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Underwriting The Recovery: Europe's Mid-Market Seeks New Ways To Fund Growth

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Underwriting The Recovery: Europe's Mid-Market Seeks New Ways To Fund Growth

*(**Editor's Note:** This article is part of a series examining the dynamics of debt in Europe and how this will shape the path to recovery.)*

The funding environment for mid-market companies in Europe is at a turning point. These enterprises, which are an engine for economic growth and employment, are increasingly seeking to diversify their funding sources as banks, their traditional lenders, embark on a deleveraging process that may take many years. At the same time, investors searching for yield increasingly want to diversify their investments into this new asset class. However, despite some progress on linking together mid-market companies with willing capital, a cohesive pan-European solution is still elusive. Most of the current funding alternatives to bank lending and capital markets fundraising are still dominated by large companies. Of the one-thousand nonfinancial companies that Standard & Poor's rates in Europe, only a handful of them meet our definition of the mid-market.

Developing an efficient pan-European funding market for these companies will necessitate changes for both issuers and investors, in our view. For debt issuers, expanding outside of a long-term banking relationship can be a significant cultural shift. Companies also regard interest rates demanded by institutional investors in many cases to be too high. For investors, we believe that better access to timely financial information could go some way toward helping to diversify into this new asset class. There are also other challenges, including differing regulatory and accounting environments across Europe.

Overview

- Europe's midsize companies are increasingly seeking alternative sources of funding as banks rein in their lending.
- Alternatives include the non-bank lending market, private placements, and bond platforms on exchanges.
- Yet, these markets in Europe are still in their infancy, lack cohesion, and operate in different regulatory and accounting environments.

A Hard-To-Define Asset Class

The mid-market is a critical engine for economic growth and employment in Europe. Across France, Germany, Italy, and the U.K., the mid-market generates about one-third of private sector revenue and employs a third of each country's workforce, according to research from GE Capital, which is an active mid-market lender.

The middle market asset class is difficult to define in Europe because both government and private organizations in individual countries regard its scope differently. For example, France, Germany, and the U.K. define midsize companies in different ways (see Appendix table 1). For the purpose of this report, we define mid-market companies as those with revenues between €100 million and €1.5 billion and outstanding debt between €50 million and €500 million. We also exclude financial firms, utilities, leveraged buyouts, and project finance.

Disintermediation Will Be A Multiyear Trend In Europe

Disintermediation--where bank lending is replaced by capital market funding--is likely to be incremental in Europe, in our view. Increasing regulatory pressure, particularly the effect of new capital requirements for banks under Basel III regulations, coupled with bank deleveraging in certain countries, means that financial institutions are narrowing their lending focus to major clients, mostly domestic companies with which they have strong relationships. They are also concentrating their deleveraging efforts on capital- and cost-intensive wholesale and international businesses. According to our research, this strategy is influenced by pressure from national governments to prioritize domestic lending and, in some cases, increase purchases of domestic government debt as foreign investors retreat (for more information, see "Global Banking Risks And Credit Trends Dominated By Fragile Economies, Evolving Regulations, And Government Support," published on RatingsDirect on Jan. 17, 2013).

We believe bank balance-sheet deleveraging will be a slow process, with a gradual shift over many years as investors develop an appetite and the ability to increase their share of term lending. According to ECB figures, disintermediation is beginning to occur overall across the eurozone (European Economic and Monetary Union), with net loan issuance to eurozone nonfinancial corporates turning negative in 2012 (see chart 1). But anecdotal research suggests that in certain regions--particularly France and Germany--mid-market companies still have relatively good access to bank credit. European Central Bank (ECB) data shows that deleveraging of bank balance-sheet loans is occurring at a much faster pace in countries such as Spain, Ireland, and Italy, while net lending from banks increased in Germany (0.2%) and decreased by only a very low percentage (-0.4%) in France in 2012 (see chart 2). And Bank of England data shows a much more long-term contraction of bank lending beginning in 2009 through to 2012 (see chart 3).

Just how quickly and smoothly the process of disintermediation will occur in Europe will in our view depend on how the regulatory framework evolves as well as other various key questions: How fast will other sources of debt finance develop? What will happen to bank lending capacity--in particular to what degree can securitization be redeployed as a funding tool in Europe? And will demand for debt grow through investment, dividends, and mergers and acquisitions? There are also cultural considerations, such as how easily a deeply ingrained banking culture will be able to change.

