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Why Germany's Mid-Market May Slowly Seek New Ways To Fund Growth

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Table Of Contents

Economic Prospects Are Promising

Mid-Market Credit Quality Is Relatively Strong

Financing Alternatives Are In Development

Greater Transparency May Help Nascent Alternative Funding Sources Gain Traction Over Time

Appendix

Related Criteria And Research

Why Germany's Mid-Market May Slowly Seek New Ways To Fund Growth

*(**Editor's Note:** This report is one of a series providing information on the creditworthiness of European midsize companies. Click here for recent reports on mid-markets in the U.K. and France.)*

As Germany's economy returns to growth, its Mittelstand companies, which contribute about one-third of the country's GDP, will play a vital role. We believe these companies may gradually tap alternative sources of funding to finance investments necessary for growth. Yet, both the investment process and the development of diversified funding markets will likely be slow for German mid-market companies--which Standard & Poor's Ratings Services defines as firms with revenues of up to €1.5 billion. Above all, the German banking system remains a very liquid and competitive lender so that the pace of disintermediation will likely be slower in Germany than in many other European markets. Furthermore, we expect growth in the Mittelstand's European export markets to be more benign than in Germany over the next two years, while the magnitude of growth in markets beyond the EU also may not meet our previous expectations. This will likely hold back the pace of the Mittelstand's growth-oriented investments. Added to this, since the 2008-2009 financial crisis, many German mid-market companies have defensively increased their equity and free cash on the balance sheet, and significantly reduced their total leverage. When investments pick up, we expect they will tend to use this financial flexibility first to finance growth projects before borrowing.

Given the strength of Germany's banks, lending to the mid-market has not receded significantly--at least not for larger Mittelstand firms with higher credit quality. Currently favorable interest rates are also providing these companies access to public and private funding markets at competitive rates, including the German Schuldschein and U.S. private placement markets. We nevertheless believe smaller mid-market companies will encounter greater hurdles to accessing bank funding over time as the disintermediation process takes effect, making access to alternative lending more important. To support the development of new lending markets, investors will seek greater transparency about the credit risk of mid-market debt issuers. For example, while domestic investors may have a good understanding of a local company's credit risk, foreign investors or those without their own credit analysis capacities might have difficulty making investment decisions without further information. In general, we believe that increased transparency leads to better capital allocation and more accurate and efficient pricing, which in turn strengthens the trust of market participants to re-invest.

Overview

- We expect that Germany's mid-market will contribute significantly toward GDP growth in Germany and Europe in 2014 and 2015.
- The mid-market currently has ample access to funds for growth, having reduced leverage and increased cash resources and equity ratios since the financial crisis. The German banking sector, its main lending source, also remains liquid and competitive for the time being.
- Larger German mid-market companies with good credit quality are currently taking advantage of favorable rates in the public bond or private placement (PP) markets, such as the German Schuldschein or USPP markets.
- However, smaller mid-market companies, or those with lower credit quality, will in our view encounter greater hurdles to accessing bank funding as the process of banking disintermediation continues.
- Private placements, direct lending, and mid-market bonds might therefore become more important funding sources for a broader range of mid-market companies over time.
- We believe that increased transparency of mid-market issuers' credit risks will be a key factor in supporting the development of alternative lending to the sector.

Economic Prospects Are Promising

The positive trend in the German economy should continue to favor its mid-market corporate sector, which employs more than nine million people, representing approximately 30% of the workforce. Our economic forecast for the eurozone suggests Germany will lead a return to growth in the region this year, with GDP expected to expand by 1.8%, compared with 1.1% growth for the eurozone as a whole (see table 1). We expect that countries whose GDP was still negative in 2013, such as Italy, the Netherlands, and Spain, will also return to growth this year.

Table 1

Europe GDP Growth And Unemployment (Baseline Forecasts)

	--Real GDP--			--Unemployment--		
(%)	2013	2014f	2015f	2013	2014f	2015f
France	0.2	0.7	1.4	10.8	11.0	10.5
Germany	0.4	1.8	2.0	5.3	5.1	5.1
Italy	-1.9	0.5	1.1	12.2	12.8	12.5
Netherlands	-0.8	1.0	1.3	6.7	7.5	7.3
Spain	-1.2	1.3	1.8	26.4	25.2	24.0
Eurozone	-0.4	1.1	1.6	12.1	12.0	11.7
Switzerland	2.0	2.2	2.5	3.2	3.1	2.9
U.K.	1.5	2.9	2.5	7.6	6.7	6.4

Source: S&P Global Economics.

The German economy has been continuously improving since 2012. Indicators for 2014 suggest some overall stabilization this year. In particular, the German Bundesbank's May 2014 monthly report points to the positive impact of a rebound in domestic growth alongside somewhat weaker figures for foreign demand. Orders received by industry

1349960 | 302045798

from domestic sources were up 2% in first-quarter 2014 on the previous quarter. International orders, by comparison, fell somewhat short over the same timeframe. We expect that this trend will continue in 2015, with strong domestic demand the main driver of German GDP growth (see chart 1). Consumption growth in Germany, the EU's largest economy, is also outpacing that of France (see chart 2).

Chart 1

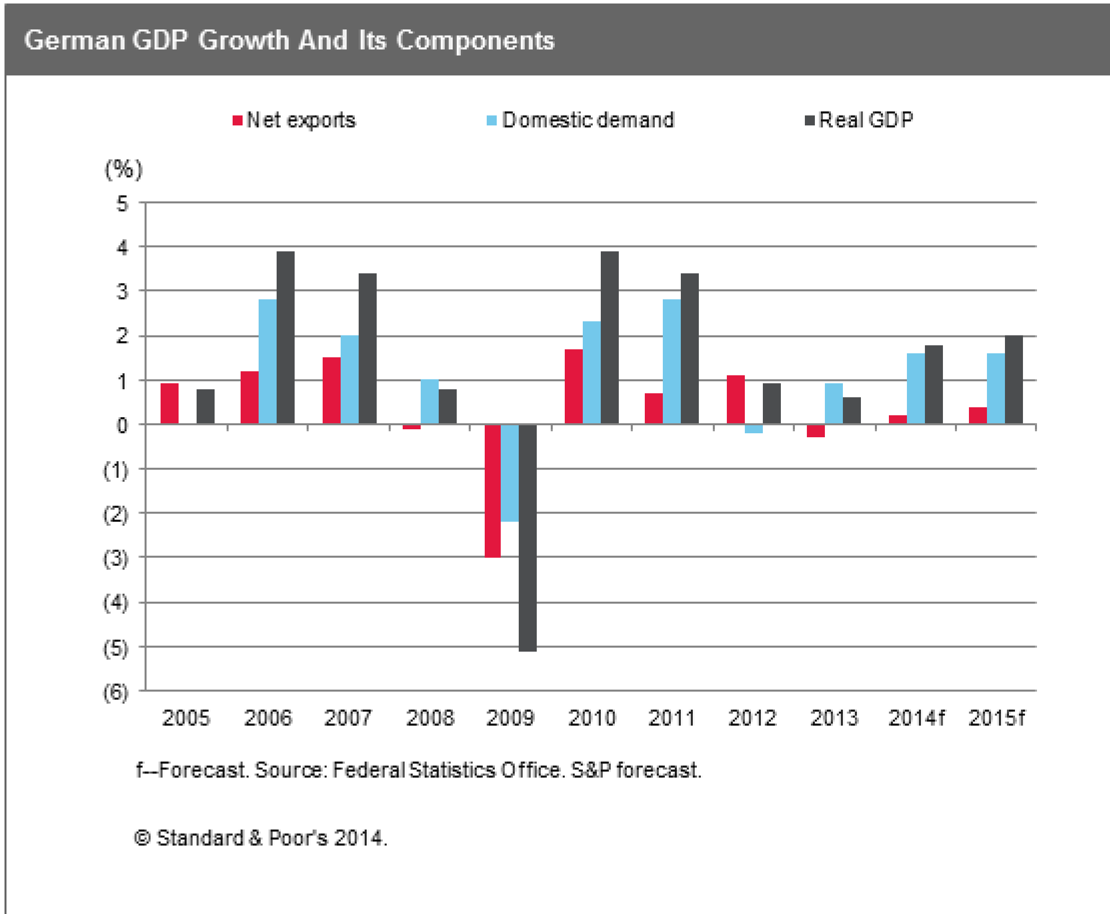
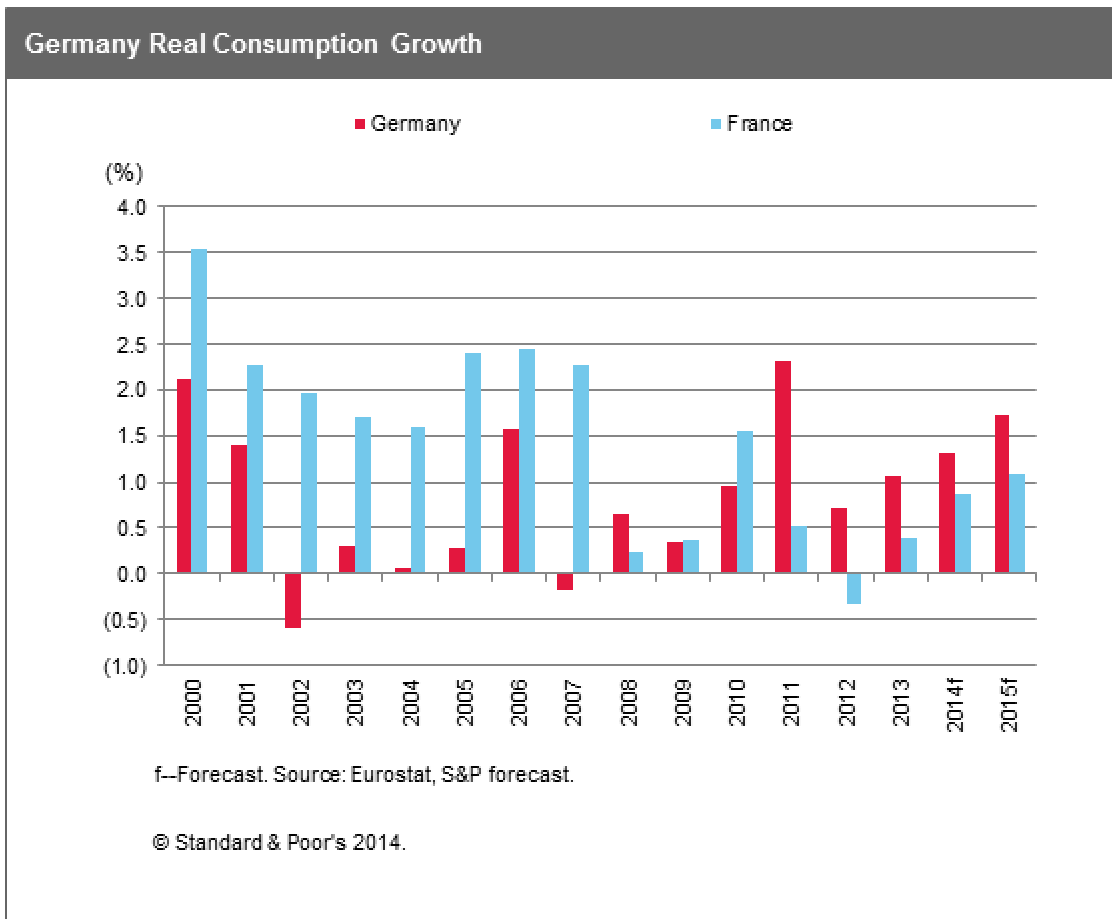
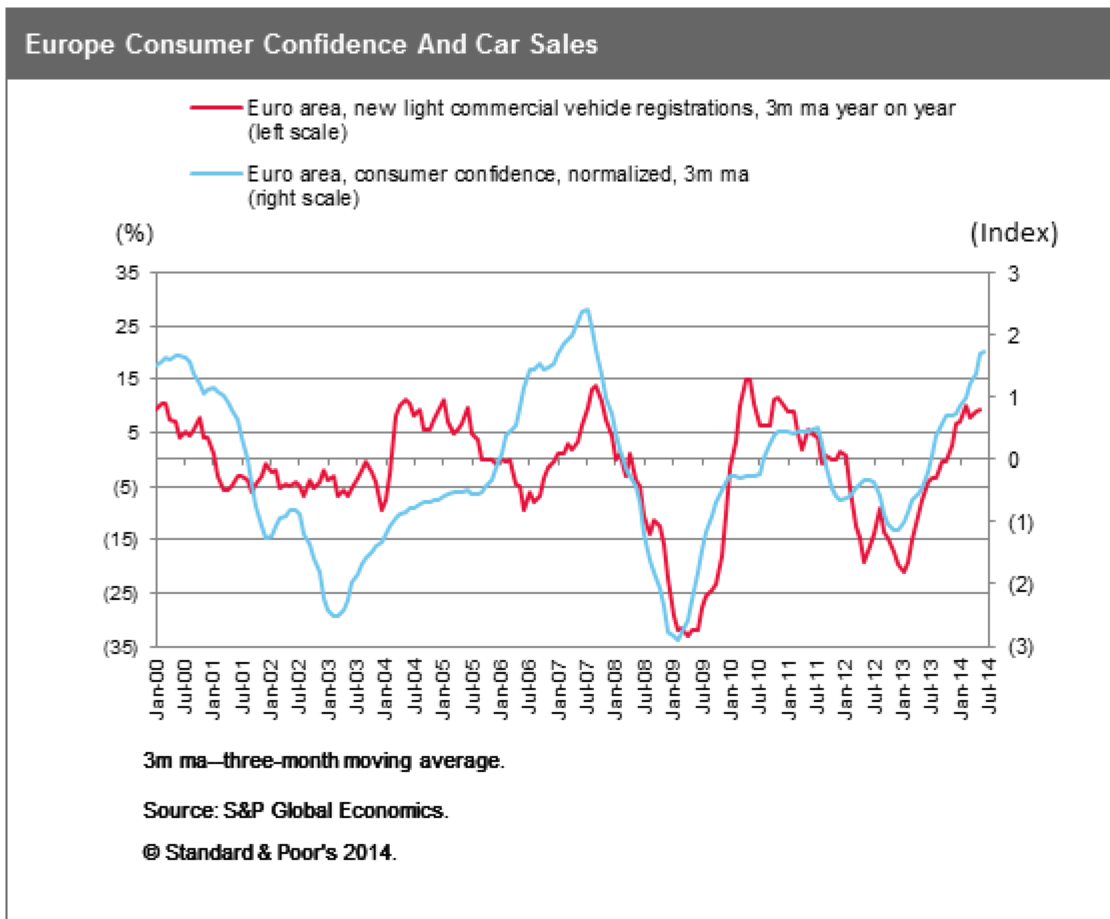


