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First loss/second loss structures help debt funds close in on German mid-market

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Debt funds are having their best year so far in the German mid-market. First loss/second loss structures are helping push unitranche deals into the overbanked German market, but while sponsors are warming to debt funds, they are also conscious about how funds will behave when the music stops, said speakers at **GCA Altium's** and **Fried Frank's** roundtable on alternative lending and private equity in the German mid-market, held in Frankfurt on 19 October.

"It's not all about the debt quantum, the relationship really matters and there has to be a well-functioning partnership. The inflation in asset prices could play into the hands of debt funds because sponsors have to pay more attention to the financing," said Matthias Wilcken, a partner at **Gilde**.

In the first nine months of 2017, debt funds completed 19 unitranche deals in the German mid-cap LBO space, compared to 12 for all of last year, according to Johannes Schmittat, a managing director from **GCA Altium**.

"2016 was not an easy year for funds because banks pushed back. But funds caught up and had a 30% market share as per number of deals in the first three quarters of this year," he added. Their market share in terms of debt size is likely to be higher still, said participants.

"At first sight, it's surprising that the success of debt funds in the German mid-market is not mainly due to their ability to offer higher leverage, as banks often portray it, but due to their flexibility with the full package and their entrepreneurial approach," said Steffen Schellschmidt, a partner at **Fried Frank**.

Some sponsors which ruled out working with a debt fund not long ago have dropped their concerns. "Debt funds think more entrepreneurial and are more flexible with capex financing," said one of the speakers.

Funds adapted their strategies and are stepping in on more complex deals where banks are less flexible, and have added undrawn acquisition lines to their offerings, said Schmittat.

"It is a must for the whole proposition. Buy-and-build scenarios require trust between sponsor and financier as one buys into a growth strategy and the ability of the sponsor to buy the right assets. If you are not able to offer that, you can't be a partner in the business. We define ourselves through our ability to pile deep into the analysis of a credit, not through leverage," said Jürgen Breuer, the head of **Pemberton's** DACH operations.

Sponsorless opportunities

Growing needs for financing by medium-sized German companies, especially for capex projects, are also an opportunity for funds to grow their presence in the sponsorless deal space, according to panelists.

Most mid-sized German companies are family-owned, and their shareholders tend to be rather conservative in M&A situations. There is strong competition from the banks due to cross-selling potential, and the growing German Schuldscheinmarket absorbs much volume, according to Volker Schulze, head of private debt for DACH at **LFPE**.

"Debt funds could position themselves by providing mezzanine-like capital for corporates in order to strengthen their balance sheet, given that many smaller companies are still undercapitalised," added Schulze.

Sponsors have also learned that certain business models combine better with unitranche financing than others.

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"Companies with strong cashflow and little cyclicality are a good fit for private debt, it is about more than leverage and makes sense for sponsors to consider," said Jochen Baumann, a managing director at **Deutsche Beteiligungs AG**.

Tie-up with banks

Funds have also become more competitive on pricing and increasingly team up with banks. Seven out of 19 debt fund deals this year in the German mid-market featured first loss/second loss structures, also known as first out/second out, according to **GCA Altium's** MidCapMonitor for the third quarter. "It is one of the factors that has boosted the debt fund market in Germany this year," said Schmittat.

Disaccord at the table around its name prove that the structure – with first loss/second loss, first out/second out, synthetic unitranche or stretched senior used interchangeably – has yet to sink in with sponsors. Private equity players often bring local banks on board for unitranche deals in order to gain the trust of management teams, since debt funds are still abstract for many companies, according to one of the speakers.

"It can sometimes be a barrier for management teams in Germany to borrow from private debt funds, especially if they have previously worked together with local savings banks. In these situations, it can be very helpful to team up with a bank," said Abhik Das, a partner within **BlueBay's** Private Debt Group.

More complexity?

However, it could also lead to a situation where funds compromise a major advantage – the fact that sponsors only have to deal with a single financing party. "Unitranche means reduced complexity. First out/second out would lead to more complexity," said Baumann.

Sponsors face little interaction with the bank in a first out/second out structure because the debt fund coordinates the whole package, and some bank involvement would be needed anyway for the RCF, countered James Staunton of **Berenberg**. "The flexibility is not lost," he said.

"There are up to five banks in Germany that have a lot of experience with providing super senior pieces. The credit principles are established, it is very efficient," added Sebastian Lorenz, a director at **Barings**.

But the trending structure can be a double-edged sword for debt funds. "When the bank does 3x super senior and the fund has 3x, it is not really senior secured lending any longer," said Jens Bauer, an investment director at **Permira**.

"It is also a topic that has little relevance for smaller unitranche deals, because it increases complexity and the lower debt quantum is rather unattractive to banks," said Schulze.

The covenant question

With banks offering ever looser documentation to sponsors, and cov-lite spreading in the mid-market, the question looms whether funds will soon abdicate covenants as well.

"We would not do covenant-lite transactions and I believe that most private debt funds have remained very disciplined in this regard. There are ways to be flexible around covenants. We are seeing less pressure from private equity firms in the mid-market in terms of pushing back on covenants – they can provide an additional level of financial discipline for their portfolio companies," said Das.

"I do think we will see cov-lite, just not by us," countered Breuer.

Sponsors that require cov-lite from funds should be willing to pay more for unitranches, said Florian Feder, an associate director at **Terra Firma**. The same, he said, should be true for transfer provisions.

"For banks, loans are a standardised piece of paper that they need to be able to sell on if things turn out badly. Funds can be more flexible. It would only be fair for funds to waive the right to sell the credit if they are compensated for that," he added.

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In good times and bad

Debt funds make a point of establishing a trusted relationship with private equity firms.

“Sponsors always have the same contact persons within a debt fund. Not like banks where the teams are changing over time,” said a panelist.

But sponsors wonder what will happen to the good relationships in more difficult times. “I’m very curious whether funds will keep their promises when the pendulum is swinging in the opposite direction,” said Baumann.

“The perception of debt funds is still different because there haven’t been any crisis situations yet. It would be a big step forward if funds offered a different approach than banks, for example, by restricting the right to realise and sell on debt,” said Jan Drewitz, a partner at **HQ Equita**.

In situations where businesses are going through troubles funds could differentiate themselves further from banks, which would make them more attractive for sponsors, added Baumann.

When asked whether direct lenders will be able to deal with restructurings parallel to their investment activities, debt fund representatives responded that they have enough resources to do so, despite their rather lean teams.

“We have an independent risk department staffed with people with significant restructuring experience, we feel very well equipped to deal with issues in our portfolio,” added Breuer.

Representatives from Ardian Private Debt, Barings, Berenberg, BlueBay, Deutsche Beteiligungs AG, Fried Frank, GCA Altium, Gilde, HQ Equita, LFPE, Pemberton, Permira, Steadfast Capital and Terra Firma attended the event.

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