

Direct lending & the European transformation

A financing solution for SMEs to participate in the transition



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IN A NUTSHELL

- European transformation is an ambitious project, requiring significant capital deployment. High debt levels limit what governments can do. Private debt will need to fill the investment gap
- Small and medium-sized enterprises (SMEs) are the backbone of Europe's economy. They account for more than half of Europe's GDP and employ around 100 million people¹
- SMEs have no direct access to capital markets or other sources beyond credit. Private investments via direct lending are an alternative addition to bank loans, which provide SMEs with the capital needed for their transformation
- SMEs have a key role to play in the European transformation. Their growth is expected to be significantly accelerated by key technological, societal and geopolitical mega-trends, with SMEs providing products and services in:
 - Technology and digitalization
 - Redesign of supply chains and reshoring of production to reduce dependencies on other regions
 - Healthcare that needs adopting to aging demographics
 - Climate change and energy transition

1 / Critical investment gap for European transformation

In December 2022, we published our framework for European transformation² that emphasized the importance to mobilize capital to solve multiple challenges faced by Europe's economies, such as adverse demographics, industrial competitiveness and the climate transition. The investment required to transform Europe is worth trillions of euros, and the investment gap is considerable. In 2019, the EU estimated³ that the level of public investment in the EU-27 was insufficient to keep the public capital stock constant as a share of GDP. The same study estimated that the investment needs for delivering the green transition and the digital transformation were at least €595bn per year, [Figure 1](#). The estimate includes €470bn per year associated to the additional investments needed to reach the EU's current 2030 climate and environmental policy goals, and

¹European Commission (March 2020). Unleashing the full potential of European SMEs

² DWS Research Institute (December 2022). A framework for European transformation <https://www.dws.com/en-gb/insights/global-research-institute/a-framework-for-european-transformation/>

³European Commission Staff Working Document. SWD (2020) 98 - Identifying Europe's recovery needs

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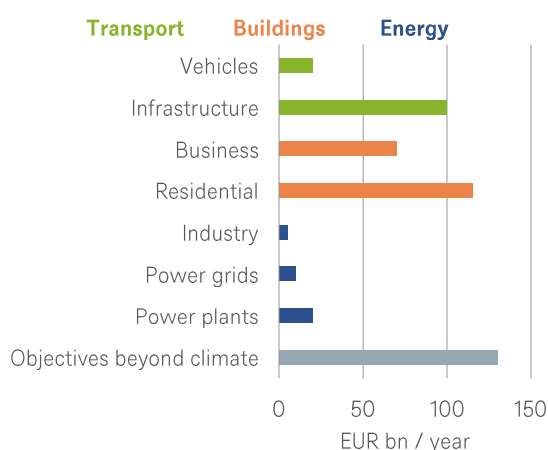
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€125bn related to the EU’s goals for digital transformation. Some of these investments were to be covered through public spending, but the remaining investment and hence financing gap was expected to be around €1.77 trillion for the 2021-2027 period, or €250bn per year⁴. This will likely fall heavily on the shoulders of the private sector⁵.

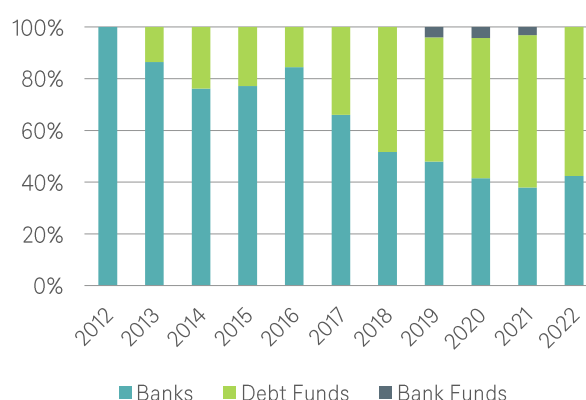
We find that banks typically provide about 70% of corporate financing in Europe. In the US, by contrast, about 70% percent of companies are financed on the capital market⁶. This reflects the heavy reliance on the banking sector in financing economic activities in Europe, where financing has been hindered by the after-effects of both the 2007-08 Global Financial Crisis and the subsequent euro sovereign debt crisis. Listed equity markets ought to step in and provide financing for long-term transformative projects in Europe, but this is largely absent. At the same time, the euro area economy has seen growing importance of the non-bank financial sector in supporting the financing of the real economy and financial market integration. The share of financing through debt funds (in terms of number of transactions) in the leveraged loan mid-market in the euro area grew from less than 14% in 2013 to almost 60% in 2022⁷, Figure 2.

