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BAI Study

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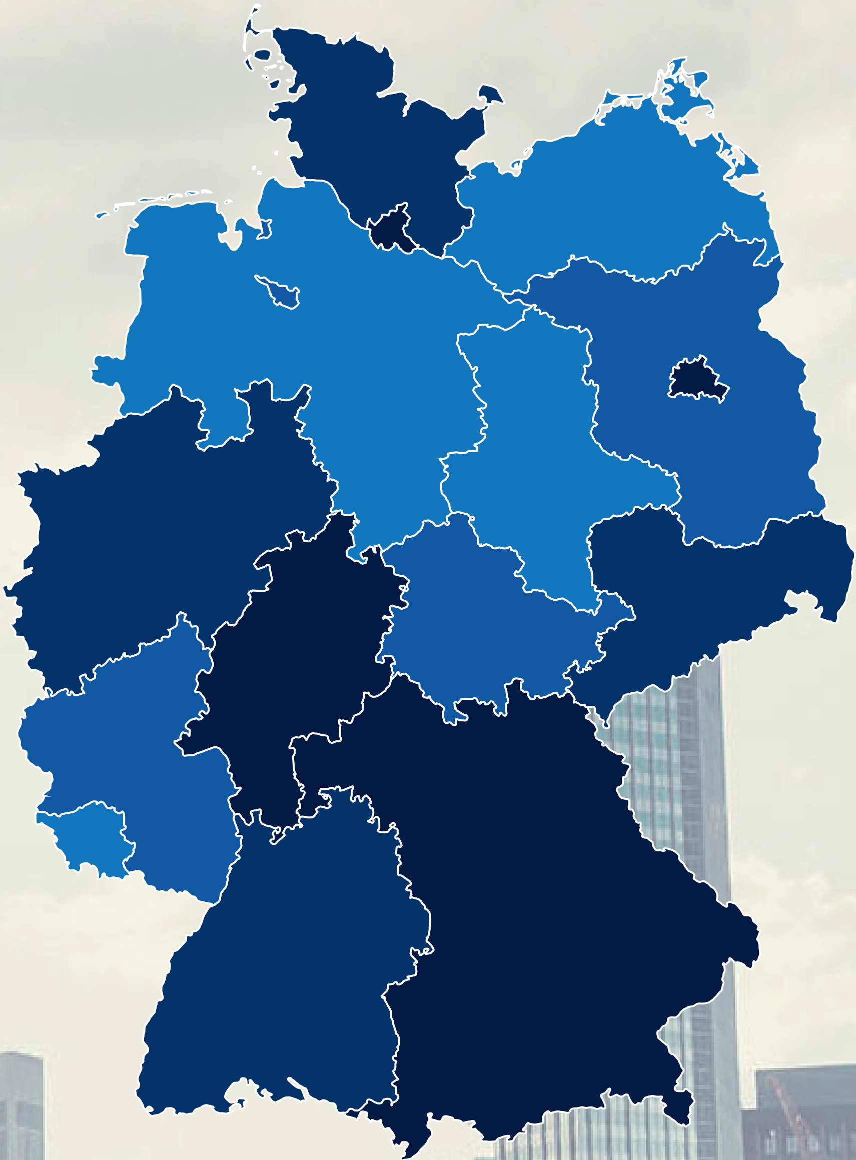


