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Alternative Capital's Critical Role in Rebuilding Europe's Economy for the Long Term

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The global financial crisis of 2008 dealt a significant economic blow to much of the Eurozone. A lasting consequence of the crisis is a precipitous drop in bank lending in many parts of Europe. According to the European Central Bank (ECB), lending to non-financial corporations declined by almost 12 percent from the peak in January 2009 to March 2014. Based on data from the Bank of England's Credit Conditions Survey, lending to businesses in the United Kingdom (U.K.) remained negative and was projected to continue on this course through much of 2014. Conversely, demand for credit across all business sizes continued to increase in the first quarter of 2014. Furthermore, according to the International Monetary Fund (IMF), European Union (EU) banks have deleveraged between €1.4-€2.2 trillion (£1.1 – £1.8 trillion) worth of assets on their balance sheets, resulting in a persistently weak appetite to lend.

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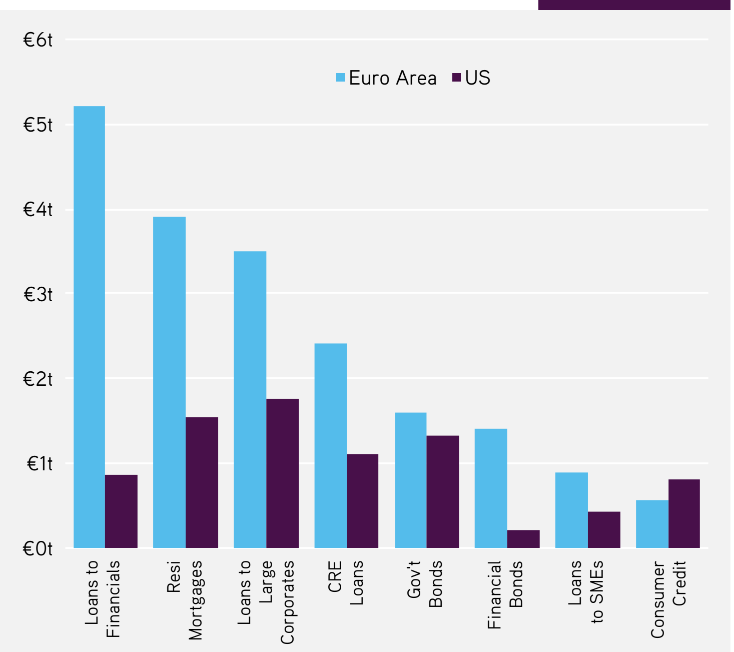
Summary

The global financial crisis of 2008 dealt a significant economic blow to much of the Eurozone. A lasting consequence of the crisis is a precipitous drop in bank lending in many parts of Europe. According to the European Central Bank (ECB), lending to non-financial corporations declined by almost 12 percent from the peak in January 2009 to March 2014.[1] Based on data from the Bank of England's Credit Conditions Survey, lending to businesses in the United Kingdom (U.K.) remained negative and was projected to continue on this course through much of 2014.[2] Conversely, demand for credit across all business sizes continued to increase in the first quarter of 2014.[3] Furthermore, according to the International Monetary Fund (IMF), European Union (EU) banks have deleveraged between €1.4-€2.2 trillion (£1.1 – £1.8 trillion) worth of assets on their balance sheets, resulting in a persistently weak appetite to lend.[4]

U.S. VS. EURO BANK ASSET BREAKDOWN — **EXHIBIT 1**



Source: ECB aggregated balance sheet of credit institutions, Q4 2013, US Assets and Liabilities of Commercial Banks, February 2014, OECD Financing SMEs and Entrepreneurs 2013; Avoca Capital Estimates.

Overall, we believe the Eurozone crisis and changing regulatory landscape showcases the need for a much broader financial services ecosystem, particularly as it relates to Europe's middle-market companies and small and midsize enterprises (SMEs). Today, these two major players in Europe's economy depend on banks for 85 percent of their funding needs.[5] This stands in sharp contrast to the United States, where bank loans account for only about 30 percent of corporate debt.[6] An SME, according to the EU, is a company with €50 million or less in turnover. In a November 2013 survey, about one-third of European SMEs polled indicated they weren't able to get as much financing as they had planned for 2013. Some 15 percent described access to financing as a "significant problem."[7]

The current environment has created more awareness of the need for non-bank lenders to offer financing for companies, in our view. However, the implications are much more profound than this. We believe the change we are witnessing is likely more of a systemic shift than a short-term fad. The national and international regulatory frameworks forcing banks to strengthen their balance sheets also seem to be transforming the continent's bank-dominated credit market and creating a new ecosystem that includes a number of non-bank lenders. Over the long term, we think companies are likely to have more options when they attempt to secure funding—a development that could herald stronger and more sustainable economic growth in Europe.

