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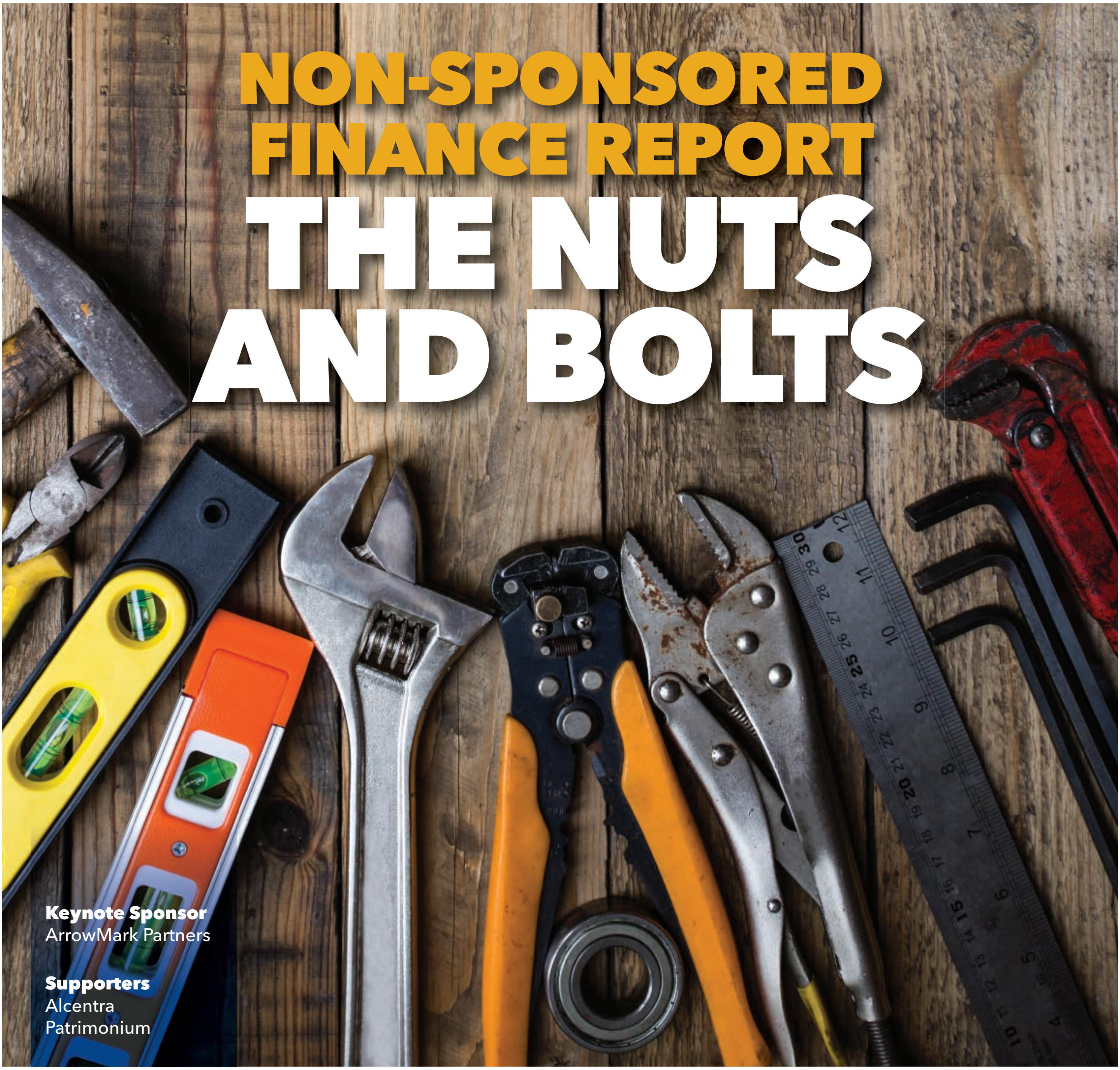