Chart 2



The KfW-ifo mid-market index (based on monthly solicited feedback from 7,000 German companies) also reflects this improving economic sentiment: it peaked in January 2014 at 20.7 points, a significant improvement from its low point in October 2012. The index trended down slightly in May 2014 to 19.6 points, a reaction to more cautious expectations on economic development in the periphery of Europe, increased concerns on potentially destabilizing developments in Ukraine with capital markets seemingly underestimating the political risk, and some elevated risk for a strong European currency in combination with deflationary price risk. Nevertheless, consumer confidence in Europe as a whole is still at six-year high on a normalized basis. This is translating into an increase in large-ticket discretionary consumer expenditure, such as the return to growth in new passenger and commercial-vehicle registrations--which overproportionally benefits the German automotive industry and its mid-market supplier base (see chart 3).

Chart 3



3m ma—three-month moving average.

Source: S&P Global Economics.

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Germany looks set to be a key driver of Europe's return to economic growth, not just in terms of domestic demand but also net exports. Many mid-market companies have developed offshoring capabilities in more cost-efficient countries to produce parts and components which are then assembled in Germany and re-exported at beneficiary terms of trade.

In parallel with this positive economic development, German mid-market companies are also experiencing stable access to debt capital. The cost of bank financing with a tenor of five or more years has been steadily declining from above 4.5% in 2011 to below 2.8% at the end of Q1 2014. Meanwhile, we have seen virtually no meaningful changes in banks' underwriting standards and continuing spread compression between average and more risky credits, according to the German Bundesbank's monthly report for May 2014. This is in contrast to conditions observable in European countries on the southern periphery. We estimate the interest spread differential for mid-market loans between Germany and Spain or Italy is currently more than 2%.

Mid-Market Credit Quality Is Relatively Strong

Standard & Poor's has analysed the impact of this overall positive economic trend on German mid-market companies' profitability and financial structures, as well as on their flexibility and demand for external financing. For this analysis,

we used data available from S&P Capital IQ, which tracks more than 56,000 German companies to date. The largest portion consists of 54,521 small corporations, which Standard & Poor's defines as those with annual revenues of below €100 million. The mid-market segment (companies with annual revenues of between €100 million and €1.5 billion) contains 1,780 companies, while there are only 166 large companies (annual revenues of above €1.5 billion). For the purpose of our analysis, we focused on those companies for which certain key financial data from 2007-2012 was available, in particular debt, equity, revenues, operating income, cash and investments, total assets, interest expenses, EBITDA, and shareholder equity (financial data for 2013 will only become available later this year). Our reduced sample consists of 2,455 companies--112 large, 630 mid-market, and 1,713 small firms, of which 14% are listed and 1.4% are rated.

Industry composition: Consumer discretionary and industrial sectors dominate

Our study shows that in general mid-market companies mirror the larger market, with strong exposure to consumer discretionary and the broad industrial sector (see chart 4). A breakdown of the broad industrial sector into subsectors (see chart 5), shows that the highest concentration of mid-market companies is in diversified support services and industrial machinery. This is in contrast to the U.K. mid-market, which has a much higher percentage in the business services sector, including office services and supplies, research and consulting, human resources, and other diversified support services. In France, the concentration of mid-market firms is in construction and engineering (25%) and industrial machinery (10%) (for further details on the U.K. and French mid-market see related Standard & Poor's studies in "Related Research" below).

Chart 4

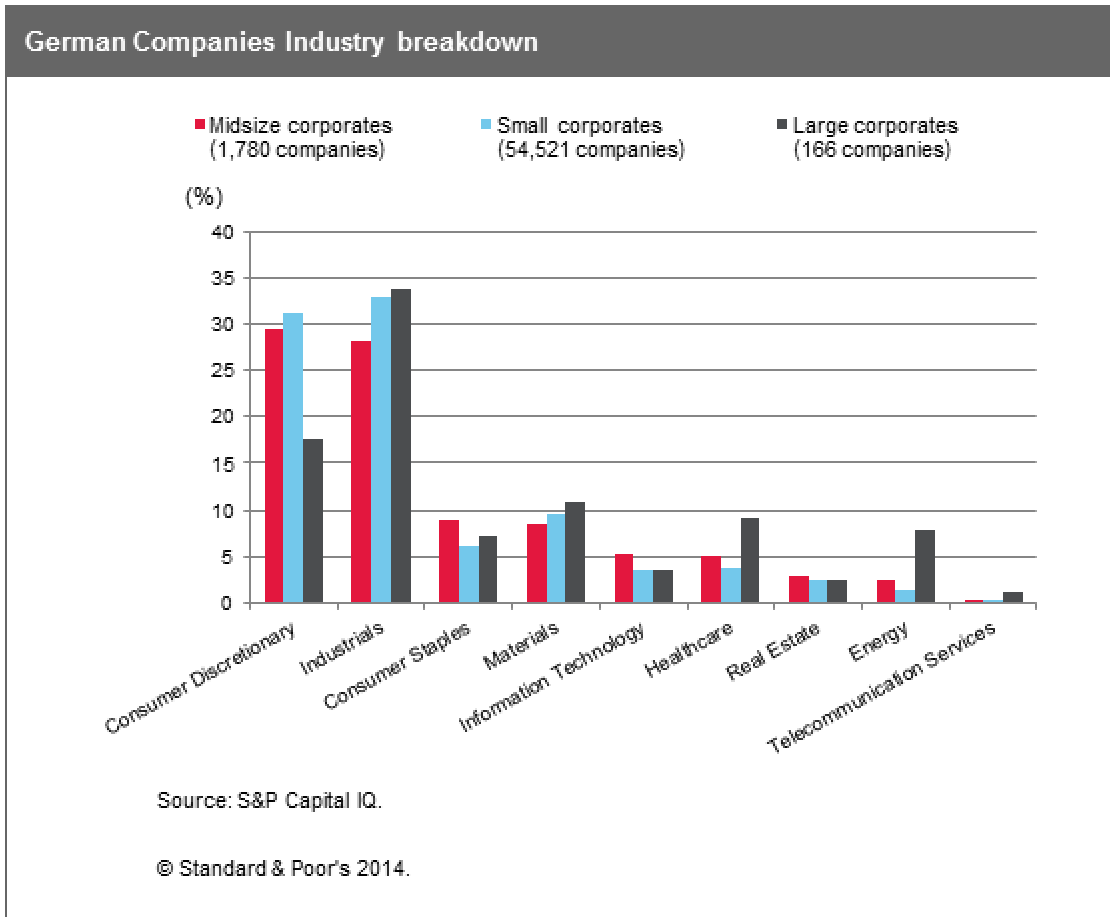
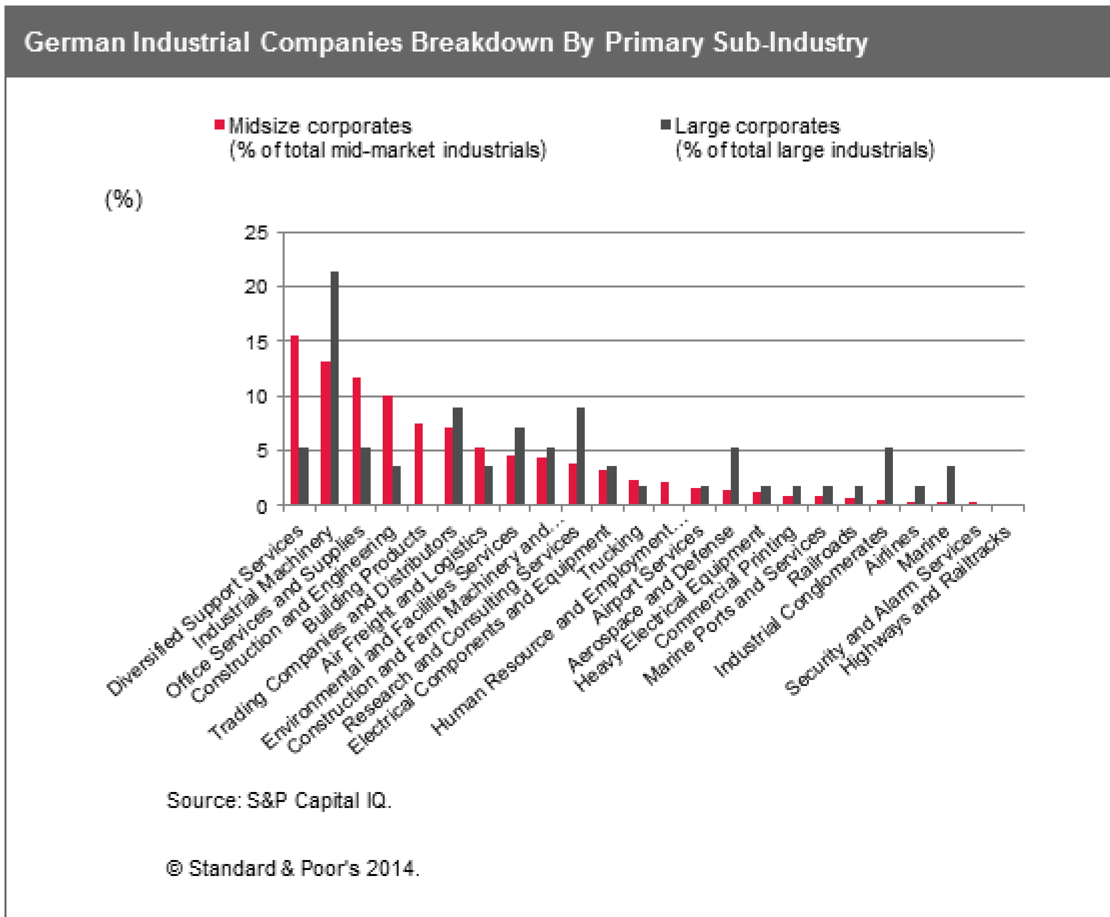
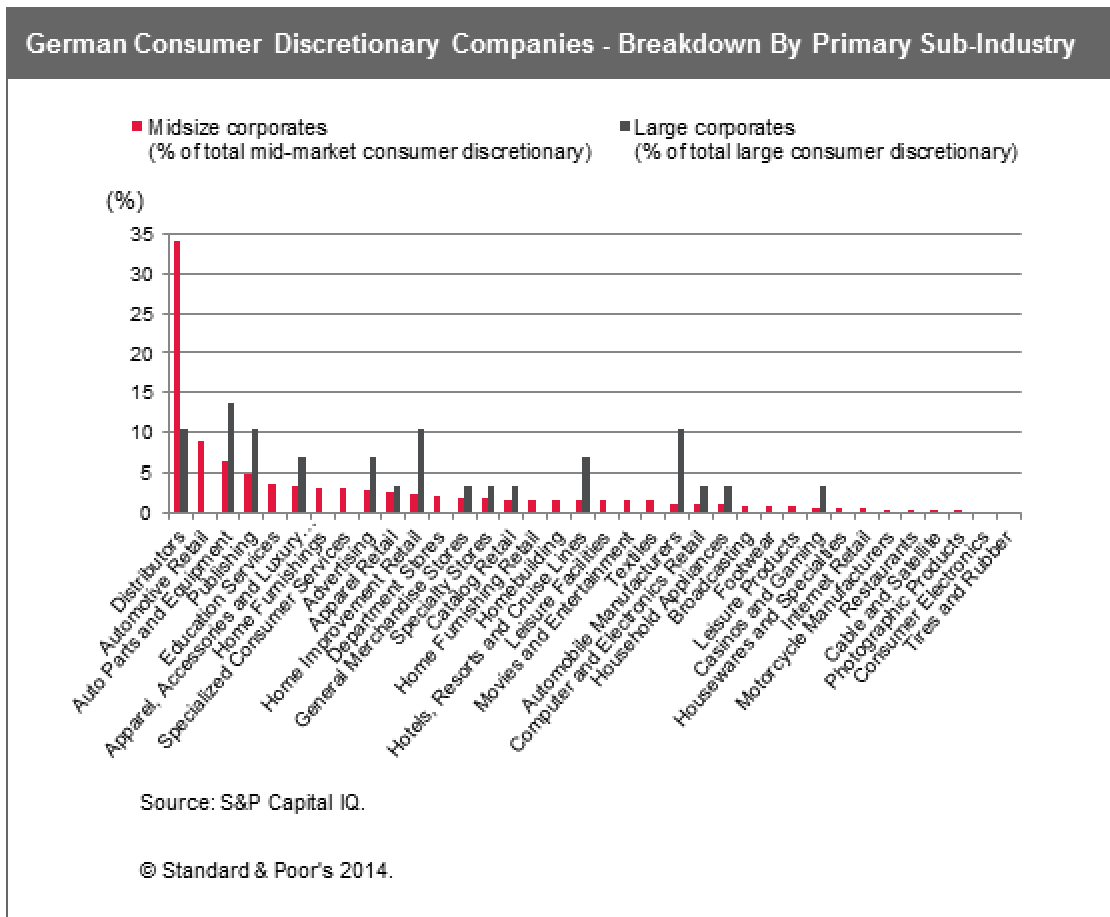


