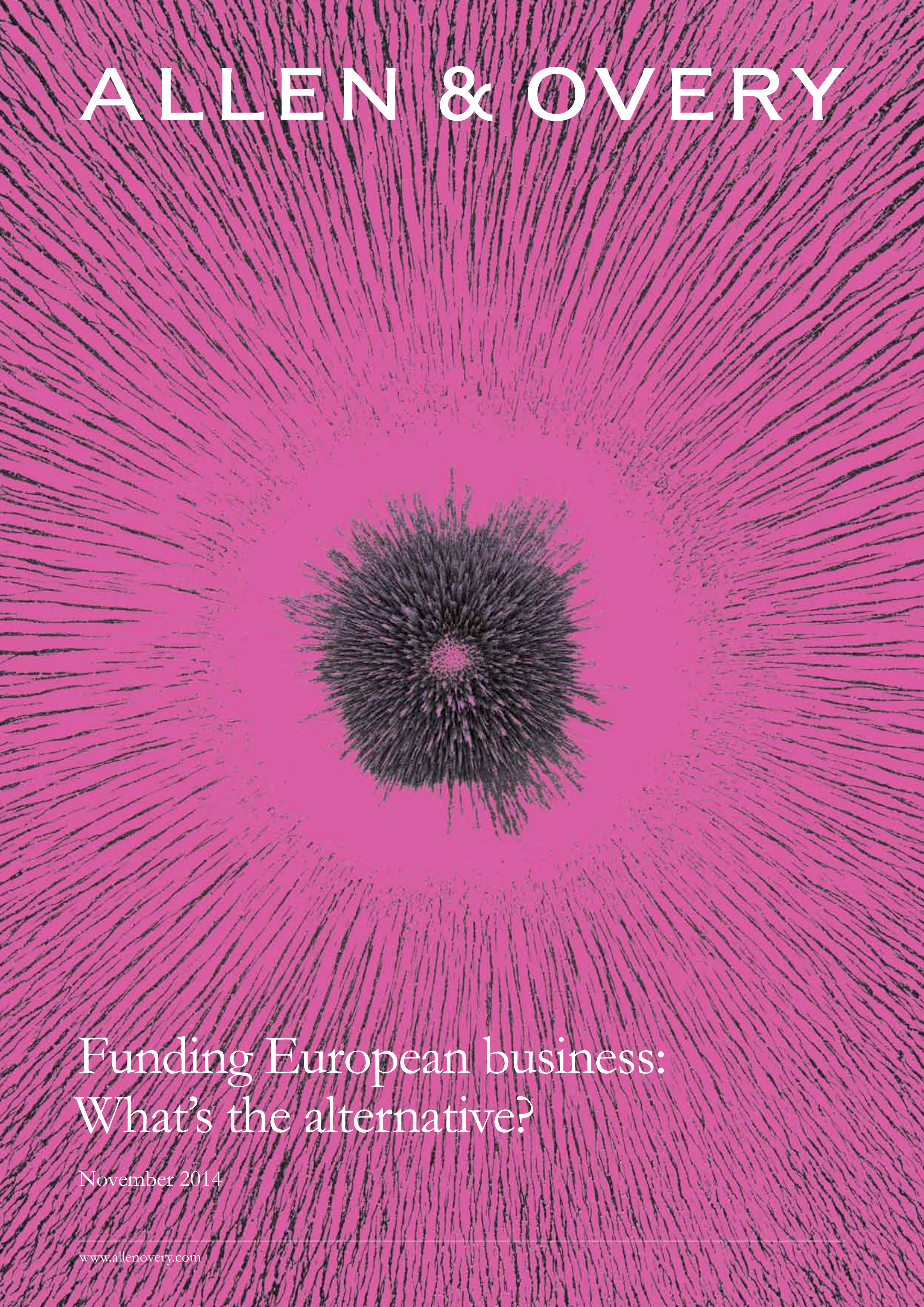
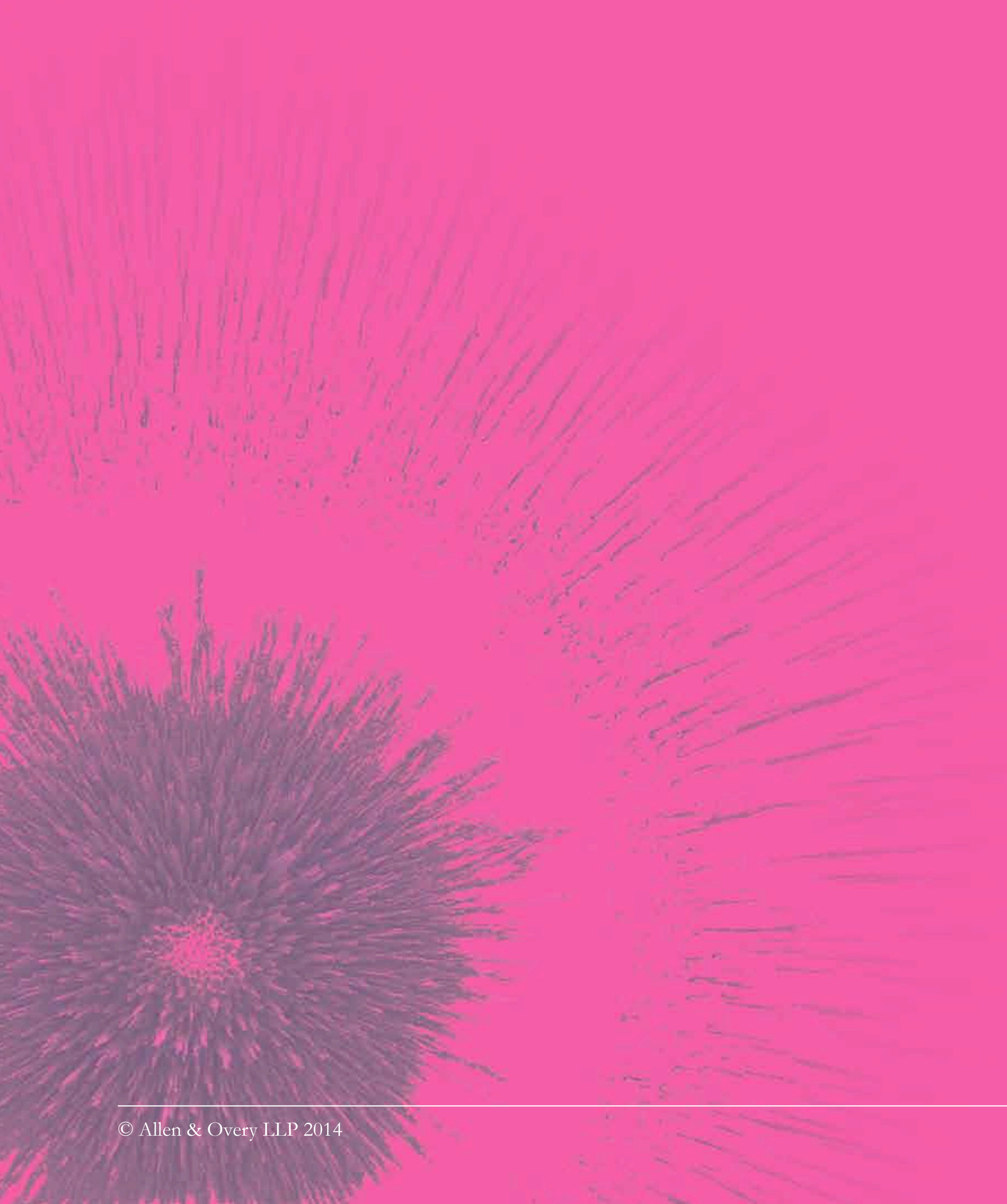


