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Unlocking the European corporate credit opportunity

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Having moderated at a US conference earlier this summer, Azla Advisors founder David Waxman offers some key takeaways from the day's discussions.

Against an almost uniformly positive backdrop in terms of sentiment towards private debt – an asset class the surface of which is "only just being scratched" – panellists and delegates at a major US conference earlier this summer were particularly positive about the European market.

US investors present clearly indicated that the best way to gain exposure to the European market was via private debt funds; others put it slightly different, that after deciding to invest in private debt, funds focused on Europe offered the best risk / return profile.

They argue that Europe-focused private debt funds offered a sustainable and growing market opportunity due to major structural factors. They also offer higher yields combined with similar net loss and recovery rates (3 percent and 60+ percent) when compared to the US, enabling a superior risk/return profile to the US private debt market.

The European market has historically been much more dependent on bank lending relative to the US. In the US, 83 percent of corporate debt historically has come from non-banks, so when the banks slow down lending in the US it has less of an impact on the market. Whereas in Europe, which historically has been a highly concentrated market where banks have dominated lending, the more severe European bank lending slowdown we have seen since 2009, and the increased slowdown we will continue to see with the implementation of Basel III (the European regulation expected to be enacted shortly), has left much more of a gap to be filled by private debt funds.

European banks have still not divested most of their non-performing loans. As their accounting policies enable them to be held at cost, the banks have not been marking them down through the Euro crisis. Accordingly, divesting over the past couple of years at prevailing current market prices would have had too much of a negative impact on earnings. But with the advent of Basel III, in order to reach the capital ratios where punitive capital weighting ratios are not applied to banks, European banks will now have to finally divest 4-5 percent of their total loan holding per year till Basel III goes into full effect in 2019 (c.25 percent of total loan books). Accordingly, they will be adding very few new loans to their balance sheets due to their divestment policy objectives.

In addition to managers focusing on European bank NPLs due to the driver cited above, managers with SME direct lending strategies were cited as particularly interesting to US LPs. Risk-averse behaviours by bank lending personnel in Europe towards smaller companies (which extends to companies delivering revenues of up to €200 million) has led to a further slowdown in bank lending to that segment of the market, opening the way for private debt funds.

The SME direct lending model is, many believe, a sustainable one. Some statistics that validate this are:

• 80 direct lending deals were completed in the UK in 2013, an increase on the 24 completed in 2012, demonstrating the significant growth in the market.

• European private debt GPs have seen a 400 percent increase in direct lending deal flow.

One final point: while both European and US LPs are spending an increasing amount of time on European private debt, their choices of European debt asset classes are narrowing as the mezzanine, distressed and CLO segments in Europe have shrunk significantly – leading them to focus on senior, direct lending and unitranche opportunities to fill their European private debt allocations. This dynamic opens up more opportunities to raise capital in the US for European managers of those strategies.

David Waxman is the founder and managing director of placement agent Azla Advisors, and has helped to raise more than $1.5 billion of capital for private debt, secondary and growth equity funds over the last eight years.