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Banking Disintermediation in Europe--A Slow-Growing Trend

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Alternative funding sources for mid-market companies remain fragmented across Europe. For the time being, bank loans are still the main pillar of corporate debt funding in the region. Yet, bank funding disintermediation--where corporations obtain debt funding from sources other than banks--is broadly gaining ground. In the U.K., bond financing had increased to 29% of corporate funding by the end of 2014 from 22% in 2006. In France it increased to 22% from 16%, and in Italy to 12% from 7% over the same period. We also see investors in pan-European private placements (PEPP) stepping up their exposure to companies with investment-grade and cross-over credit characteristics.

Overview

- Disintermediation of bank funding is gradually increasing in Europe as public and private financing routes develop as alternatives to bank financing.
- In Europe's high-yield bond market, the volume of non-sponsored deals has increased significantly from €22 billion in 2012 to €50 billion in 2014.
- Nevertheless, structural differences across countries in Europe for the supply of bank loans remain, which create different levels of needs for alternative market funding solutions.
- While public policy and private sector initiatives such as the Capital Markets Union project will support the growth of alternative market funding solutions, bank funding is likely to continue to dominate the overall supply of debt in Europe.

In Europe's high-yield bond market, a sub-segment of the total bond market at the lower end of the credit risk spectrum, the volume of non-sponsored deals has increased significantly, from €22 billion in 2012, to €44 billion in 2013, and €50 billion in 2014. The upward trend continued during the first quarter of 2015, suggesting that disintermediation is also gaining some ground across the broader corporate sector.

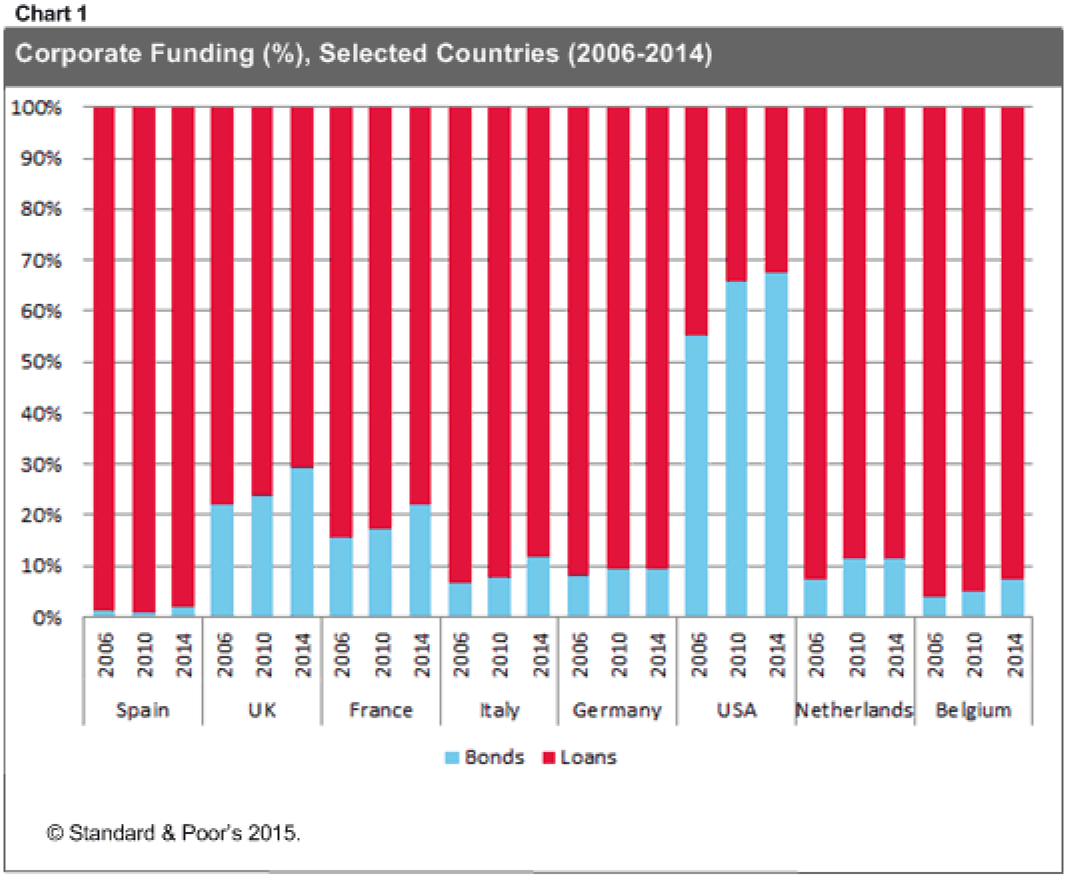
Overall, we expect alternative funding markets will continue to slowly gain further ground in Europe. More transparent and widely accessible alternative funding markets that work across EU country borders and that are able to cover the higher credit risk of mid-market companies are still to be developed. Yet, the establishment of more efficient capital allocation for mid-market companies is being supported by political efforts, such as the Capital Markets Union (CMU) project announced in July 2014 by EU Commission President Jean Claude Juncker. The CMU project encompasses a wide-ranging agenda to remove barriers to the free flow of capital in Europe and increase the role of market-based finance in funding European businesses (see Standard & Poor's Discussion Paper "Sustainable Growth: Towards A Capital Markets Union In Europe," published May 13, 2015).

But despite this progress, public bond financing in Europe is still far below current levels in the U.S., where it accounts for almost 70% of total corporate funding, including mid-market companies. Furthermore, disintermediation seems to be occurring at a different pace in individual European countries. In some countries, including Germany and France, bank loans to corporates are still by far the main source of corporate funding. Until efforts in Europe gain some ground, we expect that markets will stay fragmented and banks will continue to dominate the supply of debt.