ALLEN & OVERY

# Funding European business: What's the alternative?

November 2014



# Contents

# Introduction

## It's looking increasingly likely that a pan-European private placement market will join the mainstream of corporate finance in 2015.

The need is clearly there. As our research shows, most European borrowers are looking for viable alternative funding options and there is an expectation that private placements will be a part of the solution. Investors, too, are looking for new ways to earn solid returns. With Europe now actively seeking options to kick-start growth, there is clear political will to drive the formation of the market.

Policy-makers across Europe are keen to inject liquidity into a tier of companies that have had limited options for finance since the crisis began. Diversifying sources of funding, they hope, will support economic recovery. To that end, a number of working groups, bringing together central banks, finance trade bodies, investors and lawyers, including partners from Allen & Overy, are currently focused on turning the desire for alternative funding into an efficient, accessible and transparent market.

By early next year, one working group under the umbrella of the International Capital Market Association working together with a wider range of stakeholders, including the Loan Market Association (LMA), will have created a suite of standard documentation to facilitate the execution of private placement deals in either loan or bond format. As companies use the documents, developed with the help of Allen & Overy – and a number of issuers and investors are lining up – the market will start to become a reality.

There are still many hurdles before the pan-European market functions properly. The regulatory backdrop is being finalised, and no agreement has been reached so far on tax harmonisation and common insolvency rules. But one of the main objections raised by critics – that Europe will be unable to match pricing on the U.S. private placement market, now widely used by larger European companies – misses a big part of the rationale for the exercise.

The pan-European market is designed to open access to financing for companies that cannot or do not want to do other kinds of deals for a number of reasons. Their banks are less interested in lending to them on competitive terms, they are too small to issue listed or publicly rated corporate bonds and they are unable to access existing private placement markets, whether in the U.S. or in France and Germany.

If the European private placement market is to play this niche role, however, investors will need to build up resources, allowing them to assess risk at lesser-known companies. Our research also indicates, however, that a majority of companies would prefer to have their banks intermediate access to the private placement market rather than dealing direct with investors. Playing an active intermediary role would help prepare banks for the time when cheap central bank liquidity is finally turned off and new regulations start to bite, encouraging them to help customers access alternative funding options. At that point, the pan-European private placement market could move beyond its niche to become a more central player in corporate funding.

*Governments are increasingly anxious to support alternative credit forms, as bank lending continues to fall.*

## *The state of private lending in Europe*

European companies have turned increasingly to alternative finance in the past two years. Issuers from Europe accounted for about a third of the U.S. private placement market in 2013, where insurers, pension funds and others invest around USD50 billion a year. Direct lenders have a growing credit portfolio among a wide range of businesses. They also support a broad variety of infrastructure projects, where unlisted bond structures allow companies to provide investors with more accurate financial models than are possible under a standard bond.

Governments are increasingly anxious to support alternative credit forms, as bank lending continues to fall. Recent regulatory changes in Italy, for example, have opened the market for direct lending to companies by insurance companies and other non-banks, particularly through unlisted bonds. German companies have long been used to the Schuldschein market, traditionally a source of easy finance for the family-owned Mittelstand sector but now attracting a wider range of larger German and other European companies. With deals worth around EUR10bn a year, the market is more than twice the size of its far newer French counterpart, EuroPP, still used largely by French companies, banks and insurers.

While EuroPP has been a success since its launch two years ago and is still evolving, its narrow investor base and relatively high costs demonstrate the need for the next step – a European market with deeper pockets, common standards and flexible rules, incorporating the best practice of different markets. The pan-European market may be intended by policy-makers to fund growth by financing unrated companies without access to public debt markets, but if it is as efficient and easy-to-use as its backers claim, it is likely to become a cheaper and easier way for many companies to diversify their funding mix.

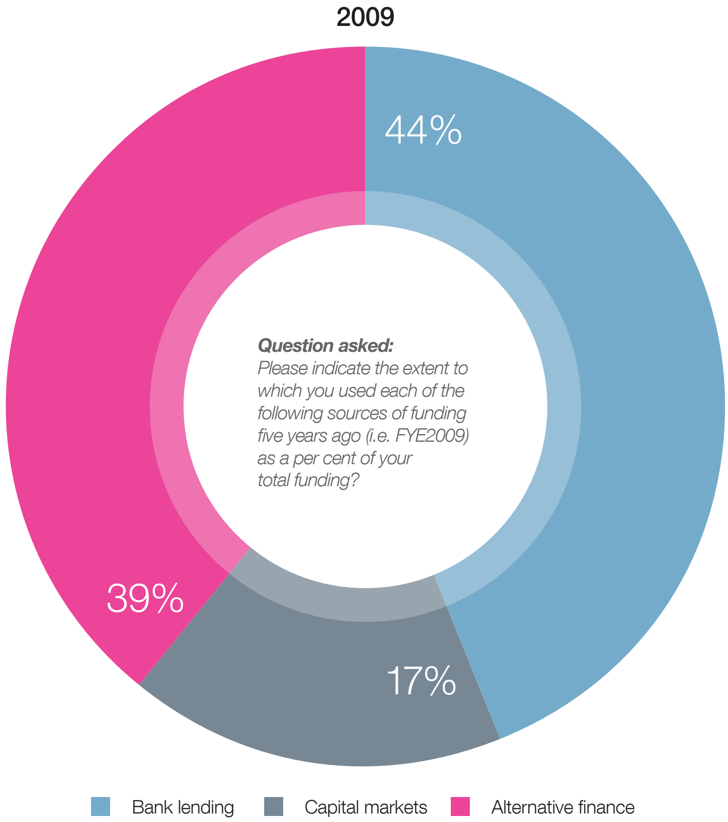
*Two significant findings emerge from our survey of over 200 finance executives across western Europe.*

