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The European Debt Fund Industry: Gaining Traction

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Management Summary

1.

Debt funds are gaining traction on Europe's financial markets, benefiting from the demand for more highly diversified funding arrangements outside the banking sector and from an environment of persistently low interest rates. In a growing number of EU member states (23 out of 28), investment funds are permitted to originate loans, while several European jurisdictions have even created a specific legal framework for debt funds. At the same time, bond yields have reached new all-time lows in many European countries. The resulting lack of high-yielding investment opportunities has intensified the search for yield, exerted downward pressure on credit spreads and supported asset prices in riskier market segments.

2.

The rapid growth of the European market for real estate debt funds – the annual fund volume increased from EUR 2.0bn in 2012 to EUR 9.6bn (2013) and EUR 14.9bn in 2014 – slowed down significantly in 2015 when new fund volume fell by more than half to EUR 6.8bn. There are, however, signs that indicate a more positive development in 2016. Between January and August 2016, European real estate debt funds with a total volume of EUR 5.4bn were placed. Meanwhile, the US market for real estate debt funds is still far larger and more mature, with a cumulative total volume of EUR 190.6bn for the years 2007 to 2015 (Europe: EUR 47.4bn).

3.

In contrast, the European market for infrastructure debt funds has developed more dynamically than its US counterpart in the first eight months of the year. By the end of August, debt funds with a total volume of EUR 6.5bn have been registered (US: EUR 4.1bn), more than in the market's record year 2014 (EUR 5.9bn). In terms of their cumulative volumes, the markets for infrastructure debt funds in the US and Europe are at the same level: new funds with a total volume of EUR 16.6bn were placed on either side of the Atlantic in the years between 2007 and 2015.

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The European market for direct lending funds appears to resume its upward trend from previous years, following a relatively weak 2015 (EUR 9.2bn). With a volume of EUR 10.1bn for the first eight months of the year, Europe has already exceeded the total volume of 2015. The US market for direct lending funds continues to grow from strength to strength, having reached a volume of EUR 25.8bn by the end of August.

5.

The available data suggest that debt funds continue to provide favorable returns. Direct lending funds that were issued in 2009 may have generated a net internal rate of return of 13.0% (on average), but newer funds – issued in 2013 – held up rather well with an average IRR of 7.1%. The returns of real estate debt funds that were issued in 2013 (9.1%) were slightly lower than those for the previous year's vintage (10.3%), but still outperformed direct lending funds and infrastructure funds. In contrast to the other two asset classes, returns for 2013 issues of infrastructure funds, were largely able to hold their ground in comparison with previous years' levels (2013: 8.6%, 2011: 8.0%).

6.

While we believe that the US market will remain the epicenter of the debt fund industry, we are optimistic about Europe's potential role as a driving force for the industry's growth. In the medium term, this growth of the debt fund industry should not only benefit from the catch-up potential, but also from political decisions on the EU-level and the interest rate environment.

7.

Whether or not debt funds will establish themselves as a funding source for the long-term financing of Europe's real economy will – in our view – largely be determined by the shape of the regulatory environment that the debt fund market will face in the future. Too many regulations, requirements and restrictions could cause disproportionately high costs and stifle the growth of this young segment of the European financial market. Such an approach would

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be counterproductive, thwarting the original intention of European policy makers to encourage the development of alternative financing instruments outside the banking sector.

1. Supportive regulatory and financial developments

Debt funds are playing an increasingly important role on Europe's financial markets, benefiting from the demand for more highly diversified funding arrangements outside the banking sector, an environment of persistently low interest rates and the resulting lack of high-yielding investment opportunities.

Institutional investors and funds can use these instruments to invest in loans that are funding companies, real estate or infrastructure projects. Debt funds – as we already briefly explained – invest in largely illiquid and non-tradable loans or assets, or they may originate loans on their own account. Debt funds are financed through equity (shares) or the issue of debt instruments (see also *Creditreform Rating, Debt Funds in Europe – Buoyant Growth in a Nascent Market, August 2015*). No standardized structural design of these debt funds has so far emerged, but two characteristics distinguish debt funds from (structurally similar) product alternatives such as securitizations: (i) the number of assets in which a debt fund invests is in general significantly smaller than in an ABS pool, and (ii) there is no slicing into tranches in a debt fund structure, i.e. there is no waterfall structure.

