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Investing for a world of change

The missing piece in private credit allocations

Investors have embraced sponsored direct lending in their private credit allocations for some time, but many are yet to explore the sponsorless* private credit market. This is partly owing to common misconceptions around the associated risks. However, well-structured loans to sponsorless borrowers can offer attractive risk-adjusted returns, robust downside protection and valuable diversification – especially if the loans are asset-backed and originated by a manager with the relevant experience, skill set and market access.

This note discusses:

1. **The sponsorless lending opportunity set in the European mid-market**
2. **Common misconceptions around the risks associated with sponsorless lending**
3. **How exposure to a well-designed strategy can offer valuable benefits to investors**

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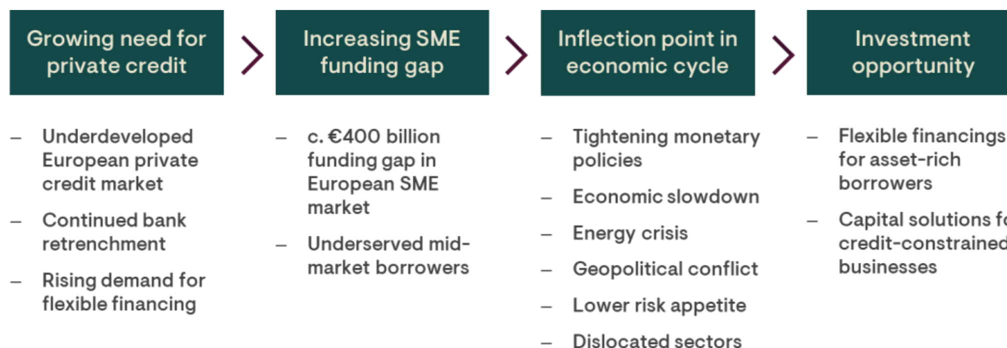
For further information on investment team please see Important information section.

A compelling investment opportunity

Over recent years, increased regulation in Europe has driven traditional lenders such as banks to retreat from lending to SMEs. This, in turn, has produced a funding gap for SMEs estimated at €400 billion and an opportunity for private credit managers to help fill this void by providing much-needed alternative sources of funding.

In addition to this structural funding gap, current market conditions are amplifying the need for alternative funding from specialist private credit managers. This is especially the case for sponsorless borrowers that do not have private equity sponsorship, and borrowers/transactions that are viewed as non-standard or complex. In such an environment, specialist private credit managers with the right origination, underwriting and execution skills can target attractive double-digit investment returns by offering flexible private credit solutions to performing borrowers in an uncrowded market. With the added layer of asset-backing as protection, these private credit solutions have the potential to generate attractive expected returns from contractual income while retaining robust expected downside protection.



Source: Ninety One. €400 billion estimated funding gap figure from Euler Hermes, April 2019.

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*'Sponsorless' refers to borrowers owned by entrepreneurs, families and shareholders other than private equity funds.

Common misconceptions

Sponsorless = small and non-creditworthy

A common concern among investors is that 'sponsorless' equates to 'small and non-creditworthy'. While no doubt there are plenty of small and less creditworthy sponsorless borrowers, there are also many that are sizeable and highly creditworthy. Indeed, the fact that a borrower may be 'non-sponsored' largely misses the point. What matters, in our view, is that the borrower is of a high quality, well managed and asset rich. Fortunately for a sponsorless lending strategy, the European mid-market has many such borrowers in need of flexible funding.

The absence of a sponsor makes it too risky

Although sponsorless deals by their nature do not have the backing of a private equity firm, they do not necessarily entail higher risk. The underwriting responsibility falls squarely on the private credit manager, who must have excellent structuring skills and a private-equity mindset and approach.

Moreover, many sponsorless borrowers are owned by founders and families who will typically do everything they can to protect their businesses. This cannot always be said of private equity owners, who have been known to withhold financial support and 'hand the keys' to lenders if their economic interests are not served. Accordingly, we believe it is more relevant to focus on the quality of the borrower and the asset-backing than to focus on whether the borrower is sponsored or sponsorless.

Complexity means it is not commercially viable to tap into this market

A sponsorless lending strategy is commercially viable for managers with the requisite skills and expertise to overcome the complexities associated with sponsorless lending. The c.€400 billion estimated funding gap mentioned above represents an expansive market opportunity, which the current market conditions are only amplifying. For a sponsorless lending strategy to be commercially viable, the manager needs to tap into only a small fraction of this opportunity set. Provided that the manager has the specialised origination network, underwriting skills and execution ability to capitalise on this opportunity, we believe it is feasible to deploy several billion euros of asset-backed loans over a multi-year period and, in doing so, develop a commercially viable investment strategy that aims to provide attractive diversification and risk-adjusted returns to asset owners.

Benefits of including sponsorless private credit in a private credit allocation

An untapped and deep opportunity set can bring diversification benefits

While larger sponsor-owned borrowers are often spoiled for choice in the sponsored direct lending market where multiple managers typically chase the same deal, a large and diverse set of sponsorless SMEs in Europe is seeking flexible capital solutions in the absence of bank financing or as an alternative to dilutive equity. These borrowers are typically found off the beaten track, located in small and medium-sized cities across Europe such as Birmingham, UK; Aachen, Germany; and Seville, Spain. With many more sponsorless than sponsor-backed borrowers, the opportunity set for investors is larger and inherently more diverse. This, in turn, can lead to investments with significantly lower correlation to other credit strategy exposures.

