising multi-billion Euro funds for corporate direct lending. Given the limited activity by global underwriting banks and reduced public market capital to be deployed, a number of deals from the BSL market were absorbed into the private credit market, resulting in an increase in the number of large club deals that have been more commonplace in the US private credit market.

Since the beginning of 2024, we have seen an uptick in appetite for banks to underwrite deals, which has introduced fresh competition in the upper-mid market and those larger club deals are being refinanced back into the BSL market, which offers more attractive fees and margins for borrowers. This is a return of the market dynamics we observed prior to 2022, a co-existence of both markets where larger deals were syndicated in the BSL market and smaller deals were issued in private credit. We expect this trend to persist.

3. What are the implications for our markets?

a. Segmentation in the upper mid-market

It is likely that private credit will retain good levels of market share in i) the smaller end of the upper mid-market (transactions with debt amounts between €200 million and €350 million) where there is insufficient liquidity for the BSL market and ii) loans issued in Sterling. Borrowers with debt amounts above €350 million value the more favourable economic terms offered by the BSL market.

Additionally, the BSL market offers the liquidity that accompanies larger loans which means smaller to mid-sized deals naturally are more suitable for private markets.

This is not a unique occurrence in history, it is a restoration of the status quo that existed before global M&A activity dropped. Underwriting banks have become more competitive after two years of lower issuance, which is driving an increase in the attractive issuance in the BSL market. Thus, we are likely to see some growth in the opportunity set for bank loans which will retake the small amount of market share that had previously crossed over to the upper mid-market. The strength of the CLO market, with c.60 warehouses open, will easily absorb this new issuance.

b. Margin compression across the European direct lending upper mid-market

Increased competition from BSL has meant a squeeze on pricing has been felt across the European direct lending market, but the effects were not uniform. Naturally, the largest impact would be on the biggest deals that are strong contenders for moving back into the BSL market, with a markedly more subdued effect for the smaller transactions. Recent press (LCD) highlighted that the margin differential can be as much as 250 bps from the upper to lower mid-market. The recent Iris transaction in the upper mid-market appears to have offered private credit lenders a 500bp margin for the Euro tranche and 475bp for the US Dollar drawings, staving off perceived competition from the BSL market for this well-known credit.

c. Relaxation in upper mid-market terms

The three main competitive axes for lenders to make themselves attractive to borrowers – loan pricing, debt leverage and loan contract terms - are undergoing change. To stay competitive with the BSL market, we have seen upper mid-market deals that previously would have had a financial covenant move to becoming cov-lite. Again, there is recent evidence – in the case of the private credit financing of Trescal, signed in 2022 – that the incumbent lenders are offering significant reductions in the loan margin paid to dissuade the borrower from seeking a refinancing in the BSL market. Similarly, as margins have reduced, the leverage on deals in the upper mid-market has also increased from 4-5x times to c.6x times. The terms in the lower and core mid-market (borrowers with EBITDA of up to €10 million and €10-50 million respectively) remain intact, with covenants continuing to provide a key element of protection.

d. Worsening outcomes for upper mid-market LPs

For limited partners invested in upper mid-market direct lending funds, there are multiple consequences of this trend, including potentially lower cash multiples within their portfolios as the loans fail to reach their target duration and yields are compressed. They may also see fund deployment and diversification start to dwindle as the biggest GP's are not able to compete for the larger deals and are left with significant dry powder – or they are forced to accept worse terms. For LP's invested with multiple upper mid-market managers, they may experience overlap in investment positions across their portfolios.

In the table below are a list of large high-profile transactions which have all been refinanced since the start of 2024.

