

Presentation on:

## European Direct Lending

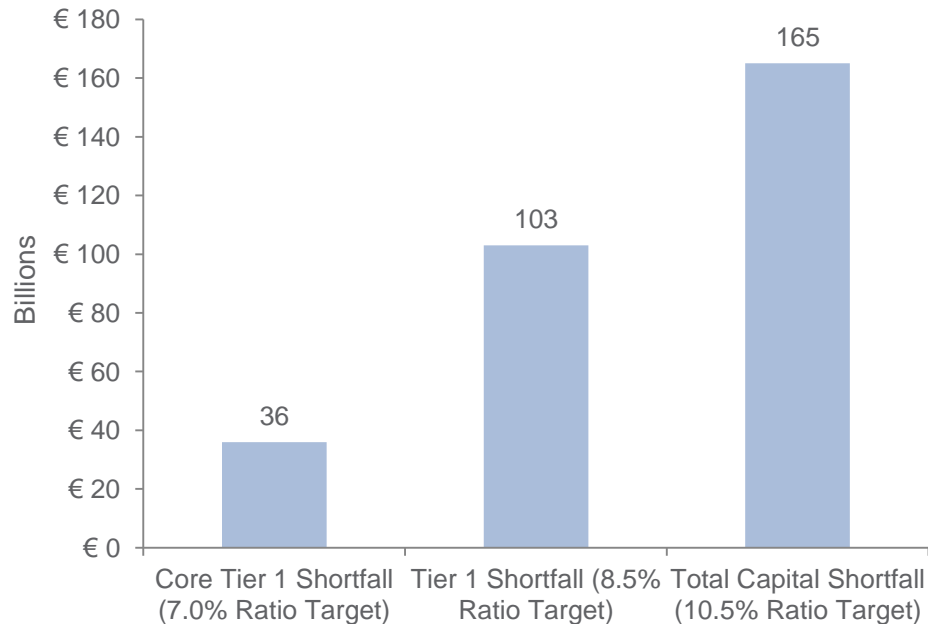


*May 2014*

## Macro-Economic Context: Supply of Capital

# Regulations Encourage Banks to Focus on Balance Sheet Size and Composition

## Estimated Basel III Compliance Capital Shortfalls<sup>1</sup>



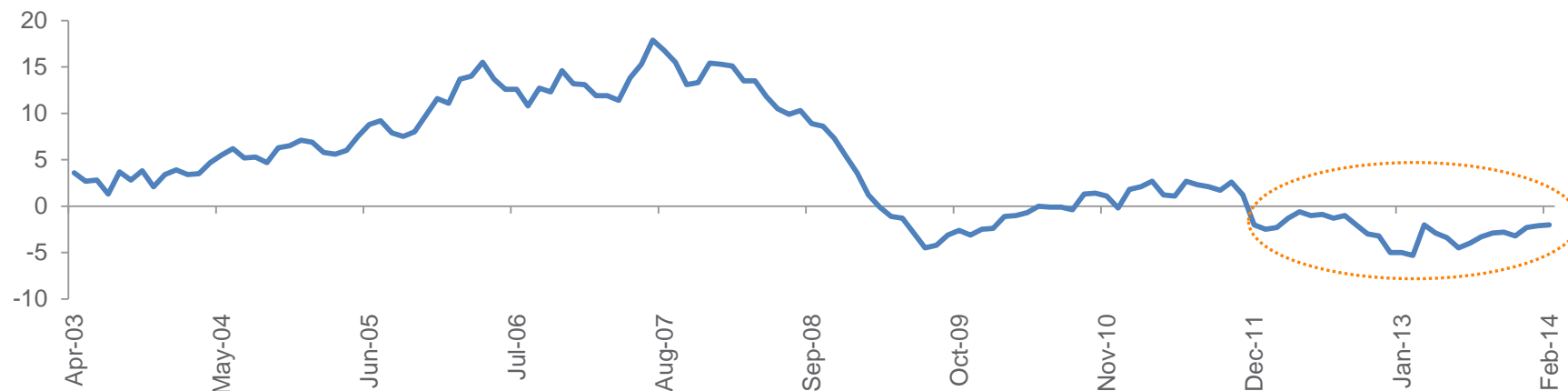
- Banks are under pressure from international and national regulators to meet higher capital ratios and reduce balance sheet risk
- European Banks are far from having deleveraged to the extent required by regulators
- Deleveraging in the European Banking sector is expected to take 5-7 years<sup>2</sup>
- Based on a conservative estimate banks have a shortfall of liquid assets of €262 billion<sup>1</sup>