Chart 1

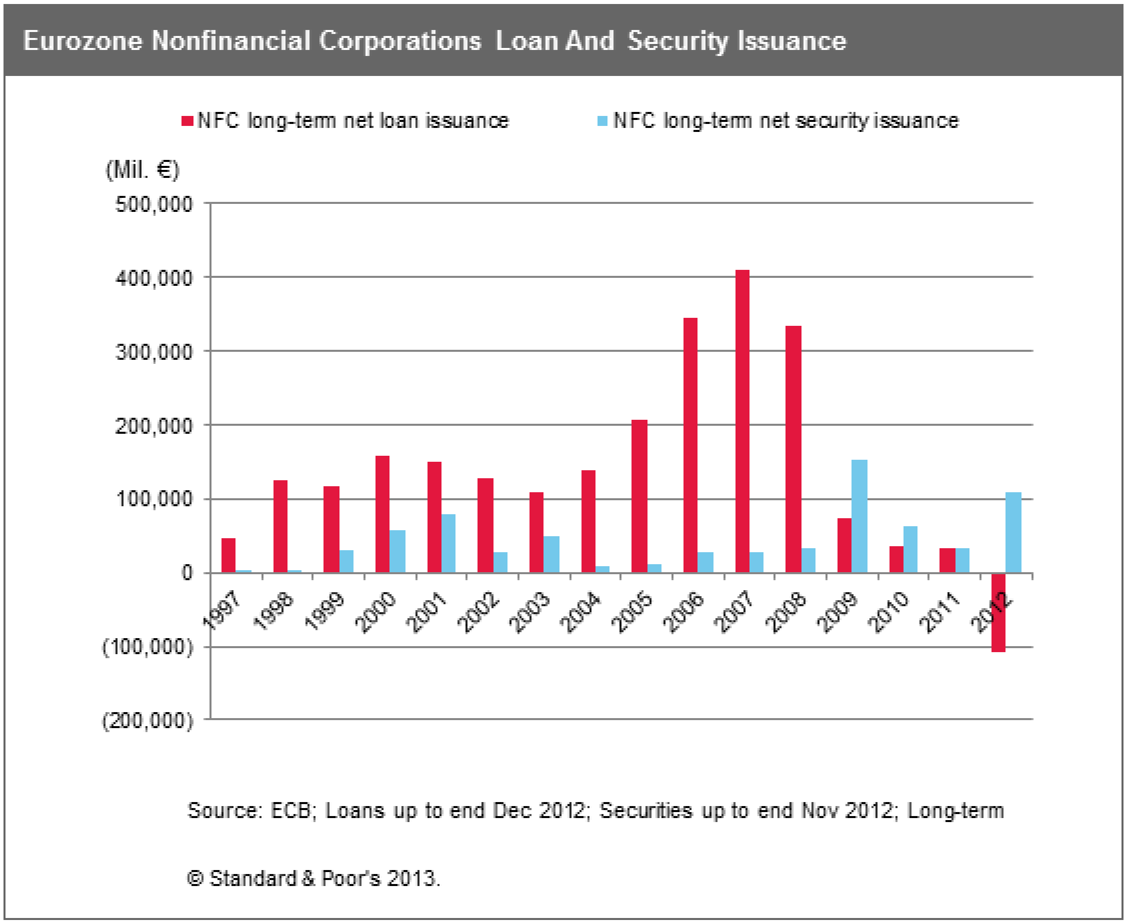
Eurozone Nonfinancial Corporations Loan And Security Issuance
NFC long-term net loan issuance
NFC long-term net security issuance
(Mil. €)
500,000
400,000
300,000
200,000
100,000
0
(100,000)
(200,000)
1997
1998
1999
2000
2001
2002
2003
2004
2005
2006
2007
2008
2009
2010
2011
2012
Source: ECB; Loans up to end Dec 2012; Securities up to end Nov 2012; Long-term
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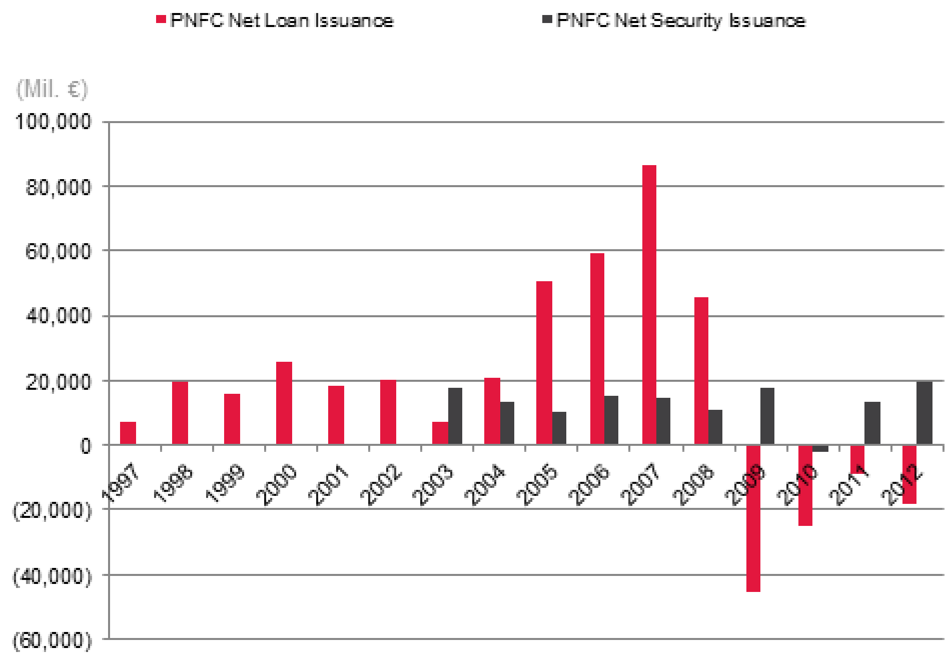
Chart 2

