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ASSET MANAGEMENT

THE EUROPEAN PRIVATE DEBT OPPORTUNITY

A COMPARISON BETWEEN THE EUROPEAN AND US PRIVATE DEBT MARKETS

SEPTEMBER 2022

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Introduction

Private Debt has seen significant growth in Europe over the last decade; we believe it has established itself as an essential alternative investing asset class.

Following the 2008/9 Global Financial Crisis ("GFC"), banks, the traditional source of debt finance, faced significant balance sheet and regulatory pressures, resulting in their retrenchment from the sub-investment grade lending market. As Private Debt capacity has grown, Private Debt funds have increasingly substituted liquid leveraged loan and high yield financings, particularly during periods of market volatility.

At the same time, the demand for credit in Europe has been strong, primarily driven by a buoyant M&A market and significant amounts of Private Equity dry powder.

In addition to these attractive supply and demand fundamentals, the European Private Debt market has a number of attractive characteristics, particularly relative to the US market. Some of these include:

(i) Europe's historically high dependence on traditional lenders contrasts with the multiple alternative sources of finance in the US market, creating a larger financing gap as banks retrench from the market and borrowers have fewer sources of debt finance. Europe does not have Business Development Company ("BDC") equivalents nor a highly developed private placement market;

(ii) The rapid evolution of Private Debt funds has resulted in the European market being highly bifurcated between a small number of large funds and a large number of small funds, thus creating less competition for Private Debt funds at the upper end of the loan market;

(iii) Europe has less developed and smaller liquid leveraged loan and high yield markets, thereby only providing access to liquid markets for larger borrowers, while smaller companies cannot find financing in these markets;

(iv) The national and geographic differences

across Europe create a less homogeneous and commoditised market than the US, enabling Private Debt managers to arbitrage these differences and inefficiencies to optimise pricing and structures;

(v) These differences require a local presence, deep relationships and specific understanding of individual markets, creating high barriers to entry for new Private Debt managers.

As a result of these factors, we believe that **the risk-adjusted returns available in the European Private Debt market, particularly for the larger players, are superior to the more mature and competitive US Private Debt market.**

This is reflected by the following:

(i) Pricing and equity conditions in the European Private Debt market compare favourably to the US;

(ii) US credit markets have historically seen higher default rates and lower recovery rates than those in Europe;

(iii) High prevalence of covenanted loans in Europe, including for larger loan sizes, where similar-sized public markets debt transactions would be structured as cov-lite.

However, it is important to overlay these advantages with the broader macro-economic positions we have seen over the last decade in Europe and the US and the current economic challenges faced by these two markets.

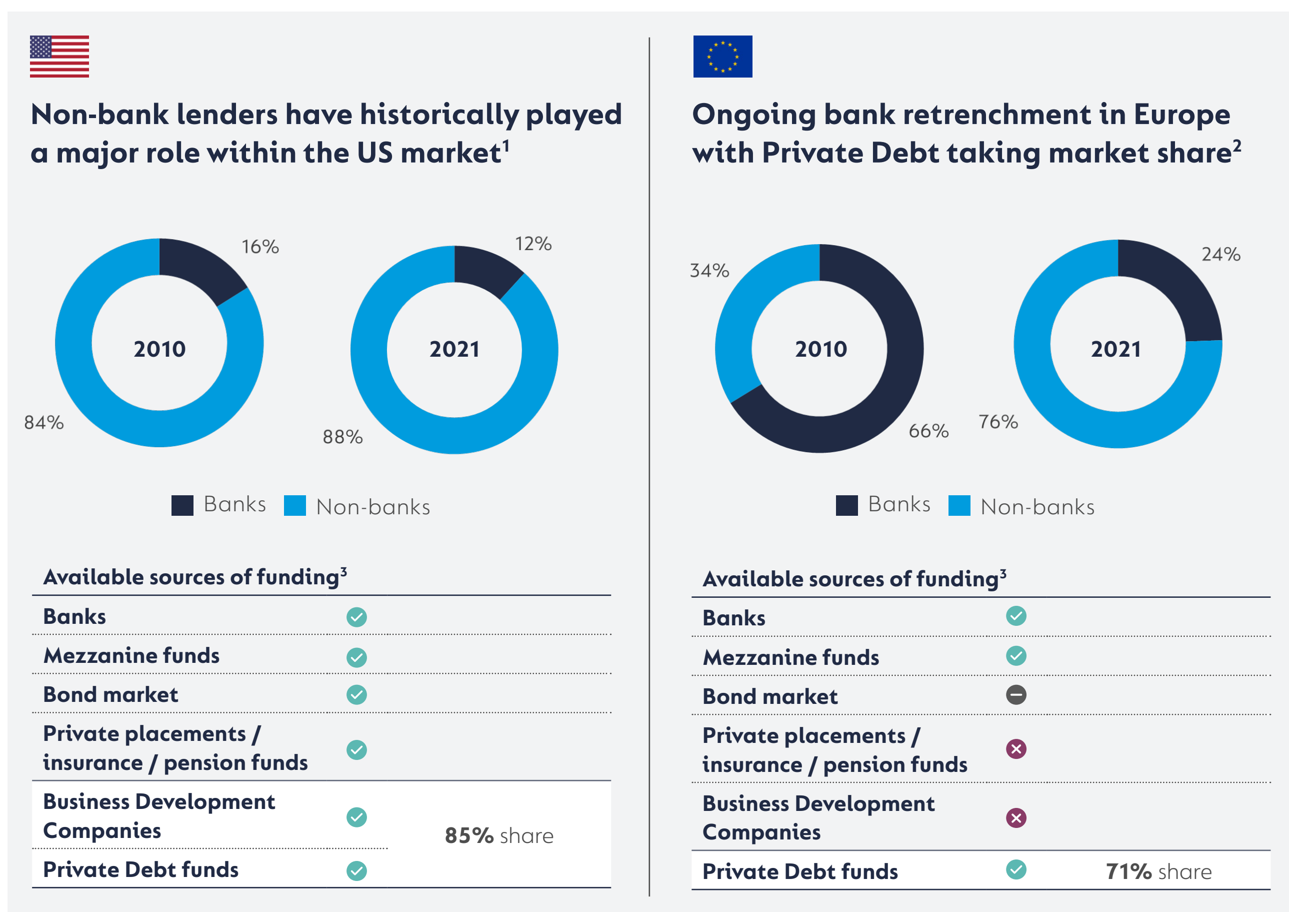
In this paper, we will seek to discuss these points in more detail.

Market Dynamics

1. Curtailment of traditional loan supply

Banks have historically represented a significantly greater share of European lending than has been the case in the US.

European companies have traditionally been highly dependent on bank loans, whereas, in the US, mid-market companies have long been able to access debt through bonds, private placements and BDCs; these options have not been widely available in Europe.



US – Available sources of funding[3]

Available sources of funding[3]		
Banks	✓	
Mezzanine funds	✓	
Bond market	✓	
Private placements / insurance / pension funds	✓	
Business Development Companies	✓	**85%** share
Private Debt funds	✓	

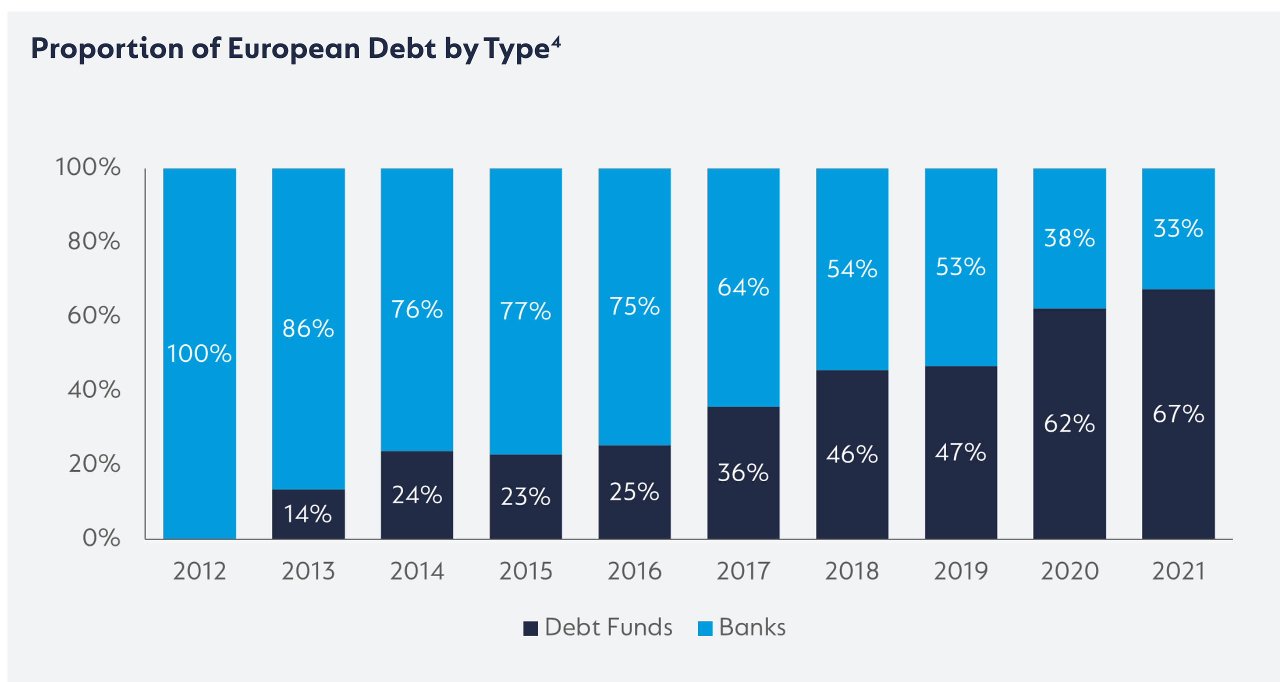
Europe – Available sources of funding[3]