**Retrenchment from lending by Banks creates new opportunities for non-banks lenders**

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# Banks Lending Cautiously and Reducing Emphasis on Non-Core Activities

## Loans to Non-Financial Corporations across the EU<sup>1</sup>



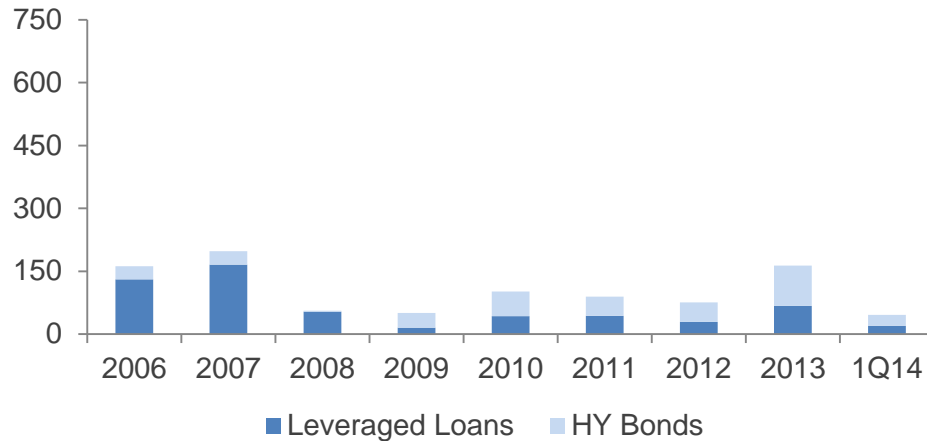
- Faced with regulations and volatile market conditions, Banks are favouring traditional retail and larger corporate credit
- Bank preference towards financing larger publicly traded companies stems from the following:
  - Significant underwriting fees
  - Ancillary business
  - Credit risk is more standardised and typically easier to assess for listed companies

**Direct lenders could fill the financing gap left by Banks**

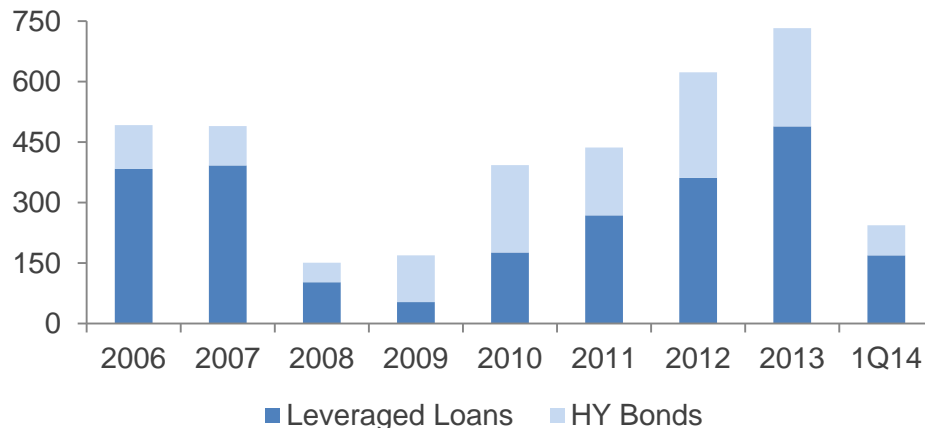
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# Lack of Alternative Non-Bank Sources of Financing