Yearly Nominal Growth Of Bank Loans And Deposits For Nonfinancial Corporates By Country*

*As of December 2012. Source: European Central Bank

Chart 3

U.K. Private Nonfinancial Corporations Loan And Security Issuance



Source: BOE; Loans and bonds up to end Dec 2012; Total net issues of all currency stand-alone and program bond issues by PNFCs.

Alternative Funding Is Nascent

The alternatives to bank funding for mid-market companies in Europe form a cluttered and incohesive landscape. In addition, most direct funding is still mainly aimed at companies larger than what we would consider to be the middle market. These include the developing loan fund market, the U.S. private placement market, the private placement market in Germany (the "Schuldschein" market), the very young private placement markets in the U.K. and France, and to some extent regional bond platforms on exchanges.

The non-bank lending market reawakens

Institutional lending by funds--as opposed to banking institutions--has been slow to develop in Europe, partially because of a lack of new deal flow since the global financial crisis of 2007-2009. Pre-2008 non-bank lending in Europe was dominated by collateralized loan obligation (CLO) funds, mezzanine funds--which specifically lend subordinated debt to companies--and some nonleveraged loan fund managers, such as M&G Investments. However, the financial crisis derailed new entrants to this market, particularly as stagnant buyout activity and the subsequent lack of new deal flow meant that it was difficult for new types of loan investors to raise capital to invest. However, over the past year there has been a resurgence in fund investors' interest to lend to smaller companies in Europe. These include private equity and asset managers, such as Axa Private Equity, Ares Capital, and Amundi.

