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Italian market shifts from traditional banks as funds and new paradigm banks take lion's share in providing rescue financing

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Other
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Muzinich & Co. Ltd
Illimity Bank S.P.A.

The Italian market has gone through a drastic change in the past few years. A traditionally bank-heavy market, it has recently become the sweet spot for new paradigm banks and private debt funds, which have been increasingly providing businesses with the funding they require. Likewise, the mid-size nature of most companies and the difficulty in fetching targeted returns makes the domestic market a tough investment proposition for hedge funds and the like, with a few significant exceptions.

In the banking space, the most notable operator is illimity Bank, founded by former Intesa Sanpaolo CEO and Italian Minister of Economic Development, Infrastructure and Transport, Corrado Passera. With a focus on SMEs and its exclusively digital and API-based operational model versus the traditional branch-based banking model, in less than five years since launch, illimity has established itself as one of the main players in the Italian financing and distressed debt market.

"The turnaround team, which does rescue financing, distressed and special situations, has done some 60 deals in the past three years, for a total of around EUR 800m invested," said Umberto Paolo Moretti, Head of Turnaround at illimity. Deals often have a strong component of rescue financing provided on a super senior basis, either via in-court proceedings or out-of-court, with a solid security package.

"As a bank, we can often have a privileged observation point on situations, particularly companies that are over-levered but not yet fully stressed since they tend to start conversations with banks first, before turning to other players," Moretti noted. "Inflation, energy costs, the conflict in Ukraine, COVID-19 have all had a massive impact, meaning that even solid business plans have suffered. There have been so many exogenous shocks – after the pandemic who would have thought there would be a war in the heart of Europe?"

The bank also invests in special sits - often companies with complex capital structures and looming debt maturities. "Given the pressure coming from rising interest rates, we see many companies that are trying to get themselves in a safer position as they know they might be at risk in the next 12-24 months," Moretti added.

"The main theme is the liquidity and who has money to invest," he continued. "Traditional banks mostly do not express interest for these asset classes, so this has opened up to new paradigm banks – which also are not burdened by legacy portfolio issues – as well as direct lenders and private debt funds."

Partnering up

In fact, the debt fund market in Italy has developed significantly, striking a successful partnership with such banks. illimity, for instance, recently teamed up with Muzinich SGR to provide a total of

EUR 52.5m new money to shipping group Synergas, partly backed by Italian export credit agency SACE via *Garanzia Italia*. The deal enabled Synergas to reduce its cost of financing as well as to repurchase two carriers, bringing its fleet of LPG and ethylene carriers to nine vessels, according to a company statement.

On its part, Muzinich, in partnership with asset manager Azimut, closed last year a EUR 148m fund aimed at providing rescue financing, seizing the opportunities offered by the insolvency law and the domestic landscape. The fund has already funded six deals, with two more hard commitments waiting for final court approval.

“We are not a hedge fund nor a pure private debt fund,” commented Carlo Bosco, Co-Head of Capital Solutions Pan Europe and Head of Italian Private Debt at Muzinich. “We have a dedicated strategy aimed at providing companies with the financing they require and cannot find elsewhere.” With targeted returns in the high single digits for the fund, companies can secure some fast, flexible funding that they can seek to refinance in two years’ time if they perform well, he added.

Opportunities galore

Despite some atavistic issues and the longstanding perception of a largely debtor-friendly market, the Italian legal framework has made several steps forward, particularly when it comes to the provision of new money.

“In Italy you can effectively do super senior financing. If a judge approves it, under one of the many options available, including article 182 and the new *composizione negoziata*, you can provide super senior rescue financing even before you have a formal agreement with existing creditors,” Bosco noted. “Perhaps the regime is still quite byzantine for existing creditors, but for new money providers it is working out pretty well.”

“As it stands, the Italian market is better than its reputation,” concurred Martin Gruschka, Managing Partner and Founder of Springwater Capital. “You would be thinking it is a disaster but in reality, we have come across very professional counterparties, be them judges or commissioners, as well as management teams proving very collaborative.”

Pan-European, special situations-focused investment firm Springwater began focusing on the Italian market in 2018 and closed its first transaction there in 2019. Earlier this year, they took over Italian tyres manufacturer Fintyre out of *concordato preventivo* proceedings. As part of the deal, the company received a combined EUR 43m new capital injection in the form of a capital increase and new financing, provided by Springwater and illimity, as reported.

“We started working on Fintyre around May 2020,” Gruschka said. “The *concordato* procedure was not an easy one but we hardly faced any competition. The main point for us was that the business could be saved, and to that end, together with management, we sought and found support from suppliers.”