## European Leveraged New Issuance<sup>1</sup>



## US Leveraged New Issuance<sup>1</sup>



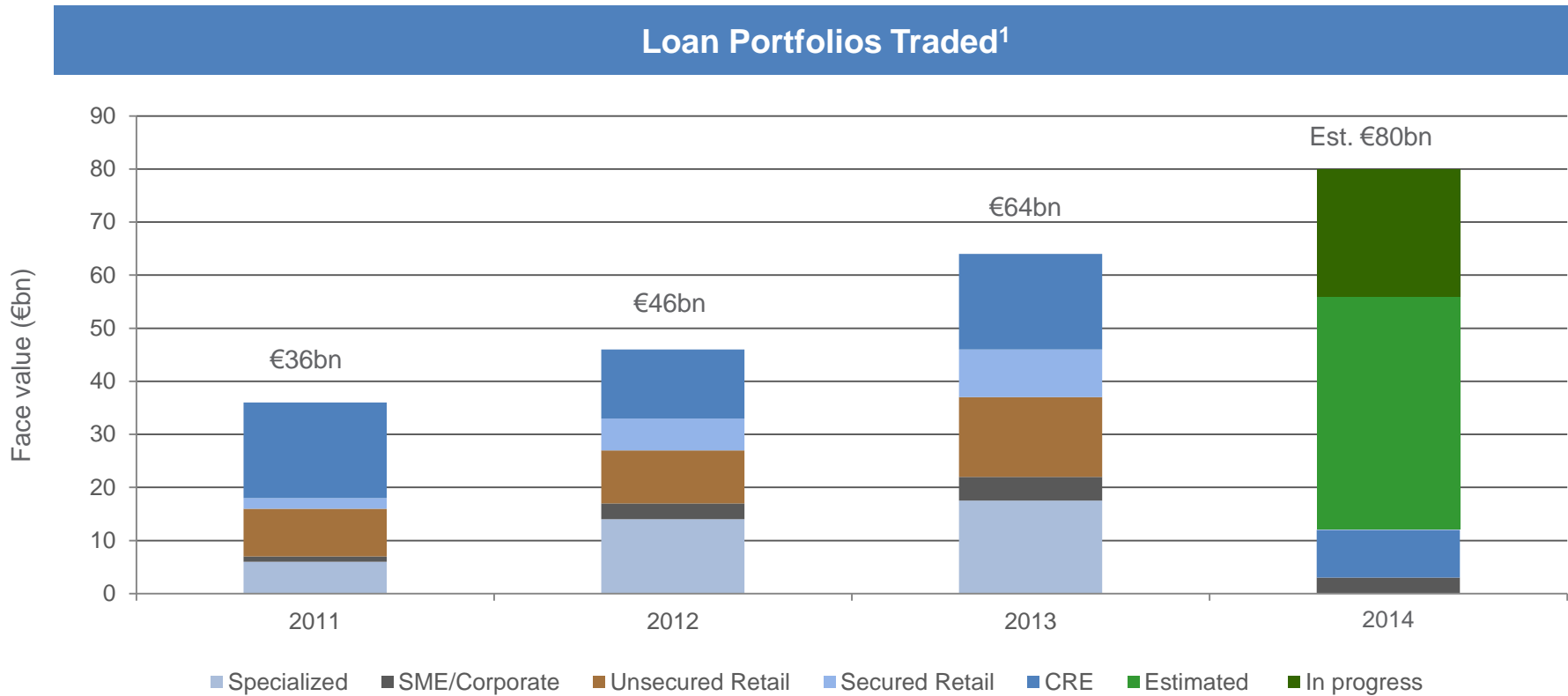
- The high-yield sector in Europe has historically been much smaller than in the US (\$232.5bn<sup>2</sup> versus \$1,050bn<sup>3</sup>)

- Institutional leveraged loan new issuance volumes in Europe have declined sharply from pre-crisis levels

- Compounding this, in Europe (unlike in the US) there are no BDCs and only a limited number of private investors

