PRIVATE CREDIT

European Private Credit: From Competition to Consolidation

INSIGHTS

The combination of a tough macro environment and growing investor demand is creating a compelling opportunity in European private credit—but partnering with the right manager is crucial.

Private credit is a resilient asset class, and one that has held up well historically through multiple recessions and cycles. But the challenges facing private credit today should not be taken lightly given the heightened uncertainty and risky macro environment. Indeed, there is no shortage of questions around what the picture will look like in the months and years ahead—for instance, how long and deep could the downturn be? What path will central bank policy in Europe and the U.S. take going forward? Will companies be able to continue passing through higher costs to customers? Much scrutiny is also being placed on how private credit portfolios will fare going forward, especially as the effects of higher rates filter through the economy. While manager performance can look similar during the good times, a more difficult environment is likely to result in much greater differentiation of performance across the industry.

On the positive side, there are a number of tailwinds creating a compelling opportunity in private credit today. In many cases, investors are getting compensated better than in the past, especially for taking essentially the same risks as a year or two ago. In particular, investors are often getting lower leverage, the potential for higher absolute returns, and access to high-quality deal flow—but the key is partnering with the right manager that takes a conservative and disciplined approach to the asset class.

Navigating a Difficult Environment

Borrowers have faced a number of headwinds over the past several months—from supply chain issues, to wage inflation and rising costs, to the energy crisis in Europe. But most middle market companies have been able to pass on the resultant price increases to their customers, which has helped the corporate fundamental picture. The next six to 12 months will likely be more challenging, however, especially as the difficult external environment looks set to persist and the increase in base rates continues to flow through into interest payments. In particular, higher costs and softening demand could result in margin erosion, decreased cash flow, and less serviceability.

Arguably, this environment sets the stage for a reset in multiples of businesses from an equity perspective. High-quality middle market companies with lower leverage and more conservative capital structures look better positioned to withstand this challenging environment. But there are a number of companies across the market that have riskier capital structures and higher levels of leverage—in some cases around 6.5–7x in Europe, which is similar to broadly syndicated corporates—which were predicated on the low-rate environment of the last few years.[1] Those businesses will likely be challenged going forward as base rates continue to rise. That said, we expect many sponsors and private equity firms to provide capital support to their transactions and help their business cover the rise in interest and service coverage costs.

Dynamics Shifting in Favor of Private Markets

After Russia invaded Ukraine and the syndicated markets essentially shut down in terms of new issuance, dynamics across the private credit landscape shifted. Many larger cap companies, which have traditionally raised capital in syndicated loan markets, turned increasingly to direct lending to source funding. As a result, there is less capital to deploy across the market today, in both Europe and the U.S.

At the same time, in combination with higher base rates, we are seeing a shift toward better deal terms, lower leverage levels and tighter documentation in private credit. Spreads have also widened significantly to reflect the macroeconomic conditions we're living in, and we expect this to remain the case in the coming months. This is essentially creating a more attractive risk-reward profile in private debt. In particular, the relative value potential in private credit today, together with having access to high-quality deal flow, can offer an opportunity to generate attractive absolute returns—which, in some cases, are the highest absolute returns we have seen in the asset class for a very long time.

