



ALLEN & OVERY

Funding European business: Strengthening alternatives

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Contents

Introduction	5
Alternative finance: a European profile	6-7
How important is alternative finance in Europe?	8
How is the use of alternative finance developing by market?	9
Which markets are leading the provision of alternative finance?	10
Which organisations are providing this funding?	12
What form does this funding take?	14
How do the respective expectations of investors to lend and corporates to borrow line up?	15
What is the impact of Brexit on the alternative finance market?	16
What is the awareness of standardised documentation and market initiatives?	18
Methodology	19

Corporates' appetite for alternative sources of finance remains strong, with nearly 50% of borrowers expecting to increase their use of this funding source over the next five years.

Introduction

Europe is on track to create a single private placement (PP) market, where corporates from all over the region can source alternative forms of capital from willing investors. While domestic alternative finance providers still rule the roost, an increased appetite to tap investors across borders is evident.

Challenges remain. As this year's research shows, the private placement market is growing, albeit at varying rates across the different European markets. The need to continue to raise awareness and promote the available International Capital Market Association (ICMA) guide and standardised documentation is highlighted by this year's research. But it's worth it, as the appetite among both corporates to access, and investors to provide, alternative sources of finance remains as strong as in previous years, with nearly 50% of both borrowers and investors expecting to increase their use/provision of alternative finance over the next five years.

Overall, more borrowers are seeking out capital from new and innovative sources. The investor base is becoming broader and deeper, with private equity groups, specialist credit managers, business growth funds, angel investors and even SME-focused online invoice trading platforms channelling capital to hungry borrowers.

Banks remain an integral intermediary in this financing market. By arranging loan and debt facilities for borrowers from investors, banks are adding a layer of security and certainty to a market that matches higher-risk counterparts. Banks, with their entrenched relationships and distribution networks, are also reinventing themselves to find new, less capital-intensive roles. It's a win-win scenario that is hastening the market's progress.

Britain's decision to leave the European Union has added a few bumps in the road. A majority of UK borrowers say Brexit has

either put their plans to raise capital from alternative sources on hold, or hindered their ability to raise funding cross-border. Conversely, Italian corporates see the schism as a chance to boost their borrowing capabilities. Next year will offer a clearer picture of whether the impending divorce will help or hinder the market's development, and where.

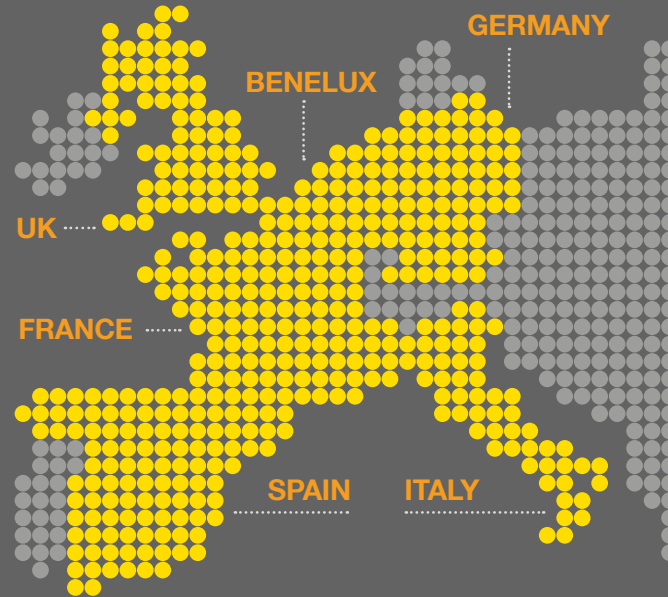
German corporates, presented with an array of available borrowing options, including a vibrant *Schuldschein* market, are overwhelmingly likely to raise alternative funding at home. French, Italian and Benelux corporates are more adventurous, raising alternative funding from international investors based outside their home countries, eg in Germany and the UK. That suggests a single market will emerge – but that it may still take time.

New legislation, notably in Italy, where authorities are aiming to erode banks' longstanding monopoly on lending, is helping to boost the market's growth. So are measures to educate corporates and investors about best practice and standardised documentation. The number of borrowers who understand the processes and know the guide has slipped this year, a helpful reminder that the need to promote and educate market participants is still a priority.

Overall, the alternative finance market still remains a work in progress and this research underlines that more needs to be done to unify a promising, but still-fragmented, single European PP market.

ALTERNATIVE FINANCE: A EUROPEAN PROFILE

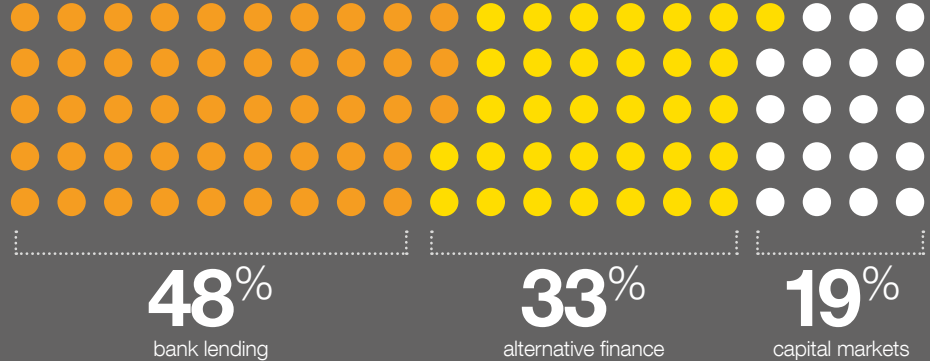
We asked a number of market participants about the use of alternative finance across six markets looking at corporate funding preferences and investor behaviour.



Six key insights

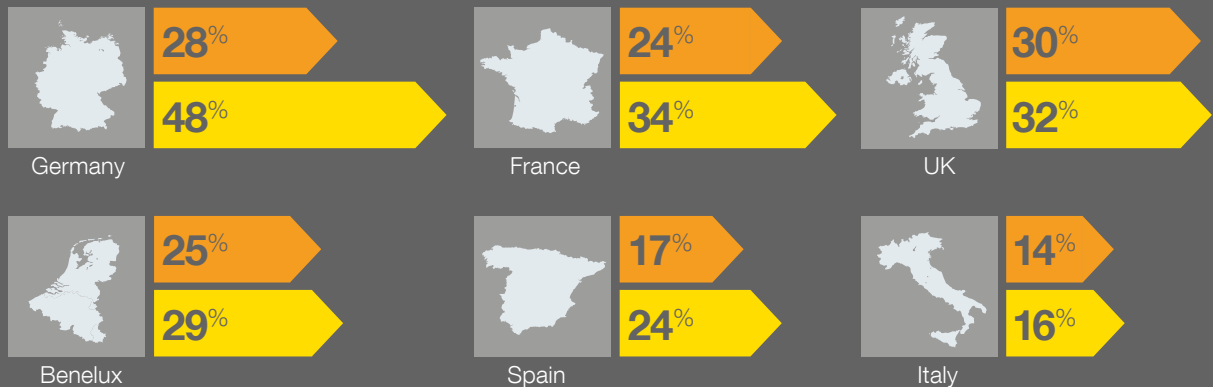
01 AN ESSENTIAL PART OF THE FUNDING MIX

Alternative finance accounts for a third of the funding mix. This has been consistent for three years and it is now established as a structurally significant source of funding for European business.



