EXPERT Q&A

Direct lenders have a chance to pick up market share across Europe as dislocation hits and banks retrench, argues Jaime Prieto of Kartesia

Why lower mid-market sponsorless deals are in the sweet spot

SPONSOR
KARTESIA

Q What do you find attractive about the lower mid-market in Europe?

The biggest attraction is the ability to be selective. The lower mid-market offers a much broader range of opportunities and is less competitive, so we are able to build the portfolio of our choice. In times of crisis and dislocation or uncertainty, that is even more important. We are able to take into account all the different scenarios that might impact an investment and construct a portfolio that avoids some of those challenges.

People often talk about whether smaller companies are riskier than large companies. To us, that misses the point because you're just looking at the average. You are going to build your own portfolio and, particularly at the lower end, the opportunities are so diverse and disparate that you are able to build a more selective portfolio than average. At the larger end, it is much harder to deviate from the average and identify assets that are stronger than those identified by your peers.

Geographically, we find the UK interesting. It's a market where there has been acute consolidation of the banking sector, so banks are less competitive and we see fewer banks in the transactions we look at. Moreover, it is also an economy with attractive sectors, such as software, services, etc. It is not as easy to find those opportunities across Europe, but it is easy to scale those companies from the UK into Continental Europe.

Q What will be the challenges and opportunities in the space in the year ahead?

Generally, we find sourcing strong management teams at the lower end of the mid-market to be a challenge and that is a critical aspect of what we do. Once we have tested the business model of a company and its market positioning, then finding the right management team is really important.

Another challenge is aligning our interests with those of the owners of a company, whether that is sponsors or founders. A lot of what we do is in the sponsorless market so there is a real importance to making sure we are building a true partnership where the owners view us not only as financiers but as a finance partner. That takes time and sometimes objectives diverge.

In terms of challenges facing the portfolio, we have come very suddenly from a situation with limited inflation to a context where there is real supply chain driven inflation, particularly influenced by the price of energy massively increasing. In the lower mid-market, that's something we are watching closely. It is supply driven and it is possible demand will not be impacted, but we are looking at scenarios where we also see a decline in consumer demand and are taking that into account when considering new opportunities.

We have just carried out a review of our portfolio and we are reasonably comfortable with where we sit. Most of our companies have minimal exposure to Russia, but many have exposure into energy and obviously that worries us. We are already seeing some very large players shutting down factories and those decisions are not taken lightly. We are acknowledging the short-term impact of the war in Ukraine while also keeping a close eye on the longer term challenges.

"Most of our companies have minimal exposure to Russia, but many have exposure into energy and obviously that worries us"

Q What are you observing in terms of bank retrenchment across Europe? How does that trend vary by geography?

There has been strong growth in direct lending across Europe over the last three years, with a lot more focus from some of our competitors on growing their presence in Continental Europe. Many jurisdictions are benefiting from that education effort around the benefits of direct lending versus traditional bank finance and that is translating into strong growth.

Having said that, the European banks are still there and we tend to work with them in situations where we can partner. Consolidation is taking place across Europe. As an example, Spain was a very fragmented market historically. The consolidation underway will favour direct lenders.

We have offices in most of the key markets in Europe, having recently built out our presence in Italy and the Netherlands, we will have gone from seven to nine offices by the end of this year. That enables us to tap into opportunities in each of those markets. The French market is very competitive, while Germany is quite fragmented and slightly less transparent, which allows us to build an angle into transactions that can generate very attractive risk-adjusted returns because companies are not looking to maximise leverage.

The Benelux region is very attractive, particularly in sponsorless situations, and Italy and Spain are smaller markets presenting interesting opportunities from time to time. The Nordics is the region where we find the banks are most like direct lenders, with a lot of flexibility, so there are good opportunities but the banks are competitive and difficult to circumvent.

The best example is the US, where consolidation by banks meant they locked into larger deals and an opportunity opened up for direct lenders to take a larger percentage of the mid-market. That trend will follow across Europe but is currently at an early stage. Over the next 10 to 15 years, the space will gradually open up for European direct lenders.

Q Are you seeing an opportunity to do more sponsorless transactions? What is driving the sponsorless market?

There are many more sponsorless companies than sponsor-backed across Europe, and as a result there is a large subset that are at least as good as the sponsor-backed companies in terms of reporting, performance, transparency and business models. It is a segment of the market that one should not avoid and where you can find very good companies.

The most interesting aspect is that the main objective of sponsor-backed companies raising financing is to achieve a capital-efficient structure and the best equity returns. When you look at sponsorless companies, the main driver in raising finance is business growth. As a result, the conversation quickly develops into whether the financing makes sense and the company can generate the returns to repay the debt.

If things go wrong, as they will from time to time, in sponsored companies the owners will look at whether it makes sense to inject more capital or not. In a sponsorless deal, the owners don't want the company to go down (it's their baby). They will do whatever they can to put in money, even if it means remortgaging their homes. If you find the right company with the right owners, you are going to see greater commitment when working through challenges.

We are generating far better risk-adjusted returns in the sponsorless market, where we see lower risk, lower leverage, lower loan-to-value and better structures leading to better returns. Today, around 60 percent of our exposure is into sponsorless companies. We have always been very exposed to those situations, which require us to build our own capabilities to make the right judgements on companies. We do our own due diligence and spend a lot of time with founders and management teams to make sure we understand what they want, and in terms of monitoring. We certainly see more opportunities there and that's a growing market.

Q In the aftermath of the covid crisis, what impact is inflation having on private credit portfolios across Europe?

Last year, inflation was demand driven so we were able to pass that on in many cases through price increases for customers. Today is a different scenario, with significant price increases across raw materials like cereals and sunflower oil, which can have a massive impact on certain companies. That has the potential to create bigger problems because the ability to pass through those cost increases is not necessarily there.

Inflation is going to have a big impact into some of those businesses that depend on energy prices and some raw materials, but also on other companies in the value chain that are servicing those businesses. That impact is a lot more difficult to mitigate, but selectivity in portfolio construction is going to be even more important.

"The reality is that today you find European economies that are a lot more levered than they were before covid"

Last year, most situations saw the equity taking the brunt of the hit, but in this new scenario there are going to be some companies that are hit and that will impact our ability to recover capital on the debt. One good thing about the lower mid-market is that there is less competition and we really work in partnership with the companies that we finance, so we have good visibility and an enhanced ability to assess and react to these challenges.

Q How can lenders like Kartesia navigate that inflationary environment, and does it create any opportunities?

The reality is that today you find European economies being more levered than they were before covid, because covid generated liquidity requirements and companies often tapped government-backed loans or direct lenders for additional capital.

Those government loans now need to be repaid, as such, companies have come out with more debt on the balance sheet that they now need to refinance. With the uncertainty created by the war in Ukraine and the potential downward pressure on margins created by cost challenges, new lenders are going to have to step in. When it comes to complex situations direct lenders have an opportunity to offer more attractive terms and win propositions.

We saw during covid that banks had already agreed corporate deals in March 2020 but when the crisis hit, those banks shifted their focus to providing government-backed loans. There were many sponsorless companies looking to tap bank financing that ultimately came to us for those deals. In a crisis, we often find direct lenders increasing penetration and we expect that to be the case going forward. ■

Jaime Prieto is founding partner of Kartesia, the pan-European fund manager