Available sources of funding[3]		
Banks	✓	
Mezzanine funds	✓	
Bond market	−	
Private placements / insurance / pension funds	✗	
Business Development Companies	✗	
Private Debt funds	✓	**71%** share

The more stringent regulatory environment for banking in Europe in the wake of the Global Financial Crisis ("GFC") has left traditional banks unable to serve the mid-market. Measures such as the Basel III capital requirements, with the high capital charges related to mid-market loans, penalised banks for making sub-investment grade loans. UK ring-fencing laws and ECB leveraged lending guidelines, too, have resulted in significant bank retrenchment in the last decade.

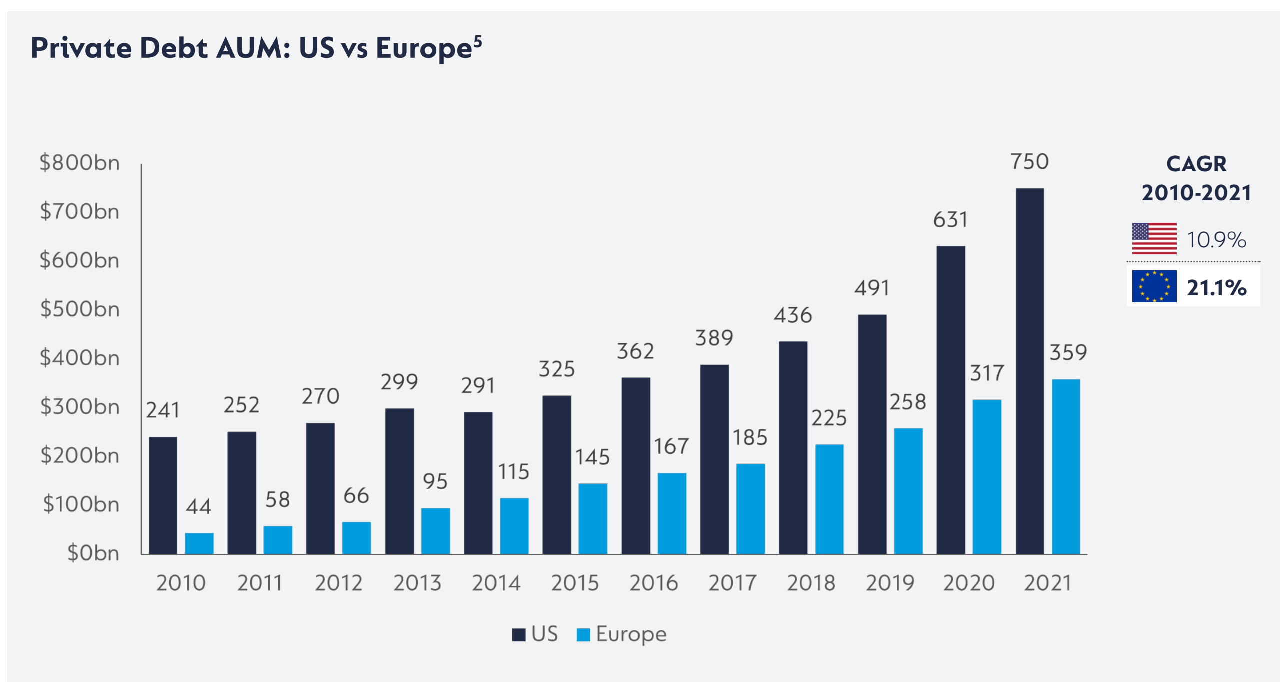
Private Debt funds have increasingly filled this supply gap. Since 2012, the share of lending represented by banks has declined considerably.

1. Source: LCD's Quarterly US Leveraged Lending Review: Q2 2022.
2. Source: LCD's Quarterly European Leveraged Lending Review: Q2 2022
3. Armont analysis of funding sources for mid-market companies.



Whereas the disintermediation of regulated US lenders by non-banks has been going on for over 25 years, with smaller banks consolidating in the 1990s and focusing less on lending to mid-market companies and more on financings for larger firms, the process in Europe only started in earnest after the GFC.

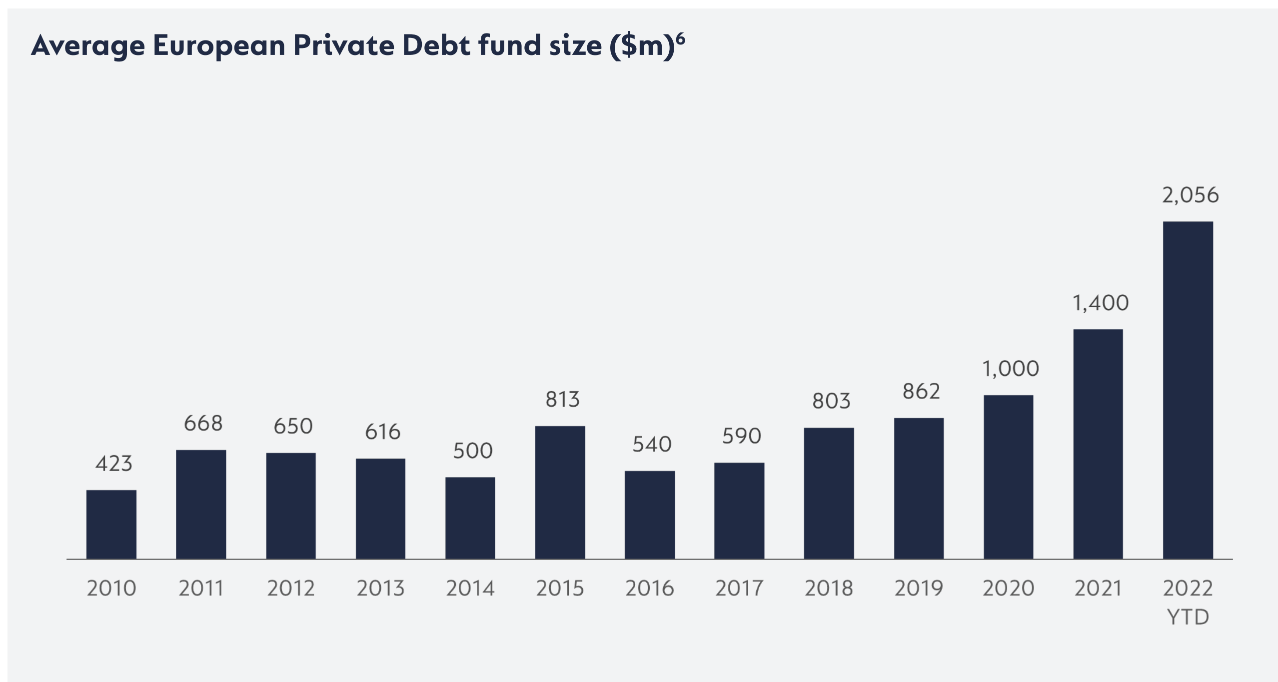
As such, **the annual growth rate of European Private Debt assets since 2010 has been double that of US managers,** at 21.1% CAGR. European Private Debt managers now hold approximately $360 billion of AUM compared to around $40 billion in 2010.[5]



4. Source: Houlihan Lokey, “MidCapMonitor” (Q1 2022). Illustrative, based on Houlihan Lokey MidCapMonitor Q1 2022 (by number of deals, includes debt funds offering senior structures). Data for the 2012-2015 period available for Germany only. From 2016 and onwards, data available for Germany, UK, France, Austria-Switzerland and Benelux.
5. Source: Preqin (07 August 2022).

