Exposing the myths around sponsorless lending

Think the sponsorless market is too small and risky? Think again. **Ignacio Diez Torca** of Trea Direct Lending takes on the doubters

A wide range of topics have been discussed in the private debt market but not much has been said about the sponsorless market. This is surprising, since the growth potential of this market is much bigger than the sponsored.

The private debt market developed in Europe at the best time, right after the financial crisis. Banks were out of the leveraged loan markets, so private debt happily lent true senior debt (3-4x leverage) at very nice credit spreads (e+7-9 percent) and fat upfront fees. Private debt funds were then repaid obtaining circa 10 percent IRRs. With their impressive track record, they raised much larger funds.

But private debt funds now have an important challenge: most of them target the same narrow market (sponsored) with far more competition, as new managers have appeared and the existing ones have become larger and larger. Some deals are literally auctions: leverage goes up, prices come down and control decreases (covenant-lite).

Sponsorless, on the other hand, is a much larger and relatively untapped market where higher risk-adjusted returns can be obtained as the barriers to entry are significant:

i. **Origination:** You have to be local, speak the language and be commercial. Borrowers do not sit in a square mile in the capital.

ii. **Negotiation:** You do not negotiate with a PE sponsor but with the owner of the company. Numbers are relevant, of course, but so is cultural affinity and being able to negotiate (and manoeuvre) on the spot.

iii. **Local knowledge:** Credit is not just numbers; there are a number of factors that play a role in family-owned businesses. Being able to understand them can provide a unique advantage.

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All these factors make sponsorless lending a much more local business than sponsored lending. That is why sponsorless funds are in general country- or region-specific.

THE SPONSORLESS MARKET IS STILL VERY SMALL

The sponsorless market is less competitive and that allows GPs to negotiate better terms, lower leverage and more control on deals. So why isn't LP investment in sponsorless funds more mainstream?

i. Private debt is still a relatively new asset class, so LPs are starting to build their portfolios, and that means starting with sponsored pan-European players.

ii. "No one ever got fired for hiring McKinsey": It carries less "personal" risk for the decision-makers to invest in big names.

iii. Sponsorless funds are still too small, and large investors require tickets of €50 million-plus.

iv. Many managers are still fundraising and deploying their first fund, so it is relatively early to evaluate them (and their financial feasibility as management firms).

v. Funds of funds are still very few and mostly focused on high yielding strategies (mezzanine, distressed, etc.) with net IRR targets of 9 percent-plus.

vi. There is a lack of knowledge and misconception about the sponsorless market both from LPs and from some private debt managers, who regard it as riskier.

Let's explore in some detail the most common misconceptions about sponsored vs sponsorless:

1 SPONSORLESS DEALS ARE MORE RISKY AS THERE IS LESS PREVIOUS DUE DILIGENCE

In sponsorless deals the amount of previous due diligence is certainly less and that makes initial screening harder and more cumbersome. Business owners do not want to pay for due diligence reports if they do not have a high degree of certainty that the deal will happen. So sponsorless due diligence tends to be confirmatory. It is not really accurate to say there is no due diligence in sponsorless deals: instead, it happens at a later stage than it would in sponsored deals.

It is also worth mentioning two points here: (i) the amount of due diligence needed by a PE firm and the PD manager when buying the company at double-digit multiples and leveraging it 6-7x is much higher than when leveraging the company 2-4x and (ii) excessive "due diligence" and quality of earnings with questionable adjustments tend to create borrower-friendly "adjustments" to EBITDA that distort the picture (6-7x "adjusted" EBITDAs might happen to be much higher when non-recurrent items prove to be recurrent).

2 ORIGINATION IS MORE CHALLENGING

This point is certainly true, and it is critical for the success of a sponsorless fund. The potential sponsorless market is quite a bit larger than the sponsored market, so developing strong origination channels and credibility in the market as a long-term player is critical to be successful. But once that foundation is in place, it poses a severe barrier to entry to new players.

3 SPONSOR-BACKED MANAGEMENT TEAMS ARE BETTER

While this argument is partly true (it is undisputable that, all else being equal, the best managers prefer larger companies that pay more and offer stock options), it has significant flaws:

i. It assumes all companies have a separation of ownership and management. In fact, most companies financed by sponsorless funds are family-owned. Within this broad universe of companies you find poor management teams, strong teams and outstanding teams. It is a matter of focusing on the best.

ii. Management teams of PE-backed companies normally have stock options which make them "aligned"… but to whom? To PE managers' compensation (carry), not to debtholders. Call options only have value if equity value goes up, and the higher the volatility of the underlying, the higher their value. It is no coincidence that companies that are backed by PE funds tend to favour more risk-taking and more leverage than family-owned ones.

In most cases, the top management of family-owned companies do not have options, they hold equity, and are much more aligned with debt investors, as they want the least debt possible in their companies.

4 SPONSORED LENDING CARRIES LESS RISK AS EQUITY CONTRIBUTIONS ARE VERY HIGH NOW

Credit risk does not change depending on how much equity a buyer has disbursed for it. Higher equity contributions only encourage equity holders to double up their bet if it goes wrong.

For a given leverage level (for example 6x), credit risk does not improve if the sponsor pays 9x, 10x or 12x. Equity contribution has increased not because the deals are less leveraged (less risky) but because prices have skyrocketed.

In the sponsorless market there is no comparable "sponsor equity contribution", but there is a family who put most of their wealth in the company and which, at market multiples, have a much higher implied equity than in LBOs.

CONCLUSION

Still in its infancy in Europe, the sponsorless market still has many challenges to overcome, but will doubtless succeed. Small local players will have to grow and deploy their first funds wisely to survive, while large players will have to adapt their structure with local teams if they want to take part in this market.

Sponsorless lending requires more time and effort than sponsored, but the reward is out there for the managers which are willing to invest the time and effort needed to source, analyse, structure and close the right deals.

For investors, sponsorless funds provide an excellent way to get some alpha and diversification into their portfolios, especially at a time when the more mainstream sponsored market has become riskier due to the large number of competitors and the high leverage multiples that this market is experiencing. ■

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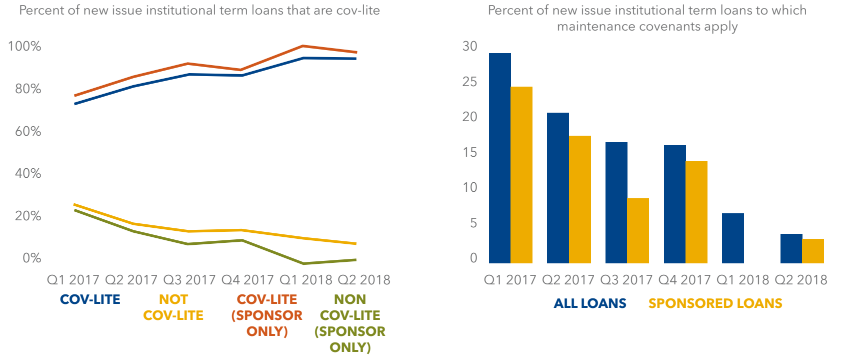
THE COVENANTS THAT WEREN'T

Covenant-lite loans have made up a larger part of new institutional term loan issuance, even in recent months



Source: *Covenant Review* ***Note:*** *Data applies to institutional term loans (eg, term loan B, C, etc) issued in tranches greater than $250m*