EUROPEAN SME LENDING

How to find your niche

London-based LCM Partners launched a new direct lending strategy, LCM SOLO, in March. The firm's CEO and co-founder **Paul Burdell** explains why the European market continues to be attractive, and what it takes to be a successful new entrant

Q What do clients want from their direct lending managers?

The European direct lending market continues to go from strength to strength, as evidenced by the continued growth of the asset class. Over €21 billion of new capital was committed to direct lending strategies in 2017. The industry remains on track to reach the $1 trillion mark globally by 2020, according to forecasts by The Alternative Credit Council.

However, behind the headline numbers there are clear trends developing. As expected, the well-established managers, with proven track records across the cycle and significant resources, continue to raise ever bigger multi-billion-dollar funds. This has been predicated on ambitious moves into larger corporate loans and top-tier transaction sizes, taking on the syndicated loan and public bond markets head-on.

Conversely, the other main driver of growth has been institutional investor demand for more niche strategies that are able to provide clients with diversification within the context of a broader private credit portfolio. Recent examples include speciality finance funds relating to activities such as royalties and litigation claims, while the technology and data-based marketplace lending platforms also continue to gain traction.

Paul Burdell

"A MAIN DRIVER OF GROWTH HAS BEEN INSTITUTIONAL INVESTOR DEMAND FOR MORE NICHE STRATEGIES THAT ARE ABLE TO PROVIDE CLIENTS WITH DIVERSIFICATION WITHIN THE CONTEXT OF A BROADER PRIVATE CREDIT PORTFOLIO"

Q As the market matures are there still opportunities for new entrants?

The recent success of strategies with an innovative take on private credit is evidence that there are still opportunities for new entrants as long as the manager is able to demonstrate the product offering is differentiated. That is not only crucial in order to catch the eye of prospective LPs in a competitive fundraising environment, but also to ensure an actual market demand for the loans themselves at rates of interest which make sense in an equally crowded lending space.

Much has been written about the on-going implementation of regulatory legislation such as Basel III and IFRS 9 and its impact on the ability of banks to lend to an under-funded SME market. While there is undoubtedly increased pressure on the banks to manage their balance sheets more efficiently, in many instances competition for transactions remains high. As a result, it is important that new managers operate in those areas of the market where the banks and other traditional finance companies are not able to lend. At LCM we want to be considered as a partner – not as a disruptor or competitor – to banks and other specialist originators.

Q In what areas of the market have the banks retrenched?

In order to operate more efficiently, banks have simplified their operations and focused on their core lending activities. Sub-scale and non-core business activities have been exited and it is these segments of the market that offer some of the most interesting opportunities for private debt managers with the relevant experience and expertise.

EUROPEAN SME LENDING

For instance, we saw this back in 2015 when we acquired a portfolio of 20,000 equipment leases from a continental European bank that had decided to exit the UK market. Over time, those borrowers have paid down their original scheduled commitments and are looking for new credit to fund replacement assets or business expansion. This experience has been repeated across the 300,000 performing loan relationships acquired into our credit opportunities strategy. This is real life evidence that some parts of the SME and retail market are underfunded and there is an opportunity for asset managers to fill the void. In our case, launching a targeted direct lending product was a natural complement to our existing operations.

Q How does a manager lend to the sub-corporate market?

Lending platforms and speciality finance companies have been the primary non-bank providers of loans to the smaller ticket consumer and SME market. These businesses have grown rapidly as investors have been attracted to the diversifying benefits of having exposure to thousands of underlying borrowers resulting in low correlation and concentration risk. Given the European consumer and SME financing market is estimated to be well in excess of €10 trillion, there is also plenty of scope for growth and scale.

However, European direct lending funds have been less active in the retail and smaller ticket SME market for two main reasons. First, alternative investment funds are not allowed to originate consumer loans directly under AIFMD. Instead, a manager must provide financing to an intermediary who will ultimately make the loans in accordance with local regulations. Second, the management and servicing of many thousands of underlying borrowers is operationally complex and intensive. As a result, direct lending managers wanting to lend into this segment must either develop their operational expertise, find intermediaries with whom to partner or run more of a private equity strategy by buying the lender.

"THE RECENT SUCCESS OF STRATEGIES WITH AN INNOVATIVE TAKE ON PRIVATE CREDIT IS EVIDENCE THAT THERE ARE STILL OPPORTUNITIES FOR NEW ENTRANTS"

$1trn

Forecast global private debt AUM by 2020

Source: The Alternative Credit Council

Q Why would an intermediary seek financing from a direct lending manager?

Intermediaries such as original equipment manufacturers (OEMs), speciality finance companies or introducers look for external financing for a variety of reasons such as their own capital constraints or requirements to fund growth. Increasingly, private debt managers are seen as an attractive source of capital. Unlike banks that have access to the consumer market directly, private debt managers are not seen as competitors and are typically more flexible in the lending solutions they can provide. They can operate across borders and with a far quicker time to market.

However, a limiting factor can be that, as these intermediaries grow both their customer base and their product offerings, they struggle to develop the operational expertise to service the underlying borrowers and keep pace with demand. Our 19 years of experience in servicing consumer and SME loans becomes an important differentiating feature of our direct lending offering in discussions with OEMs and their captive finance companies. It also further integrates our business into their operating model which, in turn, should lead to more fruitful, longer term partnerships.

Q How do you manage risk when lending to the sub-corporate market via partnerships with intermediaries?

OEMs or speciality finance providers typically provide loans to their underlying customers based on origination scorecards that have been developed over extended periods of time. The benefit of this is that managers are able to access vast amounts of granular loan level data when performing due diligence. Risk can be further mitigated by ensuring that origination standards are maintained going forward through pre-agreed lending criteria and that appropriate controls are in place over underwriting. At the same time, the terms of the partnership can be structured to ensure that interests are aligned, such as through first-loss provisions or back-ended profit sharing arrangements. With the right balance of risk and reward between the partners, working relationships can be put in place to last for many years to come. ■

Sponsored by
LCM PARTNERS