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MAY 2017
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OVERVIEW

Picking the right spots

As the private debt industry becomes crowded, more managers see the value of targeting non-sponsored deals, writes **David Turner**

The ripening of the non-sponsored market – and its growing relevance to both managers and their limited partners alike – is partly a response to the limitations of the sponsored world. Until now, sponsored lending has been a dominant feature of private debt but it does not have a large hinterland.

"The US has the highest penetration by private equity of any market in the world, but private equity still owns only about 5-10 percent of companies with an EBITDA of $10 million to $50 million," says Jeffrey Griffiths, a principal in the London office of private equity advisory firm Campbell Lutyens.

In Europe, the proportion is even smaller, making the investable universe for sponsored credit small when compared with the much larger pool of non-sponsored companies. Griffiths notes that as demand for private credit continues to grow, the market is likely to rebalance towards non-sponsored deals. One investor – who did not want to be named – predicts this trend will be most stark in the more mature US market, where the ratio of sponsored to non-sponsored deals is expected to grow from around 70:30 today to about 50:50 in five years' time.

Signs of crowding in the sponsored market have already become apparent. Christophe Morize, the Lausanne-based director of client services at alternate lender Patrimonium, tells *PDI*: "We had meetings with two large European pension funds recently, they say there is way too much dry powder, so pricing is really under pressure."

Daniel Heine, Patrimonium's founder and managing director, also notes some pension funds are now considering a radical approach and are bypassing core investments in one or two large pan-European sponsored debt providers in favour of using three to five smaller-sized country managers that do non-sponsored transactions.

While low benchmark interest rates have pushed down income returns everywhere – including non-sponsored debt – the combination of large sponsored funds and limited dealflow have put pricing for sponsored deals under added pressure. Moreover, spreads for non-sponsored deals tend to be higher across the market cycle, because of a view among many investors that such debt is riskier.

"In private credit the target returns have come down, but non-sponsored debt may offer an extra 2 or 3 percent," says Jonathan Bell, chief investment officer at Stanhope Capital, a London-based wealth manager that invests in both sponsored and non-sponsored debt in the US and Europe. "That's worth having, even at slightly higher risk."

Responding to the lack of supply of sponsored deals, lenders that previously focused on sponsored debt alone are evolving and exploring non-sponsored deals more than ever before.

"There are not that many direct lenders active in Germany, but competition is definitely increasing," says Heine. "It is coming predominantly from very large sponsored funds that are lowering their minimum loan size because of the large amount of dry powder they need to use. We might come across a big UK-based fund looking at a transaction of only €40 million or €50 million."

Across the Atlantic, this view is echoed by Jeff Davis, partner at Connecticut-based placement agent Eaton Partners. In the US, "we are seeing more non-sponsored funds because lenders like Audax, Summit and Bain have the sourcing networks and scale necessary to find their own non-sponsored deals".

However, Greth Lester, managing director and non-sponsored specialist at Denver-based ArrowMark Partners, notes that despite their proliferation, there is a limit to how large funds with a non-sponsor strategy can get.

"Non-sponsored transactions are generally smaller and more difficult to source, so non-sponsored funds must be disciplined about raising the appropriate amount of capital," says Lester. "We've seen several firms raise larger funds over time, and despite tighter pricing, they tend to creep out of the lower middle market and into sponsored transactions in an effort to put more capital to work."

Patrimonium's Heine says the typical loan his firm will make is between €20 million and €40 million, thus non-sponsored strategy funds tend to be about €300 million or €400 million in size, compared with €1 billion and upwards for sponsored funds. Patrimonium is clear that it wants to concentrate on non-sponsored debt. That said, some market observers expect to see less specialisation in the future rather than more, as funds maximise the number of transactions they look at.

"It's more likely that we will see fund managers doing both sponsored and non-sponsored, rather than having a strategy that just focuses on one rather than the other," says Campbell Lutyens' Griffiths. "The priority of private credit funds is to provide institutional investors with sources of private credit. They should be agnostic as to whether a company is private equity-backed, but use other factors such as underlying credit quality, pricing, and deal structure and creditor protections to make their choices." ■

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WHAT'S IN A NAME? QUITE A LOT, IT SEEMS

How does one describe a private debt deal that does not involve a private equity backer? Answers often vary between "non-sponsored", "unsponsored", "sponsor-less", or even "sponsorless" as a single word. It may seem like a trifling matter but it has nevertheless been a topic of debate among the editorial staff of *Private Debt Investor.*

On the face of it, industry participants don't seem to mind; all these terms are used interchangeably to describe one concept, often within the same conversation. But then again, some do prefer to use term "direct lending" when talking about non-sponsored deals.

"We try to be very clear and say we are active in the non-sponsored world, and we define that as direct lending," says Daniel Heine, founder and managing director of European-focused lender Patrimonium.

If it is not apparent already, *PDI* recently settled on the term "non-sponsored" (a departure from last year's Sponsorless Finance Special), after it was felt that this is now the prevailing terminology in the industry. But even that can be problematic. For some, the prefix "non" implies extra risk.

"Investors can be a bit wary and question whether non-sponsored companies can affect internal changes, or whether they can they be relied on to fix things and make improvements when things go wrong," says Jeff Davis, partner at Connecticut-based placement agent Eaton Partners. "When we marketed a non-sponsored fund a few years ago, we got a lot of questions about how much control the fund could have over a non-sponsored company."

But semantics aside, investors know that by taking on a higher level of risk they are rewarded with a better return profile and that attracts certain types of LP. They also understand that the buck stops with the non-sponsored lender.

"Endowments and foundations, and some family offices, show more interest in these riskier, higher-return deals, with state and corporate pension funds and insurers sticking more to sponsored investments," says Davis. "These are often two different feeding groups when it comes to credit."