02 GOING CROSS-BORDER

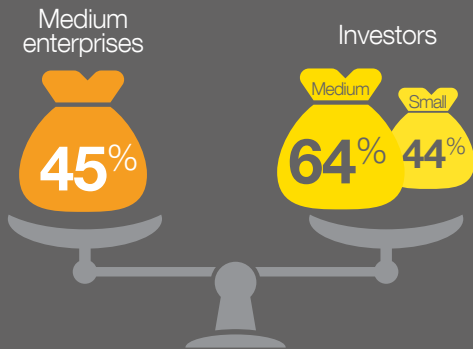
Corporates are increasingly looking beyond domestic investors in all markets.



* % of borrowers across all six markets accessing alternative finance investors in each market

● 2015 ● 2016

03 THE FUTURE'S BRIGHT FOR SMES

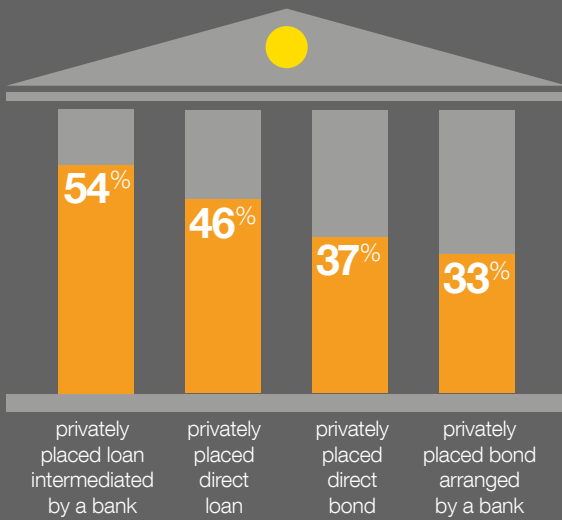


Medium enterprises keen to increase their use of alternative finance should find willing investors, who are even more enthusiastic about increasing lending to small and medium enterprises.

* % of respondents expressing plans to use (medium enterprises) or provide (investors) alternative finance over the next 5 years

05 BANKS PLAY MATCHMAKERS

Banks are playing a central role as intermediaries in the alternative finance space.



* % of borrowers who used each type of alternative finance instrument in 2016

04 SPOILT FOR CHOICE



Corporates are borrowing from a whole range of alternative finance providers.

* % of borrowers' alternative finance provided by type of investor in 2016

06 BREXIT: THREAT OR OPPORTUNITY?



43%

of investors see Brexit as an opportunity for investment

67%

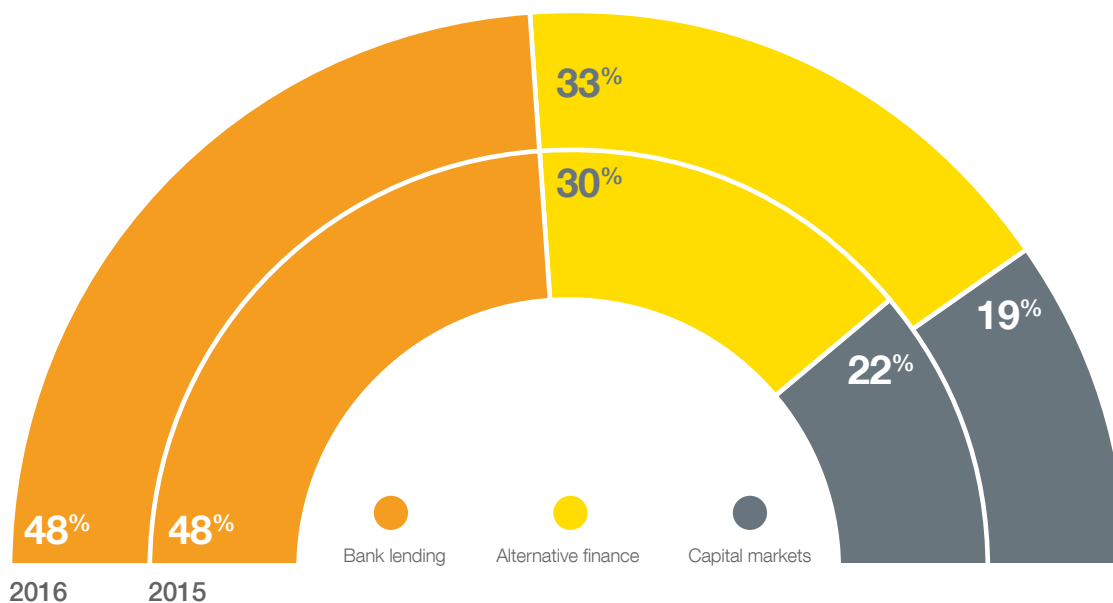
of UK corporates say Brexit has impacted plans to obtain funding from alternative finance sources outside the UK



How important is alternative finance in Europe?

A CENTRAL COMPONENT OF THE CORPORATE FUNDING MIX

Question asked of corporates: *To what extent do you use each of the following funding sources as a per cent of your total funding?*



Alternative finance has begun to establish itself as an essential and structurally significant form of corporate funding in Europe's largest economies.

Overall, corporates indicated that 33% of their funding was sourced from alternative providers in 2016, rebounding slightly from 30% in 2015, taking market share away from capital markets, which fell slightly, to 19% from 22%. Bank lending remained flat in 2016, having increased slightly the previous year. Around half of all companies – both medium and large – said they expected their use of alternative finance to increase over the next five years, which has been a consistent prediction over the past three years.

A key question is how fast alternative finance would have grown over the past year without the European Central Bank's EUR1.9 trillion asset-purchase programme, which was extended in June 2016 to include corporate bonds. Experts say this support

