European Direct Lending: Fundraising and Investor Outlook

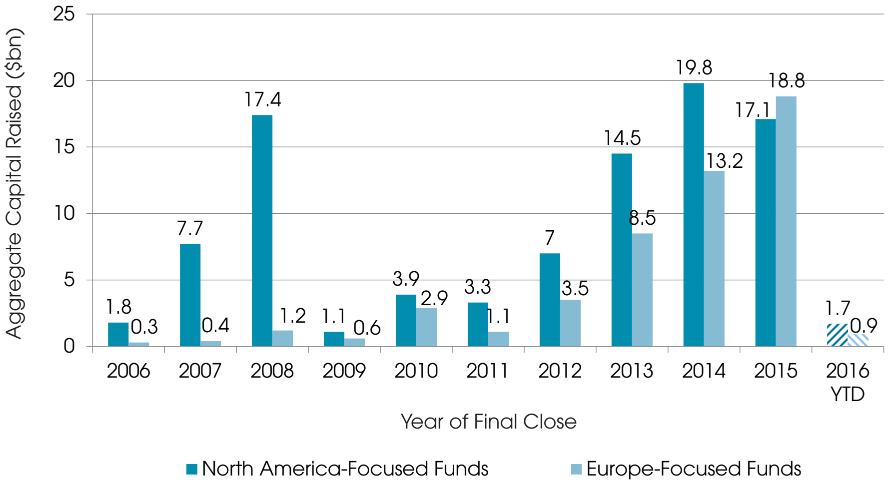
Direct lending has experienced huge growth within the private debt industry over the last few years. Doug Paolillo takes a look at fundraising and investor appetite for direct lending.

Record Fundraising

Europe-focused direct lending fundraising surpassed North America-focused fundraising in 2015 for the first time ever, as fund managers employing the strategy secured a total $18.8bn across 17 Europe-focused direct lending vehicles closed during the year (Fig. 1).

European direct lending fundraising in 2015 was up by 42% compared with the year before, while between 2013 and 2014 it increased by 55% and between 2012 and 2013 it jumped by 142%. This means that, overall, Europe-focused direct lending fundraising has increased by a substantial 437% between 2012 and 2015, compared with 144% for North America-focused funds over the same period.

Fig. 1: Direct Lending Fundraising: North America- vs. Europe-Focused Funds, 2006 - 2016 YTD (As at 22 April 2016)



Source: Preqin Private Debt Online

Investor Appetite

Forty-six percent of investors surveyed for the Preqin Investor Outlook: Alternative Assets, H1 2016 plan to commit more capital to private debt in 2016 than in 2015, and 41% plan on maintaining commitment levels. Additionally, 64% of investors surveyed intend to specifically target direct lending over the course of 2016, making it the most targeted strategy alongside distressed debt. One such example is VBV Pensionskasse, the €5.7bn Austria-based public pension fund, which has recently announced that it will commit to new Europe-focused direct lending funds over the coming year, as it continues to work towards its 5% target allocation to private debt.

Notable Fund Closures

Strong investor sentiment towards Europe-focused funds drove the closure of several $1bn+ direct lending vehicles in 2015, including two vehicles larger than $3bn that were raised by Intermediate Capital Group and Ares Management (Fig. 2). However, a successful 2015 has been followed by a slow start to 2016, with just $8.8bn raised globally across all strategies in Q1 2016. Preqin's Private Debt Online tracks the average proportion of target size achieved at final close on the Fundraising Momentum feature: Europe-focused direct lending funds closed in 2013, 2014 and 2015 average 160%, 131% and 144% respectively. Park Square Capital Partners has closed five out of its six private debt vehicles since 2004 above target, demonstrating how investor appetite has fuelled growth in Europe over the past 12 years. Park Square Capital Credit Opportunities II reached a final close on $2.4bn in 2015, nearly five times its initial target size

