How to unlock opportunities in the sponsor-less SME loan market

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Sponsor-less transactions are largely misunderstood. With greater liquidity and mounting interest from institutional investors, can we expect an influx of non-sponsor transactions funded by direct lenders?

Fast reading

- Investing in senior-secured small to medium-sized enterprise (SME) loans – whether sponsor-less or sponsor-backed – presents numerous benefits for investors, including portfolio diversification, returns with an attractive risk/reward profile, and an element of downside protection.
- Within the SME universe, sponsor-less transactions offer a vast number of opportunities. In addition, they generally see less competitive bidding, resulting in more reasonable leverage ratios, less pressure on pricing levels, more conservative loan terms, and meaningful covenants. All these elements make the space a very compelling one for lenders.
- So why are we not seeing more sponsor-less transactions being funded by direct lending funds?
- Certainly, misconceptions around non-sponsor transactions abound. Some claim the information provided to lenders is lower-quality, that management teams are less experienced, that these deals only exist in unattractive sectors, and that the absence of financial support and expertise from a sponsor is cause for concern.
- The fragmented nature of the European SME market combined with the strong market positions held by European banks and the vast regulatory and cultural differences that exist across the European business landscape are also barriers to entry.
- With that in mind, we believe that private debt funds with co-lending agreements in place with local and regional banks are in the best position to capitalise on the opportunities present in the senior-secured, sponsor-less SME loan market.

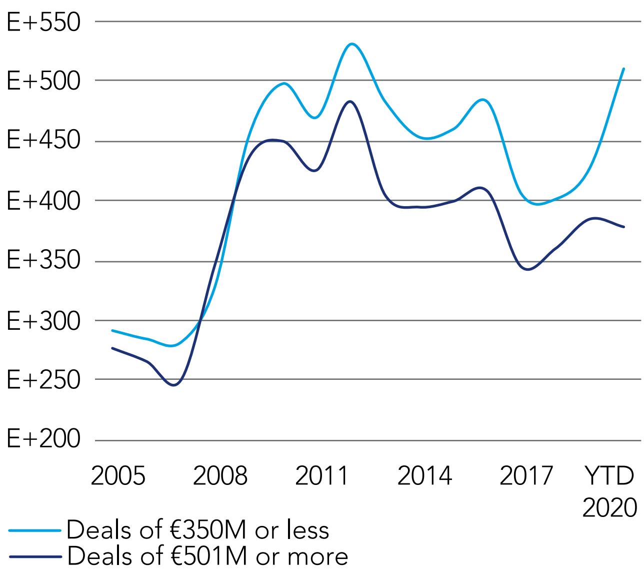
The space offers strong yield in a low-yield environment, stable returns over the last 10 years and a level of protection against downside risk and inflation.

The private debt or direct lending space has grown significantly over the last decade and continues to attract strong interest from institutional investors, who view the asset class as complementary to their investments in leveraged loans and high-yield bonds. Indeed, with the exception of a few funds targeting jumbo transactions and competing with capital markets, most direct lenders focus on sponsor-backed small and mid-cap transactions to gain access to the lower end of the corporate market. They are, however, missing a crucial and attractive piece of the corporate jigsaw: the loan market for European, sponsor-less, senior-secured SMEs.

Untapped opportunities: the case for senior-secured, sponsor-less SME loans

Investing in senior-secured SME loans – whether sponsor-less or sponsor-backed – presents numerous benefits for investors. First, the space offers strong yield in a low-yield environment, including an illiquidity premium of around 75bps and stable returns over the last 10 years. It brings a level of protection against downside risk by first ranking security on a company's cash flow and assets, before combining this with advantageous terms and covenants that give lenders control, as well as regular, detailed information on borrowers.

Figure 1. Average European term loan B primary spread by deal size[1]



Source: S&P, Capital IQ as at Q3 2020. Chart shows performance of first lien bullet term loans.

Secondly, the floating rate nature of senior-secured loans offers some degree of inflation protection. These loans also demonstrate low levels of volatility compared to equity markets, thus providing stability in a diversified portfolio. Finally, they present a reduced risk of capital loss relative to other asset classes – the average 2003-19 historical recovery rate for first-lien instruments was around 73%, compared to 27%-44% for other subordinated instruments[1].