Given the current limitations of bank lending in Europe, could sources of alternative capital provide the funds necessary to bolster EU businesses? Could the growth of alternative capital have a broader impact and expand lending options for businesses in the long term? In our latest KKR Global Institute report, we survey the opportunities for non-bank lending and the critical and transformative role it could play in boosting liquidity and economic growth across the continent. We will explain both the private and public measures taken in recent years to grow financing by alternative capital providers. We will also highlight some of the challenges and opportunities for Europe's non-bank lenders.

> **"The Eurozone crisis and changing regulatory landscape has showcased the need for a much broader financial services ecosystem."**

1 European Central Bank. "ECB Bank Lending Survey." April 2014 http://www.ecb.europa.eu/pub/pdf/mobu/mb201403en.pdf

2 Bank of England. "Trends in Lending." April 2014

3 Bank of England. "Trends in Lending." April 2014

4 International Monetary Fund. "Spain: Financial Sector Reform – Third Progress Report." July 2013

5 European Commission. "2013 SMEs Access to Finance Survey." November 14th 2013. Available at: http://ec.europa.eu/enterprise/policies/finance/files/2013-safe-analytical-report_en.pdf

6 European Banking Federation. "European Banking Sector Facts and Figures 2012." October 2012

7 European Commission. "2013 SMEs Access to Finance Survey." November 14th 2013. Available at: http://ec.europa.eu/enterprise/policies/finance/files/2013-safe-analytical-report_en.pdf

Alternative Lending Options are Good News for Europe

Europe continues to recover from the effects of the Eurozone crisis, which has been a drag on growth through much of the continent and hampered the peripheral economies of Greece, Spain, Italy, Portugal, and Ireland. In the fourth quarter of 2013, output in the Eurozone hovered just above recession levels, growing by 0.2 percent, compared to 0.3 percent in the previous quarter.[8]

The data underscores the fragility of the region's emergence from recession, in our view. The most immediate concern for many European businesses is access to credit, which we think has pushed a growing number of businesses to seek alternative avenues for capital. In 2011, for example, the U.K.-based Tensator Group, a producer of crowd management solutions with 350 employees, was unable to secure a loan to finance its acquisition of Portuguese competitor, Newvision. The company turned to alternative funding, arranged by an asset manager, to finance the acquisition.[9] The credit crunch is likewise painful for small businesses such as Pinnacle Homes, an Irish construction company, whose request for a 100,000 euro credit line was turned down, despite having secured a 2 million euro building contract. Pinnacle was finally able to get the funding because of the intervention of a government arbiter.[10]

On the macro scale, global cross-border capital flows have declined precipitously from €8.5 trillion in 2007 to a mere €3.3 trillion in 2012. The decline has disproportionately affected Western Europe, which accounts for about 70 percent of the drop.[11] With Eurozone banks scaling back cross-border lending, we believe the increase in domestic lending and bond buying has slowed market integration in Europe. A July 2013 report by the Central Bank of Ireland concludes that the "financial crisis has had detrimental consequences for banks' balance sheets, cost of funds and profitability."[12] This poor economic environment, the central bank adds, "has weighed negatively on [banks'] ability to supply credit to the real economy."[13]

Regulations on banks as part of the Basel III capital and liquidity rules also seem to be forcing banks to hold on to a greater share of their assets, rather than putting them to work. For example, Basel III will require commercial banks to more than triple their holdings of Tier One capital to at least 7 percent of risk-weighted assets.[14]

8 EuroStat. "EuroStat: Euro Indicators." November 14 2013. Available at: http://epp.eurostat.ec.europa.eu/cache/ITY_PUBLIC/2-14112013-AP/EN/2-14112013-AP-EN.PDF

9 Euromoney. "Alternative Lenders Embrace SMEs as Banks Retreat." April 12 2013. Available at: http://www.euromoney.com/Article/3190333/Alternative-lenders-embrace-SMEs-as-banks-retreat.html

