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Alternative Lending Markets In Europe Are Increasingly Open To Mid-Market Companies

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Alternative Lending Markets In Europe Are Increasingly Open To Mid-Market Companies

The alternative lending markets in Europe have progressed by leaps and bounds in the past year. The (French) Euro PP market, for instance, has seen the emergence of unlisted deals, which has ushered in new and more international borrowers. And a number of initiatives from various industry bodies are building out a pan-European private placement market. In addition, the European direct lending market--where dedicated credit funds lend directly to predominantly sponsor-owned businesses--has grown to more than €10 billion across more than 200 deals in 2014, from about €5 billion a few years ago. The amount of information and credit data on this group of companies benefitting from this alternative funding is becoming increasingly critical because mid-market companies generally have higher credit risk. We observe that 39% of the midsized companies with a Standard & Poor's corporate credit rating, credit estimate, or mid-market evaluation (MME) assessment have credit quality that falls in the midrange of our MME rating scale or 'MM5'. This indicates that a company has "reasonably adequate capacity to meet its financial commitments relative to other mid-market companies," according to our criteria.

Overview

- Issuance of private funding for companies in Europe grew last year in many alternative funding markets to over €38 billion, including private placements and direct lending.
- New developments include the emergence of unlisted deals and senior secured debt.
- The growth of these markets makes independent research and credit assessment increasingly critical because mid-market companies generally have higher credit risk than their larger peers.
- While there are hurdles to increased investment by small and midsize companies, such as slowing growth in Europe, lower oil prices and the Juncker Plan offer potential support.

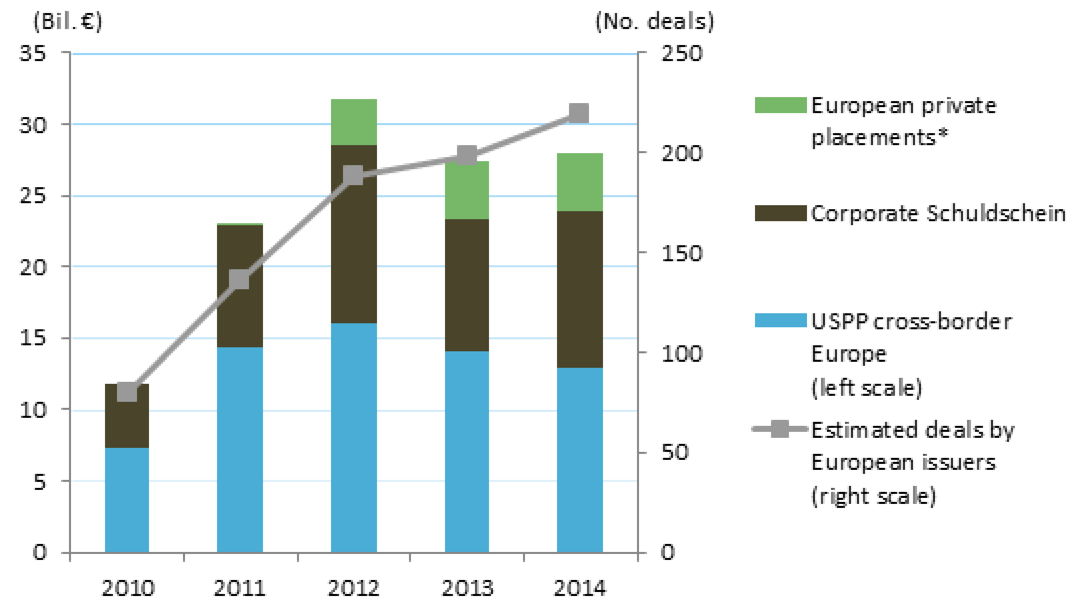
Given these positive market developments, expectations among regulators and politicians are high that alternative lending markets will support additional growth in Europe. Whether this happens depends on many factors such as the type and amount of funding available, and whether enough funding actually goes to support those companies with the highest chances of achieving growth. It also depends on investor confidence, which is currently ebbing due to perceived uncertainties, including geopolitical risk, slow growth, and the ongoing eurozone crisis.

The Private Funding Markets Continue To Grow

Issuance of private funding for companies in Europe grew last year in many alternative funding markets, in the context of the long-term trend of continuing bank disintermediation throughout Europe (see charts 5 and 6, appendix). This has been apparent particularly in the European private placement market, which still consists of predominantly French Euro PP issuance, as well as private placements arranged outside of France throughout the rest of Europe, including in the U.K. Overall in volume terms, private placement markets for European issuers--including the U.S. private placement market and Schuldschein--have remained solid over the past few years, totalling roughly €28 billion in 2014 (see chart 1).