Figure 1: Breakdown of Europe’s green transition investment gap⁸



Source: European Commission (2020)

Figure 2: The increasing role of non-bank financing in the leveraged loan mid-market in the euro area



Source: Houlihan Lokey MidCapMonitor Q4 2022

2 / SMEs are the backbone of Europe’s economy but have limited access to finance

Small and medium-sized companies, or SMEs, make up the majority of the global economy, accounting for between 50% and 70% of value added in OECD economies and contributing to, on average, 33% of GDP in emerging economies⁹. They represent 99% of all businesses in the EU, provide two out of three jobs and account for more than half of Europe’s GDP¹⁰. SMEs bring innovative solutions to many societal and environmental challenges, and they are essential to Europe’s competitiveness and prosperity, industrial ecosystems, economic and technological sovereignty and resilience to external shocks.

⁴ Climate & Company for Agora Energiewende (July 2020)

⁵ IEA (2022). World Energy Outlook

⁶ Deutsche Bank Research (March 2019). How to fix European banking and why it matters

⁷ Houlihan Lokey MidCapMonitor Q4 2022. The data refers to number of transactions and only includes senior and unitranche mid-market transactions seen by Houlihan Lokey. This is not the “entire” lending market

⁸ Until 2030. As communicated by the European Commission (2020). Data source: Commission Staff Working Document, 2020. Estimates do not represent the raised ambition of GHG emission reductions of 50-55%

⁹ OECD (2017). Small, Medium Strong. Trends in SME Performance and Business Conditions

¹⁰ European Commission (March 2020). Unleashing the full potential of European SMEs

Only 10% of European SMEs' external financing comes from capital markets and only 11% of businesses in Europe consider equity as a viable financing option, while only 1% have used it¹¹.

SMEs can turn to financing sources away from the traditional bank lenders and find some liquidity from private capital via the direct lending market. Direct lending, like private debt in general, has grown significantly since the Global Financial Crisis. According to McKinsey estimate¹², global private debt fundraising increased by more than four times in the past decade, from US\$44bn in 2010 to US\$192bn in 2021. Direct lending accounted for nearly 60% of overall private debt fundraising in 2021, exceeding US\$100bn for the first time. It has accounted for 73% of the overall growth in private debt fundraising over the last decade, growing nearly 40% per annum.

North America accounts for more than half of all direct lending fundraising between 2013 and 2020¹³. In Europe, this asset class has taken longer to develop, but the past few years have suggested a structural shift may be underway. The growth in transaction activity in Europe has also enabled substantial diversification across sectors and geographies spreading from the UK, which was a first adopter on the continent, to the core markets of France and Germany, and then expanding quickly across Benelux, Spain, Italy and the Nordics.

For borrowers, direct lending offers speed, convenience and flexibility. Borrowers work one-on-one in partnership with their lender typically in the form of one fund or a very small syndicate. Such close relationships between borrowers and lenders are almost unique to direct lending, allowing investors a remarkable level of control over the process. It also increases a creditor's influence when it comes to engaging the company on environmental, social and governance (ESG) factors.

3 / SMEs can play a key role in the European transformation

Direct lending can support technological change and improve the competitiveness of SMEs of all sizes and across all sectors and geographies. SMEs' growth in terms of generating employment and economic value and contributing to innovation is expected to be accelerated by the key technological and societal mega-trends such as advanced technologies and digitalization, redesign of supply chains to reduce dependency, aging demographics and associated healthcare needs, climate change and energy transition, to name a few.

The European Commission has identified three key areas in which SMEs need support:

- 1/ the sustainable and digital transitions,
- 2/ improved market access, and
- 3/ better access to finance⁹.

An opportunity to invest in European technology sector

European technology companies have historically faced challenges in scaling compared to the US peers because of many factors, including smaller local markets, higher regulatory burdens and a lack of capital. At the same time, they are positioned to take advantage of certain structural benefits specific to Europe, including higher population density driving economics for e-commerce and local commerce, proximity to the luxury industry and a deep technical talent pool with less competition¹⁴. Furthermore, technology is no longer seen as just a stand-alone sector, but as an enabler and partner to a wide array of other industries. Whether it is manufacturing, transportation, healthcare or education, there is no industry that technology does not affect.