10 The Wall Street Journal. "Credit Crunch Broadens European Business Rifts." April 18 2013. Available at: http://online.wsj.com/news/articles/SB10001424127887324345804578424781039188460

11 McKinsey & Company. "Financial Globalization: Retreat or Reset?" March 2013

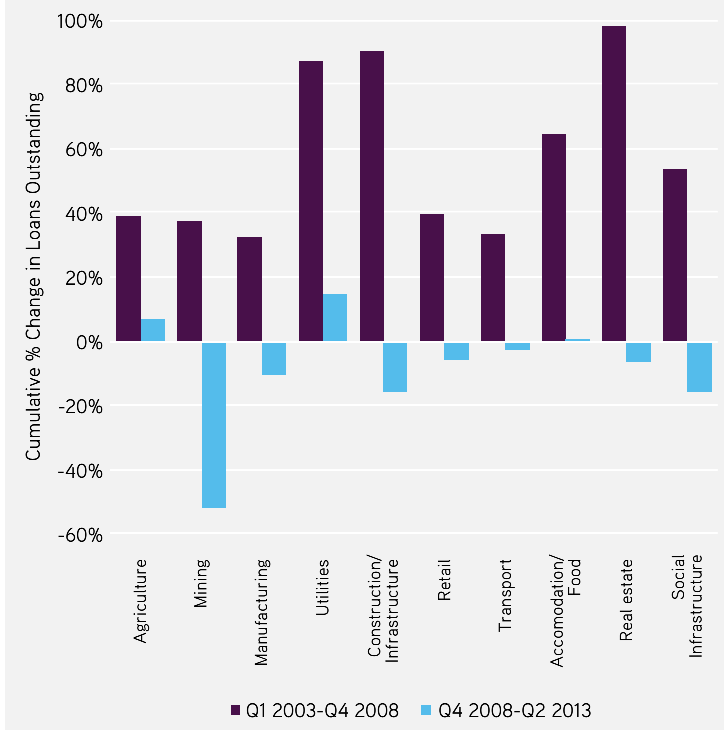
12 Central Bank of Ireland. "Loan Origination by Investment Funds." July 2013.

13 Central Bank of Ireland. "Loan Origination by Investment Funds." July 2013

14 Moody's Analytics. "Basel III Capital and Liquidity Standards - FAQ" October 13 2013

Tier One capital is a bank's most important and liquid capital and is used by regulators to assess an institution's ability to withstand future losses. The Organization of Economic Cooperation and Development (OECD) anticipates that Basel III rules alone will shave between 0.05 and 0.15 percentage points from annual GDP growth in the Eurozone.[15]

BANK LENDING IS DECREASING IN SECTORS WHERE LOAN GROWTH WAS LARGEST PRE-CRISIS — **EXHIBIT 2**



Source: ECB Statistics Warehouse, Avoca Capital Analysis, March 2014.

Last year, the Basel Committee of Banking Supervisors extended the full implementation of Basel III from 2015 to 2019 because of the negative impact it could have on bank lending and the global economy. Banks, especially in Europe, continue to be concerned that the liquidity lockdown will hamper their ability to lend enough capital to finance a strong economic recovery, in our view. Given Basel III has not been fully implemented there may be reason to be concerned. A recent study by Fitch Ratings shows that between 2011 and 2012, Europe's 16 largest banks had already reduced corporate lending by 9 percent, or €440 billion.[16]

15 The Organization for Economic Cooperation and Development. "Macroeconomic Impact of Basel III." February 14 2011. Available at: http://www.oecd-ilibrary.org/economics/macroeconomic-impact-of-basel-iii_5kghwnhkkjs8-en

16 FitchRatings. "Basel III: Shifting the Credit Landscape." November 4 2013

We believe the Eurozone unemployment rate is another indicator of the need for a more diverse financial services ecosystem. As of March 2014, unemployment was at 11.8 percent and is forecast by economists to remain at or around that level through 2014. Among those under 25 years of age, unemployment was 23.7 percent.[17] This directly correlates with the health and well-being of the region's middle-market, in our view. Middle-market companies and SMEs—the latter of which generate 85 percent of new jobs in Europe and employ 72 percent of the continent's workforce—are particularly affected.[18] European businesses rely heavily on banks for their external financing needs. SMEs in France, for example, source approximately 90 percent of their capital through banks, and only get 2 percent from capital markets. Just 3 percent of SMEs in the U.K. fund their activity through equity.[19] While firms in France and the U.K. are feeling the crunch, we believe businesses in the periphery economies are likely suffering the most.