## THE SURVEY RESULTS

The first and rather surprising result is that finance executives say alternative funding is already a significant source of finance. They expect their use of funding sourced from insurance companies, pension funds and other non-banks to increase over the next five years, but finance chiefs still expect banks to play a significant role as intermediaries, helping arrange credit through alternative sources. The second finding is that most executives would strongly welcome more alternative funding sources and see a pan-European private placement market as a key part of that picture – as long as there is sufficient clarity on costs and processes.

# How important is alternative funding in Europe?

## MORE IMPORTANT THAN MOST WOULD EXPECT




The most surprising finding from this research is that over 200 heads of finance at western European companies say that while bank lending remains the single biggest source of funding on average, alternative finance is now almost on par with this more traditional source.

Alternative finance accounts for an average 41% of their total funding mix, slightly more than five years ago (39%) and just behind bank lending (43%). Both the increase and the share are marginally higher for medium-sized companies (below 250 employees) than for larger ones – but the differences are very small.

Bank lending, according to the respondents, has also seen a small drop in use since 2009 when it accounted for 44%. Public capital markets represent just 16%, also down 1% compared to five years ago, with larger companies more likely to use capital markets at the expense of bank lending.

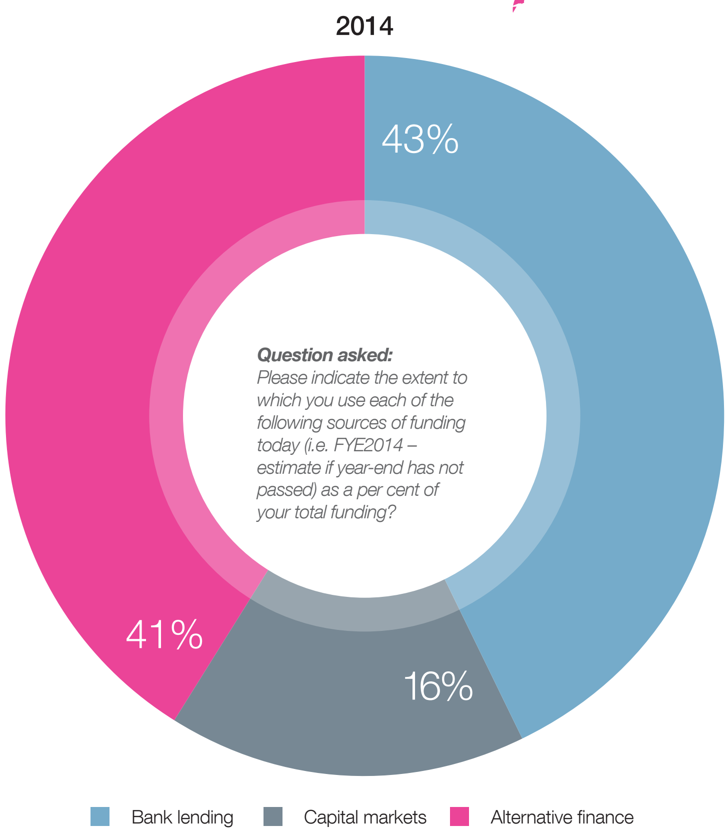
These responses can't be directly correlated to the size of European financial markets, as larger companies raise considerably more debt, in whatever form, than medium-sized ones. But these responses provide an indication of the average split between sources of funding regardless of the amounts being raised – and provide a useful insight into where corporate treasurers are turning to fund their businesses.

There are significant differences among countries, although sample sizes are only indicative. Bank lending remains dominant in Spain and Benelux, and is still a major source in Germany and France. But the UK and Italy show a significant shift to alternative funding. Broken down by sector, alternative finance is stronger in project-based industries, like energy and infrastructure, while bank lending is stronger in hotels/leisure and life sciences. Capital markets enjoy the strongest use among companies in Italy, France and Germany, where they represent around a quarter of funding.

### *Are loans up or down?*

These findings raise an interesting question about the current state of corporate finance. Could it be that alternative funding, far from being a newcomer to the market, has already moved into the mainstream? That is what the corporate treasurers

*The value of loans in Europe this year will exceed that of 2008 while new lending from banks themselves is down by 42% over the same period*




and chief financial officers surveyed here are saying – and it could explain the divergent trends shown in different statistical sources.

New bank lending has declined 42% in Europe since 2008, according to the European Central Bank (ECB), which looks at banks' balance sheets. The latest data shows a continuing decline in outstanding loans of almost EUR600bn below the amount on bank balance sheets in 2008. But Thomson Reuters, which collects data on lending transactions, shows a completely different picture. According to its latest statistics, the value of loans in Europe in the first nine months of 2014 has very nearly reached 2008's full year value of USD809bn. So are loans to European companies falling or rising?

Direct lending by alternative credit providers, outside of the banking system altogether, is not sufficient to explain the difference. Peer-to-peer lending is growing but still small – estimated at around USD2bn in the UK, for example, and direct lending by asset managers is still the exception rather than the rule. But insurance companies, pension funds and hedge funds are increasingly finding ways to lend together with banks, taking a higher share of the risk or longer tenors. The ECB admits it is scrambling to capture the shape of this new credit system that blurs the border between banks and alternative funds.

This view from European corporates' suggests non-bank funds are already being channeled into the real economy via co-lending with banks.