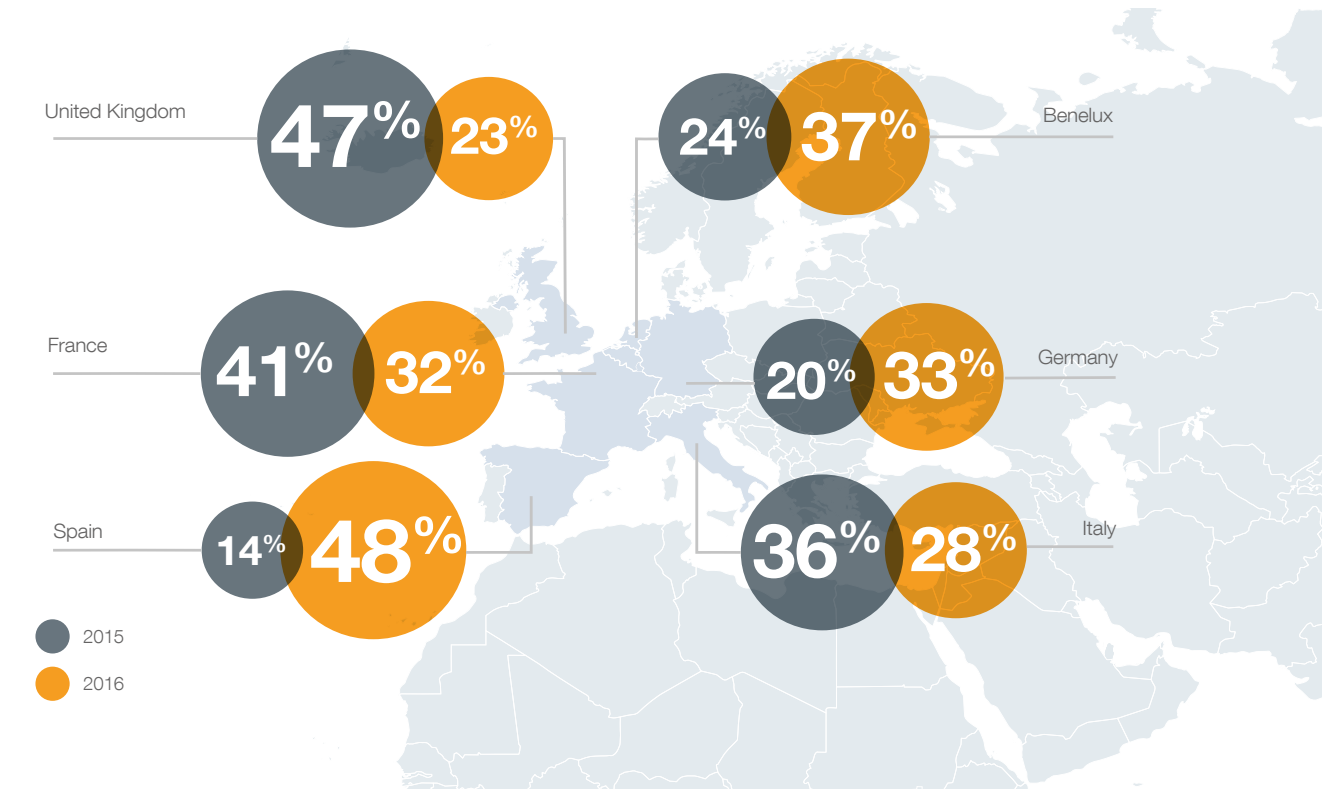
mechanism has bolstered bank liquidity – ensuring that a large share of corporates look first to mainstream lenders rather than investors for fresh capital. However the programme, set to end in March 2017, has not helped banks everywhere. In Spain, bank lending halved in 2016 as alternative lending soared, pointing to the ongoing challenges facing the banking sector in Spain.

Larger corporates showed a greater willingness to tap into new forms of capital in 2016, with 34% raising capital via alternative financing, against 26% the previous year, reducing their reliance on bank lending, down to 41% from 48%. That suggests a) a rising level of comfort with alternative finance among large firms, and b) the existence of growing pools of alternative liquidity. Mid-sized corporates showed a slight decrease in their use of alternative financing, inching down to 33% from 35%. Mid-sized firms also showed less desire to tap capital markets in search of funding, down to just 12% of their funding mix in 2015, less than half the 25% share that capital markets represented for larger companies.

How is the use of alternative finance developing by market?

ADVANCING OVERALL BUT NATIONAL VARIATIONS IN USE PREVAIL

Question asked of corporates: *To what extent do you use alternative finance as a per cent of your total funding?*



The popularity of alternative finance rose in Spain and Benelux in 2016, at a time when corporates in both were less likely to tap mainstream banks for capital. In Spain, corporate respondents indicated they sourced a 48% share of their overall funding from alternative finance in 2016, against 14% last year.

After posting strong figures in 2015, thanks to new rules that allow insurers to invest 5% of their assets in alternative finance, the popularity of new funding sources in France dipped in 2016, to 32% from 41%. France remains the second most important direct lending market in Europe after the UK; French companies are expected to remain key drivers of alternative finance.

The two countries that posted the sharpest fall-off in alternative funding, Italy and the UK, also saw a rise in the popularity of direct bank lending. In the UK, alternative finance accounted for 23% of borrowers' funding mix in 2016, against 47% in 2015 and 75% in 2014.

Both can be explained. British banks have begun to lend in earnest again. In addition, the run-up to the Brexit vote in the first six

months damped economic activity, which in turn led to investment plans being deferred, resulting in fewer corporates needing to seek additional sources of financing. In Italy, the popularity of alternative financing seems to be stabilising, having dropped sharply in 2015, suggesting the formation of a core group of corporates at ease with innovative methods of capital formation. New rules are also helping bolster alternative finance providers in Italy. In February 2016, the government passed new laws allowing EU-based alternative investment funds to lend directly to Italian borrowers.

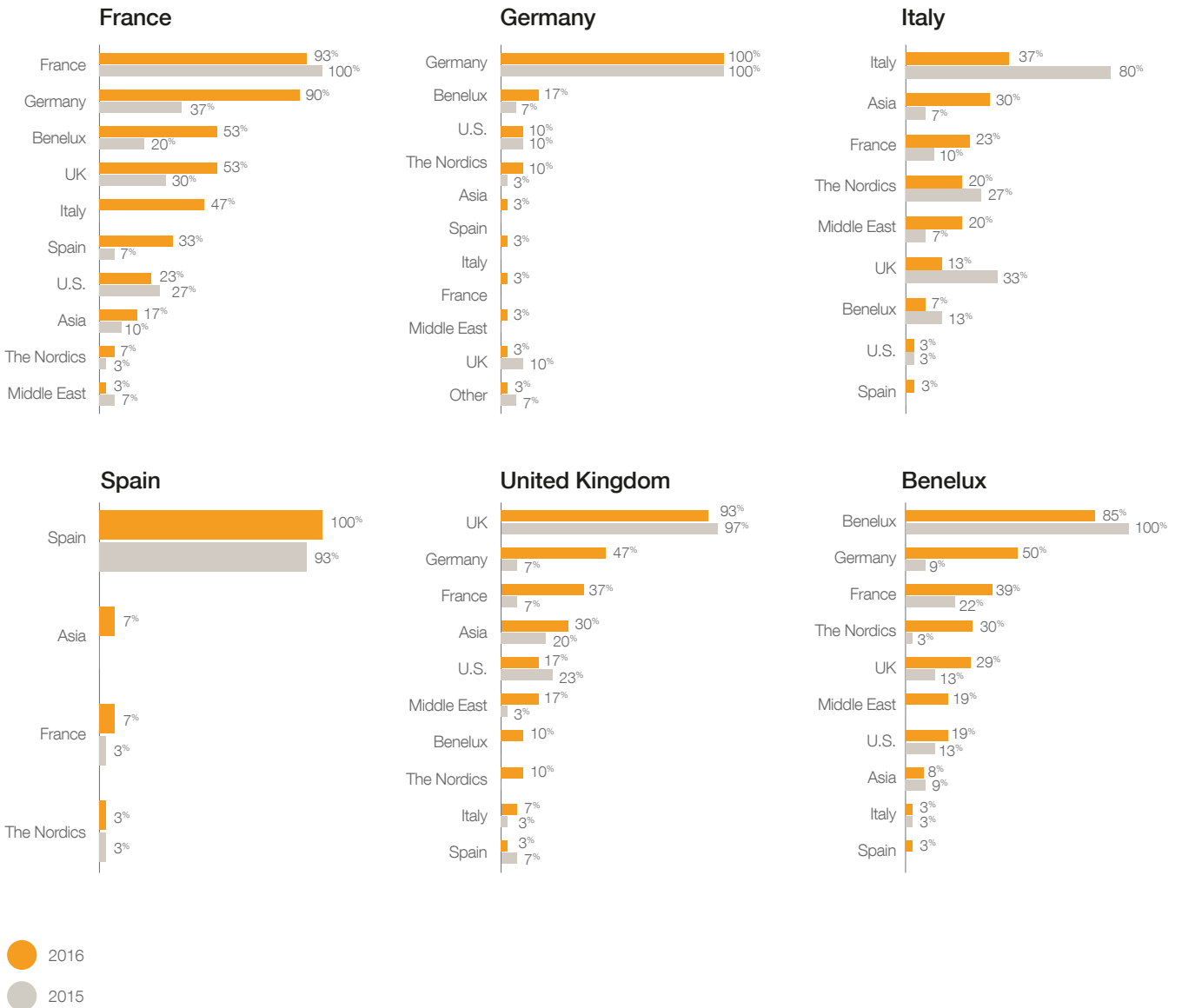
Germany remains a unique story, due to its distinctive 'Three-Pillar-Banking-System' – namely private commercial, cooperative and savings banks – and its easy-to-use *Schuldschein* market, which helps corporates borrow directly from investors at low rates of interest.

