

COUNTRY FOCUS: UNITED KINGDOM

THE UK ROUNDTABLE



L-R: Anthony Shayle, Haakon Blakstad, Kevin Lester, Nick Fenn

PDI gathered four experts to discuss the UK's role in the development of private debt in the wider European region, and found a genuine mix of optimism and concern about the key role debt is playing in the economic recovery. **Oliver Smiddy** reports.

Despite the torrential downpour outside, the mood in the UBS meeting room where four private debt industry experts gather at PDI's invitation is jovial. The World Cup is about to start, and thoughts inevitably turn to England's chances. The consensus view is that England will be knocked out of the tournament at the earliest opportunity. It's a typically pessimistic view of the long-suffering football fan. Fortunately, the collective view of the country's private debt industry is rather more optimistic.

That's based on an economic environment that has proven conducive to the industry's development. In the UK, for instance, the government has several initiatives designed to increase the flow of debt financing to the country's corporate sector. One such programme is the Business Finance Partnership, which seeds private debt funds. Nick Fenn's firm, UK

mezzanine fund manager Beechbrook Capital, was the recipient of a commitment from the BFP, and believes - not unsurprisingly - that it's been a success.

"I'm bound to say this, as a recipient, but they've done a good job," Fenn says. "The government saw in the wake of the crisis that there had been over-consolidation among the UK banks and several were in poor health. Who was going to lend to SMEs to finance growth?"

"We were concerned at one point that ministers were going to set up their own bank and start lending themselves. They have recognised, quite rightly in my view, that the more appropriate role for government is to catalyse and encourage, to create conditions that allow the private sector to rise to the challenge. So they've been seeding and anchoring a range of private debt managers. It's not a vast programme, but what they've done has been

appropriate in scale and pretty successful so far."

The UK has been at the forefront of Europe's developing private debt industry, the panellists agree.

"The UK is very much a beach-head in terms of private debt," says Kevin Lester, co-founder of risk management specialists Validus. "I do think it's still some way behind the US, not just in terms of private debt but in private placements. We've seen a lot of UK and European corporates still turning to the US for a private placement, even allowing for the need to hedge currency risk and so on. The UK is in the middle - somewhere between mainland Europe and the US."

They draw a comparison between the UK and Germany, which has indulged in what they agree, is a degree of chicanery in using taxpayer funds to support the country's industrial sector.

Lester argues you could level the same accusation at the UK government, given banks like RBS and Lloyds are majority owned by the taxpayer. "The government is pushing them to lend. It's almost a 'too big to fail' subsidy. That doesn't seem right or fair, and it distorts the market. Take the housing market. The government explicitly pushes money into that sector, which displaces capital from other sectors which would arguably [be] more productive. There's certainly concern. Private sector debt, as a percentage of GDP, has gone up 10 percent - in the US, it's gone down 10 percent. Housing and asset prices have gone up, but I see a lot of risk factors that aren't being solved, and are even being exacerbated."

There's much debate about whether the UK's resurgent economy is cause for applause or concern. Anthony Shayle, who heads UBS Global Asset Management's UK real estate debt operation and is kindly playing host to the gathering, believes conditions have improved markedly in a relatively short space of time.

"If you look at the market as a whole, over the last 18 months, there was a significant shortage of debt," Shayle says. "The economy was very weak, which is why traditional debt providers just weren't willing to lend. The economy is by no means thriving, but it is showing signs of recovery and stability, and lenders are willing to provide debt again, albeit in relatively low-risk, higher lot-size situations. The banks by and large have flocked to the lower-risk categories where they feel comfortable. There is not so much capital available for higher-risk opportunities. Given careful underwriting, I am comfortable lending there, because the real estate market is showing signs of growth. The prospects for real estate assets are improving and we can see potential for us to achieve a rate of return consistent with the risk we might take."