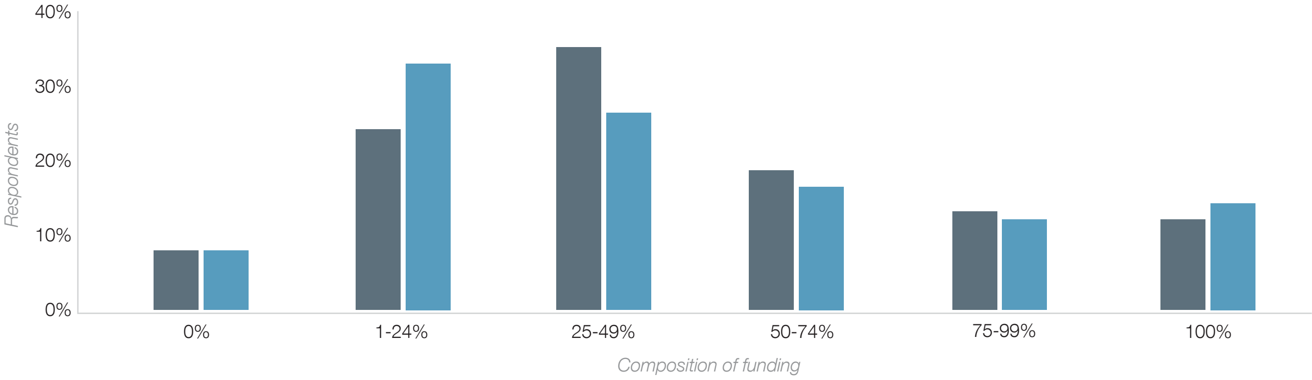
Our survey asked finance chiefs what the source of their funding was, not what product or structure they use. If alternative finance now provides 41% of European companies' debt, but the value of loans in Europe this year will exceed that of 2008 while new lending from banks themselves is down by 42% over the same period, it would seem to indicate that banks are continuing to arrange the loans, or bonds, but the money is just coming from an increasing variety of sources.

More than anything, this research and the array of other data sources available highlight the lack of clarity we continue to have on the subject.

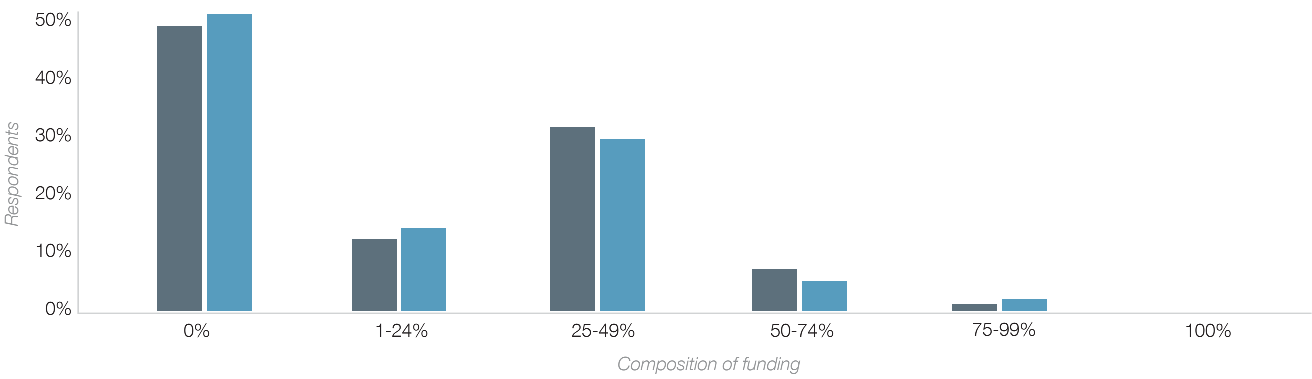
## SPREAD OF FUNDING FIVE YEARS AGO AND TODAY

***Question asked:*** *Please indicate the extent to which you used each of the following sources of funding five years ago and today as a per cent of your total funding?*

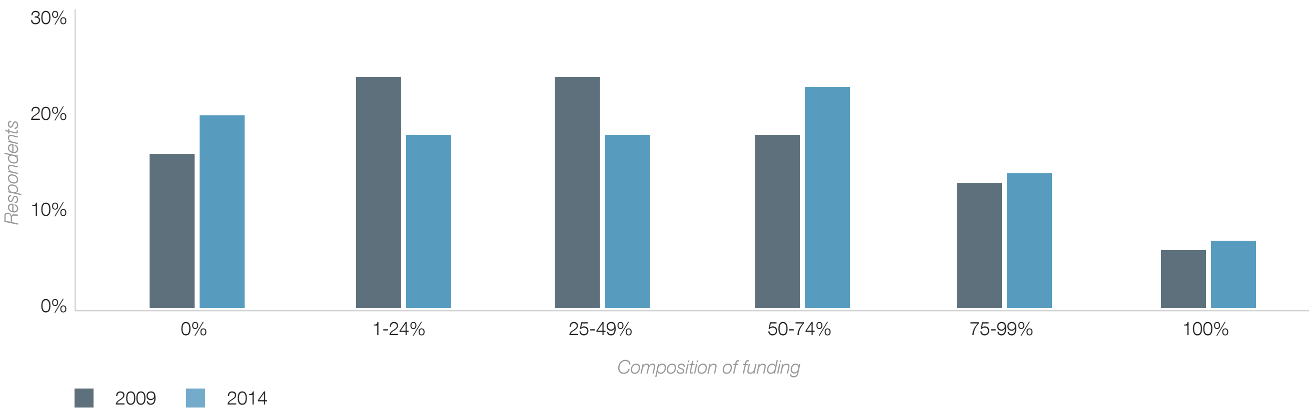
### Bank lending




### Capital markets




### Alternative finance



What is clear is that European finance heads are taking a more 'pick and mix' approach to funding and no longer relying on banks to provide for all their needs – partly through necessity and partly due to increased choice. And the survey results provide an interesting picture of the evolving funding mix. Capital markets are part of the mix for 50% of companies, but only a few – just 7% – use bonds for more than half of their funding needs. While large companies are more active in capital markets, only 9% rely on them for more than half of their funding needs.

Most of the finance executives, on the other hand, do use bank lending, at least for working capital financing. Only 7% of respondents say they do not use bank lending at all. Larger companies use banks less intensively than medium-sized companies and most respondents say that trend – to diversify the mix – has increased since 2009.

