

Investment intelligence

European private debt in 2018 and the year ahead

- European private debt continued to attract significant investor interest in 2018, while fundraising was more muted, partly due to high levels of dry powder
- Looking in less competed and emerging areas of private debt is more likely to enable sourcing value opportunities
- Discipline, patience and flexibility are necessary to navigate the ever-changing market



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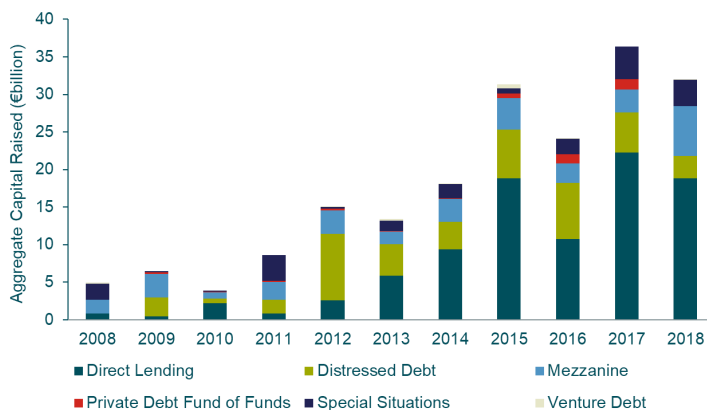
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European private debt continued to attract significant investor interest in 2018. The market continued to be competitive and conditions remained borrower-friendly as institutions looked to the private sector to access broader and specific investment opportunities for income, risk diversification and liability matching.

Fundraising was relatively muted in 2018 compared to 2017. In 2018, €32 billion of aggregate capital was raised by 48 European private debt funds, slightly lower than 2017 record levels of €38.5 billion from 61 funds¹. More than half was raised by direct lending funds in 2018, but this was a smaller proportion of the total money raised, a sign of diversification in the sector.

Europe-focused private debt fundraising by fund type, 2008 - 2018



Source: Preqin, data as at 31 December 2018. Excludes leveraged loan fundraising.

While other factors may be at play, we attribute the lower fundraising in part to the high levels of dry powder in the market. European dry powder increased to US\$92.3 billion at the end of 2018 from US\$65.9 billion in 2017. In direct lending, European dry powder has almost doubled in the past two years².

These supply and demand dynamics have created a climate in which pricing and terms have become generally less attractive. As a result of this, we have invested capital selectively, trying to avoid the over competed-for sectors of private debt and remain disciplined in a market that looks like it could potentially be the top of the market.

Here, we look at the trends affecting European private debt sectors today.

Direct lending

- European direct lending continued to become a focal point for institutional lenders in 2018 and an interesting market in which we are active. The market remained competitive, particularly given the broad nature of deals for companies owned by private equity firms. This led to greater flexibility in the structure and pricing of transactions in large parts of the market
- While certain areas of the market tend to be characterised by oversupply of capital and undersupply of transactions, the growing diversity of the market means an ever-increasing set of investment opportunities, such as asset-backed and platform lending deals
- Increasingly, investors require flexibility in their mandates and breadth and depth of expertise, in order to be able to continue to originate good quality, good relative value opportunities
- In the UK, there was lower deal activity from an M&A perspective in Q4 2018, likely due to Brexit-related uncertainty, but demand for assets from private debt funds remained resilient

Leveraged loans

- Loan issuance of €100 billion in 2018 was ostensibly lower than 2017's €120 billion but expanded by 10% in net terms, driven by an increase in leveraged buyout (LBO) and acquisition financing, while refinancing loans accounted for just a fifth of overall supply following a bumper 2017. It was the highest year of collateralized loan obligation (CLO) issuance since the global financial crisis (€27 billion)
- Spread widening through the year was less dramatic than seen for comparable public bonds, but spreads were up in 2018, ending the year at near double their pre-crisis lows (445bps)
- Uncertainty in 2019 could create opportunities for M&A activity, favouring private equity sponsors with the dry powder to take private any listed companies caught in market crossfire

¹ Source: Preqin, as at 31 December 2018. ² Source: Preqin, as at 31 December 2018.

