FIXED INCOME

Post-COVID European Private Credit: A Higher Quality Market?

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BARINGS INSIGHTS

On the back of COVID, transactions in the European middle market are showing decreased leverage levels, stronger documentation and improvements in pricing—suggesting a rebasing of the market from where it has been for the past several years.

The private credit market that has emerged in the wake of COVID looks somewhat different, and in some ways more attractive, than that which preceded the pandemic. Specifically, in the months following the initial shock, the quality of deals coming through, broadly speaking, has improved, with many exhibiting lower leverage levels, tighter documentation and better pricing. In our opinion, these are encouraging signs for how the market may continue to develop in a post-COVID world, and suggest that we may continue to see higher quality opportunities going forward. However, with a number of uncertainties on the horizon—including around the pandemic itself—we believe a disciplined investment approach, with a focus on capital preservation, will be crucial.

Key Market Movers

There are a number of key drivers shaping the opportunity in private credit today. Many of these have been apparent in the market for a number of years, but have been exacerbated or enhanced as a result of the pandemic.

REGULATORY PRESSURE

Over the last decade, increased financial regulation in Europe has continued to limit the lending activity of banks, creating a gap in the market for direct lenders to fill the shortage of capital. As a result, non-bank lenders have continued to grow their market share—from roughly 40% two years ago to just over 60% today.[1] And we do not expect this to wane anytime soon. In fact, institutional market share in Europe remains well below that in the U.S., where it is closer to 90%, suggesting there is further room to grow as banks continue to pull back from middle market lending.[2]

At the same time that supply has been decreasing, demand for private financing—particularly to support buyouts—has continued to grow. Indeed, as of August, dry powder in Europe had reached a record €194 billion.[3] This suggests that even as regulatory pressure and challenging market conditions on the back of COVID have impacted banks and other lenders, borrowers and private equity sponsors continue to seek financing solutions and certainty of execution from non-bank providers.

ILLIQUIDITY PREMIUM

Many investors turn toward private credit for the potential illiquidity premium versus the broadly syndicated market. This premium stems from the buy-and-hold nature of the asset class. Over the last several years, this premium started to diminish in some transactions as leverage levels increased and documentation weakened across the market. While this was more pronounced in the upper part of the market, it resulted in an increasing number of transactions being priced and structured in a way that did not adequately compensate investors for the illiquidity of the market—essentially, liquid assets in an illiquid wrapper.

Post-COVID, we believe the potential illiquidity premium for middle market deals remains—and could even widen. As we look across the market today, transactions are showing decreased leverage levels, stronger documentation and improvements in pricing—which we believe suggests a rebasing of the market from where it has been for the past several years. The reversal of these trends is particularly evident when comparing the terms on similar deals completed pre and post-COVID.

Recently, we have observed notable differences in deals that came about pre-COVID versus those that came about during—even in transactions where the underlying businesses exhibited very similar dynamics. One recent transaction, for instance, offered a fairly significant spread pick-up of 75 basis points (bps) relative to a pre-COVID deal that was similar in both size and leverage. Another offered a 50 bps spread pick-up, for a half a turn less of leverage, versus a deal in the same industry that closed in early 2020—despite the fact that both were high-growth, high-quality businesses generating strong recurring revenues.

1. Source: AlixPartners Mid-Market Debt Report. As of December 31, 2019.
2. Source: S&P LCD. As of Q1 2020.
3. Source: Preqin.