Advanced technologies present enormous growth potential for Europe. Technologies such as the Internet of Things, industrial data, advanced manufacturing, robotics, 3D printing, blockchain technologies and artificial intelligence (AI) offer a range of opportunities that can enable European industry to remain a global technology player and expand its leadership in the emerging markets for the products and services of the future.

¹¹ European Commission (March 2020) Unleashing the full potential of European SMEs

¹² McKinsey (March 2022). McKinsey Global Private Markets Review 2022: Private markets rally to new heights

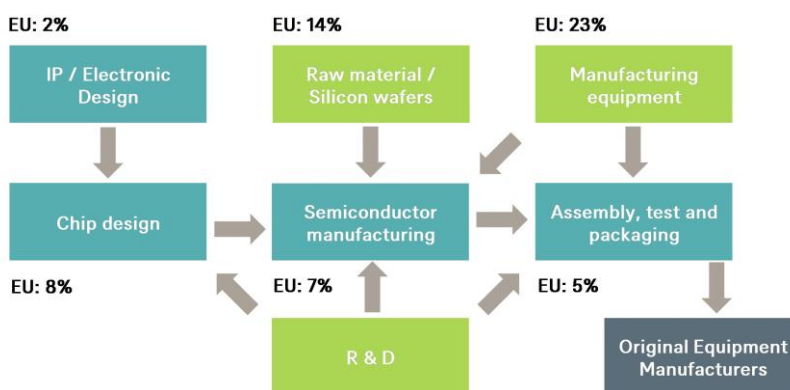
¹³ Deloitte (2022). Deloitte Private Debt Deal Tracker Autumn 2022

¹⁴ JPMorgan (2020). Five Emerging Technology Trends to Watch in Europe

Another growth driver for the technology sector in Europe is the need to reach strategic autonomy, as the Covid-19 pandemic, Russia’s invasion of Ukraine and tensions between China and Taiwan have highlighted Europe’s dependence in multiple technology areas, including semiconductors. Thus, the European Commission in February 2022 presented the European Chips Act that should bolster Europe’s competitiveness and resilience in semiconductor technologies and applications. Today the EU share of global revenues for semiconductor chips is around 10% overall, but Europe is home to world-leading suppliers of manufacturing equipment and raw materials such as substrates and gases¹⁵, Figure 3.

The Chips Act aims to mobilize €43bn in policy-driven investment for the EU's semiconductor sector by 2030, but long-term private investments are expected to exceed this. The Chips Act also emphasizes the importance of facilitating access to finance for SMEs and start-ups to scale their businesses. In fact, even though the semiconductor industry is highly consolidated, there are almost 10,000 companies in the semiconductor value chain in Europe - the vast majority are SMEs.

Figure 3: Semiconductor supply chain: European global market shares of relevant segments



Source: European Commission. A Chips Act for Europe (2022)

Investment case study¹⁶: Chip packaging

A company is a leading, full-service supplier of chip-level technologies, requiring a clean room. The company specializes on complex, high-margin, customized solutions for its longstanding customers which require high tech/process know-how and highly skilled and flexible workforce.

Investment case study¹⁷: Internet of Things (“IoT”)

A company is a global leading module provider in the Internet of Things market with a focus on the industrial sector. It designs, develops, manufactures, and sells an extensive range of connectivity module products and provides software and connectivity services.

Digitalization of SMEs is a priority and opportunity

Europe has without doubt strong assets in digital technologies and skills, both on the industry and on the research side. However, it is commonly accepted that there is a “need for action” to foster the digital transformation, especially in SMEs and traditional sectors. Digitalization of SMEs is recognized as a factor of competitiveness for businesses and an engine for growth and welfare for the economy.