UK ROUNDTABLE - WHO'S WHO



Anthony Shayle, UBS Global Asset Management

Shayle was appointed head of Global Real Estate - UK Debt, and became portfolio manager for UBS-Participating Real Estate Mortgage Fund, in April 2013. He joined UBS Global Asset Management 2009 as head of Global Real Estate - UK. Prior to joining UBS, he worked for AXA REIM (2005-2009), where he was regional head of the UK, Benelux and Nordics as well as chairman of the investment committee for the region. He has also worked for Curzon Global Partners, RODAMCO, BZW and Bankers Trust.



Nick Fenn, Beechbrook Capital

Fenn co-founded Beechbrook in 2008 with Paul Shea and sits on the firm's investment committee. He is a qualified ACA and spent 14 years in the banking industry, latterly at Mizuho Corporate Bank, where he was head of loan syndication and of mezzanine. He was also a member of Mizuho's management team and sat on the investment committees of its asset management subsidiary.



Kevin Lester, Validus Risk Management

Lester is co-chief executive of Validus Risk Management, having founded the business with Francois Scheepers. He has more than a decade of corporate risk management experience, as both a practitioner and a consultant. Previously the head of risk management for Europe, the Middle East and Africa (FX and Commodities) at Rio Tinto Alcan, he also has several years of corporate treasury experience with Dow Chemical and Avery Dennison.



Haakon Blakstad, Validus Risk Management

Blakstad is director of commercial development at Validus, having joined the firm in early 2014. He has previously work in fixed income for GFI Group, Newedge Group and Hoare Capital Markets. He is also managing director of financial consultancy Blakstad & Co.

The macro-economic backdrop, characterised by extraordinarily low interest rates, has been a boon to the private debt industry in some senses. The prospect of rising rates in due course means some managers are considering the risk factors associated with that, Lester argues, switching to floating rate products, for example, or building thresholds and triggers into their instruments.

Fenn believes the business environment for portfolio companies is encouraging. "Right across the jurisdictions we're engaged in - about half our borrowers are UK-based

but we also lend to borrowers in Northern Europe - we have seen a recovery from the low point in 2012 / 2013. Things have really picked up in the last six to 12 months. Let's not get carried away, but it feels pretty good right now compared to where we were two or three years ago," he says.

THE INTEREST RATE CONUNDRUM

"The interest rate environment is an odd one," Fenn continues. "I understand where policy-makers are coming from, but I just think they're wrong. I don't believe that

COUNTRY FOCUS: UNITED KINGDOM

ROUNDTABLE

a borrowing-led recovery is the route to a healthy, sustainable economy. I also think the endless ripping off of savers is wrong too. People who have put money away for retirement are suffering from derisory annuity rates and negative real interest rates on deposits, whereas people and organisations who have borrowed wildly are being subsidised with ultra-cheap money.

"Governments naturally want to minimise corporate bankruptcies, and the incumbents have been very successful at doing that despite the difficult times we have been through. But is that a good thing? It is if you're teetering on the edge of bankruptcy, or if you're a lender to a company in that situation, but not so much in terms of efficient allocation of resources. I was taught that inefficient and uncompetitive businesses should fail to allow resources to be reallocated to businesses that are better at utilising them. That just isn't happening."

"That's because politicians' main focus is getting re-elected every few years and their time frame is too short to allow such painful transitions," says Validus director Haakon Blakstad.

"Absolutely," Fenn replies. "It does seem to me that if you look at the liquid loan and bond markets, we're back to where we were when the last crisis struck in 2007/2008. That doesn't seem like a particularly attractive investment proposition to me. There are some private debt funds, such as Beechbrook, who have found niches where the fundamentals are attractive. We can make loans that the borrower can afford to pay back and at an interest rate that gives us an attractive return on capital. If you're not trying to deploy billions of pounds, there are niches available where you can find some good businesses to lend to on favourable terms."

SPONSOR SENTIMENT

It's all very well finding attractive assets, but do the owners and operators of those assets want to deal with non-bank lenders? "Most people will automatically go



"THERE'S HUGE DEMAND IN THE UK MARKET FOR FUNDAMENTAL LENDERS"

Anthony Shayle, UBS Global Asset Management

to their banks," Shayle says. "If they can't get capital from them, they'll turn to the 'non-traditional bank lending market'. I don't feel uncomfortable about being part of that."