Deal	Refi Date	Original Date	Geo	Sector	Sponsor	Debt	Leverage	New Margin/ Fee (bps)	Original Margin/ Fee (bps)	Cov-lite?	Lenders
Norgine[1]	Mar-24	Jul-22	Norway	Healthcare	GSAM	€650m	TBA	TBA	625/350	TBA	TBA
P&I	Mar-24	Jan-20	Germany	Technology	Hg	c. €455m	-	425/-	-	Y	1
Ivirma	Mar-24	Apr-22	Spain	Healthcare	KKR	$550m+	4.5x	450/100	575/-	Y	3
Ardonagh	Feb-24	Oct-21	UK	Insurance	HPS	c. $3.3bn	5.5x	475/150	575/-	Y	6
Iris	Feb-24	Jul-18	UK	Software	Hg	c. £900m	5.5x	500/200	450/-	Y	4
April Group	Feb-24	Jan-23	France	Insurance	KKR	€1.2bn	5.0-5.2x	400/25	650/-	Y	10
Ingenico	Feb-24	Jul-22	France	Technology	Apollo	c. €1.1bn	2.4x	500/200	-	Y	1
Advania[1]	Feb-24	-	Sweden	Technology	GSAM & IK Partners	c. €855m	-	TBA	-	Y	3
DFG	Jan-24	Sep-18	Germany	Healthcare	Advent	c. €420m	5.2x	450/50	-	Y	1
Wood Mackenzie	Jan-24	-	UK	Business Services	Veritas	c. $1.3bn	~5.5x	350/25	675/-	Y	1
Howden Group Holdings	Jan-24	Nov-21	UK	Insurance	General Atlantic	c. $2.9bn	5.3x	350/50 400/25	325/100	Y	-
GGW	Jan-24	-	Germany	Insurance	Permira	c.€1bn	6.0x	575/200	-	Y	5

Source: Debtwire, Reorg, KBRA supplemented with Alcentra observations. Shaded rows indicate Direct Lending deals that have been refinanced by the Broadly Syndicated Loans market. Magenta highlighted rows indicate deals won by Direct Lenders.

[1] Norgine, Advania deal economics to be announced publicly.

4. What is the impact on Alcentra portfolios?

We believe this is a positive development for our European liquid credit platform and that there will be limited impact on our direct lending strategy, which focuses mainly on the core mid-market, where competition to direct lenders comes from commercial banks (rather than the BSL market) and where we are still seeing tailwinds from banks continuing to reduce their leveraged loan exposure, under pressure from regulators. We have designed a very complementary offering with little overlap for our investors who want floating rate exposure (with differing requirements as outlined in the table below), that will be fairly protected from the negative effects of this emerging trend.

Alcentra	EUR Loans Investors…	EUR Direct Lending Investors…
Market Size	€395 billion Target exposure to the European BSL market	€274 billion Target exposure to the core mid-market in Europe
Average Deal Size	~€700 million Target exposure to larger transactions	~€40 – 250 million Target unitranche transactions with at least one maintenance covenant
Liquidity	**Liquid (OTC)** 1. Require liquidity 2. Require immediate invested exposure 3. Require ongoing portfolio optimisation by adjusting sectoral/issuer exposures in light of new macroeconomic and idiosyncratic issuer developments	**Illiquid** 1. Investment horizon aligned with the private equity sponsor 2. Deploys capital as opportunities arise 3. Stable portfolio with opportunity to recycle capital throughout the investment period
Average Issuer EBITDA	c.€600 million average Target exposure to larger businesses that can be more resilient in a tougher macro environment	€10-50 million Target exposure to mid-sized businesses that can deliver higher growth
Discount Margins	c.475-525bps	c.575-650bps with arrangement fees of c.275-300bps
Number of Issuers	c.200 issuers Target a relatively more diversified exposure to high conviction names	c.35-40 issuers Target a relatively more concentrated exposure to high conviction names
Investment Focus	• Target highest risk-adjusted potential opportunities that are attractive propositions in the long term • Target healthy, growing and cash-generative companies in defensive sectors, typically with tangible assets • Limits exposure to cyclical sectors vulnerable to disruption, those with excess capacity and high competition, as well as those vulnerable to technological change • Target core northern European exposures as southern European countries generally tend to favour the borrower in both documentation and restructuring terms.	• Seeks opportunities where we can be sole or lead lender to maintain control over outcomes • Target B2B companies in defensive sectors with strong cash flow generation • Sponsor owned businesses represent 88% of our investing • 81% of transactions originated directly through longstanding relationships • ~79% of the EDL platform is invested in creditor friendly geographies in northern Europe

Key Risks

Past performance does not predict future returns.

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EDL – European Direct Lending

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