¹⁵ European Commission (2022). A Chips Act for Europe

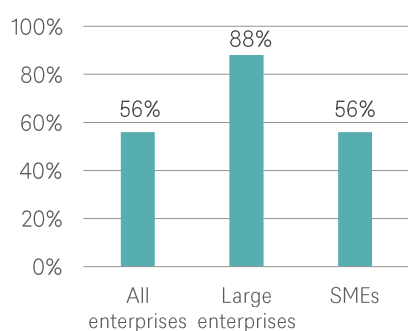
¹⁶ The above examples have only an explanatory nature

¹⁷ The above examples have only an explanatory nature

According to the recent Digital Economy and Society index (DESI) report, which tracks the progress made in EU countries in digital, only 56% of EU SMEs have at least a basic level in digitalization in 2021, while the target is at least 90% by 2030¹⁸, Figure 4. SMEs lag large companies in the adoption of all types of new digital technologies, with many opportunities, such as specialized software, cloud services, AI and big data, yet to be exploited by SMEs, Figure 5. Additionally, the European Commission highlights the importance of twinning the green and digital transition by mobilizing European SMEs across industrial sectors to accelerate both green and digital transformation¹⁹.

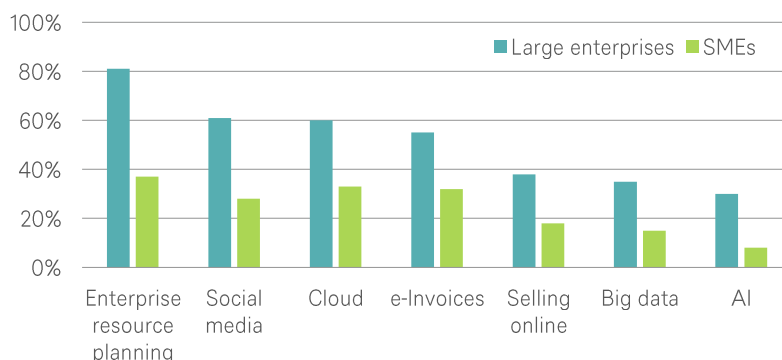
While there is an obvious need for higher levels of digitalization, SMEs themselves are also providers of products and services for this transition. They play an important role in the development, scale up and distribution of specialized software and other enabling technologies that help businesses to transform their operations, increase efficiencies and enhance customer experience, especially in niche areas that are not serviced by large corporations.

Figure 4: Basic level of digital intensity in- dex by EU enterprises in 2021



Source: Eurostat (2021)

Figure 5: Adoption of digital technologies by large enterprises and SMEs in 2020-2021



Source: Eurostat, European Union survey on ICT usage and e-commerce in enterprises

SMEs are key to improving Europe’s supply chain resilience

The Covid-19 pandemic disrupted many global supply chains at its outbreak, and the subsequent economic recovery led to enormous further strain as surging demand, coupled with shortages of workers, ships, containers, air cargo space and clogged ports, created a 'perfect storm'. Economic losses due to supply chain disruptions in the Eurozone are estimated at €112.7 billion, or 0.9% of GDP²⁰. The war in Ukraine has compounded these challenges. In addition to increased geopolitical and geoeconomic tensions, the rethinking and reconfiguration of Europe’s supply chain are also driven by the shift towards digital and low-carbon economies.

While the private sector has traditionally emphasized supply chain efficiency (for instance, by prioritizing low costs and speed of production), now it is shifting focus towards strengthening resilience. Similarly, governments are focused at supporting supply-chain resilience in order to enhance crisis preparedness and response regarding health and personal safety, strengthen national security, boost industrial strength and economic competitiveness, create domestic jobs and promote human rights and sustainability.

The European Commission is establishing an Observatory of Critical Technologies and has begun charting supply-chain dependencies and vulnerabilities. The Commission is also working on the Critical Raw Materials Act—Europe’s attempt to address risks around supply chains for critical raw materials in light of expected demand growth for the green and digital

¹⁸ European Commission (2022). Digital Economy and Society Index (DESI) 2022

¹⁹ European Commission (2022). Strategic Foresight Report 2022

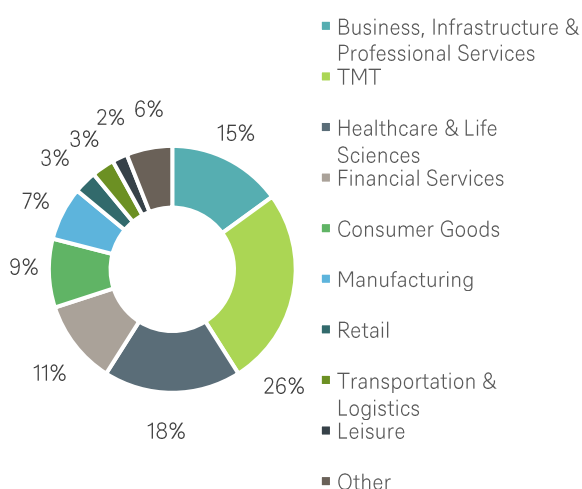
²⁰ Accenture (2022). From disruption to reinvention: The future of supply chains in Europe

transition. Additionally, as European companies will start to be required to report on their Scope 3 emissions, which are associated with their value chain, they would have to reshape and reengineer these value chains to minimize environmental impacts. We expect higher level of regionalization that will require a new manufacturing and distribution footprint.