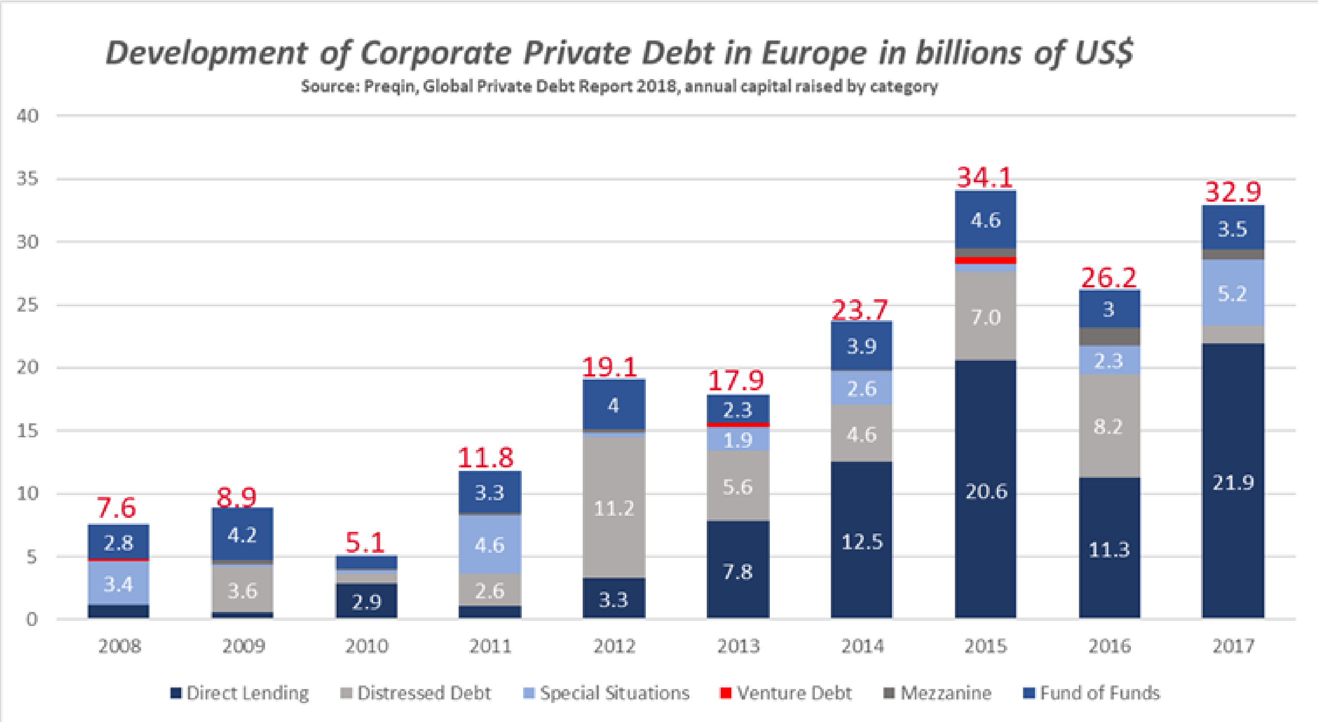
Corporate Loan Financing by Non-Banks in Germany - Perspective of the Three Market Players

(Summary)