Overall, the future looks promising. At both supranational (with the European Commission's Capital Markets Union) and national levels (with the likes of Italy working to tweak rules to foster new forms of capital deployment) alternative finance has the clear backing of regulators and legislators.

Which markets are leading the provision of alternative finance?

CROSS-BORDER ACTIVITY IS ON THE RISE

Question asked of corporates based in each of the six markets: *Where are your alternative finance providers based?*



Corporates seem to be more adventurous in some countries than in others. Spanish and German borrowers overwhelmingly prefer to source alternative finance from domestic investors.

Elsewhere, the picture is rapidly changing and becoming more cross-border. In France, 90% of borrowers are likely to tap Germany-based sources of alternative capital, up from 37% in 2015. Investors in Germany also featured prominently in Benelux and the UK, where the equivalent figure was 50% and 47% respectively. French corporates have embraced the Euro PP market since its formation in 2013 and are at ease with Germany's thriving *Schuldschein* market, which offers light documentation and, in the main, better terms than corporates will get borrowing from banks, or raising capital via the public bond markets.

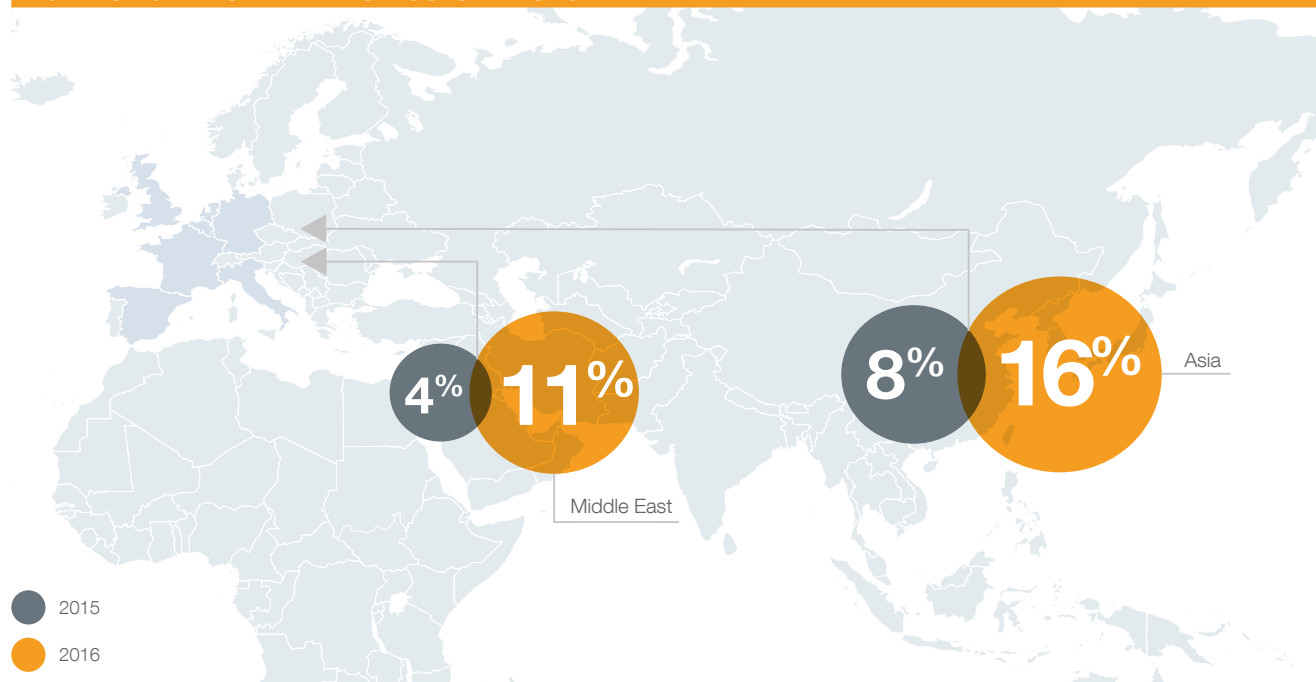
A record EUR14.2 billion (USD15.9bn) was raised via *Schuldschein* in the first half of 2016, including EUR8bn in the second quarter, according to data from Thomson Reuters, the best performance since 2008. This ties in with German corporates reporting a rise in their use of alternative finance in 2016, up from 20% in 2015 to 33% in 2016. More than half of French borrowers were content in 2016 to tap alternative funding sources in Germany, Benelux and the UK.

Corporates are also increasingly likely to tap capital sources outside core EU countries. In 2015, 3% or fewer corporates from the UK and Benelux sought alternative funding from investors based in the Middle East; in 2016, that share was 17% and 19% respectively. A fifth of Italian corporates were willing to tap Middle East funding sources in 2016; the previous year, the number was 7%.

Asian investors became significantly more prominent in 2016. UK corporates have been comfortable with Asian investors for some time, with 30% of corporates tapping Asian investors in 2016, up from 20% in 2015. However, other European companies are rapidly catching up, with 30% of Italian corporates accessing Asian investors, up from 7% in 2015 and making them the largest of foreign investors in Italy. Meanwhile, 17% of French corporates and 8% of Benelux corporates accessed capital from Asian investors in 2016. By contrast, the role of investors from the U.S. stayed static or fell in 2016 across France, Germany, Italy, Spain and the UK, only showing a moderate increase in Benelux (up to 19% from 13%).

The European market may not yet have reached its full maturity and still has plenty of room to grow to rival the U.S. equivalent, but it seems that this is not far off. In April 2016, S&P revealed that issuance of private funding for companies in Europe, including private placements via *Schuldschein* and the pan-European PP market, grew 78% to EUR32.8bn in 2015 from EUR18.4bn in 2014. Looking specifically at private placements, EY reported that Europe's PP market grew 30% year-on-year in 2015, to EUR8.3bn.