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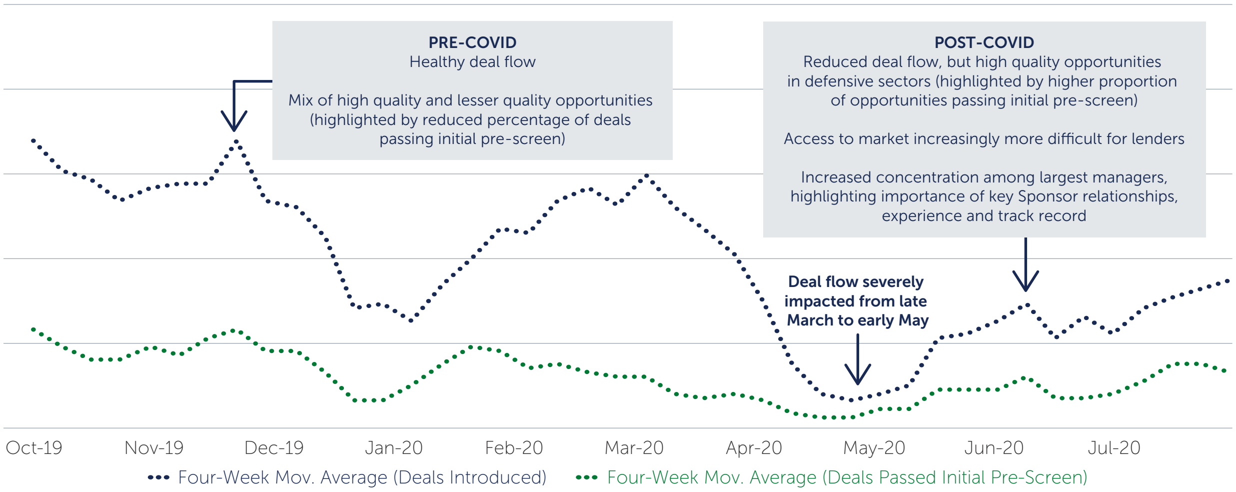
DEAL FLOW

While deal flow prior to the pandemic was higher, the quality of the deals in the market appears to be better today. For example, ahead of COVID, there were a number of opportunities in so-called fad industries like restaurants and retail, which in our view posed notable risks due to their increased vulnerability to intermediation and disruption over the lifecycle of an investment. We also did not invest in cyclical businesses like oil and gas, or mining—given the high degree of uncertainty around how these industries may evolve or change over the five to seven year life cycle of a typical private credit investment, we believe these areas look less attractive.

In markets today, in addition to exhibiting lower leverage and stronger documentation, many of the opportunities we are seeing are from resilient businesses that are looking to borrow. For instance, we have seen a number of opportunities in defensive, COVID-resilient sectors such as Software as a Service (SAAS), health care and IT managed services.

Consequently, the conversion rate of opportunities we are introduced to today and ultimately pursue is higher than it was pre-COVID, as many deals we see are, in our view, good quality and in the right sectors **(FIGURE 1)**.

FIGURE 1: A Higher Deal Conversion Rate Post-COVID



SOURCE: Barings. As of July 24, 2020. Represents deals that reached stage with a proposed capital structure.

Accessing the Opportunity

While the market appears to be trending up in quality, access to deal flow remains key. There have been a number of new entrants to the European private credit market in recent years—leading some investors to question whether access to deal flow remains intact. In our view, the number of new entrants has not resulted in a significant disruption, largely because the barriers to enter the European private credit market tend to be high, making market access quite challenging. For instance, because the private credit market in Europe is bilateral in nature, lenders need a certain amount of scale to access higher quality deals. A strong origination network is also important, particularly for gaining access to proprietary transactions. Without an established reputation and a solid network, the primary way to access deal flow is through auction processes, which can be highly competitive and lead to adverse selection. Experience with investing through multiple credit cycles is also crucial, especially as many newcomers to the asset class are not proven in times of distress.

If anything, COVID has exacerbated these already high barriers to entry, leading to smaller, tighter processes. In many cases, private equity funds are introducing a potential deal to only two or three of their key relationship lenders. Being in this core group of top tier managers is therefore vital to maintaining and gaining market share, and securing high quality market opportunities with better credit fundamentals, tighter controls and more attractive risk-adjusted returns.

Ultimately, we believe reputable managers that have strong partnerships with financial sponsors, intermediaries and portfolio companies—as well as execution skills, significant hold capacity and flexible capital structure solutions—are at an advantage. As evidence of this, there has been a flight to quality toward top tier managers over the last year, despite the fact that there are more players in the market—today, the top five managers account for over half of the market.[4]

Key Takeaway

There are still a number of unknowns when it comes to COVID—from a potential second wave and the resulting impact on the economy, to the introduction and acceptance of a vaccine. But in many ways, the post-crisis environment is shaping up to be potentially more attractive than that immediately preceding this crisis. As we have already seen to some extent, we think there is a good chance of seeing better pricing, lower overall leverage and more robust structural protections going forward, which could create favorable conditions for deploying capital and potentially generating strong risk-adjusted returns.

Even as the pandemic continues to present uncertainties, demand for private finance persists. In our view, managers who have remained focused on the true middle market and maintained a disciplined approach to the asset class are best positioned to capitalize on this long-term opportunity.

4. Source: GCA Altium MidCap Monitor. As of Q1 2020.

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