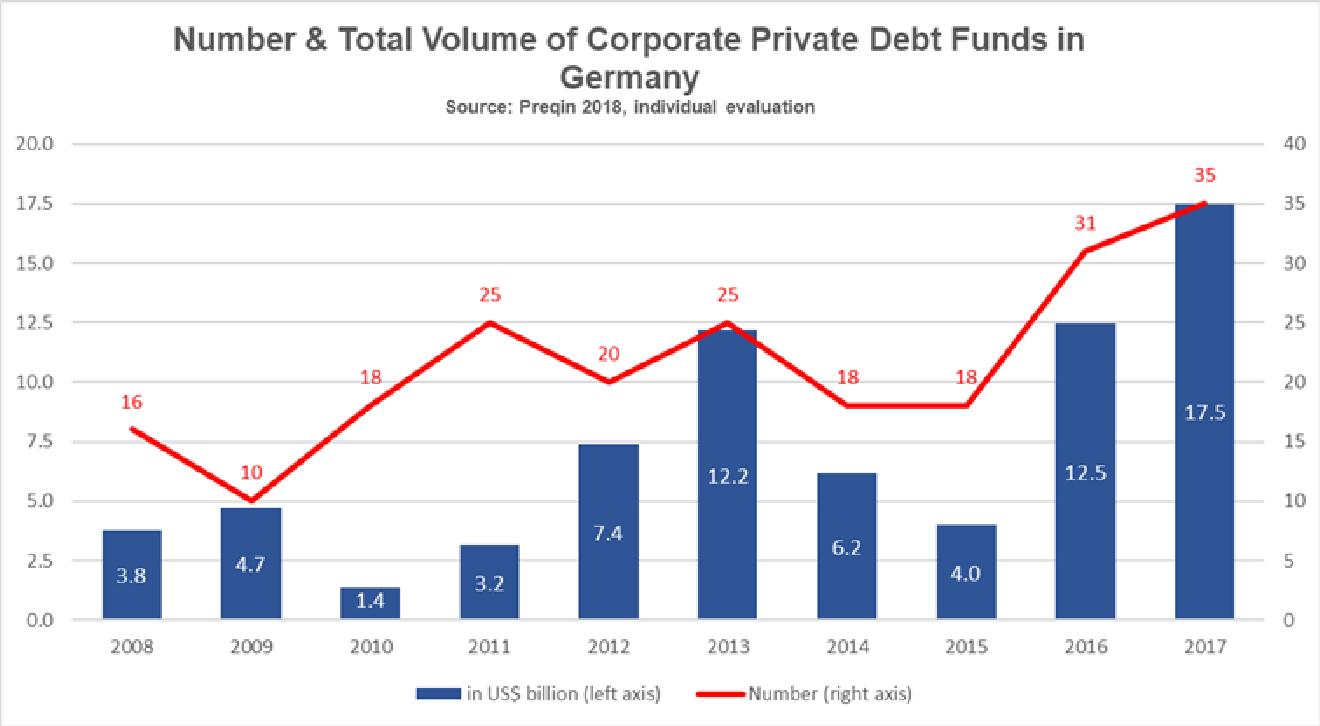
Introductory Remarks

The market for corporate loans is in a state of upheaval: triggered, on the one hand, by government initiatives such as the EU Commission's Capital Market Union, which are increasing the importance of market-based financing. On the other hand, changed regulatory requirements for lending by banks are leading in part to financing bottlenecks in SMEs. Finally, a permanently low interest rate environment is driving institutional demand for new investment opportunities. As a result, opportunities are opening up for various market players, in particular debt funds, which now also occupy the Corporate Private Debt segment in Germany and grant loans without the involvement of the capital market. This is where the BAI study "Corporate Loan Financing by Non-Banks in Germany" comes into play; for the first time the views of the three relevant market players - companies, debt funds and institutional investors – are comprehensively presented in an complete study. Based on this, an outlook on future developments is also given.