The European Commission has also recognized that debt funds may develop into a funding source for long-term investments into the European infrastructure and business financing. In light of this, the Commission has adopted several regulations with a view to enabling such funds to originate loans, including the Regulation on European Venture Capital Funds (EuVECA Regulation no. 345/2013), the Regulation on European Social Entrepreneurship Funds (EuSEF Regulation no. 346/2013), and the Regulation on European Long-Term Investment Funds (ELTIF Regulation no. 2015/760).

In a growing number of EU member states (23 of 28), investment funds are allowed to originate loans. Several European jurisdictions have even created a specific framework that outlines legal foundations and rules concerning the loan origination by funds (Cyprus, France, Germany, Ireland, Italy, Malta, Poland, Slovenia, and Spain). In Germany, for example, the Implementation Act for the UCITS Directive (2014/91/EU of the European Parliament and Council from 23 July 2014) provided the legal framework for origination of loans by alternative investment funds, after the financial supervisory authority BaFin had approved the right of capital management companies to act as direct lenders in May 2015. On 3 March 2016, the German Parliament (the Bundestag) amended the Capital Investment Code (KAGB) and the Banking Act (KWG), specifying conditions for the legitimacy of loan agreements in which alternative investment funds act as lenders and ensuring that the pertinent regulations of the law explicitly refer to the origination of loans.

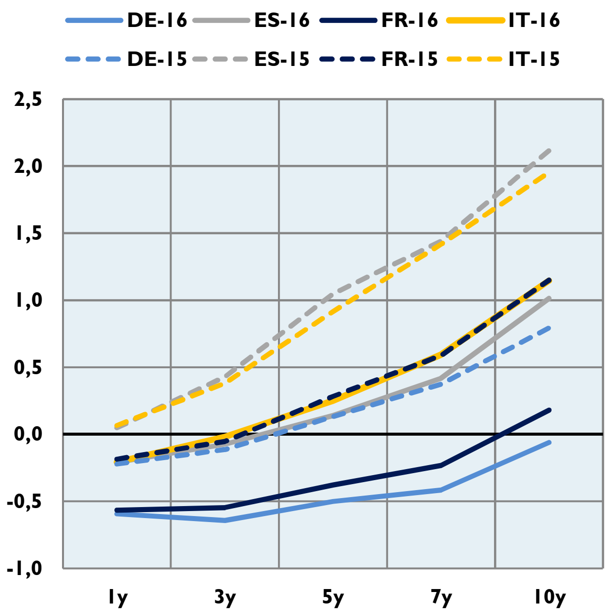
At the same time, interest rates have remained at an extremely low level. Having demonstrated an overall fairly high level of resilience, the international financial markets have nevertheless experienced bouts of turbulence as a result of monetary policy decisions and surprising events such as the UK referendum on EU membership. Faced with a growing skepticism about the growth perspectives of the global economy and repeated bouts of asset market volatility, the main central banks have acted cautiously. While the Federal Reserve raised the fed funds rate slightly, the Swiss National Bank decided to keep its interest rate unchanged. In contrast, the European Central Bank (ECB), the Bank of Japan and the Bank of

England announced further expansionary monetary policy measures. The ECB lowered the reference rates and implemented a new series of targeted longer-term refinancing operations (TLTROs-II). In particular, the ECB decided to expand its Asset Purchase Programme (APP) from a monthly volume of EUR 60 to 80bn and extend the programme to (at least) March 2017. Under the newly implemented CSPP, the Corporate Sector Purchase Programme, corporate bonds issued by non-financial corporations are eligible for asset purchases (see Chapter 4). Negative nominal policy rates now prevail in the euro area as well as in Sweden, Japan and Switzerland.

At the same time, bond yields have reached new all-time lows in many European countries and the share of outstanding government bonds with negative yields is at an all-time high. Even accounting for the latest slight rise of the risk premia, bond yields are currently lower than they were twelve months ago. Thus, many European sovereign yield curves continued to decline and have flattened (see Fig. 1). In late August 2015, three-year and one-year German Bunds recorded negative yields. One year later, these papers have been joined by German Bunds with a residual maturity of up to ten years. On 31 August 2016, ten-year Bunds had a yield of -0.061%, down from 0.794% one year earlier. Ten-year government bond yields in Japan and Switzerland also fell into negative territory. The yields for long-term bonds of other EU countries have remained positive, but also declined significantly over the past twelve months, with the Bund spread narrowing. In late August 2016, the French yield curve had also largely entered the area of negative rates, while ten-year bonds from Spain and Italy had lost 110 and 81 basis points respectively, generating yields of 1.014 and 1.145%.