1. Source. Barings' observations.

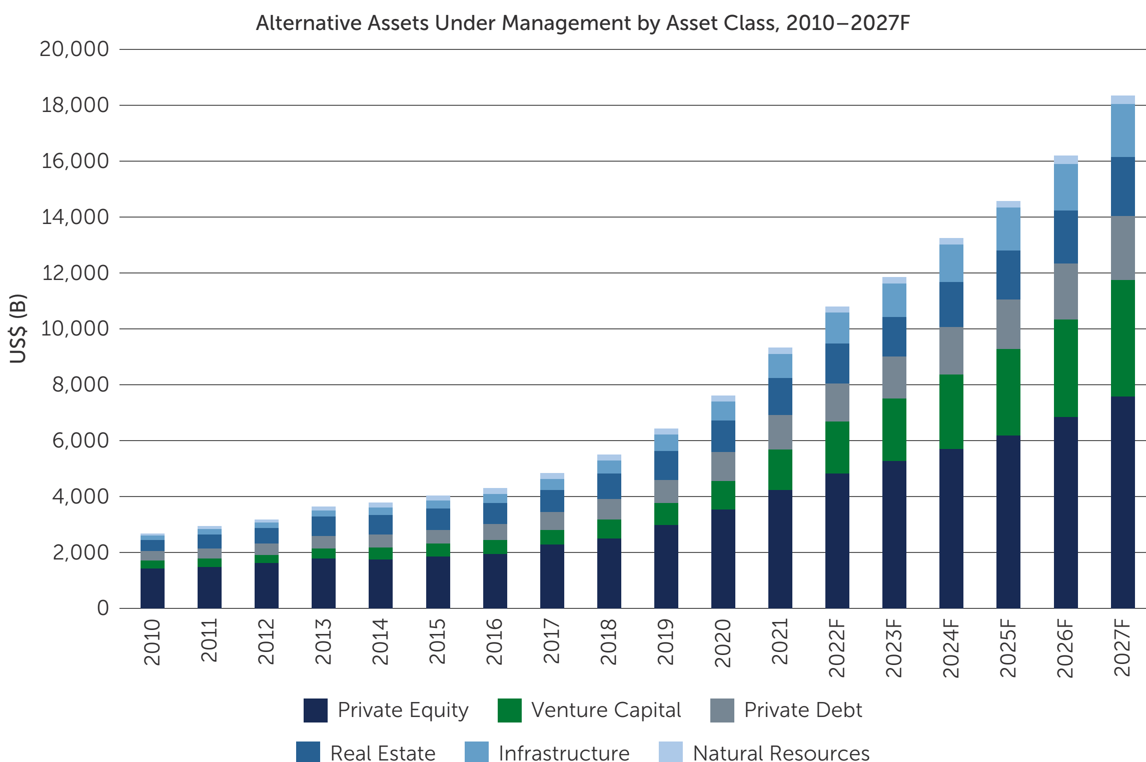
Bifurcation in Performance

In the months and year ahead, as the macro environment becomes more testing and the impact of higher rates starts to materialize, we are likely to see greater divergence in terms of manager performance across private credit portfolios. This is largely because no portfolio is the same—each manager sources different assets, which means no two risk profiles look alike. Managers that have been prudent in the way they have pulled their capital structures together, and that have picked high-quality companies with strong capital structures, and avoided some of the more cyclical sectors, should be able to see themselves through the next six to 12 months. On the other hand, managers that have created a portfolio of highly leveraged exposure look more likely to face challenges as base rates increase.

Poised for Further Growth

If you look back at history, private credit has delivered fairly consistent returns through the last two downturns, and the downside for the asset class during those periods has been less extreme than the broadly syndicated market. It is unsurprising, then, that the relative resiliency of this asset class continues to attract interest from pension funds and other institutional investors, with expectations for allocations to potentially double in the next few years **(Figure 1)**.

Figure 1: Private Debt AUM to Almost Double as Long-term Demand Remains



Source: Preqin. As of November 2022.

As the market continues to grow, we also expect to see a consolidation of managers—with performing, sustainable platforms likely to attract more capital and continue to expand, while others may struggle to survive. We are already starting to see this in Europe, with more capital being allocated to fewer managers, especially those with experience through downturns and with the resources and capital to take ownership of businesses that underperform. At the same time, in Europe, the adoption of ESG factors in private credit remains top of mind for investors. Managers with the ability to structure deals that have customized loan agreements with specific ESG or sustainability provisions—which are termed ESG-forward or sustainability-linked loans—and that engage with companies to improve ESG behavior, look well-positioned for the development in this space.

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Key Takeaway

While the long-term, structural picture for private credit looks positive, with capital inflows expected to continue for the asset class, the uncertain macro environment is likely to create near-term challenges for a number of portfolios, as well as managers. This suggests a watershed moment ahead, with a period of consolidation and growth in the asset class likely in the coming months and years.

Private credit managers build portfolios over time, with the goal of delivering a consistent return through economic cycles. Ultimately, the way to do that is by avoiding losing capital. For this reason, we believe managers that take a conservative and disciplined approach to deploying capital, and prioritize seniority and security rather than chasing yield, are best positioned to capitalize on this strong structural tailwind.

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