IBERIA

Turning bullish on volatility

As so often in finance, timing is the main question for private lenders seeking to exploit a ripening Spain, finds **Rachel McGovern**

Not all European peripheral economies, the so-called PIGS (Portugal, Ireland, Greece and Spain) of the post-global financial crisis years, are created equal. And last year, for private debt, the Spanish story changed.

With a reformed bank system, improving economic metrics, including one of the fastest growing economies in the eurozone, and a clearing backlog of non-performing loans (NPL), the jurisdiction is on the up.

In December, *PDI* published *Perspectives*, a special report built around a survey of the private debt allocation intentions of almost 100 global investors. Asked which European jurisdictions were most interesting, Spain was just behind the UK and Germany with 57 percent of respondents including it in their choices for the country in which they most wanted to get exposure.

Add to this an improved regulatory environment for creditors and debt funds hungry to expand beyond core northern European countries and you would be forgiven for thinking that the time couldn't be riper for alternative lenders.

There's one wrinkle in this aligning of the stars – Spanish banks. Nobody told them that they lack capital and shouldn't be lending to credit starved corporate borrowers.

It's not quite that simple, of course, but most seeking to access the Spanish debt market agree that the local banks are determined not to lose market share and are loathe to relinquish existing clients to rival – especially debt fund – lenders.

"ALL THE DEBT MANAGERS HAVE STORIES TO TELL, WHERE THEY WERE PITCHING FOR A DEAL WITH A UNITRANCHE STRUCTURE AND THE LOCAL BANKS CAME BACK WITH A VERY AGGRESSIVE OFFER THAT MAKES UNITRANCHE NOT COMPETITIVE AT ALL"

Aitor Zayas

SHIFTING FOCUS

In recent years, when most private debt investors considered Spain, it was through the prism of NPL sales. The government had set up Sareb, a bad bank to warehouse and sell soured real estate debt while banks also quietly sold assets.

And though the NPL opportunity – particularly for large-ticket investors – is certainly not over with an estimated €200 billion in non-core real estate still on Sareb and financial institutions' books, the market has settled down.

The large number of distressed investors backed by significant firepower also means sales are competitive and producing decent prices for sellers. Many market observers say that NPL buyers are now relying on leverage to juice their returns.

Less established is the place of private credit providers in the Spanish corporate debt market.

But there's a thriving ecosystem of players slowly making their mark (see panel).

Over the three years to the end of September 2015, 13 deals had been executed by alternative lenders in Spain and Portugal with that volume accelerating in the latter half of the period, according to Deloitte's alternative lending deal tracker.

One of the most highly spoken of and longest established Spanish debt managers is lower mid-market mezzanine lender Oquendo Capital, founded in 2007.

Other domestic debt funds have also joined the field, including Incus Capital and Resilience Partners.

Both, like Oquendo, focus on the SME end of corporate lending. Resilience is a cashflow lender providing longer-term capital. Incus also makes senior secured cashflow loans, but it is only about one third of its business, says Andrew Newton, Incus's founder. Most of the manager's lending is secured against real assets.

At the other end of the mid-market, most of the names executing deals in Spain are familiar from other European jurisdictions: Highbridge, ICG, Kartesia and Sankaty.

However, the debt funds seeking to make inroads into Spain and Portugal have struggled in a region that, on the face of it, is less in need of alternative sources of capital.

Alternative lenders have done more deals in Germany (63) and the Nordics (19 across the four countries) than Spain. Even Italy (14) beats Spain for dealflow over the last three years, record Deloitte.

In Portugal, most put that down to the size of the market, among other reasons (see panel on p. 26). In Spain, however, long a darling of private equity, market experts paint the reasons in shades of grey.

As mentioned, Spanish banks are keen to protect their market share. And some are even out to capture more from the cajas that have disappeared or foreign lenders that have exited the market, notes Aitor Zayas of Deloitte's debt advisory team in Madrid.

He says the Spanish lenders have gone from restructuring to asset gathering mode.

"Banks want to keep a grip on and fight for a share of this business. They're not going to be satisfied only keeping the revolving lines, factoring business or short-term lines. Corporate lending is a very relevant business for local banks. They also want a share of the long-term lending with these corporates," says Zayas.

One reason for this is that rather than prompting Spanish lenders to look to their capital bases, the consolidation that has swept the market has prompted the banks to try to build their assets to avoid becoming the next possible takeover target, says HIG Whitehorse's Miguel Lasso.