**The shortage of capital faced by European companies is further exacerbated**

# €64bn of loan portfolios traded in 2013<sup>1</sup>

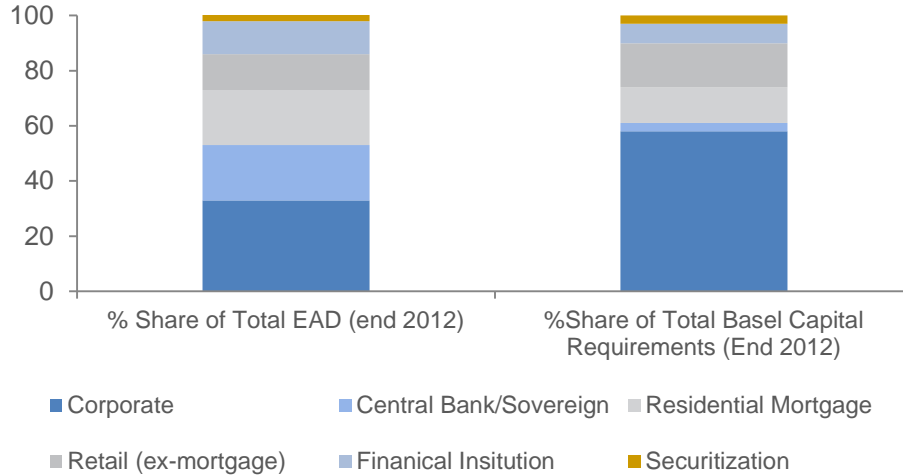


**CRE and unsecured retail remain the most actively traded asset class**

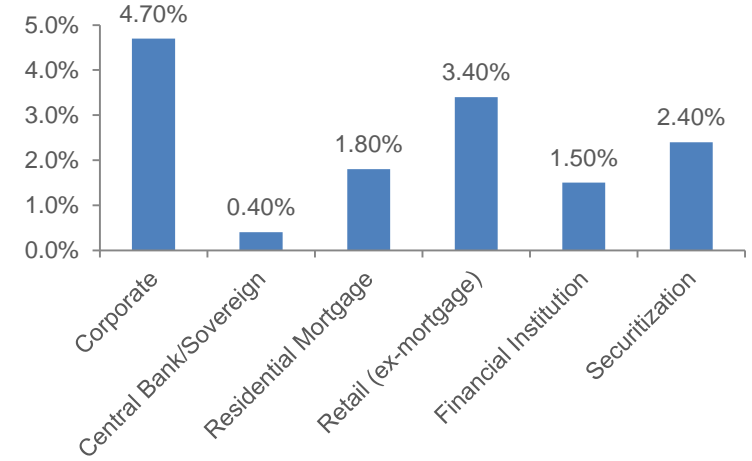
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# Banks Are Re-Allocating Across Balance Sheets Ahead of Basel III<sup>1</sup>

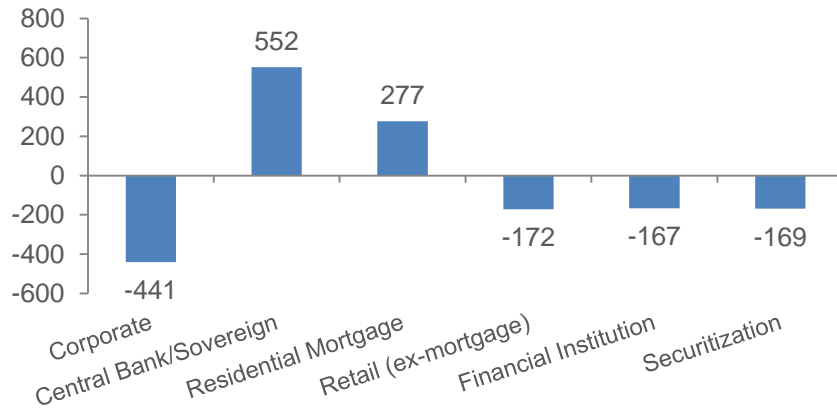
## Loan Portfolios Traded



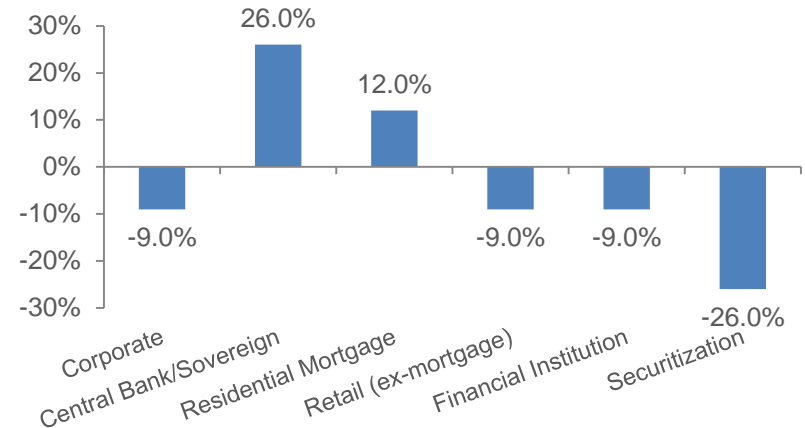
## Average Basel Capital Requirement<sup>2</sup>



