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Q&A

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Europe's private debt market is growing at an unprecedented rate. Global corporate placement agent and fundraising adviser FIRSTavenue explains what is driving investor interest and why alternative credit will remain a part of the asset mix for the long term.

The amount of capital invested in European private debt vehicles has hit record levels during the last year. Why is investor appetite for private debt so strong?

There are two major drivers. Firstly, Europe's private debt market is coming off a low base when compared to the US. The private debt market in the US has been operating for much longer and Europe is still catching up.

Secondly, and probably the overriding impetus, is where interest rates are sitting. With rates so low, investors are searching for yield. That is a global trend.

Private credit provides an investor with decent secured senior risk and an attractive yield in a model that is scalable. For an investor looking for alternatives to fixed income lines, private debt is an obvious place to start.

If interest rates go up and bond and fixed income yields rise, will that temper appetite for private credit in any way?

A lot of the direct lending deals are floating rate structures that would benefit from a rate rise.

If rates rise then there will be a shift as investors weigh up the relative value consideration, but investors will still see clear opportunities across a range of direct lending strategies. This market is here to stay and will not go away if rates go up.

Some investment professionals have raised concerns that there is not enough deal flow to absorb all the private debt capital that has been raised. Are current fundraising levels sustainable?

It is not as straightforward as that. You have to be more granular about it. At the larger end of the market there is competition and we have seen a lot of club structures taking deals rather than sole lenders.

Collaboration is becoming a feature at the larger end of the market and there will be fewer opportunities to do deals independently.

But we have seen a lot more focus on the mid-market and lower mid-market. This space has been overlooked and underserved; managers are recognising that you can get returns from these deals while retaining a meaningful place in the senior structure. That means that there is still plenty of opportunity to deploy capital at an interesting risk-return ratio.

So, we are seeing managers shift up the risk curve and following strategies with a regional and lower mid-market focus. There is also a lot to go for down the non-sponsored route, where Europe still lags the US.

If competition pushes pricing down and risk up, are current returns sustainable?

We have seen competition push pricing down, particularly at the larger end of the market, but even so private credit still provides interesting yields relative to public market debt offerings.

In the US we have also seen investors boost returns by using leverage at fund level.

In Europe there is less appetite for boosting returns through leverage, principally to avoid increasing risk and incurring a high Solvency charge, although subscription lines do regularly feature in the region.

We have observed a number of equity financial sponsors branch out into private credit. Why is this? Does it raise any conflicts of interest?

It is a trend and it makes sense. It allows firmly established managers to diversify their revenue streams. There is also this opportunity to fill the gap left by banks, and financial sponsors have taken that opportunity.

Finally, it is a great way to leverage your platform. All the sector and company research and analysis done for the equity business can apply to the credit business.

Conflicts, of course, can arise when you are doing credit and equity and investors are understandably nervous about the possibility of firms lending for the own deals.

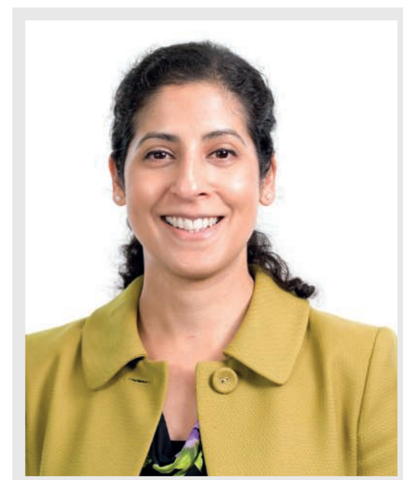
The managers are aware of this and have responded. It is standard to have strict policies in place to block lending to the equity side of the business.

How transferable are a financial sponsor's equity investment skills to a debt context?

A track record as a successful equity sponsor helps, but you do need to bring in people with credit underwriting experience. Those skills are necessary. You can't just say that the team that has been investing equity will now start lending too.

What are the differences between raising a debt fund and raising an equity fund?

You will have the same European waterfall structures and governance structures as private equity funds, but because the return targets are lower for debt, pricing will be in line with those



targets, a debt fund will differ from a classic 2-and-20.

There is also a bit more variety around terms and fund life. We have seen shorter fund lives and reinvestment periods. In terms of who you are speaking to within institutions, most organisations now have dedicated private debt teams that are distinct from their equity operations.

To what extent can a private credit manager differentiate from the competition? Is debt a commoditised product or can lenders develop a unique offering?

As the market matures you see more and more differentiation.

There are many more funds coming to market with a specific focus on a particular region or on a specific segment of the market. There is more choice for investors now in terms of the underlying assets that they are exposed to e.g. infrastructure debt, real estate debt, aircraft financing.

There is more diversity in the market already, and that will be an ongoing trend as managers become more focused in order to source deal flow and deploy. ●