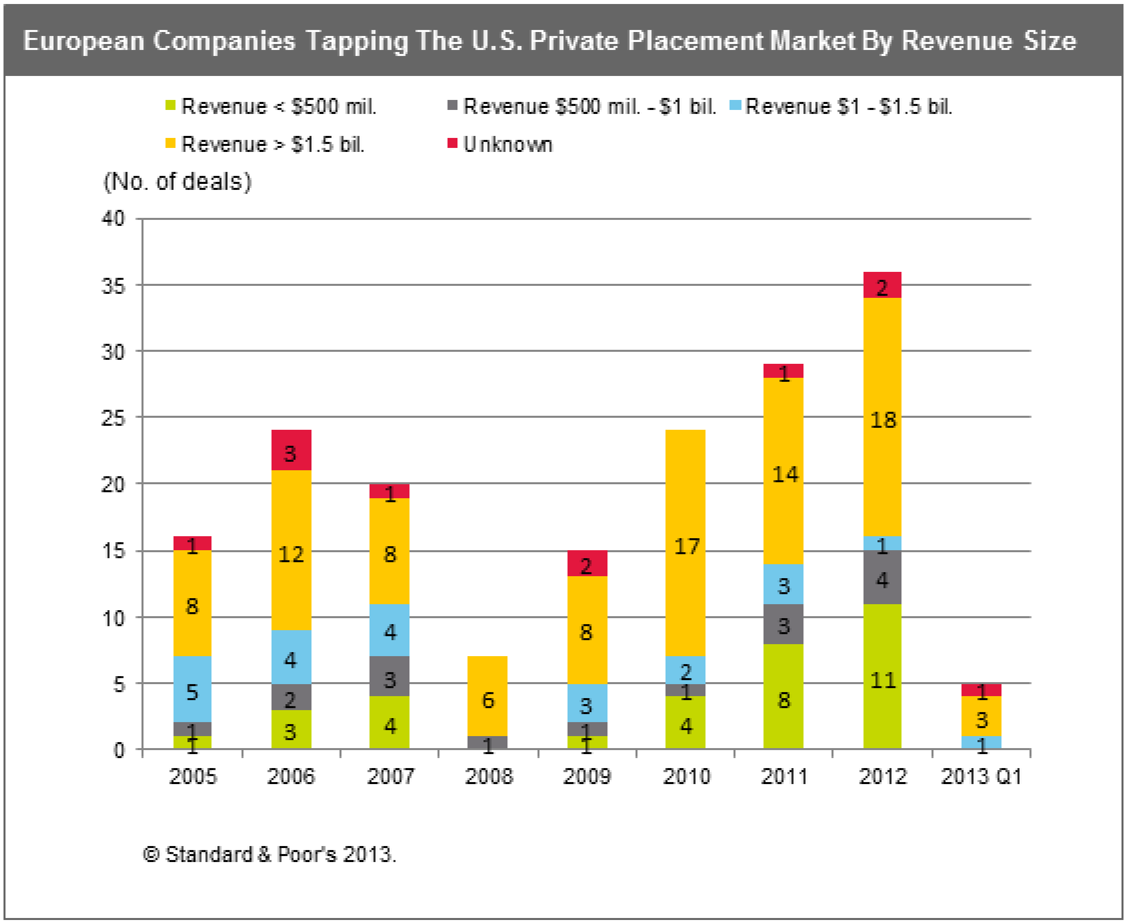
More recently, press reports indicate that there are new CLO transactions under way--structured transactions that have not been seen since before the financial crisis--including one that has already been priced from Pramerica. These funds in Europe typically help fund private equity buyouts and a handful of small-to-midsize enterprises, and have indicated they may increase lending to these types of companies.

Private placement markets offer stability and simplicity

The U.S. private placement market is a unified and efficient market that mid-market and larger companies can use to access funding. In 2011, it was a $50 billion market, and in 2012 it expanded to $55 billion. The number of European companies tapping it is also growing (see chart 4). Although 39% ($43 billion) of issuance by volume came from European companies in the period 2010 to first-quarter 2013, only about 10% of French, German, and U.K. issuers fall within our definition of the mid-market (for more details see Appendix table 2).