Chart 5



In Germany's consumer discretionary sector, by far the largest proportion of mid-market companies are in the distributors sub-segment (see chart 6).

Chart 6



The industry segmentation shows that Germany benefits from a strong presence of hybrid production chains in which mid-market companies focused on industrial production and service to business clients and consumers work closely together to create customer-specific value. This is particularly notable in the automotive sector. Value-added distribution services are a key component in the overall value chain.

Profitability: Rising costs are denting margins

EBIT margins since 2007 indicate that German mid-market companies' profitability is lower but less volatile than larger peers (see chart 7). This trend is similar to, although more pronounced than for mid-market companies in the U.K. and France.

Margins among Germany's mid-market have been on a declining trend since 2010, owing to rising costs, for example for energy and qualified personnel. While these are fundamental issues that need to be addressed, reinvestment in their highly specific industrial-service network capabilities is nevertheless a key factor in maintaining a competitive advantage.

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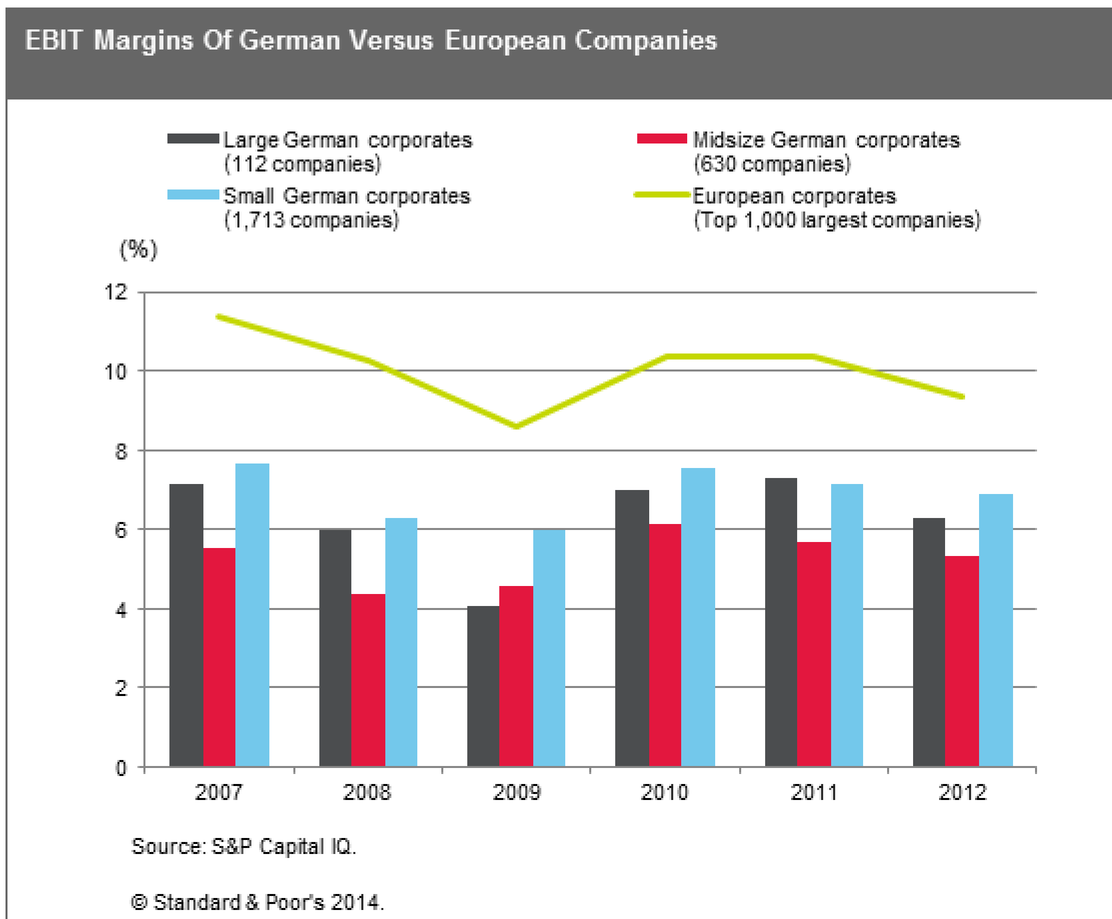
Chart 7



Equity ratios and cash levels: Companies are cautious on investments

The financial crisis encouraged many companies to pursue a more conservative financial policy, as the increase in German companies' equity to total assets since 2007 indicates (see chart 8). Large companies have increased their equity ratios from 26.6% in 2007 to 31.2% at the end of 2012, equivalent to a rise of 4.6%. Over the same timeframe, mid-market companies increased their equity ratios by 5.8%, from 33.4% to 39.2%. Still, while large companies' equity ratios appear to have stabilized at around 31%, mid-market companies' ratios are still rising. Noteworthy is that large German companies have been able to reduce their pre-crisis equity funding gap from over 10% to approximately 5% compared with U.K. companies over time, which makes them internationally now more competitive in terms of balance-sheet structure.

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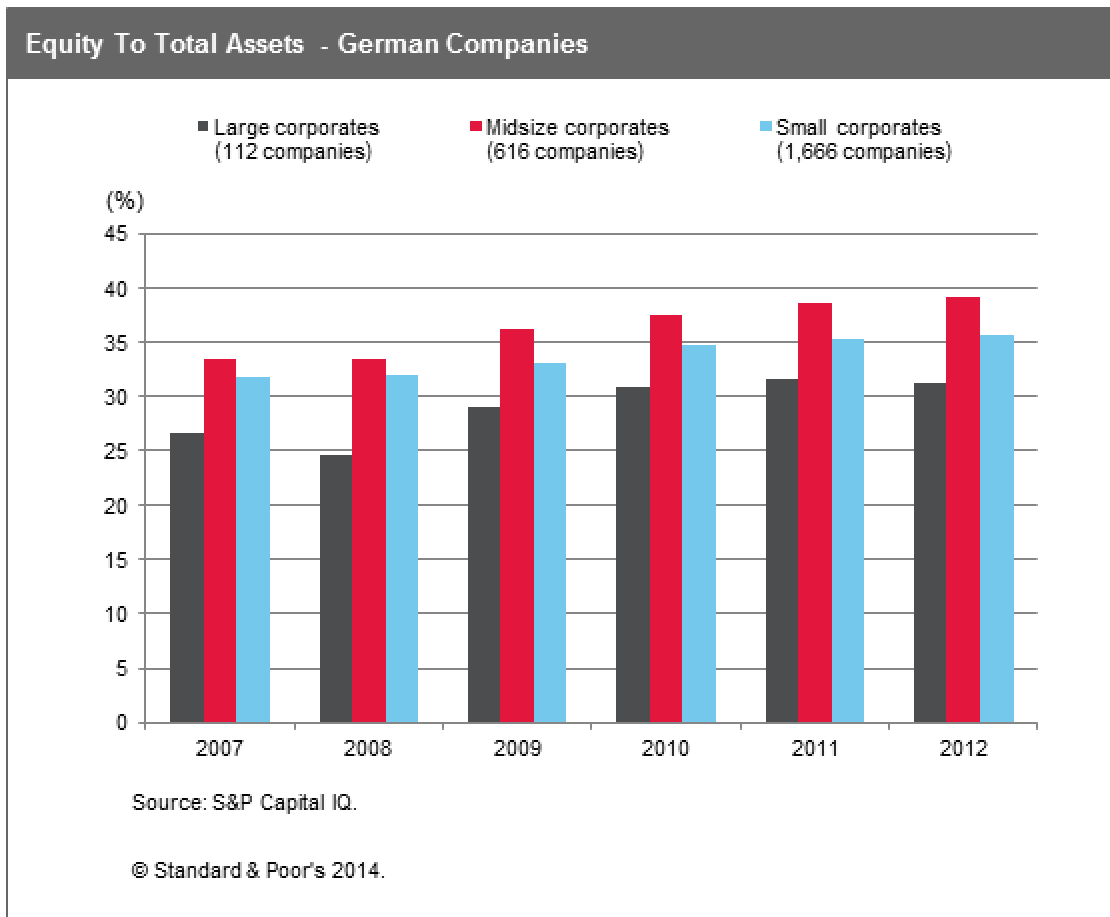
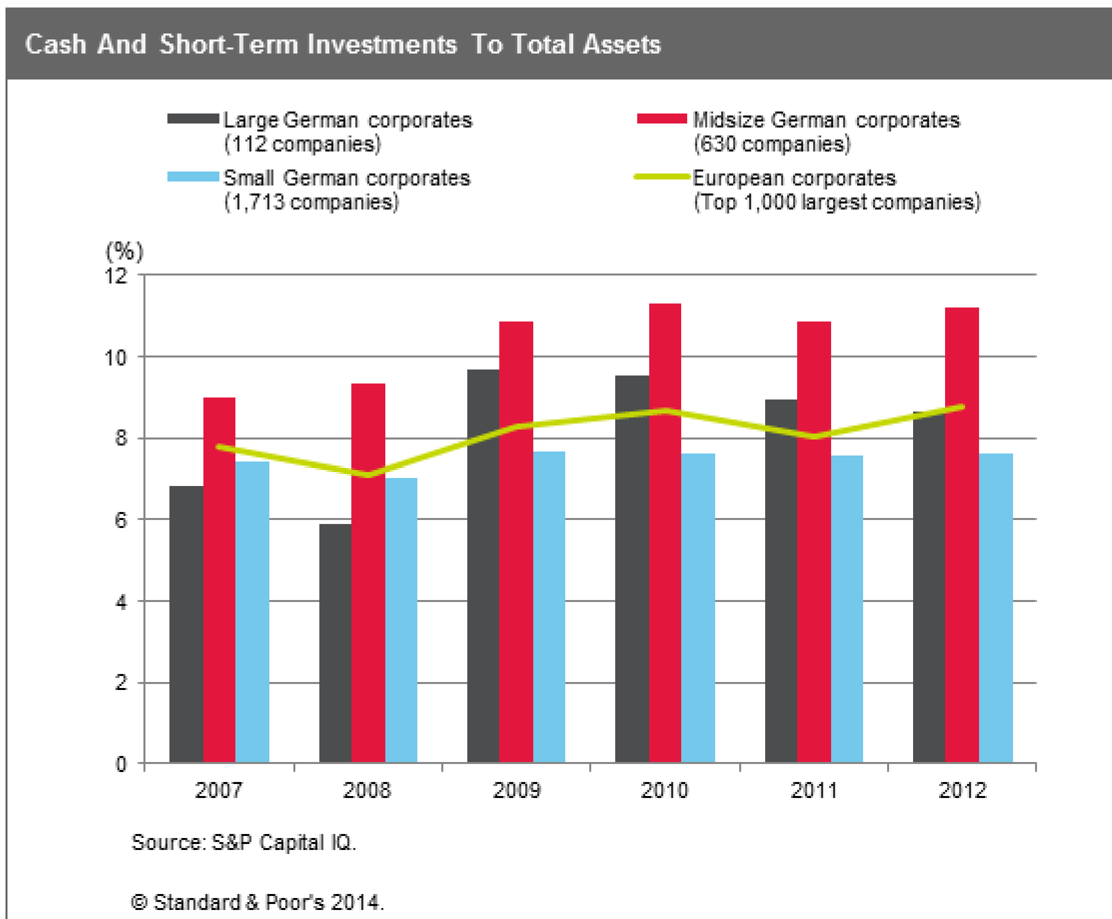
Chart 8