Fig. 1: Development of sovereign yield curves in Europe

In %, yield curves as per 31 August 2015 and 2016, respectively



Source: Thomson Reuters, Creditreform Rating

The subsequent search for yield has boosted the market for riskier investments and exerted downward pressure on credit spreads, e.g. the spreads of bonds issued by non-financials domiciled in the euro area narrowed significantly – independently from their credit ratings.

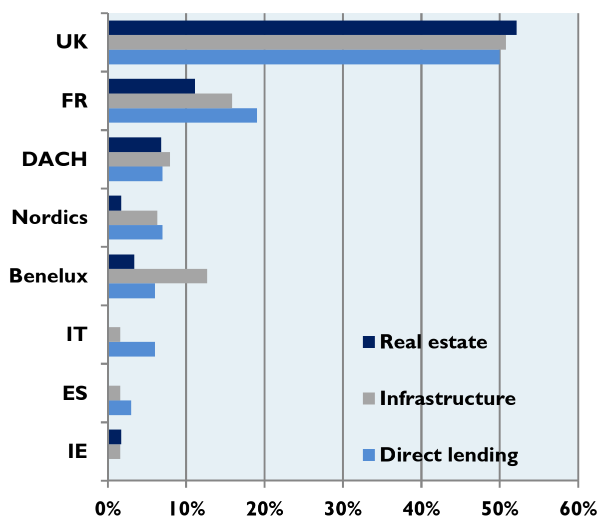
In principle, debt funds are benefiting from the current interest rate environment and the search for yield. While institutional investors such as insurance companies and pension funds may profit from new yield opportunities in the current low-interest environment, banks can – in view of increasing regulatory restrictions – decide to sell their loan portfolio and release regulatory capital. Managers of alternative investment funds, meanwhile, may explore new business potentials.

Having said this, European debt funds are heavily concentrated in a relatively small number of countries, as measured by the domicile of the fund manager (see Fig. 2). Roughly half of all European debt funds are domiciled in the UK: 50.0% of direct lending funds, 50.8% of infrastructure funds, and 52.1% of real estate funds – making the UK the most important market for debt funds in Europe. France follows far behind in second place (with 11.1% of all European real estate debt funds and 19.0% of direct lending funds). The DACH countries (Germany, Austria and Switzerland) only account for 6.8 to 7.9% of those funds.

It seems uncertain whether and to what extent the impending exit of the UK from the European Union will have a significant impact on the fund industry's choice of domicile. Ultimately, this may be determined by the extent to which a non-EU Britain will remain able to benefit from the European Union's free movement of capital, but also by the extent to which debt funds will be regulated in a then independent UK.

Fig. 2: Where European debt fund managers are domiciled

Share of debt funds as a percentage of total European debt funds, by domicile of fund manager, as per 31 August 2016.



Source: Creditreform Rating

In the following, we would like to present the updated results of last year's study of the development of the market and the performance of debt funds, identifying the key trends in the three asset classes (real estate, infrastructure and direct lending/corporate) and contrasting this development with the corresponding trends from the US market. For this purpose, we have followed an inductive and explorative approach, gathering all available information about the European market for debt funds in order to cast a spotlight on the most striking developments. The calculations of Creditreform Rating are based on Preqin data and our own market research. Creditreform Rating continuously monitors the market development in this segment, as we carry out analyses of existing, future and contingent risks on the various levels of debt fund structures and issue ratings on a large number of financial instruments that are related to debt funds.

2. Market developments in Europe and the United States

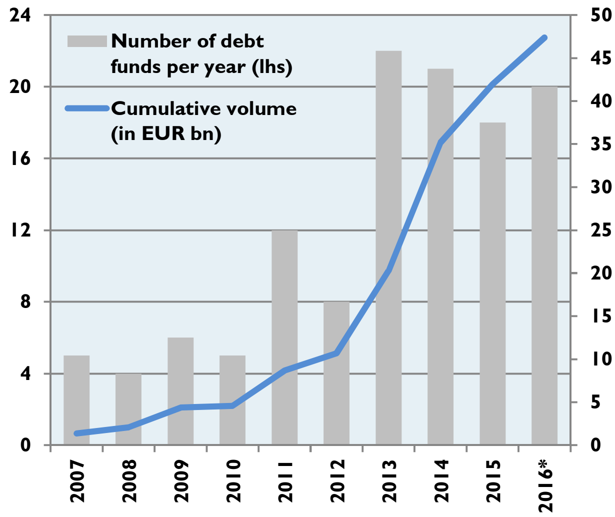
Between 2007 and 2010, the market for European real estate debt funds grew at a moderate pace (see Fig. 3). During this period, between four and six new debt funds were established per year and the newly placed funds' total volume grew by EUR 0.2 to 2.3bn per year. It was only in 2013 when the pace accelerated significantly, the annual volume growing five-fold from EUR 2.0 to 9.6bn, while the number of newly established funds increased from 8 in the previous year to 23. Since then, the number of new funds has decreased (21 in 2014, 18 in 2015), and their total volume fell even more steeply. The 2015 volume of new funds (EUR 6.8bn) did not even reach half the previous year's level (2014: EUR 14.9bn).

