Direct Lending - An Attractive Source of Long-Term Return

An allocation into direct lending can provide a diversified source of higher, less volatile returns over a longer-term time horizon

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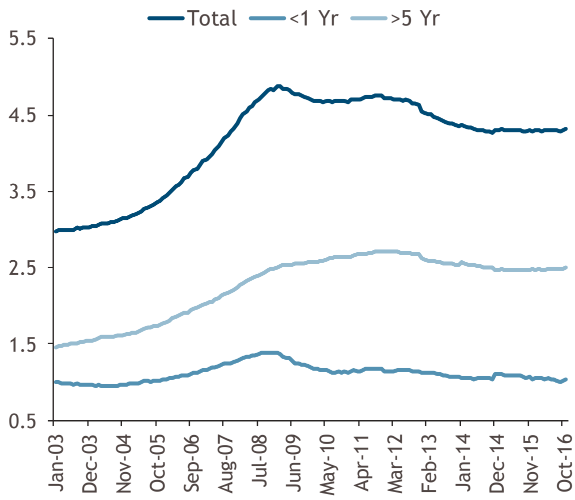
Since the 2008 financial crisis, heavier regulatory burdens have resulted in the need for greater capital requirements and stronger risk management for banks.

These evolving dynamics have led to a structural shift in the European lending landscape as banks retreat from the market. But while the role of banks as lenders has reduced, the borrowing requirements of businesses remains buoyant and growing.

This in turn has resulted in an increasing opportunity set for direct lenders - asset managers offering direct lending solutions who have stepped in to fill the lending gap left by the banks.

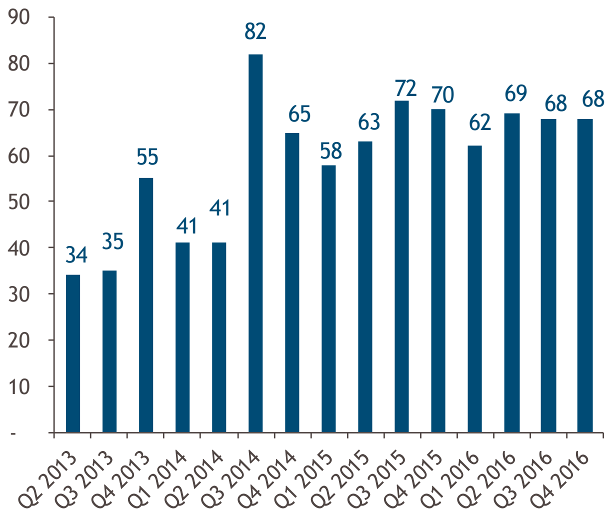
Fig. 1- European Bank Loans to Corporates Has Declined



Source: ECB, our statistics - banks' balance sheet - total loans to corporates November 2016

The role of a direct lender can be seen as twofold. The first is to supply funding to businesses such as small-to-medium-sized enterprises (SMEs) seeking bespoke lending solutions. The second is to offer investors an alternative investment capability with an attractive risk-adjusted return profile.

Fig. 2 - Non-Bank Lending Deals in Europe are Increasing



Source: Deloitte Alternative Deal Tracker Q4 2016

"In Europe direct lending is still in its relative infancy"

The private debt market is not a new phenomenon, with sub-asset classes including mezzanine debt, special situations, real estate and distressed debt firmly established in the marketplace. However, the sub-asset class of direct lending in Europe is a more recent occurrence because it evolved as a result of the financial crisis.

While the concept is embedded in the US lending landscape, where direct lenders sit comfortably alongside banks as a source of financing, in Europe direct lending is still in its relative infancy. Nevertheless, it is growing in popularity and we believe appears here to stay.

"The floating rate features of the investment instruments within a direct lending fund mean they are insulated from moves in interest rates"

A Long-Term Investment Allocation

In a world of low yields in traditional fixed income, direct lending funds offer an attractive alternative source of return on a risk-adjusted basis when considered as part of an overall portfolio allocation. Consequently, institutional investors are showing increasing interest in these less-liquid strategies.

As central bank rhetoric turns increasingly hawkish, fixed income investors are looking for solutions that can provide protection from rising rates and market volatility. The floating rate features of the investment instruments within a direct lending fund mean they are insulated from moves in interest rates, while the illiquid profile provides protection from mark-to-market volatility. Investors are compensated for the latter with an attractive illiquidity premium, which leads to higher yields than liquid investments. The illiquid nature of the investment meanwhile sits well with the longer-term investment horizon of many institutional investors.

The capital and risk profile of the asset class can also be seen as attractive. Depending on the asset manager, debt can be positioned higher up the capital structure, which can offer greater protection against default.

A Focus on Origination

While we believe the opportunity set across Europe continues to grow in its appeal, how investors execute their investment allocation is something that should be taken under careful consideration.

We believe a strong team of highly-skilled, dedicated investment professionals focused purely on structuring and executing the best deals is key to a successful strategy in this space. Lenders can have a direct impact on the businesses to which they loan money, as well as a more direct influence on the outcome of their investment.

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Having a local presence in these markets is also vital in giving a lender the ability to invest into directly-originated transactions, as well as a greater understanding of cultures and jurisdictions. Therefore, we would encourage those considering an allocation into the direct lending space to approach a dedicated service provider.

From a lenders point of view, we believe the European middle-market is a particularly attractive segment of the market, with an estimated 100,000 businesses generating approximately €7 trillion in annual revenues and enjoying an estimated 4.9% annual revenue growth (Source: Amadeus BVD, as of 5th August 2016). The size and continual development of this market means there are ongoing requirements for new sources of debt capital.

Here to Stay

The European direct lending market emerged as a result of the ensuing chaos from the financial crisis. Yet we believe it is not a short-term trend. The financial crisis highlighted inefficiencies in the way businesses source capital, with the realisation thereafter that the system actually benefits from a diversified range of funding options. As we have witnessed in the US, we believe direct lenders can and do have a long-term role to play alongside banks.

This trend is being underpinned by a wave of changing regulations across Europe, making it easier for businesses to source capital from direct lenders. In the last two years Germany and Italy have relaxed the lending laws to allow non-banks to provide financing solutions. At the same time, we are witnessing tighter controls restraining bank lending activity still further.

Taking the US market as an example, we believe over the long term funding in Europe will be increasingly provided by the institutional finance market. Demand from SMEs is outstripping supply, which is providing a healthy technical backdrop and underpinning the long-term opportunity set.

In our view, direct lending appears here to stay. An optimal trend for both lenders and borrowers.

About the Author

Kirsten joined Muzinich in 2015. Prior to that, Kirsten worked as a Managing Director in the principal debt investing team at Macquarie, responsible for sourcing and executing transactions ranging from leveraged senior, unitranche and mezzanine debt to equity in the UK, Germany and Benelux. Previously, she worked for Silver Point Capital, a US based credit/distressed fund, in the private debt team in Europe. Kirsten started her career at Morgan Stanley in 1999, working in the generalist M&A and Leveraged Finance teams in Germany and London. Kirsten graduated from ESB Reutlingen and Middlesex University London with a B.A. Honors in European Business Administration.

About Muzinich

Muzinich & Co is a privately owned, institutionally focused investment firm specializing in public and private corporate credit. Founded in New York in 1988, today the firm has offices in London, Frankfurt, Madrid, Manchester, Milan, Paris, Singapore and Zurich. Muzinich offers a broad range of corporate credit funds across both developed and emerging markets and currently has around $35 billion of AUM and 153 employees, of which 76 are investment professionals.

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