Creditreform Rating

# Catching up to the US?

## Private debt is driving the dynamic European debt fund market


Financial Research
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## Management Summary

### 1.

The brisk demand for alternative financing solutions shows no signs of abating, which is why the conditions for debt funds remain good and why their pace of growth has further accelerated since 2013. Driven mainly by the expansion of the direct lending funds segment, the total volume of European debt funds crossed the 100bn Euro-mark for the first time in 2016, reaching EUR 121.1bn by the year's end and EUR 144.4bn at mid-2017. The market for European debt funds had a good year in 2016, with a widening gap between the asset classes real estate and direct lending. While the cumulative volume of direct lending funds grew by EUR 13.6bn to EUR 54.3bn in 2016, the volume of real estate funds increased by EUR 8.9bn to EUR 47.4bn. Volumes of European infrastructure funds also reached new all-time highs in 2016.

### 2.

In the USA, direct lending funds were also able to maintain their growth momentum – their total volume increased from EUR 89.8bn in 2015 to EUR 105.2bn one year later. As a consequence, this asset class increased its relative importance on the US market, too. In contrast to the developments in Europe, however, US direct lending funds have not been able to threaten the market dominance of real estate funds. In 2016, real estate funds in the United States had a total volume of EUR 227.2bn, more than two times as high as direct lending funds.

### 3.

Comparisons between the investment patterns of US and European debt funds reveal similarities as well as differences. The energy industry, for example, is the preferred sector in which infrastructure funds on both sides of the Atlantic invest. Direct lending funds, meanwhile, scatter their investments over a much wider range of industries, both in the US and in Europe. While European real estate funds favor residential properties, their US peers show a preference for commercial real estate.

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4.

Our performance analysis demonstrates that the yields of newly issued infrastructure funds (from the years 2013 and 2014) were slightly higher than the yields of previous years' issues, reversing an earlier trend, while the net IRR of recent real estate debt funds continued to fall. The returns of recently issued direct lending funds have stagnated over the past few years.

5.

The US-debt fund market is significantly larger and more mature than its European counterpart. European fund volumes struggled for a while to keep up with the development of their transatlantic peers, but over the recent past, we have observed that the European market appears to be catching up. The catch-up process in the market for direct lending funds started earlier than in the other segments, having reached roughly one seventh of the US market's volume already by 2010. According to the latest figures, European direct lending funds account for approximately half of the volume of their American counterparts. European infrastructure funds, conversely, continued to lag behind the development of their transatlantic counterparts for several years (2007-2010), but have since made up for their initially slow pace of growth. In 2016, their total volume accounted for roughly 75 percent of the US market's volume. European real estate funds were also able to reduce the lead of the US market, albeit less significantly so: in 2016, the total volume of the European market still accounted for only 20 percent of the market on the far side of the Atlantic.

6.

Whether or not European debt funds will be able to maintain their growth momentum will mainly depend on regulatory decisions and monetary policies. In the medium to long term, the pan-European development of debt funds – a relatively young market segment – will confront the regulatory authorities with challenges. Europe's current regulatory environment still features a wide range of different national regimes. Meanwhile, there are few indications for a radical change in the ECB's monetary policy stance and for a significant rise in interest rates. Having said that, we do not believe that a change of the ECB's current course and a slow, gradual rise of interest rates would cause severe problems for the debt fund industry. Although such a rise in the interest rate would serve to make other financial instruments more competitive, we expect structural factors on both the supply and the demand side to support a sustained development of debt funds as an important element of the European refinancing markets.

## 1. Alternative financing solutions remain attractive

Institutional investors and funds can use debt funds to invest in loans that are funding companies, property 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 generally 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 debt fund market continues to grow in importance. This is also reflected by the decision of the International Organization of Securities Commissions (IOSCO) to subject debt funds to a closer examination. By conducting a global survey among the members of the Committee on Investment Management, IOSCO managed to gain an overview of the different experiences that the various jurisdictions have acquired with debt funds. In its report, IOSCO concludes that debt funds are a relatively new instrument in an early stage of development. Even in the US, where a permission to operate debt funds has been in effect for some time, debt funds still represented a "niche market". The report also points out that debt funds have so far been almost entirely ignored by some of the world's leading financial markets including Hong Kong, Switzerland and Singapore. On the other hand, the markets in certain European jurisdictions such as Belgium, Germany, Italy, Luxembourg, Portugal, and the UK, have come to see debt funds as a viable alternative to bank loans.