Chart 1

Estimated Volume Of Issuance From European Companies On Private Placement Markets



*Includes both listed and unlisted deals done by French companies (under the Euro PP charter) as well private placements from other European issuers outside the Euro PP market. Sources: Standard & Poor's estimates, Private Placement Monitor, Barclays, BayernLB Research, IKB, Société Générale, CMS Bureau Francis Lefebvre, l'Agefi, BNP Paribas.

The USPP market remains the largest one for European issuers with about €13 billion raised in 2014, though it declined from just over €14 billion in 2013 and €16 billion in 2012. The Schuldschein loan market, mature and stable in size between €9 billion and €12 billion in the past three years, continued to open up for non-German issuers in 2014, as highlighted by the €359 million that the French healthcare service provider Korian issued in the last quarter of 2014. This happened at the same as time as the European private placement market (including French Euro PP) continued to gain traction, with €4 billion of issuance in 2014, in line with 2013, compared to €3.2 billion in 2012, according to our estimates.

Meanwhile, in the growing direct lending market, Standard & Poor's estimates that credit funds have raised a substantial €45 billion of capital up to the end of 2014, which we expect to be deploy mostly in sponsor-led transactions. Although this market is most active in London, the companies tapping into this capital are from a wide variety of countries in Europe. Based on conversations with market participants, we believe corporates raised more than €10 billion in capital in 2014 across more than 200 deals, at least double the volume and value at the end of 2013, when we believe the total raised was closer to €5 billion.

New Developments As The European Private Placement Market Surges Ahead

Steps have also been taken, on the initiative of the Pan-European Private Placement (PEPP) working group, to build on the French Euro PP Charter and propose common market standards and best practices, critical for the development of a Europe-wide private placement market. The Loan Market Association, in conjunction with the PEPP, has launched new loan and bond documentation for European private placements under English law, while the Euro PP working group has also launched revised documentation under French law.

This builds on the growth of transactions outside of the French Euro PP market. For example, there were transactions from Italian, Belgian, and Spanish corporates publicly reported in 2014. In addition, deals below €50 million have increased by 40% in 2014 and the median deal size has dropped 15%. Currently, the average size of issuance is €70 million, the average coupon is 4.2%, and the average associated maturity is seven years.

Another new feature is in the emergence of unlisted deals on the Euro PP market, representing 45% of the number of deals in 2014, and €1.5 billion by value. This is a drastic increase compared with the €350 million of unlisted deals in 2013 by value, according to Standard & Poor's data (note: these figures are not exhaustive as they do not take into account all private placements in the form of loans for which public information is usually not available). The introduction of unlisted bonds or loans as eligible for private placements for French investors has meant that it has become much easier for a wider variety of companies--including smaller ones--to tap the newly developing market. For example, mid-market metal and glass container manufacturer Fareva last year issued a record €225 million unlisted Euro PP bond with a seven-year tenor and a 3% coupon, combined with an unlisted Euro PP loan of €50 million. Although the possibility to issue on an unlisted basis has increased deal flow, it has also decreased transparency in this market, as unlisted companies do not have to make their transactions public.