Disintermediation Is Broadly Gaining Ground

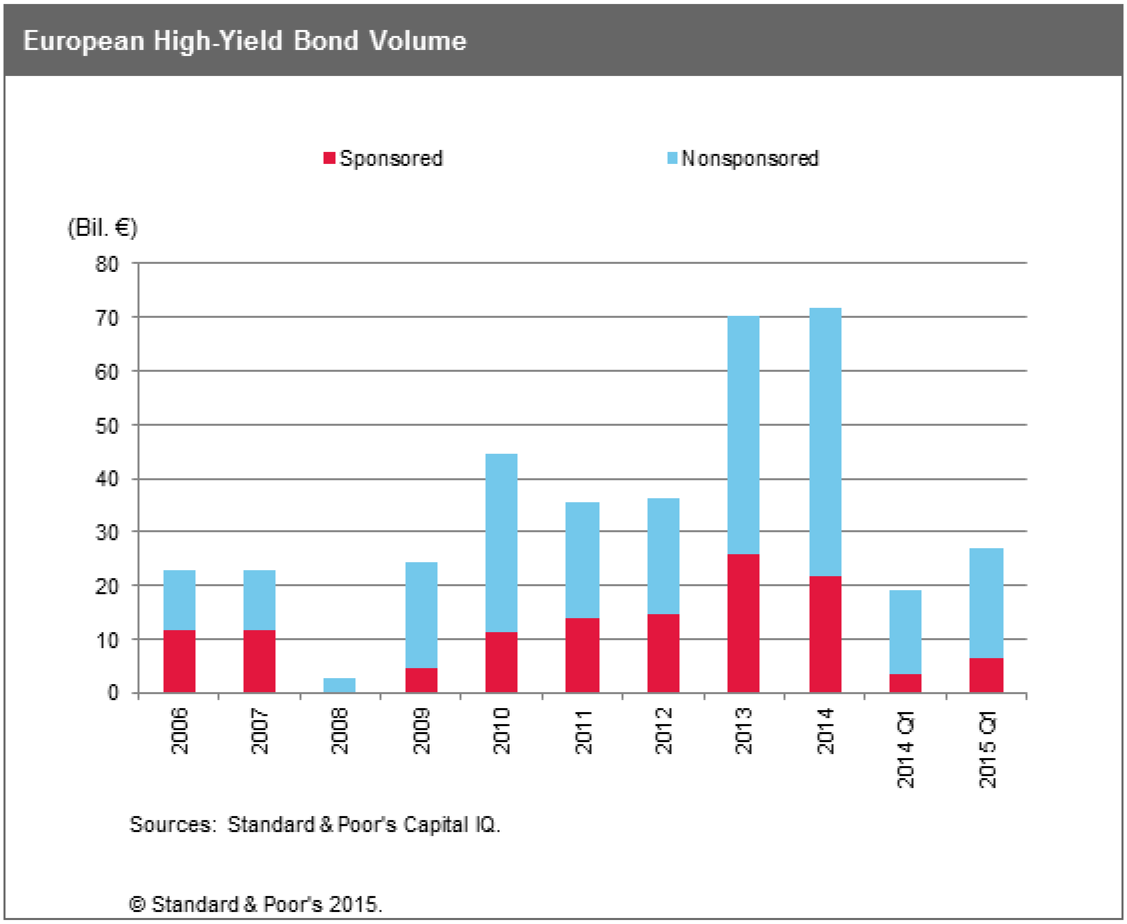
Statistics suggest that public and private financing routes in Europe are generally developing as an alternative to bank financing. Between 2006 and 2014, bond financing increased by 48% in the U.K., and by 95% in France and Italy. Yet, on an absolute level, bond financing is still limited compared with loan financing. While the U.K. has the highest proportion of public bond financing in Europe at 29%, this is still far below the U.S., where it makes up almost 70% of total corporate funding, including mid-market companies (see chart 1).

Chart 1



Nevertheless, developments on Europe's high-yield bond market suggest disintermediation is also gaining some ground in the broader corporate sector. The volume of non-sponsored deals increased significantly from €22 billion in 2012 to €50 billion in 2014 (see chart 2).