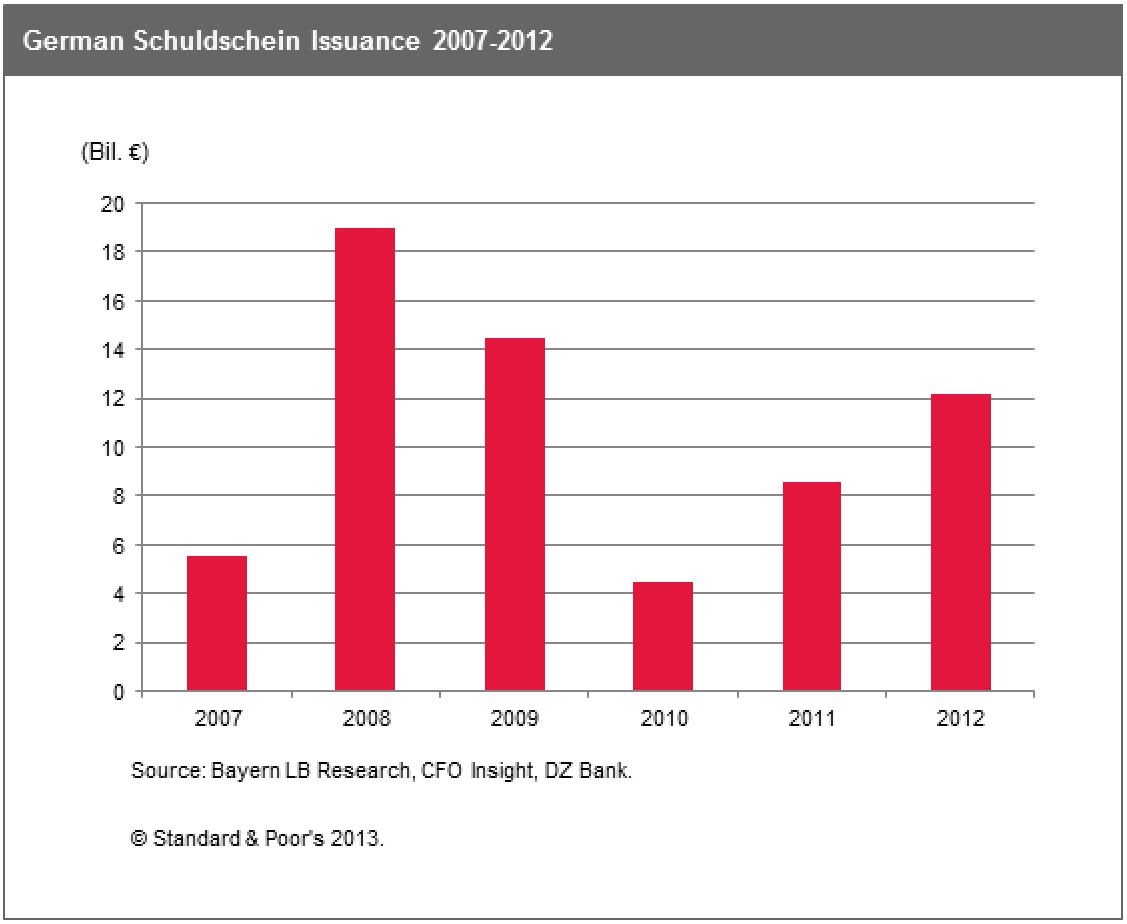
In general, the U.S. private placement market is a private bond market available to both U.S.-based and non-U.S.-based companies. The market is flexible in terms of size: issuers can raise up to $1 billion. Private placement bonds are typically fixed-rated U.S. dollar-denominated tranches with maturities of between three and 15 years. Yet, issuance of floating-rate debt and in multiple currencies is all a possibility. Investors in the U.S. private placement market are typically insurance companies. They are long-term "buy and hold" investors and do their own rigorous due diligence, taking comfort from the fact that U.S. private placements typically have covenants similar to bank credit facilities as opposed to the usually looser bond covenants. From the company's perspective, the market is seen as relatively stable (it was open throughout the period 2008-2009). Furthermore, the process is relatively simple, as no Securities and Exchange Commission (SEC) registration is required, and the lender base does not expect ancillary business, unlike in a banking relationship.

Chart 4



The most developed of the European private placement markets is the German Schuldschein corporate market, which is essentially a bilateral, unlisted, unregistered loan market, governed by German law. Both large multinationals as well as midsize domestic companies have historically tapped this market. Looking at companies for which there is publicly available issuance information, only a handful in 2010-2012 would fall into the mid-market group (for examples, see Appendix table 2). In 2012, the market had a volume of €12.2 billion, and in 2011 there were 65 deals with a volume of €8 billion (see chart 5). Companies typically borrow in sizes of €10 million to €500 million, with floating or fixed coupons and maturities of two to 10 years.

Chart 5



The main investors in the market are German banks, insurance companies, and to a lesser extent investment funds, including some for retail investors. Although Schuldschein loans cannot be listed on stock exchanges, there is a secondary market for the instruments, in which the original arrangers of the facilities act as market makers.

Although most users of the market are German, non-German corporates are increasingly using them to reach German investors. For example, the French textile and apparel mid-market company Etam Developpement S.A. completed a €40 million issue in 2011, and health care company Eurofins Scientific S.A. raised €170 million in 2011 (see Appendix table 2). However, one type of Schuldschein investor, the German savings banks ("Sparkassen") is not allowed to invest in foreign companies. Furthermore, foreign issuers must be willing to comply with German law.