## EAD, EUR Bil. Change Since 2010



## EAD, % Change Since 2010



<sup>1</sup>Fitch Ratings, December 6, 2013. <sup>2</sup>As % of EAD, End 2012

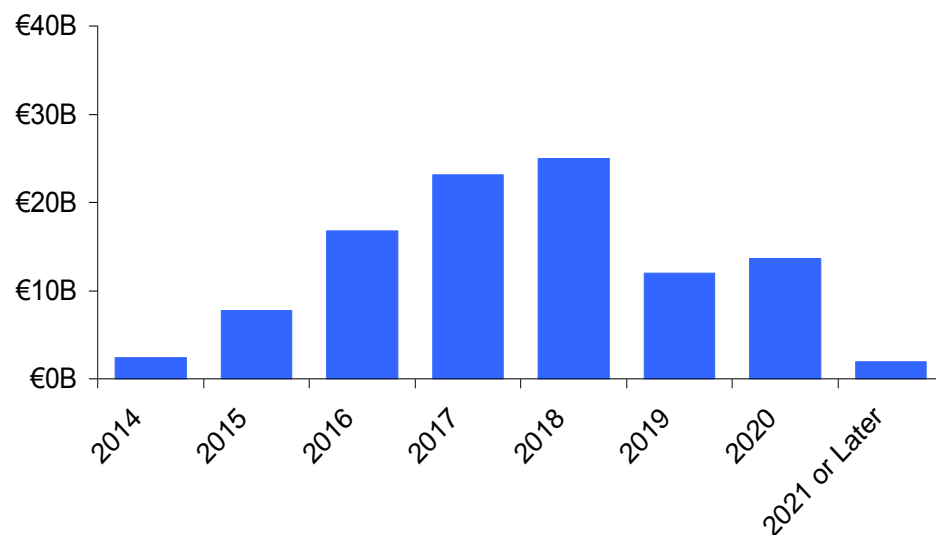
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## Macro-Economic Context: Demand for Capital



# European Corporates Refinancing Needs Set to Increase

## Institutional Leveraged Loan Maturity Wall<sup>1</sup>



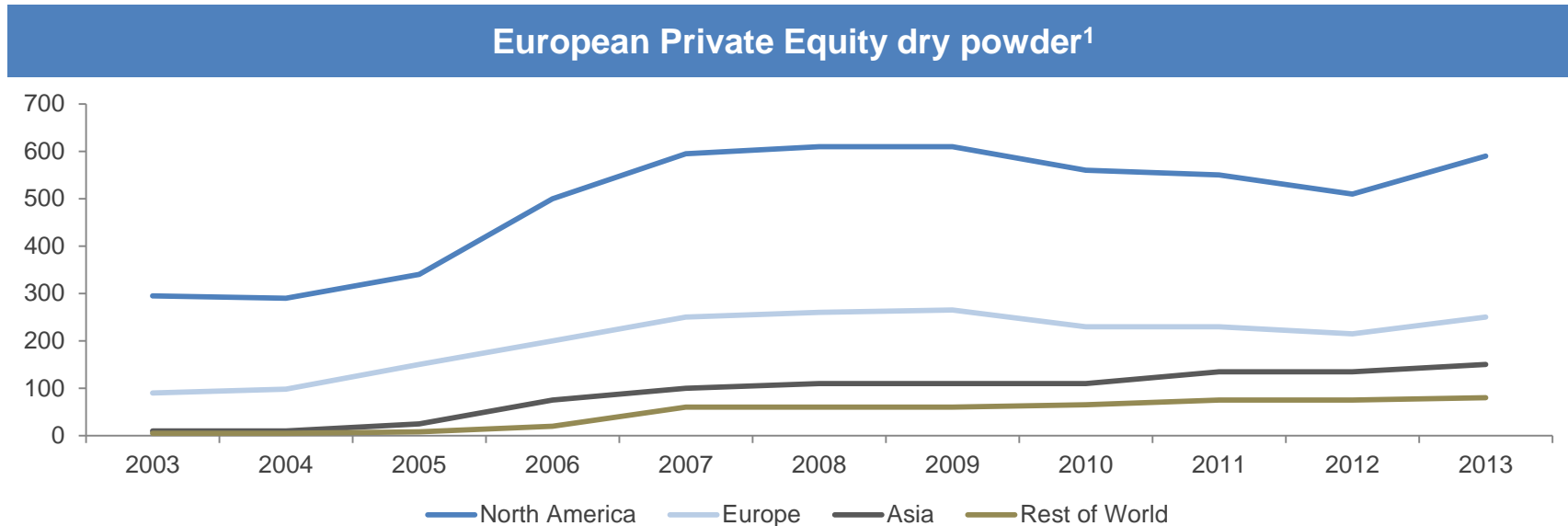
- The recent crisis and economic uncertainty have adversely affected refinancing plans of many corporate borrowers
- As a result, a number of pre-2009 LBOs, supported by debt maturing in 2016-2018, are now facing a so-called "Maturity Wall"
- The maturity peak for institutional European leveraged debt is currently expected to fall in 2018
- In Europe, corporate borrowers have much greater refinancing requirements than the public market is currently capable of absorbing