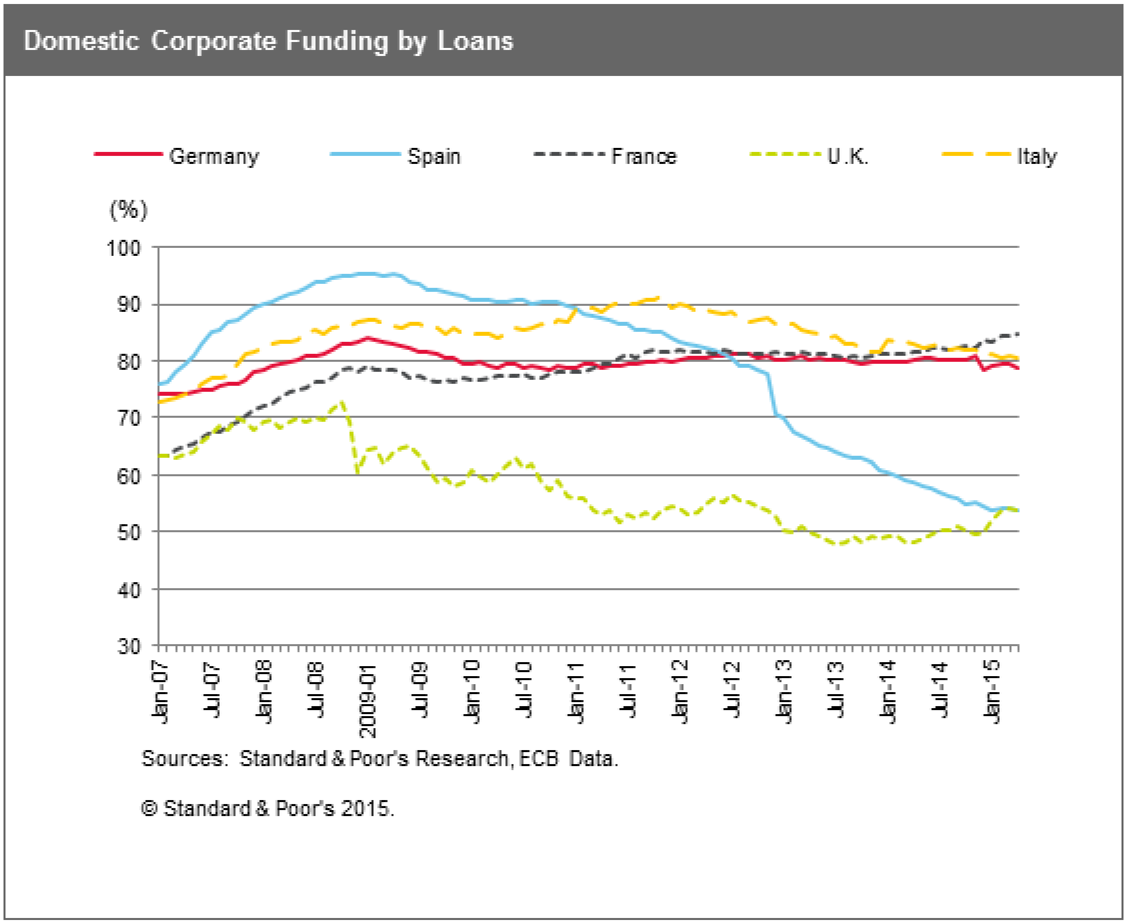
Chart 2



The Pace Of European Disintermediation Varies By Country

Disintermediation is progressing at varying paces in different European countries. Bond financing appears to have become a partial substitute for domestic bank debt in the U.K. and Spain. But banks continue to supply a high portion of corporate domestic loans in Germany and France (see chart 3). In Italy, the proportion of bank funding has declined continuously, but remains at a high level.

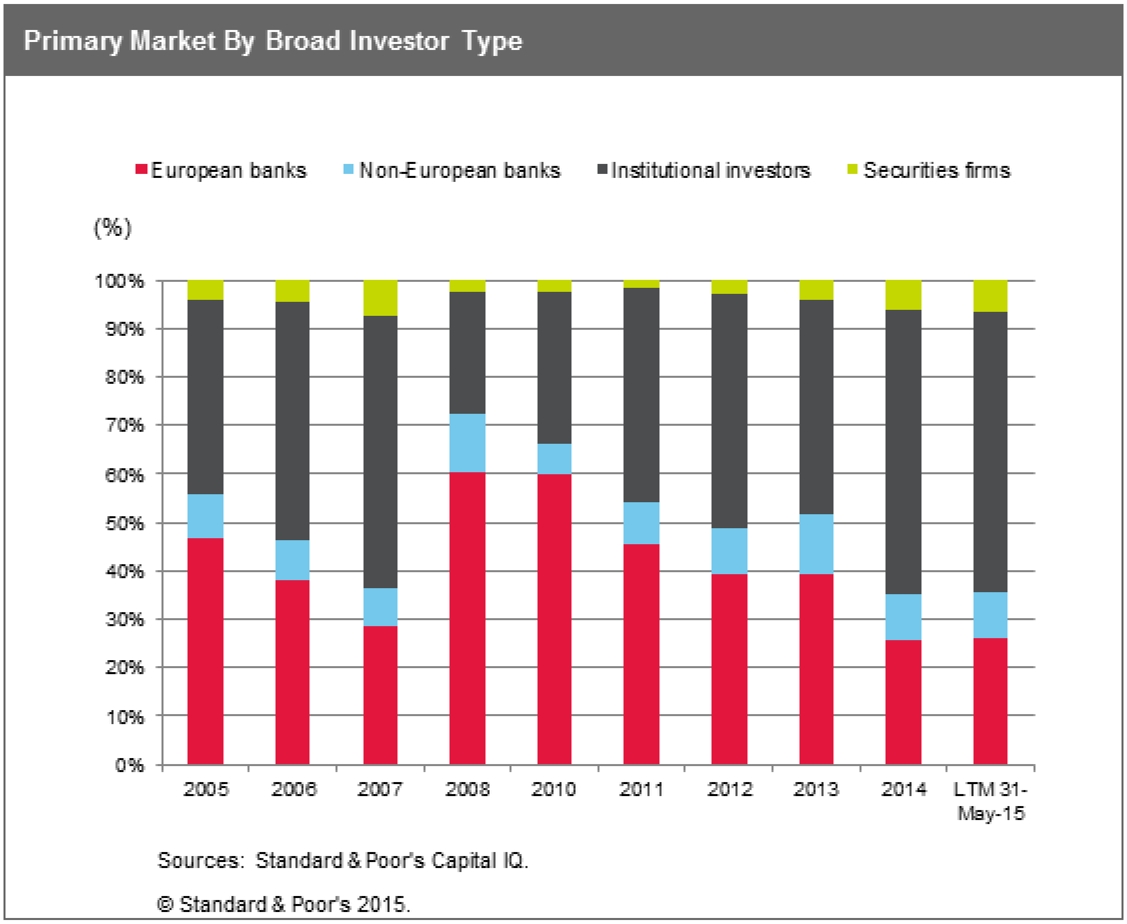
Chart 3



This variation is rooted to some extent in the historical development of banks in their respective countries. For example, in Germany cooperative and savings banks have a long-established track record of providing local funding to mid-market companies. These banks increased their lending by about 3% during the 2008-2009 financial crisis at a time when the country's larger commercial banks reduced their overall exposure. Governed by German public law, German savings banks fulfill a public mandate of providing funding to local businesses, and are owned by local cities and counties that cannot sell shares to third-party investors. This structure makes saving banks an integral part of the German banking landscape, a situation that is unlikely to change quickly.