"IN SPAIN, 2015 SAW A STRONG REBOUND FROM NOT LENDING AT ALL [TO BANKS PROVIDING CREDIT]. I'M NOT SURE THAT THAT REBOUND WILL BE AS STRONG THIS YEAR. BANKS ARE UNLIKELY TO BE AS AGGRESSIVE IN DOING DEALS AND EXTENDING MARKET SHARE"

Jaime Prieto

On top of this, Spain's banks are further behind other European traditional lenders in preparing for Basel III regulations and the impact that will have on the cost of extending longer-term loans.

While the bounce back of credit provision in Spain means a more competitive landscape, the fundamental challenge to bank lending remains.

As David Brooks, an executive vice-president at Sankaty who looks at the Spanish market puts it: "If Spain is behind parts of Europe [in terms of preparing for Basel III], then Europe is behind the US. Generally speaking, that all favours the growth of private lending."

For the moment, however, no matter what the borrowers' individual situation Spanish banks provide senior debt at 3.5x leverage at pricing under that offered by their European counter-parts, say debt fund managers. The usual private debt deal clinchers – an extra half or full turn of leverage combined with a more flexible, bespoke financing package, has a harder time competing against Spanish lenders determined

GOING LOCAL

One of the strongest arguments that smaller country-focused shops make is that they are on the ground all the time, know the market better and as a result have better sourcing capabilities.

"Unlike many other platforms that need to travel to Spain to source deals, we are a Madrid-based platform travelling to the country's regions, doing everything in the local language and under Spanish law," says Incus's Newton who, after a career at international investment banks, founded two firms in Spain: independent loan servicer HipoGes, in which he sold most of his stake to Cerberus in 2014 and Incus Capital.

Several transatlantic and pan-European managers agree that having a presence is essential and have established offices in Madrid to close any gap between themselves and wholly domestic players (see table on p. 27).

But there is also an argument that having a senior team member from the country you're targeting can work just was well. That's the approach that London-based BlueBay has taken to Spain, hiring ex-GE Capital lending veteran, Vincent Vitores. And Deloitte's Zayas says the strategy has worked for Kartesia – Prieto is from Spain.

It's also working for Highbridge who hired Valero Domingo from 3i a couple of years ago. In July 2015, Highbridge executed one of the largest deals by a debt fund in Spain. The US-headquartered lender extended a €126 million senior loan to Grupo Ezentis, a utility servicing company to both refinance existing debt and support its acquisition of a Brazilian telecoms servicer.

IBERIA

PORTUGAL LAST IN LINE

One-fifth the size of the Spanish market but not one-fifth the opportunity. That is the conclusion of many managers asked about Portugal.

There are and will be deals done by alternative lenders, they say, but aside from the fact that it is much smaller with fewer companies large enough to tap alternative lenders, it is also well behind Spain in terms of recovery, says HIG Whitehorse's Miguel Lasso.

Incus Capital's Newton who has hired a partner to source from Lisbon for his firm, says Incus is keen to do deals there but also recognises that it remains a smaller opportunity than Spain.

Portugal, unlike fellow troika bailout countries Ireland and Spain, has not set up a bad bank to take spoiled assets off the balance sheets of financial institutions. And it lags in terms of general recovery.

EU forecasts for full-year 2015 GDP growth published last autumn put Ireland at 6 percent, Spain at just over 3 percent with Portugal trailing behind on 1.7 percent.

to hang onto their clients. One manager recalls a deal they were looking at where the senior debt was financed by a bank offering a 275bps margin.

"All the debt managers have stories to tell, where they were pitching for a deal with a unitranche structure and the local banks came back with a very aggressive offer that makes unitranche not competitive at all," Zayas says.

But not everyone agrees that the resurgent bank activity is unusual.

Says Brooks: "I do agree that they [Spanish banks] are increasingly focused on middle-market lending, maintaining market share and growing the book, but we view that as them catching up to where some other European banking markets are, we don't view them as more aggressive."

Jaime Prieto, co-founder of pan-European lender Kartesia, agrees, saying that it's a case of skewed expectations of the debt funds.

Those who started lending in Spain earliest executed very favourable deals with strong companies, note Prieto and others. Kartesia was one of those making a number in 2014, but now that there is more liquidity in the market returns from loans to strong credits have fallen.