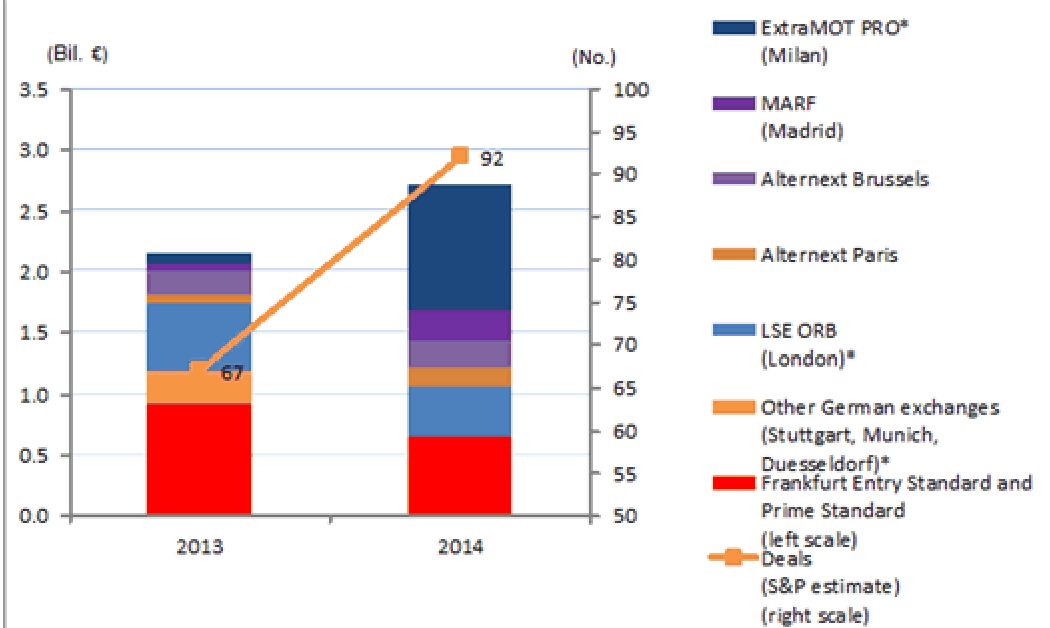
We have also observed the emergence of senior secured debt, pari passu with bank loans, with public French infrastructure group NGE's €70 million Euro PP issue in July 2014. This is a debt structure that speculative-grade companies typically use in the public markets. The appearance of this structure on the Euro PP market implies that it is starting to see a wider range of credit risk (Standard & Poor's does not provide a credit opinion on this company).

Bond Exchange Platforms Are Seeing More Action

Issuing bonds via exchange platforms continues to be an increasingly open avenue for small and midsize enterprises (SMEs) seeking funding in sizes smaller than €200 million. In the past year, the ExtraMOT PRO segment on the Milan exchange saw incredible growth, with more issuers in 2014 than all other European exchange platforms combined, led mainly by SMEs (see chart 2).

Chart 2

Estimated Size Of Bond Segments For Small And Midsize Issuers On Selected European Exchanges



Note: Excludes deals of €200 million and above (ExtraMotPRO, Frankfurt Prime Standard); excludes financial or public issuers (LSE ORB). Sources: Standard & Poor's estimates, exchange websites (bond listings as of Jan. 15, 2015).

Likewise, Madrid's Alternative Fixed-Income Market or MARF also saw a pick-up for smaller companies, attracting a similar number of issuers to the other, more established exchanges. And although the German exchanges did see a dip, we believe the reason is the high default rate of German mid-market companies. Although these markets are open for companies with a wide range of credit profiles, there are those with higher risk, some of which have defaulted. In fact, in Germany a total of 21 issuers with publicly listed mid-market bonds between 2012 and 2014 have defaulted, out of a total 151 issuers that came to German mid-market bond platforms, according to Statista 2015 data. For more information on this and the German market, see "Why Germany's Mid-Market May Slowly Seek New Ways To Fund Growth," published July 30, 2014.

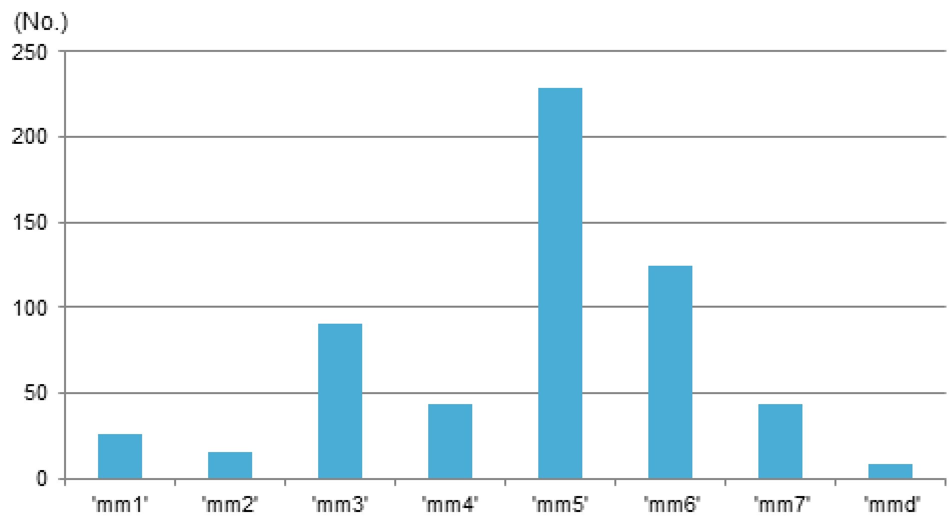
Credit Assessments Are Essential For Mid-Market Companies

The type of defaults seen in Germany highlights the possibility of mismatch of risk and price, and shows how important it is for external third-party credit experts to provide analysis of SMEs. Large high-profile issuers might be able to issue bonds without any risk assessment in the form of a public rating. As long as an issuer's credit risk is low, the need for detailed and accurate credit risk assessments might not be as important. However, for medium and smaller mid-market companies, independent research becomes much more important because, on average, their credit risk is higher.

