



# Why Europe?

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## Executive summary

**The European direct lending market is an attractive diversifier for institutional investors. In low interest-rate environments, investors globally are hunting for yield to meet their long-term liabilities. Appetite for direct lending has not been reduced by the Covid-19 pandemic – in fact, we believe the asset class looks both resilient and attractive.**

Despite being an illiquid product, private credit – and specifically mid-market direct lending – proved to be less volatile than high-yield bonds or leverage loans in Q1 and Q2 2020, with smaller mark-to-market losses. In addition, the yield pick-up within European direct lending has remained extremely attractive compared with broadly-syndicated leveraged loans.

For investors looking to diversify their exposure through the European direct lending market for the first time, there are many similarities between the US and Europe. Notwithstanding of course the nature of the product, there is the range of institutional investors; the historic reliance on private equity as a driver of deal flow; and the transition away from traditional banks as the lender of choice for mid-market corporates.

But there are also significant differences, in particular the earlier stage of market development in Europe, with much more room to grow; the fact that European banks are still cutting back their corporate lending when compared to US banks; and the notably lower level of competition among direct lenders in Europe compared with the US.

In this brochure we aim to answer the questions most frequently asked about European direct lending. We also explain why we believe that Pemberton could be the right partner for prospective investors entering our market for the first time.



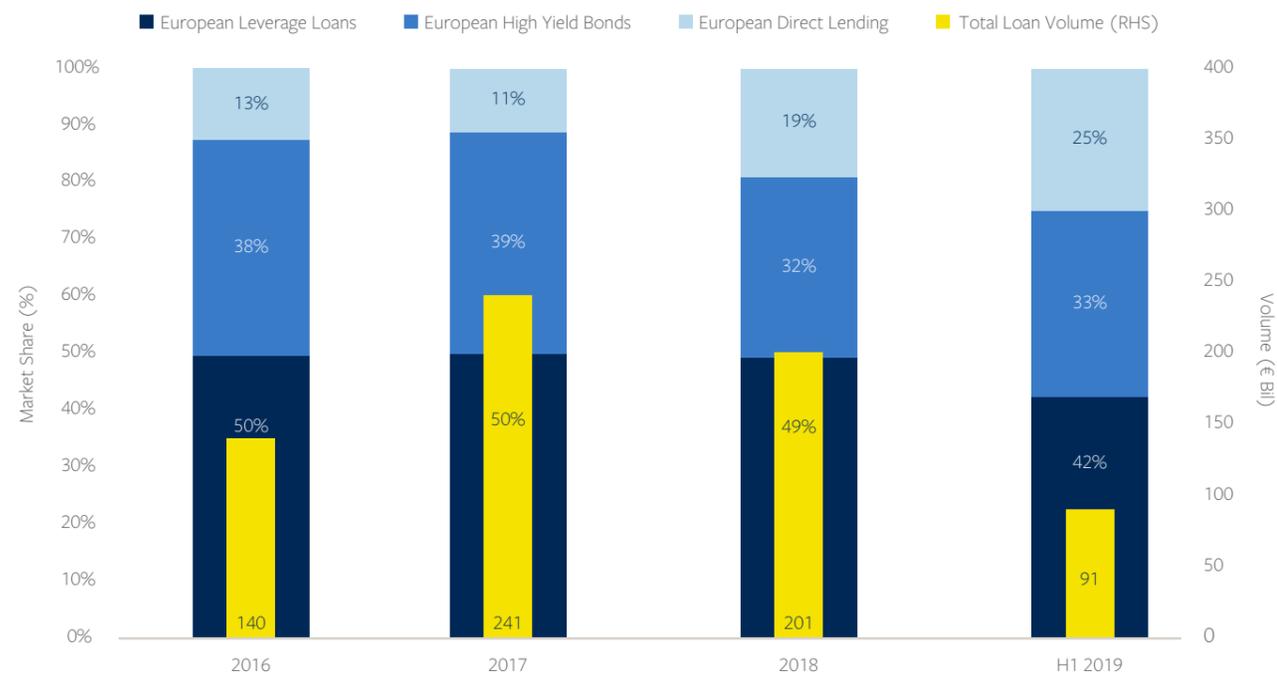
# Key characteristics of the European direct lending market

## 1. Shifting market dynamics

**US companies have traditionally had more access to public markets – high-yield bonds and syndicated loans – while in Europe corporates have been very reliant on bank lending. However the situation has changed since 2010, and the rise of direct lending has played a notable role in this. We forecast that well-established market trends will continue to underpin the sustained growth of direct lending in Europe through the next decade.**

Europe remains a market where loans dominate corporate funding. Against this backdrop, direct lending has been steadily taking an increasing share of mid-market loan financing in Europe. As you can see in Figure 1, in 2016 direct lending accounted for just 13% of the European mid-market loan market by source, compared with 50% for leverage loans and 38% for high-yield bonds. But by H1 2019 direct lending was taking 25% of the market, leverage loans 42% and high-yield bonds 33%.