In terms of the total volume of assets under management, debt funds are still fairly small as compared to the total European investment fund universe. In the euro area alone, investment funds had a volume of EUR 11.82tr at the end of Q2-2017. Nevertheless, debt funds are increasingly seen as a viable alternative to conventional financing instruments. Many credit institutions have, in the wake of stricter banking regulations, cut down their loan business or even ceased to operate entirely in certain segments of the market. Over the years, this has created a certain gap on the financing side which is being increasingly filled with debt funds.

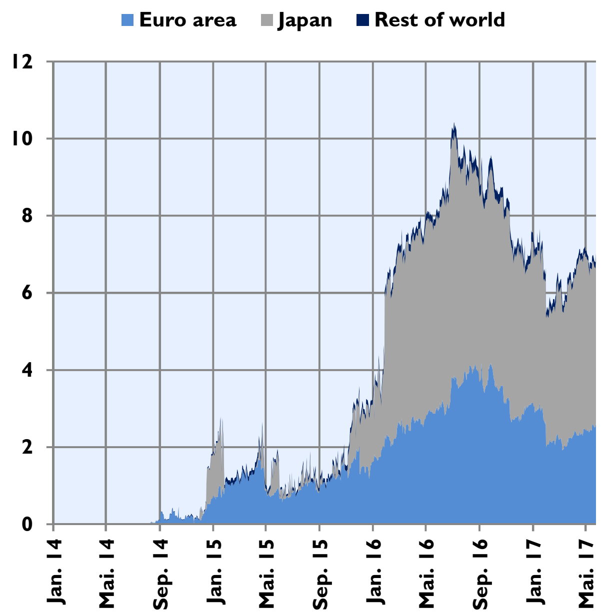
The current interest rate environment, meanwhile, alongside high and rising stock prices, provides good conditions for a further growth of the debt fund industry. Driven by an increasingly dynamic international trade and by improving perspectives for economic growth, global stock markets – specifically the markets in industrialized countries – have been booming, and the credit spreads of non-financials have continued to narrow. Although the markets were wrong-footed by certain political events (such as the result of the presidential election in the US) and continue to be affected by global economic uncertainties, it seems as though they had adjusted to the new environment.

While the future monetary policy path remains uncertain and market players are asking with increasing concern when and to what extent both Europe and the US will exit their quantitative easing policies, interest rates remain near their all-time lows, and the monetary policies of the world's key central banks continue to be very accommodative. While the Federal Reserve has increased the target range of the Fed Funds Rate four times since late 2015 (current target range: 1 to 1.25%), the European Central Bank (ECB) and the Bank of England have kept interest rates at 0 and 0.25% respectively. The Bank of Japan is continuing to pursue its QE strategy, modifying it only slightly inasmuch as it has implemented yield curve control.

The yields of ten-year government bonds of key industrialized countries have recovered somewhat from last summer's historical lows, although not everywhere to the same extent. The recovery was somewhat stronger in the US where the yields of 10-year Treasury Bonds rose to 2.607% in March 2017 and to 2.212% on 31 August 2017, having previously fallen to a low of 1.365% in July 2016. Yields also picked up in the euro area. 10-year German government bonds climbed out of the negative-interest range and reached a yield of 0.363% by late August 2017. Yields for 10-year bonds issued by France and Italy rose to 0.665% and 1.852% respectively, from 0.169% and 0.982% a year ago. At the same time, the volume of government bonds with negative interest rates remained relatively high (see fig. 1). In late May 2017, euro area government bonds with negative yields still totaled USD 2.62tr. For Japan, this figure was even higher at USD 4.25tr. To be sure, both of these figures fall considerably short of their recent highs of USD 4.19tr (September 2016) and 6.31tr (July 2016) respectively. We therefore assume that debt funds continue to benefit considerably from a low-interest-rate environment and from a search for "yield momentum". While institutional investors may benefit from new yield opportunities in the current low-interest environment, banks may opt to deleverage in the wake of increasingly strict regulatory requirements.