There are, however, signs for an upturn in 2016. Most remarkable is the number of newly established real estate debt funds: 20 funds have been newly placed from January to August 2016, more than in the entire year 2015 (18). The volumes, too, appear to be on the rise once again.

In the first eight months of the year, European real estate debt funds with a total volume of EUR 5.4bn have been placed, only slightly less than during the whole of 2015 (EUR 6.8bn).

Fig. 3: Real estate debt funds in Europe

Cumulative volume in EUR billion, including placed funds and funds in the placement stage, *) YTD (31 August 2016)



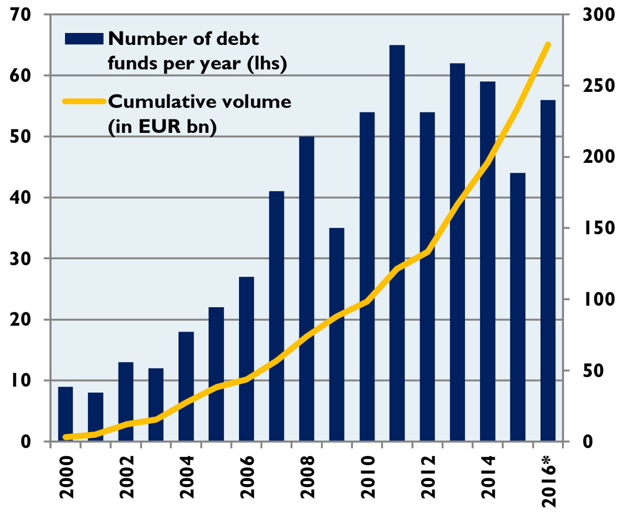
Source: Creditreform Rating

The US market for real estate debt funds is significantly larger and more mature than its European counterpart. While the total cumulative volume of European funds for the years 2007 to 2015 reached EUR 47.4bn, the US figure of EUR 190.6bn was roughly four times as high. However, the growth rate for this period was higher in Europe.

Moreover, in contrast to the European market, the US market for real estate debt funds has been able to maintain its momentum in 2015 (see Fig. 4). Last year's volume of newly established funds in this asset class amounted to EUR 38.1bn, an increase of 30% from 2014 (EUR 29.3bn) and a new all-time high. Hence, the market volume has increased nearly three-fold since 2007 (EUR 13.0bn). The number of newly established funds, meanwhile, has not risen quite as sharply and consistently. After 65 new funds were set up in 2011, this number has fallen, with 2015 (44) reaching the level of 2007 (41).

Fig. 4: Real estate debt funds in the US

Cumulative volume in EUR billion, including placed funds and funds in the placement stage, *) YTD (31 August 2016)



Source: Creditreform Rating

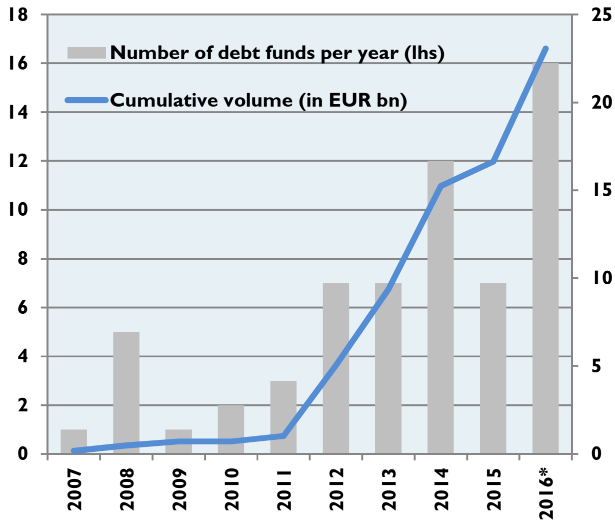
Data for the current year suggest that the robust upward trend on the market for US real estate debt funds is set to continue. Over the first eight months, the business year 2016 has already managed to exceed the previous year's totals for the number of newly established funds and their volume (2016 year-to-date: 56 new funds with a total volume of EUR 44.5bn). For the second consecutive year, a new all-time high volume of new funds seems within reach.