**Figure 1: European market share by loan source<sup>1</sup>**



<sup>1</sup> This figure shows the deal volume of European leverage loans, European High-yield Bonds, and European Direct Lending for 2016-H1 2019. The data is based on 55 leading direct lenders and 1937 completed deals in Europe and published in Deloitte's alternative deal tracker Spring 2019 report. Source: LCD and Deloitte.



We expect that both the absolute and relative importance of direct lending in Europe will continue to grow, backed by several well-established drivers which we will now examine. Moreover, Covid-19 will continue to impact growth in the global economy for the next year, and we believe banks will continue to withdraw capital from the mid-market due to loan losses in the consumer and SME sectors – creating more opportunities for direct lenders to step in and continue.

**We forecast that well-established market trends will continue to underpin the sustained growth of direct lending in Europe through the next decade.**

## 2. Market size – room to grow

**Direct lending in Europe soared from just US\$1.5bn in 2009 to US\$90.9bn in 2018<sup>2</sup>. This mirrored the sector’s growth trend in the US but with a time lag of about five years. Based on the US experience, we expect that the European market will continue to grow substantially through the next decade as it is still largely under-represented in proportion to the economy.**

Direct lending in the US started in the early 2000s, but it was only after 2010 and the Global Financial Crisis (“GFC”) that we began to see the same trend in Europe. In terms of absolute AUM, over the last 10 years Europe has continued to lag the US by about five years<sup>3</sup> but following a decade of growth Europe now accounts for 37% of combined US/European direct lending<sup>2</sup>.

As a result of its earlier start, the US market has a more saturated market of private direct lending managers, but we believe that in Europe direct lending can continue

to take more market share from the banks. That should benefit those managers, like Pemberton, that are deeply embedded in the market.

So how much could it still grow? In the US, direct lending was equivalent to 74bps of GDP in 2018, while in Europe the figure was only 48bps<sup>4</sup>. If European direct lending comes into line with US levels in terms of direct lenders’ AUM as a percentage of GDP, the European market could grow by a further 50%.



2. Data source: Preqin.

3. Total assets under management (AUM) in USD for the US for 2006-2014 and for Europe for 2010-2018. Data source: Preqin Pro, World Bank.

4. Total assets under management (AUM) as percentage of GDP in current USD for each year starting in 2009 and ending in 2018. GDP for Europe relates to the European Union. Data source: Preqin Pro, World Bank.

## 3. Drivers of growth

**There are four main drivers that explain the growth of European direct lending: the decline in bank lending; banking sector consolidation; bank regulation that discourages SME lending; and the growth of private equity investment and its reliance on direct lending. We expect these same factors to continue to support the growth in European direct lending through the coming decade.**

### a) The decline in bank lending

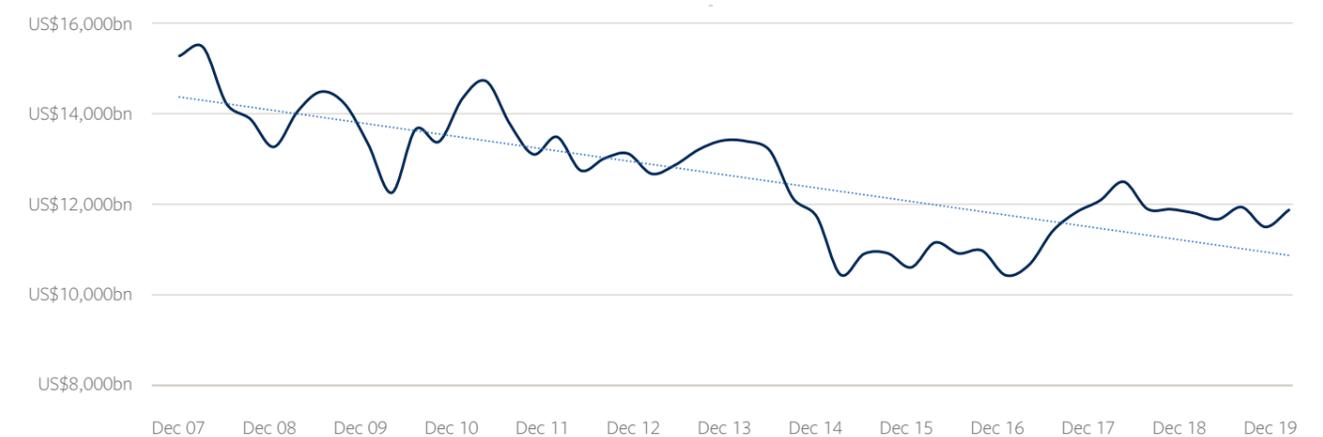
Traditionally, Continental European companies have relied on bank financing more than companies in the US or the UK that had more access to public markets. This situation was reinforced for mid-market companies by their more limited access to public markets and owners’ frequent unwillingness to dilute ownership through equity issuance. But as European banks have retrenched, direct lending has increasingly filled the gap.

The dominance of bank lending among European corporates has declined in recent years, although in 2018 domestic credit by banks to the private sector as a percentage of GDP was still 86% for the EU compared with only 52% for the US<sup>5</sup>.