Fig. 1: Market volume of government bonds with negative yields

In USD trillions




Source: BIS, Creditreform Rating

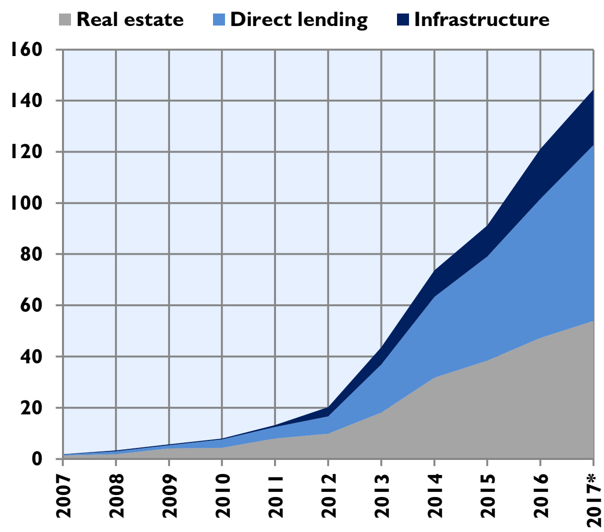
In the following, we would like to present the updated results of last year's study into the development of the market and the performance of debt funds, identifying the key trends in the three asset classes (real estate, infrastructure and direct lending/corporate) and contrasting this development with the corresponding trends from the US market. For this purpose, we have followed an inductive and explorative approach, gathering 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 data that were provided by Preqin 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 US

European debt funds underwent a period of dynamic growth during the past decade (see fig. 2). The cumulative volume of placed and raising European debt funds amounted to EUR 1.8bn in 2007. Five years later (2012), this amount had grown to EUR 20.2bn, and over the following years, this pace of growth gathered further momentum. Driven mainly by the expansion of the direct lending segment, European debt funds crossed the 100bn Euro threshold in 2016, reaching a total (cumulative) volume of EUR 121.1bn. By the end of Q2 2017, this volume had further increased to EUR 144.4bn.

Fig. 2: Development of the total volume of European debt funds

Total cumulative volume in EUR billions, including placed and raising debt funds



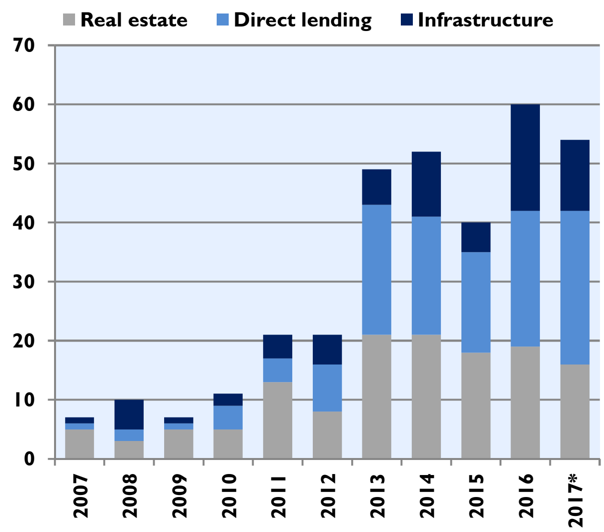

Quelle: Preqin, Creditreform Rating

The increasing importance of direct lending funds is reflected by the growing proportion of this asset class in the total volume. While direct lending funds accounted for one third of the entire market volume in 2012 (33.3%), their share grew consistently and gradually to 47.7% by the end of Q2 2017. According to these latest figures, real estate and infrastructure funds account for 37.3% and 15.0% respectively of the total market volume.

In the years from 2007 to 2010, between seven and eleven debt funds per year were established. Although 18 out of 35 funds were real estate funds (see fig. 3), their total volume (EUR 4.3bn) exceeded the investments in direct lending funds over the same period (EUR 3.3bn; see fig. 4) only by a far smaller margin. Already in these early stages of market development, the direct lending segment clearly outpaced the infrastructure funds, with the direct lending segment posting a total volume of EUR 8bn at the end 2010 (infrastructure: EUR 0.7bn).