Market Overview

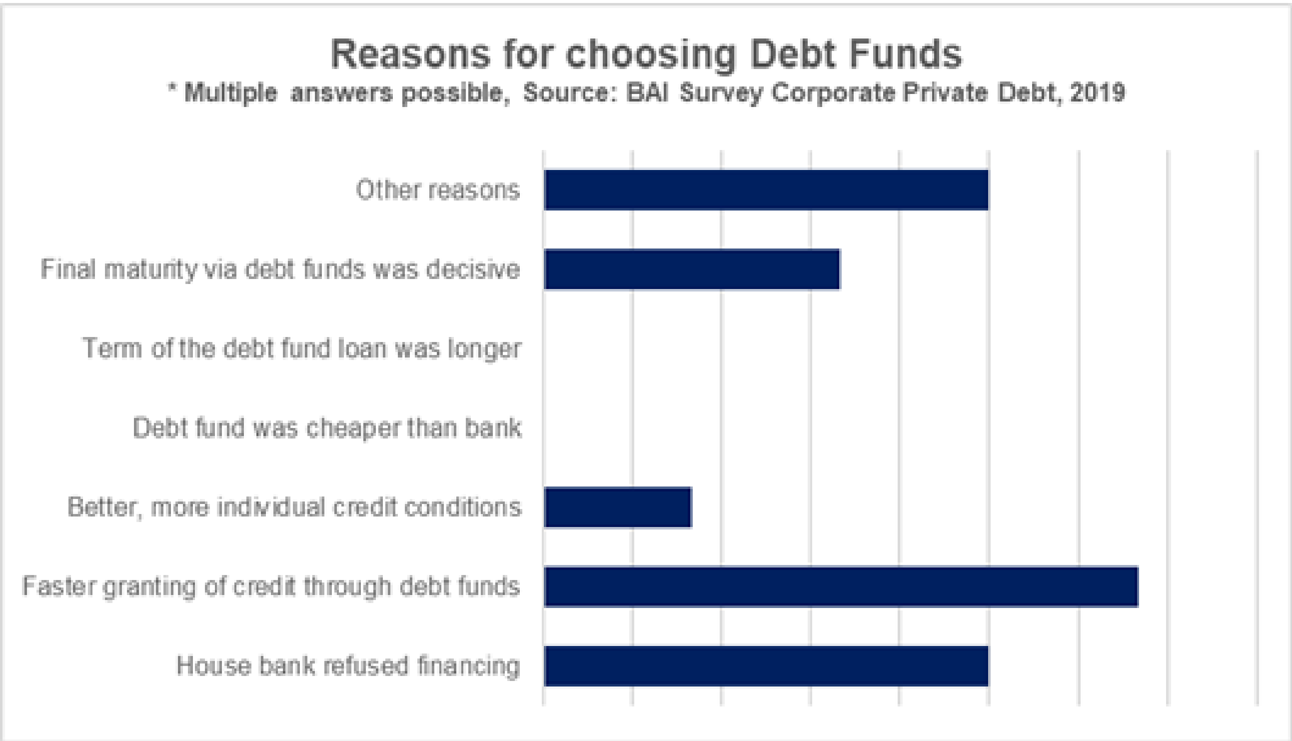


The corporate private debt market in Europe has been characterised by fluctuating growth over the last ten years. Primarily the classic lending business (**Direct Lending**), which is also the focus of this study, grew. Acquisition and growth financing is provided here in particular, which is predominantly received by companies in the sub-investment grade range (from BB), but also in part in the lower investment grade range (from A/BBB). Depending on the economic cycle and the corporate situation, the **Distressed Debt and Special Situations** segments are also becoming increasingly important when banks no longer wish to or are no longer able to hold corporate loans on their books. The main market driver of the corporate private debt market in Europe is regulation, which on the one hand restricts banks in their lending through Basel III, and on the other permits direct lending through investment funds. Finally the supervisory regime for insurers (Solvency II) tends to favour investment in debt instruments such as corporate loans.



There are around **35 active corporate debt funds** in Germany, but only some of them reside here. The funds often operate out of Luxembourg and invest their collected capital throughout Europe for diversification reasons but focus on Germany. In contrast to other European jurisdictions, investment funds in Germany are only permitted to grant loans directly to companies since May 2015. As a result of the subsequent growth, the debt funds in Germany already achieved a market share of around 35% in 2017 for company takeovers in the SME sector (source: GCA Altium MidCapMonitor); the trend is rising.

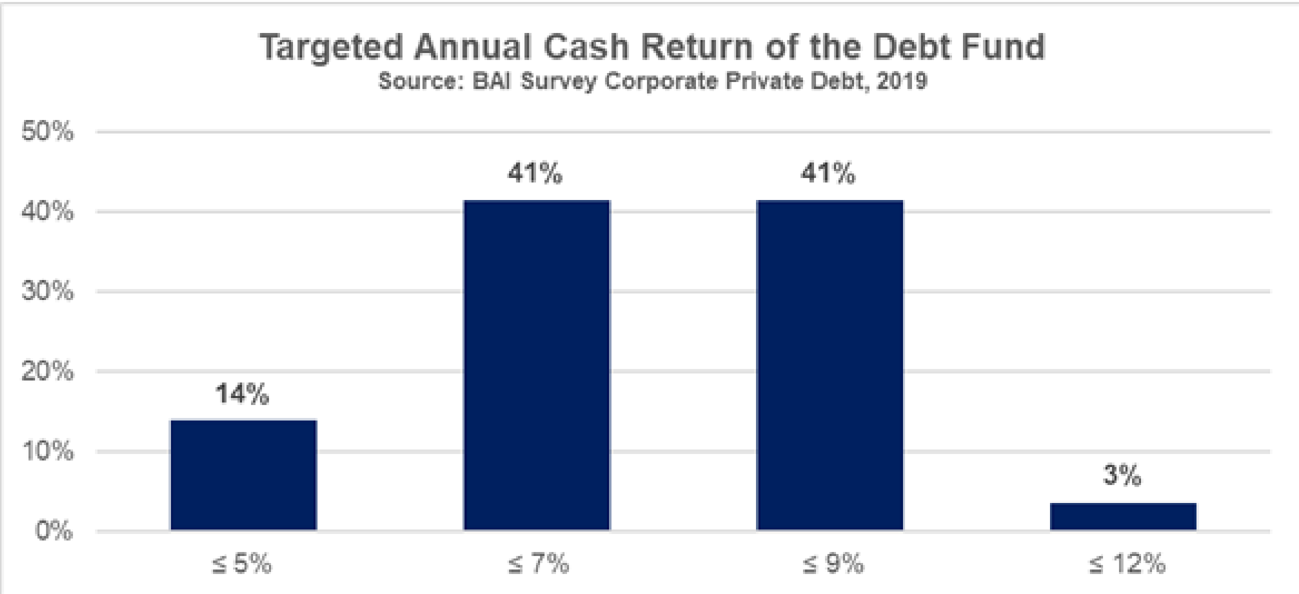
Companies (Borrowers)