But while the benefits highlighted above apply to non-sponsor transactions, what of sponsor-less senior-secured SME loans specifically? One of the key drivers for investing in this market is its size: small and medium-sized corporates account for a large share of the loan transactions arranged each year in Europe. Tapping this space, together with the private equity-backed universe – which is more skewed towards bigger mid-caps and large-caps – can provide lenders and their investors with a wide range of opportunities[2], thus increasing portfolio diversification. With access to a larger deal flow, savvy investors can ultimately pick and choose the SME transactions with the best risk/reward profile.

Another compelling argument in favour of non-sponsor transactions is their potential for risk-adjusted returns. This is particularly relevant in the current environment, where the private equity-backed direct lending space seems to exhibit certain signs of a "hot" market. We believe sponsor-less transactions often display more reasonable enterprise value and leverage multiples, combined with stronger loan terms.

2020 and the sponsor-less market

With so much liquidity currently funnelling to the private equity market[3], sponsors are competing fiercely for assets and having to pay very high prices for the companies they seek to acquire. In 2020, the average enterprise value for leveraged buy-out deals (LBOs)[4] was at an all-time high at 11.9x, way above the 9.3x observed in 2007, and a far cry from the trough of the global financial crisis, when many sectors were showing average listed enterprise value multiples around 7x.

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As a result, sponsors are now looking to offload some of the risks associated with these high valuations to lenders, demanding aggressive structures – in the case of particularly high leverage multiples – and very loose legal terms. The First Lien Debt Ratio rose to 5.2x for syndicated sponsored deals in 2020[5] – the highest it has been over the last 15 years[6].

Aggressive structuring requests include high EBITDA add-backs and covenant headroom, which render the structure almost cov-lite.

The issue is that lenders and their investors are secured on the companies they lend money to. Should the enterprise value of these businesses fall during the life of the loan – for example, in the context of a downturn – then the value of that security will also fall. In addition, due to looser legal terms, lenders will likely struggle to crystallise the security for a longer period of time, thus reducing the chance and value of the recovery. Recovery rates in an insolvency are ultimately linked to the speed with which lenders can step in to initiate a restructuring.

Sponsor-less transactions, however, generally see less competitive bidding, resulting in lower enterprise values being put forward by acquirers and less pressure on pricing levels. Furthermore, business plans presented by management teams tend to focus on organic growth linked to capital expenditure and research and development investments (R&D); they do not usually exhibit punchy growth assumptions, which are otherwise necessary to justify high purchase multiples. This drives more conservative loan terms – including lower debt/EBITDA multiples and adjustments to EBITDA – and more meaningful covenant levels based on realistic banking cases with tighter covenant headroom. This, in our opinion, offers strong downside protection and adequate risk-based pricing levels to lenders and their investors.

Setting things straight: misconceptions and sponsor-less transactions

So, with greater liquidity and mounting interest from institutional investors, why are we not seeing more sponsor-less transactions being funded by direct lenders?

This can partially be attributed to the misconceptions that exist around non-sponsor transactions[7]. There are those who claim that:

1 information provided by borrowers to lenders in the case of non-sponsor transactions is lower-quality;

2 management teams are less experienced;

3 these deals only exist in unattractive sectors, and;

4 the absence of financial support and expertise from a sponsor is cause for concern.

1 Average recovery for first-lien instruments and other instruments (second lien, mezzanine, senior unsecured and subordinated unsecured) over 2003-2019. Source: S&P, European Corporate Recoveries Over 2003-2019: The Calm Before The COVID-19 Storm, August 2020.

2 As of March 2020, there were 25 million SMEs in Europe, representing 99% of all businesses in the EU and employing two out of three. This accounts for more than half of Europe's GDP. Source: European Commission, Unleashing the full potential of European SMEs, March 2020.

3 European buyout fundraising hit a record c.€79bn in 2019 and almost €300bn has been raised by European buyout funds in the 4 years to 2019. This equates to the total fundraising reached over the eight preceding years (2007-15). Thereof, a material share remains to be invested. Source: Invest Europe Research, Investing in Europe: Private Equity activity 2019 (slide 13).

4 Avg. LBO purchase price as multiple of pro forma trailing EBITDA, net of fees. Source: S&P, LCD European Leveraged Buyout Review Q1 2021 (p.69).

5 Annual pro forma debt/EBITDA ratios of sponsored deals. Source: S&P, LCD European Leveraged Buyout Review Q1 2021 (p.37).