2. Growth in fund sizes among top players

Fund sizes have also grown markedly over the same period, with the average size of European Private Debt funds reaching over $2 billion in 2022.[6]



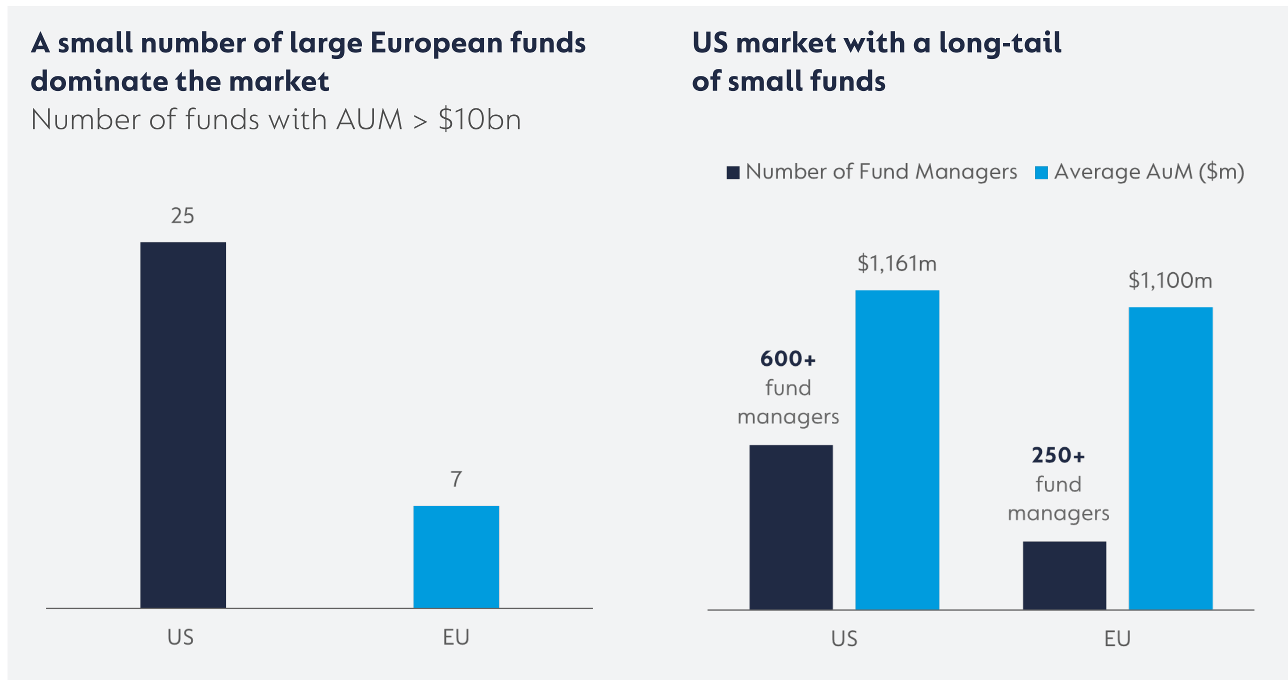
At the upper end of the market, the competitive landscape in Europe is attractive with only a handful of large fund managers capable of underwriting entire loans of €500 million or above.

This has enabled a further growth dynamic to emerge: deals that would historically have been financed in the liquid loan or high yield markets are being provided by Private Debt funds with greater frequency. Larger companies are increasingly seeking private capital solutions, as Private Debt managers are able to offer (i) greater speed and efficiency in underwriting, (ii) greater flexibility with respect to structuring for bespoke business requirements, (iii) the ability to provide follow-on capital to facilitate future inorganic growth, and (iv) greater certainty of execution - particularly when liquid markets are volatile or closed. **In the face of inflation and macroeconomic volatility, in our view, Private Debt can provide certainty where the markets might otherwise be uncertain.**

Only seven managers in Europe (~4% of the managers in the market) have AUM of over $10 billion, and they account for approximately 40% of total capital. **The reduced competition at the higher end of the market enables larger funds to achieve better pricing and terms** and to focus on higher quality businesses, typically with EBITDA of €100 million+. In contrast, the US market is more mature and more competitive; there are 25 managers with AUM greater than $10bn.[6]

6. Source: Preqin (07 August 2022).

Europe dominated by a few large players[7]



European managers are also increasingly comfortable collaborating, further scaling up their deployment capacity. Neil Campbell, a partner in DLA Piper's debt finance practice in London, says:

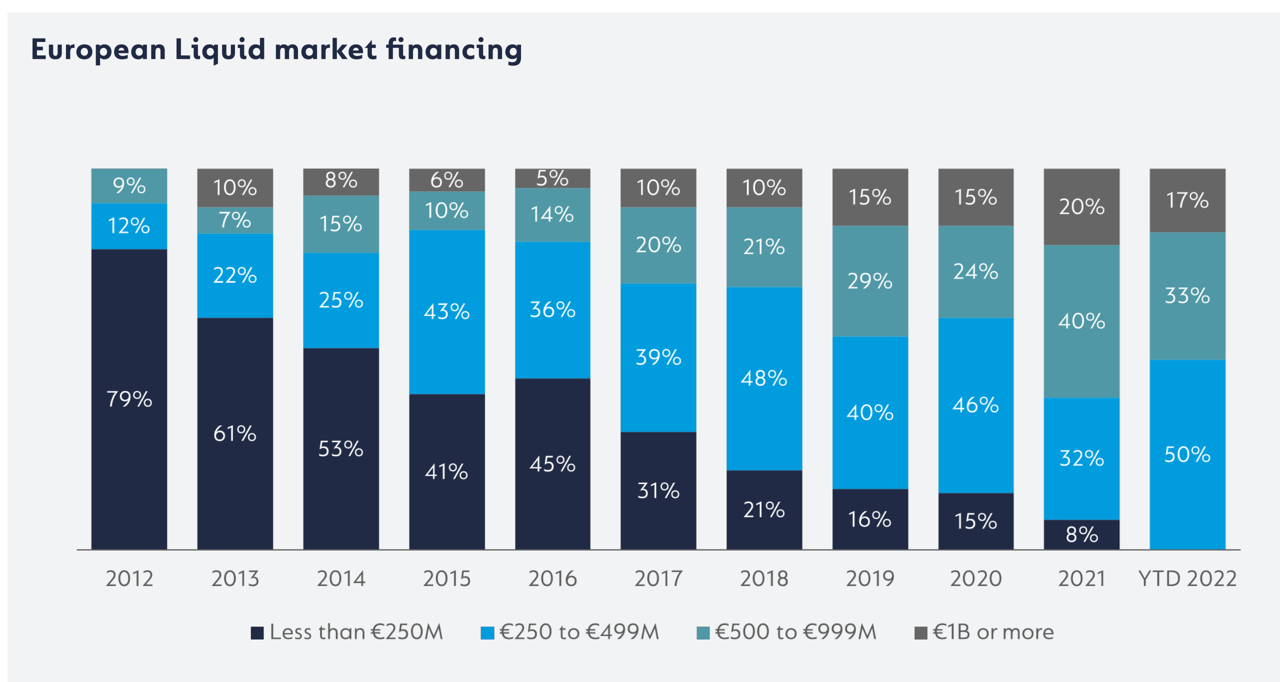
"Whilst our experience generally is that private credit would still prefer to hold the whole investment, sometimes sponsors will say to a lender we're very happy to have you in the deal, but we'd like to partner you with another fund; private credit will typically prefer to deploy some capital rather than none, and then the sponsor will potentially have access to huge pools of capital for follow-on funding." [8]

7. Source: Preqin (07 August 2022).
8. Source: DLA Piper, "Taking the Stage: Private Credit market in Europe" (7 April 2022).

3. Europe's liquid markets provide limited financing for smaller issuers

The dominance of banks as the primary source of capital across Europe stems in large part from historically close relationships between the local lending institutions and corporate borrowers. Moreover, the absence of deep liquid leveraged loan or high yield bond markets meant that many European SME businesses lacked an alternative source of financing.

As a consequence, loans of less than €250m have largely disappeared from the Leveraged Loan market, suggesting that such financings are completed almost wholly in the Private Debt market.[9]



4. European Private Debt: not as commoditised as the US

The different geographical and national boundaries in Europe provide greater barriers to entry and cross-border inefficiencies versus the US market, which is more generic and commoditised.

According to PDI: ***"In Europe, only 1% of asset finance is cross-border, and there are 44 distinct markets in which Private Credit managers must operate".***[10]

European lenders must contend with lending oriented to each European country's unique culture, economic strengths and weaknesses, legal structure and relationships.

European lending is also largely relationship-driven, significantly more so than the more competitive and transactional US market.

Private equity sponsors in regional markets trust local operators, often with local language and cultural grounding, and it can be difficult to compete cross-border.

9. Source: LCD, "European Leveraged Lending Review" (Q2 2022).
10. Source: PDI, "The European debt opportunity" (4 August 2022).

The patchwork nature of multiple jurisdictions makes origination in Europe a challenge, and the more complex the deal structure, the more local the team needs to be. Understanding the nuances of local companies is critical, particularly in a default, because the options as a lender are very different in the UK versus Italy or France for example.