However, the trend is definitely one of reduced bank lending, and bank lending has had a steadily diminishing role in Europe since the GFC. In fact, the relative decline since 2001 of domestic credit by banks to the private sector has been greater in Europe than in the US. Over US\$3 trillion of domestic bank financing has been withdrawn from Europe’s non-financial sector since 2007 (Figure 2).

However, while bank lending in Europe, especially to mid-market firms, has been declining, direct lending has expanded. It seems that this is in many cases a straight substitute for what would previously have been bank loans, although in certain capital structures – specifically towards the senior end of the structure- direct lending can complement bank lending.

**Figure 2: Withdrawal of US\$3+ trillion of domestic bank financing from Europe’s non-financial sector<sup>6</sup>**



5. Annual domestic credit by banks to the private sector as a percentage of GDP for the European Union and the US in 2018. Data comes from the World Bank

6. Bank for International Settlements (Euro Area – Credit to Private Non-Financial Sector from Banks in US\$bn), December 2019.

### b) Banking sector consolidation

Banking sector consolidation has been another secular trend in Europe since the GFC. The combination of the significant decline in number of banks and the fall in banks' assets in relation to GDP has created opportunities for private credit, including direct lending.

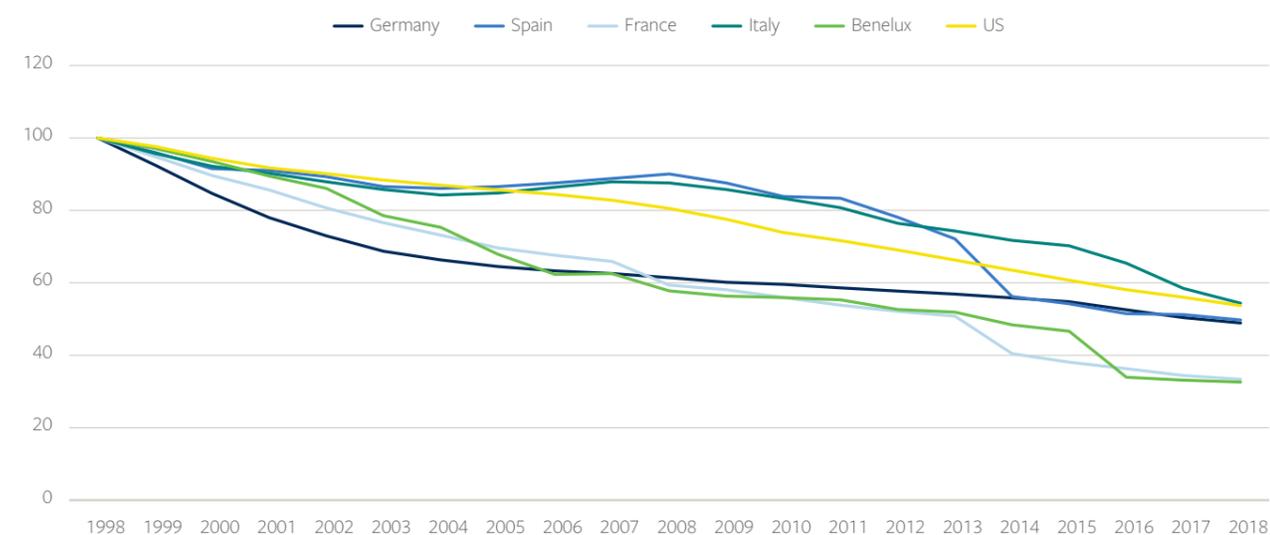
The last decade has been characterised by a significant and continuing reduction in the number of banks in most major European countries. In some, the number has more than halved – down by 50% in France and 60% in Germany (Figure 3). This reduction in the absolute number of banks has arguably been one factor in the shrinkage of bank lending, as successive mergers led to a smaller overall lending limit per borrower for the merged banking entity.

And despite this huge reduction in the number of banks, many analysts argue that the process of sectoral consolidation has further to run.

The decline in bank balance sheets relative to the economy has also been notable over this period. The ratio of European banks' assets to GDP has declined from 350% in 2008 to 260% in 2016<sup>8</sup>. Arguably, this reduction in lending has also been a driver in the process of banking consolidation, as decrease in lending has reduced profits and created a vicious circle of mergers and acquisitions.

Continuing pressure on banks' profitability may lead to further consolidation and retrenchment within the sector, although it is possible that the resulting larger, merged entities may become more profitable over time, which could ultimately arrest the trend.

**Figure 3: Number of banks<sup>7</sup>**



<sup>7</sup> This figure shows annual numbers of credit institutions in Germany, Spain, France, Italy, the Benelux countries and the US, between 1998 and 2018. (According to the ECB, a 'credit institution' is any institution that is either an undertaking whose business is to receive deposits or other repayable funds from the public and to grant credit for its own account, or an undertaking or any other legal person that issues means of payment in the form of electronic money). Numbers for each country/region are normalised to their 1998 values for expositional purposes. Data source: data for European countries and the US comes from the European Central Bank and the Federal Reserve Bank of St Louis, respectively.