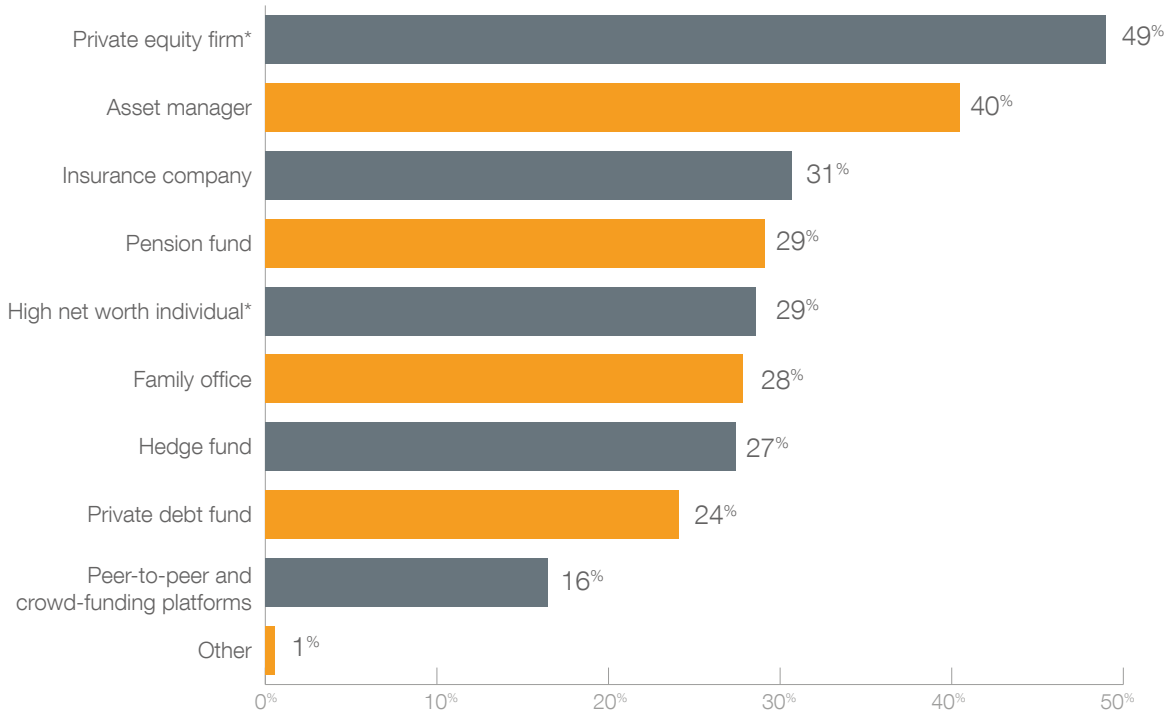
INCREASING INVESTMENT FROM OUTSIDE EUROPE



Which organisations are providing this funding?

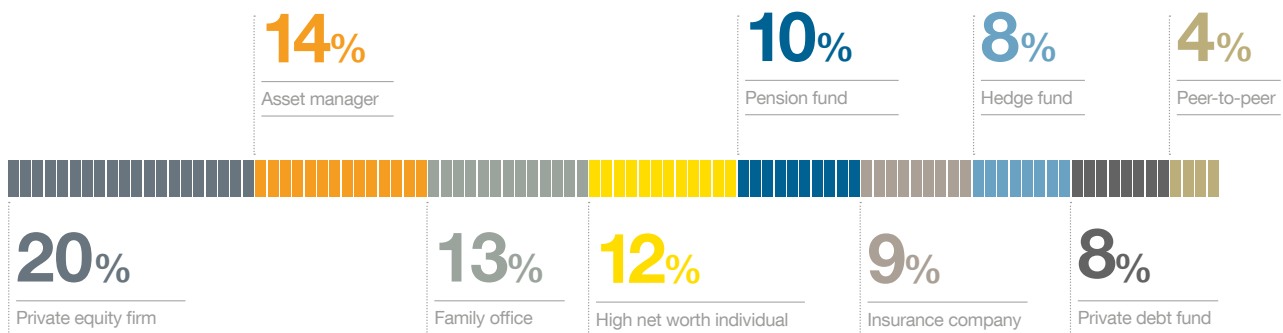
PRIVATE EQUITY TOPS A DIVERSE RANGE OF SOURCES

Question asked of corporates: Which of the following types of alternative finance providers (end investor, not bank intermediaries) do you currently use?



*Note: Private equity and high net worth individual were not included in previous years.

Question asked of corporates: What proportion of the alternative finance that you use is provided by each of these sources?



Any funding market requires an equal measure of demand and supply. Data often focuses on the former, and rightly so, but who is providing the latter?

Nascent funding markets rarely narrow as they grow, and alternative financing is no exception. This year's data show that borrowers in search of alternative funding most commonly tap private equity groups, asset managers, insurance companies and pension funds.

Every country has its own traits. In France, corporates prefer to borrow from asset managers, insurers and private equity firms. German borrowers most commonly source alternative capital from high-net-worth individuals, followed by private equity firms and asset managers. Family offices play a vital funding role in family-focused Italy. Pension funds are often the first port of call for borrowers in Spain, but the opposite is true in Germany. The alternative funding mix is broadest in the UK and Benelux, where almost all forms of alternative funding can claim strong support from borrowers.

Drilling down, some alternative funding sources are growing in lockstep with the market – while others seem to be in retreat. Though it is difficult to make a meaningful year-on-year comparison due to the addition of private equity to the survey this year, it is striking that this source makes up 20% of the funding mix for corporates using alternative finance across the six jurisdictions polled.

Wider market data show that more capital was extended to European corporates by buyout firms in the full year 2015 than at any time since 2008, according to trade association Invest Europe.

As well as maintaining traditional equity strategies, private equity firms have evolved in the last few years to develop specialist debt arms and hire fund managers in significant numbers who focus on direct lending amongst other types of debt finance. This market development has also resulted from significant M&A activity in the credit asset management market, with many specialist debt managers being acquired by private equity firms.

Many of these debt arms, as well as operating within the CLO market (so participating in larger cap primarily non-investment grade corporate credits), have also raised fund capital for the purposes of direct lending strategies for SME borrowers.

Although, from a borrower's perspective, funding from these private equity groups and other specialist credit managers involves dealing just with the relevant managers, the funding is itself sourced from a wide array of fund investors, particularly insurance companies, pension funds, sovereign wealth funds and family offices – suggesting that the breakdown of investor types is more complex than first considered, making it challenging to establish a clear picture of the definitive sources of this capital. These funds are also commonly leveraged, so part of the available funding is sourced from bank debt.

While these funds have sometimes played a role in syndicated debt deals in the past, the move towards direct lending marks a significant development in the alternative finance space. This may explain the relative decline when it comes to larger and more traditional investment classes. Insurance companies made up 16% of the alternative funding mix in 2015, but just 9% this year. The same is true with asset managers (20% in 2015; 14% in 2016) and pension funds (13% in 2015; 10% in 2016).