**Direct lenders can help businesses refinance maturing debt or restructure**

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<sup>1</sup>LCD European High-Yield Weekly Review, April 18, 2014

# Private Equity Dry Powder in Europe Remains High<sup>1</sup>



- The amount of capital committed to Private Equity Funds available for investment remains high (just over \$200bn)<sup>1</sup>
- As funds move closer towards the end of their investment periods, Fund Managers are keen to find viable investments and deploy remaining capital in the next few years
- The willingness of Private Equity Managers to invest creates opportunities for direct lenders to be brought in as lead debt arrangers

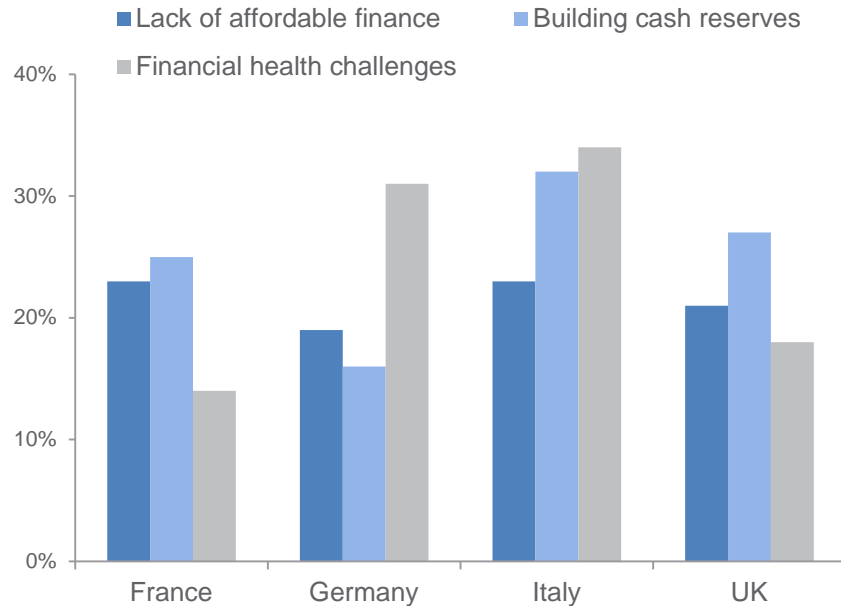
**Fund managers keen to invest on the equity side are driving demand for debt**

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<sup>1</sup>Preqin Global Private Equity Report, 2013

# Shortage of Capital Compounded for Middle Market Companies

## Financial Obstacles<sup>1</sup>



- 60-80% of SMEs in Europe are financed via the banking sector (versus 40-55% in US)
- High yield bond market in Europe is often difficult or impossible to access for middle market companies given an average issue size of €180mm
- Middle market companies typically require flexible lending solutions that are unavailable through public markets
- Euro area SMEs report in net terms an increase in their need for bank loans and a deterioration in the availability of bank loans<sup>2</sup>
- ECB survey results point to increased rejection rates for euro area SMEs when applying for a loan (12%)<sup>2</sup>
- The percentage of SMEs reporting access to finance as their main problem remains broadly stable (at 16%)<sup>2</sup>

**Scarcity of alternative sources of capital allow private investors to negotiate better loan terms**

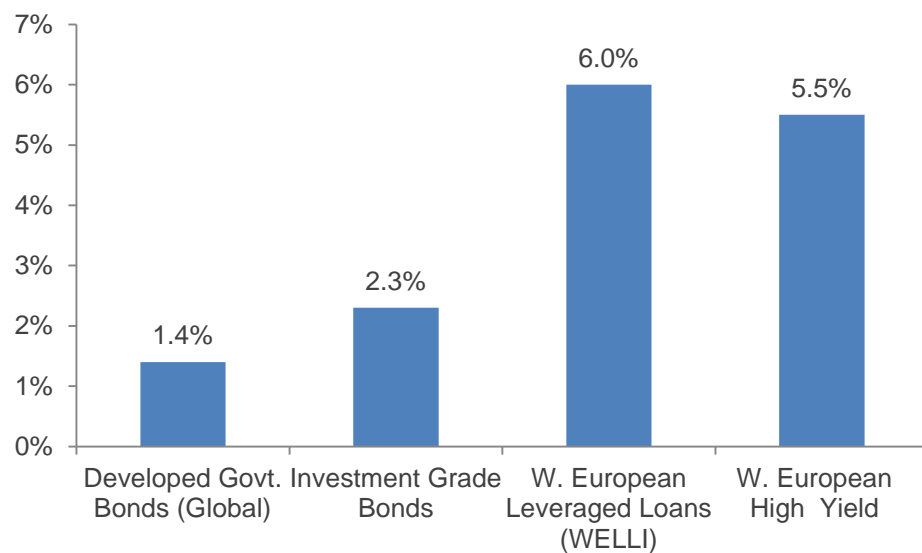
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<sup>1</sup>European SME CAPEX Barometer", GE Capital, June 2012. Research carried out in January 2012, and completed 1<sup>st</sup> week of February 2012. <sup>2</sup>ECB Report on the results of the survey on the access to finance of SMEs in the euro area – April to September 2013, 14<sup>th</sup> November 2013