Indeed, according to Standard & Poor's assessment of credit for mid-market companies included in our corporate credit ratings, credit estimates, and mid-market assessments via MME testing, we find close to a normal distribution, with 39% of the total of 580 companies having the equivalent of an 'MM5' score (see chart 3). Our data also show that 60% of these 'MM5' companies are sponsor-owned, with 50% of the total dataset falling into the same category. Among the 26 companies assessed as 'MM1', 65% operate in the utilities sector, 20% in the transportation sector, with the remaining split between the healthcare and chemicals industries.

Chart 3

Distribution Of Mid-Market Companies Rated Or Assessed By S&P*



*Number of mid-market companies with either a corporate credit rating, a credit estimate, or an MME tested mapped to the MME scale. Total is 580 as of January 2015. We define a mid-market company as having revenues below €1.5 billion and debt below €500 million. Includes LBOs.

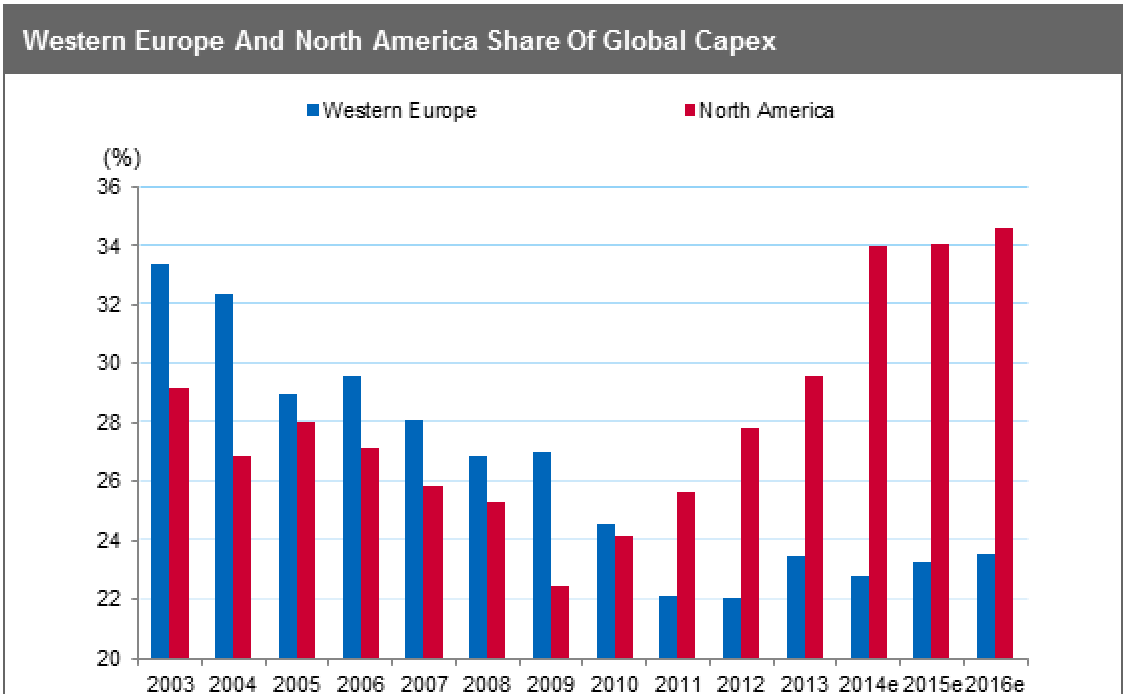
In the absence of credible credit assessments, that is, without opinions about default probability, investors have difficulties making appropriate decisions for their capital allocation and pricing. Such information and transparency are key to effective capital allocation. To this end, Standard & Poor's extended the scope of its MMEs to public ratings in November (for details, see "Mid-Market Evaluation Rating Methodology," published Nov. 20, 2014).

Hurdles For Smaller Firms Remain, But Help Is On The Horizon

We believe that the main driver for growth for SMEs and midsize firms ultimately depends on greater capital expenditure, which will also boost demand for additional financing.

