BLOG

# Brexit: A blessing in disguise for PE direct lending funds?

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**EMERGENCE OF PE DIRECT LENDING FUNDS IN EUROPE:**

In the aftermath of the 2008-09 financial crisis and in the wake of a new regulatory environment, commercial banks worldwide began deleveraging their balance sheets. As banks turned risk averse, lending became more restrictive. During this period of credit squeeze, mid-market companies were affected the most, as big corporations always had the option of tapping the public markets – both equity and bonds. It was during this period that direct lending emerged as a substitute for commercial banks in Europe. For investors, it emerged as a new asset class that had the potential of offering higher returns, in a world that was still coming to terms with next to zero interest rates.

Direct lending, as we know, refers to loans typically issued to mid-market companies (EBITDA typically in the range of EUR5mn-EUR75mn) by non-banking financial institutions. In Europe, it was only after the recession that direct lending came to the limelight. Within Europe, the UK emerged as the largest market in terms of direct lending deals, followed by France.

The emergence of private equity-backed (PE-backed) direct lending funds in Europe was not surprising, as it closely mirrored the development of direct lending funds in the US – various estimates put the share of bank lending in total external long-term financing at around 20% in the US, in sharp contrast to over 75% in the Europe. This clearly indicates that the European middle-market companies that were far more dependent on bank financing felt the maximum impact of the credit squeeze when banks turned risk averse. To address this growing demand, asset managers raised billions of dollars from investors to lend to companies, as fund houses stepped into an arena traditionally dominated by banks. As per Preqin, over USD18bn of capital was raised by Europe-focussed direct lending funds closed in 2015.
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Over the years, as the market evolved, borrowers have started accepting direct lending players in their own right and not just as a substitute of commercial banks. Corporations have been working with direct lending players for capex/LBO, while tapping commercial banks for working capital requirements. PE-backed direct lending funds provided several benefits to corporations over financing from commercial banks or NBFCs, such as the ability to secure relatively large ticket-size loans, longer loan maturities, faster execution, and flexible/customized covenant terms. The evolution of new debt structures such as ‘unitrache’ further facilitated this change in their financing preference.

## IMPACT OF BREXIT AND OUTLOOK:

After months of speculation, the referendum result on 24 June 2016 in the UK made Brexit a reality, shocking both the financial and the political world. Even though the actual repercussions of Brexit (and any possible political contagion) will not be known for a long period, markets have been volatile across the globe, particularly in the UK. Historically, in the times of great volatility, investors have tended to dump the risky assets and have taken to presumed safe assets such as the US dollar, gold, and Gilts. Assuming history repeats itself (and some indications are already there, if rising gold prices are anything to go by), mainstream banks and other non-banking financial institutions are expected to take a cautious approach and become more risk averse. Hence, lending activity to SMEs (who are generally considered more risky) in the UK will become more restrictive, at least in the short term.

We expect that with their locked-in capital and higher risk appetite, PE-backed large direct lending funds, though cautious in the short term, will return to the market much sooner than their banking or NBFC counterparts. Effectively, it could mean a big potential opportunity for large direct lending funds to get an extra bang for their buck.

In summary, the story for large direct lending funds has played out like a fairy tale so far. However, the moment of truth for these funds will come when the European/global economy hits the rough patch next, prompting defaults by mid-market companies. Even before that, the party could be spoiled if the sector gets overcrowded and the yields decline (the US market being the case in point). Until then, the fruits of higher yields are there for investors to enjoy, conditional upon the fact that lending is done rationally and after thorough due diligence.

Acuity Knowledge Partners can play a key role in supporting direct lending funds of PE firms in tapping into this opportunity by providing research and analytics bandwidth that enables these funds to conduct due diligence on more opportunities (expand coverage) and in much greater detail (make well-informed investment decisions).





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