For many years, the market segment of European infrastructure debt funds seemed to be characterized by a fairly sluggish growth. Between 2007 and 2011, the number of newly established European funds grew at a slow pace (in the low single-digit area), while the total volumes of these funds did not exceed the threshold of EUR 300m in any single year. In 2012, however, the growth rate skyrocketed (see Fig. 5), and in the three following years, the cumulative volume increased more than three-fold from EUR 5.1 to 15.2bn

(2014), while the annual number of newly established funds rose to twelve (2014). This momentum, however, has more recently been lost. In 2015, both the number of newly established funds (7) and their volume (EUR 1.4bn) failed to match the previous year's levels.

Fig. 5: Infrastructure debt funds in Europe

Cumulative volume in EUR billion, including placed funds and funds in the placement stage, *) YTD (31 August 2016)



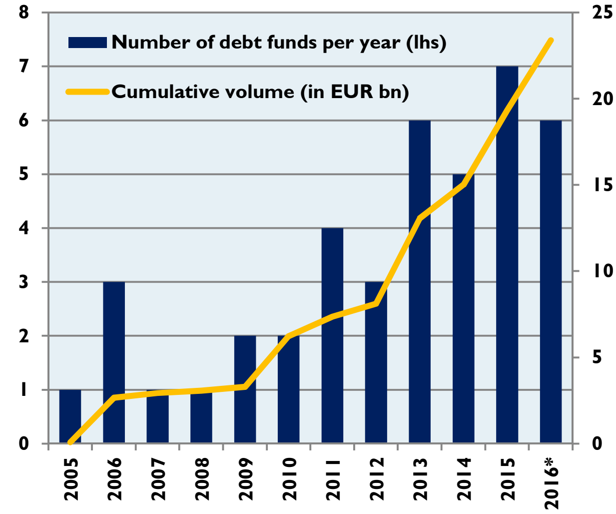
Source: Creditreform Rating

In contrast to the situation on the markets for real estate debt funds, the European market for infrastructure debt funds is of roughly even size to its US counterpart. Even though the US market had reached a volume of EUR 3bn before 2007, the volume of newly placed funds on either side of the Atlantic amounted to a level of EUR 16.6bn since then.

Over the past five years, the US market has also shown a dynamic growth momentum (see Fig. 6). Whereas only two new debt funds were established in 2009, this number rose steadily from four (2011) to seven in 2015. The total volume of new funds in 2015 (EUR 4.3bn) also more than doubled the previous year's volume (EUR 2.0bn) and almost reached the all-time high from the year 2013 (EUR 4.9bn).

Fig. 6: Infrastructure debt funds in the US

Cumulative volume in EUR billion, including placed funds and funds in the placement stage, *) YTD (31 August 2016)



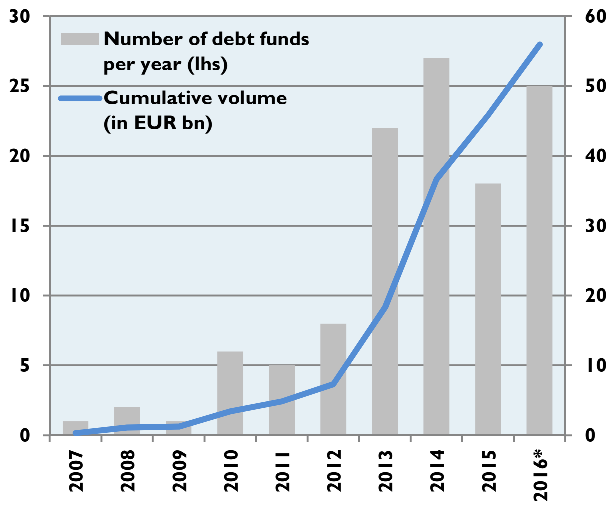
Source: Creditreform Rating

In the first eight months of 2016, the European market for infrastructure funds has grown faster than the US market. Between January and August, 16 funds with a total volume of EUR 6.5bn were set up in Europe, beating the market's all-time high from 2014 (EUR 5.9bn). The US market for infrastructure debt funds also advanced well, though showing much weaker growth over the same period. This year's levels of newly established funds (6) and the fund volume (EUR 4.1bn) have not yet reached the previous year's levels. By the end of the year, however, the figures from 2015 may still be reached or even exceeded.

