Lead Left Interview – Eric Green and Mark O'Keeffe (Part 2)

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This week we continue our conversation with Eric Green and Mark O'Keeffe of Muzinich and Co. Muzinich is a global institutional asset manager specializing in corporate credit; headquartered in New York, the firm has offices in London, Manchester, Paris, Frankfurt, Zurich, Milan and Madrid. *Second of two parts – View part one*

The Lead Left: Tell us about the outlook in Europe, where I know you all have been very active.

Mark O'Keeffe: We raise money locally for local investments. It's not a relationship value play. We have a deep investor base. Investing is probably most difficult in Italy. We raised the first private debt fund ever there, so we're a bit of a pioneer. But every strategy has to be reviewed in the context of the local economy.

There are some pretty aggressive institutions out there. Italy as a market has a number of "firm-owned" companies. In those cases we play the role of both investment banker and lender. In general, these smaller companies are less sophisticated about credit.

Eric Green: The public markets is an allocation business. You have global funds that have tactical capital, assessing relative currency moves, etc. The private debt business is about individual companies. In that sense, the UK is similar to the US. On the continent, it's *not* like the US. The legal regimes are different, for one thing.

And the scope of private equity is also very different. You need to be investing in family owned businesses. There are a few sponsors such as TA and Summit who are actively investing in Europe. But leverage is more conservative. In Italy, for example, we're a sole lender in one deal at only 3x! Absolute returns are lower, but so is leverage. Plus there are a lot of good manufacturing companies in Italy and Spain; it's not like the US.

And unlike here, banks *are* a factor in Europe. Twenty years ago banks had a strong private debt presence in the US. Private equity and debt funds found a way to invest through that. Europe is like turning the clock back in this sense. We began investing in 2014, putting on some good deals..

TLL: What about pricing and terms in Europe?

EG: For first lien debt, the spreads are around Libor plus 600 bps plus fees to get you to about a 7% IRR. Maybe some PIK on top of that for stretchier deals. In the UK, leverage might be a bit higher than 3x, perhaps 4x.

MOK: But upfront fees are better than in the US. You can earn anywhere from 2.5% to 4%.

TLL: What about size of companies?

MOK: Really we're focused on the lower middle market, around $5-15 million ebitda.

TLL: And who's the competition?

MOK: In the lower end of the middle market it tends to be resident country funds for 5-7 year capital and for shorter maturities banks. We have partnered with larger funds. For example, we did a new financing this quarter for a roll-up in the medical waste management space. It was about a $75 million deal. We brought in a larger lender group. We also were co-lead in Italy with a larger lender on another transaction.

TLL: So you're syndicating deals?

EG: We try to be collaborative. We can underwrite a $30 million deal and then sell down into the $20 million range. It's really situational. There's competition, but also collaboration. We have committed about $800 million equivalent and have invested $300 million equivalent across twenty portfolio companies.

TLL: What are your plans in terms of investing in the US?

EG: We have lots of experience here and while recognizing there is always plenty of competition. It's a very a large market with aprroximately 85,000 companies in the lower middle market with approximately one-third private equity owned. That leaves lots of opportunity. We have established legal structures and will be raising capital for the U.S. market in early 2017.

MOK: With a new US administration and a lighter regulatory touch expected, banks won't be making a broad move getting into leverage finance. The big banks will get bigger, especially with less regulatory overlay, and if the SIFI (Systemically Important Financial Institutions) definition goes higher. That all means the banks will leave the middle market behind.

EG: And in the meantime, lots of non-banks are getting bigger, such as Ares and Golub. We believe diversification is critical for investors.

In July 2014 we created a fund of funds for investing in public BDCs. This has attracted significant dollars from Asia. Since then we've tripled our AUM for that fund, and it continues to grow into a sizeable business.

TLL: What's driving that performance?

MOK: Yields are well above what their alternatives are. Despite concerns in the US about lack of growth and what we see as low rates, the rest of the world doesn't see it that way. This fund gives investors access to the US middle market, to proven good managers – though not all!

EG: It's easy to confuse the BDC structures with strategies. We think it has a lot of validity as a structure. We think it'll be utilized more and more. It will also continue to attract more institutional interest, but you need to focus on the fee structure. It's evolving. For example, Troy Mason and Greg Mason at Ares showed at the Wells Fargo BDC Conference that there's a significant backlog of private domain BDCs which might be likely to come into the public domain. That will help the sector; more choices will be better, although all this will certainly take time.

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