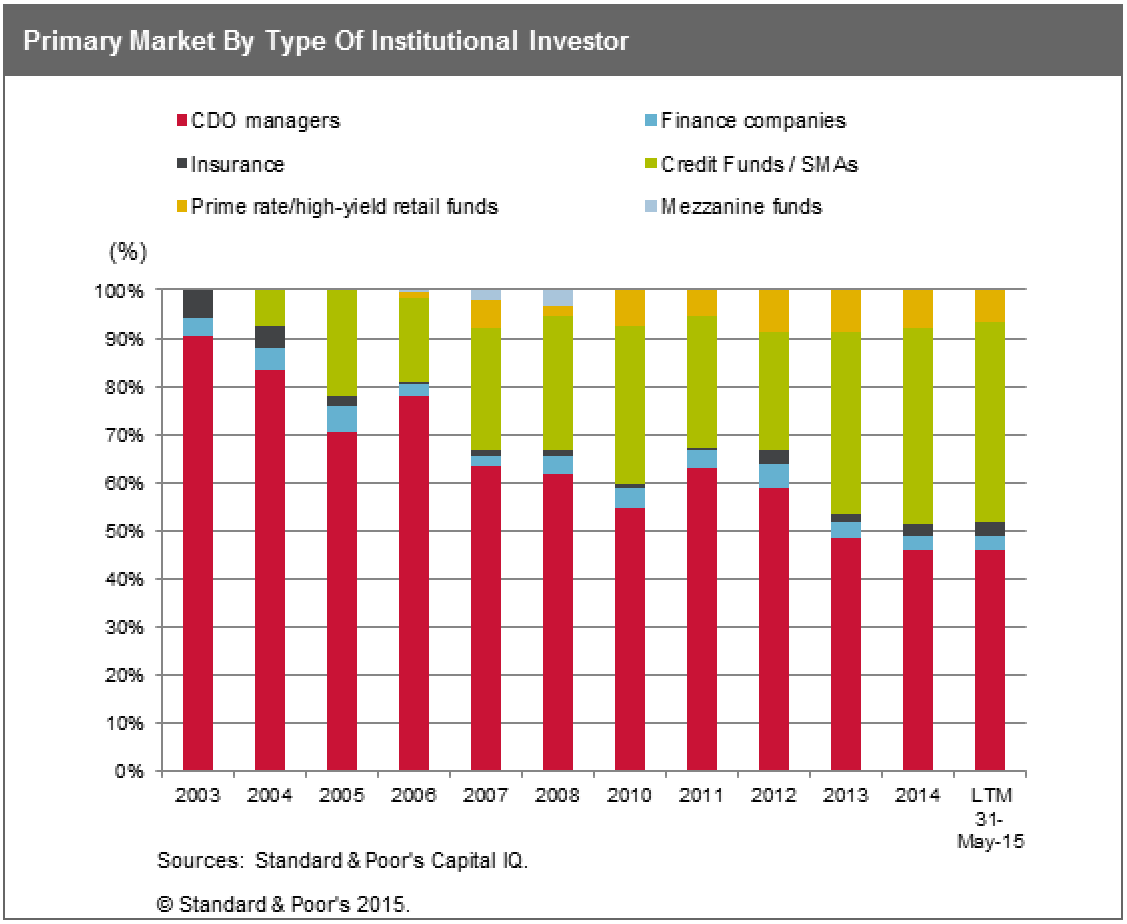
In terms of type of investors involved in disintermediation, a look at the distribution in the primary high-yield market offers some insights. As banks continued to retreat again in 2014 to levels similar to those in 2007, institutional investors have gained significant ground, covering over 50% of total deal volume (see chart 4).