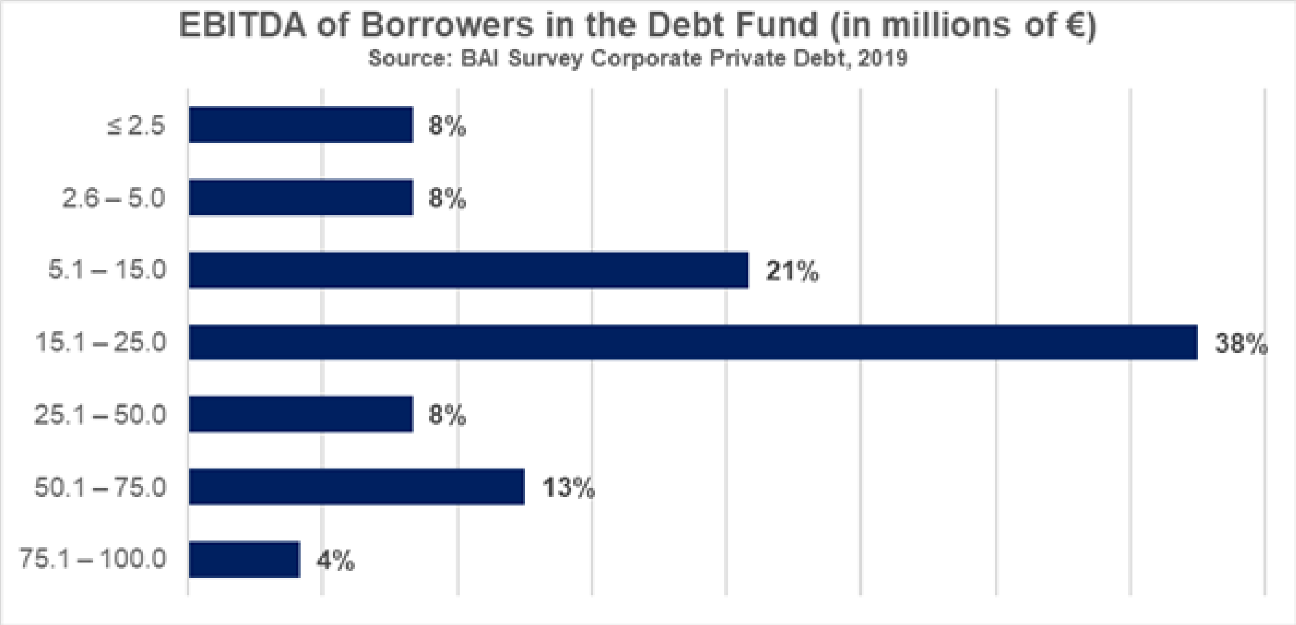
The borrowers of debt funds in Germany come exclusively from SMEs, which traditionally financed themselves through shareholder and bank loans. The credit volume of the corporate loans now provided by debt funds shows a large spread and lies between EUR 2.5 million and EUR 150 million and is mainly used for acquisition or growth financing, or in special situations. The main reason given for loan financing via a debt fund is primarily the faster granting of credit, but also rejection of financing by a house bank. The contractual maturities are predominantly in the range between 5 and 7 years. The overwhelming majority of loans are due at maturity and have more than two creditor protection clauses, whereby the degree of indebtedness represents the most important restriction in the loan agreements. The comparison of the survey with the Creditreform database led to similar results, so that the core statements could be confirmed.