In line with the increase in equity ratios, companies' cash holdings have also risen (see chart 9). Large companies increased their cash and short-term investments to total assets from 6.8% in 2007 to 8.7% in 2012, equivalent to a 1.8% increase. Levels peaked at the height of the financial crisis in 2009 at 9.7%, but have since trended downward toward the average for the largest European companies over time. Mid-market companies, meanwhile, increased their cash ratios by 2.2% from 9% in 2007 to 11.2% in 2012, so maintaining the high cash levels.

This indicates that mid-market companies in Germany have become much more conservative than their larger counterparties regarding their optimal equity level and cash resources. One consequence of this is that they are more independent from any external financing sources. It also gives them greater flexibility to pursue investments with their own funding at their discretion. Yet, such a pick-up in investments remains to be seen because companies appear reluctant to invest in growth capital expenditures for the time being (see Standard & Poor's "Global Corporate Capital Expenditure Survey," published July 21, 2014).

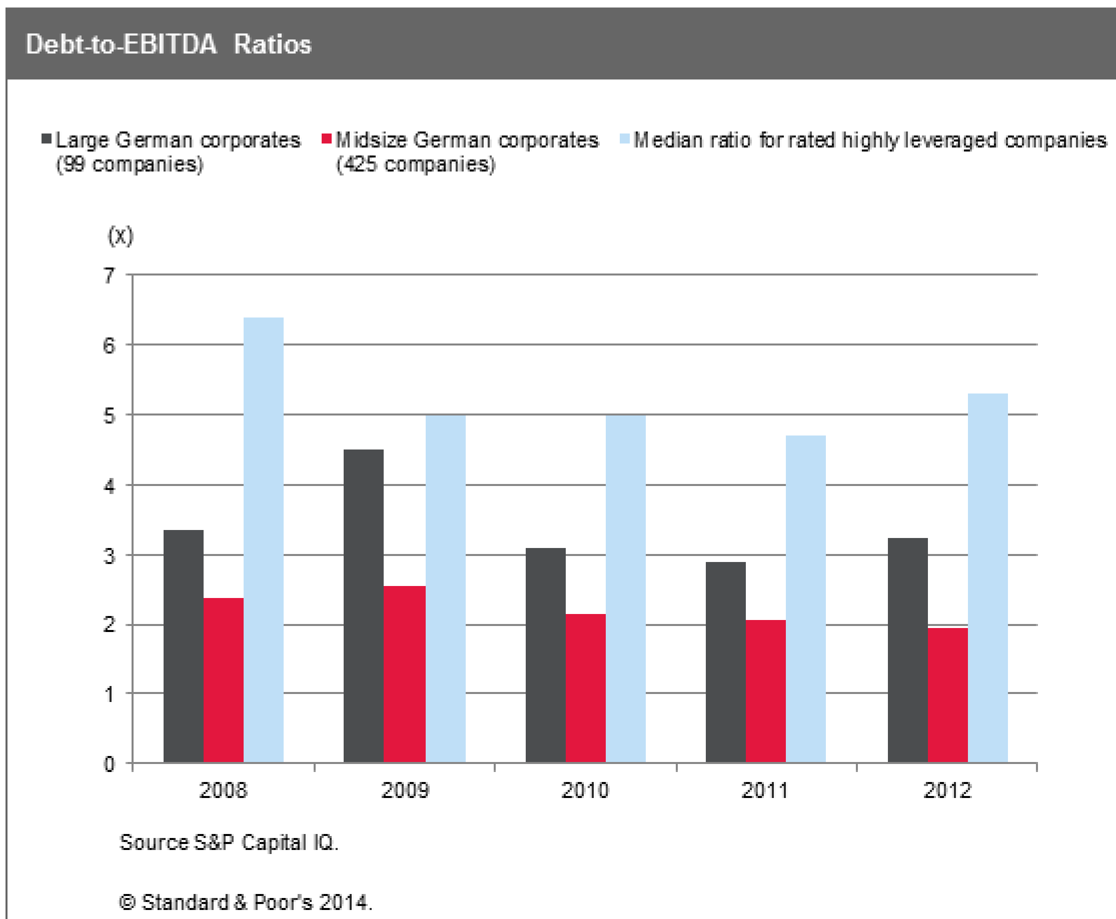
Chart 9



Leverage and interest coverage: Conservative

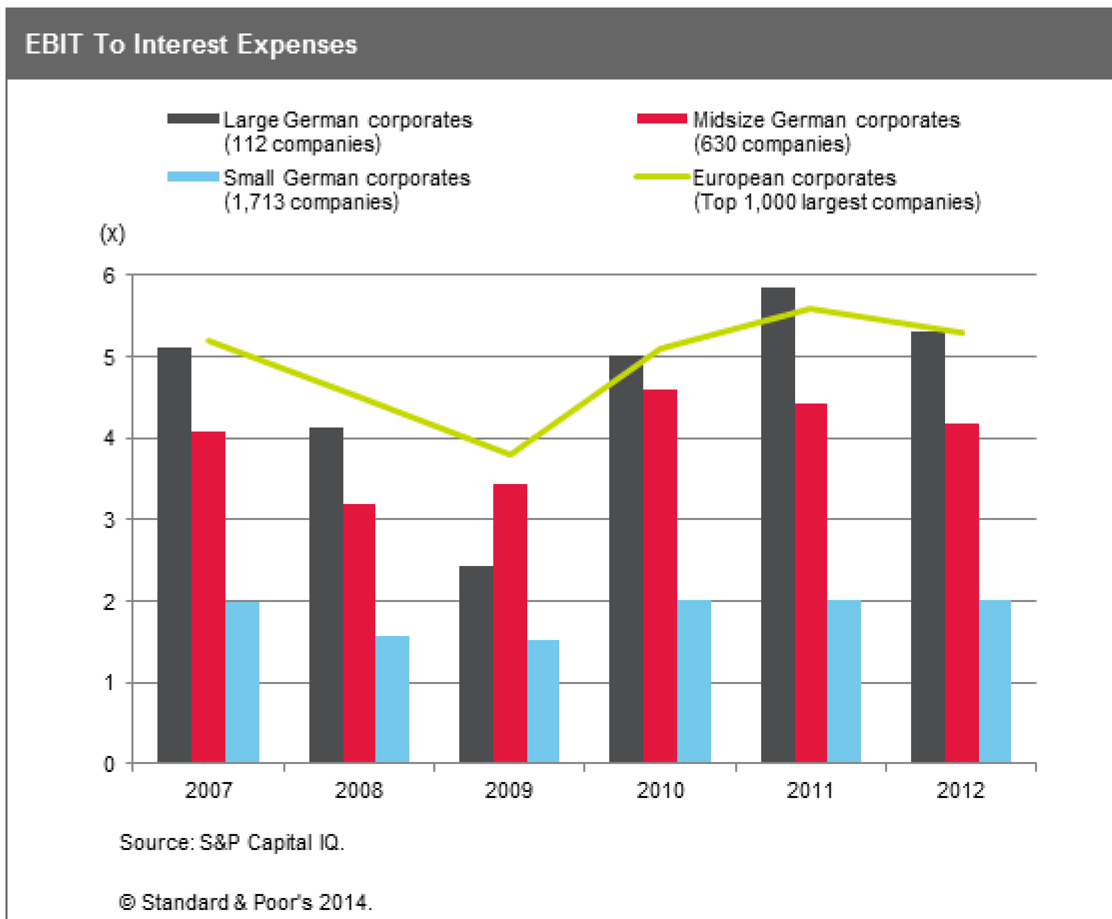
With the exception of the financial crisis year 2009, large German companies operate on average 1x higher debt-to-EBITDA ratios than mid-market companies (see chart 10). Large companies' leverage was 3.4x on average in 2008, then fell to 2.9x in 2011, but trended upward again in 2012 to 3.2x. Mid-market companies, however, have decreased leverage from 2.4x in 2008 to 1.9x in 2012. In general, they stay approximately 3x less leveraged than the average LBO deal. This is typical for many German mid-market companies, which are mostly owned by families or entrepreneurs. They tend to have conservative financing strategies that put less emphasis on total leverage.

Chart 10



By contrast, interest coverage shows a different pattern from leverage ratios. Large companies have on average a 1x better EBIT-to-interest expenses coverage ratio over time than mid-market companies. In 2007, large companies showed at coverage of 5.1x, which in 2012 reached 5.3x. Mid-market companies started with 4.1x in 2007 and reached 4.2x at the end of 2012. A possible explanation for larger companies' better interest coverage is that they have better EBIT margins and typically higher credit quality, owing to a more competitive business position than smaller mid-market companies. This should have a beneficial effect on the overall interest to be paid on their debt facilities, in spite of on average higher leverage.

Chart 11



Indicative credit risk assessment: Relatively good

To better gauge the overall indicative credit risk of mid-market companies in Germany, the U.K., and France, we analysed a second mid-market sample consisting of a total of 136 companies mainly from the U.K., France, and Germany for which we obtained public information to form a more detailed credit analysis. The German sample comprises 53 companies (39% of the total sample), the U.K. 44 companies (32%), and France 34 companies (25% of the total), with five companies (4%) from other countries.

Given the small sample size and limitations posed by only having access to public information, the results of the analysis should be viewed as indicative. We believe, however, that the assessment allows us to draw some conclusions on the much larger non-public mid-market universe in Germany beyond this dataset.