Fenn chimes in that borrowers, who several years ago wouldn't have looked beyond their banks for financing, are routinely now considering a unitranche or mezzanine package provided by private debt funds.

Fenn believes that borrowers have got "a bit jaundiced" about the approach of commercial banks to lending. "Some banks haven't done themselves many favours in recent years with their patterns of behaviour - overreactions to mild problems in companies in particular.

"Non-bank lenders like Beechbrook are thriving because, whilst we are more expensive, borrowers get [a non-amortising loan] and [they] get financial covenants

that allow more headroom. At our end of the market leverage is quite low so you don't need to set the covenants particularly tightly. Some borrowers regard the extra spread they're paying us as the cost of insuring against default. Also, we generally take a little bit of equity in the transaction, so if there is a problem, we're more likely to be sympathetic because there is a degree of alignment with shareholders. More borrowers are starting to think, 'Yes, that's an interesting story'. They see that the flexibility and more collaborative approach of non-bank lenders can be really valuable to them."

Private debt funds are well placed to develop their business in an evolving economic landscape, given their flexibility, Lester believes. "Private debt funds have a real advantage over a bank when it comes to covenants. They can design covenants that are very calibrated to the company itself, rather than boiler-plate solutions that banks favour. They can work more closely with borrowers in the event of a breach too. That's a really big factor in their favour. We've been looking at how you quantify that advantage, and how you break down your return. One private debt fund manager that we work with quantifies that

COUNTRY FOCUS: UNITED KINGDOM

ROUNDTABLE



as their 'uniqueness' premium - the part of their return that's down to their ability to design a bespoke debt instrument.

"You see bank covenants which are essentially a means to generate auxiliary fee income," Lester continues. "So they'll say, 'You need to hedge against your oil price exposure'. But there's little thought going into these, so companies end up going into these hedging programmes which can end up constraining liquidity in the business and creating additional problems."

Fenn argues banks set tight performance covenants deliberately. "We believe that some banks set fairly tight performance covenants in the expectation that they will breach. It gives them a chance to change their mind, or charge additional fees and increase their interest rate. Our message to companies is, 'Yes, you'll pay a premium to borrow from us, but we won't charge exorbitant waiver fees or default interest if you have a problem down the line.' The last thing a company needs at a difficult time is someone taking more money out of their pocket. We always have an equity interest of some sort, so it's in our interest to see the company work successfully through its difficulties."

"PRIVATE DEBT FUNDS HAVE A REAL ADVANTAGE OVER A BANK WHEN IT COMES TO COVENANTS. THEY CAN DESIGN COVENANTS THAT ARE VERY CALIBRATED TO THE COMPANY ITSELF, RATHER THAN BOILER-PLATE SOLUTIONS THAT BANKS FAVOUR"

Kevin Lester, Validus Risk Management

Shayle argues there's been a return to old school principles. "There's huge demand in the UK market for fundamental lenders," he says. "By that I mean people who are back to basics, who look at the business, look at the borrower, in my case - look at the assets, or more generically in the business itself, and determine whether or not the fundamentals hang together. I think the market between 2005 and 2007 may have lost sight of that resulting in a huge explosion of credit which to some extent was fuelled by the

ability of banks to originate and sell down into the CMBS market. It was all about how fast [you could] originate the loan and "ship-it off" the balance sheet.

Fenn adds that the same was true of corporate loans in CLOs.

Blakstad believes the drying up of CLOs and CMBS in Europe has created opportunities for private debt funds. "Investors still want exposure to SME risk, or real estate risk, and the banks aren't lending and packaging these things up and delivering it to them. The secondary market was still there as a source post-crisis, but this has dried up as outstanding issues mature. Many investors have since changed their mandate to include private debt funds to regain that exposure," he says.

"There's been a lot of talk in the real estate market about the return of CMBS as a source of finance. Do you think that's taking place?" asks Shayle.