Private Debt Funds (Lenders)

Around three quarters of the debt funds active in Germany are based in Luxembourg. Only around 13% of debt funds reside in Germany. The respective volume of the debt funds is broadly distributed and has a statistical accumulation (just under one third) at a volume of less than 250 million euros and another (one fifth) in the range between 1.5 billion and 3 billion euros. Overall, around 60% of all debt funds active in Germany have a volume of more than EUR 500 million. Senior tranches and unitranches are the most common, each with a share of more than one third.

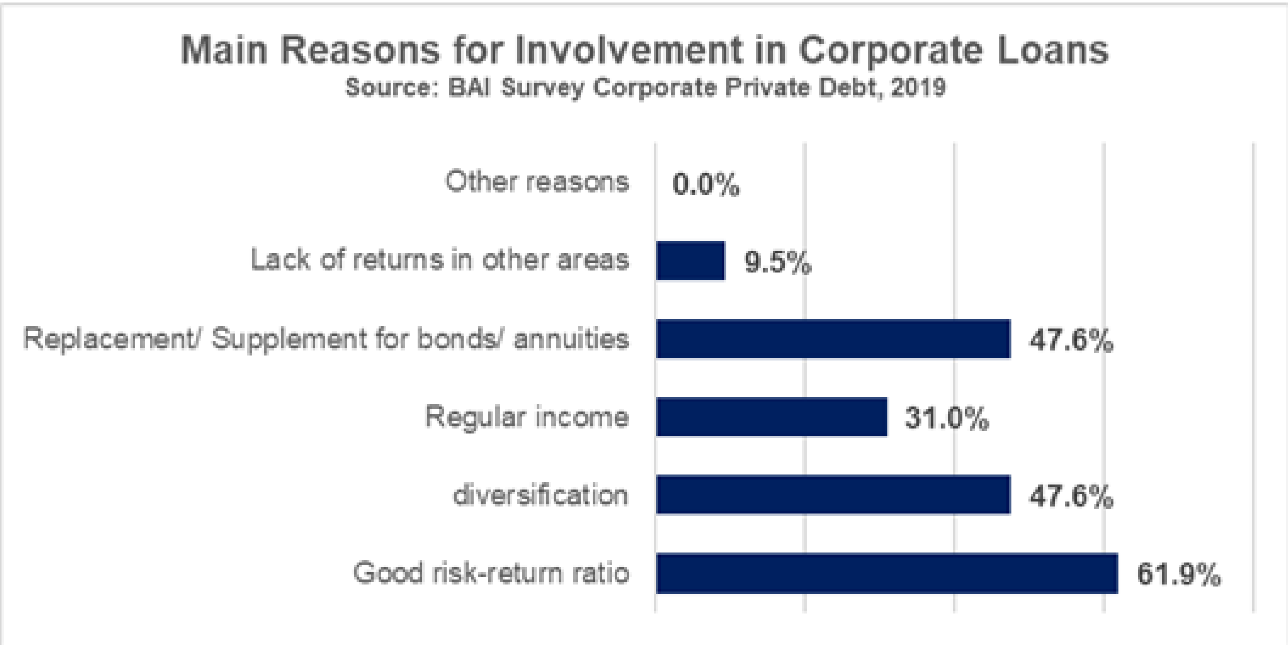


The annual cash yields targeted by debt funds are up to 7% and 9% respectively, with a share of 41% each. These are achieved primarily through individual loan yields between 5% and 12%, with the higher yields being achieved by adding other higher-risk tranches or purchase on the secondary market. The borrowers are almost exclusively established medium-sized German companies and come from all sectors of the economy.



