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Direct Lending Takes Off in Europe

U.S. Investment Firms Offer Funds to Companies as Continent's Lenders Pull Back

By Noémie Bisserbe in Paris and Jeannette Neumann in Madrid
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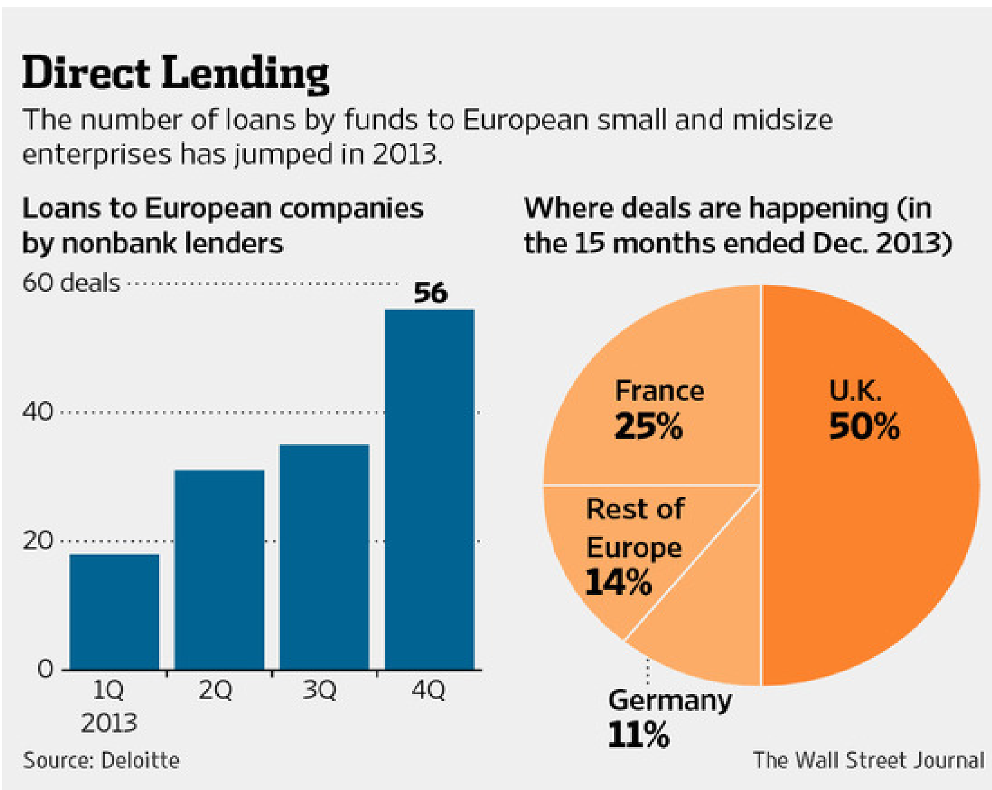

U.S. investment firms are peddling loans to small businesses across Europe as the region's banks cut back on lending in the face of new regulation and a weak economic recovery.

U.S.-based funds such as Czech Asset Management, KKR & Co., Sankaty Advisors and Taconic Capital Advisors LP have begun lending to small and medium-size European companies and are looking to close more deals in the coming months.

"U.S. direct lending funds are serving as miniature banks, lending to small businesses across Europe," said Steve Czech, head of Connecticut-based Czech Asset Management.

Unlike in the U.S., direct lending is still new to Europe, where smaller companies have until now largely relied on banks for financing. But strict new rules forcing banks to hold more capital to absorb potential losses have led banks in Europe to reduce lending, especially to risky companies.

As a result, despite the higher interest rates often charged by these funds, some European companies now have few other options to raise much-needed cash.

The emergence of this type of lending shows that despite efforts by the European Central Bank and other European Union regulators to improve access to credit, many small to medium-size companies are still struggling to raise funds as banks focus on cutting their lending portfolios instead of issuing new loans. This could prove a significant stumbling block to the continent's fragile recovery, analysts say.

The trend is also raising concerns among some national regulators. "These loans often come at a hefty price and may not be as sustainable as bank funding," said a senior French banking regulator.

Gestión Integral del Agua de Huelva SA, a public water utility in southwestern Spain, is one company that has turned to alternative funding. In November, Giahsa borrowed €85 million ($116.6 million) from Taconic Capital, based in New York City, and the Children's Investment Fund, based in London. It was the first time the company took out a nonbank loan. The 13-year loan carries an 11.85% annual interest rate and a 5.5-year duration.

"If we hadn't done it, maybe we wouldn't be talking right now," said Executive Director Manuel Domínguez Limón.

Giahsa, which supplies water to 65 cities in Huelva province, had been scrambling since 2011 to refinance debt and pay rent on water pipes. Giahsa typically paid around 7% for similar loans before the crisis, the company says.

Loans by nonbank lenders to European companies more than tripled to 56 in the fourth quarter of 2013 from 18 in the first quarter, according to a recent study by Deloitte LLP, which tracked 32 alternative-lending funds raised over the past two years. About half of those funds have roots in the U.S., says Floris Hovingh, head of Deloitte's alternative-lender coverage.

In 2011, U.S. investors thought the sovereign-debt crisis would create lucrative investment opportunities in Europe as new rules and a challenging economy forced banks to go on diets and sell assets. But the ECB offered cheap, emergency loans in December 2011 and February 2012, which enabled banks to cope with the crisis better than expected.

Investors, however, had raised funds and promised their clients returns of above 10%. "They had to deliver," said Mr. Hovingh. So funds started pitching European companies directly, rather than buying loan portfolios from banks.

Hewden Stuart Ltd., a small Scottish construction-equipment company, was grappling last year with a stagnant economy and falling demand. The company borrowed £30 million ($49.8 million) from Czech Management.

"We had already renegotiated our credit facility with our banks. It may have been challenging to get more out of them," said Chief Executive Kevin Parkes. He declined to disclose details of the deal due to confidentiality agreements. Interest rates on such loans range typically from 6% to 15%, U.S. fund managers say.

About half of the deals that closed in Europe in the 15 months ended in December 2013 involved companies based in the U.K., such as Hewden, compared with 25% in France and 11% in Germany, according to Deloitte.

Interest has begun to grow in Southern Europe.

Jesús Olmos, who heads KKR's Spanish operations, said the firm is looking to issue loans of more than $100 million to small and medium-size Spanish companies. In April 2013, KKR lent €320 million to Uralita SA, a building-materials company. KKR opened its first Spain office in February.

JZ Capital Partners Ltd., a private-equity firm listed in London, and Avenue Capital Group, based in New York City, invested €400 million to create a vehicle to focus on lending to Spanish companies, called Toro Finance, which opened in Madrid on Jan. 2.

Toro Finance has lent €75 million to finance a dozen projects since then, says Mar Turrado, head of the fund. Toro Finance has spoken with 250 companies in recent months, Ms. Turrado says.

Some funds say it has been a challenge to convince Spanish companies, long reliant on bank loans, to shake up their financing.

Companies were initially skeptical and "thought we were trying to replace the banks and rip them off," said Stefan Lindemann, director of HIG Whitehorse, a HIG Capital LLC fund that focuses on European direct lending. Now, he says, more companies are open to direct lending.