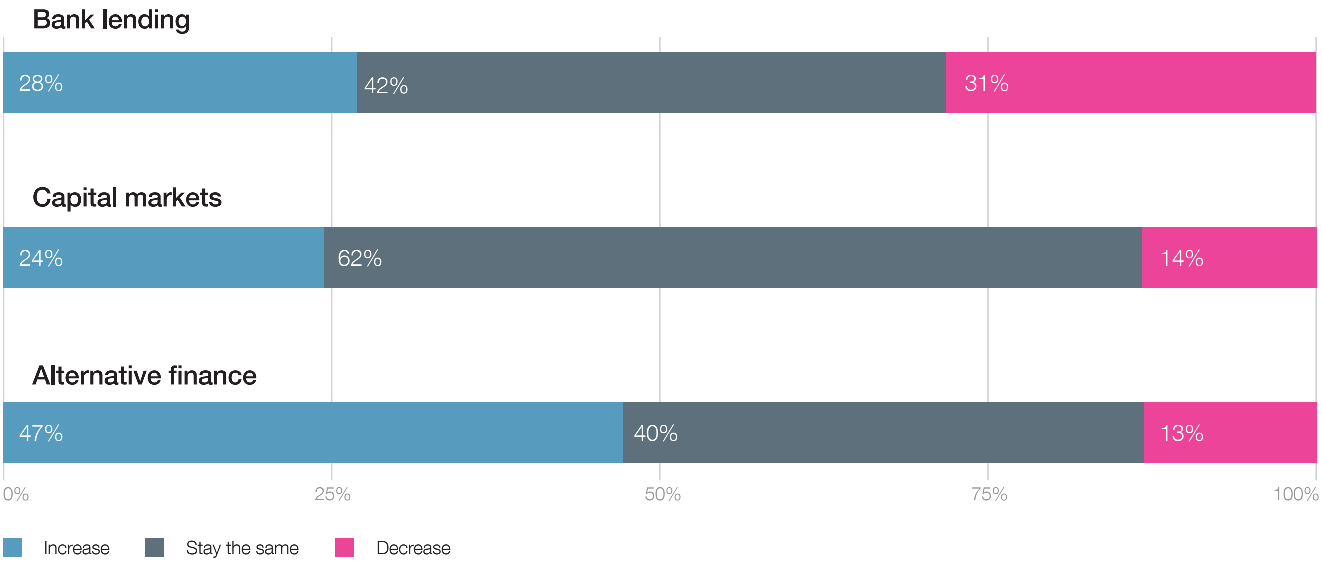
That is where alternative funding sources appear to have gained ground. Some 44% of our respondents say they use alternative finance for more than half of their funding needs, and that share varies little by size of company. For bank lending, the corresponding share is 40%.

*Some 44% of our respondents say they use alternative finance for more than half of their funding needs.*

# How will funding sources change over the next five years?

**SHIFT FROM BANK LENDING TO ALTERNATIVE FUNDING**

***Question asked:*** *Do you expect your use of bank lending, capital markets and alternative funding to increase, decrease or stay the same over the next five years?*

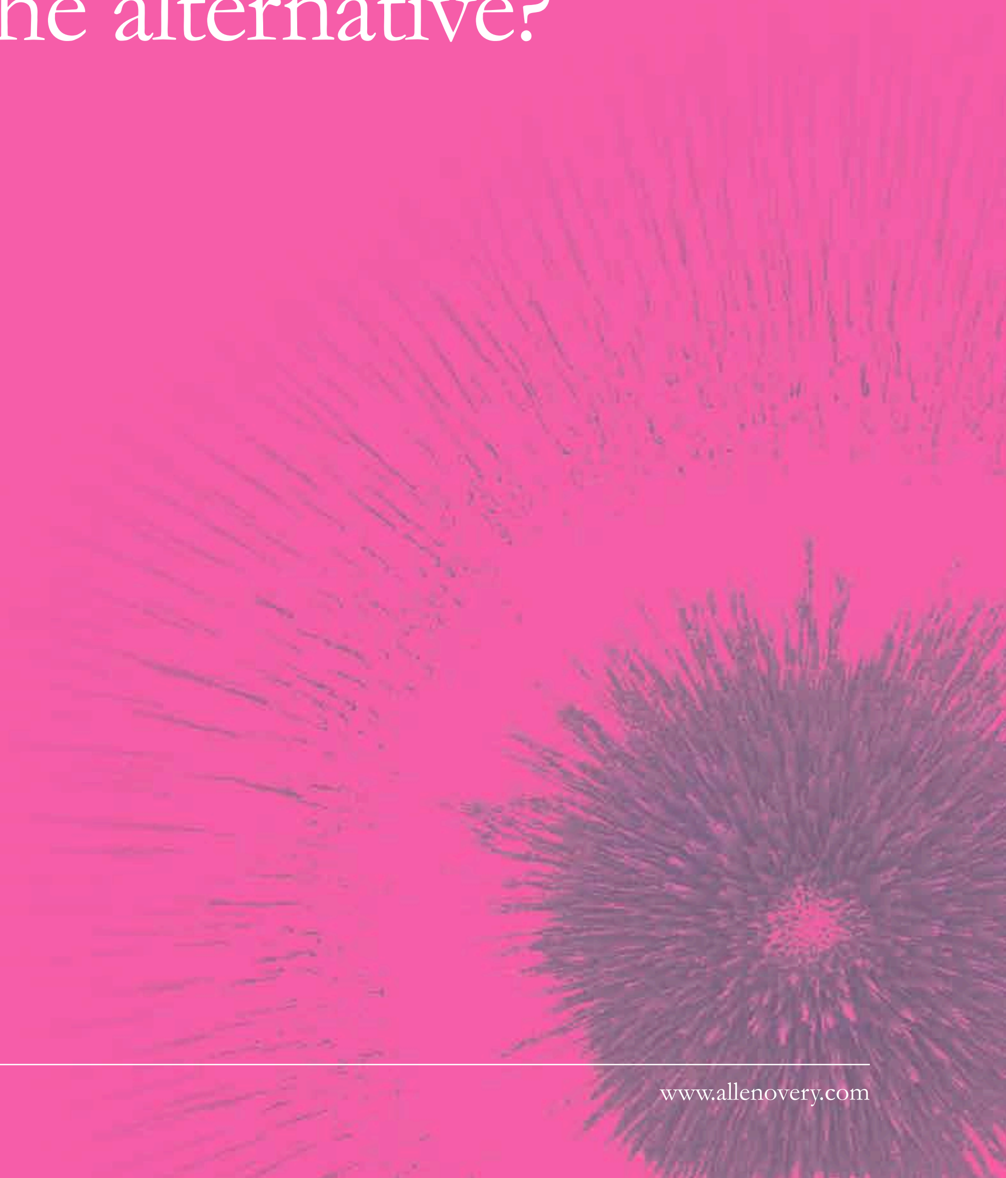



Nearly half (47%) of respondents expect their use of alternative funding to increase over the next five years, while only 13% think it will decrease. That clear shift towards alternative finance is the biggest trend to emerge from respondents' answers to this question. Much of the increase in alternative funding comes at the expense of bank lending, where slightly more respondents expect to see a decrease. With capital markets, slightly more respondents expect an increase.