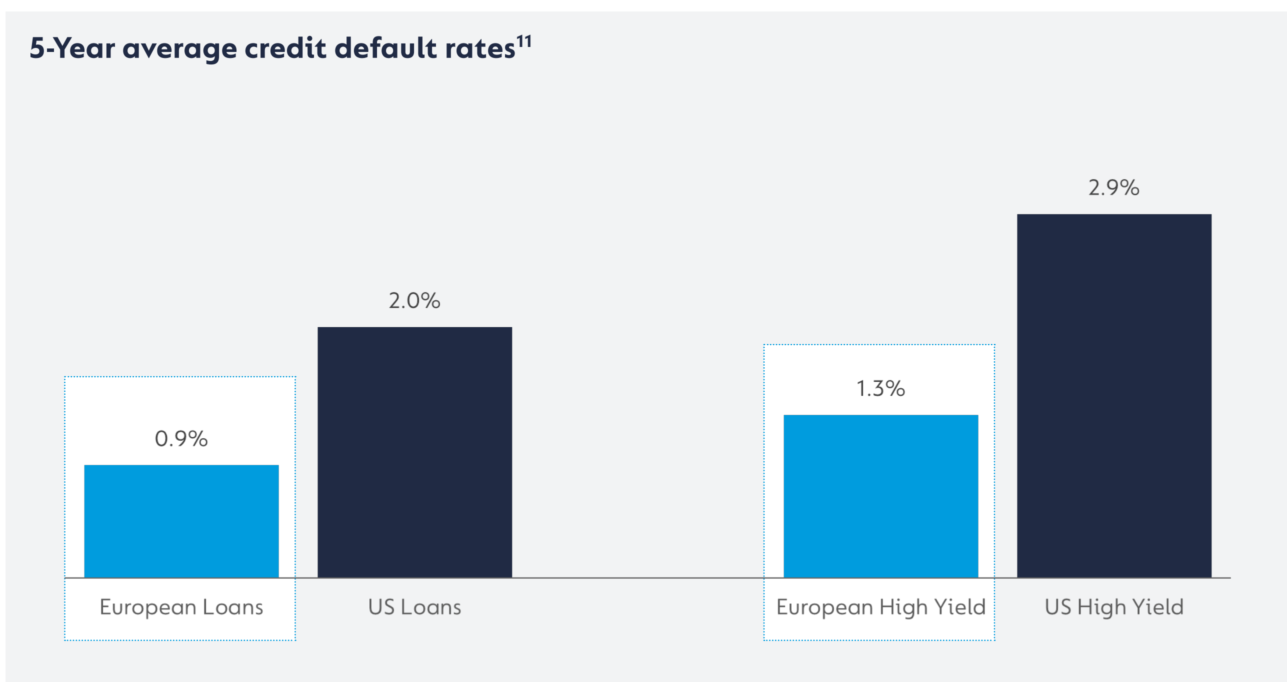
It requires national teams of local experts to originate and execute deals in Europe, and only those firms with this infrastructure can serve the region. This results in higher barriers and lower competition in European markets than in the US, hence more favourable risk-adjusted returns for LPs.

Risk and Return Considerations

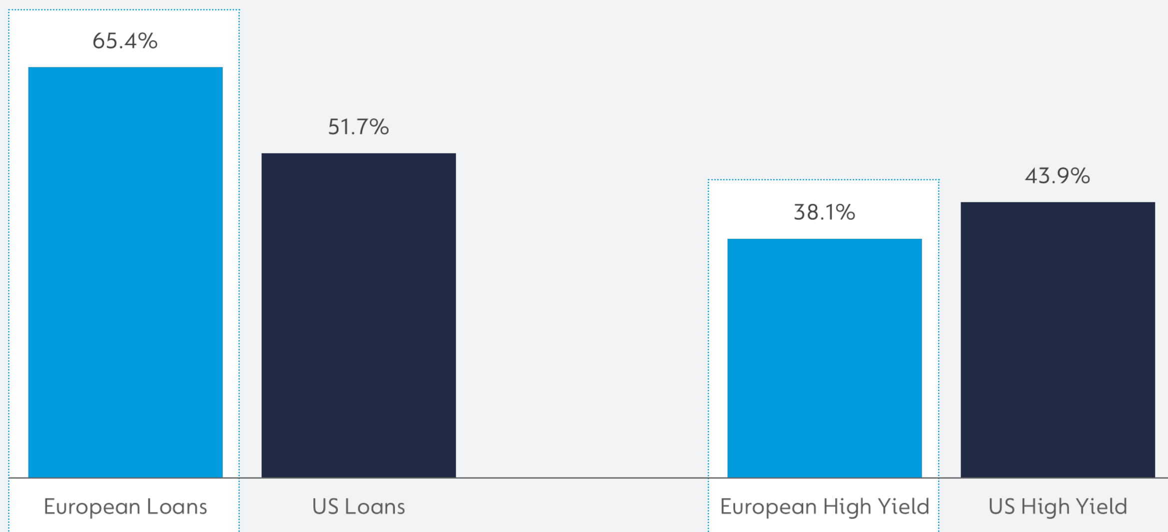
We believe that Europe offers materially better risk and return features in Private Debt than the US.

1. Lower defaults and higher recoveries for European credit

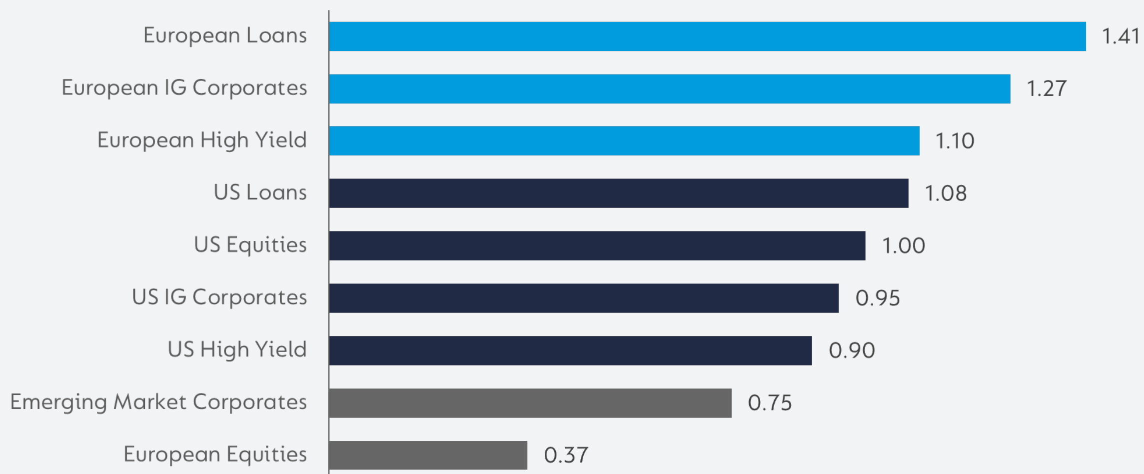
US credit markets have historically seen higher default rates than those in Europe, with **5-year average defaults in the US for leveraged loans and high-yield bonds nearly double those observed in Europe** over the same period. Recovery rates for European leveraged loans were also higher than the US, driven partly by more stringent underwriting standards.



11. Source: Credit Suisse. European Loans represented by the Credit Suisse Western European Leveraged Loan Index ("CSWELLI") and U.S. Loans represented by the Credit Suisse Leveraged Loan Index ("CSLLI"). Distressed exchanges included in default rate calculation. European High Yield is represented by the Credit Suisse Western European High Yield Index and US High Yield is represented by the Credit Suisse US High Yield Index. Distressed exchanges included in default rate calculation. Data as of December 31, 2021..



In public markets, Sharpe ratios for European credit are consistently higher than their US equivalents, with European leveraged loans outperforming US loans by a significant margin.

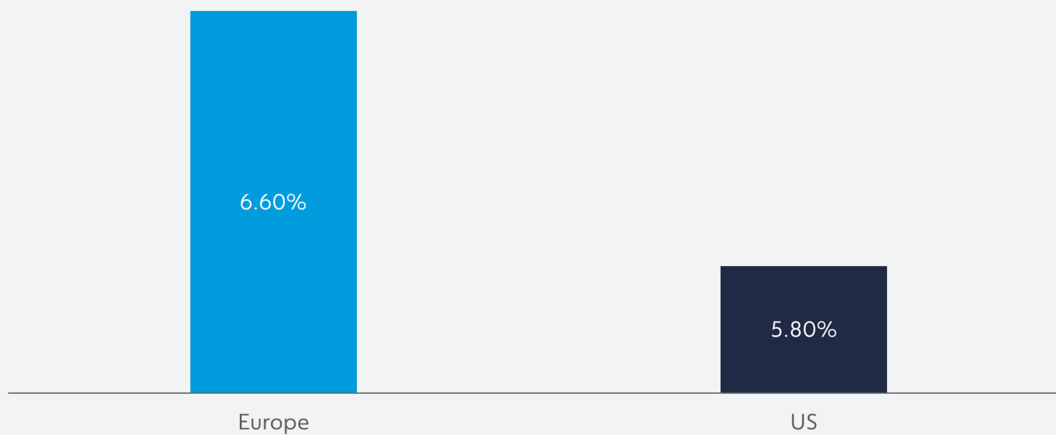


12. Source: Credit Suisse. European Loans represented by the Credit Suisse Western European Leveraged Loan Index ("CSWELLI") and U.S. Loans represented by the Credit Suisse Leveraged Loan Index ("CSLLI"). Distressed exchanges included in default rate calculation. European High Yield is represented by the Credit Suisse Western European High Yield Index and US High Yield is represented by the Credit Suisse US High Yield Index. Distressed exchanges included in default rate calculation. Data as of December 31, 2021.
13. Source: ICE BofA, Credit Suisse, Bloomberg. European Loans represented by the Credit Suisse Western European Leveraged Loan Index. US Loans represented by the Credit Suisse Leveraged Loan Index. European High Yield represented by the ICE BofA European Currency high Yield Constrained Index (HPC0). US High Yield represented by the ICE BofA US High Yield Constrained Index (HUC0). Emerging Market Corporates represented by the ICE BofA Emerging Markets Diversified Corporate Index (EMSD). European Equities represented by the Euro Stoxx 50 Index. US Equities represented by the S&P 500 Index. Data as of December 2021.