- Even if leverage levels do not increase from here, further dilution in loan covenants and other documentary protections will make credit selection and issuer due diligence even more vital

Restructuring

- Ongoing high levels of liquidity and easy refinancing conditions in public markets created investment opportunities which were greatly competed-for and rather opaque. Long-term bottom-up distressed investors, such as M&G, instead focused on privately-sourced special situation opportunities
- Reflecting weakness in the public markets, the pipeline of potential opportunities has increased across sectors, including food and beverage, industrial, oil and gas services, retail, software and services, and transportation
- In the third quarter of 2018, more attractive yield compensation for the risk taken emerged, reflecting less forgiving financing markets. In 2019, we anticipate there may be more opportunities to deploy investment capital in distressed debt opportunities

Specialty Finance

- Against a backdrop of spread widening in public credit markets, Euro area consumer loan lending margins versus European investment grade remained high and steady in 2018³
- The specialty finance sector continued to expand in 2018, supported by healthy deal flow from European banks looking to offload pools of high-quality consumer loan assets from their balance sheets, with performing loans representing 15% of traded loan portfolios in the first three quarters of 2018⁴
- Alongside growing appetite from institutions, this growth is expected to continue throughout 2019 and beyond as bank deleveraging still has some way to go in Europe and regulatory pressure shows few signs of abating

Private placements

- European private placement (PP) issuance in 2018 was up slightly on 2017 levels (from US\$63.4 billion to US\$59.5 billion), although these figures are based solely on broker quotes and believed to understate the market
- UK PP issuance was up 27% year-on-year compared to 2017, which was driven by the trend of US dollar-based investors participating in deals, such as in social housing
- In contrast to the leveraged loan market, the private placement market has maintained covenant protections on their deals and pricing has a natural floor at the level of public corporate bonds. As a result, investor demand has increased which has outstripped supply and allocations for all investors have been scaled back during the year

Infrastructure debt

- There was continued strong appetite for the traditional long-dated investment grade end of the market. Pricing for such mainstream assets suffered over the first nine months of the year, reflective of the continued imbalance between investor demand for assets and available supply
- In 2018, borrowers sought to reduce, relax or even remove covenants, highlighting the importance of discipline in the investment process. It was, however, still possible to find areas of good value, notably in more complex transactions, or those in countries or sectors with a historic credit issue
- In Q4, spread widening tracked the weakness in the public bond markets, albeit not to the same extent, and the Euro market continues to price much tighter than sterling
- Below investment grade, the market saw continued attempts to expand the definition of infrastructure with a number of borrowers seeking to transition to this market from the leveraged loan market
- Looking forward to 2019, we expect there to be a continued focus on ESG and impact investing, as natural complements to infrastructure investing. As infrastructure equity funds continue to broaden their investment horizon, we expect parts of the debt market to follow suit

Real estate debt finance

- In 2018, we continued to see strong deal flow as borrowers looked to refinance around €150-250 billion of debt secured against European commercial real estate. In addition, there continues to be significant new origination of debt secured against existing and development assets
- Going forward in 2019, we are increasingly conscious of the need to be disciplined and undertake rigorous underwriting to identify opportunities that present the most attractive relative value returns

Private debt is a huge, diverse sector offering interesting opportunities. It does require expertise to navigate effectively, such as robust underwriting, due diligence, credit risk assessment and risk management processes. Looking in less competed and emerging areas of private debt is more likely to enable sourcing value opportunities. A manager that can seek across the entire market, without being a forced buyer, should be well-positioned to navigate the ever-changing market we face ahead.

³ Source: ICE BofAML indices Euro IG Index LIBOR OAS., 4 January 2019. Euro area loan and rate data available from ECB Statistical Data Warehouse, latest available data as at 31 October 2018.

⁴ Source: Deloitte, "Full Steam Ahead Deleveraging report", Q3 2018.

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