

US AND EUROPE

Transatlantic visions

Having launched its US and European direct lending platforms in 2004 and 2007, respectively, Ares Management has seen private debt evolve on both sides of the pond.

Michael Arougheti, the firm's president and co-founder, and **Kipp deVeer**, partner and head of the firm's credit group, offer their insight

Q How did private credit or direct lending in the US evolve to where it is at today?

Mike Arougheti: Direct lending has become an established asset class because of its appeal to investors and borrowers alike – and we became a market leader in the US by growing our platform with local offices across the country. There are three factors that helped the asset class grow. Bank consolidation was the first catalyst because it took capacity out of the banking system and created a natural need for middle-market borrowers to look elsewhere for corporate loans. Second, direct lending also benefitted from healthy capital markets, where firms like ours could access capital in the equity and debt markets. And lastly, the evolution of the financial sponsor and private equity business has also been a significant catalyst for growth of middle-market companies and as such, has increased the demand for private credit.

Kipp deVeer: Supporting the growth of the direct lending market has been the significant infusion of institutional capital. Back in 2003 and 2004, a pension plan, insurance company or sovereign wealth fund really didn't know where to allocate a direct lending investment since it didn't fit into their fixed-income allocation. It also wasn't included in their alternatives or private equity portfolio allocations. Thirteen years later, these same investors are choosing what elements of private credit they want – some



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Mike Arougheti

want senior debt, others want flexible capital, and others want mezzanine. Some want all of the above.

To give you a sense of the acceptance of the asset class and our commitment as a leading direct lender to the middle market for more than a decade, we have invested more than \$45 billion in the US across over 1,000 transactions.

Q When did private debt start to develop in Europe, and how does it compare with the US?

KD: In 2005-07, there were some very dramatic attempts by non-banks – largely through the formation of collateralised loan obligations – to bring institutional capital into what we now think of as larger-cap leveraged finance and some middle-market transactions.

MA: We had a view that non-bank lending in Europe would develop along the same lines as in the US market with bank consolidation and a regulatory framework pushing assets out of the banking system. We also expected to see the continued development of the liquid credit markets alongside the private credit markets and the maturation of the private equity business, and therefore we would see the same kind of increase in demand for credit in Europe as we had experienced in the US.

Ares was arguably the first true direct lending platform in Europe, and we prepared ourselves for this market to develop much more slowly than it actually did. When the financial crisis hit, the demand for private credit grew dramatically. Having been in Europe for a decade, we have made more than 130 investments totaling more than €10 billion.

Q What do you think are the important distinctions between the European and the US markets?

KD: The largest difference today is on loan terms, where they are generally stronger

for lenders in Europe because the market is less mature. The US direct lending market is more competitive and requires a higher degree of selectivity. With a significant balance sheet and our extensive relationships, we can push back on weaker loan terms and typically achieve more attractive structures than the market.

Q How do you differentiate direct lending from other private credit strategies?

KD: At Ares, direct lending is when our team directly originates a middle-market loan and structures it with a private company. It includes cashflow or asset-based lending and such lending transactions may be sourced through sponsored or non-sponsored channels.

MA: Within our view of private credit, we also have private structured credit capabilities, including private asset-backed securities, rediscount lending and private securitisations, true asset-based lending and asset-backed strategies. We also manage real estate debt funds in our real estate group and distressed funds through our private equity group. Private credit often includes many or all of these strategies and direct lending is one component.

Q What is the best way for credit managers to originate transactions?

MA: Our experience is you must build deep, local origination networks. It has to be built out geographically since so much of this business is building relationships with in-market companies, sponsors and intermediaries. Then, you overlay product expertise and/or industry expertise alongside your geographic footprint. We think a narrow product set doesn't position you to find the best risk-adjusted returns at any point in time because market conditions constantly change.



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Kipp deVeer

Q What is your strategy in the current market?

KD: Our view is that the US market is later in the cycle, and we are seeing other players adding a fair amount of risk to their portfolios. We think there is a lot of undisciplined underwriting today. We are focused on being conservative in terms of company and industry selection and transaction structuring. One of the benefits of our scale is that our large portfolio provides plentiful opportunities from existing borrowers seeking additional growth capital. This keeps us less focused on the new deal business, which we think is probably more difficult than it has been in a while.

Q Are incumbent lenders at an advantage when trying to seek better deal terms?

KD: Always. There's less competition and

you have existing relationships with an existing borrower. Their tendency is to want to stick with us if we've been good to them, which I think we generally are.

MA: And if you've been living with borrowers for years, getting monthly financials, and you have a relationship with the management team at every level, you have a lot more conviction around your underwriting. No question.

Q What are your favourite sectors?

KD: You'll find us in a lot of industries that have better-than-GDP growth. They include services, healthcare, information technology, software services, food and beverage and other industries that have pretty inelastic demand even in a recessionary environment. You also see us further up the capital structure than usual in senior loans.

Q Where do you think the future growth in direct lending will come from?

KD: With approximately \$38 billion of direct lending AUM, as of 30 June this year, we expect to continue to benefit from our market-leading position in both the US and Europe. We also anticipate that we will continue to expand our non-sponsored investments in both geographies. Because of the number of family-owned businesses in Europe, we think non-sponsored transactions are a big opportunity over the long term.

MA: We're also putting roots down in China with direct lending. The issue with new markets is you have to have the long-term view that they will develop. The good news in the Chinese market, at least, is that there is already precedent for non-bank capital. So, how the regulatory framework gets organised around that business is a big question and a big opportunity. ■