Fig. 3: Number of European debt funds in the various asset classes

Number of placed and raising debt funds, *) Year-to-date: end of Q2 2017

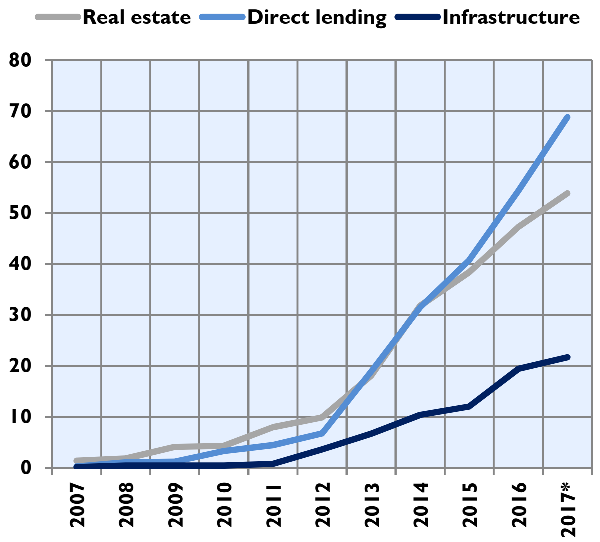



Source: Preqin, Creditreform Rating

Following first indications for an accelerating pace of the market development in 2011/12, growth rates increased significantly in 2013. The number of new direct lending and real estate debt funds increased to 21 and 22 respectively in 2013. This rise was accompanied by an equally vivid growth in volumes. While the total volume of infrastructure and real estate funds increased by nearly 50 percent to EUR 6.7 and 18.1bn within a single year, the volume of the direct lending funds tripled to reach EUR 18.8bn in 2013. For the first time, direct lending funds had more assets under control in Europe than the other types of debt funds.

Fig. 4: Volumes of European debt funds in the various asset classes

Total cumulative volume in EUR billions, placed and raising debt funds, *) Year-to-date: end of Q2 2017




Source: Preqin, Creditreform Rating

Since then, the gap between the asset classes real estate and direct lending has widened, mainly due to the more dynamic growth of the private debt segment. While the total volume of direct lending funds had amounted to roughly EUR 22bn in 2014 and 2015, it grew by another EUR 13.6bn to EUR 54.3bn in 2016, benefiting from the establishment of 23 new direct lending funds. By comparison, in 2016 the total volume of real estate funds increased by EUR 8.9bn to EUR 47.4bn (19 funds). European infrastructure funds underwent a remarkable development as well, recording new record highs both in the number of newly established funds (18) and in newly placed capital (EUR 7.4bn). Overall, the European debt fund market could register robust growth figures for 2016.

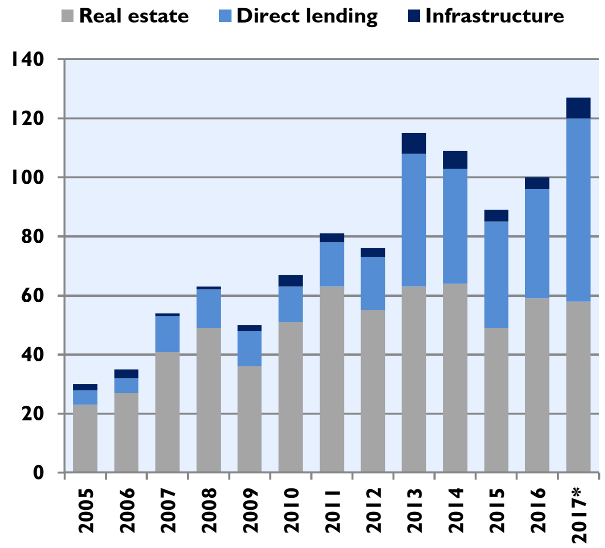
The developments in the first six months indicate a robust development in 2017. European debt funds managed to attract new investments with a total volume of EUR 23.3bn, and 54 new funds were established within this period: 26 direct lending funds (nearly half the total), 16 new real estate funds and 12 new infrastructure funds. Direct lending funds therefore managed to strengthen their already dominant position on the market.

In contrast to the development in Europe, debt funds began to assume importance on the US capital markets at a relatively early stage. The number of newly established debt funds in the US has been rising annually since 2005: from 30 in 2005 to 76 in 2012, while the total volume of these funds grew from EUR 11.9bn to EUR 146.6bn (see fig. 5 and fig. 6).This healthy growth of the US debt fund market was mainly driven by the dynamic development of real estate funds whose total volume rose by a factor of ten from EUR 10.7bn to EUR 102.4bn over this period. Infrastructure and direct lending funds, too, went through a period of rapid growth, albeit from a more modest base, increasing in volume from EUR 0.2 and 1.0bn respectively (2005) to EUR 8.7 and 35.5bn in 2012.

Since 2013, growth of the US debt fund market has become more broad-based, mainly driven by the development of direct lending funds and, to a smaller extent, of infrastructure funds. Both asset classes went through a period of rapid growth in 2013, in terms of newly established funds as well as fund volumes. Infrastructure funds with a volume of EUR 10.0bn were issued in 2013 (2012: EUR 0.8bn), while growth in the direct lending segment (45 funds with a volume of EUR 16.8bn) was even more dramatic.

