GERMANY FORUM 2019

View the collection of articles from our publication Private Debt Investor, and get an overview of the German private debt market.

PEI Alternative Insight

PRIVATE DEBT INVESTOR

German banks in retreat – but will they have the last laugh?

Debt funds have increasingly colonised the country's LBO market, but risks appear to be mounting.

By Andy Thomson

As the size of the German sponsored market has increased by leaps and bounds in recent years, so the proportion of deals financed by debt funds rather than banks has also shot up.

The number of leveraged buyout deals in the country climbed from 28 in 2012 to 103 in 2017, before falling back slightly to 89 last year, according to investment bank GCA Altium. Over this period, the slice of the deal pie accounted for by debt funds has gone up from precisely zero seven years ago to very nearly half (48 percent) in 2018.

For those who doubted that Germany would ever become fertile soil for debt funds given its traditional and apparently resilient banking culture – and there were many – the data is likely to be a source of great surprise or even shock. And for pan-European debt funds, which have thought of Germany as a potential pot of gold that may nonetheless be tantalisingly out of reach, it may well feel like a barricade has been successfully breached. Dive a little deeper into the data, however, and the story becomes more nuanced.

FOR ONE THING, HOW ARE DEBT FUNDS ABLE TO BE COMPETITIVE ON PRICE IN A MARKET WHERE THE BANKS HAVE DRIVEN DOWN MARGINS?

The answer is that they're doing it by teaming up with the banks. Last year, almost a quarter of unitranche deals, for example, featured first out/second out structures that used cheap bank debt to lower the weighted average margin.In light of partnerships such as these, the old "bank versus fund" narrative seems increasingly outdated.

But if it's true that the banks are stepping back from centre stage – happy to play a role in deals without leading them – is this necessarily a bad move? Taking a more cautious stance may be entirely appropriate at a time when the cycle is late-inning and risks appear to be growing. The GCA Altium report noted that covenant-lite unitranches had recently been offered and executed, albeit for what it described as "very strong credits".

It may be that, even in the face of more adventurous deal structuring plus political and economic headwinds, German private debt deals end up staying the course. The likes of covenant-lite deals may be creeping in around the edges, but it still seems far-fetched to imagine Germany becoming one of Europe's riskiest markets overnight. That said, it may only take a handful of bad deals to taint the reputation of the non-banks and hobble their hitherto strong advance. Are the banks playing a clever long game?

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Find out more from the keynote, Jurji Puth, Managing Director, GSO Capital, during The Institutionalisation of Private Debt session.

Why it's important to get heavy in the German market

Fund managers attempting to penetrate the Mittelstand need to target asset-heavy businesses to compensate for weaker credit metrics. Daniel Heine of Patrimonium explores the landscape.

By PDI Staff Writer

The German market is opening up to private debt but it is not the easiest of markets to operate in. PDI caught up with Daniel Heine of fund manager Patrimonium to find out more about the market's dynamics – including why partnering with banks is a good way forward.

HOW WOULD YOU DEFINE THE LOWER MID-MARKET – AND WHAT IS THE SIGNIFICANCE OF THAT IN TERMS OF TYPES OF COMPANIES TARGETED?

We narrow it down to the German-speaking markets, with around 90 percent being Germany and the rest Austria and Switzerland. The companies we target typically have EBITDA of between €10 million-€50 million, with revenues of around €100 million-€300 million. Above that – where you have companies with revenues of €500 million or more – we would consider to be the mid-market.

The mid-market is already able to access public instruments in Germany. It has a well-developed Schuldschein market and mid-market companies use that to access financing from mainly insurers and pension funds.

The lower mid-market represents the backbone of the German economy in terms of volume of companies and number of employees. These are businesses that don't make the cut when it comes to issuing public instruments as they are too small. In the past, they have been fully dependent on the traditional providers of finance, especially the banks.