SMEs have key roles to play in addressing Europe’s healthcare challenges

European health systems are facing big challenges. In addition to aging populations, the rise in chronic diseases, shortage of healthcare workers and constraints on public finances, European health care systems are now required to deliver more and better care with fewer resources. The population of people over 65 years old in the EU-27 is projected to increase significantly, rising from 90.5 million in 2019 to reach 129.8 million by 2050²¹. During this period, the number of aged 75-84 years is projected to expand by 56%, while the number aged 65-74 years - by 17%. Traditional health care systems, designed to deliver acute care, won’t be able to cope with these challenges without a fundamental transformation.

Figure 6: Total private debt deals by industry in Europe (ex-UK) in 2021-2022



Source: Deloitte Private Debt Deal Tracker Autumn (2022)

SMEs can help the transformation by developing innovative technologies and providing specialized services. According to the European Medicines Agency (EMA), SMEs developed nearly 20% of all human medicines recommended for authorization in 2020; half of these target a rare disease²².

SMEs constitute 95% of Europe’s 34,000 med tech companies²³, which include medical devices, in vitro diagnostics and digital health, employing directly more than 800,000 people. The highest number of these SMEs are based in Germany, followed by Italy, the UK, France and Switzerland.

Innovation in the healthcare and life sciences sector is a lengthy and complex process and requires adequate funding. Healthcare and Life Sciences have been one of the dominant users of private debt in Europe, accounting for 18% of total deals in 2022²⁴, Figure 6.

Continuing investments in the healthcare digital transformation and technological innovations by private and public markets is needed to ensure the health and well-being of European citizens, whilst stimulating research and development and contributing to Europe’s global competitiveness.

Investment case study²⁵: Ambulance services

A company is the largest provider of outsourced mission-critical ambulance services with activities in multiple European countries. The company provides emergency and scheduled patient transportation services for regional governments, private clients and national health associations through a concession-based business model.

²¹ Eurostat (2020). Ageing Europe – looking at the lives of older people in the EU

²² European Medicines Agency. www.ema.europa.eu/en/human-regulatory/overview/support-smes

²³ MedTech Europe (2022). The European medical technology industry in figures

²⁴ Deloitte (2022). Deloitte Private Debt Deal Tracker Autumn 2022

²⁵ The above examples have only an explanatory nature

Investment case study²⁶: Omega-3 manufacturer

A company is a worldwide, fully integrated producer of medium to high concentrations of Omega-3 solutions for two main end-market segments: Nutraceuticals and Pharmaceuticals. The value chain of the company consists of natural oil sourcing in factories located in the US and in Europe and of a concentrated oil produced in Germany. This oil is an input material for capsules and liquid oil for various clients across Europe and the US.

SMEs are essential to Europe's energy transition

While large public companies appear to be better positioned to lead the sustainability transition, more and more SMEs are viewing sustainability as a business opportunity. Furthermore, as many large companies commit to the transformation and make climate pledges, they are cascading climate action down the supply chain to their suppliers, often SMEs, making the sustainability transition existential for their competitiveness rather than optional. In fact, **SMEs are responsible for around 60% of all greenhouse gas emissions**, making them critical to the success of the green transition on European continent²⁷.

More than half of all SMEs have already invested or are planning to invest in reducing emissions and tackling the impact of climate change, while more than two-thirds of SMEs are already engaged in resource efficiency activities, mostly by minimizing waste or saving energy²².

SMEs are also well positioned to identify strategic clean energy opportunities, enabling them to innovate, to grow and hire more rapidly and thereby succeed in the global market. All along the supply chain, thousands of components will need to be manufactured for turbines, solar panels, inverters, batteries, and other equipment. There are also opportunities that will emerge from frontier sectors like hydrogen, carbon sequestration and small and modular nuclear reactors. Improved access to finance and to human capital with appropriate expertise and skills and better policy environment, creating higher certainty in the markets, are the key enablers for SMEs' sustainability transition.

