MV|Credit

The Growth of European Private Debt

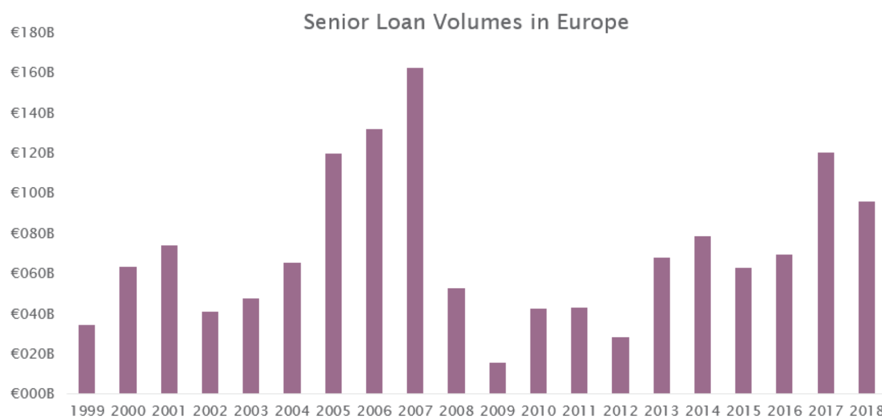
This paper examines the retrenchment of investment banks in the private debt space and the growth of private debt funds in Europe. We will review the following:

1. *Introduction to the leveraged loan market*
2. *Investment banks retrenching from the market*
3. *The evolution of private debt funds*
4. *Why invest in a private debt funds?*
5. *MV Credit in private debt*

INTRODUCTION TO THE LEVERAGED LOAN MARKET

The leverage loan market covers corporate leveraged loans in both sponsored (i.e. owned by a private equity sponsor) and non-sponsored borrowers with an indicative rating below Investment Grade (i.e. below BBB- or Baa3, typically BB- to B). Leverage loan instruments can be defined as Senior/First Lien, Unitranche or Subordinated Debt instruments. These instruments are characterised by their position in the capital structure and the increasing return-risk profile for the lender. The majority of the market falls into the sponsor backed segment and is private by nature.

The leverage loan market has grown significantly since the Great Financial Crisis ("GFC") where the market all but dried up as issuances slumped to record lows, mirroring the wider economic backdrop. As the global economy recovered, the leverage loan market swelled to sizes not seen since before the GFC, with demand from yield starved investors seeking an alternative to the record low interest rates seen on both sides of the Atlantic (leverage loans are typically floating rate and provide a natural interest rate hedge). This can be seen by the strong issuances recorded below in Europe:



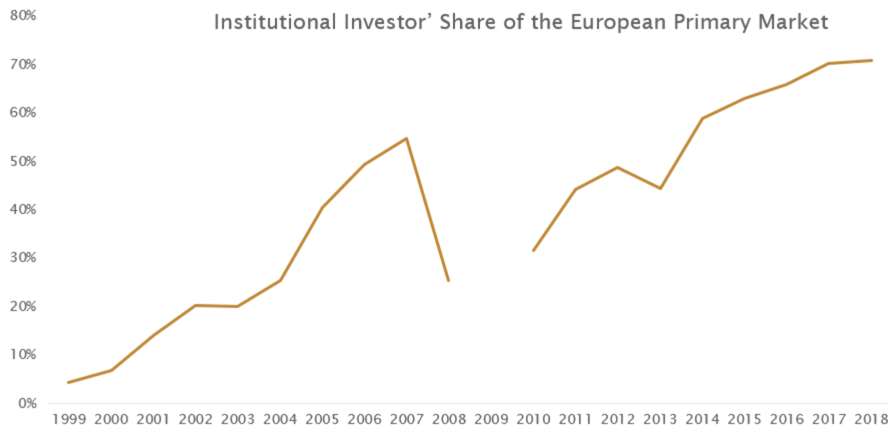
Source: EUR Global Leveraged Lending Report 2018 Q4 – LCD

It is worth noting that the above chart only represents the Senior Loan section of the market. Whilst this is by far the largest part of the private debt landscape, a function of the market being private means that a lot of issuances will not be captured in the data above, it is particularly hard to track the Subordinated and Unitranche segments of the market.

BANKS RETRENCHING FROM THE MARKET

Prior to the GFC, investment banks played centre stage in the private debt market, lending across the capital structure from Subordinated Debt (Mezzanine and Second Lien) up to Senior Secured Loans. This is especially true in the European market where over 80% of the market was underwritten by investment banks. This market is now dominated by private debt funds and asset managers, with c.70% of market share in Europe. What happened?

After the demise of Lehman Brothers, many banks had to retrench from the private debt market, as more stringent regulations were placed on them (Basel III and the Volcker Rule). Regulators started to pay considerable attention to what was held on banks' balance sheets and the capital they held against their assets. This has led to fewer banks operating in the space, and with the banning of proprietary trading, decreased liquidity in the market. Banks now cannot hold excessive inventory on their books in fear that this activity will be classified as proprietary trading rather than simple market-making.