Fig. 2: 10 Largest Europe-Focused Direct Lending Funds Closed in 2015

Fund	Firm	Vintage	Fund Size ($mn)
Senior Debt Partners II	Intermediate Capital Group	2014	3,356
European Loan Programme	Ares Management	2014	3,189
Park Square Capital Credit Opportunities II	Park Square Capital Partners	2014	2,389
AXA Private Debt III	Ardian	2013	2,191
BlueBay Direct Lending Fund II	BlueBay Asset Management	2015	2,123
GSO European Senior Debt Fund	GSO Capital Partners	2014	1,964
Permira Credit Solutions Fund II	Permira Debt Managers	2014	872
P2P Global Investments fund	Marshall Wace	2014	683
Idinvest Dette Senior III	Idinvest Partners	2015	580
Kartesia Credit Opportunities	Kartesia Advisor	2013	544

Source: Preqin Private Debt Online

Fig. 3: Europe-Focused Direct Lending Funds Closed in 2016 YTD (As at 21 April 2016)

Fund	Firm	Target Size ($mn)	Vintage	Fund Size ($mn)	Primary Geographic Focus
3i European Middle Market Loan Fund	3i Debt Management	381	2014	305	Europe
EQT Mid-Market Credit Fund	EQT	554	2015	576	Europe
KKR Direct Lending Europe	KKR	750	2015	800	Europe

Source: Preqin Private Debt Online

of $500mn, and was the third largest Europe-focused direct lending fund closed that year. In 2007, Park Square Capital Partners raised its first fund in the series – also its first in direct lending – which reached a final close on just over $420mn. Many other fund managers in this segment have also seen the same levels of fundraising success, as the increase in final close size correlates with the industry-wide surge in investor appetite for the region. Looking ahead to the rest of 2016, 71% of investors surveyed by Preqin plan to target Europe as a region for private debt investment in the next 12 months.

Time on the Road

Europe-focused direct lending funds closed in 2015 spent significantly less time on the road than funds closed in previous years. While funds closed in 2012 took an average of 19 months to reach a final close on just 84% of their initial target size, a change occurred in the years after: funds closed in 2013, 2014 and 2015 took an average of 11, 13 and 11 months, respectively, to reach a final close. This surge in positive sentiment has resulted in successful fundraising cycles for Europe-focused direct lending funds over the past few years, which are expected to remain in high demand as fund managers seek to secure commitments in 2016.

Slow Start to 2016

As of April 2016, only three Europe-focused direct lending funds have closed (Fig. 3). 3i European Middle Market Loan Fund, EQT Mid-Market Credit Fund and KKR Direct Lending Europe were all targeting less than $750mn. However, these funds closed during a slow period for all private debt strategies. Global private debt fundraising across all strategies in Q1 2016 ($8.8bn) reached its lowest level since Q2 2012 ($8.6bn), and just three additional Europe-focused funds closed in the quarter: KKR Special Situations Fund II, MML Capital Partners Fund VI and Park Square Capital Partners III.

In a recent interview conducted by Preqin, Jeremy Ghose, Managing Partner and CEO of 3i Debt Management expressed optimism towards institutional investors continuing to approach the private credit space:

“There are a large number of pension funds and insurance companies that do not use consultants to guide them, and we often find they are more flexible and able to make decisions more quickly. They are now beginning to look at our asset class, although we have been educating them for the last three to five years.”

Considering that institutions are still being educated on alternative credit investing, specifically on upcoming opportunities in Europe, it is possible that there is still significant fundraising capacity from a global base of investors. Ghose identified the current bifurcation of the global credit market as the most pertinent risk to investors in private debt. Specifically, Ghose attributed the divergence of US and European markets to the discontinued quantitative easing in the US versus the ongoing stimulus by the ECB, which has misaligned the markets’ stages within the credit cycle. Discussing the credit cycle in Europe, he said:

“Usually, in the past, Europe has followed the US with a six-month, maximum nine-month lag, but this time I think it’s going

Fig. 4: 10 Largest Direct Lending Funds Currently in Market (As at 21 April 2016)