Following the financial crisis in 2008-09, the traditional lenders have retrenched. They retrenched first at the weak end of the borrower base – the weaker quality credits and the lower ratings. Germany is still an overbanked market but it's now starting to bifurcate. Companies which qualify for a banking solution can get that on very favourable terms. But if their rating is too weak then they get rejected and fall into our direct lending/sponsorless universe.

HOW MUCH OPPORTUNITY IS THERE IN GERMANY?

From a value perspective it's a fantastic universe, as Germany is such a developed and broad market – it's the world's fourth-largest economy. It is currently around five years behind the UK in terms of the development of its private debt market. UK banks are further ahead in having recapitalised their balance sheets but I would expect Germany to catch up to where the UK currently is over the next three to five years.

WHAT ARE THE MAIN CONSIDERATIONS WHEN MAKING AN INVESTMENT IN GERMANY?

There are three key characteristics. One is that the German market is essentially sponsorless. Traditionally there have not been many private equity deals and companies are family owned and generally not up for sale. The good news for the likes of us is that it's very much a credit culture.

Two, if a company qualifies for bank finance then that finance will be significantly cheaper. If you're looking for an alternative finance solution then your credit metrics will be weaker. As a fund manager, what's the remedy for accepting weak credit metrics? You have to be compensated by hard asset collateral, and that's something many German companies provide. There is a tradition of asset-heavy businesses.

Three, you are dealing and working with family companies and there is a question of mutual trust. They want to know their counterparty and you have to provide them with convincing references, as they are afraid that you will want to take over the business. The more deals you do in the market, the more references you can provide and the more trust you can earn.

HOW SHOULD FUND MANAGERS BE PREPARING THEMSELVES FOR A TURN IN THE CYCLE?

We have been around since before the GFC and went through it with a mezzanine portfolio, so the experience is still fresh in our memory. That is important because everyone who has been in the market for more than a decade knows this cycle will come to an end.

HOW ARE WE PREPARED?

With the current portfolio, the best remedy is to look for risk/return profiles where there is very solid downside protection. If the worst comes to the worst, you want to be able to liquidate the collateral and have a strong recovery.

Parallel to our direct lending fund we also have a special situations fund and it's important to have capital commitments in place, as when the cycle ends, opportunities for special situations will increase. If the capital is ready to deploy, you can make some very interesting investments.

For example, we have entered into a sourcing partnership with HSBC in Germany, one of the largest providers of "insolvency money" i.e. pre-financing of company salaries for a three-month period guaranteed by the state as a subsidy for companies in insolvency, to make additionally available a super senior loan which is what insolvency administrators often need to orderly run off the business and either sell the assets or the shares of the insolvent company.

This additional loan pushes all the other lenders down and typically displays a very strong risk-return profile due to its super seniority. Under Basel III, the traditional financiers struggle to provide such an instrument to a company in insolvency. We have set it up and it's well placed if the cycle really ends and is a good example of a sourcing partnership with a bank.

HOW MUCH COMPETITION IS THERE?

Competition is definitely increasing from various ends. Funds from the UK are more focused on larger mid-market sponsored deals, but there is a bit more of a tendency for them to lower their thresholds and do smaller deals. Our deal tickets are typically in the €20 million-€30 million range and the UK houses more like €80 million-€100 million but thresholds are certainly being lowered and the sponsor world is pushing into sponsorless. There are also new teams spinning out from both existing funds and banks. Germany is becoming a focus, and more competition will undoubtedly come.

DO YOU HAVE A SECTOR PREFERENCE?

We are sector-agnostic. The important thing to bear in mind is that the moment a company has flawless credit metrics, they qualify for bank finance – and we can't compete with that. To come back to the point made earlier, we are at the weaker end of the credit metrics spectrum and we want to be compensated by collateral. So we naturally focus on asset-heavy businesses, and we are somewhere between cashflow and asset-based lending.

ARE PARTNERSHIPS BETWEEN FUNDS AND BANKS THE WAY FORWARD FOR PRIVATE DEBT?