Digging deeper into the data by size of company, there are some interesting nuances, however. Finance executives from medium-sized companies are particularly enthusiastic about the increase in alternative funding, with over half (54%) expecting to use more, but a third also expect to use more bank lending. They also expect their use of capital markets to increase slightly.

For larger companies, it is a different picture. Only 23% of respondents expect to increase their use of bank lending, compared to 33% that expect a decrease. Nearly twice as many (42%) expect to use more alternative funding and only 11% less – the larger the company, the clearer the trend to diversification, with over a quarter (27%) of respondents from large companies also planning greater use of capital markets.

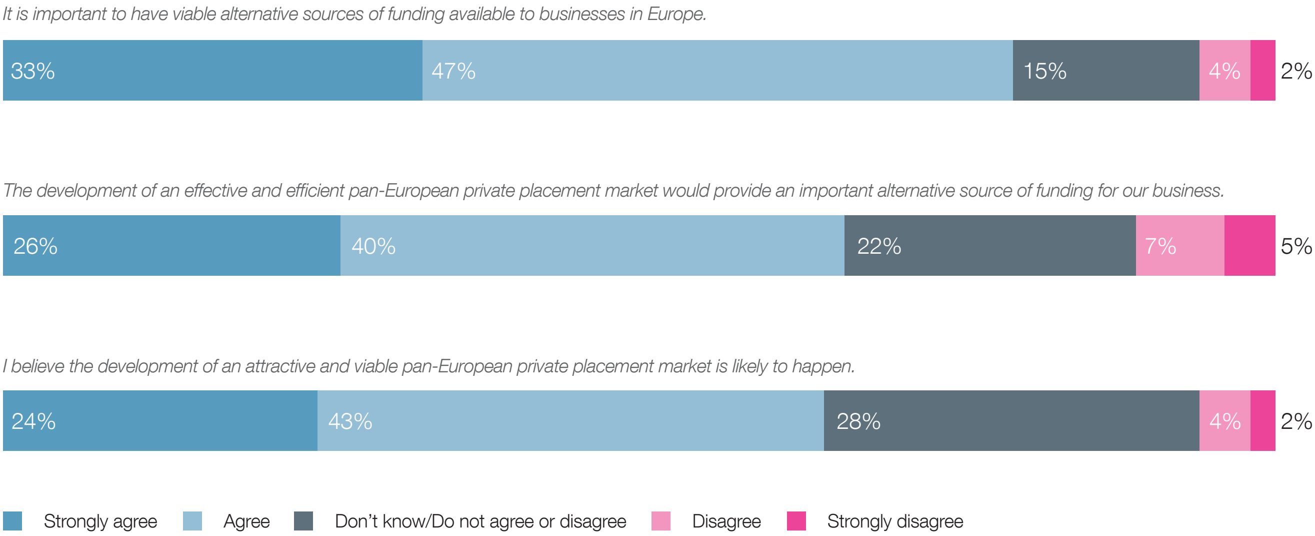
# So, what's the alternative?



# Would a pan-European private placement market fill a funding gap?

**YES, BUT GERMAN COMPANIES FEEL LESS OF A NEED THAN OTHERS**

***Question asked:*** *Please state the extent to which you agree or disagree with each of the following statements*




Respondents see a clear need for more alternative funding sources in Europe, with 80% agreeing it is necessary and only 6% disagreeing. Two-thirds (66%) regard a well-functioning pan-European private placement market as an important source of funding for their own company and the same share (66%) agree that a viable market is likely to emerge.

Given the number of false starts for similar initiatives in the past, that is a remarkable testament to both the change in corporate attitudes since the crisis and the political will that is driving this attempt to get the market off the ground.

In most countries there is a strong perception that alternative funding is needed and that a pan-European private placement market would be helpful. Support levels are particularly strong in Italy and France, with positive responses to all three questions at 90% and above.

In contrast, there is considerable uncertainty in the UK about whether such a market can be achieved. Germany shares that scepticism to a degree, but it falls out of line across the board.

Only 37% of German respondents see alternative sources of funding as necessary and just 33% regard a pan-European private placement market as part of the solution. One reason is the unique financing environment that German companies currently enjoy.