MOVING TOWARDS A MORE DIVERSIFIED SYSTEM

Europe's prolonged recession coupled with the current funding and economic environment provides a potential opportunity for a systemic shift to take place and thus for complementary, non-bank lenders to support corporate borrowers with competitively priced credit, in our view. In its recent green paper on Europe's long-term financing situation, the European Commission argues that the reverberations of the financial crisis provide an important opportunity to diversify Europe's credit markets. While the Commission believes banks will continue to be important capital providers, it confirmed that in order to truly revive the economy, it will be necessary to improve the mixture and overall resilience of different funding sources. The Commission also questions "whether Europe's historically heavy dependence on bank intermediation in financing long-term investments will give way to a more diversified system with significantly higher shares of direct capital market financing and greater involvement of institutional investors and alternative financial markets."[20]

We believe the emergence of a more diverse funding ecosystem could provide borrowers with efficient, competitively priced credit instruments, according to the Financial Stability Board (FSB), an international body made up of regulators, central banks and international organizations. In a report published in 2013, the FSB laid out the technical rules for identifying and addressing systemic risk. To this end, it indicated that a diversified credit market, comprised of both banks and non-bank lenders, could strengthen capital markets. "Credit intermediation activities by non-bank financial entities often generate benefits for the financial system and real economy," the report stated. Providing alternative financing and funding to the economy, the FSB added, creates "competition in financial markets that may lead to innovation, efficient credit allocation and cost reduction."[21]

Furthermore, we believe that non-bank lending can avoid the systemic risk associated with direct lending by banks. Alternative investment firms invest on behalf of sophisticated investors who understand and can absorb potential losses. Investors in credit investment funds, hedge funds, and private equity funds provide stable, longer term capital; these types of investors, unlike bank depositors, cannot instantly withdraw their capital. This can be critical for a company during periods of economic volatility. It also generally avoids "runs on the bank." These investment funds do not borrow from central banks or possess government guaranteed deposits. They typically lack high leverage and each investment within a fund is independent, limiting contagion. If one company backed by a fund were to fail, this would not implicate other companies in the fund.

Lastly, we believe an expanded funding pool would also likely have a positive impact on corporate growth. Well funded, more confident companies would be better positioned to invest in their businesses and hire employees. That, in turn, could be a boon to Europe's major economies, which are emerging from recession. "It is in the interest of citizens, investors and future pensioners in Europe to ensure that there is an efficient and functioning ecosystem of different funding models for the different stages of growth of these companies," the European Securities and Markets Stakeholder Group stresses.[22] Rather than weaken the financial system, an ecosystem of vibrant non-bank lenders to complement the traditional banking sector would help keep a steady supply of capital flowing to both large and small companies.

> "
> **A diversified credit market, comprised of both banks and non-bank lenders, could strengthen capital markets.**
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17 EuroStat. "Euro area Unemployment Rate at 11.8%." April, 2014

18 European Banking Federation. "European Banking Sector Facts and Figures 2012." October 2012

19 European Banking Federation. "European Banking Sector Facts and Figures 2012." October 2012

20 European Commission. "Green Paper: Long-Term Financing of the European Economy." March 2013

21 Financial Stability Board. "Strengthening Oversight and Regulation of Shadow Banking." August 2013

22 European Securities and Markets Authority. "Securities and Markets Stakeholder Group – Report on Helping Small and Medium Sized Companies Access Funding." October 12 2012

Who Are The New Players?

A number of governments and public institutions that are concerned about the challenging bank funding climate, such as the ECB and IMF, have stated that alternative sources of financing need to be both identified and developed. And, in fact, a growing number of European businesses are tapping alternative credit sources for funding.[23] Providers of alternative capital are not merely carbon copies of banks. They work through the long-term capital needs of companies and offer them a variety of sophisticated funding instruments.

Also, as banks shed assets to meet tougher capital requirements, non-bank lenders seem to be stepping in to fill the gap. These alternative funders have built a track record investing in and working with companies that have sound, long-term market prospects but that may have been hampered by temporary economic or financial headwinds.