2. Risk-Return characteristics of European Private Debt

We believe that the return premium available in Europe for Private Debt managers is between 50 to 150 basis points for an equivalent risk – average margin for European Private Debt deals was 6.6% versus 5.8% in the US in 2021, with similar levels of average leverage.[14] Equivalent risk is important because many US deals have 'super senior' (1st out) pieces structured ahead of the Private Debt lender tranche (the '2nd out'), effectively leveraging the returns, but at a higher risk with lower recovery expected in a downside scenario.

European Private Debt market with higher absolute margins[14]
Average margin for Private Debt transactions, 2021



14. Source: Proskauer, "Private Credit Insights Report" (2021).

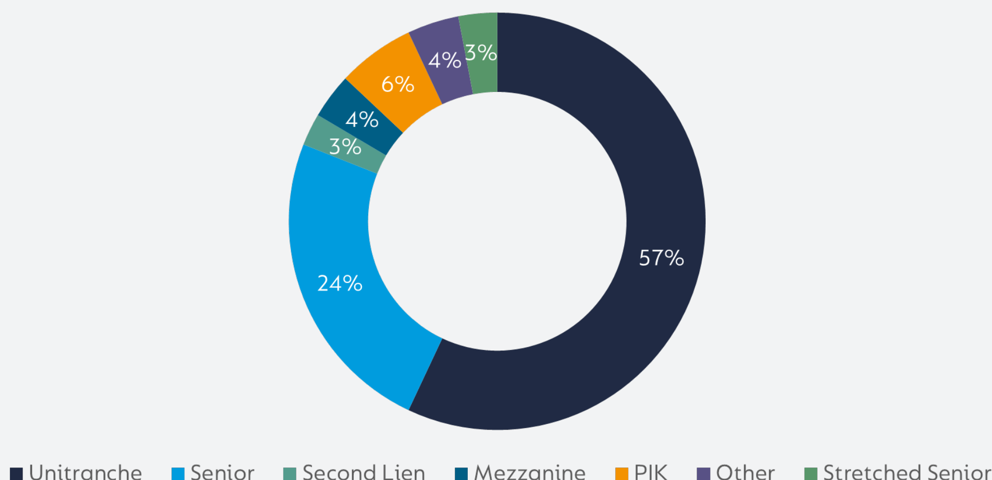
3. Comparison of Terms

European Private Debt Transactions Afford Lenders Greater Protections.

European Private Debt issuance predominantly comprises first lien lending with strong protections, the majority of loans being covenanted. **Loan contracts usually include covenants that limit a borrower's ability to impact the value of a loan negatively.** These include maintenance-based covenants and other lender protections, such as requiring borrowers to meet certain financial conditions, like keeping their ratio of debt to EBITDA below a specific level for example.

Over the last twelve months, 84% of European transactions were structured as first lien:[15]

European Private Debt transactions by seniority[15]

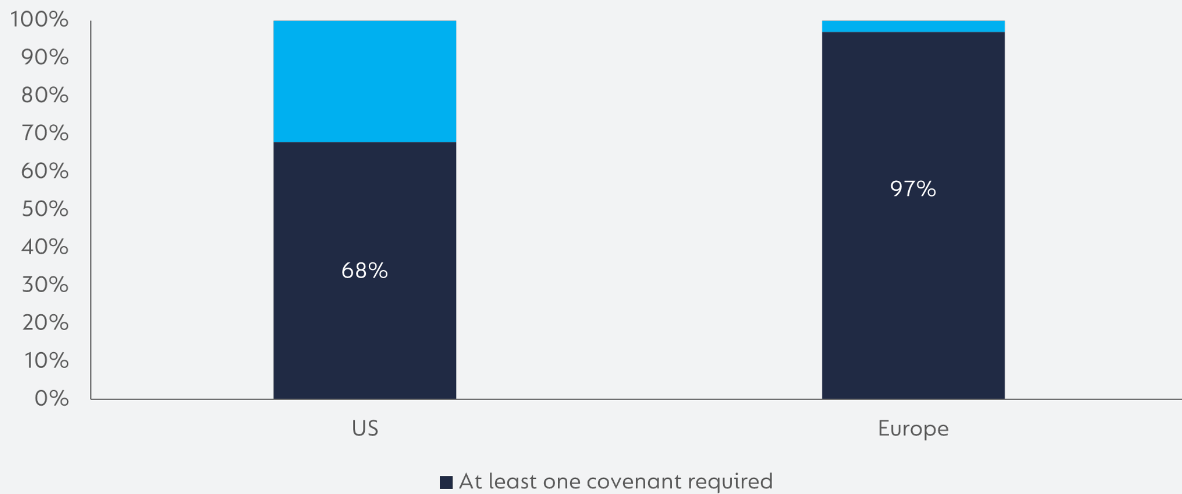


European Private Debt has significantly better protections than the US, particularly at the larger end of the market, where loans without any covenants (so-called "cov-lite" loans) have long been the norm. The historical difference between the makeup of lenders in Europe and the US, with banks historically playing a central role in corporate lending in Europe, explains much of the divergent trends in the US; institutions control the US market to a far greater extent.

According to a recent Proskauer survey, nearly all European managers (97%) require at least one covenant in their deals, whereas 68% of US respondents would consider cov-lite transactions.[16]

15. Source: Deloitte, "Alternative Lender Deal Tracker" (Spring 2022).
16. Source: Proskauer, "Trends in Private Credit" (Q1 2022). Number of covenants required by European managers for companies with EBITDA greater than €25m

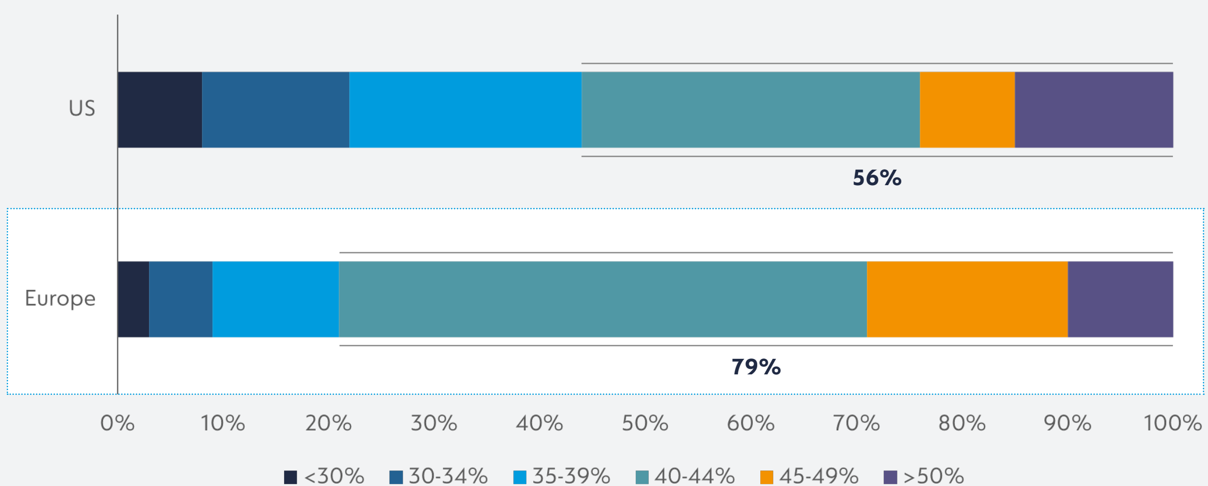
Respondents requiring at least one covenant on a transaction[17, 18]



Greater Equity Requirements

Equity requirements by lenders also vary significantly by region, with **European managers requiring larger equity cushions** from borrowers compared to their US counterparts. Proskauer found that almost 80% of European Private Debt providers require 40% or more equity contribution, whereas this figure is only slightly over 50% for US managers.[17]

How much equity does your organization typically require in your transactions?[17]



17. Source: Proskauer, "Trends in Private Credit" (Q1 2022).
18. For US respondents who would consider cov-lite transactions, 4% would consider these for deals less than $30m EBITDA, 18% for EBITDA of $30-40m, 35% for EBITDA of 40-50m, and 44% for EBITDA of $50m or greater. Number of covenants required by European managers for companies with EBITDA greater than €25m.