NON-SPONSORED FINANCE REPORT

THE NUTS AND BOLTS

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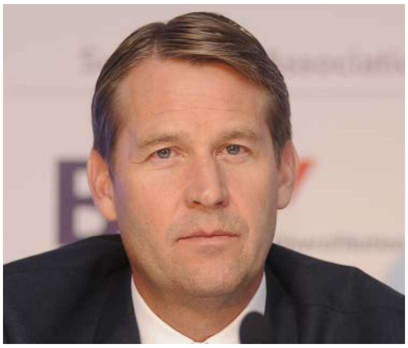
Mittelstand mechanics

Active in the German Mittelstand – or mid-market – for over a decade, Swiss lender Patrimonium has carved a niche for itself in the non-sponsor space. **Daniel Heine**, the firm's head of private debt, offers *PDI* some insight on the firm's strategy

Providing non-sponsor lending to more than 100 companies with a total volume of around €750 million, Patrimonium has made a name for itself as a leading alternative lender to the smaller, mostly family-owned German Mittelstand companies. In 2012, the firm launched its first lending fund providing sponsorless direct senior secured loans ranging from €5 million to €40 million, a vehicle that has since gone from strength to strength. Now Patrimonium is in the market with a follow-up vehicle.



Heine: a strategy evolving with the times

Q You are looking to raise €350 million for your second complementary Patrimonium Middle Market Debt vehicle, how will the strategy differ from the first?

Daniel Heine: We are experiencing a further retrenching of the traditional banks in the German market and have seen that the lending gap left behind by these providers is slowly widening. Therefore, we are enlarging our current strategy to the lower yielding but also stronger credit metrics range of companies. Over the past 12 months we have been approached by companies with BBB-BB rating profiles that are looking for additional debt solutions as a diversification to their existing lending providers. We are currently in the process of evaluating what format we will be offering such collateral to our investors. Due to the nature of these companies, lending instruments can be more standardised, therefore looking at the current low level of spreads – and at the German bank-dominated lending landscape – a structured transaction in CLO format, instead of a fund format, could also be an attractive proposition. However, regardless of the format, we believe that given the size of the German market, its deep credit culture, the resilience of the Mittelstand, and the overleveraged nature of the German banking system, the market we are serving is expected to enjoy steady growth.

Q Why does the Mittelstand stand out as an attractive opportunity in the European private debt space?

DH: The reasons for this are threefold. First, Mittelstand companies, with 91 percent of them being family-owned, have a deep-rooted credit culture, so debt is the instrument of choice. These companies are often cautious when it comes to equity solutions – only 1,500 of them, less than 0.1 percent, used private equity financing between 2013 and 2014. Secondly, the German legal framework is a stable and reliable environment for lenders and lender rights are well protected and developed. Thirdly, Germany is the fourth largest economy in the world. The size of the direct lending market, and its high degree of fragmentation in terms of number of companies, makes it by far the most interesting and attractive in Europe.

Q To what extent will this strategy be targeting non-sponsored opportunities, has this changed from the previous strategy?

DH: We have no policy of limiting us to non-sponsored opportunities only, but we do expect that most of the opportunities which we will be sourcing will continue to be non–sponsored situations. This is mainly due to our existing sourcing network which we have built over the past 10 years in Germany and our deep-rooted connection to the Mittelstand.

On top of this, the bulk of the Mittelstand represents an investment universe of approximately 40,000 companies. These companies display revenues in the range of €10 million and €250 million with EBITDAs in the €10 million bracket. Given average net debt or EBITDA gearing levels of around 3.5 to 4.5x, the typical single investment volumes are in the €10 million to €30 million area.

As most of these self-originated companies are typically family-owned, we do experience less competition compared to sponsored strategies as debt and lending instruments in such situations are usually not auctioned and are typically bilaterally negotiated. Therefore, loan size, German loan documentation and German law – combined with working with a German team – can create entrance barriers which make it harder for large UK or US funds to enter the market.