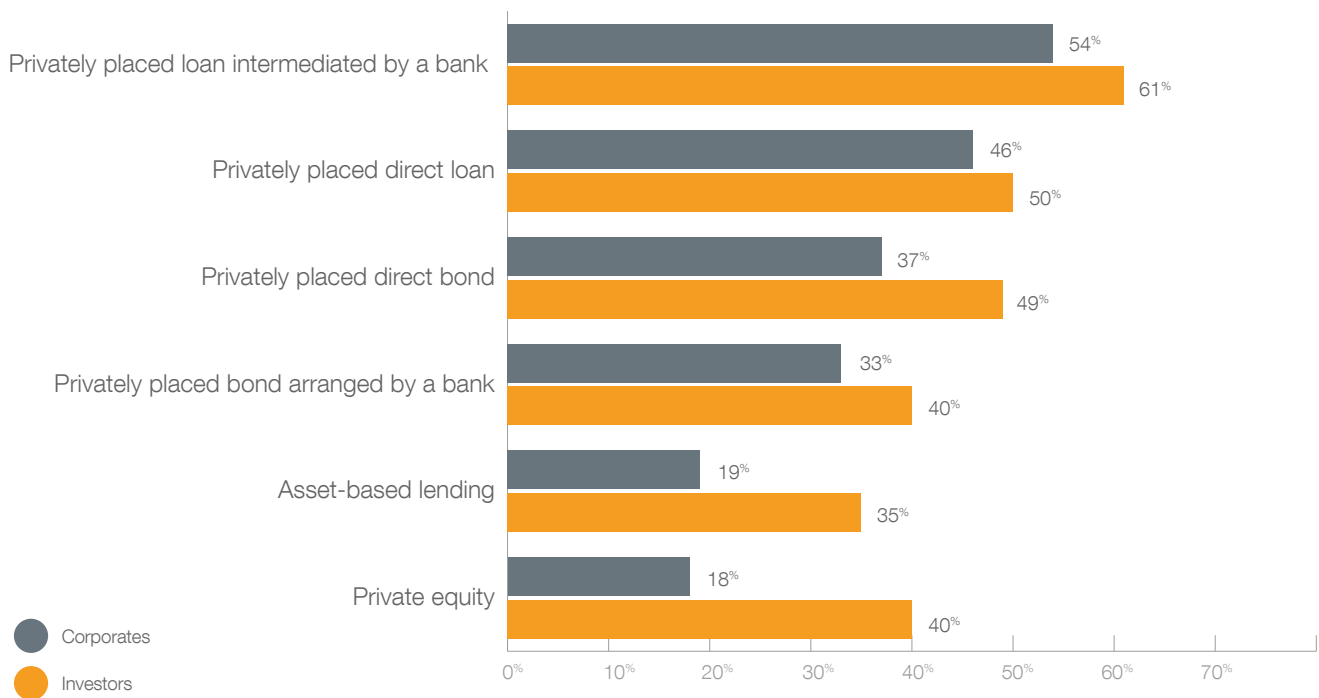
“While these funds have... played a role in syndicated debt deals in the past, the move towards direct lending marks a significant development”

What form does this funding take?

THE PREFERENCE FOR BANK INTERMEDIATION IS EVIDENT

Question asked of corporates: Which of the following forms of alternative finance do you currently use?

Question asked of investors: When providing alternative finance to large, medium or small companies, what form does this currently take?



One of the major highlights in this year’s report is the central role played by mainstream banks, which can earn fees by brokering a deal that links investor with borrower.

To banks boasting long client lists, but keen to generate income without putting their capital reserves to work, this approach makes good sense. It is in line with financial regulators’ ongoing attempts to increase bank lending for SMEs and the real economy (or, at least, to facilitate intra-European lending) while still maintaining a safe banking system with well capitalised banks.

In 2016, 54% of borrowers raised capital via private placed loans intermediated by a regulated lender, against 48% the previous year, making it the most popular form of alternative finance. The increase was up sharply in Italy (from 40% in 2015 to 57% in 2016) and the UK (27% to 43%), but also up in Spain (from 50%

to 57%), where, as noted earlier, bank lending has fallen sharply over the past year. Germany was the only market where private placed loans intermediated by a bank fell. France was static, where 90% of borrowers used their banks to intermediate the private placed loan.

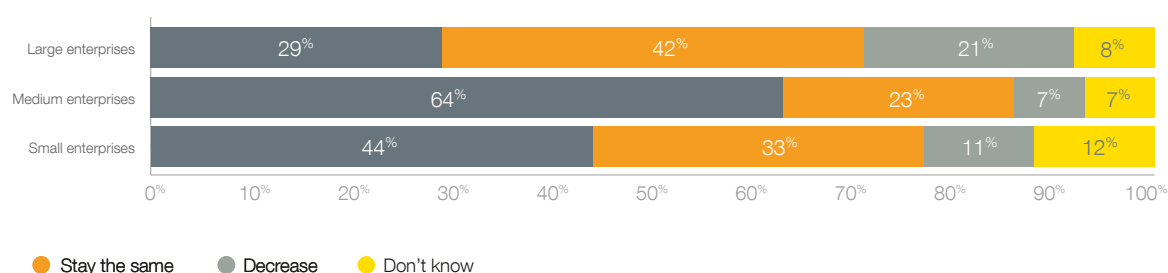
Two of the most common forms of alternative finance continue to be privately placed loans and bonds. The former dropped a little, to 46% in 2016 from 55% in 2015. Privately placed bonds enjoyed a surge in popularity in 2016, with 37% of borrowers raising capital this way, against 22% in 2015. The rise was strongest in France (up from 23% to 43%), Italy (3% to 37%), and Spain (13% to 37%).

Investors showed the same preferences as borrowers, though the addition of private equity investors to the research has resulted in a significant increase in the use of private equity (from 9% in 2015 to 40% in 2016). Asset-based lending has also jumped up the preference ratings for investors, from 9% in 2015 to 35% in 2016.

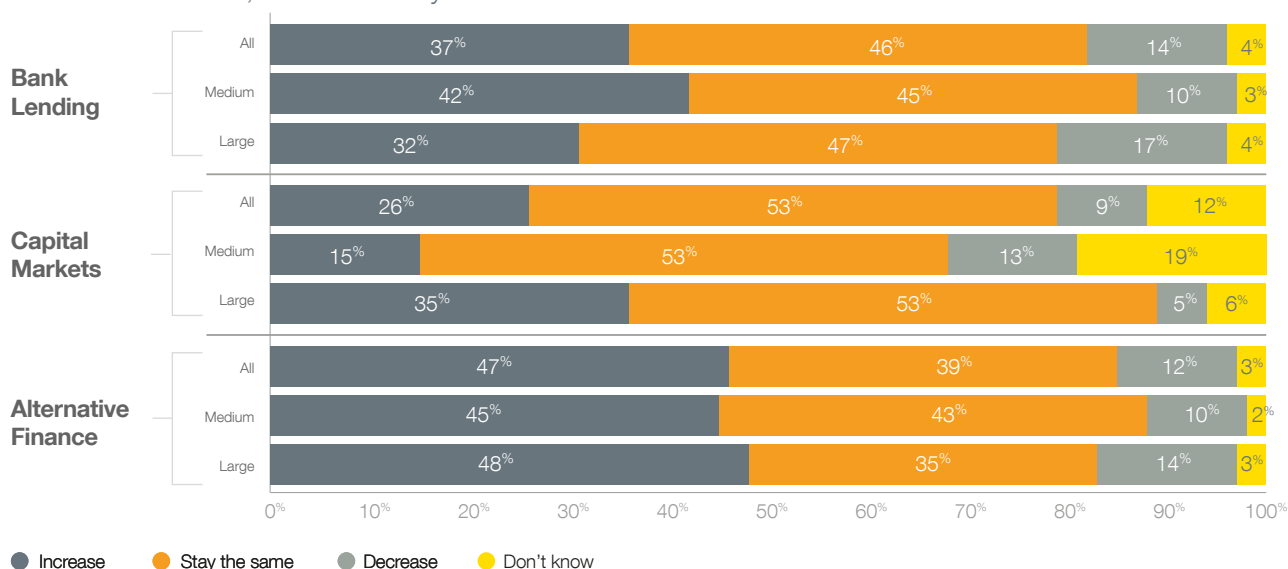
How do the respective expectations of investors to lend and corporates to borrow line up?

THE FUNDING OUTLOOK FOR SMALL AND MEDIUM ENTERPRISES IS BRIGHT

Question asked of investors: Over the next five years is the amount that you fund large, medium and small businesses likely to increase, decrease or stay the same?