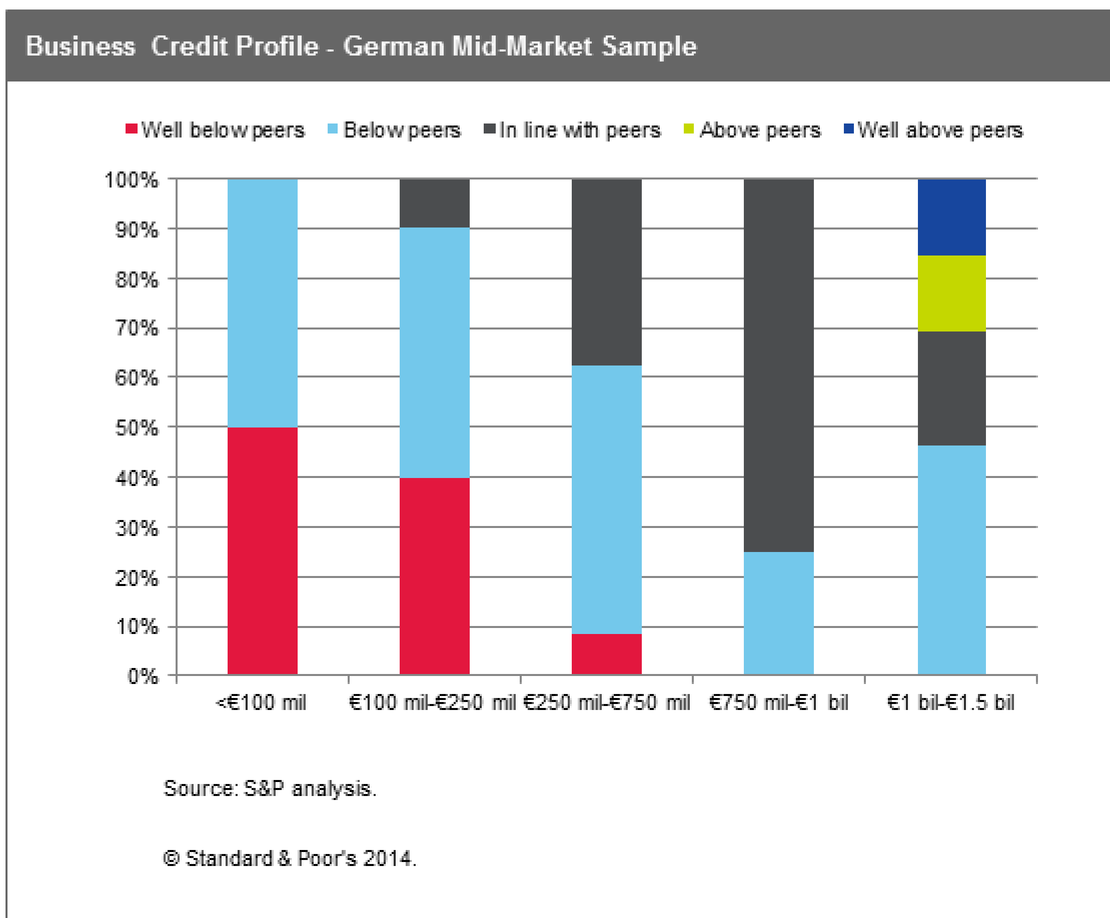
For the assessment we have applied our Standard & Poor's Mid-Market Evaluation (MME) framework (for details see "Mid-Market Evaluation Methodology," published June 25, 2014, and "Credit FAQ: Standard & Poor's Mid-Market Evaluations Explained," June 27, 2014, on RatingsDirect). An MME is an opinion on a mid-market company's creditworthiness relative to other mid-market companies on a specific scale ranging from 'MM1' (highest) to 'MM8' (lowest) and 'MMD' (default).

The criteria apply to companies with annual revenues below €1.5 billion and total reported debt facilities (drawn and

undrawn) below €500 million, or the local currency equivalents. We use our global corporate ratings criteria as the basis for MMEs, but we have simplified the analytical process and customized part of the global corporate criteria to take into account the specific characteristics of mid-market companies. For the dataset we specifically look at the business credit profile, the financial credit profile, and the resulting MME (for an overview, see chart 20 "The Mid-Market Evaluation Process" in the Appendix).

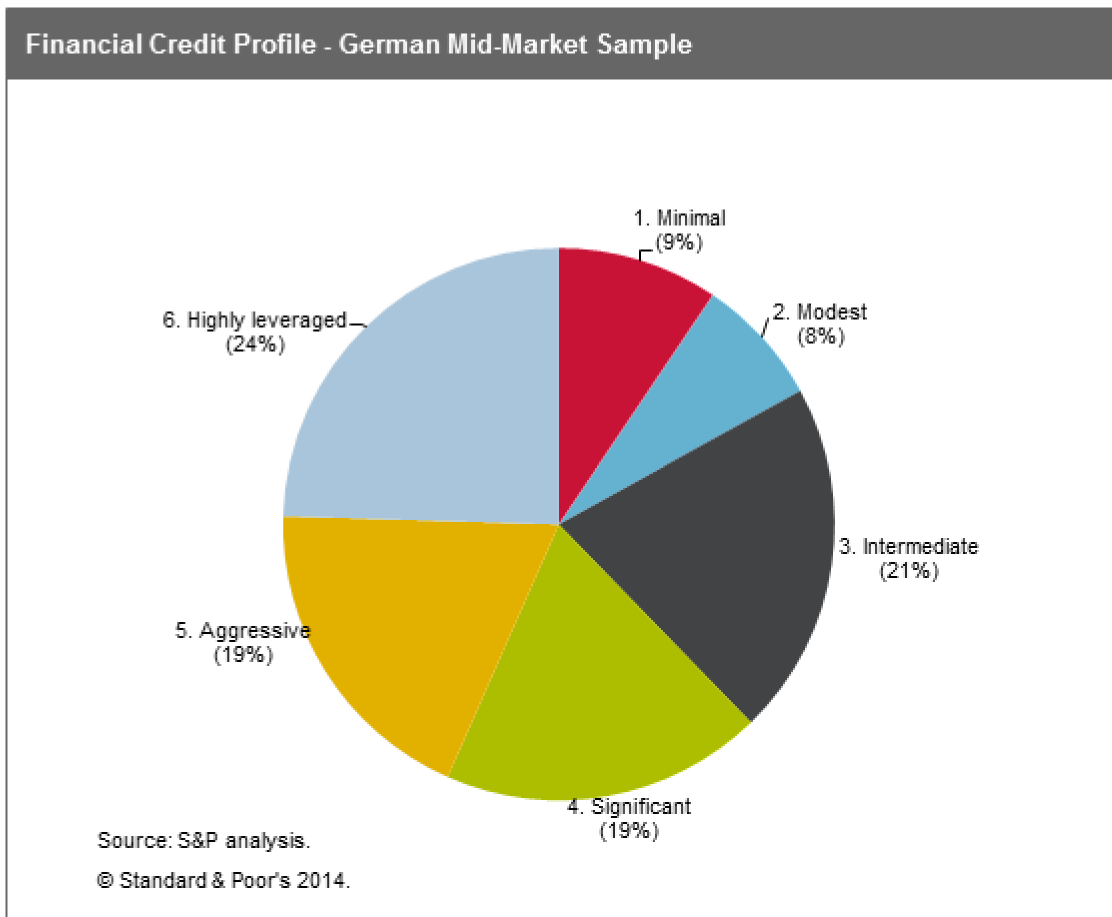
In terms of business credit profile, the number of companies in the German sample that we assess at the lower end of the scale decreases with an increase in total revenues (see chart 12). Many companies with total revenues of between €100 million and €1 billion have a business credit profile in line with peers, according to our assessment. Some of those with revenues of above €1 billion can demonstrate stronger business credit profiles.

Chart 12



With respect to German mid-market companies' financial credit profiles, 38% show a prudent financial policy (falling within the first three categories on the scale), while we deem 24% to be "highly leveraged", which would be similar to an LBO-type total leverage of larger than 5x (see chart 13).

Chart 13



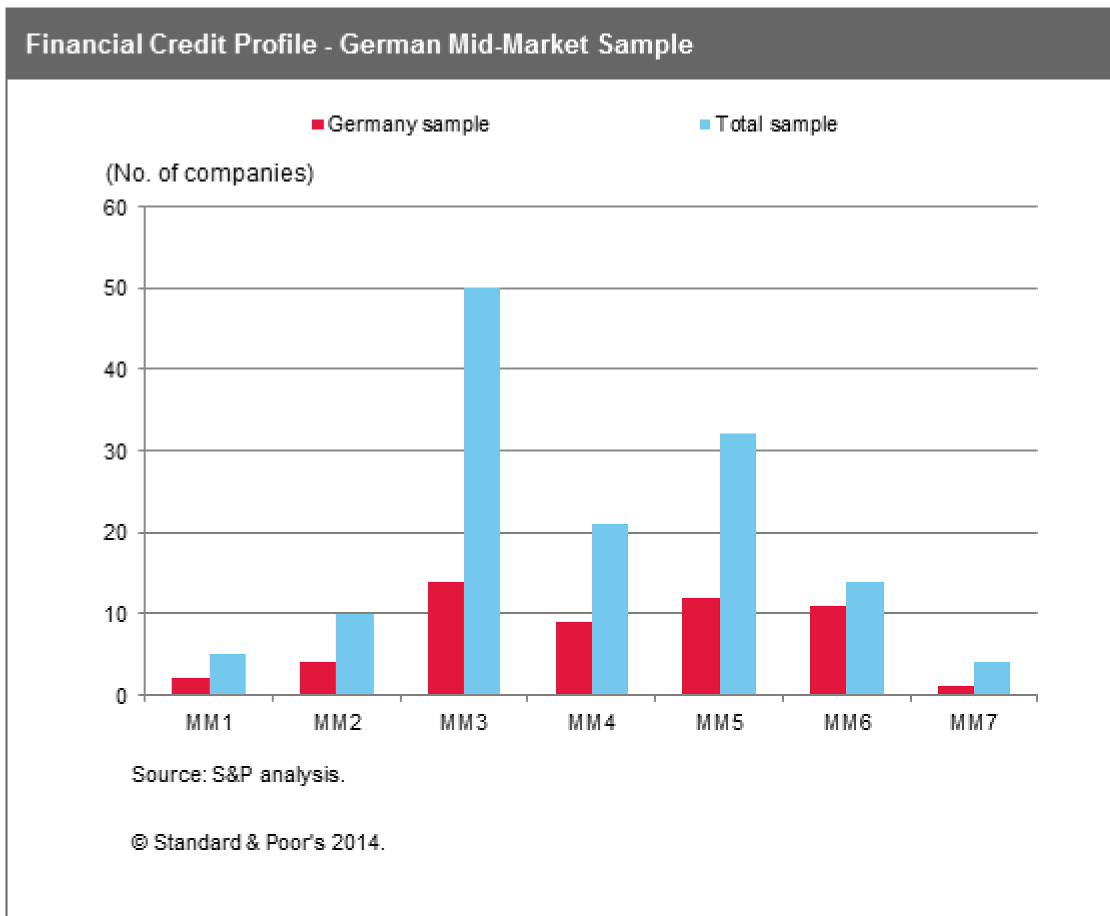
The resulting overall indicative credit risk assessment based on our MME methodology shows that the majority of tested German companies have an MME between 'MM3' and 'MM5' (see chart 14). This represents relatively good creditworthiness on our scale for mid-market companies, suggesting they have a good to reasonably adequate capacity to meet their financial commitments relative to other mid-market companies.

In general, we find that smaller mid-market companies tend to be more vulnerable than larger and more diversified peers to cyclicality and volatility. There are a variety of reasons for this: the scale of their operations is more limited; their activities less diversified; and their operating margins more volatile. Nevertheless "hidden champions" (market leaders in their respective industry that are not necessarily visible to wider public) benefit from a good competitive advantage and strong margins because they hold dominant market positions in their relative niche. Notably, some of the smaller companies, with revenue of less than €100 million, could reach a business credit evaluation comparable with the industry average. This indicates that a company's overall competitive position and high profitability can mitigate the impact of a smaller scale of operations.

According to research by Simon-Kucher & Partners, more than 1,300 so called "hidden champions" in Germany pursue this strategy. They focus on generating know-how in a very specific product or service. Our analysis reveals that many of these companies' business credit profiles are exposed to greater challenges, owing to concentration risk. However,

mid-market companies reduce the risk from having less diversified product ranges by expanding their end markets across Europe or even globally. Growth is typically not the main driver for this geographic expansion. Rather, it is to improve the quality of their product and/or service. Quality is often supported by extension of ownership across the value chain. Mid-market companies cover around 42% of the total value chain, which is 12% above the average of German industry in general. German mid-market companies also put strong emphasis on stable customer service, proximity to clients, and the development of new patents to improve their competitiveness. Successful innovation is a key success factor for the German Mittelstand. Simon Kucher & Partners estimate that German "hidden champions" develop five times more patents per 1,000 employees and spend five times less on R&D per patent than their larger counterparts. This suggests that size is not a systematic benefit or constraint for the German mid-market.