In the U.K., the Association of Corporate Treasurers (ACT) is leading a working group exploring the development of a private placement market. The group released an interim report in December that says there is clear demand for this type of market, but that there are changes that need to be made to facilitate this in the U.K. These include the need for clear regulatory treatment for insurance company investors, standard documentation, readily available information about market activity, a track record of performance and defaults built up by individual investors, and investors that are prepared to set up internal resources to participate in the market. According to ACT, these obstacles can be overcome, but it will take time. It says the regulatory treatment for insurance company investors could be the most difficult obstacle, while standard documentation and information about market activity could be the barriers most easily resolved.

Currently, U.K. companies use the U.S. private placement market: 44% of the FTSE 350 and 40% of the FTSE 250 have issues outstanding, according to the Breedon Report, commissioned by the U.K.'s Department for Business Innovation and Skills (BIS). However, these tend not to be mid-market companies, according to our definition. For example, in 2012, energy utility SSE, Anglian Water, and Thames Water tapped the U.S. private placement market. Yet, these companies' turnover place them well beyond our mid-market definition..

Until recently, most European private placements completed in France were also too big to fall within our mid-market definition. However, at the end of 2012 and in the first quarter of this year, there were six issues that fell within the mid-market (also see Appendix table 2). For comparison, 22 companies in total issued private placements in France in 2012. In addition, Société Générale and AXA Group last year established a joint venture that works like a private placement market for mid-market companies. Société Générale has credit expertise, but not an unlimited balance sheet. AXA, meanwhile, invests strongly in sovereign issues and is looking to diversify into more corporate lending. The partnership signed two transactions in 2012. These included a €150 million fundraising for Néopost, the postal service company, in September, which would be close in size to a mid-market financing.

Bond platforms on exchanges are still in development

Germany has also taken the lead in developing funding avenues for companies in Europe via exchanges. More than 55 companies have debt of approximately €3 billion that is actively traded across the three main stock exchanges in Germany: BondM on the Stuttgart Stock Exchange, Mittelstandsmarkt on the Düsseldorf Stock Exchange, and Entry Standard on the Frankfurt Stock Exchange.

These platforms allow retail investors and family offices the opportunity to invest, as well as some traditional institutional investors. In Germany the companies that tap these markets would be considered midsize. Indeed, 51 of the companies currently listed have revenues of below €500 million.

However, the markets are less developed in France and the U.K. In the U.K., the London Stock Exchange has set up ORB (the Orderbook for Retail Bonds) to allow private investors to buy into individual corporate bonds in small denominations. It mostly started with large companies such as Royal Bank of Scotland, Tesco Bank, and National Grid issuing. Yet, some mid-market companies are beginning to tap the market, such as International Personal Finance PLC. In France, NYSE-Euronext launched its bond market in 2012, which is open to retail investors. It has executed three transactions so far, from agricultural commodities company AggroGeneration S.A., family-owned property developer Capelli, and camping resort firm Homair Vacances.

In Italy, Borsa Italiana manages the bond exchange platform MOT. Borsa Italiana is owned by the London Exchange group, and is a regulated market, open to retail investors. Issuance on the market, however, is heavily dominated by bank funding. However, last year, the Monti government changed the law in a move that's expected to open the bond market more broadly, including to midsize corporates, so we expect the market there may develop in the near term.

In Spain, according to press reports, it is believed that the new Mercado Alternativo de Renta Fija--or Fixed Income Alternative Market (MARF)--will be ready before this summer. Companies expected to use the market to issue debt would have on average revenues of about €100 million. There is also the Sistema Electrónico de Negociación de Deuda (SEND) in Spain, which is an electronic fixed-income trading platform, aimed at retail investors.

Obstacles To Overcome For Both Investors And Issuers

Although the European market has made some progress in linking together mid-market companies with willing capital, a pan-European, cohesive solution is still elusive. We believe that issuers, for their part, can find expansion beyond a long-term banking relationship to be a significant cultural shift. This often coincides with a reluctance to disclose financials broadly.