Fund	Firm	Target Size ($mn)	Vintage	Fund Status	Primary Geographic Focus
Hayfin Direct Lending Fund II	Hayfin Capital Management	2,564	2016	Raising	Europe
Alcentra European Direct Lending Fund II	Alcentra Group	2,279	2016	Raising	Europe
Ares Capital Europe III	Ares Management	2,214	2015	Fourth Close	Europe
Griffin-Benefit Street Partners BDC	Benefit Street Partners	1,500	2016	Raising	US
Guggenheim Private Debt Fund II	Guggenheim Investment Management	1,500	2015	First Close	US
Highbridge European Lending Fund	Highbridge Principal Strategies	1,500	2016	Raising	Europe
Audax Senior Loan Fund III	Audax Senior Debt	1,300	2016	Raising	US
Pemberton Mid-Market European Debt Fund	Pemberton Capital Advisors	1,107	2015	Second Close	Europe
Carlyle Asia Structured Credit Opportunities Fund	Carlyle Group	1,000	2014	First Close	Asia
Prospect Credit Strategies Fund	Prospect Capital Management	1,000	2016	Raising	US

Source: Preqin Private Debt Online

to be different because the central banks are behaving in different ways in different jurisdictions with their money printing."

At this stage, North America- and Europe-focused fund types and sizes within private debt have different goals. The differing economic outlooks in the two regions will continue dictating how fund managers, such as 3i, EQT and KKR, discover high-quality investment opportunities in 2016 and beyond. Given that institutional demand for direct lending and other private debt strategies is expected to remain strong, and drive a strong supply of fund options in both North America and Europe throughout the rest of the year, it will be necessary for credit managers seeking commitments in 2016 to propose strong strategies that will set them apart from competing fund managers entering the evolving credit market.

Funds Currently in Market

There are currently 31 Europe-focused direct lending funds in market targeting an aggregate $19.5bn, which will likely continue to fuel competition among fund managers in the industry; 2016 could be another strong year as long as the investment outlook remains positive. Direct lending strategies constitute almost half of all Europe-focused private debt funds in market, suggesting that investment opportunities in the segment are the strongest at this stage in the credit cycle. Of the remaining 33 Europe-focused funds in market, distressed debt, mezzanine and special situations constitute eight funds each, while fund of funds and venture debt account for seven and two funds, respectively.

Europe-focused direct lending funds maintain an above-average target size when compared with funds focused on different regions. Globally, the average target size of direct lending funds on the road is $496mn, while Europe-focused direct lending vehicles have an average target size of $600mn. The largest three direct lending funds in market globally, by target size, are all Europe focused, each targeting more than $2.2bn. The largest vehicle is Hayfin Direct Lending Fund II, which is focused on the European middle market with a diversified industry mandate (Fig. 4). The next two largest Europe-focused funds are being raised by Alcentra Group and Ares Management and both funds are focused on European debt and seek loan opportunities across a diversified range of industries. However, these three funds' targets are all lower than the final values of the largest three funds closed in 2015 – possibly a sign of tempered expectations from fund managers anticipating an over-supply in the marketplace. The pace of fundraising expansion has certainly attracted managers motivated to leverage resources in Western European markets, but it is yet to be seen if all capital committed to the strategy can be fully deployed in the coming years.

Established Managers vs. First-Time Funds

Preqin's data on Private Debt Online shows that it took, on average, 1.6 months less for established fund managers of Europe-focused direct lending funds to reach a final close during the period 2013-2015 compared to first-time fund managers. Unsurprisingly, more established fund managers have seen a slightly smoother road to fundraising success; this trend has also been witnessed across other private debt fund types where high levels of expertise and past performance are highly coveted. The preference for established fund managers alongside the overall growth of institutional investor allocations has resulted in larger Europe-focused funds, with five of the 10 largest direct lending funds in market primarily focusing on Europe.

Outlook

Given the changing regulatory landscape and constant evolution for both private fund and bank lending in Europe, the outlook for direct lending fundraising looks promising in the near term. European direct lending has been stated as an investment preference by 583 of the 2,000 institutions tracked by Preqin that are active in private debt. Furthermore, 300 (52%) of these 583 investors are based in North America, quantifying the massive investor base that could be the key to fundraising success for managers, especially those based in Europe which may not have considered the potential for transatlantic commitments on this scale in the past. One example of a US-based institution in this situation is Oklahoma Tobacco Settlement Endowment Trust, which has recently issued an RFP for a Europe-based direct lending manager to invest between $20mn and $30mn.