Chart 14

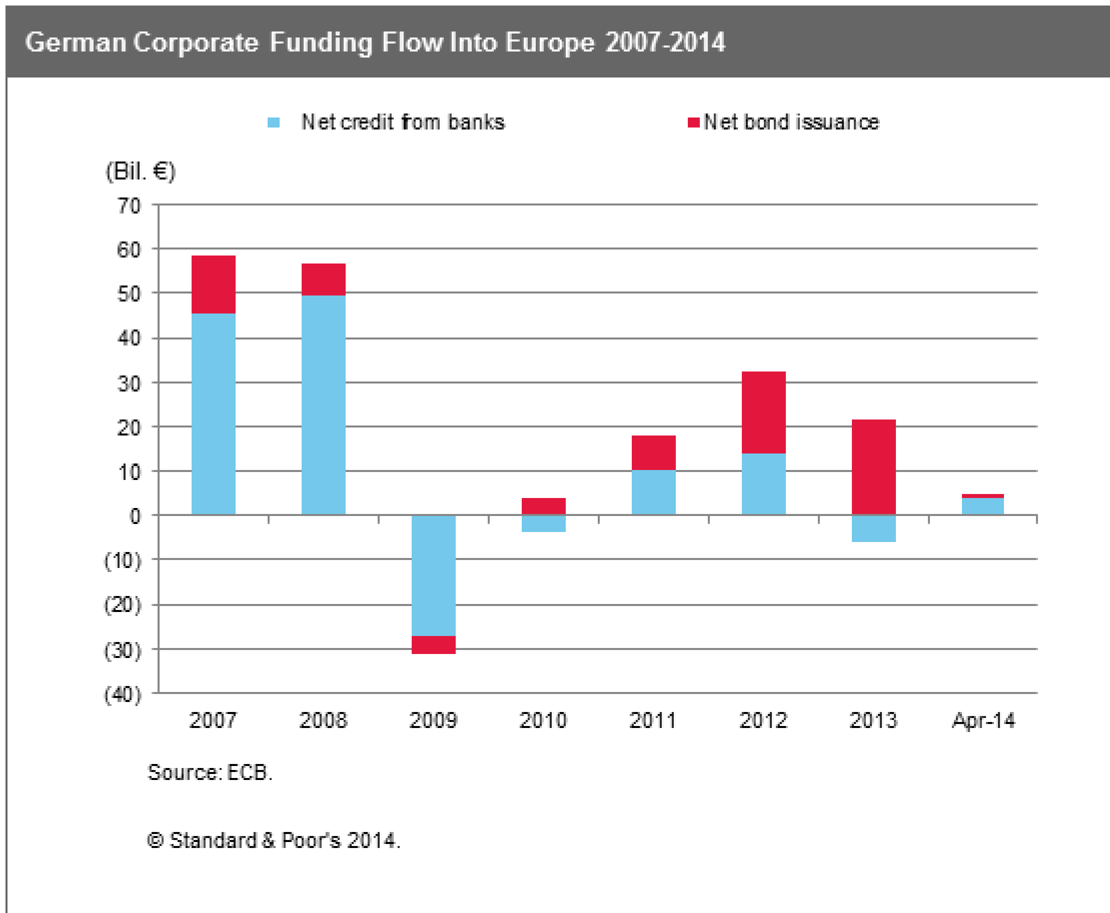


Financing Alternatives Are In Development

A generally positive economic outlook combined with solid credit characteristics should put German mid-market companies in a position of strength if and when they tap various debt investors for additional funds, especially those positioned at the better MME credit-risk assessment range.

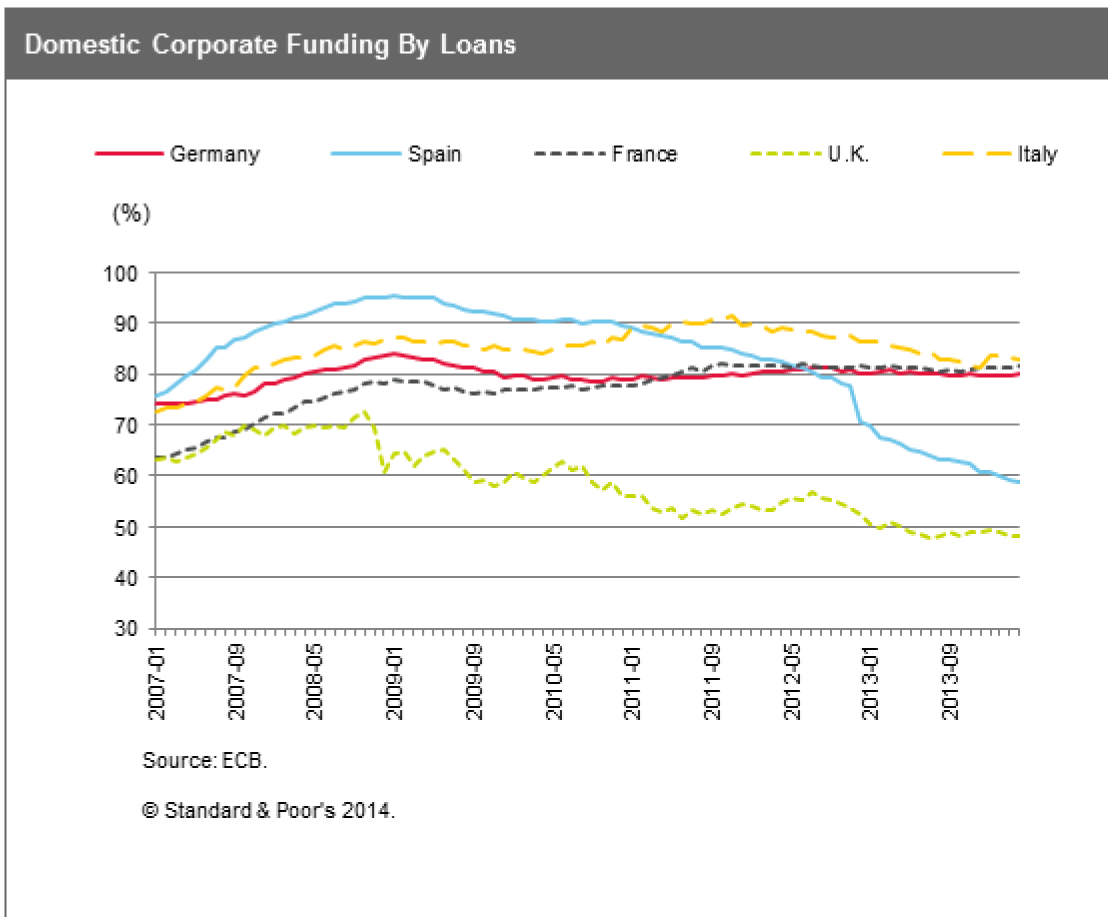
In Germany, bank lending started to increase again in 2011 and 2012, and bond financing also began to pick up significantly (see chart 15). Given the low interest environment, the public bond market remains highly attractive for issuers, as relatively large net bond issuance volumes in 2012 and 2013 demonstrate.

Chart 15



Loan funding in Germany has been relatively stable over time, demonstrating the absence of any domestic bank loan funding squeeze after the 2009 financial crisis. The trend in France has been similar (see chart 16). In Italy and Spain, on the other hand, domestic corporate funding via loans peaked in 2011 and has since come under pressure, albeit from a high absolute value.

Chart 16



The time and speed at which the disintermediation process occurs in Europe will depend on various factors, in our view. These include the pressure on banks to consolidate their balance sheets, the speed of development of alternative funding sources, the evolution of institutional investors',notably insurers', regulatory framework as part of Solvency II, and the cultural shift away from a traditional relationship banking culture. This is especially relevant for Germany, which has a high number of banks including commercial banks, regional banks (Landesbanken), local saving banks (Sparkassen) and cooperative banks (Volks-und Raiffeisenbanken). We therefore expect that disintermediation in Germany will take some time. Given the low current interest rate environment, the market will stay "overbanked" and offer mid-market companies in general very attractive funding rates.

Consequently, bank debt will remain the most efficient and most widely used financing method for mid-market companies for the time being. We nevertheless believe that other sources of funding will increasingly play a role in mid-market financing (see table 2). Below, we analyze various funding alternatives in more detail, focusing on the German market. (For a more general view on other European markets such as the U.K. and Euro private placement markets, see "Mid-Market Funding In Europe Is Making Strides, But Has Far To Go," published April 29, 2014, on RatingsDirect).

Table 2

Selected German Debt-Financing Alternatives

	--Private Placement--		--Senior Debt--		--Public Securities--	
Product	**USPP**	**Schuldschein**	**Bank loans**	**Direct lending**	**Eurobond**	**Mid-market bond**
Market characteristics	Mature market	Mature market	Mature market	Nascent market	Mature market	Nascent market
Typical investor	Insurers	Banks (corporate, savings, cooperatives); Insurers; Pension funds	Relationship banks	Specialized debt funds; Banks/asset managers cooperating with institutional investors	Institutional investors; Asset managers; Banks	Retail; Selected asset managers
Benefits for investor	Low credit risk; Seasoned market	Stable exposure to higher credit quality; Established recognized product	Cross-selling opportunity	Attractive returns Access to separate asset class	Larger issuers with high liquidity	Access to separate asset class
Typical funding sizes	€50 mil.-€250 mil.	€15 mil.-€300 mil.	€5 mil.-€500 mil.	€10 mil.-€200 mil.	>€250 mil.	€10 mil.-€200 mil.
Currencies	USD predominantly, EUR, GBP	EUR predominantly, USD, GBP	EUR	EUR	EUR	EUR
Typical maturities	5 to 15 years	3 to 7 years	Up to 5 years	Up to 10 years	5 to 10 years	5 to 7 years
Typical issuer	Large size to upper mid-market	Large size to upper mid-market	Small to large size	Small and medium mid-market	Large size	Small and medium mid-market
Benefits for issuer	Access to competitive USD market; Well established market and documentation; Deep funding	Well established market and lean documentation; Widening of investor base for medium to long-term financing	Bilateral agreement with relationship bank or syndicated loan facilities; Ability to pool other bank services (e.g. clearing, FX)	Flexible and quick access to senior secured financing; Unitranche deals possible; Longer tenors available (above 5 years)	Wide investor pool with deep funding abilities; Long maturities; No covenants;	Alternative funding pools; Access to lenders of "last resort".

Source: S&P market research.

Bank loans

The benefits of traditional bank loans for mid-market companies are obvious. They have far fewer investors to deal with than a public instrument, and management and owners can keep their commercial and financial information confidential. However, privacy has its cost. Bank debt is a much less liquid instrument and typically requires some liquidity premium in pricing.

Access to bank debt financing is especially important for medium to small companies because they could have a relatively higher credit risk profile, typically commensurate with our mid-market classification of 'MM3' and below. They require a higher level of credit analysis and monitoring by investors than large corporates or upper mid-market companies. However, investors often do not have sufficient important credit information when a company is held privately. An extensive due diligence and credit analysis is necessary to understand and verify the implications for the company's credit profile and assess default risk. Transparency is therefore a key to unlocking access to alternative funding for a larger range of mid-market companies.

Public bonds

Large corporations and the larger mid-market companies that are not owned by a private equity sponsor typically tend to have relatively good credit risk profiles commensurate with our assessment of 'MM1' and 'MM2', resulting in an overall low probability of default. The most effective form of funding for these companies tends to be issuance of public securities, such as Eurobonds. Public bonds have the advantage of providing the company with a competitively priced, long-term, fixed-rate and unsecured instrument with no, or very few, covenants.