Question asked of corporates: Over the next five years do you expect your use of bank lending/capital markets/alternative to increase, decrease or stay the same?



Investors in Italy and Spain were most likely to anticipate a rise in alternative funding to medium-sized enterprises, with a staggering 87% of investors in Italy and 83% of investors in Spain expecting to increase lending. Spain is the only country where investors expected to increase their funding to large corporates significantly, with 47% of investors planning to do so.

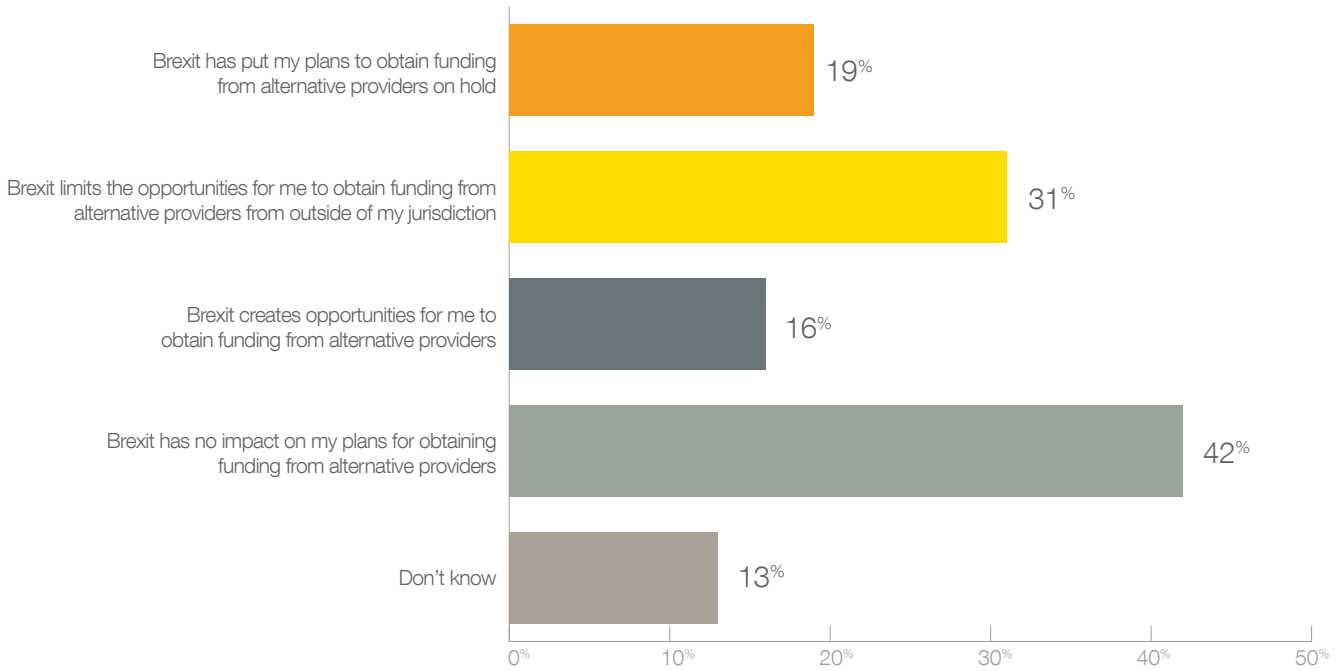
By contrast, only 17% of investors in France (down from 37% in 2015) and 23% of investors in Italy (down from 87% in 2015) were planning on increasing lending to large companies. Investors in the UK and Italy are most likely to forecast an increase in funding to small enterprises, with the figure in the UK 47% in 2016, against 7% in 2015.

Borrowers in Italy and Germany expected their use of alternative finance over the next five years to increase the most, with 73% in Italy and 65% in Germany predicting rises. This is a remarkable turnaround for Germany in particular, where only 26% expected their use of alternative finance to increase in last year's survey. In the remaining four markets, a third of borrowers expected to increase their use of alternative finance, with the UK at 39%, Benelux and Spain at 35% and France at 33%. In aggregate, large corporates (48%) were looking to increase their use of alternative finance slightly more than medium enterprises (45%).

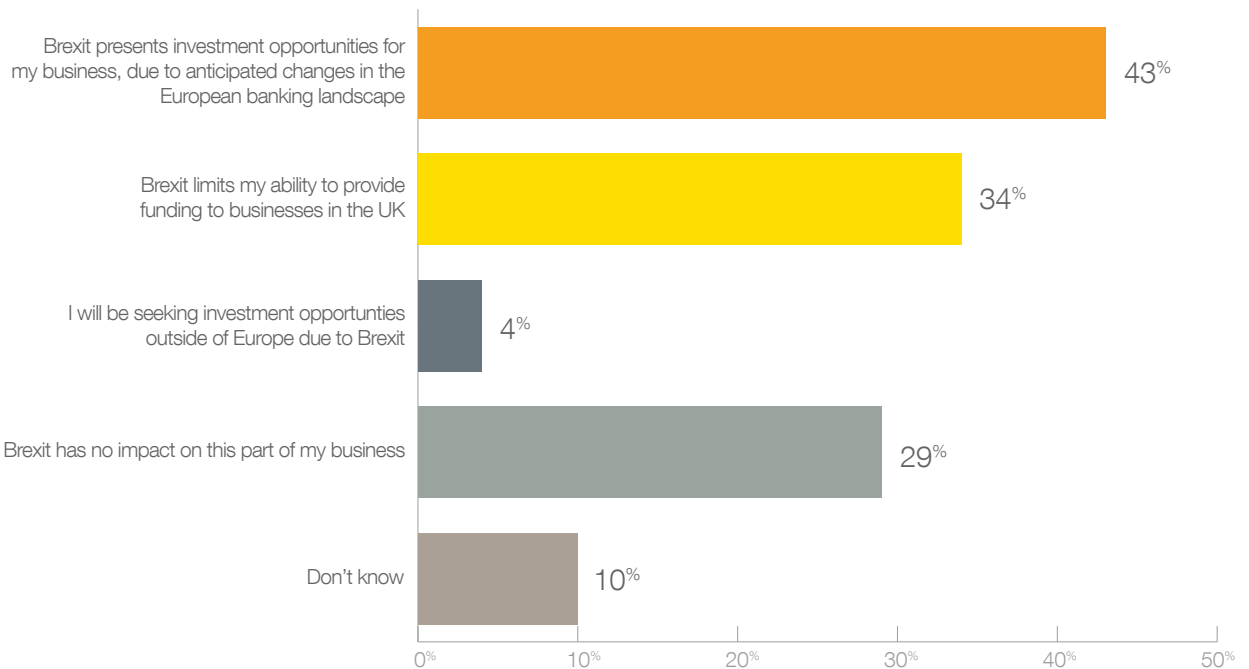
What is the impact of Brexit on the alternative finance market?

BREXIT HAS CREATED MIXED SENTIMENTS FOR THE MARKET

Question asked of corporates: *What is the impact of Brexit on your plans for obtaining funding from alternative providers?*



Question asked of investors: *What is the impact of Brexit on your plans for providing alternative funding to large, medium and small businesses?*



The UK's vote to leave the European Union on 23 June is a significant event that was, understandably, not a factor in last year's report.

