INSIGHT

UK Private Debt - Open for Business

December 2018

UK private debt Co-Heads Grant Davidson and John Clifford, who have worked together for over 4 years, discuss the lending landscape in the UK lower mid-market, and why they believe now is an exciting time for UK private debt - for borrowers and investors.

Grant Davidson
Co-Head of Private Debt, UK

Before joining Muzinich, Grant was at Investec and Lyceum Capital where he was responsible for the origination and execution of funding opportunities in the UK lower mid-market. He has 13 years' experience of funding in the lower mid-market.

John Clifford
Co-Head of Private Debt, UK

Prior to joining Muzinich in 2017, John was a Managing Director in Investec Bank's Growth and Acquisition Finance division, where he oversaw a number of notable transactions in industry-recognisable names across a variety of sectors. John has 13 years' experience in lending to UK mid-market businesses.

What does the current UK private debt lending landscape look like?

We broadly segment the UK private debt market into three main providers of capital:

Micro Lenders (lending <£10m)

This segment generally comprises challenger-type institutions and a small number of micro private debt funds. We see the UK high street banks as remaining relatively committed to this end of the market.

Lower Mid-Market Lenders (lending £10m - £30m)

This is our main focus. Again, the UK high street banks operate here, but market intelligence tells us that they continue to retrench from the market (driven by their increasing loan regulatory requirements), and have significantly reduced their exposure to the UK lending market over the past 5 years. We envisage this trend will continue to accelerate over the coming years. As a result, this has opened up the market for private debt lenders such as Muzinich.

The private debt segment of this market is split between those lenders seeking returns greater than 10% and those seeking returns of between 6% and 10%. There are very few players in this particular segment of the market, which we believe gives us a strong competitive position.

Upper Mid-Market Lenders (lending >£30m)

We see this market as highly competitive from a lending perspective - margins and terms are coming under increasing pressure as a result of the large number of funds looking to deploy capital.

Are there any specific trends that you may benefit from in the current environment?

The lower mid-market, where we are focused, is experiencing a number of trends that we believe will continue to provide interesting opportunities for us.

Alternative lending deals continue to be on the rise, increasing each year in terms of volume, value and market share. Sponsors are increasingly choosing to partner with private debt funds due to the flexibility in funding structures and terms, along with greater speed and confidence of delivery. Banks meanwhile are continuing to move away from providing senior debt, with a preference for less capital-intensive super senior revolving credit facilities and working capital financing.

Larger direct lending funds are also moving away from the lower mid-market as they raise larger funds and need to deploy capital into larger deals.

Furthermore, an increasing number of sponsor-less companies are turning to direct lenders to finance growth, and we see this as a potentially interesting area for expansion over the coming years.

Additionally, we have seen a significant number of opportunities being sourced from the North of England (Manchester, Leeds, Sheffield, Newcastle, Liverpool).

While covenant degradation has been a theme much discussed in other areas of credit markets, covenants within the lower mid-market continue to remain a feature of transactions.

Are you facing any challenges in finding good investment opportunities?

No, not at all. Our team has a combined experience of over 25 years of investing in the UK lower mid-market. As a result, we have developed very good relationships amongst both private equity sponsors and debt advisers.

Introducers reference our candour when it comes to providing feedback on a particular asset, and we believe our reputation for transaction deliverability is one of our key strengths.

Brexit is clearly providing uncertainty for UK corporates and we are looking forward to a time when our potential client base has clarity on the implications on their day-to-day operations. Once we have that clarity, we believe there could be an uptick in deal funding opportunities, which could be positive for UK lenders.

Have you noticed any changes in credit quality of the companies you are working with?

Over the past few years we have not seen many changes in the credit quality of the companies that have been introduced to us. Each potential credit is analysed on a case-by-case basis and, although there may be short-term periods of what are deemed to be lower-quality, this is normally offset by periods where the credit quality of introductions is very high, in our view.

This trend has certainly been the case more recently where, over the past three months, we have deployed in excess of £65m into three transactions.

Are there any specific industries or sectors which you believe offer better opportunities?

We are a sector agnostic lender and, as such, we appraise a range of companies across all sectors. Our regional presence also enables us to source a good proportion of our transactions from the North of England.

It is fair to say that no particular sector offers better opportunities than others, rather we analyse in detail the credit qualities of each potential lending opportunity and price the risk on a case-by-case basis.

That said, over the past 12 months the sectors that have provided the most deal flow include technology, business services and travel/tourism.

For investors looking for additional yield, can private debt still offer an advantage over public debt markets, even in a rising rate environment?

We believe private debt has become a well-recognised and acceptable allocation in investor portfolios. While the liquidity in public markets can appear an attractive attribute, the yields available in private debt investments tend to be higher than those on offer in public markets.

Private debt investment products track the London Interbank Offered Rate (LIBOR). As such, there is minimal risk of decreases in capital values as a result of an increase in benchmark interest rates – this is especially important in a rising rate environment.

Additionally, by its nature, private debt does not trade on an active basis (i.e. there is no daily mark-to-market). As a result, there is generally lower volatility associated with private debt investments than can be experienced in public debt.

What do you believe are your main competitive advantages?

The number of players within the sector seems to have settled, with very few new entrants entering the lower mid-market over recent years.

The vast majority of UK private debt funds are based in London and work out of one office. However, we are one of the small number of lenders with a broader presence in the UK. We believe this provides us with a competitive advantage as it means we can access local deal flow.

Similarly, we are focused on both sponsor and sponsor-less transactions, whereas many funds prefer to focus on one particular client segment.

Perhaps one of the key challenges we face is to provide our investors with appropriate risk-adjusted returns. However, we believe we are well positioned to manage this risk. Fundamental credit analysis forms the backbone of all our investment decisions (in both private and public credit markets) and we spend a significant amount of time diligencing credits prior to any investment decision. We are also able to leverage the specific sector experience of our colleagues who focus on public market credit opportunities.

We are not looking to over leverage the companies we partner with, but believe the flexibility and certainty of delivery we can provide our clients is highly valued by them.

Typically structures are conservative, with meaningful equity contributions, and we seek to work with those management teams and private equity houses that have strong track records of supporting and growing UK businesses.

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