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

THE LEAD | March 21, 2016

As we wrap up our series on direct lending in Europe, let's examine the supply/demand dynamic we expect to drive deal activity for providers and users of private debt.

As our *Chart of the Week* shows, European funds have almost $30 billion in dry powder available to support loans. On the supply side, private equity firms have $140 billion available to deploy for investments. That would seem to give direct lenders plenty of opportunity to put money to work.

But the total annual volume of new issue leveraged loans in Europe is a fraction of the activity in the US. Last year, according to S&P Capital IQ, there was just under $45 billion in new institutional European deals. That compares to over $257 billion in the US for the same period, or almost six times as much.

Plus, as we've discussed, banks in Europe have been aggressive about defending their market share, particularly with relationship sponsors. That has pushed direct lenders to offer unitranche financings as well as more risky lower-in-the-capital stack solutions. While volume information on this activity is not readily available, Preqin estimates that 233 European private equity deals have been closed in the past twelve months with a total valuation of $90 billion.

What financing options do sponsors have in Europe versus the US? Pretty much the same variety of alternatives are available in both markets, though American direct lenders are several years ahead of their European counterparts in both size and sophistication.

According to one source, mezz has largely disappeared in Europe. Banks don't like it because, unlike in the US, European mezz is structured as second lien so presents inter-creditor concerns.

Another worry expressed by credit veterans is that the direct lending market in Europe is less mature than in the US. That results in more competition for fewer opportunities, thus increasing the likelihood of great concentration in portfolio positions.

One further difficulty with nation-oriented lending is that each country has its own economic strengths and weaknesses. As one pan-European lender told us, "country-specific funds are compelled to follow the credit cycle of that country." To avoid that trap you need to toggle among economies, depending on your view of their outlook. Timing cycles is tricky, and adds a layer of complexity US managers don't have.

Finally, noted one top manager, European funds face a potential mismatch between funding costs, which are at rock-bottom, and lending spreads. "There will likely be a shakeout of direct lenders down the road," he said. "The US experienced this in 2009 as poorly performing (or inadequately funded) managers flushed away in the downturn. For Europe, the day of reckoning may still be ahead."