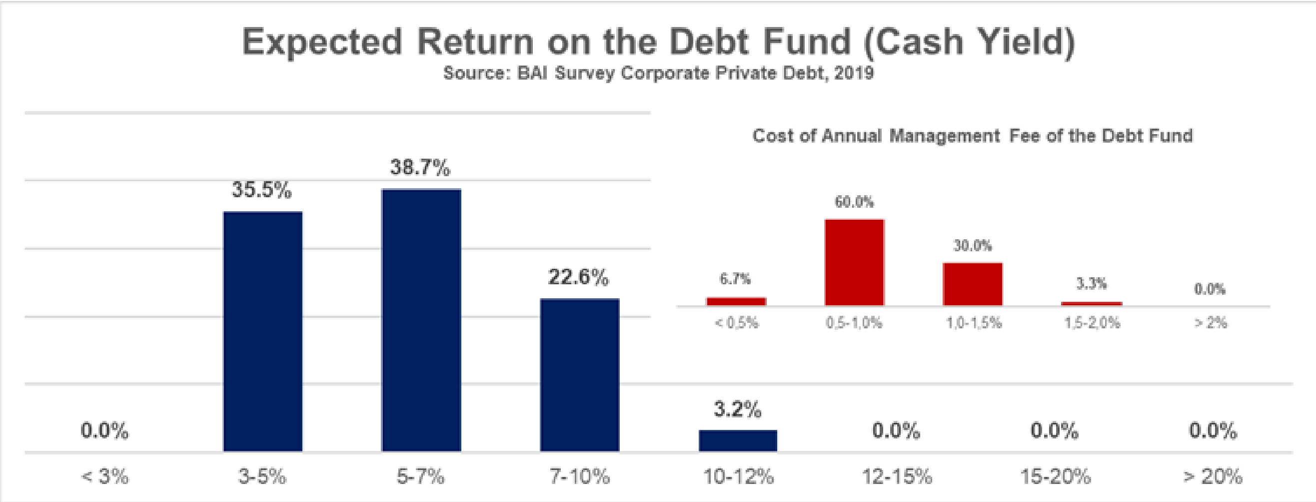
Almost 60% of the these companies have EBITDA in the range between EUR 5 million and EUR 25 million; around a quarter even have EBITDA in the range between EUR 25 million and EUR 100 million. In a good half of all cases, the debt fund is the only lender; in one fifth of all cases, the house bank also provides a working capital line. Around one third of the debt fund managers surveyed criticised the regulation for investors, i.e. Solvency II or the Investment Ordinance. The legal requirements in Germany for the debt funds themselves, on the other hand, are not generally seen as an obstacle, but many managers still opt for Luxembourg as a residency location.

Institutional Investors (Funders)