Preqin's Private Debt Online currently tracks more than 100 private debt fund managers that operate Europe-focused direct lending funds, ranging from global diversified alternatives managers to boutique direct investment funds.

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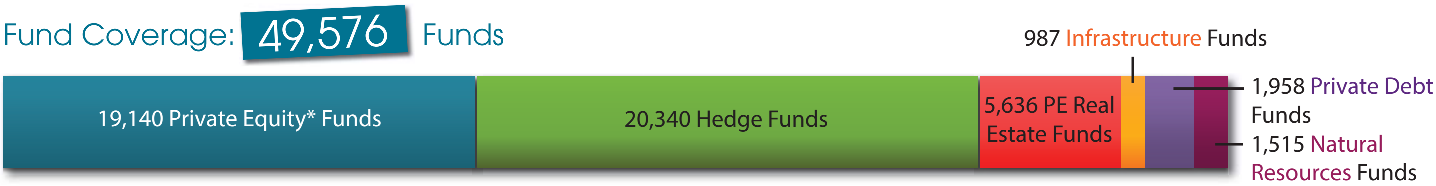
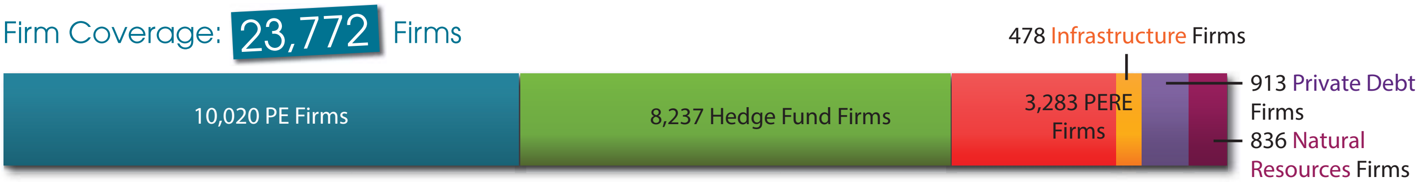
Preqin Global Data Coverage

As of 1 April 2016

Fund Coverage: 49,576 Funds



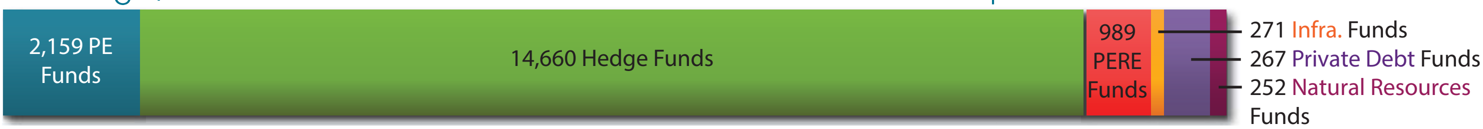
Firm Coverage: 23,772 Firms



Performance Coverage: 22,017 Funds (IRR Data for 6,807 Funds and Cash Flow Data for 3,101 Funds)

Fundraising Coverage: 18,598 Funds Open for Investment/Launching Soon

Including 3,120 Closed-End Funds in Market and 301 Announced or Expected Funds



Deals Coverage: 157,835 Deals Covered; All New Deals Tracked

Investor Coverage: 13,839 Institutional Investors Monitored,

Including 9,619 Verified Active**** in Alternatives and 102,899 LP Commitments to Partnerships

Alternatives Investment Consultant Coverage: 530 Consultants Tracked

Fund Terms Coverage: Analysis Based on Data for Around 12,660 Funds

Best Contacts: Carefully Selected from Our Database of over 356,011 Active Contacts

Plus

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***Venture capital deals: Preqin tracks cash-for-equity investments by professional venture capital firms in companies globally across all venture capital stages, from seed to expansion phase. The deals figures provided by Preqin are based on announced venture capital rounds when the capital is committed to a company.
****Preqin contacts investors directly to ensure their alternatives programs are active. We emphasize active investors, but clients can also view profiles for investors no longer investing or with programs on hold.