Fig. 5: Number of US debt funds in the various asset classes

Number of placed and raising debt funds, *) Year-to-date: end of Q2 2017



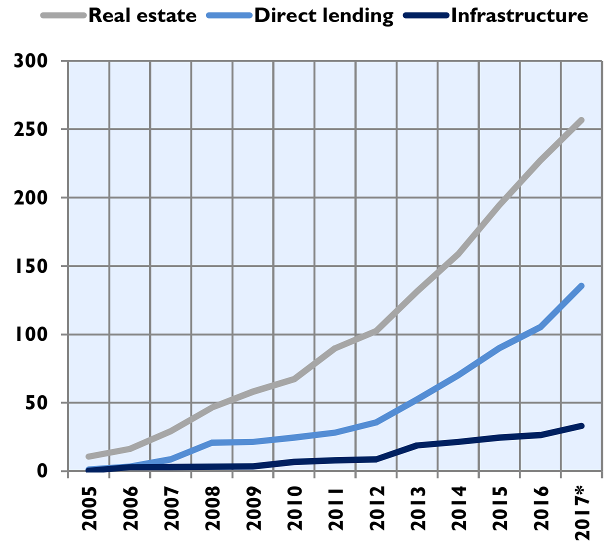

Source: Preqin, Creditreform Rating

Direct lending funds managed to preserve their growth momentum over the following years, increasing their total volume from EUR 52.3bn (2013) to EUR 105.2bn. Recently, however, the fund volumes have grown at a more measured pace, increasing by EUR 15.4bn in 2016 after additions of EUR 17.7 and EUR 19.8bn in 2014 and 2015 respectively. In the wake of this development, direct lending funds have increased their share of the US debt fund market, too. In contrast to Europe, however, they have failed to usurp or even seriously threaten the market leadership of real estate funds. The total cumulative volume of US real estate funds in 2016 amounted to EUR 227.2bn, more than two times as much as the volume of direct lending funds. US real estate funds are still growing strongly, by EUR 35.6bn in 2015 and by 32.7bn in 2016.

The latest available figures (end of Q2-2017) appear to indicate that US debt funds are still growing at roughly the previous years' pace. In the first six months of the year, 62 direct lending funds with a volume of EUR 30.2bn were established, closely followed by real estate funds with a fund volume of EUR 29.4bn. Twelve new infrastructure funds were also issued, accounting for investments with a total volume of EUR 6.6bn.

Fig. 6: Volumes of US debt funds in the various asset classes

Total cumulative volume in EUR billions, placed and raising debt funds, *) Year-to-date: end of Q2 2017

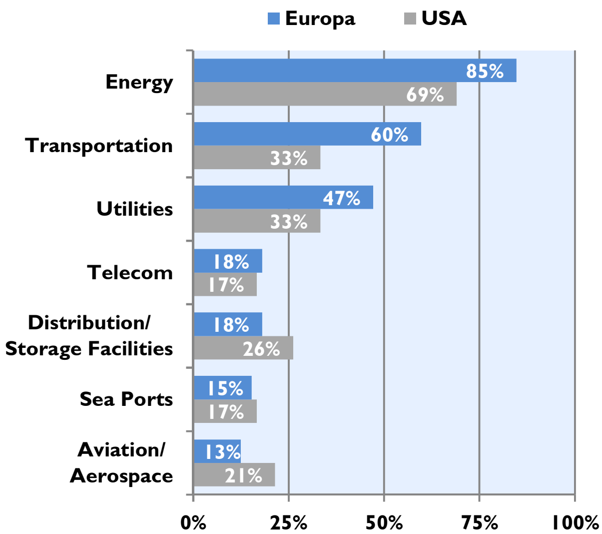



Source: Preqin, Creditreform Rating

Comparisons between the investment patterns of US and European debt funds reveal similarities as well as differences. For instance, infrastructure debt funds in both the US and Europe largely target the same industries, the preferred investment targets being energy, transportation and utilities. One difference, however, is that European funds concentrate their investments more strongly on these preferred targets. 69% of US-American fund managers make investments in energy businesses, while the corresponding figure in Europe was 85% (see fig. 7). One third of US fund managers (33%) targets either transport companies or utilities, but 60% and 47% respectively of their European peers.