## Opportunity: Attractive Risk-Adjusted Returns

# Private Lenders Able to Access Senior Debt & Capture Illiquidity Premium

## Expected Annual Returns of Various Debt Asset Classes<sup>1</sup>



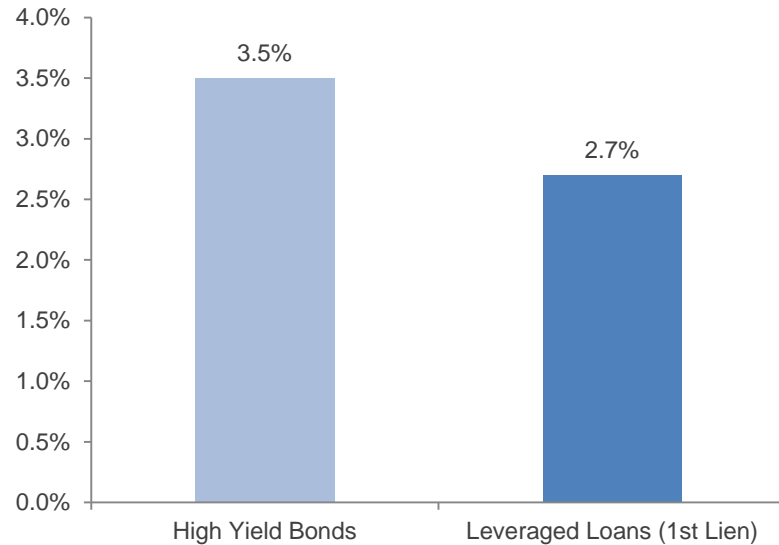
- Yields on Government and Investment Grade credit remain low due to high demand fuelled by market uncertainty and quantitative easing
- HY bonds produced a 9.1% in 2013<sup>2</sup>, however 2014 results are expected to be more modest with total return predominantly income as apposed to price appreciation (vs. 2013) with increased volatility
- Scarcity of capital is forcing some middle market companies to pay a premium to their lenders
- In European Direct Lending Spreads of Mid to High Single Digits are available for Senior and Unitranche loans

**Higher returns versus fixed income alternatives**

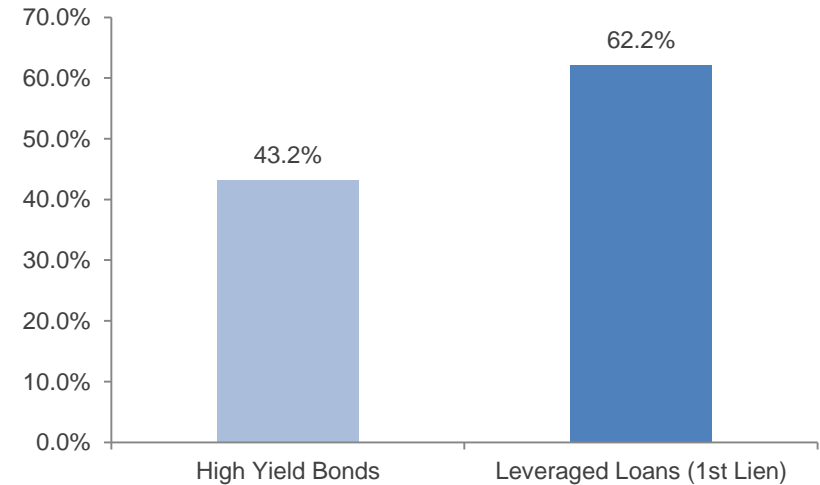
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# Historically, Loan Default Rates are Lower & Recovery Rates Higher Than High-Yield<sup>1</sup>