<sup>8</sup> Bundesbank, 2018, <https://www.bundesbank.de/en/press/speeches/finding-the-right-measure-of-consolidation-in-the-banking-sector-729610>



### c) Banking regulation

Banking regulation has played an important role in the reduction of lending by European banks, and that process is likely to continue. Lending to SMEs has been particularly discouraged in Europe, which has opened the door to direct lenders.

The Basel III Accord increased the cost of credit provision and therefore the cost of loans charged by banks. This has been a feature of the sector in both the US and Europe, with similar results.

SMEs have been particularly affected given the higher risk weightings now applied to small business loans, and the resulting higher cost of such loans to borrowers.

The full roll-out of Basel III will only be complete in 2027, so it is likely that this trend will continue for more years. In doing so, it will provide an ongoing driver behind the growth of direct lending.

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**d) Private equity investment**

The rise of direct lending in the US was to a significant degree driven by the rise of private equity investment. In the early 2000s, major US private equity sponsors increasingly turned to direct lenders to finance their portfolio companies. Europe has followed the same trend, again with a time lag. And given the amount of ‘dry powder’ that European PE managers have at their disposal, we forecast a further boost to direct lending in the coming years.

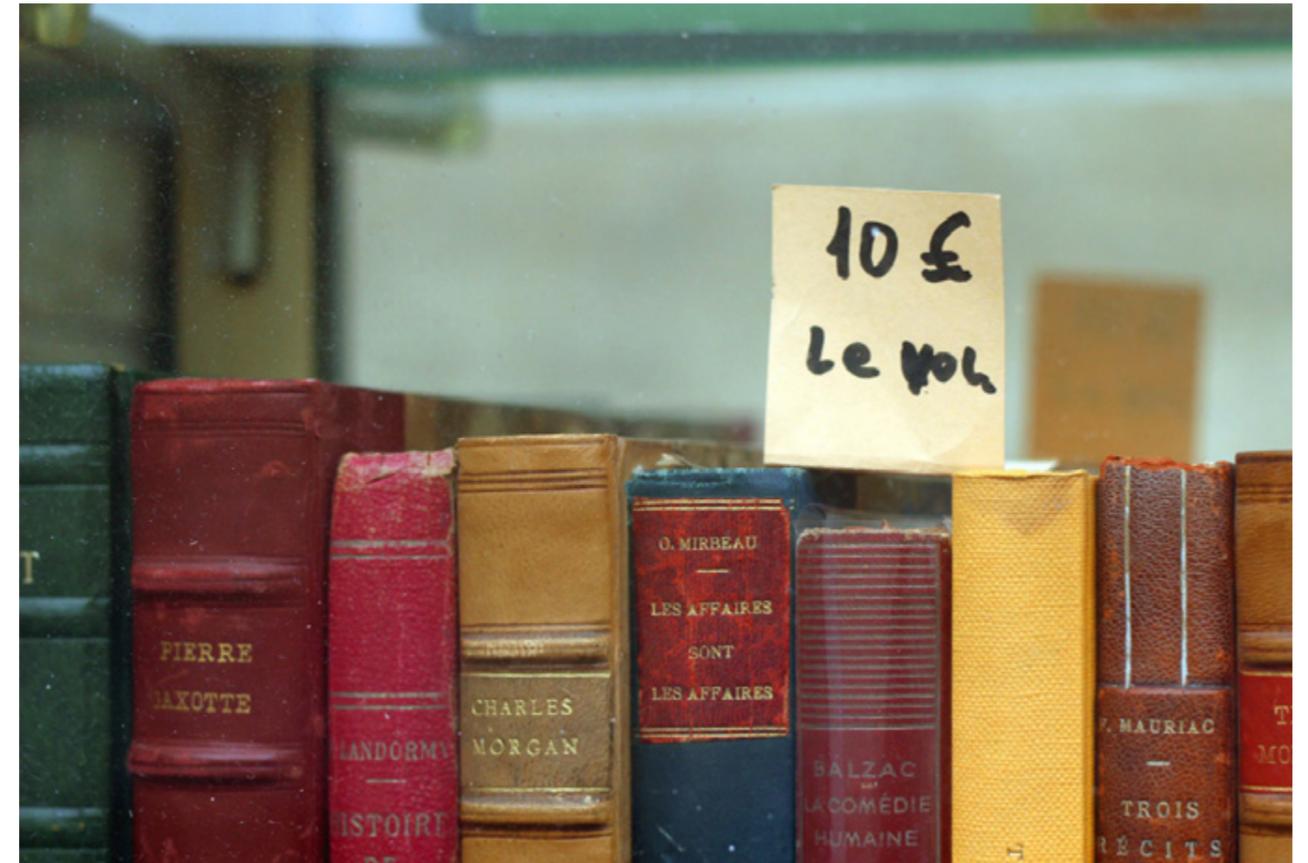
As previously experienced by the sector in the US, European direct lending has expanded over the past decade on the back of a buoyant private equity market. In fact, on a deal-count basis most direct lending in Europe involves a private equity sponsor – 81% of 495 deals in 2019 according to Deloitte’s 2020 Spring Alternative Lender Deal Tracker. This compares with just 40% of global direct lending deals recorded by Prequin for the period 2004-2019.