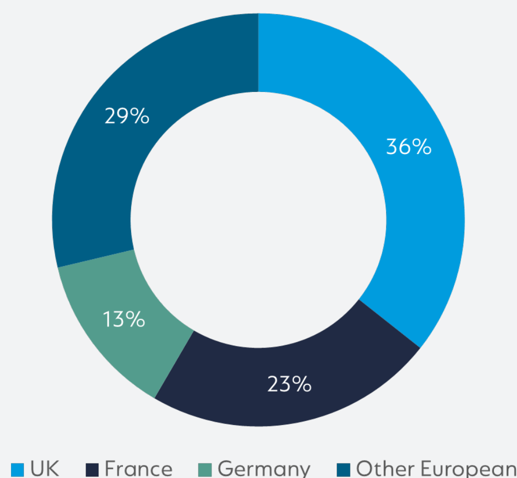
Enforcement Regimes

The European markets are subject to different enforcement regimes with varying degrees of lender-friendly characteristics.

The US enforcement regime for senior secured loans is robust; however key European Private Debt geographies, such as the UK, Germany, and certain Nordic countries, offer stronger, or at least as strong, protections. Although enforcement regimes are arguably weaker in countries such as Italy and Spain, there is the ability to structure around these geographies through security of assets in alternative jurisdictions or the ability to enforce outside these countries.

Many European countries have recently overhauled or upgraded their insolvency regimes in line with international best practices. Additionally, the EU has recently commissioned a report[19] benchmarking enforcement regimes across the continent to assess the efficiency of the legal framework in member states, thereby finding possible issues to improve. This **continued modernisation of European countries' administrative and judicial systems will, in our view, likely result in further improved prospects for European lenders** to work through enforcements in the future.

The UK, France and Germany account for over 70% of European Private Debt[20]



19. Source: European Banking Authority, "Report on the benchmarking of national loan enforcement frameworks" (November 2020)
20. Source: Deloitte, "Alternative Lender Deal Tracker" (Spring 2022).

Current macroeconomic environments in Europe and the US

1. An era of stability and accommodative policy has come to an end

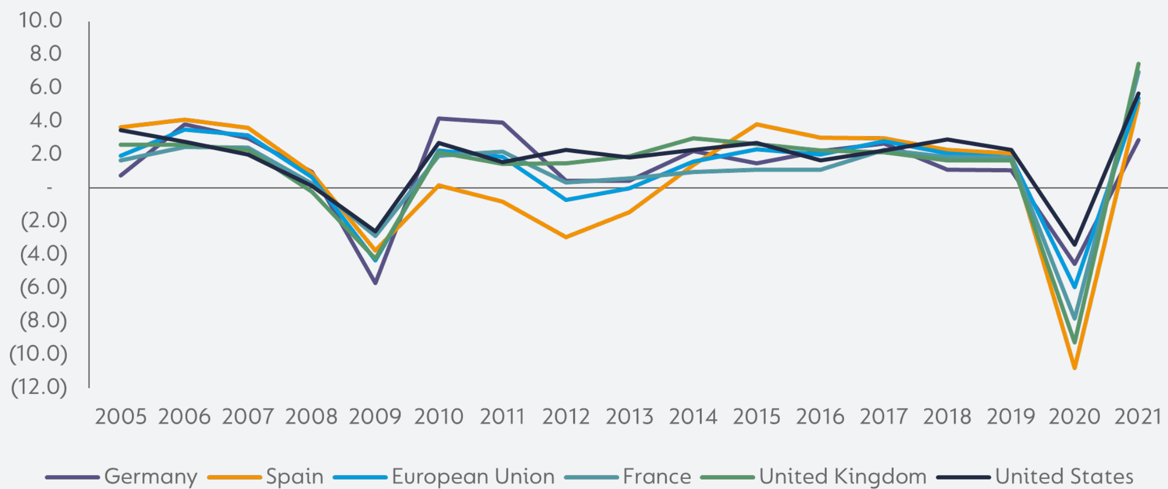
Since the GFC and prior to the onset of Covid-19, both the European and US economies were stable and growing, with average growth rates in the US of 2.1% and 1.3% in the EU between 2010 and 2021.[21]

This environment facilitated investment as decision makers had sufficient certainty of future stability - the value of M&A transactions grew at a 9%[22] CAGR in both the US and Europe.

The effect of near-zero interest rates across the developed world allowed some borrowers to paper over cracks in their business models.

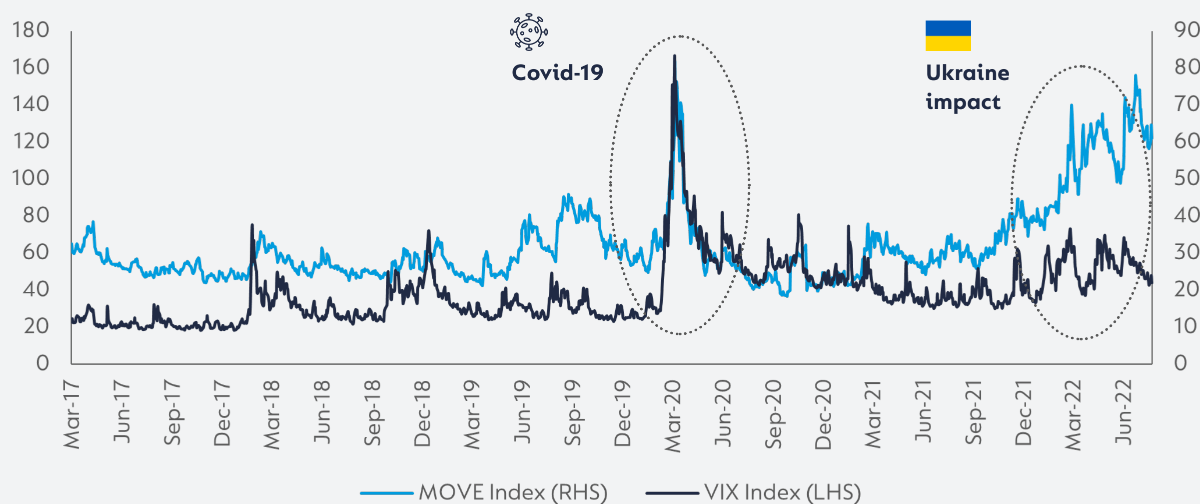
We expect the current rising rate environment to expose these issues, causing issues for borrowers and unprepared lenders.

Annual change in GDP, 2005-2021[21]



21. Source: World Bank, "World Bank Open Data" (2022).
22. Source: Pitchbook, "Global M&A Report" (Q2 2022).

Volatility is back – successive shocks have impacted global growth prospects[23]



The Covid-19 pandemic brought the era of stability to a halt, and the unprecedented global pandemic required similarly novel policy responses. Across the US and Europe, a range of emergency monetary and fiscal policies were enacted.

Where there were signs of US monetary policy returning to normal pre-Covid with rates rising above near-zero, this was quickly reversed with the Federal Funds Rate falling back to zero, and a variety of facilities being put in place to support various sectors of the economy. Fed support was in parts open-ended – the FOMC stated on March 23rd 2020 that it:

"…will continue to purchase Treasury securities and agency mortgage-backed securities in the amounts needed to support smooth market functioning and effective transmission of monetary policy to broader financial conditions".[24]

US Fiscal policy was similarly stark, with trillions of dollar worth of support coming from the successive Trump and Biden administrations.

The European response was equally robust, albeit starting from a main policy rate of zero at the beginning of the pandemic. As with the Fed, the ECB increased and extended existing monetary operations, as well as providing new facilities and programmes to relieve certain sectors and markets. Since the initial shock, a total of over €2.3tn has been provided to support the EU's recovery from the pandemic.[25]

Ultimately, the biggest catalyst for recovery was the widespread availability of vaccines, which allowed life to largely return to normal. Through a combination of pent-up demand post-Covid and a hangover from highly accommodative policy, the US and European equity markets grew by 100% and 70%,[25]