Bespoke asset backing can offer stronger expected downside protection

Whereas sponsor-focused direct lenders typically lend to corporates on a cash-flow basis, private credit managers with a focus on asset-backed loans to sponsorless borrowers can benefit from better expected downside protection. This is because the loss-given default on asset-backed loans is typically expected to be lower than the loss-given-default on cash-flow loans. Moreover, in the present economic environment it can be challenging to underwrite corporate earnings with confidence, whereas the value of certain assets has the potential to be more predictable.

A less competitive field means better lending terms

Unlike the European sponsored direct-lending market where there are a number of established private credit managers, the European sponsorless private credit market remains relatively underdeveloped, with only a handful of managers. A lower level of competition typically allows sponsorless private credit managers to obtain better financial terms with respect to pricing, structure, financial covenants and security.

The main reason for lower competition is the higher barriers to entering this market – especially in relation to both origination and execution. Originating attractive sponsorless lending transactions requires a differentiated model, which relies on direct sourcing of opportunities via smaller local market advisors and brokers who are often based in second and third tier cities. This is more labour intensive and necessitates an expansive network that typically takes years to develop. In addition to specialised origination ability, the need for private equity expertise and workout skills also constitutes a significant barrier for would-be market entrants.

Significant potential for risk-adjusted return pick-up

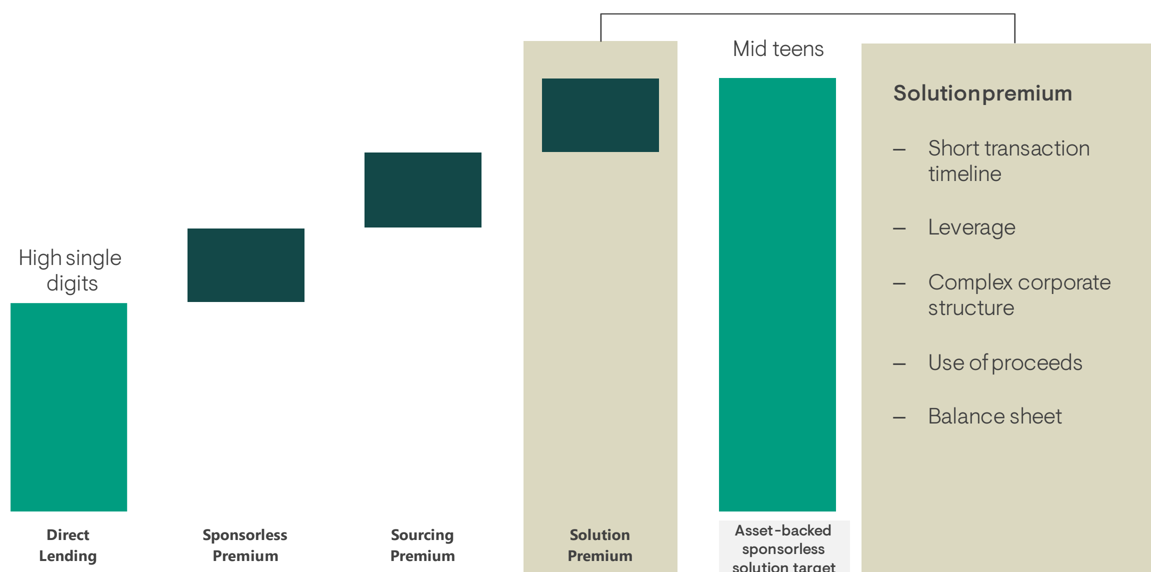
Currently, there is a demand/supply imbalance in the sponsorless mid-market, characterised by high borrower demand for flexible private credit and a relatively limited number of managers capable of offering such alternative credit. This demand/supply imbalance is a key reason behind sponsorless borrowers' willingness to pay a premium for private credit solutions that meet their needs.

Historically, sponsorless SMEs have addressed their financing needs through either the banking market or through raising equity as these companies are typically too small to be able to access the capital markets. In the absence of bank financing and as an alternative to raising equity, sponsorless borrowers are willing to pay a premium for flexible and bespoke financing. In exchange for providing swift and tailored funding solutions, private credit managers can negotiate attractive risk-adjusted expected returns derived from arrangement fees, cash coupons, payment-in-kind (PIK) coupons and, potentially, upside via equity stakes or performance-linked metrics. This means investors can target a significant pick-up in risk-adjusted returns relative to the sponsored direct-lending market, which is generally very competitive and characterised by price-based competition.

Comparing sponsorless and sponsored opportunity sets

		Asset-backed sponsorless	Sponsored direct lending
Competition	Barriers to entry	High	Moderate
	Competition	Low	High
Downside protection	Asset-backing	Yes	Seldom
	Lender protections	High	Variable
Returns	Typical return	Mid-teens	High single digits

Proprietary sourcing and tailored funding solutions – indicative unlevered gross IRR and return premia



Asset-back sponsorless targets are indicative and subject to change. These may not be achieved, losses may be made.

Source: Ninety One. April 2023. For illustrative purposes only.

General risks: The value of investments, and any income generated from them, can fall as well as rise. Past performance is not a reliable indicator of future results. Investment objectives and performance targets are subject to change and may not necessarily be achieved, losses may be made.

Investing in debt entails risks related to a borrower's ability and willingness to repay the principal and pay interest. A rise in interest rates or a period of economic downturn could severely disrupt the market for private credit and erode a borrower's creditworthiness; should the borrower's financial situation deteriorate, the value of the security may also suffer a similar decline. Further risks include, but are not limited to economic, political and legal risks, currency risk, auditing standards and financial reporting differences, possible lack of diversification, control issues, market fluctuations and interest rate risk.

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