Chart 4



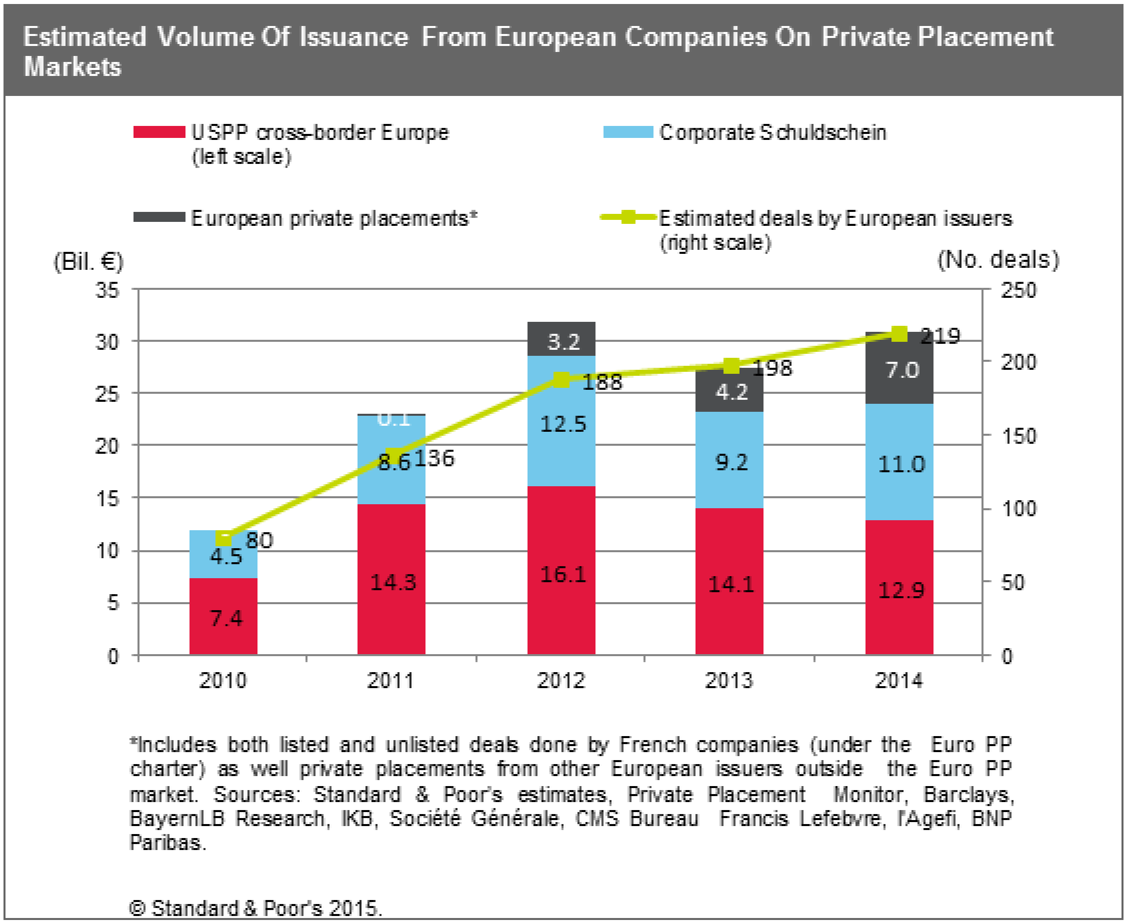
Within the institutional investor group, credit funds and separately managed accounts (SMAs) have increased their footprint significantly to over 41% of the total volume, from 24% in 2012 (see chart 5). They appear the best equipped to manage higher credit risk, while also offering more flexible terms and conditions than classical bank financing. Insurance companies and retail funds still play only a minor overall role in the high-yield segment. They are instead pursuing investment via credit funds and SMAs at this stage.

Chart 5



The pan-European private placements (PEPP) market gained some momentum in 2014, growing to a total volume of €7 billion from €4.2 billion in 2013 (see chart 6). Investors in European private placements are stepping up their exposure to companies with investment-grade and cross-over credit characteristics.

Chart 6



Funding Alternatives for European Corporates

Medium-size companies contribute nearly one-third to the private sector GDP of the EU economy. For this important segment to obtain optimal funding, sufficient capital must flow freely from investors into the best available alternative investment targets at appropriate risk-adjusted prices. Well-functioning financing markets support the efficient allocation of capital and greater funding for capital expenditure, which in turn boosts overall European growth.

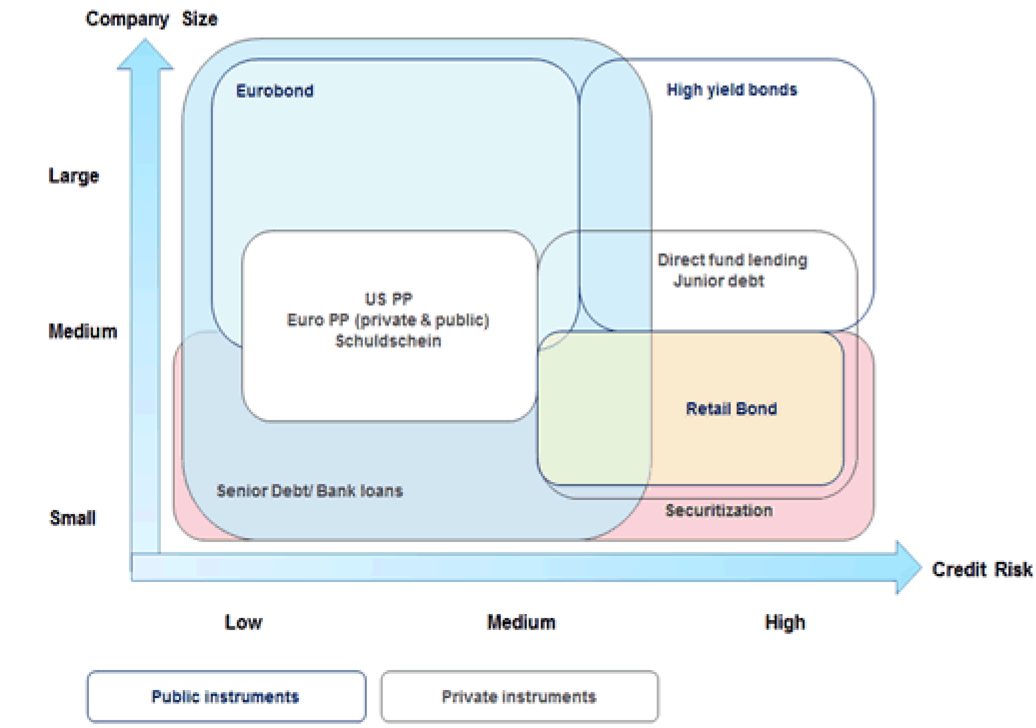
We forecast that mid-market companies in Europe (eurozone plus the U.K.) will need €2.7 trillion-€3.1 trillion over the next five years to honor their refinancing and to fund growth. Recent research by Standard & Poor's on mid-market financing in Europe has shown that the main barrier to growth is not the amount of debt capital market funding available: Nonbank funding of European companies grew to over €38 billion in 2014, including private placements and direct lending. While this represents only a small percentage (less than 0.5%) of corporate loan funding in Europe relative to the €70 billion primary volumes of issuance in the European high-yield market in 2014, it is still quite substantial.

As disintermediation continues in Europe, with rising corporate funding needs, we expect capital markets funding will become a growing complement to bank lending, especially for mid-market companies.