What is striking is the small size of the debt fund market investing in infrastructure projects as compared to other asset classes. Thus, the total volume of the European market for infrastructure debt funds in 2015 was equivalent to little more than one fifth (20.6%) of the market for real estate debt funds. The cumulative volume of real estate funds (as per the end of August 2016) was twice as large as the cumulative volume of the market for infrastructure projects. In the US, the gap between the two asset classes is even wider: here, the infrastructure market accounts for merely one tenth of the volume of real estate debt funds.

Fig. 7: Direct lending funds in Europe

Cumulative volume in EUR billion, including placed funds and funds in the placement stage, *) YTD (31 August 2016)



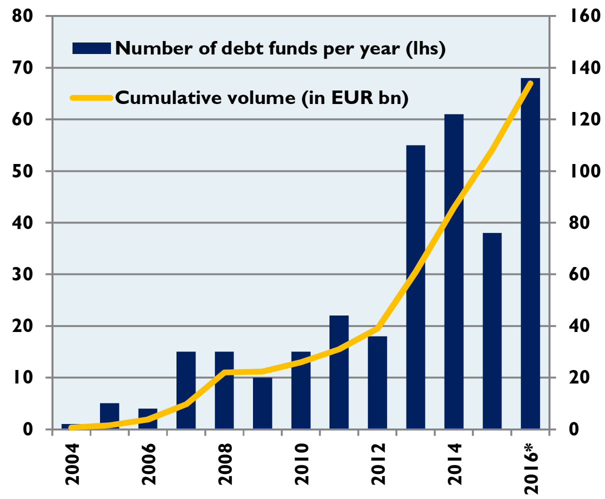
Source: Creditreform Rating

Turning to direct lending, the US market for direct lending debt funds is larger and more mature than its European counterpart (for a comparison of cumulative volumes, see Fig. 7 and Fig. 8). Since 2006, direct lending funds with a total volume of EUR 132.3bn have been placed in the United States, more than twice as much as in Europe during the same period (EUR 56.2bn). This discrepancy reflects the fact that the US financial system is more market-based, but it also must be taken into account that direct lending funds have been established several years earlier on the US capital market. Between 2006 and 2009, 44 direct lending debt funds have already been placed in the US – only four in Europe. However, the European market for direct lending debt funds has experienced dynamic growth over the past few years, specifically in 2013 and 2014 when (in total) 49 new funds with a volume of EUR 29.3bn were established. This more than doubled the total number of new funds from the period between 2006 and 2012 (24), while the total volume of the new funds was almost four times higher (2006-2012: EUR 7.6bn).

Following a relatively poor 2015 (new funds with a total volume of EUR 9.2bn), the European market for direct lending funds has shown signs of recovery in 2016 and may regain some of its previous growth momentum. From January to August 2016, 25 new funds were established in Europe, already more than for the whole of 2015 (18). Thus, it seems possible that the all-time high from 2014 (27) will be reached by the end of the year. In terms of their volume, too, the newly established funds (EUR 10.1bn) have already improved last year's mark of EUR 9.2bn.

Fig. 8: Direct lending funds in the US

Cumulative volume in EUR billion, including placed funds and funds in the placement stage, *) YTD (31 August 2016)



Source: Creditreform Rating

The US direct lending market appears equally robust. In the first eight months of the year, new funds with a total volume of EUR 25.8bn have been placed, exceeding the threshold of EUR 20bn for the fourth consecutive year. Equally striking is the growth in the number of new funds: with 68 funds, the year-to-date number (end of

August) is already significantly higher than the total for the entire year 2015 (38).

3. Debt fund performance

One of the key metrics regarding the debt fund performance is the so-called net internal rate of return (the net IRR). The net IRR indicates the return minus fee and capital costs which an investor may expect from his investment within a specific period of time, based on past and expected future cash flows. In this context, it should be noted that this return analysis is based on a relatively small sample of debt funds with a fairly heterogeneous portfolio structure.