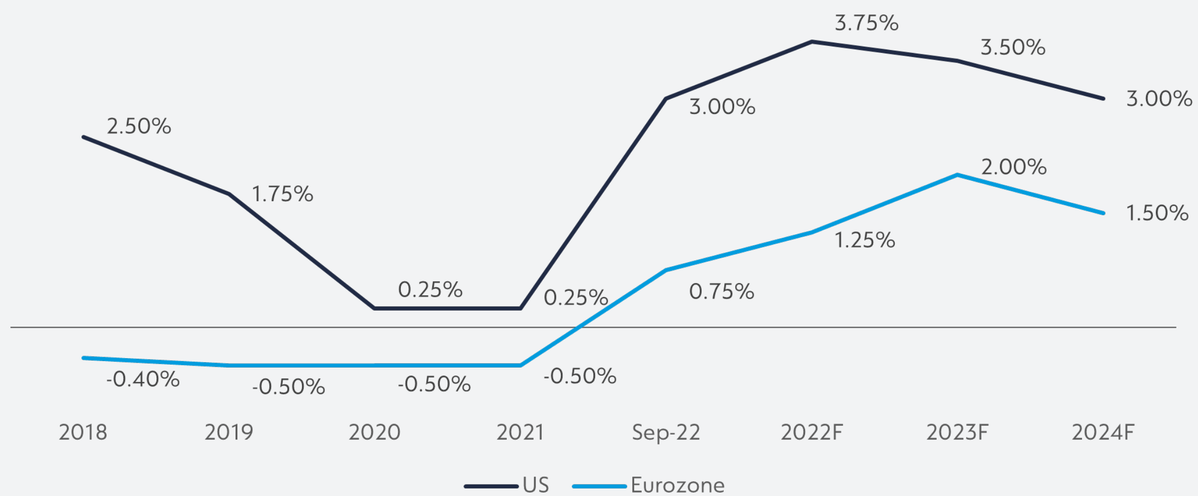
23. ICE BAML MOVE Index 2017 latest, VIX index 2017 latest, sourced Bloomberg August 2022 2. S&P Capital IQ LCD Global Market Intelligence as of August 2022. New Issue Yield to Maturity Senior Secured Bonds; USD:EUR 1.00 as per Bloomberg 7th September 2022.
24. FOMC Press release, 23/03/2022 https://www.federalreserve.gov/newsevents/pressreleases/monetary20200323a.htm
25. https://www.consilium.europa.eu/en/policies/coronavirus/covid-19-economy/

respectively, from the March 2020 trough to the peak in late 2021.

A gradual but unsteady recovery over 2021 has given way to a more challenging outlook, with a number of closely interlinked issues around the globe:

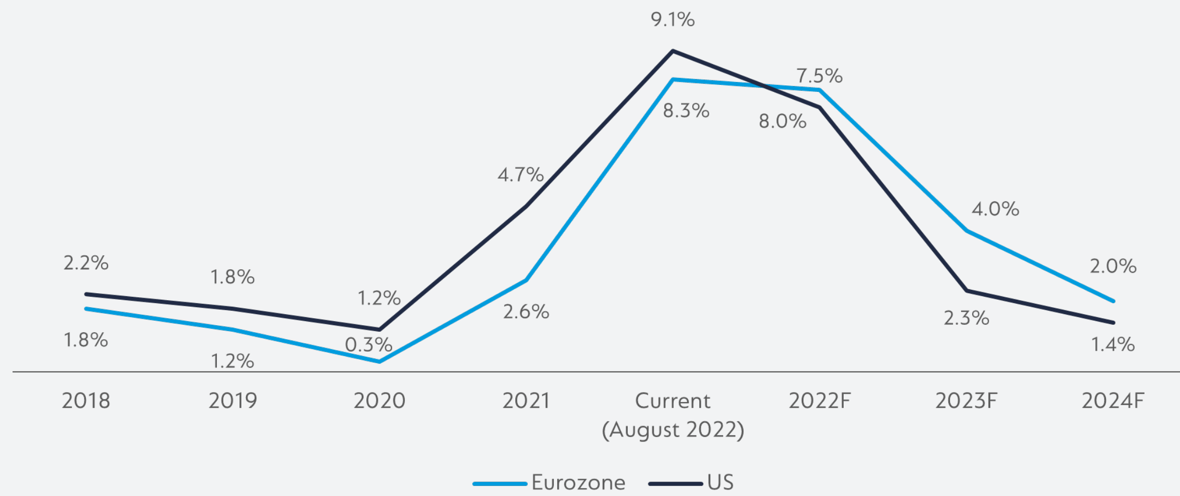
- Energy and raw material price increases with European gas prices eight times higher in September 2022 than is usual for this time of year, driven in large part by the ongoing war in Ukraine;
- Supply chain disruption as China continues to pursue a zero-Covid policy;
- General labour shortages across developed economies due to people dropping out of the workforce;
- Inflationary pressure for consumer and businesses as a result of the above factors;
- Rising interest rates as central banks seek to address inflationary pressures, which in turn impacts debt-laden consumers and businesses.

Central Bank policy normalisation[27]
Historical and forecast interest rates



27. Source: World Bank, "World Bank Open Data" (2022).

Rising global inflationary pressure in the near term[28]
Historical and forecast interest rates



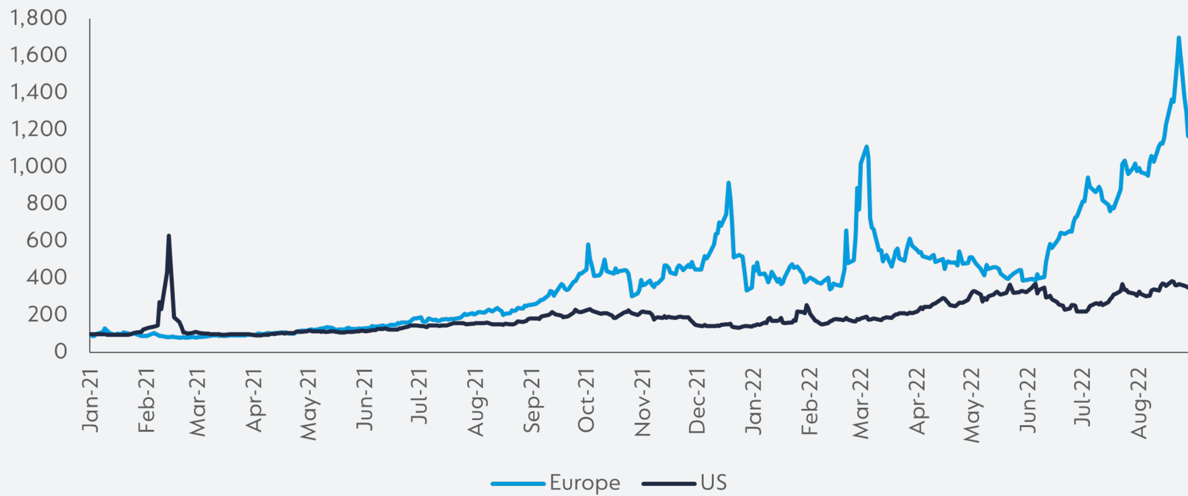
Taking the above factors together, we believe that Europe will likely be more affected than the US by these ongoing difficulties due to its high dependency on Russian natural gas, the supply of which is now being used as a proxy in Russia's war against Ukraine. US gas prices have been far more stable than those in Europe.

As at mid-September, the European Commission is looking to propose concrete measures to alleviate the crisis. Markets have reacted positively, with benchmark gas futures declining 9.3% to their lowest in months when draft proposals were leaked to the press in mid-September.[29]

In addition, measures by national governments to promote alternative energy sources, cap gas prices to consumers and businesses and seek to curb consumption will likely mitigate many of the effects of very high energy prices over the medium term. Even with pan-European measures being taken at the level of the EU, we believe that the economic consequences of these factors will be felt more strongly in Europe.

28. Source: World Bank, "World Bank Open Data" (2022).
29. https://www.bloomberg.com/news/articles/2022-09-12/european-gas-declines-as-bloc-plans-details-on-intervention?leadSource=uverify%20wall.

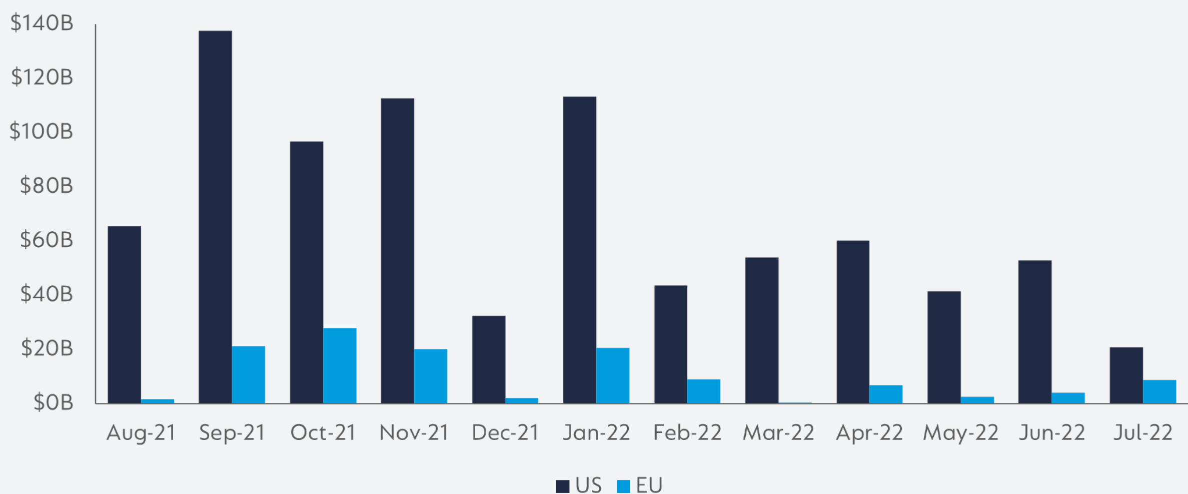
Natural gas prices in Europe have been more volatile than the US[30]