## Default Rates



## Recovery Rates



- First lien loans have experienced lower default rates compared to peer asset classes due to a lower risk profile of senior secured loans
- In the event of default, first lien loan investors are the first to be repaid and can request asset liquidation to generate the cash required
- The retraction of banks from middle market financing created an opportunity for private investors to tap into the safer senior loan market traditionally dominated by Banks

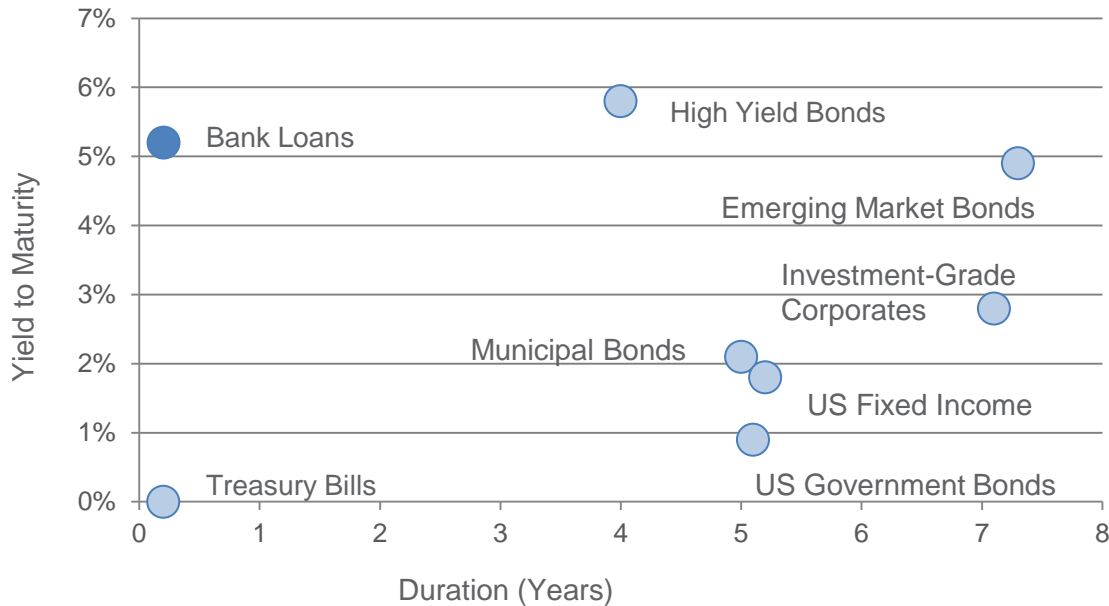
**Greater protection in the event of default**

<sup>1</sup>Credit Suisse (8 April 2014) 1995- March 2014

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# Floating Rate Nature of Loans Mitigates Impact of Rising Rates<sup>1</sup>

## Duration and YTM across Fixed Income Investments (March 2013)



- Empirical evidence suggests that senior loans act as a natural hedge in a rising interest rate environment
- The interest rate on senior loans typically resets regularly resulting in minimal duration risk
- Senior secured loans offer a compelling investment opportunity during flat and rising interest rate markets relative to other fixed income investments

**The floating rate nature of loans mitigates interest rate risk**

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<sup>1</sup><http://www2.blackrock.com/us/individual-investors/insight-education/featured-insight/point-of-view-with-james-keenana>

## European Direct Lending Investments



## Investment Characteristics: Geography, Type, Size

- Northern European countries, including the UK, are in Alcentra's opinion favorable jurisdictions for investment
- Companies with strong growth prospects in defensive sectors with no sector greater than 25% of commitments
- Middle market businesses with Enterprise Value less than £500m
- Approx. €5m – €40m lending amount per investment



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# Investment Characteristics: Returns, Protection, Approach

## Available Returns<sup>1</sup>

- Senior debt returns in the range L+5-6%; leverage  $\leq$  4x EBITDA
- Uni-tranche returns in the range L+8-12%; leverage  $\leq$  5x – 6x EBITDA
- Mezzanine returns in the range L+12-20%; leverage  $\leq$  5x – 6x EBITDA
- Transaction fees of 4% typical on current European investments

## Protection

- Direct influence over company decisions during the life of the investment
- Direct negotiations with Management Teams, owners and issuers
- Carefully prepared effective covenants with regular monthly monitoring

## Flexibility & Control

- Offer financing solutions and assist with strategic company development
- Close proximity to issuer allows debt holder to act faster in challenging times
- Pro-active involvement post transaction (Board observer and voting board member positions)

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Source: Alcentra <sup>1</sup>No investment strategy or risk management technique can guarantee returns or eliminate risk in any market environment.

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