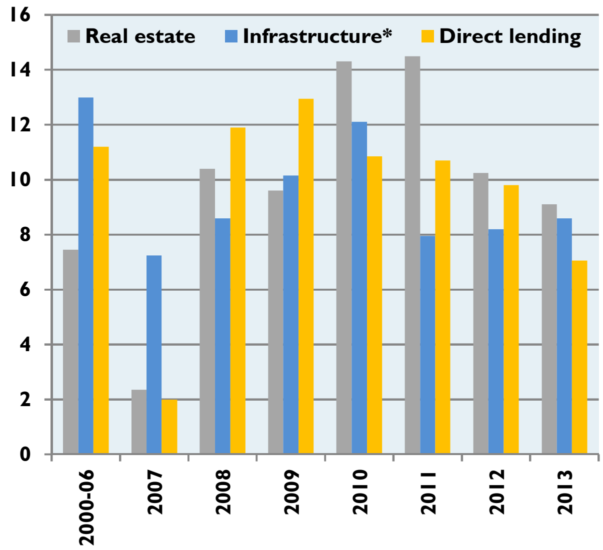
The performances of debt funds from different years of issue have evolved quite differently over the past few years. More recently placed direct lending debt funds, for example, tend to generate lower returns than their predecessors. While direct lending funds from the year 2009 reported an average net IRR of 13.0%, the returns fell for funds from each following year (see Fig. 9): to 10.9% (vintage 2010) via 9.8% (2012) and 7.1% (2013).

Between 2007 and 2011, the net IRR of real estate debt funds grew steadily from 2.4% (vintage 2007) to 14.5% (2011), but fell back more recently to 9.1% (2013). Nevertheless, real estate debt funds from 2013 continued to outperform the same year's infrastructure and direct lending funds, even though the gap between these asset classes was smaller than for the years 2010/2011.

Infrastructure funds underwent a fairly stable development. While the net IRR of newly established funds has recently been significantly lower than the net IRR of funds from earlier in the decade (2000-06: 13.0%), funds from recent years – in contrast to the development of recently established direct lending and real estate debt funds – did not experience falling returns. Thus, the net IRR of funds from 2013 (8.6%) slightly exceeded the level from the year 2011 (8.0%).

Fig. 9: Debt fund performance according to asset class

Median net IRR for debt funds that were established in the respective years, in %, *) Investment strategies: debt, primary, secondaries



Source: Creditreform Rating

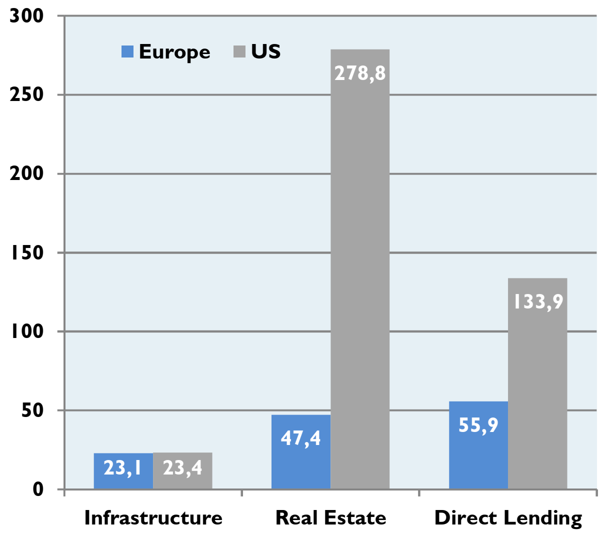
4. Outlook

While we believe that the US market will remain the epicenter of the debt fund industry, we are confident that Europe will realize its potential as a driving force for the industry's growth. While the infrastructure debt fund markets on both sides of the Atlantic may be of similar size, the enormous leads of the US markets in the asset classes real estate and direct lending provide significant catch-up opportunities for Europe (see Fig. 10).

We therefore expect the development of the European debt fund market to maintain its current momentum, with high year-on-year growth rates of the fund volumes. In the medium term, this growth of the debt fund industry should not only benefit from the catch-up potential but also from political decisions on the EU-level and the interest rate environment.

