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European private debt fast catching up with US

Published: **18 December 2014**
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Accordingly to new research by Swiss bank UBS, alternative direct lending in Europe is catching up to the US market with a strong focus on senior debt.

Direct lending activity and fundraising from non-bank firms is increasing in Europe and “playing catch up” to the US direct lending market, according to newly published research from UBS Wealth Management’s chief investment office.

“Europe is catching up so fast, it’s quite unusual,” said Cyril Demaria, executive director and private market analyst within the Swiss bank’s wealth management unit.

The research noted that the portion of European bank funding of leveraged deals in the continent has declined from 60 percent in 2010 to less than 30 percent in 2014.

According to *PDI*’s fundraising data, which was cited in the UBS research, fundraising in Europe has grown year-over-year to reach €15.6 billion in the first three quarters of this year, putting 2014 on target to break the 2013 record. In Demaria’s assessment, the fundraising itself is not overly ambitious, banks are reducing their activities, so he says there will be enough deals for alternative lenders.

The real risk lies in firms increasingly looking to do more risky, covenant-lite deals. “As the quantity of cov lite deals increases, the question is, why is it like this?”, Demaria told *PDI*.

There has been some debate over whether healthy companies need covenants, but Demaria noted that it doesn’t cost anything to put covenants in place and underwriters should install them for peace of mind.

With respect to banks versus alternative lenders, Demaria said that the European market would never return to the bank-dominated landscape in place before the financial crisis and slew of regulation that followed.

Asked whether alternative lending will reach the same penetration in Europe as it has in the US, he said; “It probably won’t happen overnight, it will take longer. Europe is not a unified market in terms of banking services, so it depends on the size of the loans and the lending activity in certain markets.”

The research also noted that the majority of non-bank lending in the US and Europe has concentrated on the senior debt arena due to a combination of low interest rates, high availability of financing and favorable debt terms.

“US volumes in 2013 exceeded 2007 levels, with 2014 potentially on track for a new record … In effect, senior debt has significantly reduced use of other tranches in the US, and Europe is following this trend (less than 5 percent of the total debt is subordinated),” according to the report.

Senior loan volumes totalled $463 billion in the US and $89 billion in Europe over the 12 months to September, according to S&P Capital IQ data cited in the report, while mezzanine in Europe has dropped to negligible levels.

“Alternative lenders are going to have to be more creative and innovative,” added Demaria.

Unitranche financing is one increasingly popular option for boosting senior debt returns and Demaria argued that when interest rates rise, loans are likely to continue to be structured as blended instruments rather than either subordinated or senior.

The research is geared towards UBS’ European wealth management clients. Demaria explained that the firm doesn’t have an express private debt allocation that it recommends, but depending on the needs of the clients, UBS normally recommends a three to 11 percent allocation to private markets which encompasses private debt.