Given currently low overall capex spending in Europe (see chart 4), it becomes clear that the risk-return equation does not seem to be sufficiently balanced to warrant this spending. Since 2011, Europe has been significantly lagging North America in capex, and so far this has been limited to renewals. The main reasons for this hesitation among many companies in Europe are their expectations of relatively weak growth in the eurozone, and other economic and geopolitical uncertainties.

Chart 4



Capex--Capital expenditure. e--Estimated. Sources: S&P Capital IQ, Standard & Poor's Ratings Services' calculations, IMF; Universe is global capex 2000. Nonfinancial companies only.

We see other factors that are supportive of additional investments. Among them are low oil prices, via its positive effect on additional consumption and corporate profitability, which eases costs for both businesses and private consumers. The euro's slide against the U.S. dollar is making exports from Europe somewhat cheaper, and, due to loose monetary policy, liquidity for corporates is still available at low lending costs.

It remains to be seen whether companies benefiting from lower oil prices can turn their cost savings into higher investments. The expected effect is that private consumption will rise and so will top-line growth through higher demand. Companies related to the oil industry are bound to cut investment significantly if low prices are here to stay. Given their share of 40% of global capex in Europe, the overall net effects on top-line growth of an incremental increase in capex are unclear at this point. On the more positive side, some specific industries with a concentration of mid-market companies--in France, the U.K., and Germany--have good prospects for further capex growth, such as information technology, consumer, and health care (see chart 6, appendix).

Another supportive factor for SMEs and mid-market companies is the current Juncker Plan, which proposes a total of €315 billion of investment into Europe's economies. The European Fund for Strategic Investments (EFSI) will contribute €21 billion initially through EU guarantees and the European Investment Bank (EIB) contributions. The bulk of the EFSI will support infrastructure debt investments, but a meaningful portion will be dedicated to SMEs and mid-market companies. In particular, the EIB will provide €5 billion in the form of equity-type investments and loan guarantee facilities. This aims to generate a total of €75 billion of funds over the period 2015-2017 for SMEs and mid-market companies through a 15x multiplier or through raising additional private capital on top of the €5 billion of EU capital.

How the money will be distributed will be decided by an administrative council jointly controlled by the EIB and the EC. Since the funds are supposed to support growth and the creation of new jobs, we expect that a higher percentage will be allocated to countries that have suffered most in the financial crisis. It remains unclear, however, which SME and mid-market companies specifically will benefit from this cheaper source of capital. The current "ring-fencing" of the €5 billion just covers SMEs and mid-market companies in general. From an economic perspective, the EU money would probably best be put to work by supporting companies that create the highest degree of innovation and the most jobs as they grow, and those that currently are cut off from external financing to realize their plans. This would most likely be start-ups, younger firms, and established SMEs with a growth focus.

Research contributor: Silvia Platzer.