Fig. 7: Target industries of infrastructure funds

Funds can target more than one industry

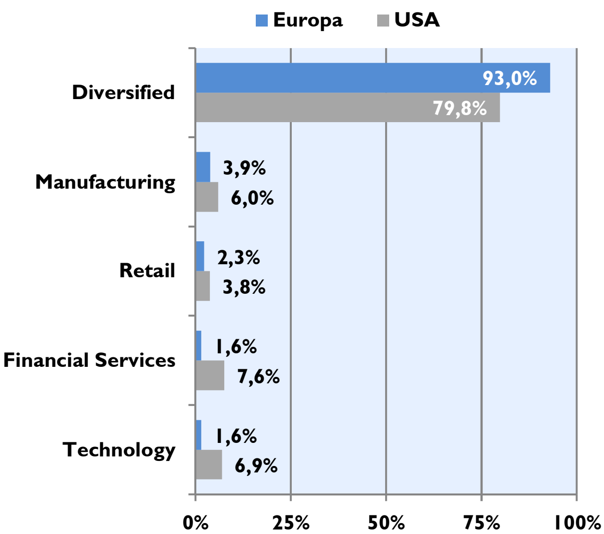



Source: Preqin, Creditreform Rating

Direct lending debt funds, by contrast, scatter their investments across a far wider range of industries; both in the US and in Europe (see fig. 8). A clear majority of investment managers on both sides of the Atlantic have a preference for a diversified investment strategy: 79.8% in the US, even 93% in Europe.

Fig. 8: Target industries of direct lending funds

Funds can target more than one industry

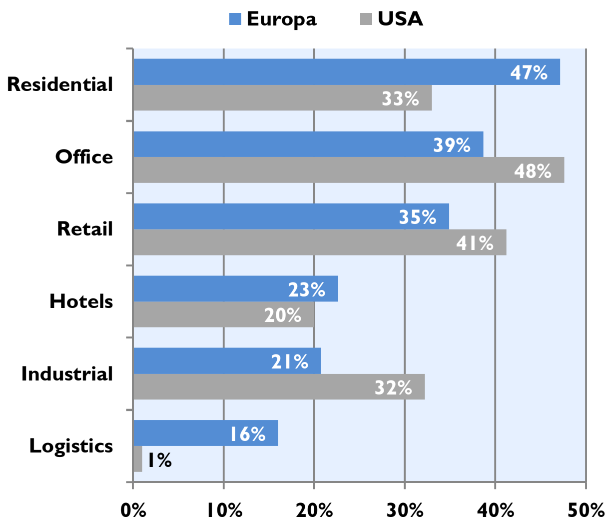



Source: Preqin, Creditreform Rating

While European real estate funds show a preference for residential properties – 47% invest funds in homes (see fig. 9) – their US counterparts target primarily commercial real estate, most frequently office buildings (48%), retail space (41%) and industrial facilities (32%). European funds, meanwhile, are more likely to invest in logistics facilities: the only type of commercial property that is more frequently targeted by funds in Europe than in the US. 16% of European funds have invested in storage facilities and distribution centers, only 1% of their American peers.

Fig. 9: Target industries of real estate funds

Funds can target more than one industry




Source: Preqin, Creditreform Rating

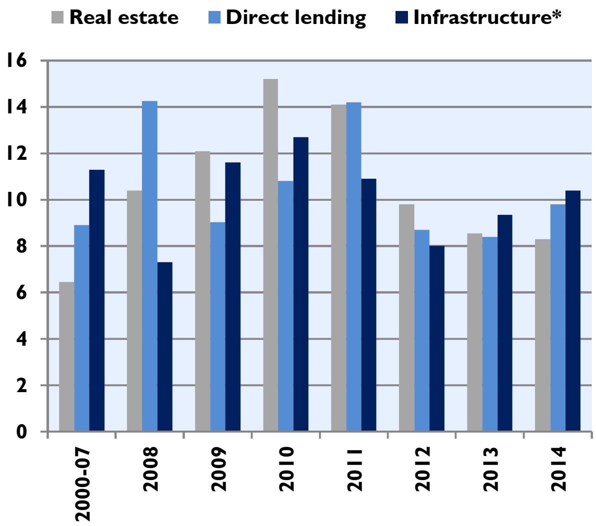
## 3. Performance of Debt funds

One of the key financial ratios for meaningful assessments of any debt fund's performance is the net internal rate of return ("net IRR"). The net IRR identifies the returns that an investor can expect to receive from his investment in a specified period of time, taking into account fees and capital costs, based on existing and anticipated cash flows. It has to be noted that this performance analysis is based on a relatively small sample of debt funds and that this sample features funds with different portfolio structures.

After the average net IRR of infrastructure funds that were issued in 2011 and 2012 decreased, newly established funds from the two most recent years generated slightly higher returns (on average). Funds that were issued in 2014 produced average yields of 10.4% (2013: 9.4%; see fig. 10).