However, for the vast majority of mid-market companies, a public Eurobond issuance is not a viable option because of the size of the benchmark threshold; costs associated, and unwanted information disclosure. There have been various efforts in Europe to launch platforms for mid-market public securities. Germany has taken the lead in developing funding avenues for companies in Europe via various exchanges. More than 120 companies issued a total of approximately €6.7 billion that is traded across the main stock exchanges in Germany, including the Stuttgart, Dusseldorf, Munich, and Frankfurt. In addition to traditional institutional investors, these platforms also attract retail investors with access to public securities.

One disadvantage of the public bond mid-market widely discussed in the public domain is the inability of many investors to conduct enough credit analysis on issuers. If investors don't have their own credit assessment capability, then they need to rely on the credit analysis of external third-party credit experts, such as rating agencies. As long as an issuer's credit risk is low, the need for detailed and accurate credit risk assessments might not be as important. Large high-profile issuers might be able to issue bonds without any risk assessment in form of a public rating. For medium and smaller mid-market companies, however, an accurate credit risk analysis becomes much more important because, on average, their credit risk is higher. In the absence of credible credit assessments, investors have difficulties making appropriate decisions for their capital allocation and pricing in relation to the expected default probability. The high default rate of German mid-market companies with publicly listed mid-market bonds (16 issuers between 2012 and 2014 to date) highlights the possibility of mismatch of risk and price. Therefore, transparency is key to effective capital allocation, and in contrast to the bank market, such transparency needs to be public.

Private placements

An alternative to bank and bond funding for mid-market companies are private placements (PPs). So far, mainly larger companies with relatively good credit risk profiles have tapped these markets. They have developed more actively since 2012, particularly for mid-market companies. They include, the well-established U.S. private placement market and the private "Schuldschein" market in Germany.

In addition, in France and the U.K., a number of initiatives were launched in 2013 aimed at developing PPs. These nascent markets have expanded since mid-2012 and could pave the way for the development of private placement markets in other European countries.

Direct lending funds are also becoming available in Germany through a different form of PP. As an example, Amundi, the French asset manager active in the private placement loan market, has partnered with the lender Unicredit to provide finance to German mid-market business.

The PP market allows a company to not only to save time and transaction costs, but also to avoid costly disclosure requirements associated with public securities law. The restrictions of a PP instrument can be more onerous than

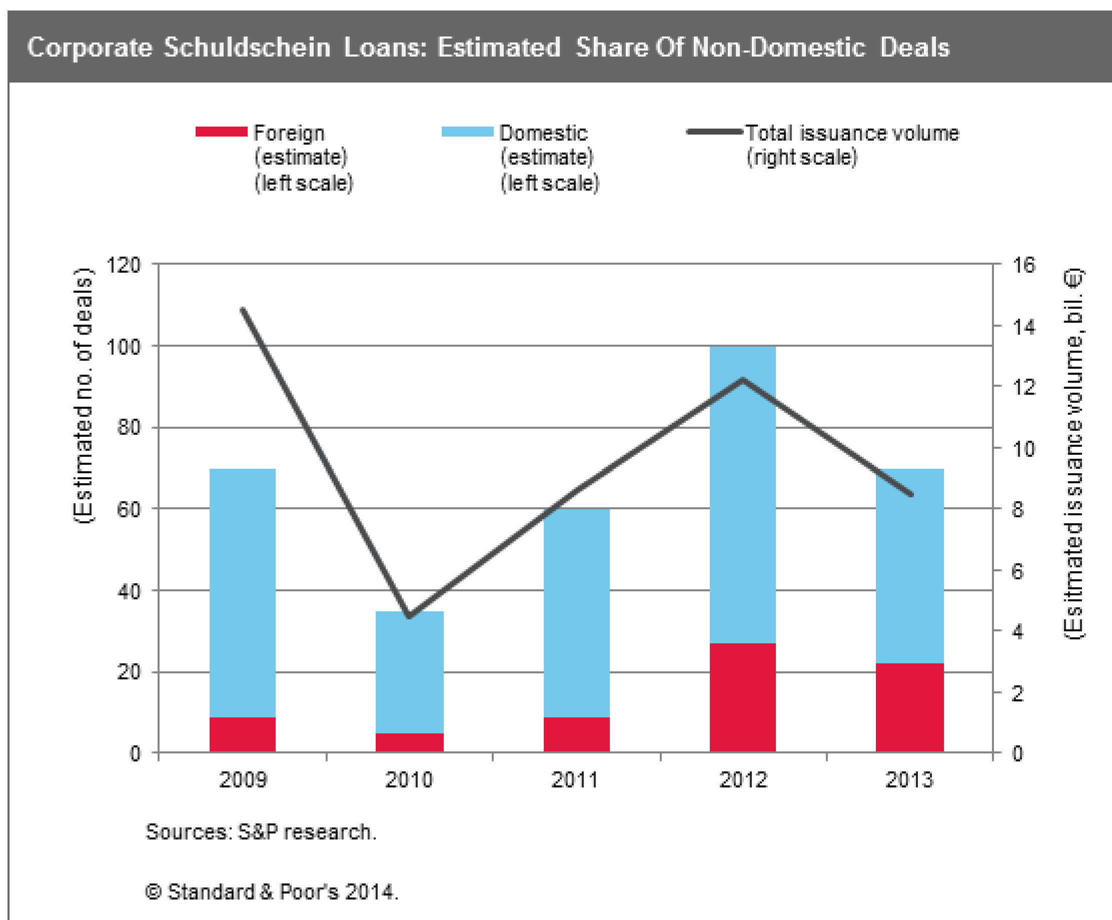
public bond issuance in terms of the covenants required. But the flexibility and low cost of the instrument, together with competitive pricing, make it an attractive funding source.

Investors in the PP market are mainly insurance companies, pension funds, and in some countries also commercial banks. PP instrument documentation is generally flexible enough to cover sufficient credit protection clauses in line with the credit risk of the respective issuers, without becoming too punitive in terms of covenants. The current regulatory environment allows institutional investors to extend funds mainly into high credit quality issuers (that is those equivalent to 'MM1' and 'MM2' on Standard & Poor's mid-market scale).

German Schuldschein market

This is a longstanding private placement market widely used by the federal states, banks, and corporations. The market had a total estimated size above €70 billion in 2013. Within this total, however, managed and arranged corporate deals averaged a total €9.2 billion per year over the past five years (see chart 17).

Chart 17



A Schuldschein is a straightforward and comparably simple financing instrument, owing to the relatively short documentation requirements under German law. A Schuldschein is often viewed by investors as a potential first step in establishing a relationship with an issuer. The main investors in the market are German saving banks (Sparkassen) and cooperative banks (Volks-und Raiffeisenbanken), as well as German insurance companies, although an increasing

number of European and Asian banks, investment management companies, or pension funds also invest.

Financing maturities typically range from three to 10 years, with a preference for shorter maturities in 2013 (50% were less than five years, 75% less than seven years). Investors particularly value that Schuldscheine do not need to be marked-to-market, while at the same time they can realize some yield pickup and access a certain asset class that is not accessible through the more traditional public capital markets. The Schuldschein market shows low secondary trading activities: investors mostly follow a buy-and-hold strategy, and the majority of them hold their paper to maturity.

The Schuldschein market is still primarily an investment-grade type issuer segment (equivalent to Standard & Poor's 'MM1' and 'MM2' mid-market categories). We do, however, see some investor appetite to move down the credit risk curve into cross-over territory ('MM3') and toward smaller deals to obtain more favorable yields and widen the investment opportunity space.

This market has been growing steadily since 2008, with the exception of 2013 when issuance volumes fell to €8 billion for 65 deals (versus a record high of €14 billion for 110 deals in 2012). This can be explained by higher financing needs in 2012 and opportunistic pre-financing activities.

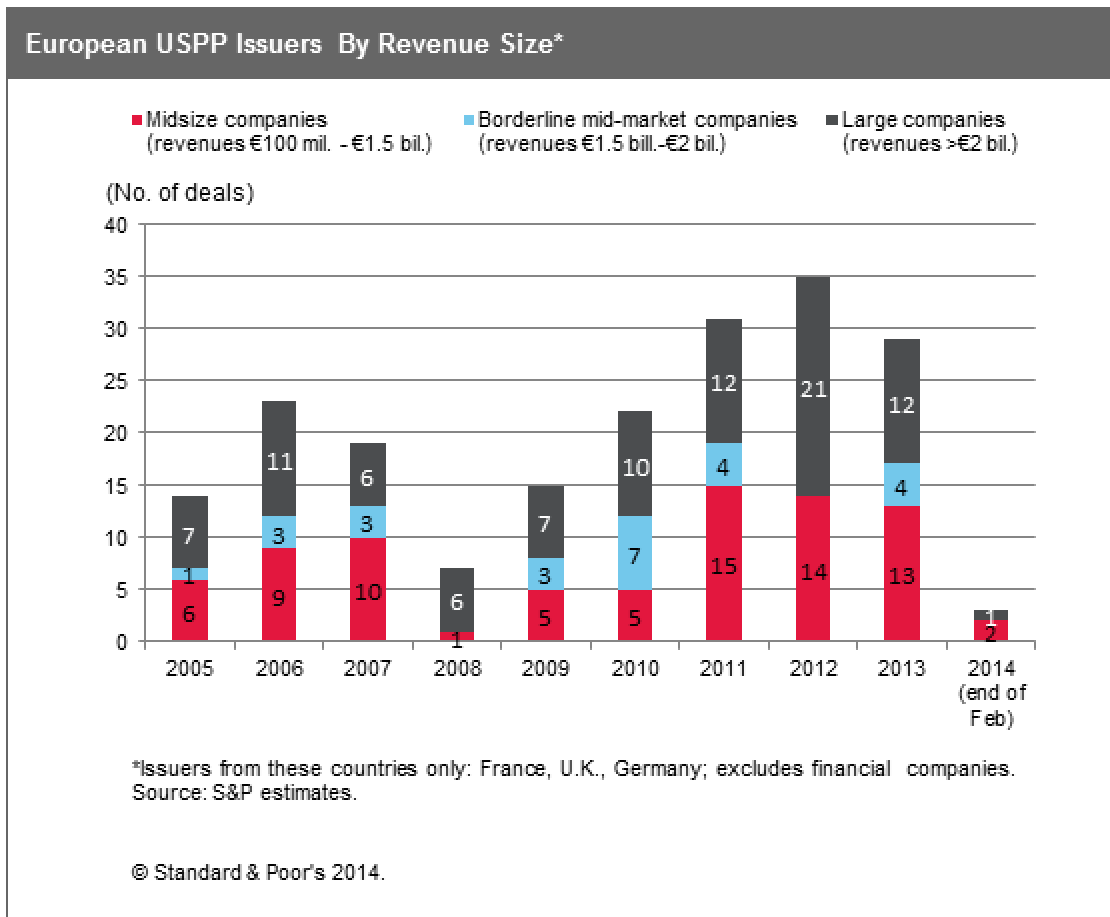
The Schuldschein market remains the most developed of the European PP markets, with the specific characteristics of being a bilateral, unlisted, unregistered loan market, governed by German law. Although the market for Schuldscheine is dominated by German issuers (62% of volume in 2013, down from 87% in 2011), foreign issuers are increasingly represented (see chart 17).

U.S. private placement market (USPP)

This is a unified and efficient market that mid-market companies can use to access funding. Although its share has been declining since 2012, it remains the most important private placement market by volume size for European companies. In 2013, they issued $24 billion of this $57 billion market. The number of European companies tapping the USPP has been growing steadily since 2008 (see chart 18) and there were a record-high number of deals in 2012. In general, the USPP remains a private bond market, available to both U.S.-based and non-U.S.-based companies. It is flexible in terms of size (from $20 million up to $1 billion), and oriented typically toward fixed-rate U.S.-denominated tranches, with traditional bullet structure. Duration has extended notably in the overall USPP market, with tenors of 10 years and longer representing nearly 75% of total volume in 2013 compared with 46% in 2012. Investors in the USPP are typically institutional buy-and-hold investors and do their own due diligence, taking comfort from the inclusion of similar covenants to bank credit facilities.

While the mature and efficient USPP market represents a reliable source of alternative funding for mid-market companies, it is not accessible to all of them because the market is dedicated to companies with implicit investment-grade credit quality willing to comply with a standardized and heavy documentation, including bank type covenants.