Other opportunities can stem from family-run businesses that do not have succession plans in place nor the corporate governance that as an institutional investor you must have. “There are great opportunities there, and Italy is not worse than many other countries," added Springawater's Partner Iñigo Barcaiztegui. "The challenge we face sometimes is that parties are not always incentivized to take decisions. No decision, no mistake. This can slow the process down," he continued. "But with the latest changes to the insolvency law there will be incentive for judicial commissioners to achieve successful outcomes."

Go small, stay local

For rescue-financing type deals, most of the opportunities fall in the range of between EUR 10m and EUR 25m of new money, with hardly anything above the EUR 50m mark.

"There is huge demand for financing, and most of this has been satisfied through SACE guarantees. Not all corporates could access this capital though, so we focused on this portion of the market, where there is a need and very little offer," Bosco said.

Other investors in the market – across the spectrum of performing, special sits and distressed – include Pillarstone, Dea Capital, Kartesia and HIG Whitehorse.

However, while opportunities are up for grabs, not all of them ultimately turn into deals.

"There are tons of opportunities, but you need to do lots of due diligence before. The ratio is now 1:4 or 1:5 of deals done versus all deals being reviewed. It was 1:10 when we started, so it's getting better," Moretti said.

While banks have a low cost of capital, and funds like Muzinich target returns in the high single-digits, the pure distressed funds may not find the Italian market appealing enough from an IRR perspective.

One exception is Hong Kong-headquartered asset manager SC Lowy, which has been actively investing in the country and in 2018 bought Italian lender Credito di Romagna, later renamed Solution Bank.

"The market has diversified with the entrance of new paradigm banks and funds while traditional banks have for the most part disappeared, plus you have some sophisticated and experienced niche players like us," commented Alessandro Esposito, Head of Investments – Italy at SC Lowy. "To invest in this market, you need to be quick and flexible, perhaps initially investing in smaller size and then building up from there."

While new capital injected under a court proceeding is generally considered safe, it may not always work for a distressed fund from an overall risk/return standpoint, as the Officine Maccaferri's *concordato* process showed. The tribunal, in fact, rejected the new money proposal by the group's bondholders, deeming it too expensive, as reported.

"You can arrange DIP financing and have no issues structuring the loan with super senior priority. However, if the situation goes downhill, the duration of a workout/liquidation in Italy can be very long, which means you may have your new super senior capital in limbo for years with little or no return," Esposito continued. "Being able to effectively analyse and price process risk is key in a market like Italy and only comes with significant experience. We like idiosyncratic situations where we can clearly protect our downside and simultaneously create significant upside via active management."

Additionally, a few years back, as banks had to offload their NPLs exposure, the market was flooded with portfolios up for sale, which is no longer the case.

"You need to adapt to the market's changes. Before, you used to have two auctions a week, now you don't," Esposito pointed out. "Servicers may have different pieces of a company's loan, so you may need someone that aggregates those pieces for the benefit of the company."

The secondary trading market – or lack thereof – indeed remains one of the sore points.

Before the pandemic, secondary trading was driven by banks' needs rather than a match of demand and supply, and reducing non-performing exposure was easier and more effective via portfolio sales, according to Moretti. "The secondary market has never been liquid really," he said. "Pre COVID-19 credits were being transferred from banks to platforms, without fully generating a secondary market. And the abundance of liquidity more recently has further weakened attempts at creating a liquid secondary market."

What the future holds

There is something which everyone agrees on. The financing issued in the past 24 months to support companies throughout the pandemic has certainly fulfilled its major purpose – to stabilise the system. But what will happen now that SACE guarantees scheme has closed, as well as how SACE-backed loans may play out in a workout scenario is far from certain.

"Demand for rescue financing will not go away with the COVID-19 support measures, and we expect a material pick-up in demand at the end of 2022, once the impact of the war in Ukraine filters through the bottom line. Borrowers will have to compete with limited capital dedicated to this important pocket of the market and with a massively dislocated high yield market, that offers attractive high single-digit yield," Bosco commented. "We are fundraising to address this increasing demand".

The macro backdrop is unquestionably not easy, and for a country like Italy with a very slow growth rate, it takes a little to go down and much longer to rebound. On the flip side, the government proved very proactive throughout the pandemic, and so did the legislator, introducing new proceedings and changes to the restructuring toolkit, including the *composizione negoziata della crisi* and the soon-to-be-live *Codice della Crisi d'Impresa*, the brand-new Italian bankruptcy law.

Rescue financing will likely remain a key theme and the main entry point for funds and banks into a company's capital structure in view of further strengthening or restructuring its balance sheet, possibly contributing to the creation of a more liquid secondary market, at last.

by Chiara Elisei