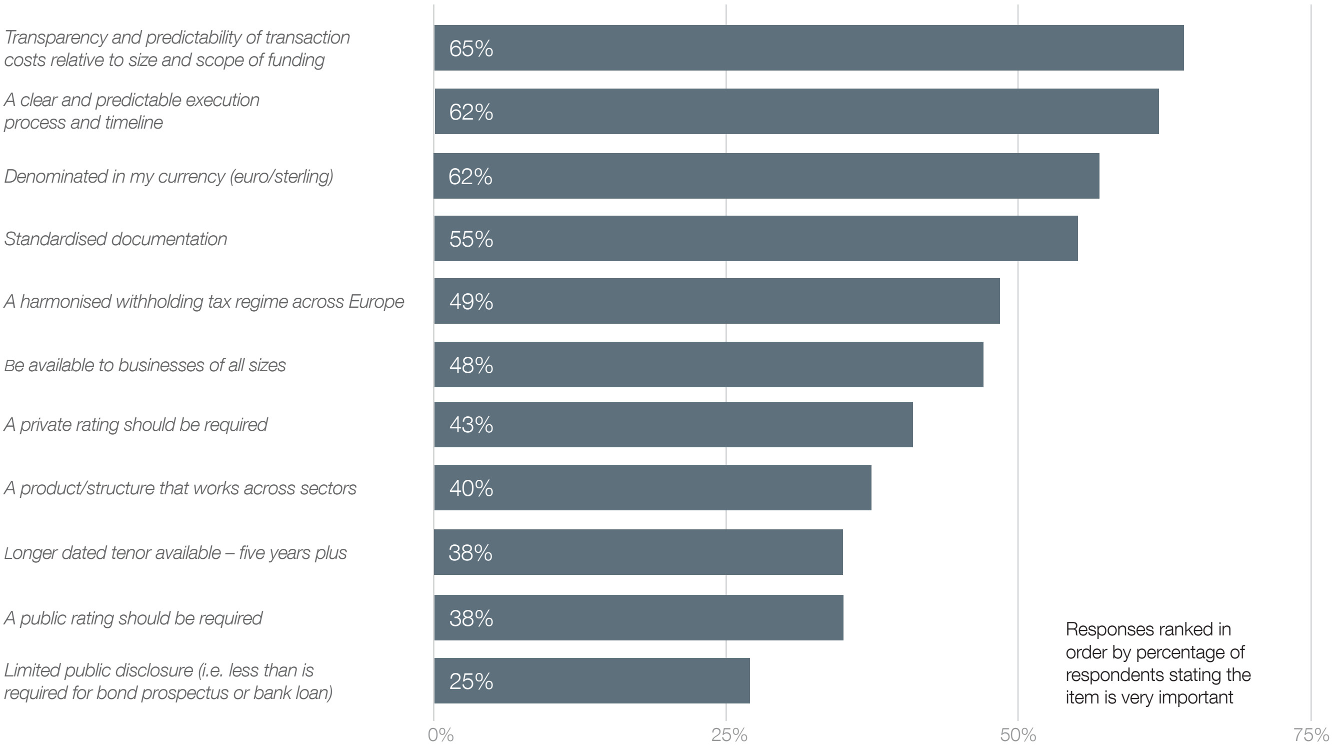
A broad range of different types of banks offer very competitive lending terms, while the continent's largest and oldest domestic private placement market – Schuldschein – adds an additional flexible financing option, at least for investment-grade companies.

Once the pan-European private placement is in place, smaller German companies are likely to use it, but the push for a pan-European market will not come from Germany.

# What is needed to make a pan-European market viable?

## CLEAR COSTS AND PROCESSES TOP THE LIST

***Question asked:*** *Please tell me how important you consider each of the following to be in order for a pan-European private placement market to be an attractive and viable option for both borrowers and investors?*




Respondents consider costs and processes to be far more important for a well-functioning private placement market, than ratings, tenor and disclosure rules.

The leading concern is the transparency and predictability of costs. Some commentators have suggested that greater bureaucracy could make a European market more expensive than the U.S. private placement market.

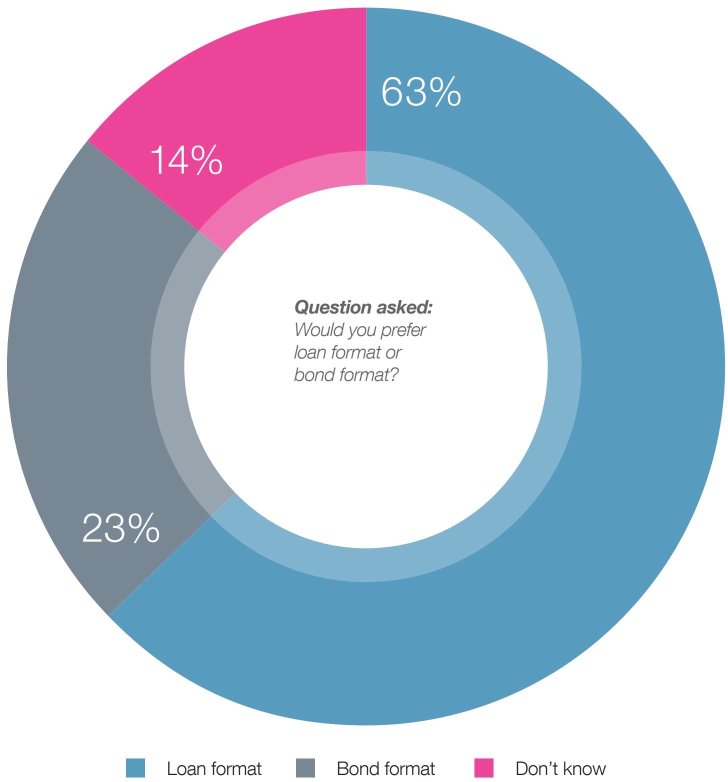
This is followed by the need for clear and predictable processes, denomination in the issuers' own currency (a particular concern among British respondents but also ranking high for some of the Eurozone respondents) and standardised documentation.

Half of respondents (49%) feel that harmonising the withholding tax regime across Europe would be key, but this is low down the list of priorities for British and Benelux respondents.

Medium-sized companies were more concerned that the market be available to businesses of all sizes, elevating this to their fourth-ranked priority.

# Loans or bonds?

## DEFINITE PREFERENCE FOR LOANS, BUT IT DEPENDS ON EXPERIENCE




Nearly two-thirds of respondents (63%) would prefer to see a loan, rather than a bond, format in the private placement market. While that response is clear the breakdown by country suggests it is largely a question of familiarity and regulations.

Countries that still rely heavily on bank lending, such as Spain, tend to focus primarily on loans: Spanish respondents are virtually all in favour of a loan format, for example. In Italy, regulations have only just been changed to allow a bond format, perhaps explaining the Italian respondents' lack of familiarity with this option.

