A Review of European Direct Lending (Second of a Series)

THE LEAD | February 24, 2016

Burger King isn't just selling Whoppers any more. Last week the second largest burger giant began serving hot dogs at all its locations year-round. "We're applying sixty years of flame-grilling expertise," said Alex Macedo, President of North America. "We also have to chop the onions a little differently," he added.

The thesis regarding opportunities today in European debt is reminiscent of this fast food story. Why shouldn't investors think about private credit overseas the same way they think about US loans: isn't it the same grill, just different meat? Or perhaps there's a reason there are no national hot dog chains.

Turns out there are fundamental differences between the U.S. and European markets. One is the way each developed alternative lending. The disintermediation of regulated U.S. lenders by non-banks has been going on for twenty years; in Europe that process only restarted immediately post-credit crisis (see *Chart of the Week*).

"People don't realize that Europe is the much more efficient bank market for loans compared to the U.S, which is controlled by institutions," one leading UK credit provider told us. "We're beginning to see a shift as leverage comes down and regulations go up," he continued. "But banks still hold sway in many regions."

This is particularly true for the middle market. "Smaller deals – below €25 million ebitda – are attracting bank attention," another private fund head reported. "Libor spreads are dropping, and floors are falling away," he said.

"Supply/demand in Europe is relationship-driven," our friend went on. "Private equity sponsors are bringing their lenders to the table. Where there's an opening is offering up-and-down-the-capital-stack solutions. But that will close when banks come back. It's mostly option value for U.S. firms trying to come into this market."

Timing is also critical. Different technicals have been driving loan prices in different directions. The U.S. is being challenged by energy-related fears and retail loan outflows, while Europe is still in the relatively early days of its own QE program.

But even that's changing. While one CEO of a US-focused debt fund characterized Europe's loan market was "frothy," he admitted that "negative sentiment began filtering through the Euro market, as risk-off dominated the US. At first it was like speaking to different planets. Europe was cranking out L+475 at 99 like crazy, while deals here were getting hung. Now Euro deals like *B&B Hotels* and *Photobox* are flexing up."

And European LBOs are smaller. That means banks are still able to club some deals amongst themselves, rather than having to distribute to institutional accounts.

For broadly syndicated loan investors, toggling between relative value plays may be working short-term. *Vivid Seats*, for example, looks pretty cheap for Euro buyers. But that's hardly a long-term strategy to build market share and lending capabilities.

Next week we look at legal, cultural, and logistical hurdles for Europe's direct lenders.