Chart 18



European issuers access the USPP market regularly. Their total issuance volume peaked in 2012 at $20 billion and retreated to $16 billion in 2013 (see chart 19). Companies from the U.K. and Ireland led the European issuance volumes in 2013, issuing approximately $10 billion, followed by German companies, which issued approximately $2.5 billion. Terms remain attractive, with average spreads for deals categorized as 'NAIC-2' of 180 basis points (bps) for a seven- and 10-year average life and 200 bps for a 12-year average life. This is often more competitive than an average 200-300 bps spread for German Schuldscheine for a seven-year average life. However, European companies needing to swap back into euros would end up with much shorter maturities on their hedging instruments and additional costs. But the trend seems to develop also for providing non-USD tranches by US-investors.

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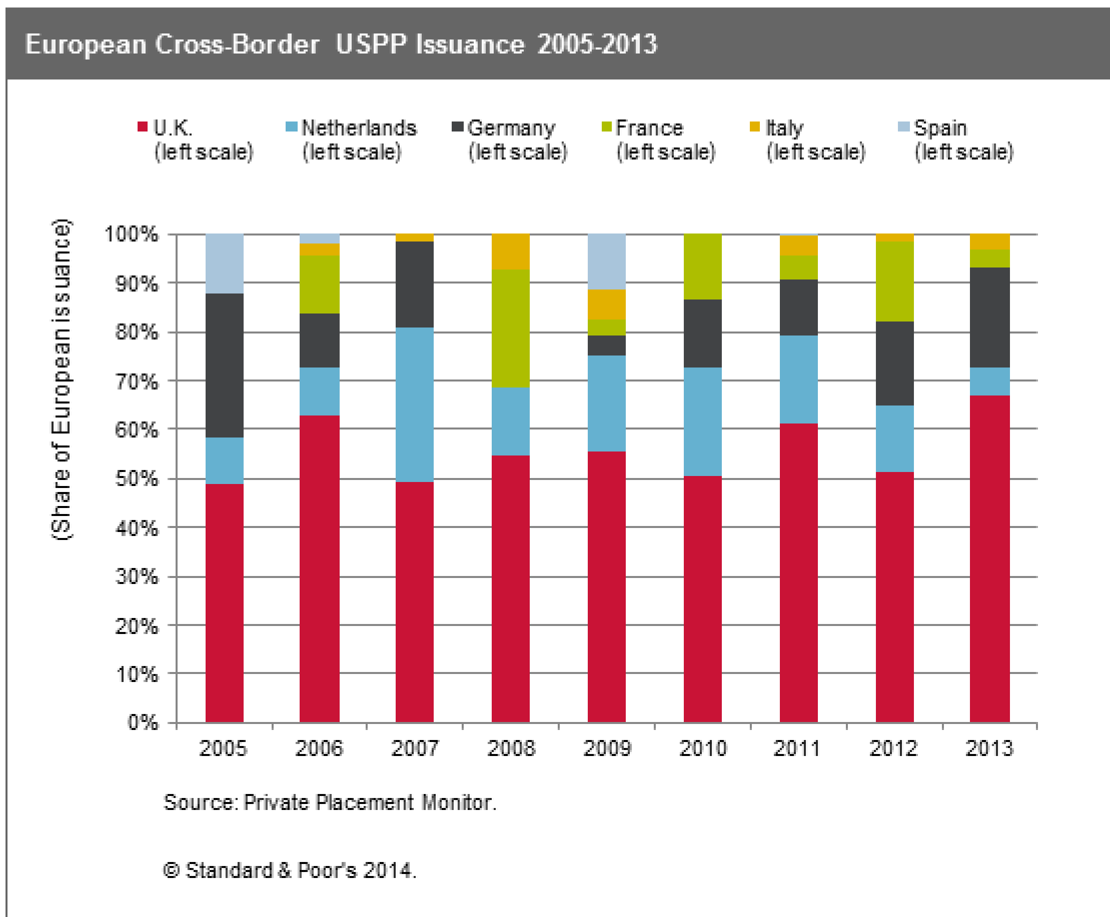
Chart 19



Both the German Schuldschein and the USPP market offer only limited potential at this stage for funding medium to small mid-market companies with lower credit quality. Institutional investors active in those markets currently have only limited regulatory leeway to invest in noninvestment-grade companies. Their main domain is still investing in issuers with a rating of 'BBB-' ('MM2') and better, even though some insurance companies use their flexibility to invest in certain cross-over issuers to realize higher returns.

The implementation of Solvency II in Europe in 2016 will likely not significantly increase German insurance companies' flexibility to invest in lower rated mid-market companies because capital requirements for credit investments increase with longer tenor and lower ratings. Given an insurance company's stewardship role for assets under management and the current exposure to credit risk, which is heavily geared toward the 'A' rating category and above, material changes to the insurers' investment portfolio mix in terms of expansion down the credit curve appear relatively limited. Nevertheless, life insurers in particular are pressed to seek for yields to fulfil their policyholder commitments in a low-yield environment and have expanded their corporate bond portfolios in recent years. They may also find it attractive to further expand their investments into high quality corporate credits to benefit from portfolio diversification and potentially re-allocate funds from currently low-yielding sovereign bonds, which still dominate insurers' sector allocations.

Direct lending

Another evolving form of financing is direct lending, in which funds partner with institutional investors--such as insurance companies, pension schemes, and asset managers--to match the institutional investors' need for longer term investments with long-term mid-market lending. One example of this is Amundi's recent partnering with the lender Unicredit to provide finance to German mid-market businesses. These fund structures are able to combine senior secured debt or unitranche exposures to strong mid-market companies into a portfolio of assets.

Benefits to the investor are exposure to a pool of assets that are typically less correlated in terms of business risk than an equivalent large cap fund. In addition, total yields are typically higher because of additional spread compensation for the illiquidity of the instrument compared to a public instrument. In turn, the borrowers gain access to long-term financing, which allows them to reduce uncertainty in their capital structure and align lender and borrower interests in the long term. Direct lending funds can offer longer tenors, but solutions are typically more expensive than relationship-driven bank financing. Another advantage over bank financing is that some direct lending funds can often offer larger ticket sizes up to €100 million-€150 million at or close to senior bank debt spreads with a bullet repayment. Tailor made documentation combined with a fast execution makes direct lending fund offers especially attractive for mid-market companies that require financing for more complex scenarios.

Statistical data provided by Deloitte's Alternative Lender Deal Tracker in May 2014 records 22 direct lending transactions in Germany since Q4 2012, which is less than in the U.K. (93 transactions) and France (50 transactions). Of the total 198 tracked deals, only 39 did not involve a private equity sponsor, which demonstrates that direct lending has not yet evolved into a widely used non-LBO mid-market financing source in Germany and rest of Europe.

Greater Transparency May Help Nascent Alternative Funding Sources Gain Traction Over Time

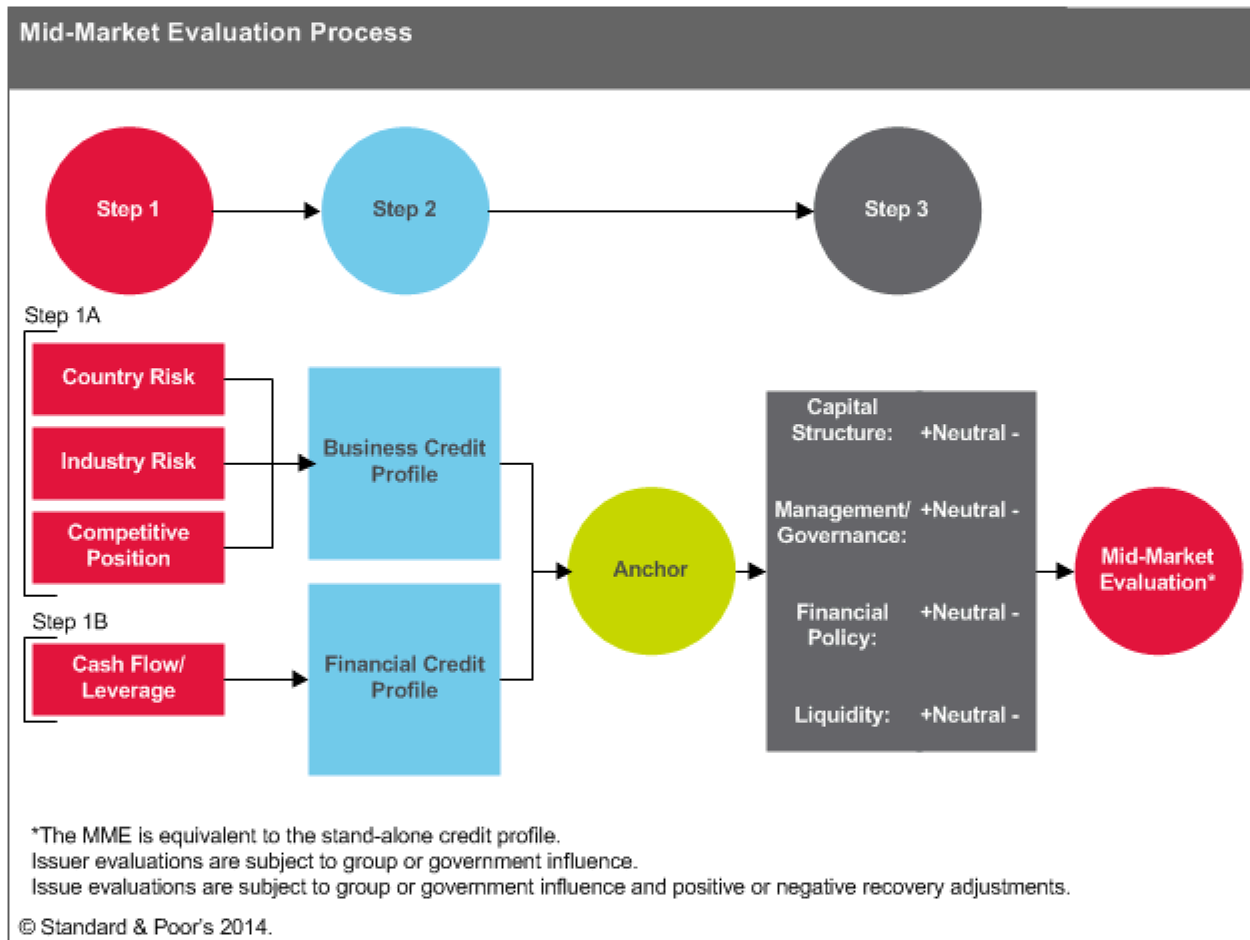
While banks are likely to dominate the funding market for German mid-market companies in the foreseeable future, and mid-market companies with good credit quality currently benefit from strong investor demand in the private placement market, we see signs that nascent alternative funding markets could become more important over time. First, evolving direct lending and mid-market bond platforms have started to become accessible to a broader range of mid-market companies. Direct lending, for example, is becoming more attractive for German issuers in non-typical standard refinancing situations, such as M&As that require fast execution and incremental leverage above standard bank leverage targets, or in distressed situations. Second, some mid-market companies appear to be using the currently positive financing environment strategically to build up a reputation with alternative lenders so as to diversify their funding sources beyond plain bank debt. The current market environment of willing investors and favorable pricing is supporting this strategy. Should the environment change in the future, for example through more difficult access to bank loans or a rise in interest rates, these companies will be in a stronger position to use this competitive advantage to gain access to more flexible and competitively priced debt.

We also believe that direct lending and mid-market bond financing would increase the financial flexibility of mid-market companies with lower credit quality should bank disintermediation start to limit their bank borrowing. Yet, to ultimately close the likely funding gap, additional institutional and other funding sources still need to be further

developed. In our view, credible transparency about a company's credit risk will be key to unlocking the internal and external capital allocation decisions of this class of investors, as access to comparable information is fundamental for investment decisions.

Appendix

Chart 20



Related Criteria And Research

Related criteria

- Mid-Market Evaluation Methodology, June 25, 2014

Related research

- Global Corporate Capital Expenditure Survey, July 21, 2014
- Credit FAQ: Standard & Poor's Mid-Market Evaluations Explained, June 27, 2014
- Mid-Market Funding In Europe Is Making Strides, But Has Far To Go, Apr. 29, 2014
- Midsize U.K. Companies Seek New Funding Sources To Unlock Growth, Nov. 26, 2013

- French Mid-Market Companies Display Financial Conservatism In Challenging Economic Times, Oct. 1, 2013

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