For borrowers, the overall sentiment appears somewhat mixed, with 31% of corporates of the view that Brexit will limit opportunities to access investors across borders and 19% revealing it has caused them to put funding plans on hold. However, 42% said it has no impact on their plans and 16% even believe it has created opportunities to obtain funding. It is worth noting the timing of the survey, over the summer in the immediate aftermath of the vote, is likely to have had a significant bearing on sentiment.

More than two-thirds of UK borrowers say the Brexit vote has hindered their ability to tap into alternative sources of funding beyond their home borders. Nearly half say it has put their plans to secure funding from alternative providers on hold – a reflection of the broad unease with which Brexit was met by the vast majority of London's finance providers. The countries closest to the UK geographically also seemed more downbeat, with 53% of French and 37% of Benelux corporates saying it would limit their opportunities to obtain funding and 43% of companies in France saying it caused them to put their plans on hold.

Curiously, half of Italian borrowers say Brexit is likely to aid their efforts to secure funding from alternative providers. That is perhaps due as much to hopes that the UK's decision will convince Brussels to focus on boosting growth, jobs and capital formation, as much as the belief it will portend changes in the region's banking landscape. Nearly three out of five German borrowers say Brexit will have 'no impact' on their alternative funding plans, a reflection of the strength-in-depth of the country's mainstream and alternative funding markets. It is a similar position to that of corporates in Spain, where 63% said it has no impact on their plans. This robust view is driven by the fact that UK investors currently do not play a significant part in the funding mix for companies in Spain.

By contrast, investors were more upbeat and shrugged off Brexit, with 43% saying that it provides opportunities for them due to anticipated changes in the European banking landscape and 29% saying it would have no impact on them. As with borrowers, investors in countries nearest to the UK were more downbeat, with 60% of investors in France and 47% in Benelux saying it would limit their ability to provide funding to businesses in the UK. Italy again was the most bullish on viewing Brexit as opening up opportunities – 80% of investors in Italy said it presented opportunities for them. Just 4% cent of investors said the vote would lead them to lend to companies based outside the European Union.

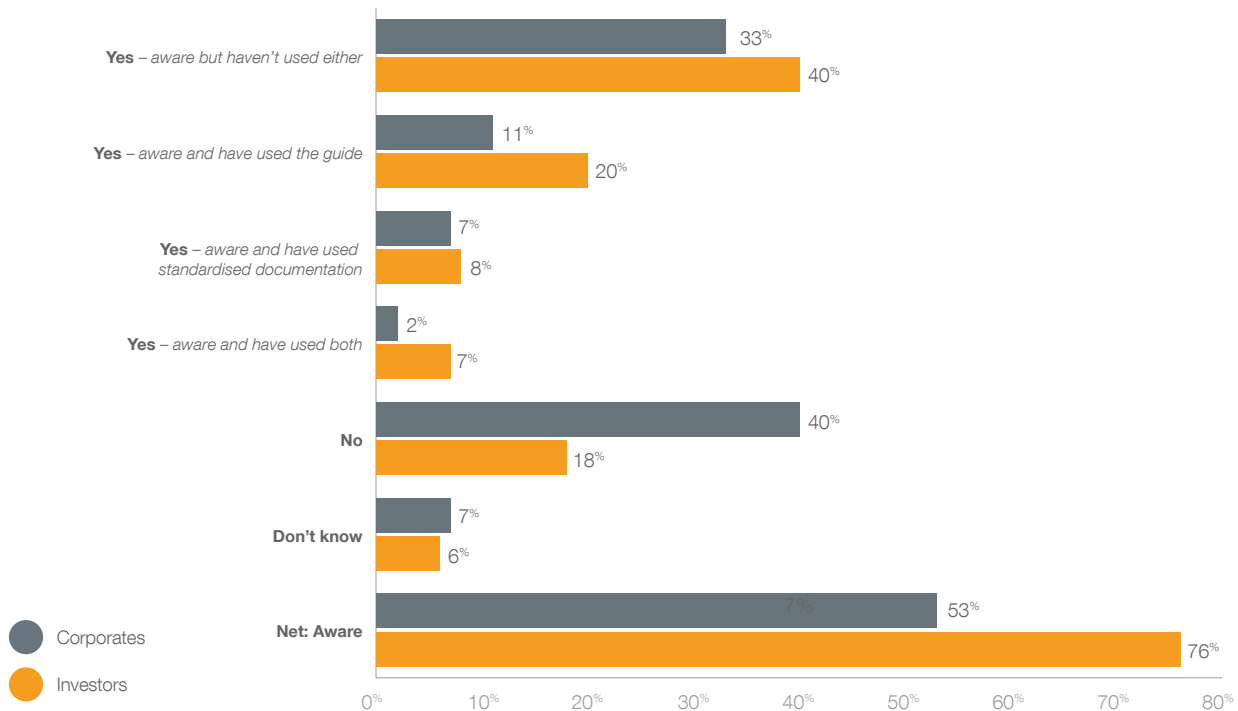
It's unlikely that the full impact of Brexit will become clear for several years. Experts said the gloomy prognosis in the UK among borrowers and investors reflected a wider sense of unease, among British corporates and London-based financial services providers, as to the UK's long term place in the world.

“Investors were more upbeat and shrugged off Brexit, with 43% saying that it provides opportunities for them due to anticipated changes in the European banking landscape”

What is the awareness of standardised documentation and market initiatives?

MARKET EDUCATION INITIATIVES MUST CONTINUE

Question asked of corporates and investors: *Are you aware of the launch of the pan-European corporate private placement market guide and standardised loan and bond transaction documentation?*



In February 2015, the International Capital Market Association (ICMA)'s Pan-European Private Placement Working Group – of which Allen & Overy is part – produced the first Pan-European Corporate Private Placement Market Guide, a handbook covering best practice for borrowers, investors and intermediaries considering a European private placement. This was accompanied by complementary standard documentation from both the Loan Market Association (LMA) and the French Euro PP Working Group.

Awareness of these initiatives among investors has remained at roughly the same level in 2016 as at the end of 2015 – net awareness was 79% then and is now 76%. However, actual usage of either the guide or the standardised documentation dropped – usage of the guide decreased from 31% in 2015 to 20% in 2016 and that of the standardised documentation fell from 14% in 2015 to 8%.

This reduction is perhaps not surprising given the increasing prominence of banks in intermediating loans, where they are likely to play a significant guiding role in assisting with documentation and pushing the transaction through. Usage of the guide is highest in Italy, the UK and Benelux and usage of standardised documentation is highest in France.

Awareness among borrowers fell, however, from 76% in 2015 to 53% in 2016. Given that 76% of corporates surveyed were privately held and 50% were medium-sized entities, and many of those surveyed who have accessed alternative finance may be new borrowers in the European private placement market, the reduction is perhaps unsurprising. Awareness was highest in Benelux, France and the UK. While awareness has dropped, encouragingly usage of the guide was actually slightly up (from 9% in 2015 to 11% in 2016) and usage of standardised documentation was stable at 7%. As with investors, the guide's highest level of use occurred among borrowers in Italy and that of standardised documentation was highest in France.

At the time this survey was conducted, the second iteration of the ICMA guide had not yet been published, its publication being on 25 October 2016, so we expect that publicity around its launch will once again raise awareness and prompt an increase in use of both this and the documentation. The survey results are, however, a useful reminder that the task of raising awareness and promoting the ICMA guide and standardised documentation is a constant and on-going priority.

GLOBAL PRESENCE

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