PRIVATE PLACEMENTS

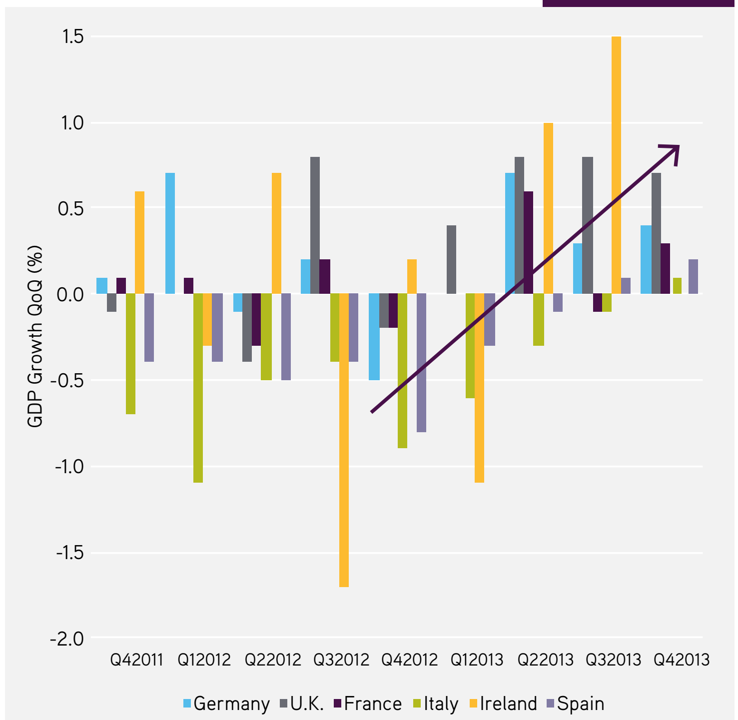
The European market for private placements, the sale of securities to a select group of private investors, is embryonic compared to the €36.6 billion in private debt placements that take place every year in the U.S.[24] However, a growing number of European companies, especially middle-market companies shut out of bank loans, now seem to be negotiating euro- and sterling-denominated private placements.

In Germany, schuldscheins, which share some characteristics with U.S. private placement loans but do not require a sales prospectus, are well established funding sources for local companies. Now, however, they are attracting a number of international borrowers. Last year, Sonepar, the French electrical parts distributor, issued a €400 million schuldschein.[25] Other noteworthy issuers include Swiss specialty chemicals maker, Clariant, and U.K. grocer Sainsbury. In 2012, corporate-issued schuldscheins jumped 104 percent over the previous year, with the total approaching €13.6 billion. The number of Schuldscheins issued by non-German companies increased 356 percent, accounting for a total of €5 billion.[26]

Private placements also seem to be addressing the lending void in France. Since it launched about a year ago, the French private debt market has raised €5.8 billion.[27] Notable issues include the six-year note, €145 million raised by French vegetable processor Bonduelle. Large insurers, including AXA and CNP Assurances, are some of the country's most active investors in the nascent private placement market.[28]

In the U.K., insurance companies have participated in private placements as well, but their capital has largely gone to the U.S. The Breedon Report, commissioned by the British government to highlight financing alternatives for businesses that have historically relied on bank funding, argues that sterling-based private issuances could potentially grow to £15 billion. The report also found a significant portion of private placement capital could find its way to SMEs and middle-market companies.

EUROPE RETURNING TO GROWTH — **EXHIBIT 3**



Source: Bloomberg, Eurostat.

However, we believe there may be several barriers to a private placement market in the U.K. In a follow-up note to the Breedon report, the U.K.-based Association of Corporate Treasurers noted, for example, that because there are no standard loan documents associated with private placements, companies pursuing them could incur significant legal fees.

23 European Securities and Markets Authority. "Securities and Markets Stakeholder Group – Report on Helping Small and Medium Sized Companies Access Funding." October 12 2012

24 PwC. "In the Debt Markets." June 2013. Available at: http://www.pwc.co.uk/corporate-finance/publications/in-the-debt-markets/schuldschein-german-private-placements-attract-international-borrowers.jhtml

25 L'AGEFI. "Sonepar Emet 400 millions sur le Marche du Schuldschein." June 28, 2012. Available at: http://www.agefi.fr/articles/sonepar-emet-400-millions-sur-le-marche-du-schuldschein-1229196.html

26 PwC. "In the Debt Markets." June 2013. Available at: http://www.pwc.co.uk/corporate-finance/publications/in-the-debt-markets/schuldschein-german-private-placements-attract-international-borrowers.jhtml