"In terms of competition and returns, I don't think the direct lending to private equity-backed firms is as interesting as the sponsor-less end of the market at the moment," says Resilience Partners co-founder Adriana Oller.

ORIGINATION

So although the private debt mainstay – sponsor-backed mid-market corporate lending – looks like it should be a nut worth cracking, most of the domestic and international lenders and advisors that *PDI* speaks to, say that for the moment, the opportunity lies in specific niches.

Zayas, who advises on these deals, says the key is origination: "The way I see it,

Andrew Newton: 'You can't win by competing directly with the domestic banks'

due to the relative smaller size of Spanish middle-market companies, private debt investors need to make an additional sourcing effort in the Spanish market versus other European jurisdictions. Due to the high penetration and availability of bank financing, it is not that easy to identify the situations where private debt can be competitive in Spain."

Incus's Newton agrees: "You can't win by competing directly with the domestic banks. Incus wins deals by providing an alternative product to the banks, based on speed and flexibility."

His alternative is to move down the size curve to SME lending and offer structures in which the commercial banks are less competitive. Very cheap asset-backed loans used to be provided by the cajas, says Newton, and with their disappearance there is room for commercial non-bank lenders.

"In 2007-08 when 95 percent of the capital going to Spanish SMEs came from the traditional banking system, for me that was the anomaly. This is now coming more in line with the rest of the eurozone with 20-30 percent of the capital coming from alternative sources of capital rather than the traditional banking system," says Newton.

David Brooks: Spanish banks are increasingly focused on mid-market lending

Resilience Capital's Oller agrees, pointing out that on the corporate SME side, banks won't lend over three years. So she and her team, most of whom worked together at mid-market private equity and debt shop 3i, extend longer-term loans with an average tenor of seven years.

Similarly, for Kartesia and Sankaty, the opportunity lies in the borrowers that the banks won't finance, but for different reasons. "We still see a good opportunity in what we call 'grey borrowers' – companies that have been through or require restructurings – because it's still very tough for them to get bank financing and there are still many in Spain that we can support," says Prieto.

And following the devastation of the global financial crisis, there are plenty of examples that have "challenging historical financials and a 'story' to tell", says Brooks.

Sankaty has written cheques for a cinema projector business and an insurance outsourcing business. The team has even spied potential borrowers from among the NPL portfolios acquired by colleagues in other parts of the business.

So where does this leave alternative lenders in Spain?

Though the managers and advisors who spoke to *PDI* on and off the record about the prospects for Iberia in 2016 were almost universally bullish, the country shows no signs of suddenly tripling the number of deals done this year.

M&A activity is likely to fall over the next 12 months, putting lenders who thrive on event-driven financing on the back foot.

Balancing that is the prospect of Spanish bank lenders reconsidering the resurgence of last year.

"In Spain, 2015 saw a strong rebound from not lending at all [to banks providing credit]. I'm not sure that that rebound will be as strong this year. Banks are unlikely to be as aggressive in doing deals and extending market share," says Prieto.

His view may prove prescient.

After *PDI* spoke to the Kartesia co-founder in December, over the first three weeks of the New Year an index of Spanish bank stocks fell 17 percent. The sector was hit on all sides with political uncertainty following the Spanish election, concerns about the European Commission looking into NPLs, as well as more general market volatility.

Looking through the prism of January's tumultuous markets, the most bullish of Spain's private lenders could yet prove right. ■

Domestic alternative lenders

- Incus Capital
- Oquendo Capital
- Resilience Partners

Alternative lenders with an office in Spain*

- HIG Whitehorse
- Idinvest Partners
- KKR
- Muzinich & Co.
- ICG
- N&1
- Magnetar Capital
- Hayfin
- Trea Asset Management

*Source: Deloitte

Alternative lenders with a Spanish specialist

- Alcentra
- BlueBay
- Kartesia
- Sankaty
- Highbridge

PONDEROUS PARTNERSHIPS

A few partnerships between Spanish lenders and institutional investors or debt managers have popped up in Spain, say market experts.

Most, as in several other European jurisdictions, have not had much impact at all. One senior Spanish banker at a large domestic lender said that his bank tried to set up a distribution network for loan assets, directing them on to investors and debt managers, but that it failed to get off the ground.

Of course, some have made progress. In 2013, Bankinter announced that it would team up with Magnetar Capital on deals to grow a fund of up to €200 million. And in November, the pair signed a €60 million loan to refinance the debt of Canary Islands food distribution company Dinosol Supermercados.