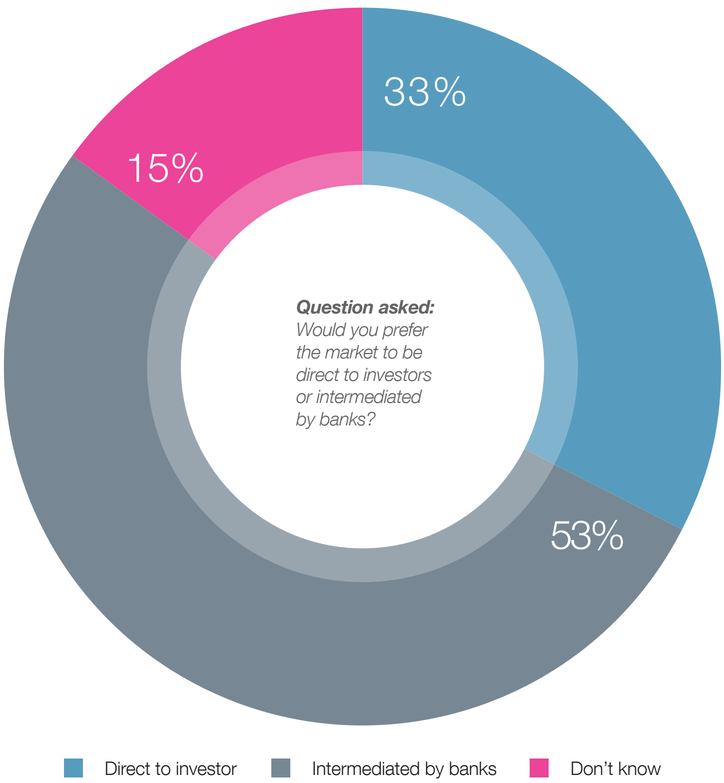
France, by contrast, has had a fast-growing domestic private placement market in place for the past two years, based on a listed bond format which has only recently been broadened to facilitate unlisted bonds and loans. Unsurprisingly, almost half (47%) of French respondents are in favour of bonds – the highest percentage among all countries – but the other half still prefers loans.

In the current drive for a pan-European private placement market, issuers and investors will be able to choose whether they prefer to package deals as a loan or listed or unlisted bond (respondents who prefered the bond format show no preference either way).

Investors may prefer bonds due to their easier transferability and issuers due to slightly looser covenant terms. However, given the smaller size of the companies targeted for the pan-European market, loans could well be the default option and will ensure investors are not subordinate to banks in the creditor ranking.

# Direct or intermediated market?

**PREFERENCE FOR BANKS TO REMAIN INVOLVED**



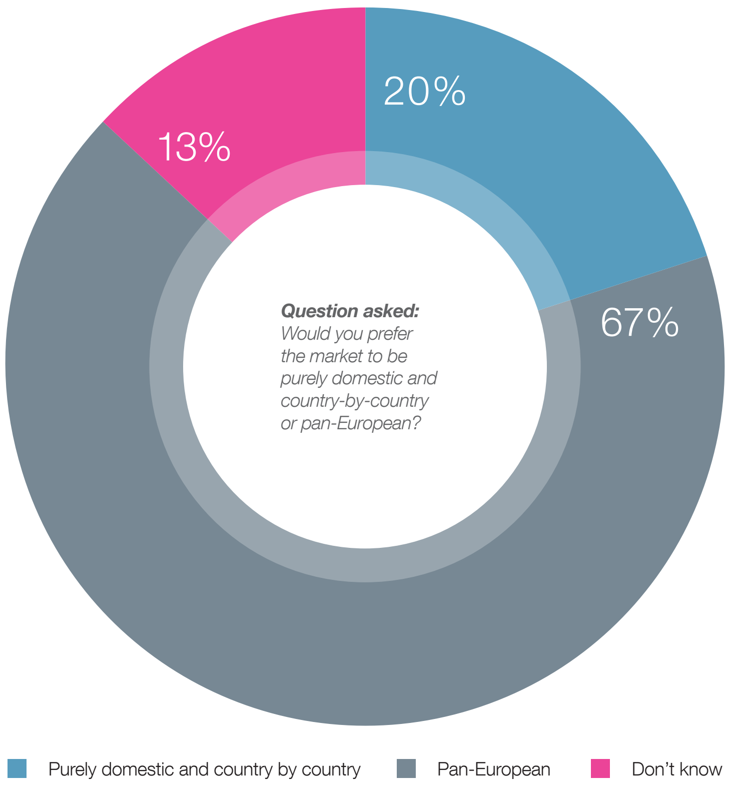

Over half of respondents (53%) say they would like banks to play an intermediary role in the private placement market, while only a third (33%) would prefer to take a direct route. Both options will be open to issuers in the European private placement market, with banks able to play an agency role as they do in the U.S. private placement market – arranging the deal and advising, but not underwriting it.

Responses vary quite strongly by country, again reflecting levels of experience, but also the perceived need to diversify away from banks and keep costs low. Benelux, French and British respondents are most strongly in favour of bank intermediation. Spain, whose respondents report strong reliance on bank lending, is the only country with a small majority in favour of direct access to the market. But Italy, which shows a low level of bank lending, also tends towards direct access. Germany, where companies using Schuldschein can also choose to go directly or through their banks, is mixed but also somewhat more in favour of direct access.

Ultimately much will depend on the ability of investors to assess the risk of the smaller companies appearing on the private placement market. But banks are expected to have a crucial role to play in helping European companies gain access to alternative funding sources.

# Domestic or pan-European?

**CLEAR PREFERENCE FOR A SINGLE EUROPEAN MARKET**




Two-thirds of respondents (67%) say they want to see a pan-European private placement market develop, rather than a series of domestic markets. Larger companies show an even stronger preference, with three-quarters (75%) of finance executives saying it should be pan-European.

That preference is also particularly strong in sectors like telecoms and technology, energy and natural resources and infrastructure/transport, where private placements are frequently used in project financing. Just 20% of respondents are happy to see more domestic markets emerge, as in Germany and France, each with different rules, players and pricing.

The strongest support for a pan-European market comes from respondents in Italy and Spain (over 80% in each), where companies currently have to issue debt in other countries' private placement markets. Interestingly, however, respondents in France and Germany are also clearly in favour of a pan-European market to complement their own domestic market.

Respondents from the UK, which despite its role as a global finance hub, has no domestic private placement market and tax regulations that make accessing other markets more expensive and difficult, are the least enthusiastic about a pan-European market. Even here, more British respondents favour the pan-European option than the domestic one, but nearly a quarter in the UK don't yet know.

# *Methodology*

This survey has been conducted using telephone interviews with 218 respondents from companies with 50 or more employees, with respondents split evenly between medium and large enterprises and across all major commercial sectors excluding financial services in Germany, France, the UK, Spain, Italy and Benelux. Respondents all have substantial decision making input over their company's funding arrangements.

YouGov plc makes every effort to provide representative information. All results are based on a sample and are therefore subject to statistical errors normally associated with sample-based information.

Fieldwork was undertaken between 16 September 2014 and 14 October 2014. Percentages may not always add up to 100% due to roundings.

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