27 American Banker. "European Private Placements Fill Lending Void, Present Threat to U.S. Banks." American Banker, August 26 2013

28 EuroTreasurer. "French Disintermediation: Bonduelle"s EU Private Placement." EuroTreasurer. March 10 2013

BONDS

SMEs also seem to have been turning to retail bonds to raise money. Known as 'mots,' these bonds are well established in Italy, where they have traded on Milan's Borsa Italiana since 1994. Other European countries may be following Italy's lead. In 2010, the London Stock Exchange launched its Orderbook for Retail Bonds (ORB), modeled largely on the Italian mots.[29] Since their inception, ORBs have raised more than £3.4 billion.[30] In late 2013, U.K.-based Premier Oil, an oil and gas company with a market capitalization of £1.6 billion, also explored the retail bond market with an offer for a £150 million, seven-year note priced at 5 percent.[31]

Spain also seems to be turning to retail bonds to boost financing for small and mid-size businesses. Overall, the Spanish credit pool has been shrinking at an annual pace of about 12 percent.[32] The government, eager to give SMEs a way to secure financing, backed the decision by the country's stock exchange, the Bolsas y Mercados Españoles, to launch the Fixed-Income Alternative Market in 2013. The new retail bond market, supported by a €3 billion government credit facility, is poised to give smaller Spanish businesses an alternative to the anemic Spanish banking sector. In December, construction company COPASA issued the exchange's first placement, a €50 million, five-year note priced at 7.5 percent.[33]

LONG-TERM ALTERNATIVE CREDIT SOLUTIONS

A number of asset managers with dedicated credit funds see an opportunity to lend to middle-market borrowers across Europe. There are three types of alternative credit providers. Mezzanine funds extend hybrid loans, which can be converted into equity. Special situation funds, which provide capital based on specific market events, are another funding channel. These strategic investments can take the form of rescue financing designed to address a cash crunch, as well as loans triggered by other milestones, such as a debt refinancing. Finally, some alternative credit is allocated by direct lending funds, which typically give loans to middle-market companies that cannot secure a competitively priced bank loan. These funds usually show up as senior debt on companies' balance sheets.

Alternative investment firms can provide financing across the spectrum of early-stage and mature companies and can channel capital through credit instruments as varied as direct loans, private placements, or even hybrid debt such as mezzanine financing. We believe that alternative investment firms will play an important role in Europe's emerging alternative funding stratum, partly because the industry has longer time horizons. The European Commission singled out equity financing as an effective, and underdeveloped, source of funding for startup companies. Data shows that just 7 percent of Europe's SMEs tap early stage equity investors for capital.[34]

Alternative investment firms generally invest in companies across all industries with solid fundamentals, many of which may have been shut out of the European banking system because of challenging market conditions. So it was for Spanish building material company, Uralita, which had been affected by the collapse of the Spanish financing and European construction market. Last spring, when the company was unable to obtain competitively priced bank financing, Uralita secured a €320 million, seven-year refinancing.[35]

> "An expanded funding pool would also likely have a positive impact on corporate growth. Well funded, more confident companies would be able to invest in their businesses and hire employees."

In June of 2013, the European Commission proposed creating a new European Long Term Investment Fund (ELTIF) to provide professional and retail investors with a readily available pooling mechanism through which to invest in companies or projects that require long-term capital financing and are not traded on regulated markets. The Commission's aim in proposing the ELTIF is to establish a long-term assets counterpart to its successful Undertakings for the Collective Investments of Transferable Securities (UCITS) fund for investments in liquid financial assets and to build within the EU a common, comparable cross-border standard for what long-term assets are, for whom they may be suitable, and how they function. We believe the industry has responded positively to the Commission's proposal, but as of May 2014, it has not been enacted.

In the U.K., a government-supported scheme known as the Business Finance Partnership (BFP) has incentivized direct lending funds to boost loans to middle-market companies. The British government

29 London Stock Exchange Group. "Retail Bonds" Available at: http://www.lseg.com/areas-expertise/our-markets/london-stock-exchange/fixed-income-markets/trading-fixed-income-markets/retail-bonds

30 London Stock Exchange Group. "Retail Bonds" Available at: http://www.lseg.com/areas-expertise/our-markets/london-stock-exchange/fixed-income-markets/trading-fixed-income-markets/retail-bonds