The appeal of direct lending to PE sponsors is clear: certainty in the lending rate compared with syndicated loans; relatively quick approval; and contractual flexibility tailored to specific business models. Many PE-sponsored borrowers are prepared to pay higher interest rates than on bank loans in order to access these benefits.

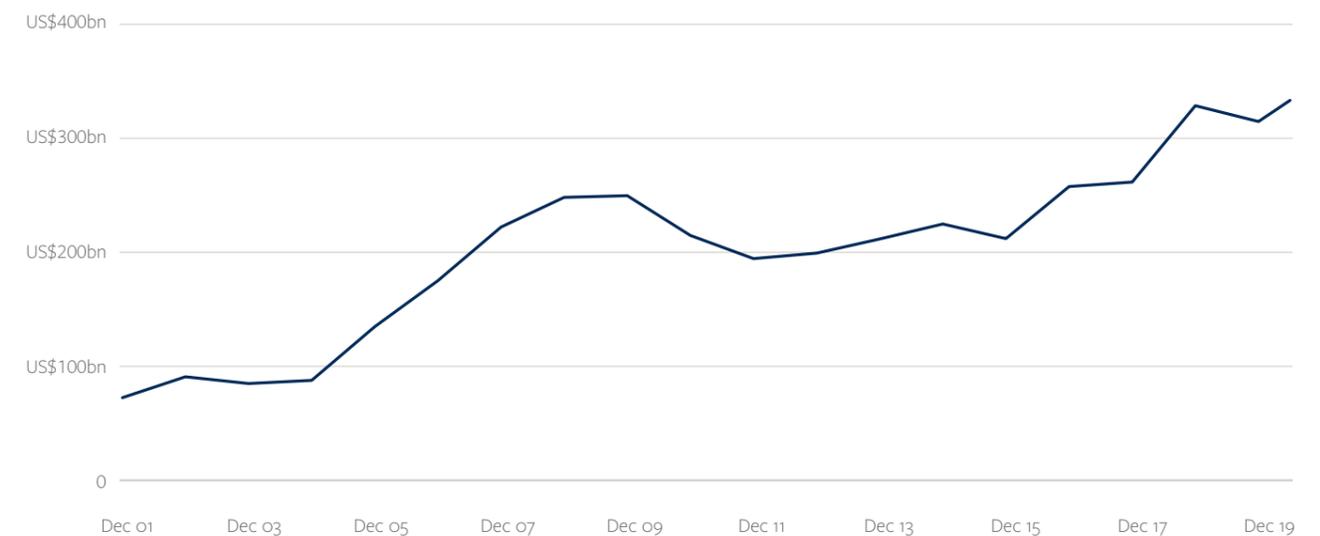
**We expect these same factors to continue to support the growth in European direct lending through the coming decade.**

Looking forward, European private equity still has a substantial amount of money that it could put to work. As of June 2020 the PE industry’s ‘dry powder’ was estimated at US\$333.3bn. When this amount is invested it should boost European direct lending volumes still further (Figure 4).

At Pemberton, we expect private equity to continue to be a major driver behind direct lending growth in Europe. However, the dependence of direct lending growth on private equity is far from total. In the 12 months to December 2019, 20% of 324 European (ex UK) direct lending deals were to non-sponsored borrowers and in the UK that figure was 16% from a total of 160<sup>9</sup>.



**Figure 4: European PE has a substantial amount of dry powder<sup>10</sup>**



<sup>10</sup>. Prequin Dry Powder (Strategy: ‘Private Equity’ and Location: ‘Europe’).

<sup>9</sup>. Deloitte Alternative Lender Deal Tracker Spring 2020

**e) Supply of capital from investors to continue**

The investors supporting the growth of direct lending are very similar in the US and Europe: insurance companies, pension funds, sovereign wealth funds, endowments & foundations, and family offices. Institutional appetite for direct lending has expanded in recent years, and we expect similar investors to commit more capital to the asset class. This will be helped by the fact that the market has become even more lender-friendly in the wake of the Covid-19 pandemic.

A growing number of institutional investors see direct lending as a relatively lower risk asset class where risk-adjusted returns remain attractive. According to Preqin, approximately 1,900 investors were active in European direct lending as of September 2020, 53% of them based in the US<sup>11</sup>.

Insurance companies and pension funds need steady income and are increasingly looking for investment opportunities in a continuing low interest rate environment. Given the outlook for interest rates across Europe, we expect this trend to continue, with more institutions increasing their allocation to alternatives and specifically to direct lending.