6 For context, the same ratio was 4.6x in 2007.

7 Source: informaconnect.com, Sponsored vs. sponsorless lending: what are the key decision-making factors?

1 On the first point, sponsor-less transactions and good access to information are not necessarily mutually exclusive. A full due diligence pack can be arranged and the level of financial reporting – in terms of management information and KPIs, as well as systems – can be of the same standard as sponsor-led transactions. While some non-sponsor transactions are less structured in the absence of a debt advisor running the sales process – and require a deep-dive analysis from the lender at the outset of the transaction – access to and communication with management is often more fluid. As a result, lenders may gain a more thorough understanding of a credit and its merits. However, in that context, direct lenders focused on origination and with limited credit analysis resources will struggle to complete such transactions.

In our experience, some of the generalisations around non-sponsor transactions differ from the reality.

2 With regards to the management teams of sponsor-less companies, and their supposed lack of experience, depth and incentivisation relative to sponsor-backed peers, one must resist the temptation to jump to hasty conclusions. Some management teams will have spent their whole career in a space, and will know their niche inside-out. They are better suited to run their business and navigate troubled waters than, say, a new executive parachuted in from a so-called adjacent industry by a sponsor for his/her ability to drive sales. An individual like this could well miss the risks of a particular niche and the key drivers to succeed in it.

Another generalisation is that management teams are more incentivised to deliver growth in a sponsor-backed environment. Although sponsors always ensure that senior management's remuneration includes shares, the truth is that, in many circumstances, the private equity fund owns most of the equity. Conversely, in sponsor-less transactions where top management owns the lion's share, the leadership team feels more empowered and incentivised to deliver a growth plan.

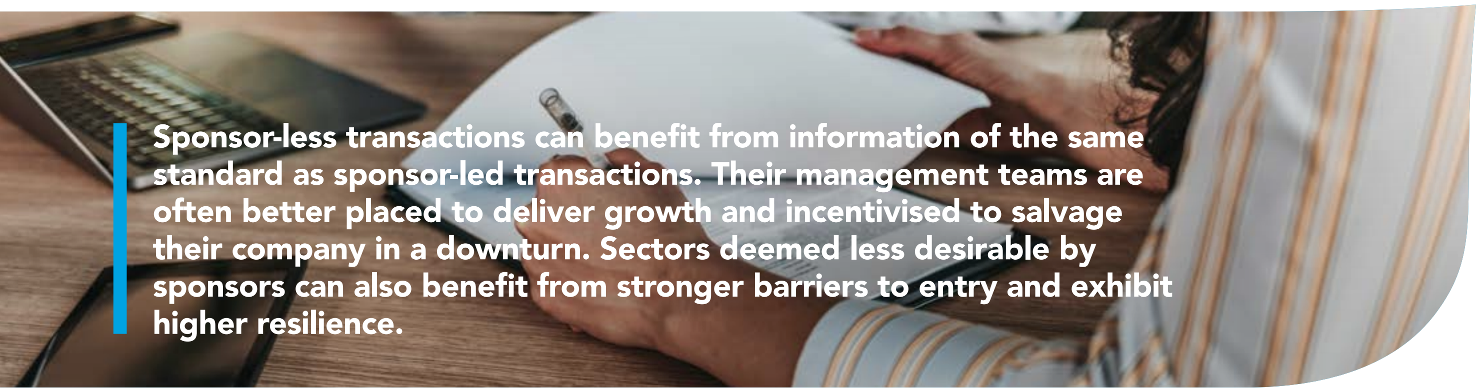
This said, one might argue that when a family or entrepreneur retains majority ownership, they may not be the best placed to bring the business to the next level. As the European market of SMEs in family or founder's hands is vast, this hurdle can be ironed out by a wide sourcing capability that enables one to cherry pick companies with competent management teams.

As for a sponsor's ability to take a business through its next phase of expansion by, for example, professionalising its sales model and/or improving operational efficiency, one might challenge whether there are any levers left to pull at the fourth or fifth LBO. In this scenario, a company may have even less room to drive up performance or improve profitability, making it more challenging to manoeuvre around the hefty leverage resulting from the high purchase multiple paid by the sponsor.

3 Furthermore, given the high level of returns required by private equity investors, sponsors tend to be more skewed towards 'high-octane' sectors, such as software and technology, media and marketing. These industries can be more volatile, cyclical and intangible, making them harder to defend and more open to substitution risk in the long-term. This has the potential to leave lenders more exposed to a loss throughout the life of the facilities, as most loans have a contractual maturity of six to eight years.

On the other hand, some sectors, deemed by sponsors as less desirable due to a more limited upside and modest growth profile, can benefit from stronger barriers to entry and exhibit higher resilience in a downturn, thus offering better downside protection and higher expected recovery to lenders throughout the cycle. After all, coming back to portfolio construction 101, debt investments are sought after *inter alia* for their ability to counter higher yielding but riskier and more volatile strategies.