2. Liquid market volatility provides opportunity for Private Debt

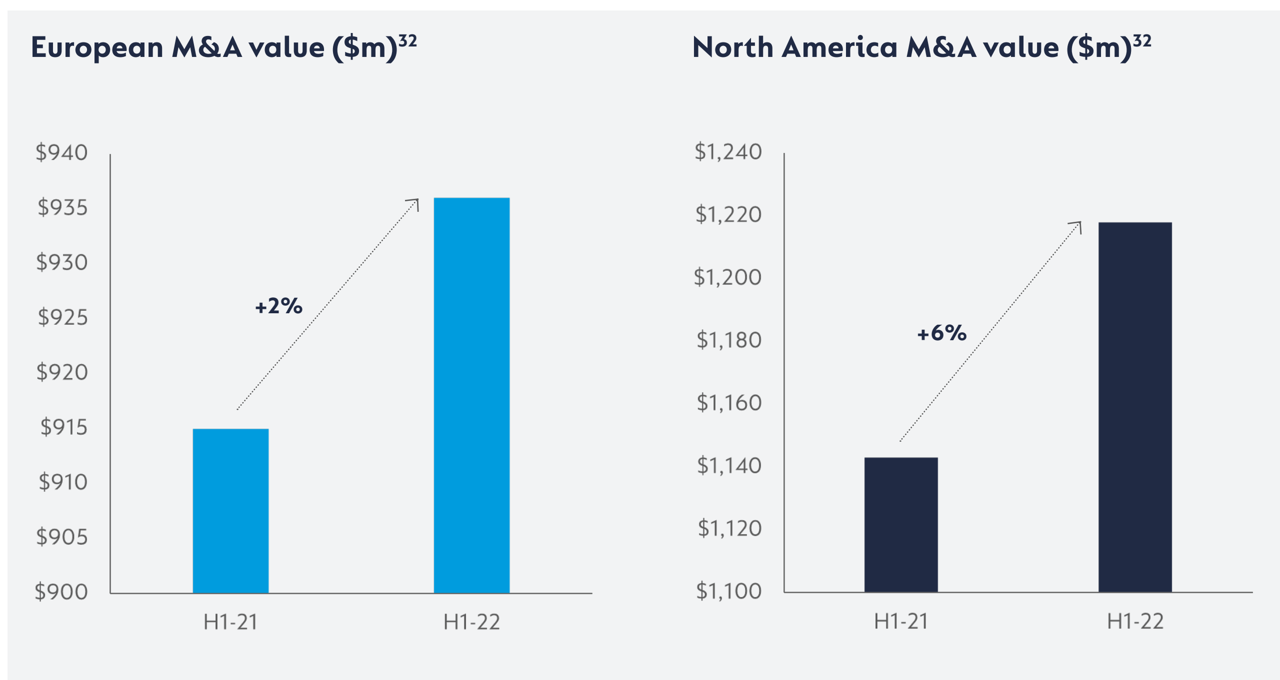
Since the onset of the Ukraine war, the liquid loan markets have seen a significant decline in volumes. Institutional issuance fell by 56% in the YTD period in the US, while Europe, unsurprisingly given the factors outlined above, saw a 70% decline.[31]

European versus US Primary Loan market issuance[31]



30. Source: Bloomberg. Europe is represented by the Netherlands TTF Natural Gas price and the US is represented by the Henry Hub Natural Gas price.
31. Source: LCD, YTD refers to year to July 2022.

M&A volumes, however, remained robust through this period with the North American and European volumes growing at 2% and 6%, respectively.[32] We believe this creates a significant opportunity for Private Debt. While overall deal volumes are likely to fall, as buyers and sellers adjust to new valuations, there remains significant M&A transaction volume that cannot be financed in the bank or liquid markets. Private Debt is well placed to fill this gap and we believe, as discussed earlier in this paper, **the European market is characterised by fewer financing options than the US, which only serves to improve the Private Debt opportunity.**



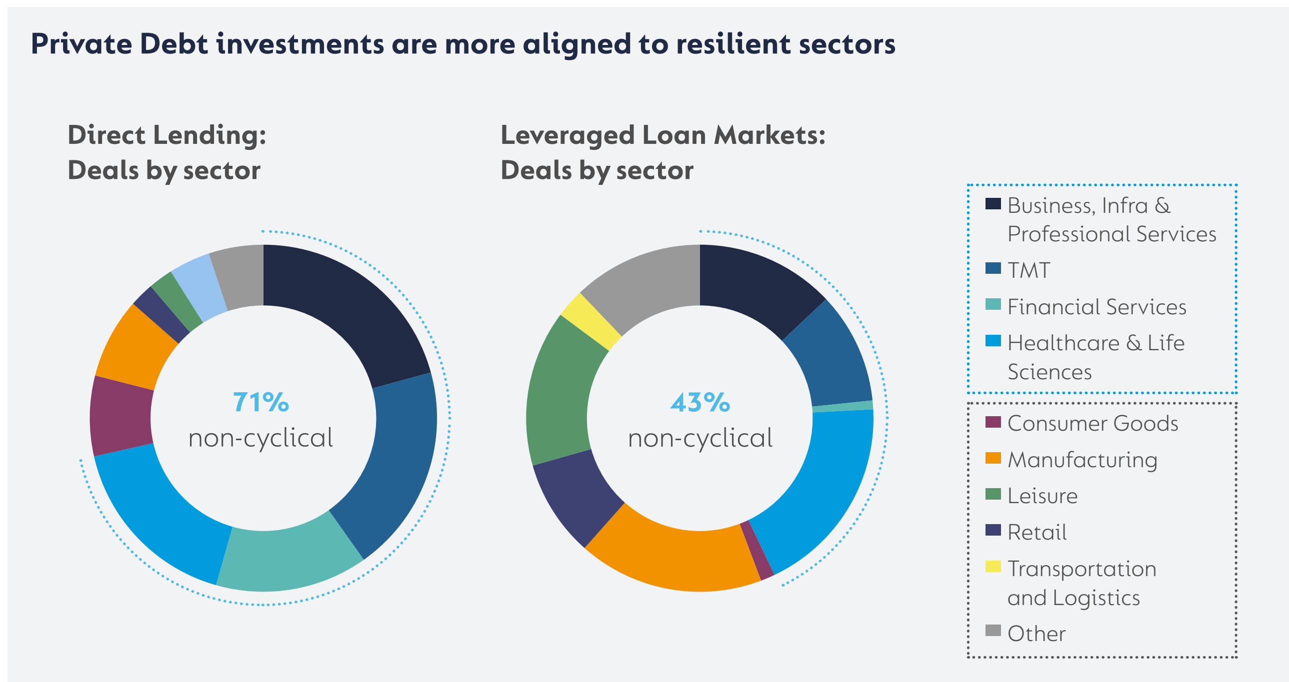
We are already seeing the impacts of the resurgent supply and demand disparity through increasing opportunities to finance larger (and therefore generally better) businesses at improved pricing, lower leverage multiples, and more favourable lending terms. Crucially, it is lenders at the top end of the size range that are able to take advantage of this dislocation – a small club of like-minded lenders is now able to compete with the liquid markets in terms of size, while providing certainty of execution in a volatile marketplace.

32. Source: Pitchbook Q2-22 Global M&A Report.

3. Private Debt providers have shown better discipline than the liquid markets

Critically, Private Debt players have focused on non-cyclical business in sectors such as TMT, Business Services, and Healthcare. This is in contrast with the liquid markets that have significant exposure to Consumer Goods, Leisure and Retail – the sectors that will undoubtedly be tested by consumer spending coming under stress. **As long as this sector focus continues, we believe that Private Debt providers will avoid significant defaults and losses** in the market.

Private Debt investments are more aligned to resilient sectors



Summary

In our view, the rise of the Private Debt industry in Europe since the GFC is undoubtedly one of asset management's greatest success stories this century.

The unique financing environment in Europe has meant that the Private Debt industry has been able to displace balance-sheet constrained banks, and is now selectively displacing liquid market financings.

Whilst there have been a large number of new entrants into the market, the leading market players have remained largely the same since its inception and can now benefit from highly attractive investment dynamics.

A heterogeneous regulatory and legal environment in Europe mean that managers who can navigate this landscape are able to achieve premium returns, in contrast to the commoditised US market. We also believe that European Private Debt lenders enjoy greater contractual protections than their US counterparts.

As we enter a period of increased headwinds across the global economy, the committed and locked-up nature of Private Debt capital means that it is a compelling proposition versus the liquid markets.

We believe that, particularly in more volatile environments, European Private Debt offers a number of uniquely attractive characteristics when compared to US Private Debt, so long as managers continue to invest in robust businesses that will be capable of withstanding more difficult macroeconomic circumstances.

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