Fig. 10: Performances of debt funds in the various asset classes

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




Source: Preqin, Creditreform Rating

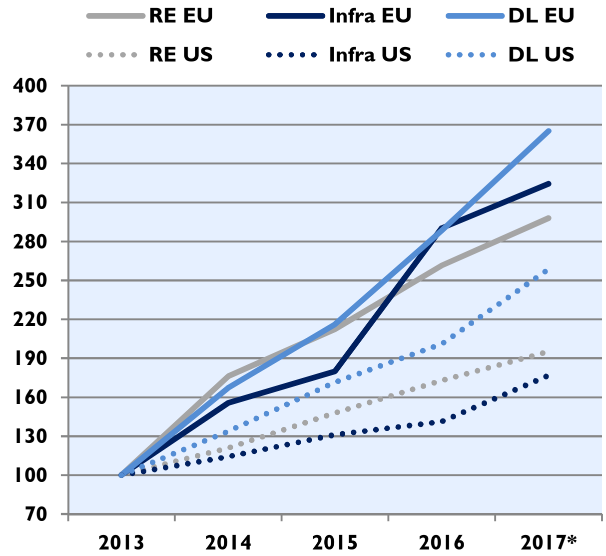
The returns from more recently issued real estate debt funds, however, continued the downward trend of the previous years. Funds that were issued in 2014 generated an average net IRR of 8.3%, which means that since 2011 – when new funds generated an average net IRR of 15.2% – the newly established funds followed on a downward trajectory. The returns for new direct lending funds, meanwhile, have by and large continued to stagnate. During the period under review, average net IRRs between 8.4% (funds issued in 2013) and 14.3% (funds from 2008) were recorded. The most recently (2014) established funds generated an average net IRR of 9.8%, close to the lower end of the long-term range of results.

## 4. Catching up to the US?

The debt fund markets in both the US and Europe have grown significantly. While debt fund markets in the US are more mature and attracted larger amounts of capital, there are – in our view – signs that the European market is catching up. Since, however, the European market started this catch-up process when it was already quite a long way behind and since it still is comparatively less mature, the headway it has made over recent years can easily escape attention. We decided to account for this by indexing cumulative volumes to the year 2013, the point in time when the European debt fund market experienced a significant upturn.

Fig. 11: Growth dynamics of debt fund markets

Indexed market volumes (2013=100) of placed and raising debt funds, *) as per the end of Q2 2017



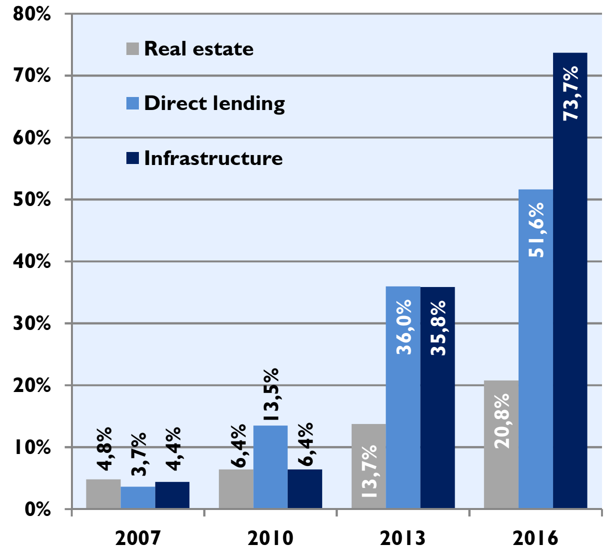

Source: Preqin, Creditreform Rating

Fig. 11 shows that – during the period under review – the European markets for direct lending funds, infrastructure funds and real estate funds all registered higher growth figures than their US counterparts. It is noteworthy that direct lending funds have recorded higher growth rates than the other types of debt funds on both sides of the Atlantic since 2013. The stronger growth momentum of the European markets alone, however, does not provide conclusive evidence, bearing in mind the very low initial levels of European debt fund volumes. This is why we analyzed the proportion of the cumulative volume of European funds to the volume of US debt funds at specific points in time.

European infrastructure funds are closest to reaching the level of the US market. Having made only little progress in the period between 2007 and 2010 (when the volume of the European market accounted for only 4.4 and 6.4% of its US counterpart), the growth of the European market for infrastructure funds has been significantly more dynamic since 2013 (see fig. 12). In 2013, European infrastructure funds had attained a total volume that was equivalent to 35.0% of the US market, a figure that rose to 73.7% in 2016. In the same period, European real estate funds also caught up with their US counterparts, albeit at a much slower pace. In 2016, the volume of the European market reached EUR 47.3bn, only 20.8% of the US market's volume. In contrast to the markets for infrastructure and real estate funds, the gap between European and US direct lending fund volumes already began to narrow at a relatively early stage. In 2007, the European market accounted for a mere 3.7% of the US market's volume, but by 2010, this percentage had already risen to 13.5%. In the following years, the cumulative volume of European direct lending funds grew at a significantly higher rate, allowing European funds to catch up. According to the latest available figures, the total volume of European direct lending funds accounts for 51.6% of the US market.