Currently, mid-market funding alternatives come primarily from domestic sources across Europe in both private (loan) and public (security) formats (see chart 7).

Chart 7

Debt Funding Alternatives For European Corporates



The funding map shows that larger mid-market companies with low credit risk have full access to established funding from banks as well as term funding from the U.S. private placements, Schuldschein, European private placements, or eurobond markets. For those companies, no funding gap is currently visible.

Smaller companies typically rely exclusively on bank financing, including overdrafts, working capital facilities, trade credit, leasing, and term loans. Their access to capital markets or private placements is generally not viable on a cost-benefit analysis due to their relatively small total funding requirements.

The existing funding alternatives for the medium-size segment consist of a patchwork of different markets, each one catering to different investor groups in terms of underlying company credit risk, yield expectations, market liquidity, and regulatory capital constraints. For example, to access the U.S. private placement market or Germany's Schuldschein, investors would generally need to view a company as an investment-grade credit risk. The percentage of companies considered speculative-grade in these two private placement markets, however, is relatively low given insurers' and banks' high regulatory capital requirements for speculative-grade type risk. Nevertheless, the risk appetite of some investors--especially non-European--seems to be pushing the boundaries of the German Schuldschein market deeper into crossover territory (i.e. 'BB'-type credit risk on Standard & Poor's rating scale).

The newly established pan-European private placements (PEPP) market is perceived to have a wider scope and also offers many 'BB'-type companies access to alternative--mostly French--investors. In addition, the recently established direct lending market through credit funds covers mainly LBOs in Europe based on certain minimum yield expectations. This new type of investor class has emerged due to the banks' continuing retreat in LBO underwriting capacity. Lending appetite via debt funds has increased significantly, as has competition for deals in this area.

In addition, public retail bond markets offer companies across the medium- to high credit-risk spectrum access to a diversified base of retail investors. These markets also continuously grow through entries of selected institutional investors.

However, companies' cost for accessing public capital markets is relatively high. Moreover, less investor sophistication compared to purely institutional markets and lack of transparency impose the risk of adverse selection issues, i.e. lower credit quality might not become sufficiently transparent for market participants. Markets might then not properly develop deep funding capabilities or, in a worst case, even break down (as revealed by the German mid-market public bond market's extraordinarily high default rates).

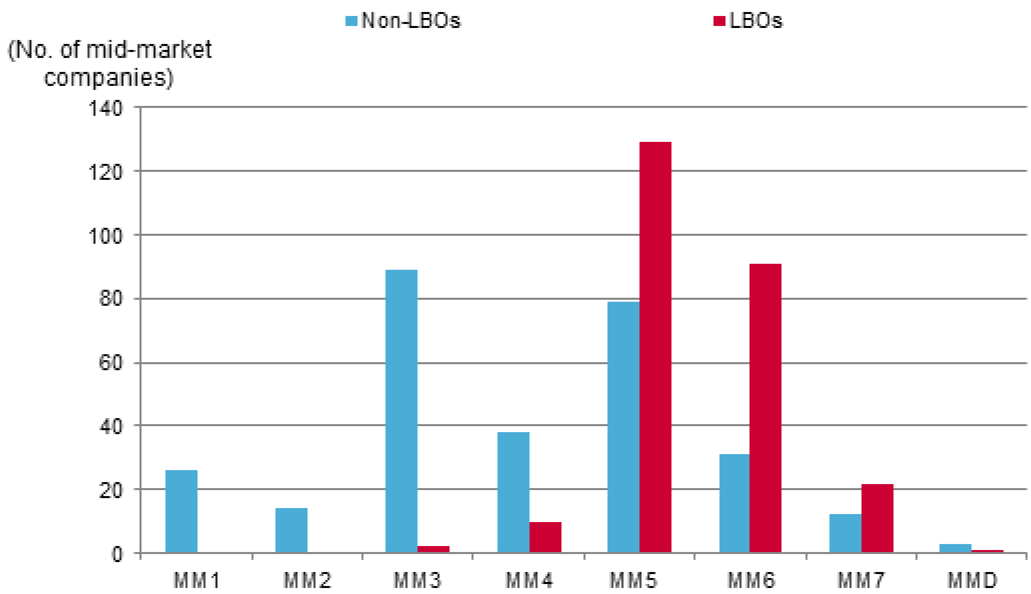
Where European Mid-Market Companies Stand On The Credit Spectrum

Based on Standard & Poor's research, most mid-market companies do not fall into very low default probabilities commensurate with investment-grade convention. Rather, they have higher default probabilities covering the full spectrum from cross-over to high yield. In fact, mid-market companies in the LBO segment typically show a credit risk of MM5 and MM6 on our mid-market scale (which indicatively maps to 'B+/B' and 'B-' on our corporate ratings scale), whereas non-LBO companies are spread out more evenly across the credit-risk spectrum, with a strong representation on MM3 and MM4 on our mid-market scale (which corresponds to 'BB+/BB' and 'BB-' on our corporate ratings scale; see chart 8).

The distribution of credit risk for mid-market companies is important. To the extent investors face regulatory constraints or high perceived information asymmetries regarding speculative-grade credit risk, alternative financing markets for medium-size companies will likely not be able to grow as hoped for by investors and European policymakers trying to support access to alternative financing. Consequently, there is a strong argument for generating cost-efficient access to comprehensive and transparent credit analysis across Europe.

Chart 8

Distribution Of Mid-Market Companies Analyzed By S&P



*Number of mid-market companies with either a corporate credit rating, a credit estimate, or a mid-market evaluation (MME) mapped to the MME scale. Total is 547 as of April 2015. Source: Standard & Poor's.