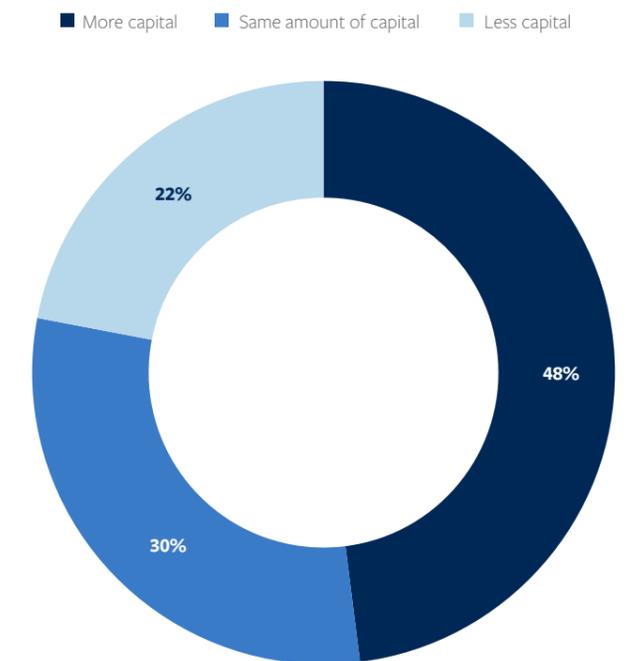
One positive factor is the relative strength of covenants. Mid-market direct lending has not experienced the same pressure on covenant structures and other lender protections seen in recent years in the syndicated loan market. A key attraction for investors in direct lending strategies is the downside protection offered by financial and non-financial covenants in the lending agreements with borrowers. At Pemberton, our loans have financial maintenance covenants and non-financial covenant protections that tend to be significantly stronger than those available in the broadly syndicated loan market.



The direct lending market has become more lender-friendly since the beginning of the Covid-19 crisis. The improved lending terms that we have been asking for on new deals generally include tighter documentation (baskets, payments, add-backs), higher pricing, stronger non-call protection and increased reporting requirements with rolling cash flow forecasts.

We expect this environment to persist, attracting more interest from investors in the asset class. Figures from Preqin suggest that as of September 2020, 48% of investors expected to allocate more capital to private debt funds in the next 12 months, and 30% said they would maintain their positions (Figure 5).

**Figure 5: Investors' expected capital commitments in the next 12 months<sup>12</sup>**



<sup>12</sup> Preqin Investor Update: Alternative Assets H2 2020, Expected Capital Commitments is: "Investors' Expected Capital Commitments to Private Debt Funds in the Next 12 Months Compared to the Previous 12 Months".

<sup>11</sup> Preqin Markets in Focus. Alternative Assets in Europe September 2020.

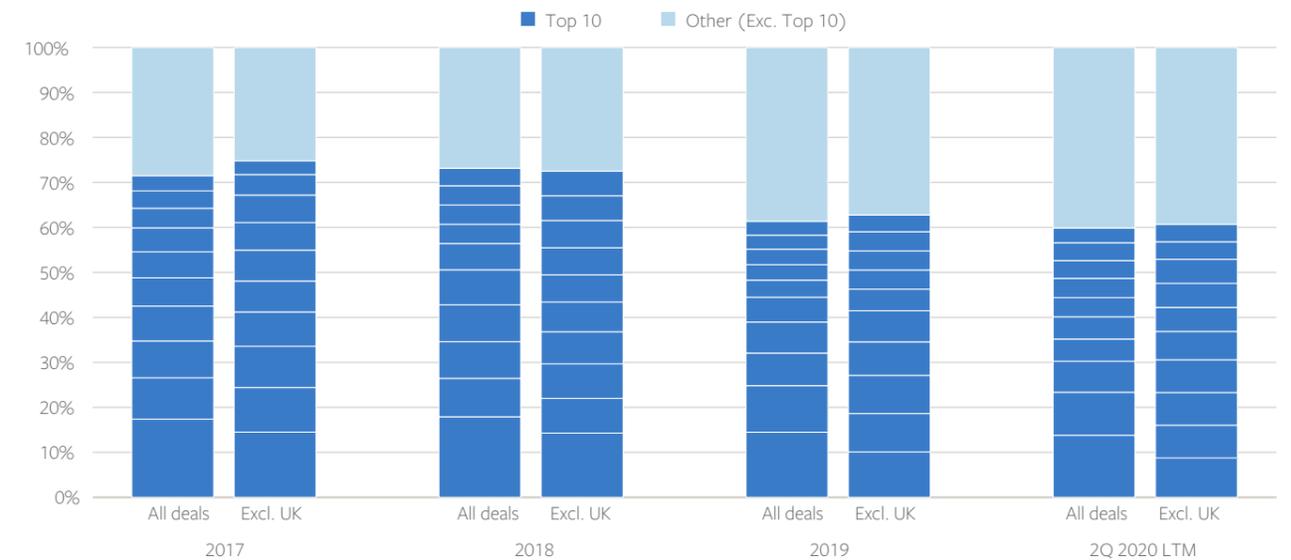
#### 4. Returns and relative value

Returns from direct lending in Europe generally compare favourably with those on offer in the US. In addition, the European market is less competitive, has fewer ratings actions and is experiencing a lower level of defaults than in the US.