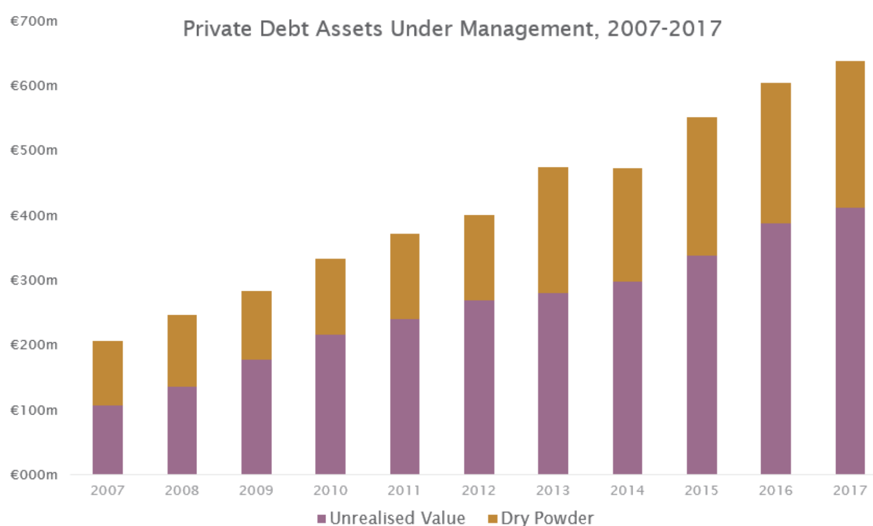
Source: EUR Global Leveraged Lending Report 2018 Q4 – LCD

Furthermore, banks are now incentivised to pull back during the bad times, leaving an even larger gap in an economic downturn for asset managers to fill the void. It is a well-established economic view that readily available credit is key to financial stability, and this is where asset managers (which can provide countercyclical capital) step in; this is a function of long term, nimble and patient capital. Asset managers are typically long-term investors, and therefore do not have to worry about market moves and can instead focus on the financials of the companies they hold, offering more opportunities to outperform.

THE EVOLUTION OF PRIVATE DEBT FUNDS

Private debt funds and asset managers capitalised on the gap left by investment banks to provide capital to business, which in turn supported the real economy and provided financial stability in 2008. This, coupled with investors demand for yield, has led to the rapid growth of the private debt asset class. Not only has the space expanded, new products such as Unitranche financing have been developed and deployed in size.

Asset managers keep raising record sums of money from LPs who wish to diversify and invest in private debt. Fund managers now range from pure-play private debt managers, to PE shops looking to expand into the asset class. Private debt is starting to become part of the central portfolio allocation model and no longer a satellite enhancement, with 42% of investors planning to invest more capital in private debt in 2019 than in previous years, the highest increase across all alternatives. The long term sees 54%[1] expecting to increase their allocation to private debt.



Source: Preqin Private Debt Online

As highlighted, private debt funds have a different set of strategic priorities and operational constraints than an investment bank or other vehicle (i.e. a CLO). This presents them with a unique opportunity to (i) generate attractive returns for LPs as they invest with a long-term mindset and (ii) to support the economy when the banks cannot.

[1] 2018 Preqin Global Private Debt Report

WHY INVEST IN EUROPEAN PRIVATE DEBT FUNDS

The European private debt market exhibits attractive risk adjusted returns (return per unit of risk) compared to similar asset classes. The floating rate feature of European private debt also provides a natural hedge against rising interest rates, something other asset classes, such as European high yield, do not benefit from. In addition, European high yield has higher defaults and lower recoveries than European leverage loans.

Furthermore, the illiquid nature of the capital invested into a private debt fund allows the manager a greater deal of flexibility. In a closed ended fund structure, a manager does not end up being a forced seller, therefore enabling a portfolio to heal itself naturally and reduce volatility in returns for the investors. If a fund manager has fixed term, illiquid capital, then the opportunity to resolve a potentially damaging credit improves greatly.

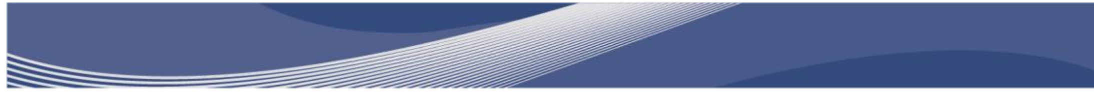
It is the combination of a strong asset class, with the long-term structure of the investment opportunity that makes investing in private debt funds an attractive opportunity.

MV CREDIT IN PRIVATE DEBT

The majority of the senior members of the MV Credit Team have been working together since the formation of MV Credit in 2000 and some have worked together since 1994. Together they have successfully navigated a number of credit cycles. With each successive fund, MV Credit has demonstrated its ability to adjust to different credit cycles by delivering consistently high returns for its LPs.

The team’s experience is extremely valuable when the European private debt market is relatively immature (especially for asset managers operating in the space) and even more so for the Unitranche product and incumbents. The key in private debt is experience: to ensure capital preservation and discipline are maintained.

Whilst it is true this white paper describes the displacement of investment banks and the development of private debt funds, MV Credit’s extensive track record began long before the banks retrenchment.



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