In addition, the historical convention of splitting markets into investment-grade and high-yield in a binary or simplistic way creates additional hurdles in properly defining mid-market funding segments. Standard & Poor's research on historical default rates shows no "cliff" exists between investment-grade ('BBB-' or higher) and speculative-grade ('BB+' and lower). Rather, default rates gradually increase as one goes down the rating scale (see chart 9 and table 1 in the Appendix).

This finding supports the conclusion that funding sources need to span a credit spectrum supported by an institutional, legal, and regulatory setup catering to both investment-grade and cross-over as well as speculative- grade companies.

A setup needs to recognize that funding alternatives for companies with lower credit risk should not necessarily be separated by an artificial border of being explicitly or implicitly rated or unrated as investment-grade versus speculative-grade. Rather, it seems more appropriate that investors can clearly identify credit risk along with ensuring appropriate capital requirements.

Challenges To Establishing Alternative Debt Funding Solutions In Europe

The challenges to establishing alternative debt funding solutions in Europe are primarily related to existing market structures. Public and private alternative funding for mid-market companies with relatively good credit quality is primarily provided by established and proven European local markets (such as the German Schuldschein) or foreign overseas markets (such as the U.S. private placement market). But mid-size companies with higher credit risk, commensurate with a speculative-grade rating ('BB+' or below), are still mainly reliant on domestic bank or public high-yield bond funding even though the pan-European Private Placement market is offering new avenues for down to 'BB-' type of credits. In addition, private direct lending funds, typically sponsored by institutional money, seem to selectively pick up corporate funding demand in this area.

In addition, in a cross-border context, investors might shy away from high search and credit review costs for relatively small lending ticket sizes for nondomestic companies they are not familiar with. Broader and more standardized and cost-efficient credit risk coverage of mid-market companies in Europe would make a step change towards reducing the information asymmetries between investors and companies. But widely accepted solutions still have to evolve. Support is coming from the political side, with projects such as the Capital Markets Union (CMU) announced in July 2014 by EU Commission President Jean Claude Juncker. The CMU project encompasses a wide-ranging agenda to remove barriers to the free flow of capital in Europe and increase the role of market-based finance in funding European businesses (see Standard & Poor's Discussion Paper "Sustainable Growth: Towards A Capital Markets Union In Europe," May 13, 2015). Until those efforts in Europe gain some ground, we expect that markets will stay fragmented and banks will continue to dominate the supply of debt in spite of high influx of funding supply by debt funds and providers of public debt.

Appendix: An Explanation Of Our Estimate Of Mid-Market Companies' Funding Requirements For The Next Five Years

We forecast that mid-market companies in Europe (eurozone plus the U.K.) will need €2.7 trillion-€3.1 trillion over the next five years to honor their refinancing and to fund growth. This estimate rests on the following assumptions:

- Of €9.4 trillion of total non-financial corporate debt outstanding, as of December 2014 (according to European Central Bank and Bank Of England data), we estimate that a little more than one-third relates to large corporations, based on S&P Capital IQ data. The balance relates to small and midsize corporations, representing about €5.9 trillion of debt outstanding.
- Assuming that mid-market companies are responsible for about 25% of total corporate debt, broadly consistent with their economic weight in terms of revenue contribution, for instance, mid-market companies will need about €2.4 trillion to cover their refinancing needs until 2019 (assuming that corporate debt outstanding has an average tenor of five years).
- We forecast that annual nominal GDP growth will average about 2.8% in the eurozone and 4.0% in the U.K. between 2015-2019.
- Taking account of our growth forecasts, and assuming that new debt financing for mid-market companies grows between 1x and 2x nominal GDP, these companies will require additional financing amounting to between €370 billion–€780 billion over 2015-2019. All in all, by our calculations, midsize companies in the eurozone and the U.K.

could have funding requirements of between €2.7 trillion and €3.1 trillion until the end of 2019 to support both refinancing and growth.