4 / Direct lending can incentivize transformation through sustainability-linked loans

One trend that is worth highlighting in the debt market is the growth in the **sustainability-linked finance**, i.e. bonds and loans where a portion of the interest rate is linked to the borrower's ability to meet certain environmental, social, or governance targets. Typically, a borrower and a lender select key performance indicators (KPIs) that can be based on a credible methodology, be quantifiable and material to the borrower's core business. Then performance targets are established for each KPI and the interest rate ratchet is determined. This ratchet represents how much the borrower's interest rate will change based on whether or not they achieve their KPIs.

Case study²⁸: Typical KPIs in sustainability-linked loans

Companies financed through direct lending are active across a wide range of sectors and therefore a number of ESG topics are relevant to the businesses involved. Sustainability-linked loans more frequently include one to four environmental KPIs, however one or more social and/or governance KPIs are also becoming wide-spread. . In the leveraged loan market, 40-70% of loans, depending on the quarter, included a sustainability-linked element in it, while the number of KPIs gradually increased to 2.5x per fourth quarter of 2022²⁹. Among most common KPIs are the reduction of carbon emissions, increasing female representation of boards and independent third-party ESG ratings, while more business specific KPIs may include reduction of specific types of waste, increasing input of recycled materials and increased use of raw materials from certified sources (e.g. wood).

²⁶ The above examples have only an explanatory nature

²⁷ European Commission (April 2022). Annual Report on European SMEs 2021/22

²⁸ The above examples have only an explanatory nature

²⁹ Covenant Review (January 2023). Seminar Series with Covenant Review: Covenant Outlook for 2023 – Not distressed yet?

The major difference between sustainability-linked finance and the “green” finance is the use of proceeds. For “green” bonds and loans, proceeds are project-specific, so they can be used to finance a predetermined list of activities with environmental benefits. In the case of sustainability-linked finance, proceeds can finance any company’s activities, but the interest rate is linked to a measurable improvement in the predetermined KPIs.

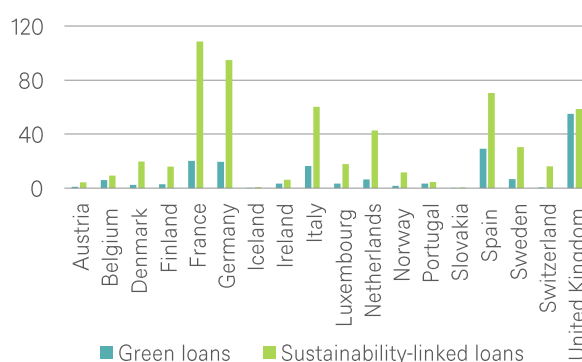
Globally, sustainable loans outstanding hit US\$1.5trn in 2022, two thirds of which were sustainability-linked loans³⁰. The vast majority of these loans were issued in mature markets. Figure 7 shows the growth of sustainability-linked loans across major European countries, while Figure 8 shows which European countries have the highest proportion of green and sustainability-linked loans outstanding.

Figure 7: Green and sustainability-linked loan issuance from major European countries plus UK (US\$ bn)



Source: IIF (January 2023)

Figure 8: Outstanding green and sustainability-linked loan in European countries (US\$ bn)



Source: IIF (January 2023)

5 / Conclusions

Private capital has an important role to play to unlock investments at scale and drive the European transformation. This is particularly necessary since a large part of Europe’s transformation needs to be undertaken by small and medium-sized enterprises that require improved access to finance. A range of investment solutions is needed, and direct lending could provide speed and flexibility required to drive technological change, accelerate growth and improve the competitiveness of SMEs on European continent³¹. We see many opportunities for direct lending to finance European technology sector and for SMEs to drive digitalization, reengineering of supply chains to boost resilience, adaptation of health care sector to aging population challenges and sustainable transformation. Borrowers that are considered suitable for direct lending typically have strong defensive characteristics, e.g. leading market positions, high growth, strong and stable cash flow.

³⁰ IIF (January 2023) Sustainable Debt Monitor www.iif.com/Publications/ID/5220/Sustainable-Debt-Monitor-Poised-for-a-Rebound

³¹ Energy Efficiency Financial Institutions Group. <https://valueandrisk.eefig.eu/financingenergy>

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