Fig. 10: Size of the debt fund markets in Europe and the United States

Total volume in EUR billion, including placed and outplaced debt funds and funds in the placement stage, year-to-date (31 August 2016)

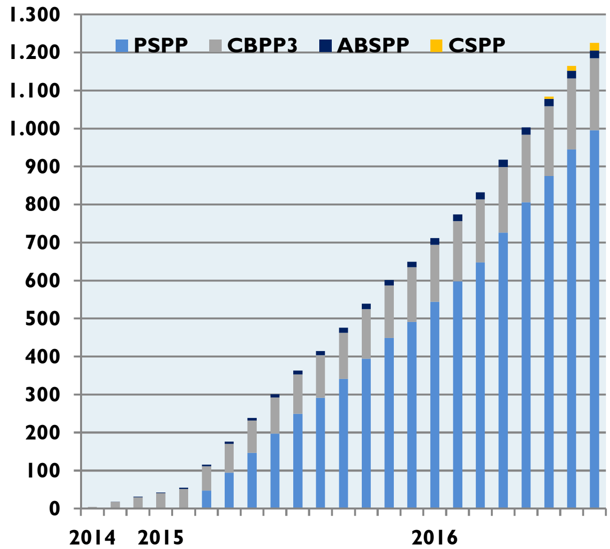


Source: Creditreform Rating

Following its meeting on 8 September 2016, the ECB decided to keep the key interest rates unchanged on their current low levels. More importantly, the ECB's Governing Council stated that it expects the key interest rates to remain at present or lower levels for an extended period of time, well past the horizon of the Eurosystem's net asset purchases. The monthly asset purchases of EUR 80bn are intended to run at least until March 2017, which should – either directly or through spill-over effects – exert downward pressure on interest rates and spreads across the board. By 31 August, the Eurosystem has purchased assets with a total volume of EUR 1,225.6bn (see Fig. 11), with the Public Sector Purchase Programme (PSPP), i.e. the acquisition of government bonds, accounting for the lion's share (EUR 995.4bn or 81.2%). On 8 June, the ECB started to purchase corporate bonds of non-financial issuers (under the CSPP) in order to improve the financing conditions in the real economy. By the end of August, the ECB had acquired corporate bonds with a total volume of EUR 19.9bn. Although the corporate bond market is generally less liquid than the market for government bonds, the CSPP had a significant impact on the market spreads. That said, the announcement in March alone resulted in a significant contraction of corporate bond spreads.

Fig. 11: Development of the Asset Purchase Programme

Breakdown of the Eurosystem holdings under the expanded asset purchase programme, cumulative purchases in EUR billion, as per end of month



Source: ECB, Creditreform Rating

The generally good perspectives for debt funds are further brightened up by the efforts of the EU Commission to support the development of alternative funding instruments (outside the banking industry) for small and medium-sized enterprises as well as infrastructure projects.

These political ambitions have been confirmed by the Commission's Action Plan on Building a Capital Markets Union that was released in September 2015 (see European Commission, COM(2015) 468 final). In this Action Plan, the Commission concludes that loan-originating funds operating cross-border must currently comply with different national requirements. The Commission expresses its intention of evaluating – in close cooperation with the European supervision authorities (EBA, ESMA, EIOPA) and the EU member states – whether there is a need for a coordinated approach for implementing a EU framework of rules and regulations for debt funds.

Whether or not debt funds will establish themselves as a funding source for the long term financing of Europe's real economy will – in our view – largely be determined by the EU's ability of demonstrating a sense of proportion when developing such a regulatory framework. In other words: there is a risk that the EU will throw the baby out with the bath water.

The Opinion released in April by the European Securities and Markets Authority (ESMA/2016/596) may indicate in which direction the EU is moving. In its paper, the European supervisory body favors common regulations for EU debt funds and outlines basic principles of an EU-wide regulatory framework. ESMA believes that such regulations will be required to mitigate the debt funds' inherent systemic risks and to reduce the potential for regulatory arbitrage. ESMA proposes that only closed-ended funds should be permitted to originate loans and that debt funds as well as fund managers should require a special authorization. ESMA also specifies a range of additional requirements for the risk management system of AIF managers and demands certain restrictions in terms of maturity and leverage, while also listing eligibility criteria for debtors and investments.

From our point of view, a coordinated approach must generally be welcomed, since the current absence of standardized and comprehensive guidelines and requirements for debt funds means that these funds operate under a wide range of different regulations across Europe. The creation of a level playing field through the provision of standardized rules might very well benefit the further development of the market.

Any prediction on what scale, in which level of detail and with which results the EU will regulate European debt funds is surrounded by a high degree of uncertainty. It is important, however, that any such move to regulate the market will not be overly restrictive. To be sure, an EU-wide regulatory framework may very well make it easier for funds in some EU countries to originate loans. However, an excessive amount of requirements and restrictions will only serve to burden the market players with disproportionate costs and stifle the growth of this young segment of the European market. Ultimately, such an approach would be counterproductive, thwarting the original intention of European policy makers.

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