Fig. 12: How the European debt fund industry is catching up

Cumulative volumes of European debt fund segments as percentages of their US counterparts




Source: Preqin, Creditreform Rating

Overall, European debt funds have been able to catch up over the past decade, though European markets still lag their US-counterparts. With the exception of the market for infrastructure funds, the total volume of European debt funds is significantly smaller than the volume of their transatlantic peers. Thus, the European market for debt funds continues to offer a large potential for further growth.

## 5. Outlook

Our analysis of the debt fund markets on both sides of the Atlantic has demonstrated that the United States have not only pioneered this relatively new financing instrument but also remain its biggest market. At the same time, however, the European debt fund market has shown buoyant growth. The increasing attention that the regulatory authorities have recently dedicated to this asset class is another indication for its growing relevance. Whether or not European debt funds will be able to maintain their recent pace of dynamic growth, continuing the positive development of the past few years, will mainly depend on regulatory decisions and monetary policies.

In the medium to long term, the pan-European development of debt funds – a relatively young market segment – will confront the regulatory authorities with challenges. Europe's current regulatory environment still reflects a largely heterogeneous landscape, as evidenced by the recently released IOSCO Survey (see Chapter I). Analyzing the current state of the global regulatory framework, the IOSCO Survey finds that the regulations in six of the surveyed jurisdictions, all of them located in Europe (Belgium, Germany, France, Ireland, Italy and Spain), feature special, partially conflicting provisions for debt funds. In principle, we welcome the fact that debt funds increasingly attract regulatory attention: this can only accelerate their acceptance as an independent asset class. At the same time, a lack of harmonization between national regulations and provisions can create uncertainty among fund managers, preventing them from investing and thereby hamper further growth.

Further evidence for Europe's need to harmonize its regulatory provisions is provided by the EU Commission's Mid-Term Review of the Capital Market Union Action Plan, released in June 2017. With reference to cross-border investments, the Commission concludes that European investment funds are too small to operate as cost-effecient as funds in other jurisdictions. The Commission has also identified the lack of convergence between different national supervision and regulatory regimes as one key reason for the geographical limitation with regard of the distribution of European funds. The EU Commission plans to assess the feasibility of amending cross-border AIF regulations in the first three months of 2018.

In view of the current monetary policies in the euro area, there appears to be little prospect for a significant rise in interest rates in the medium term. In view of consistently low inflationary pressures across the euro area, the ECB deems it necessary to stick to its expansive monetary policies. Following its meeting on 07 September 2017, the ECB announced its decision to keep interest rates unchanged. Moreover, ECB expects that interest rates remain at their current levels, for an extended period of time, and well past the horizon of the net asset purchases. The ECB also announced the continuation of its asset purchasing program. At least until the end of this year, the ECB will purchase assets with a value of EUR 60bn every month. Continuously expansive monetary policies in the euro area are intended to maintain the pressure on the yields of fixed income instruments. This should benefit higher-risk investments with potentially higher yields. In such a low-interest environment, alternative investment funds are likely to attract the attention of capital market investors.

Will an eventually forthcoming change of the ECB's current monetary policy stance and a slow, gradual rise of the interest rates cause severe problems for the debt fund industry? We do not think so. Although such a rise in the interest rate would serve to make other financing instruments more competitive, we expect structural factors on both the supply and the demand side to support a sustained development of debt funds as an important element of the European refinancing markets.

The demand for long-term financing arrangements remains high, and large institutional investors have, for some time, been extending their debt fund portfolios. We also believe that the trend towards capital market-based financing instruments – which has gradually emerged in Europe over the past ten years – will not be reversed and that the banks' disintermediation will continue to unfold, albeit very gradually. One key factor is the increasingly restrictive nature of banking regulations which makes it harder and harder for banks to generate profits by lending money in the sub-investment grade. The political will of the key European actors, meanwhile, is undiminished. In the Reflection Paper on the Deepening of the Economic and Monetary Union from 31 May 2017, the EU Commission emphasizes its objectives of a capital market union and of providing innovative, sustainable and diversified financing instruments for private households and businesses alike.

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