Appendix

Chart 5

Corporate Funding In 2014 Versus 2013, Selected European Countries

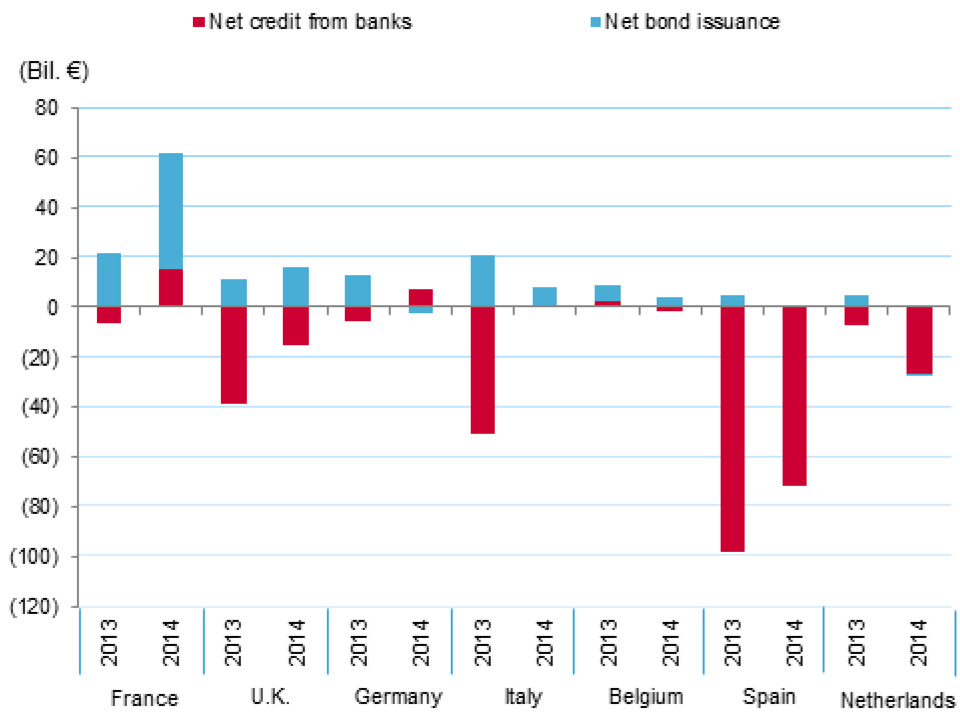


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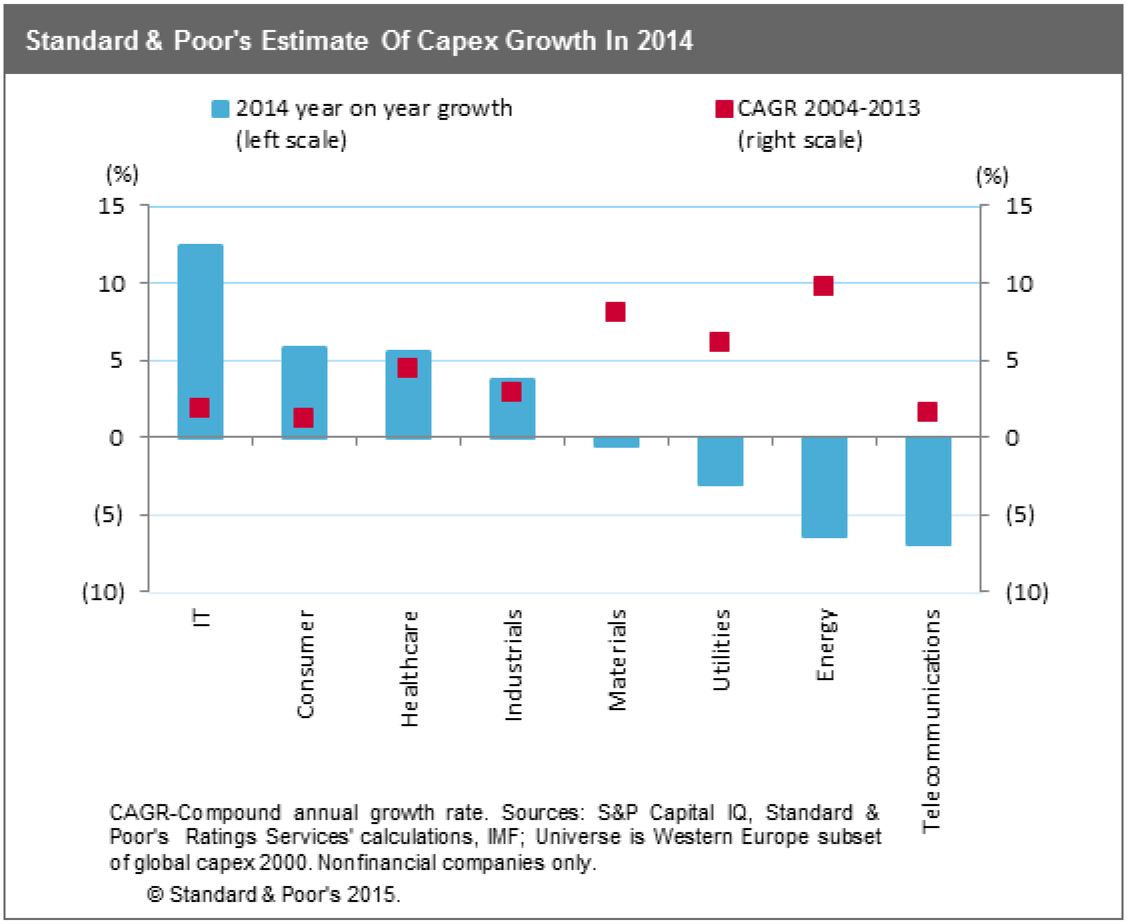
Chart 6



Related Criteria And Research

Related criteria

- Mid-Market Evaluation Rating Methodology, Nov. 20, 2014

Related research

- Flatlining: European Corporate Credit Outlook 2015, Dec. 8, 2014
- Credit FAQ: Standard & Poor's Mid-Market Evaluation Ratings Explained, Nov. 20, 2014
- France's Mid-Market Is Resisting Tough Economic Conditions, Oct. 8, 2014
- Mid-Market Funding Is Making Strides, But Has Far To Go, April 29, 2014