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European direct lending remains less competitive than in the US, which is good news for investors. Half as many direct lending managers compete for mandates compared with the US, and the top 10 fund managers dominate about 70% of the direct lending market (Figure 6).

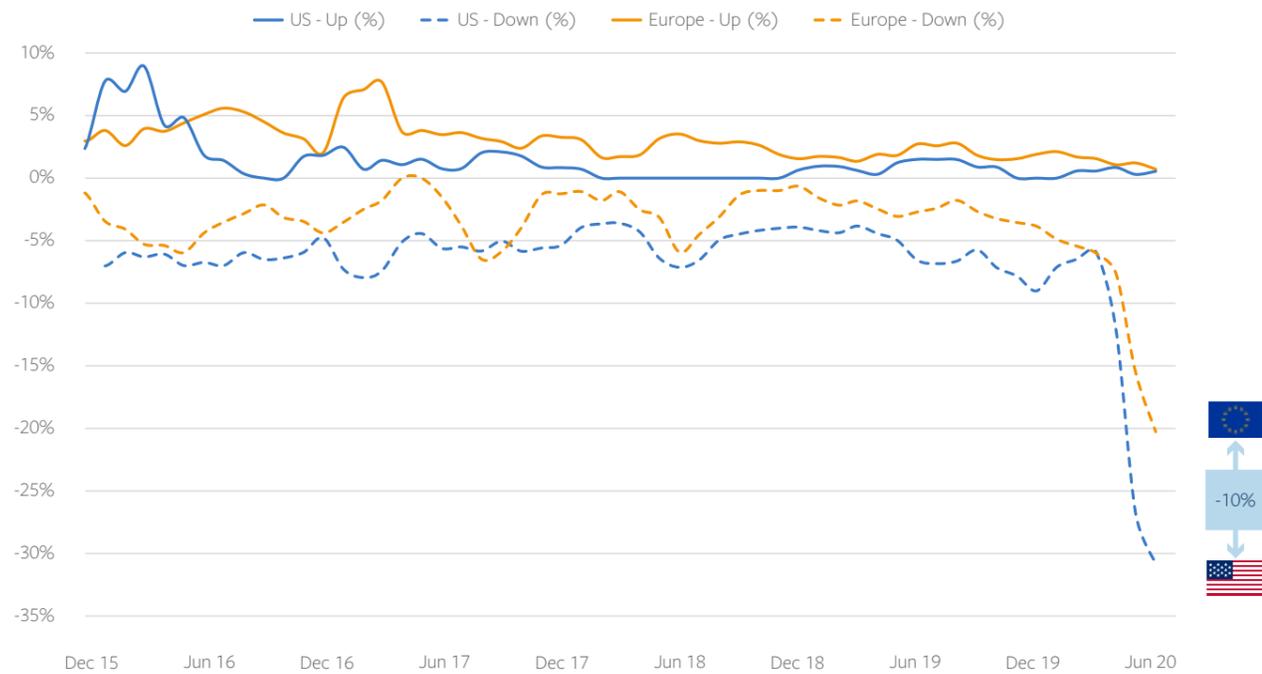
**Figure 6: The European private debt market is less competitive and the top 10 fund managers dominate lending. % of participated deals (Europe)<sup>13</sup>**



<sup>13</sup>. 2020 Q2 – GCA Altium MidCap Monitor – Unitranche Financings. Deal count figure is adjusted to reflect Pemberton's undisclosed deals.



