SPAIN

Why funds are feeling bullish

Corporate lending in Spain has traditionally been dominated by the banks, but in the SME space fund managers are finding gaps to exploit. **Andy Thomson** reports

When Santander agreed to acquire the beleaguered Banco Popular last summer, it was the latest landmark in the consolidation of the Spanish banking sector, which ended up putting an estimated 80 percent of Spanish business financing in the hands of just five banks.

On the face of it, this doesn't appear to leave a huge gap for non-bank lenders to step into – as is in other European markets. However, this hasn't stopped them from trying. At the larger end of the market, a combination of incumbent banks fighting to protect market share and pan-European funds seeking to take a slice of the action has created what market professionals see as an aggressive environment with tight spreads.

Many see the best opportunity for private debt providers at the small to medium-sized end of the market, where the banks have their fill of credits, demand for financing from borrowers is strong, spreads are wider and deals are of a non-sponsored nature. "The lower mid-market will grow quite fast as a private debt opportunity because there is a huge need and very few players," says Ignacio Diez, founding and managing partner at Trea Direct Lending, a Barcelona-based fund manager.

While the banks are certainly still interested in the SME market, they are virtually at the limit of credits that they are permitted exposure to under Basel III regulations. Corporate credit is estimated to make up around 22 percent of Spanish banks' balance sheets, compared with a figure closer to 10 percent for UK and other northern European banks.

Jaime Prieto, co-founder and managing partner of pan-European fund manager Kartesia, says the crisis also weakened the relationship between banks and borrowers. "Lots of companies went through tough times as their end markets suffered, and this tarnished their reputations with the banks," he says. "Following the recovery, the banks still won't finance those companies with a tarnished reputation, even though they are performing well under improved market conditions."

> "PRIVATE DEBT IS A GOOD THERMOMETER FOR THE SPANISH ECONOMY AND WE HAVE BEEN SEEING A BIG PICK-UP"
> **Adriana Oller**

Market conditions have indeed taken a notable turn for the better. Having been hit hard by the global financial crisis and forced to seek an EU bailout for its financial sector, Spain has seen GDP growth of 3 percent or more for the last three years.

"Private debt is a good thermometer for the Spanish economy and we have been seeing a big pick-up," says Adriana Oller, partner and founder of Madrid-based fund manager Resilience Partners, which typically targets businesses with between €3 million-€10 million of EBITDA. "We saw 100 potential deal opportunities last year and we have already seen 60-70 opportunities so far this year."

She says many of these situations involve companies now turning their thoughts to expansion for the first time since the crisis.

Diez insists that for the size of deals it is targeting – starting as low as €5 million – Trea only has competition from a couple of other funds. The biggest challenge is reaching out effectively to potential borrowers, but he believes the message is getting through. "The relationship with entrepreneurs is pretty good. They didn't know about us a couple of years ago, but they're learning. They know that relying on five banks might be a risk going forward. When you need significant capex or you're going through an acquisition or re-financing, you don't want to be knocking on only five doors. You need to talk to new players."

Diez believes that at the larger end, where pan-European funds are offering unitranche, their return target is typically around 7 percent. In a "much more inefficient" market, and with leverage at a conservative 2-4 times EBITDA, he says Trea is seeking 8-9 percent. The current gross IRR on the firm's first fund, which closed on €70 million in April last year, is 10 percent. The firm is currently raising a successor with a target of €150 million.

ADDING ALPHA

Madrid-based Incus Capital targets specialty credit, asset-backed lending and opportunistic secondary deals. The focus is primarily on the Spanish mid-market although the firm also considers investments in Italy, Portugal and France. The firm has set its sights progressively higher on the fundraising trail. Its first fund raised €130 million, the second raised €270 million and the third is understood from market sources to have reached its target of €500 million.

"There is clear demand in the market for our financing solutions," says Incus managing partner Andrew Newton. "Private credit is becoming more understood in the market and we are finding ourselves very well positioned for winning business. We have a track record, our investors are comfortable with the asset class, and they want further exposure to our specialty credit strategy."

Of the competitive environment, Newton says: "Other funds come here [to Spain] but we generally don't see them as competitive on the size of asset-backed deals we focus on. Having a local platform is a distinct advantage when it comes to sourcing and closing deals in a timely fashion. We have a very clear idea about the companies and the collaterals that we support. We can move quickly to provide the right solution. These are critical factors for achieving the attractive risk-adjusted and absolute returns for our investors."

While many funds seek to take refuge at the smaller end of the market, there is at least one fund manager seeing the banks not as the enemy but as a partner against the pan-European funds.

Oquendo Capital offers a range of debt solutions to the lower mid-market, frequently providing the mezzanine layer and preferred equity in support of bank-led deals.

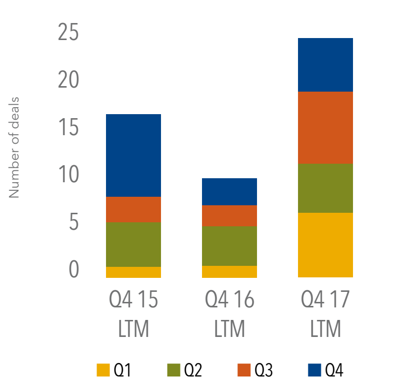
"We continue to do a lot of business by partnering with the banks," says Alfonso Erhardt, the founder partner of the firm, which is currently investing its €200 million third fund. "We allow the banks to compete with unitranche by providing the gin to their tonic in the form of a bit of extra leverage. We are also quite active on the sponsorless side where we have a lot of relationships and where we can tailor a transaction through a wide range of instruments: debt, preferred equity and minority equity. Unitranche providers are not really present in that segment of the market."

In order to exploit the sponsorless market effectively, lenders must communicate what they do to borrowers which may not be familiar with the private debt offering. "We are seen as something of a hybrid – are we cheap equity or expensive debt?" says Erhardt. "Getting the message across is slow but gradual, and we need to talk people through the deals we have done before."

For those with the required patience, Spain looks poised to bring rich rewards. ■

WAKING FROM A SIESTA

After a dip in 2016, Spanish alternative lender activity shot up last year



Source: Deloitte