In addition to the barrier of funding-rate expectations, other obstacles to the development of an efficient market include investors' need for better access to company information, particularly if an investor is small and hasn't had the means to build internal research and risk management capacities. Differing regulatory and accounting environments across Europe also make establishing a cohesive funding market an uphill struggle. Standard & Poor's, through this series of funding articles, aims to help shed some light on the detail, as well as the larger themes and trends as this nascent market continues to develop in Europe.

Related Criteria And Research

All articles listed below are available on RatingsDirect on the Global Credit Portal, unless otherwise stated.

- Underwriting The Recovery: Internal Financing And Financial Discipline Keep European Companies On An Even Keel, April 4, 2013
- Underwriting The Recovery: Financing The Path Back To Growth In Europe, April 10, 2013

Appendix

Table 1

Examples Of Varying Midsize Company Classifications By Country And Institution

Source of data	Country	Definition	No. of companies
French article 51 of the Loi de modernisation de l'économie (2008)	France	Entreprise de taille intermédiare (ETI): Employees 250-4,999 and either revenue < €1.5 bil. or balance sheet of < €2 bil.	64,600
GE Capital	France	Revenue €10 mil.-€500 mil.	36,000
Department of Business Innovation & Skills (BIS)	U.K.	Employees 50-249	30,475
Breedon Report	U.K.	Revenue £25 mil.-£500 mil.	30,475
GE Capital	U.K.	Revenue €20 mil.-€1 bil.	21,500
Ifm Bonn - Institut fur Mittelstandsforschung	Germany	Employees 10-500 and turnover of €1 mil.-€50 mil.	426,695
Hoppenstedt	Germany	Turnover between €24 mil. (~$30 mil.) and €397 (~$500 mil.)	4,200
GE Capital	Germany	Revenue €20 mil.-€1 bil.	21,000
EU Commission (Mittelstand)	Germany	Employees 50-249 and turnover of €10 mil. - €50 mil. and total balance sheet €2 mil.-€10 mil.	64,173

Table 1

Examples Of Varying Midsize Company Classifications By Country And Institution (cont.)

GE Capital	Italy	Revenue €5 mil.-€250 mil.	62,000

Table 2

Examples Of Mid-Market European Companies Issuing Private Placements*

Company	Market	Year of issuance	Industry	Country	Deal amount (mil. €)	Capital IQ Revenue (mil. €)¶	Capital IQ total balance sheet debt (mil. €)¶
Low & Bonar	U.S. PP	2010	Manufacturing	U.K.	60	469	135
Filtrona plc	U.S. PP	2010	Manufacturing	U.K.	160	818	253
RPC Group plc	U.S. PP	2011	Containers & Packaging	U.K.	300	1355	244
Fenner plc	U.S. PP	2011	Manufacturing	U.K.	200	1047	260
Mersen	U.S. PP	2011	Technical Services	France	100	811	270
Premier Farnell plc	U.S. PP	2011	Wholesale	U.K.	235	1,094	418
1887 Co Ltd	U.S. PP	2011	Beverages	U.K.	300	475	455
Saft Groupe SA	U.S. PP	2012	Manufacturing	France	150	598	219
Groupe Faiveley Transport	U.S. PP	2012	Transporation	France	75	901	448
Sage Group	U.S. PP	2013	Technology	U.K.	400	1,340	209
Etam Developpement SA	Schuldschein	2011	Consumer Discretionary	France	40	1,184	273
Eurofins Scientific SA	Schuldschein	2011	Healthcare	France	170	1,044	455
Wacker Neuson SE	Schuldschein	2011	Materials	Germany	289	1,092	233
EnviTec Biogas AG	Schuldschein	2012	Energy	Germany	30	247	77
Touax SCA	EU PP	2012	Industrials	France	10	358	492
Séché Environnement	EU PP	2012	Industrials	France	25	434	217
Ubisoft	EU PP	2012	Information Technology	France	20	1,061	93
Tessi SA	EU PP	2013	Information Technology	France	20	262	117
Group Laurent-Perrier	EU PP	2013	Consumer Staples	France	15	219	292
Akka Technologies	EU PP	2013	Industrials	France	100	474	272

*As per Standard & Poor's definition: from the U.K., France, and Germany, excluding financials and utilities, 2010-2012. ¶Latest available financial year-end. Source: S&P Capital IQ, Standard & Poor's

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