4 Lastly, the absence of a deep-pocketed sponsor that can step in and inject equity in the midst of difficulty is often viewed as a deterrent. However, as the Covid-19 crisis proved, sponsors may not always be in a position to provide additional liquidity. This may occur when an investment vehicle is near the end of its contractual life and most of the capital has already been returned to investors, when the likes of a downturn or pandemic creates portfolio credit issues that put multiple investments under pressure and force sponsors to choose which assets to salvage or, simply, when a sponsor lacks incentive. Indeed, for the latter, having received back their initial investment and perhaps more, via dividend recaps, some sponsors prefer to hand back the keys to lenders and preserve IRR. Management teams in sponsor-less transactions, on the other hand, have built their business from scratch, own most of the equity, and are in the driving seat – these teams feel compelled to save the company they have built, protect their wealth and focus on the upside still to come.



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Navigating the fragmented European SME market

The main obstacle for direct lenders to penetrate the non-sponsor market is sourcing.

Despite the gradual disintermediation of the European sponsor-led market over the last decade, Europe has not experienced bank consolidation to the same extent as the US, a move that enabled US direct lenders to fill the gap left in the small and mid-cap segment[8]. With the political agenda and nationalistic sentiment at play in many European countries – even more so with regards to cross-border mergers – one can expect the European banking consolidation to remain a slow process. In that context, European banks remain dominant in the fragmented SME universe, where the vast majority of sponsor-less small and mid-market companies (too small to access the capital markets) source all or part of their finance from banks that have fostered long-term relationships in their region. For direct lenders to be able to source sponsor-less transactions, replicating the banks' vast on-the-ground origination capability in Europe would require significant time and resource – given the size of universe compared to the concentrated world of Private Equity[9] – and would likely result in a lower conversion rate compared to sponsor-backed transactions, as corporates tend to be less acquisitive on an individual basis than sponsors.

The disintermediation of the European SME world will be further hindered by the vast regulatory and cultural differences that exist across the European business landscape. Unlike the US, where the legal framework is more standardised and sponsor-less strategies can be launched across the whole region, lenders in Europe are forced to develop country-specific strategies and build local knowledge, infrastructure and connections.

With this in mind, the road to penetrate the space is not expected to become more straightforward for standalone direct lenders any time soon.

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The co-lending agreements giving private debt funds an advantage

But for some private debt funds, could things be different? Certainly, funds that have established co-lending agreements with local and regional banks, making them best placed to unlock the sponsor-less SME loan market. Through their partnership with banks, these funds can get access to small and mid-market companies with growth capital or refinancing needs, that do not want to go down the private equity route to avoid losing control or equity. Partnering with a bank the company has worked with for many years, such a fund will also gain better access to management during the due diligence phase and benefit outright from a certain sense of trust.

The fund can be privy to valuable information on the company, such as its track record over the last cycle – as opposed to the last three years of historic performance, which is typically all that the due diligence process in an auction covers – the impact of ancillaries, guarantees and revolving facilities on cashflow, and any past material events. Finally, these funds can leverage enhanced economics, as the "all in" yield of the additional liquidity they provide will be cheaper than the expenses associated with a full refinancing.

For investors, identifying European private debt funds benefiting from such arrangements in the sponsor-less space – combined with a strong presence in the private equity-backed landscape – is key to accessing the private debt asset class in its entirety and optimising portfolio diversification.

[8] Even if some countries like Germany and Spain have experienced higher consolidation with respect to their small local cooperative or savings banks, as of January 2020 there were still almost 6,000 credit institutions operating in the European Union. See Statista, Number of banks in Europe 2020 by country, November 2021. See also EBF, Banking in Europe: EBF publishes 2019 Facts and Figures, September 2019; Eurostat, The European economy since the start of the millennium – number of banks decreasing, 2019.

[9] The world of private equity funds is much more concentrated than the corporate landscape, meaning origination efforts centred on sponsors have more of an more impact over the long-term for direct lenders, with a higher level of 'repeat' business per sponsor. According to InvestEurope, there were 467 investment firms active in a buyout transaction in Europe in 2019 (including all types of firms, from large private equity buyout funds to family offices. On the other hand, as of March 2020, the European Commission was reporting 25 million small and medium-sized enterprises (SMEs) existing in Europe. Source: Invest Europe Research, Investing in Europe: Private Equity activity 2019 (slide 37). Source: European Commission – Unleashing the full potential of European SMEs, March 2020.

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