Q How do you differentiate yourself in the non-sponsor market?

DH: Lending to Mittelstand companies is ultimately a very hands-on business. It requires a lot of local expertise, starting with the language, understanding the culture and having full command of the local law and customs. Last, but not least, you need to be able to give reference on your lending activities as private debt is still a new concept to traditional Mittelstand companies. After being active in this market for more than a decade, and after having financed more than 100 companies in Germany, we can bring all these ingredients to the table and this differentiates us from the competition.

On top of this our market position is at the smaller end in terms of single loan amounts which sets us apart from the competition managing larger single exposures. Our investment range typically ends at single transaction volumes in the €40 million area, which is typically the lower end of what larger funds do.

Q Are non-sponsor opportunities growing in the jurisdictions you focus on and, if so, why?

DH: Absolutely. Of course, bank disintermediation does not happen overnight, but we reckon that the German lending market is, as per our estimate, roughly 20 years behind the US. If you take this as a proxy for further growth, we definitely can assume that our market is a growing market. We have calculated our market volume for alternative lending to smaller Mittelstand companies in Germany at around €300 billion. If we conservatively assume a bank retrenching of approximately 1 percent per annum in this segment, we are looking at a financing gap of around €3 billion a year. Therefore, we believe that with a €300 million-400 million fund we are sensibly addressing this market segment.

"TRADITIONAL LENDERS ARE NOW STARTING TO GIVE GROUND ON THE STRONGER-RATED COMPANIES, THEREFORE A RETURN SPECTRUM WHICH WAS PREVIOUSLY DOMINATED BY THE BANKS HAS BECOME AVAILABLE"

Q Do you see the opportunities opened by the retrenchment of the banks as a long-term trend?

DH: I am fundamentally convinced that direct lending is here to stay. We will see similar growth rates as in private equity and I cannot imagine that the European banking sector will be able to repair their own balance sheets or that the Basel accords will reverse. On top of that, it makes huge sense if Europe is fostering the growth of the direct lending sector to diversify credit supply to the real economy.

Q What is the logic behind targeting lower coupon rates with your latest mid-market vehicle?

DH: Traditional lenders are now starting to give ground on the stronger-rated companies, therefore a return spectrum which was previously dominated by the banks has become available. We expect this trend to materialise in cooperative financing solutions where a bank and a debt fund are financing alongside each other and are providing a "direct lending unitranche" to their clients.

In practical terms this usually means that the bank is continuing to provide a revolving credit facility, or a thin super senior tranche, and the debt fund provides a senior secured term loan. This way financing becomes very attractive for the Mittelstand and together the fund and the bank can make sound risk-adjusted investments.

The co-habitation of banks and funds is, contrary to expectations, a very attractive solution for all. The bank is still able to provide a loan and continues to be able to serve the Mittelstand with additional products and services that a fund cannot such as forex, private banking, and insurance.

The debt fund, meanwhile, can provide a term loan thereby avoiding any kind of variation in respect to volume which is typically difficult to reflect in a closed ended fund structure.

Finally, the client benefits from an attractive blended total rate for its debt. We are convinced that this cooperation has a lot of growth potential, particularly in Germany where the market is still bank dominated. Thus in a nutshell, we are digging deeper into the bank-dominated Mittelstand lending market where credit quality is higher but coupon rates are lower.

Q On the investor side, do you see a pick-up in interest for non-sponsor direct lending funds?

DH: Yes, absolutely. We met recently a large pension insurance company in the Nordics planning to invest into the European private debt space. Their initial plan was to allocate a large volume to one pan-European sponsored lender. But having seen the current level of competition and dry powder, and the resulting compression of yields these pan-European players are confronted with, they decided to change their allocation to non-sponsor country managers where an attractive illiquidity premium can be found. In our specific German, lower middle market direct lending segment, we experience a coupon of 6 percent to 10 percent for loan amounts between €10 million and €40 million and high estimated recovery rates due to control over balance sheet and strong hard asset collateral as security. ■