31 Premier Oil. "Premier Oil Launches 5% Sterling Bond Due 2020." November 25 2013

32 The Wall Street Journal. "Spain Launches Bond Market for Small Businesses." The Wall Street Journal. October 7 2013

33 Bolsas y Mercados Españoles. "MARF Receives Its First Issue Launched by COPASA." December 20 2013

34 European Commission. "Europe 2020: Access to Finance." Available at: http://ec.europa.eu/europe2020/pdf/themes/09_sme_access_to_finance.pdf

35 KKR. "KKR Asset Management to Provide Debt Financing to Uralita." April 29 2013

has invested £1.2 billion in direct lending funds, and the private sector is expected to match the government's contribution.[36] A tranche of the funds will provide loans to companies with turnovers of up to £500 million. Another tranche will channel loans to U.K. SMEs with turnovers of no more than £75 million.

Although BFP only supports British companies, a number of other asset managers are extending direct loans to businesses across Europe. Last spring, BlueBay Asset Management, a fund manager owned by the Royal Bank of Canada, announced a final closing on an €800 million fund to provide between €20 million and €100 million to companies in the U.K. and northern Europe valued at less than €500 million.[37] London based Chenavari Credit Partners also mounted a successful campaign to secure cash for direct lending funds, having raised €733 million for this fund in 2013.[38]

The capital extended by these alternative lenders comes largely in the form of long-term equity from the fund's investors. While funds do not typically have the same safety net commercial banks have, such as access to liquidity funding from the ECB or government-backed investor protection regimes, they do tightly manage risk. Hence, to the extent that the funds lend leveraged capital, they do not typically incur leverage levels above three times the equity under management. When combined with the equity holdings provided by the fund's investors, we believe the leveraged capital still remains dramatically lower than comparable bank financing structures.

Alternative investment firms are also in a position to fill the gap left by declining bank and government infrastructure financing, in our view. The European Investment Bank estimates that Europe will need €2 trillion of infrastructure investment to meet the EU's Europe 2020 growth targets.[39] Alternative investment firms could provide expertise and capital to support large-scale energy, transportation and information technology projects. According to Preqin Investor Network's 2013 Global Alternatives Report, nearly 60 percent of investors with infrastructure investments who participated in the poll plan to increase their allocation over the year and beyond.[40]

Balancing alternative lenders' higher appetite for risk are their strong credit selection standards as well as their in house operational restructuring capabilities, which we believe can be extremely helpful to the companies involved. "The best practices which the Central Bank has encountered amongst loan originators suggest a highly involved selection process requiring specialist skills," the Bank of Ireland stated.[41] It's not enough to have lendable capital. We think a dedicated staff with the expertise to identify projects, negotiate loan terms, and monitor repayment may be just as critical. Tracking the overall progress or providing hands-on operational support to the project backed by the loan is also key to the success of these kinds of arrangements. These are tools that are typically only available through alternative investment firms. Furthermore, given that alternative investment funds invest a substantial part of their own equity and therefore tend to be exposed to the credit risk, they tend to focus much more attention on ensuring the best long-term credit solution possible.

36 Department for Business, Innovation & Skills and HM Treasury. "Encouraging Private Sector Investment." December 9 2013

37 Bloomberg. "BlueBay Raises 800 Million Euros for Europe Direct Lending Fund."Bloomber, May 21 2013

38 Bloomberg. "Chenavari Said to Target $1 billion Europe Direct Lending Funds." Bloomberg, April 29 2013

39 European Investment Bank. "The Europe 2020 Project Bond Initiative – Innovative Infrastructure Financing." December 21 2012

40 Preqin. "2013 Preqin Investor Network Global Alternatives Report." Pg 77 Available at: https://www.preqin.com/docs/reports/2013_PIN_Global_Alternatives_Report.pdf

41 Central Bank of Ireland. "Loan Origination by Investment Funds." July 2013

Recommendations for the Path Forward

With European banks increasingly unable or unwilling to lend, we believe non-bank financing could be critical to Europe's economic recovery. However, we think both policymakers and investors need to be aware of potential barriers to the emergence of non-bank funding across the continent. There are several ways both capital providers and regulators can smooth the way for these key financing resources:

1. **Education and Outreach**

Europe remains, at its base, a banking market. Group treasurers of middle-market and SMEs instinctively turn to banks when they need to secure short or long-term funding. Therefore, we think it is critical to inform smaller businesses about the alternative financing opportunities that are becoming more prominent in the wake of the financial crisis. According to a recent report by the Association of Corporate Treasurers "there is… a lack of awareness of non-bank lending as an alternative to relationship banks," especially amongst companies with little exposure to international capital markets.[42]

