Boutique credit

A quiet champion of the real economy

by Louis Gargour, founder, LNG Capital

The disintermediation of bank lending has been a key feature of the financial landscape in the aftermath of the financial crisis, writes LNG Capital founder Louis Gargour. Encouraged by regulators, banks have retrenched, restricting their lending to only the largest and highest-quality opportunities, leaving smaller companies without access to traditional funding sources. This funding vacuum has quickly been filled by alternative lenders, led by large credit hedge funds, a trend that has been widely reported by the financial media. However, less attention has been paid to the emergence of smaller boutique players, who are taking advantage of this new financial landscape.

The extreme prudence of banks has created space for large credit funds to move in and identify opportunities slightly outside banks' risk parameters. Lending opportunities between £20m and £100m ($26m-$129m) are too insignificant for banks in the current climate, but this segment presents a sizeable market for large credit funds to exploit. At the lower end of the scale, a similar dynamic has emerged. Companies below £20m ($26m) are deemed too small to warrant further investigation by both banks and large funds, thereby creating an interesting space for boutique credit managers.

The lack of appetite from major institutions does not automatically indicate that these smaller deals are inherently risky, but simply that they cannot generate the volume of return required by such huge organisations. Indeed, at this level, there is a plethora of opportunities for skilled boutique managers to identify and fund quality businesses that play a vital role in the economy.

As a result, boutique managers are able to lend at very favourable rates, and have the ability to demand very generous terms. These managers can set the penalties for breaches of covenants and non-payment, demand preferential positions in the capital structure and rights over cashflows, and select which assets a company must pledge. This way, managers can significantly limit their downside risk. Also, when good opportunities present themselves, boutique managers can negotiate equity upside, meaning if the company does well they benefit from that success via an increased rate of return.

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However, the companies themselves also benefit from these agreements. Starved of traditional financing, many have been forced to turn to expensive alternative funding sources. At LNG Capital, we work with a car-leasing firm that previously sourced its funding from expensive peer-to-peer lenders. We liked the business, and offered them a more competitive deal that still provided us with an attractive rate – but, on top of this, we negotiated an equity kicker. The lower interest rate we provide has supported the company's investment in growth, and through our equity interest in the business, we have further benefited from their success.

Nevertheless, it remains vital for boutique managers to select their investments carefully. Picking suitable jurisdictions for investment remains a prerequisite. Northern European countries provide a good level of security for investors, with their strong rule of law and effective court systems, meaning there are standard systems for timely legal recourse if a lender is not repaid. In contrast, Southern European countries represent a far greater risk for credit managers, as their legal systems are convoluted and can result in lengthy delays and less satisfactory outcomes.

When picking sectors, boutique managers should look for industries where businesses have tangible assets, such as plants and equipment, that can be used as collateral and where the value of those assets is greater than the size of the loan. At LNG, we've found success lending to food and beverage producers and a German commercial property company.

The symbiotic nature of these relationships frequently stretches further. Often the lending requirements of these businesses correspond well to the time horizons of credit funds. Unlike distressed lending, many of these investments have a two-to-three year duration, which places a boutique fund manager with a three-to-four year time horizon in a good position to lend money. The current environment presents boutique managers with the chance to create relationships with a range of businesses who are vital for the economy, but it also represents a meaningful new way to generate alpha.

PE firms also bring corporate governance, reporting and due diligence to the investment process," explains Shea. "Meanwhile, in a sponsorless debt fund, the manager needs the skills and resources to contribute these features themselves to ensure high quality deal sourcing, sifting, execution and portfolio management."

Picking your spot

Some managers have tried to further differentiate themselves by becoming experts in their home markets. Managers often talk of understanding the culture of business managers and borrowers in local markets, particularly if a fund wants to source loans without private equity backers.

One such manager is Resilience Partners, a Spain-focused SME lender which printed its first deal in November last year. The firm was launched by former 3i Spain duo Adriana Oller and Agustin Pla, to help finance Spanish performing firms. Resilience follows a path trodden by Oquendo Capital, a similar Spain-focused direct lender which focuses on small to medium-sized borrowers.

However, larger lenders aren't oblivious to this. BlackRock recently hired a French direct lending head in Paris, while Paris-headquartered Tikehau Capital is planning Italian and Spanish offices as part of its expansion plans.

However, there are difficulties in some other jurisdictions. For example, despite a valiant effort from the likes of Prometheus, the direct lending market in the Nordic region is limited. Corporate finance is supported by a strong banking sector, with only limited opportunities for mezzanine lending.

Frankfurt-based Robus Partners has developed a strong local pipeline for its fund in Germany, which has been a notoriously difficult market for global managers to enter.

"If you really want to do business with German companies, you have to structure the loans to the companies and the funds for the investors differently," Robus' managing director Dieter Kaiser says.

"We focus on non-sponsor-backed companies and mainly discuss short- to mid-term financing solutions," Kaiser explains. "You need a different kind of sourcing channel for these companies, as unlike private equity houses, these companies don't know much about private debt funds. Most of our negotiations take place in German, and we also do not have problems with German language loan documentation."

Sector specialists

Industry focuses are also a way for managers to set themselves apart from the crowd. IPF Partners, for example, focuses on lending to healthcare companies. This allows them to have

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