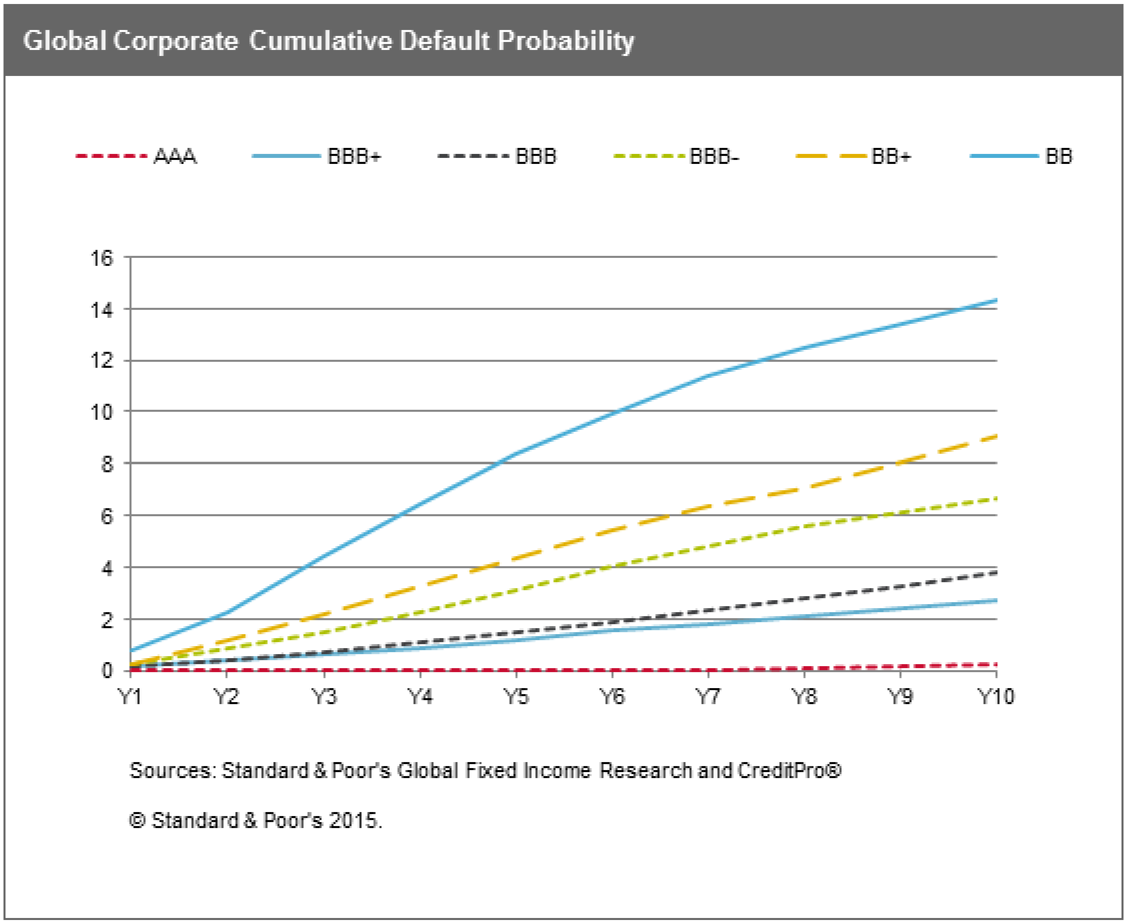
Table 1

Global Corporate Average Cumulative Default Rates By Rating Modifier (1981-2014) (%)

	--Time horizon (years)--														
Rating	**1**	**2**	**3**	**4**	**5**	**6**	**7**	**8**	**9**	**10**	**11**	**12**	**13**	**14**	**15**
AAA	0	0.03	0.14	0.24	0.36	0.47	0.53	0.61	0.67	0.74	0.77	0.8	0.84	0.91	0.98
AA+	0	0.05	0.05	0.11	0.17	0.23	0.29	0.35	0.42	0.48	0.55	0.62	0.69	0.77	0.85
AA	0.02	0.03	0.09	0.23	0.38	0.51	0.64	0.77	0.87	0.98	1.07	1.14	1.26	1.34	1.42
AA-	0.03	0.1	0.2	0.28	0.37	0.49	0.56	0.63	0.69	0.76	0.84	0.91	0.94	1	1.06
A+	0.06	0.11	0.23	0.38	0.51	0.62	0.75	0.9	1.06	1.23	1.4	1.58	1.79	2.03	2.23
A	0.07	0.17	0.26	0.4	0.54	0.74	0.94	1.13	1.35	1.61	1.82	1.97	2.1	2.2	2.4
A-	0.08	0.2	0.32	0.46	0.66	0.86	1.13	1.33	1.49	1.63	1.76	1.9	2.04	2.16	2.27
BBB+	0.13	0.36	0.63	0.91	1.21	1.54	1.77	2.01	2.29	2.56	2.82	2.98	3.2	3.5	3.87
BBB	0.19	0.49	0.76	1.18	1.6	2.01	2.41	2.81	3.24	3.67	4.13	4.55	4.89	5.01	5.25
BBB-	0.3	0.91	1.63	2.47	3.29	4.04	4.71	5.35	5.87	6.4	6.97	7.45	7.9	8.56	9.01
BB+	0.4	1.18	2.21	3.26	4.29	5.33	6.21	6.86	7.66	8.43	8.97	9.56	10.12	10.56	11.25
BB	0.64	1.96	3.87	5.64	7.31	8.68	9.93	10.95	11.9	12.71	13.54	14.25	14.59	14.8	15.08
BB-	1.09	3.37	5.76	8.09	10.11	12.12	13.75	15.31	16.6	17.74	18.61	19.28	20.04	20.76	21.39
B+	2.23	6.06	9.82	13.06	15.53	17.42	19.15	20.68	22.08	23.43	24.48	25.31	26.09	26.79	27.41
B	4.29	9.71	14.04	17.14	19.53	21.74	23.26	24.29	25.16	25.97	26.73	27.45	28.11	28.69	29.39
B-	7.5	14.5	19.6	23.2	25.96	28.1	29.79	30.89	31.49	32.04	32.67	33.22	33.53	33.89	34.3
CCC/C	26.38	35.58	40.67	43.77	46.28	47.24	48.27	49.06	50.03	50.73	51.28	51.94	52.72	53.38	53.38
Investment grade	0.11	0.29	0.5	0.76	1.03	1.29	1.54	1.78	2.01	2.24	2.46	2.65	2.83	3.01	3.2
Speculative grade	3.87	7.58	10.79	13.39	15.49	17.23	18.69	19.9	20.98	21.97	22.79	23.49	24.13	24.68	25.22
All rated	1.5	2.95	4.23	5.31	6.2	6.97	7.62	8.18	8.68	9.15	9.56	9.9	10.21	10.49	10.78

Sources: Standard & Poor's Global Fixed Income Research and Standard & Poor's CreditPro®.

Chart 9



Related Criteria And Research

Related Criteria

- Mid-Market Evaluation Rating Methodology, Nov. 20, 2014
- Corporate Methodology, Nov. 19, 2013
- Credit FAQ: Standard & Poor's Mid-Market Evaluation Ratings Explained, Nov. 20, 2014

Related Research

- Putting The Credit Quality Of Mid-Market Companies On The Radar, July 6, 2015
- S&P's First European Private-Placement League Table Shows €6.4 Billion In Transactions In 2014, June 8, 2015
- Sustainable Growth: Towards A Capital Markets Union In Europe, May 13, 2015
- Alternative Lending Markets In Europe Are Increasingly Open To Mid-Market Companies, Jan. 26, 2015

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