2. **Credit and Ratings**

At the same time, we believe non-bank lenders need to effectively assess the creditworthiness of companies within the small and mid-size market. In 2013, Standard & Poor's rolled out their Middle-Market Evaluation (MME), a tool that provides lenders with credit analysis of middle-market borrowers across Europe. Buy-side firms that lack the ability to perform strong credit analysis can also partner with banks. In such a partnership, the fund would lend the capital, and the bank would assess the client's creditworthiness. Such partnerships already exist, most notably in France, where Societe Generale has teamed up with French insurer AXA to provide private placement loans to middle-market companies with revenues of more than €250 million.[43]

3. **Regulatory Hurdles**

While the EU has harmonized a number of financial regulations, European member states still have a myriad number of national regulations, especially regarding licensing requirements. While Ireland, the U.K., and Spain do not license lenders, France and Germany require any entity that originates loans to have a license.

The EU LTIF proposal specifically acknowledges that large-scale and long-term capital commitments required for operating efficient investment pools for long-term assets have been hampered by regulatory fragmentation among member states. Where funds and incentives do exist on a national level, they are not coherent with comparable initiatives in other member states, thus, as the EU LTIF proposal points out: "Preventing the scale of pooling of capital and investment expertise that creates economies of scale for funds and therefore benefits investors." However, the majority of member states have no fund models or equivalent incentives that address long-term asset classes. In the absence of a cross-border fund vehicle, investors in these markets are excluded from investing in long-term asset classes. Simplifying this fragmented regulatory framework by imposing a single, EU-wide rule would lift a significant regulatory hurdle, in our view.

42 Financial Times. "Non-bank lenders step up U.K. funding deals" Financial Times. November 26 2013

43 Societe Generale. "Societe Generale and AXA Partner to Launch a New Financing Offer for French Companies." May 31 2012

A Welcome Evolution

We believe the pullback on traditional lending is providing European capital markets a chance to evolve, presenting a number of opportunities: for banks and alternative investment funds to partner together; for non-bank lenders to grow; and, for middle-market companies and SMEs to diversify their funding. It is also, very possibly, the beginning of a systemic shift for European capital that may be able to buttress a weakness in the lending market.

Of course, Europe's major banks have not stopped lending and still provide the financial backbone of the economy. Banks extended €5.6 trillion to non-financial companies in 2012.[44] But banks are being much more selective, preferring to lend to larger companies over shorter periods of time. Furthermore, bank deleveraging has yet to peak, in our view, indicating that available lending capital could tighten further. According to some estimates, European banks still need to deleverage trillions of euros to meet standards established by economies such as Australia and Japan.[45] Europe's middle-market companies and SMEs, the continent's economic engines, feel the pinch most acutely. We believe a dearth of bank lending to middle-market companies and SMEs could continue to stifle Europe's much-awaited economic recovery.

Working hand in hand with alternative investment firms with access to flexible capital, we believe banks would be well positioned to help and retain their clients while not tying up their balance sheet or capital. Partnerships of this nature may also make it possible for banks to leverage the expertise that many alternative investments firms possess in analyzing the credit risk of large firms that tap public or private debt markets.

There is an emerging opportunity for non-bank lenders to provide the credit facilities middle-market companies and SMEs need, in our view. But spreading the word is also critical. Corporate treasurers, especially at middle-market companies and SMEs should be made aware of opportunities to tap the ecosystem of alternative, competitively priced non-bank financing.

Finally, we believe capital providers with long-term investment approaches, such as alternative investment firms, could also help companies grow and provide them with robust operational assistance. The emergence of these and other providers of alternative capital could help address structural deficiencies in the lending markets and potentially bolster European economic growth.

"It is in the interest of citizens, investors, and future pensioners in Europe to ensure that there is an efficient and functioning ecosystem of different funding models."

44 Association for Financial Markets in Europe. "Unlocking Funding for European Investment and Growth." June 2013

45 RBS Macro Credit Research, 2012, cited in The Alcentra Group. "European Banking Changes Create New Opportunities for Direct Lending to Mid-Sized Companies." 2012. Available at: http://us.bnymellonam.com/core/library/documents/knowledge/AlphaTrends/sEuroBanking.pdf

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