"What's holding it back is two things: first, origination by banks has been weak due to regulation, and second there's been huge pressure from politicians and regulators not to do this sort of thing, because it was felt to have contributed to the crisis. Now they're coming round to the idea that it wasn't the same here as in the US. A lot of CMBS, CLOs, and ABS in Europe actually did ok. So people are realising these structures are a good way of diversifying risk. The structures need to be simpler and more transparent," says Blakstad.

Lester believes CLOs are definitely making a comeback. He's also starting to see leverage being used at the fund level too, and while he's careful not to criticise that course of action, wider trends in the market are, he feels, cause for concern.

"Are we repeating the mistakes that got us into the crisis in the first place?" he asks? "It's hard to argue against that. It takes a while, because people still remember the blow up, but they're dipping their toes in, getting comfortable and they're

falling into the same bad habits, applying more leverage and so on."

Fenn counters: "Investors have to put their money somewhere - they can't stay out of the market forever and we are seeing increasing signs of interest among institutional investors in private debt funds. Low volatility and moderate risk combined with a running yield is increasingly seen as an attractive investment."

"Exactly. You've got these incredibly compressed risk premiums in debt markets, equity markets, currency markets. Almost the only way to do anything is to make use of a bit of leverage. It's almost as if the whole macro strategy is pushing investors to take more risk," Lester adds.

Shayle points out that the UK economy is intimately wedded to leverage. "To get GDP going, you need consumer demand. To get that going, you need to establish confidence, to make consumers feel more wealthy. When you do that, borrowing can start to grow, assuming, of course, that there are banks willing and able to lend. That maybe part of what some cautiously hope will happen," he says.

He's alarmed by the effect increasing liquidity is having on borrower behaviour. "There has been an increasing number of borrowers who sit in front of us and say, 'We want your best pricing bid'. That's the sort of thing you'd have seen back in the period before the Global Financial Crisis. You've got borrowers claiming 'We'll get it cheaper elsewhere'. I find it desperately concerning that borrowers are able to bid sources of credit against each other. I worry about a market retracing its steps because some of the regulatory devices that are meant to be in place haven't had the fullest necessary effect."

Fenn believes a volte-face from banks and a return to lending in high volume to the UK SME community is a theoretical threat to his firm's business model, but he also believes it's highly unlikely.



"WE BELIEVE THAT SOME BANKS SET FAIRLY TIGHT PERFORMANCE COVENANTS IN THE EXPECTATION THAT THEY WILL BREACH. IT GIVES THEM A CHANCE TO CHANGE THEIR MIND, OR CHARGE ADDITIONAL FEES AND INCREASE THEIR INTEREST RATE"

Nick Fenn, Beechbrook Capital

"Banks' appetite for term lending to smaller corporates has structurally diminished. They're happier lending to big corporates because they are relatively low risk, it is not so capital intensive and it attracts lucrative ancillary business. At the smaller end of the corporate spectrum, risk is higher, lending is more capital intensive and the ancillary business is less meaningful. They do have great distribution networks, though, so it makes sense for them to partner up with someone who does have the appetite to lend to smaller businesses and won't

be embarrassed to price those loans at a commercial rate. The bank retains a client, carries on providing an overdraft and so on, it's quite an efficient model. Informal or formal tie-ups are likely to be fruitful for both banks and private debt funds," he adds, alluding to recent partnerships between the likes of Barclays and Bluebay Asset Management.

"Particularly in the UK, but also in the other European jurisdictions we cover, there's a long-term structural change underway. We don't think banks will regain their appetite for SME lending to the extent they had before. They've taken onboard the regulatory capital requirements. And in any case, borrowers increasingly see us as a serious alternative to bank financing."

It's a positive note to end on. Despite the fears regarding the precarious underpinnings of the recovery in the UK and Europe, the torrential rain outside, and the pessimism over England's chances in Brazil, it seems there's reasons to be optimistic that the UK's private debt industry will help to counterbalance the banking community's arguably deleterious behaviours. ■