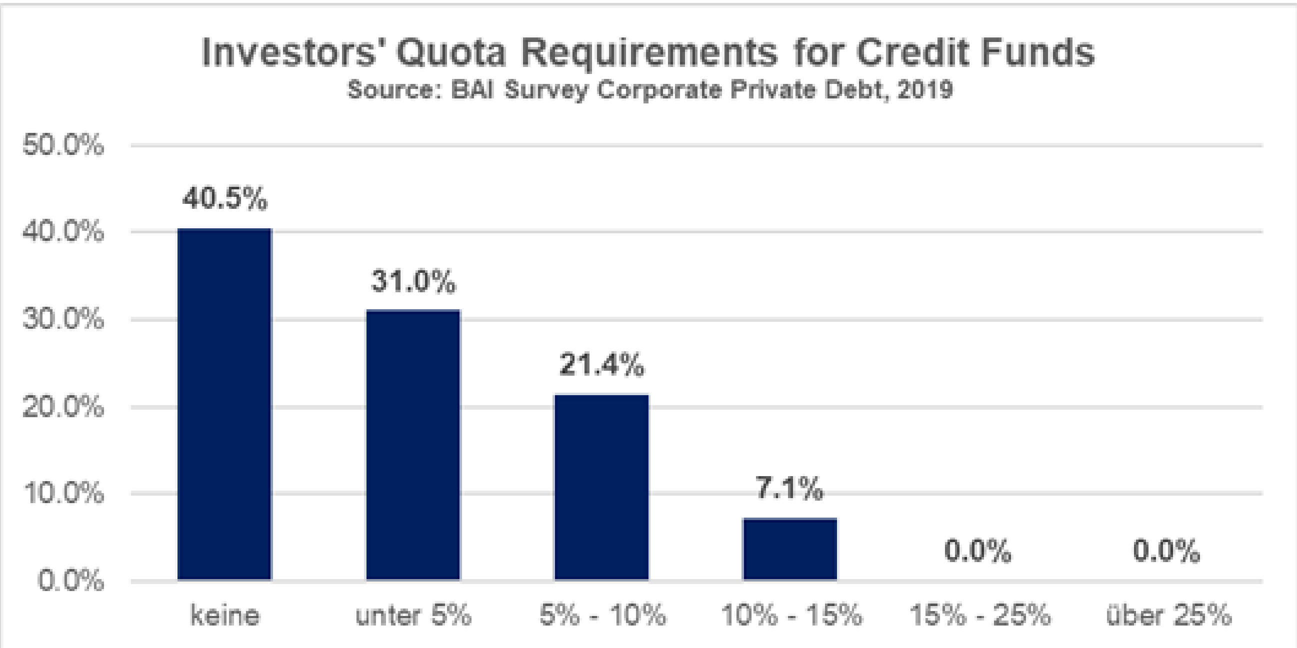


The main reason for institutional investors to engage in corporate lending is the good risk-return ratio. Corporate loan funds often serve as a substitute for bonds and are added to a portfolio for diversification reasons. Most investors already have many years of experience in the area of corporate loans and generally prefer individual funds to funds of funds.

For this reason around 80% of investors invest in more than 5 debt funds at a time. Preference is given to senior tranches and unitranches issued by debt funds that do not use leverage themselves. The borrowers need the loan primarily for a takeover or as growth financing. The contractual form of the credit agreement remains solely with the debt fund. Investors also place their trust in the asset managers when designing creditor protection clauses, but attach importance to a debt and interest cover ratio. More decisive for around two thirds of investors, however, are the costs of the fund, which may not be higher than 1% of the fund value, and the return (cash yield), which, due to the preferred choice of senior tranches and unitranches, should also be at least between 3% and 10%. Additionally, a steady and annual distribution is preferred, as is the case with bonds.



Most investors (around 40%) do not have a quota requirement for an investment in the corporate loan asset class. One third have a quota of less than 5% for allocation to debt funds, while one fifth have a target value of between 5% and 10%. 7% are willing to invest up to 15% of their managed assets in corporate debt funds.



Core Statements of the German Debt Fund Market

The three surveys among the various market players provide some key information on the German debt fund market:

	Investors	Credit Fund	Company/ Borrower
Core Results/ Assessment of the Survey	– Continuously distributing pension replacement with attractive yield and diversification potential as main reasons for investment in credit funds – Diversification potential of credit risk across several credit funds and number of borrowers – Expected cash yield mostly between 3 and 7% (p.a.) and thus more on the conservative side – Allocation quota partly not yet available, partly not yet reached – Investors' points of criticism mainly concern regulation (transparency principle and class allocation under AnlV)	– Still relatively few credit funds (around 35) dedicated among others to the German market (volume around EUR 17 billion) – Credit characteristics comparable with other European markets in terms of credit size, yields (mostly 5-7%), collateralisation (mostly 2 safeguard clauses), debtor leverage, maturities (mostly 5-7 years) and capital structure (senior and unitranche) despite above-average anchoring of the banking sector – Fund domicile predominantly in Luxembourg; only smaller credit funds with German domicile	– Typical German medium-sized businesses with established companies from all sectors, mostly in the sub-investment grade sector – In a European comparison, an above-average number of smaller companies as borrowers (EBITDA between EUR 5 and 25 million) in line with the German SME structure – Financing via credit funds is mainly used in growth, acquisition and particularly complex situations – There is great potential for growth, as the majority of loans are still granted by the house banks and by the owners

Outlook

The corporate private debt market in Germany will gain in breadth and depth in the future. Growth will not be continuous, but will continue to be volatile and will extend beyond the existing focus areas of acquisition and growth finance. Loans from debt funds not only replace bank loans, but in some cases also shareholder loans. Debt funds can play out their advantages particularly in the case of longer maturities, challenging business developments, and in the sub-investment grade area of German SMEs. On the other hand, a cooperation bank/debt fund can be very useful, especially in complex financing structures. Private equity funds will continue to play a certain role in the initiation and brokerage of loans in the future, as their involvement in SMEs will also remain stable; in addition to these sponsored deals, however, companies without PE participation will also continue to open up to this form of financing, especially if the level of awareness of debt funds continues to rise. The currently known volume of debt funds of around EUR 17 billion (source: Preqin) offers significant growth potential. Corporate Private Debt in Germany also offers competitive returns and collateral for investors. As a result, debt funds are an important enrichment for the financial centre and expand the financing opportunities of German SMEs to complement banks and other market-based forms of financing that are currently developing.

The complete study can be downloaded from BAI's homepage at www.bvai.de .

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