**Figure 7: S&P LCD rolling 3M count of rating actions (% of total number of loans)<sup>14</sup>**

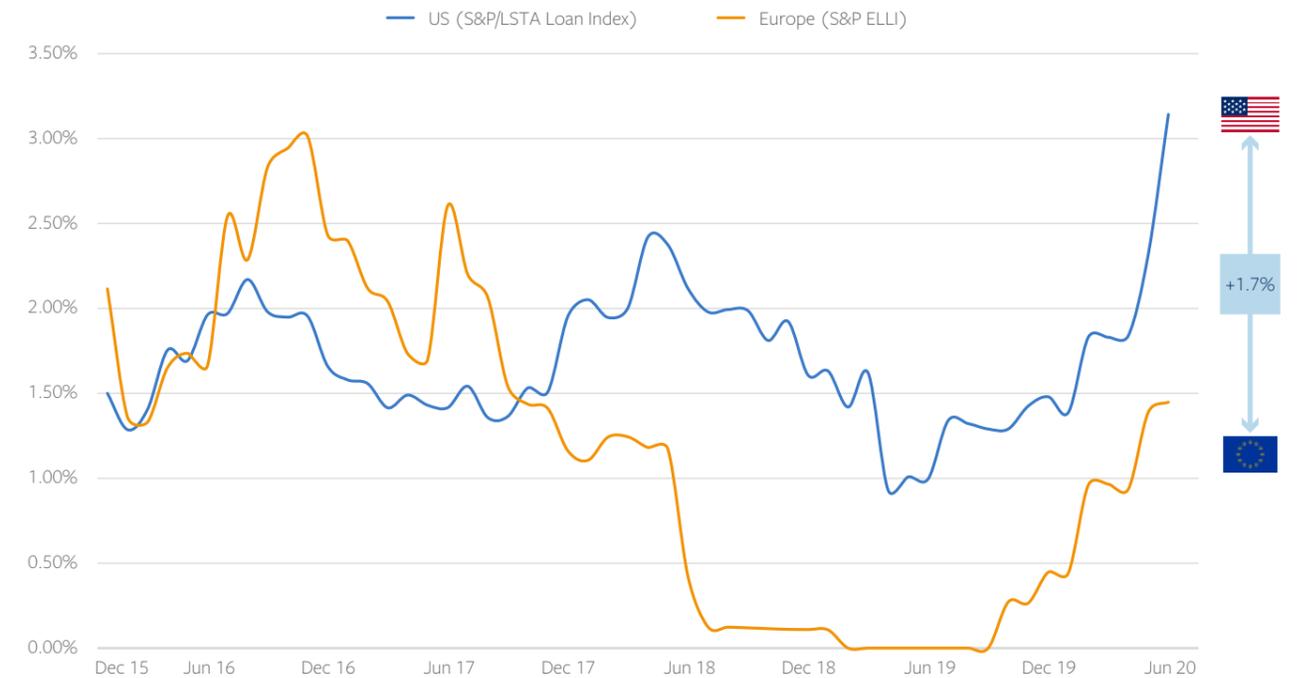


European direct lending loans typically have a lower enterprise value multiple, and there are often only five lenders on the short list. That compares with the US market, where higher multiples require more leverage and there are often 25 lenders on the short list<sup>15</sup>. Single-lender deals are more common in Europe, while club deals are more common in the US. This makes negotiation with sponsors easier in Europe and provides the direct lender with more control.

For investors new to the market it is also worth noting that Europe has recently had fewer downgrades and defaults than the US. As of June 2020, there were 10% fewer rating actions in the EU than the US (S&P LCD rolling 3-month count). Only 20% of European loans had had a ratings action, compared with over 30% of US loans. This came after a time when ratings actions in both markets had hovered between 0-10% (December 2015 to December 2019). (Figure 7)

<sup>14</sup>. Rolling 3-months Upgrades-Downgrades for US (S&P/LSTA Leveraged Loan Index) and Europe (S&P ELLI).  
<sup>15</sup>. First Avenue Partners LLP.

**Figure 8: S&P LCD lagging 12M loan default rate (by principal amount)<sup>16</sup>**



At the same time, as of June 2020 the loan default rate was 1.7 percentage points lower in Europe than the US (S&P LCD lagging 12-month loan default rate as of June 2020). The level of European defaults remained clearly lower than the US level since the second half of 2017, but recently that gap has widened (Figure 8).

The Covid-19 pandemic has meant that new deals are being structured more conservatively than previously. This includes tighter documentation, lower leverage, higher equity cushions and higher pricing.

At Pemberton, our due diligence process remains robust and we are focused on understanding the implications of the pandemic for potential borrowers both currently and with respect to potential future lockdowns. We also focus on sources of resilience, such as cost-base flexibility or the ability to deliver services online where applicable.

When dealing with borrowers whose business models are resilient to the impact of Covid-19, we believe the risk-adjusted returns in the private debt market are highly attractive.

<sup>16</sup>. Euro vs. US Lagging 12-Month Loan Default Rate: based on Principal Amount for US (S&P/LSTA Leveraged Loan Index) and Europe (S&P ELLI).

## 5. Why Pemberton?

**A small number of lenders dominate direct lending in Europe, and Pemberton is among them. We believe we are very well placed to understand and manage the risks inherent in mid-market direct lending. Our locally based approach helps both our origination pipeline and subsequent portfolio management.**

At Pemberton we segregate the types of risk we originate into clearly defined strategies. This allows investors to allocate to a specific strategy and understand the capital requirements fully ahead of making an allocation.

For example, beyond our core Mid-Market Debt strategy, we launched a Strategic Credit Strategy that provides senior through to mezzanine term financing.

We also have a trade receivables fund that provides short-term working capital loans to mid and upper mid-market companies.

In addition, we recently held the first close of our Senior Loan Strategy, which will enable investors to capitalise on the potential returns that can be achieved by providing senior secured first-lien loans to low-levered European mid-market companies. This is a very different approach from that of competitors who use mixed buckets that include mezzanine and equity risk.

We are confident that we have built one of the broadest financing platforms in Europe, with an array of products that can provide flexible financing to leading mid-market companies and competitive returns to institutional investors.

As one of the leading direct lenders in Europe, the scale of our platform gives us advantages at all stages of the investment process. Our 40+ dedicated investment team benefits from a highly structured and sophisticated monitoring process thanks to the 11-person credit team. Meanwhile our locally-based origination effort – with 14 people in the seven key origination markets in Europe (Q3 2020) – continues to engage with sponsors and companies at ground level.

**Our locally based approach helps both our origination pipeline and subsequent portfolio management.**



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