I have been saying for many years that banks and funds are natural partners, and today that idea is materialising. You have been seeing relationships based just on sourcing, like the example above, but now you are also seeing even stronger partnerships.

We have a cooperation agreement with Credit Suisse and we are in the process of launching a fund, the Private Debt Co-Investor Fund, to target a hybrid universe of companies which are still bankable – mainly B and BB rated. They qualify for bank lending, but the banks are typically restricted by the regulators to maximum hold levels on those credits. It's important for the banks to continue to lend to those businesses and, by having a partner, they can split the exposure.

The banks want to continue to run the relationships with corporates and they have different services to offer. We only have capital, so we are not competing with the banks. In our Private Debt Co-Investor Fund we are launching, we can split the exposure. It's a very modern product with full alignment of interest between the bank and the fund and proves that the partnerships we have been talking about are really happening.

Daniel Heine is founder and managing director of private debt at Patrimonium, a Swiss alternative asset management company managing today approx. CHF3.5 billion with around 60 employees.

Find out more during the Turning to the Mittelstand session with Natalia Nowak Managing Director, CVC Credit Partners.

Will 2019 be the year the dominos fall?

Don't expect a quiet year ahead. We look at five ways in which the private debt market may be shaped in the next 12 months.

By Andy Thomson

In all sorts of ways, 2018 has been quite a year. Surely 2019 will struggle to produce half as much excitement? Don't bet on it. Here are some of the key talking points as a new year fast approaches.

DEAL STRUCTURES REACH A BREAKING POINT:

The end of the cycle has been the subject of speculation for so long that maybe there is a waning belief it will ever happen. But, as 2018 draws to a close, stress in the system appears to be moving from theoretical to tangible. Concerns about deal terms started with covenant-lite, but some argued this was a red herring since it was more of an issue for syndicated loans than the mainstream private debt market. Of growing concern is the minutiae of deal agreements. There are anecdotal reports that some deals based on unrealistic EBITDA adjustments are now running into trouble – this having crept up on the margins of the covenant-lite debate as a major concern.

EUROPE'S POLITICAL PRESSURES INTENSIFY:

In August, a study by S&P concluded that politics posed a bigger threat to Europe's credit markets than underlying business performance. Four months on, we have frequent and spectacular contortions around Brexit and mass anti-government protests on the streets of Paris – to which may be added ongoing political turbulence in Germany and the rise of populism in Italy. On top of this looms the risk of growing trade tensions between Europe and the US. The question for private debt is whether all this political risk has been appropriately factored into pricing.

SPECIAL SITS AND DISTRESSED INVESTORS PRIMED FOR ACTION:

Should the cycle finally turn, it doesn't spell doom and gloom for everyone. When we caught up with Marc Lasry at our New York Forum earlier this year, he predicted the next distressed cycle will come within a year or two – and plenty of capital has been raised in anticipation of that. Special situations investors also stand to benefit, though they like to point out that theirs is a strategy for all seasons, come rain or shine.

OVER-RELIANCE ON THE PRIVATE EQUITY MARKET:

A Deloitte survey revealed that, in the first quarter of this year, the non-sponsored share of the private debt deal market stood at just over 17 percent. For some time prior to that, much talk had been about how this part of the private debt universe would grow its share – and yet, back in Q1 2015, that share stood at a little more than 22 percent. As non-sponsored deals shrink, does this mean sourcing new deals becomes a challenge as and when the private equity boom comes to an end? The cost of setting up the infrastructure required to root out opportunity among family-run small businesses is high – but is it higher than the cost of failing to undertake contingency planning?

ESG AND DIVERSITY RIGHTLY IN THE SPOTLIGHT:

The appointment of Eimear Palmer at ICG this week provided further evidence of the determination of fund managers to make ESG a fundamental part of their investment processes. The argument that private debt firms can merely sit on the side-lines as ESG issues are taken care of by private equity firms is no longer tenable, if it ever was. Expect diversity to also claim its place as a key talking point (and hopefully not just a talking point) in 2019. There is much still to be done.

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