Filling the funding gap

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New regulations and capital adequacy requirements introduced following the global financial crisis are increasingly squeezing the bank lending that was once the life blood of many small to medium-sized companies (SMEs) operating in the UK and other markets.[1]

Under rules – such as the EU's Basel III capital requirements – banks can now be penalised for longer dated lending to smaller companies and face restrictions on the size of loans they can offer any single borrower.

These constraints – and their growing impact on SME funding – have prompted concern within the EU and from industry trade bodies such as the UK Federation of Small Businesses[2] and are encouraging the development of a number of alternative lending sources.

Supply shortage

Most recently, initiatives such as crowdfunding[3] and internet-based lending services have moved to fill gaps in this growing lending void. However, for the most part these remain small scale ventures, serving predominantly small companies and demand for loans continues to outstrip supply.

Commenting on the current market supply and demand picture for credit, Alcentra Chief Investment Officer, Paul Hatfield, says: "While we saw a modest increase in bank lending to SMEs in 2015 – driven partly by government pressure to support business – this has tended to form a relatively small part of overall loan packages and has mainly been channelled via very secure senior lending at the top of individual capital structures."

While European non-bank lending to corporates is growing fast, it currently contributes less than 20% of overall market share.[4] Given the US market is already closer to 70% non-bank funded[5], Hatfield sees significant scope for growth within this sector in Europe as the market matures.

"There is still a shortage of capital supply for SMEs across Europe which could present strong opportunities for investors in this area," he adds.

Alcentra is one of a growing number of investment management firms committed to direct lending and is helping to bridge the gap in supply of institutional debt capital.

Sound regulation

Assessing the outlook for the loans sector, Hatfield sees the UK and France as Alcentra's main European target markets, with growing opportunities in Germany and significant potential emerging in the Scandinavian region.

"We expect to see some very successful fund raising in the months ahead and there are many opportunities to put that money to work," he says. Hatfield believes investment in the credit sector is compelling against a backdrop of low yields, equity market volatility and the disappointing recent performance of many asset classes.

"In terms of benefits, investors are still in a low yield world where interest rates remain low but they may be able to achieve high single digit net returns by investing in loans. If you look at what has happened with other asset classes, investment in lending can offer an attractive risk/return ratio," he adds.

Assessing current risk levels, Hatfield says the loans market looks robust from a default perspective, with investors potentially benefiting from the current low interest rate environment.

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Commenting, he says: “It’s too early in the cycle to see any major increase in defaults, though we do see some potential stress building up in the oil and gas sector following the slump in energy prices. If interest rates do rise significantly in a few years this may drive market stress in these areas, but at the moment we’re not seeing any major defaults.”

Describing the specific risks facing Alcentra and its approach to risk management, he adds: “We know what we are getting into in terms of illiquidity and risk and we keep a very close track of our investments. We also have big credit teams to monitor our positions. Even if investments do start to get stressed we will roll up our sleeves, get involved and aim to work out any potential problems.”

In the current credit market, direct lending is proving the most attractive strategy, according to Hatfield, with strong demand for loans in both the US and Europe. Structured credit is also an area of increasing interest, with some investors accessing investments in this area via multi-strategy credit funds.

Multi-strategy solutions

Commenting on the growing appetite for these solutions, Hatfield says: “In recent months we have seen demand for multi-strategy credit solutions coming from a range of institutions. Typically, UK pension funds don’t tend to have cheap and easy access to alternative credit, so if they invest in a multi-strategy credit fund they can simplify the process, pay once and gain access to a special situations fund, a structured credit fund, a direct lending fund or a single multi strategy bundle. This saves scheme managers from having to pick several managers to invest in the different credit strategies available.”

Looking ahead, Hatfield says a number of factors are likely to influence the credit markets over the next 12-18 months. He points to likely impacts from the ongoing roll-out of Basel III regulations in 2016/17 and possible impacts of the US’s Dodd-Frank reforms such as the Volcker Rule[6] which could place further constraints on bank lending and speculative investment. In addition, he adds that the possibility of further quantitative easing by the European Central Bank could also create new demand if the ECB were to widen its buying activity to encompass a broader range of assets.

Despite much recent industry debate over US Federal Reserve interest rate policies, Hatfield remains unfazed by the prospect and feels a modest rate rise could actually benefit the non-bank lending sector.

“We expect to see only a marginal upward shift in rates, which is unlikely to make a massive difference to markets. Ultimately, it will be the pace of interest rate increases that will be important rather than the timing of the increase. However, once the market reaches the 1% level you get through the LIBOR floor levels on loans and they may become very attractive to investors.

“Either way, we see a very healthy pipeline for new business and expect to see a growing range of lending opportunities develop in 2016, against a backdrop of stable fees and returns,” he concludes.

Important Information

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1. Reuters: ‘European Union may ease bank capital rules to boost lending’, 15 July 2015.
2. Federation of Small Businesses press release: ‘FSB concerned new international banking rules could squeeze lending to SMEs’, 27 July 2015.
3. The Independent: ‘Small Talk: The crowdfunding industry has had three years of dramatic growth’, 27 April 2015.
4. Reuters: ‘In new trend, European fund firms become banks in all but name’, 27 May 2015.
5. Ibid.
6. The Wall Street Journal: ‘Volcker Bank-Risk Rule Set to Start With Little Fanfare’, 21 July 2015.