EXPERT Q&A

M&A activity may have slowed but the European market continues to offer the potential for attractive returns, says Adam Wheeler, co-head of Barings' Global Private Finance Group

Europe's compelling private debt opportunity

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Q How would you describe the current private credit environment and the opportunities being created by volatility?

We are definitely seeing the impact of higher interest rates on the private credit market. We have seen reduced leverage levels, and the overall return profile in the market is probably the highest we have seen in decades.

Spreads have widened by at least 100 basis points from where they were 18 months ago. While we have seen a slight reduction in enterprise values, there is still a significant amount of equity cushion behind us.

As a consequence, the asset class looks very attractive on an absolute return basis. These rates are probably unsustainable in the long term, but for the rest of 2023 and into 2024, the opportunity set will likely deliver returns that are fairly consistent with what we are seeing today.

Meanwhile, the broadly syndicated loan market looks likely to remain shut for some time, so that is not really available as a source of capital. There is also less capital in the private credit market, as direct lenders have deployed significant amounts over the past 18 months – effectively reducing the amount of capital chasing transactions.

Q What are you seeing in terms of activity levels, dealflow and pricing?

M&A activity is certainly slower, as you would expect in such an uncertain environment. Investors are put off buying because of the uncertainty, and reluctant to sell because they don't think they will attract the prices they expect for an asset. As the uncertainty eventually fades, private equity firms that have held assets for a long time will likely want to sell, while others will be sitting on significant amounts of dry powder. We expect dealflow to return by the end of this year, with Q4 in Europe potentially quite busy.

At Barings, because we have a large existing portfolio of issuers, we are able to continue providing debt to support companies that we already lend to. Incumbency results in dealflow for us and we do not necessarily have to go out and find new platforms in order to deploy more capital.

Pricing has certainly widened because there is less capital competing for transactions. When you apply base rates, the absolute returns in the asset class are above 10 percent for first-lien secured risk – compelling for a first-ranking debt instrument.

Q How are macro pressures impacting performance across the portfolio, and where do you see the challenges emerging?

We have definitely seen the impact of inflation across the portfolio, particularly around higher employment costs as access to labour has tightened amid a shortage of semi-skilled and unskilled labour. Input prices have certainly gone up, but companies seem to be managing supply chains reasonably well, with some passing on price increases to customers and seeing demand remain relatively robust.

Having said that, higher interest rates have not really started to flow through to the portfolio yet. We expect to see that happening in the first half of this year. That's likely to produce some softness in the top line and therefore some margin erosion.

We believe our portfolio is positioned very well to withstand the challenging environment. We have constructed a conservative portfolio of companies which are at the lower leverage end of the risk spectrum, rather than chasing yield through higher leverage or looser covenant structures. The deals in our portfolio also have a high amount of equity sitting behind them. We take a defensive approach and have avoided cyclical businesses, meaning we don't have any exposure to the retail or consumer sectors. Instead we tend to focus on companies in the business services, healthcare and software sectors, which have more resilient business models.

We expect things may continue to deteriorate going forward, particularly if rates remain higher for longer than expected. The fallout from Credit Suisse and Silicon Valley Bank is another risk factor, and will likely exacerbate tightening credit conditions. Direct lenders that have ample capital should be particularly well-positioned in this environment.

Q What is the outlook for private credit in Europe, and how do you see the market developing in comparison to the US?

The macro backdrop is likely to see further deterioration going forward. However, we expect to see activity levels normalise toward the end of this year – and those lenders that have capital may be able to generate attractive returns for the next 18 months. But not everyone in the market is going to be able to raise capital. As a result, there will likely be less competition over the next few years.

> *"We expect dealflow to return by the end of this year"*

In Europe, we are still seeing banks at the smaller end of the market providing solutions to private equity firms, unlike in the US where the market is dominated by direct lenders. For this reason, we expect to see credit funds taking more market share in the lower mid-market and increasing penetration.

Pricing in the US and Europe today is relatively similar, which is unusual because the US has been priced wider than Europe for the last few years. Further penetration here should enable more deployment than in the US, where much more depends on M&A markets. The growth profile for direct lenders in Europe is therefore a lot stronger.

Q Finally, what are investors currently focused on when allocating to private credit?

The denominator effect has clearly had an impact on allocations, but the investors we talk to still like the asset class and want to allocate to it. Many are still working through their allocations for 2023, but our sense is that most will re-up this year – it is just a question of how much. Most investors now view direct lending as a core allocation, which wasn't the case several years ago.

Some estimates suggest that allocations to private debt could double in the next four years, so while there may be a short-term blip because of the denominator effect, the long-term trend is toward greater allocations from institutional investors. Most investors have an allocation to direct lending, opportunistic credit and increasingly either real estate or infrastructure debt, and direct lending is typically the largest of those.

Ten years ago, direct lending was very much a new market in Europe. Investors today are much more familiar with the asset class, and many have been invested for years. These investors have continued to increase their allocations to the asset class given the positive historical performance, consistent yield, and – if you pick the right manager – resiliency through the cycle. Manager selection will certainly become more important, however, and we will likely see significant divergence of performance going forward following a relatively benign several years during which most managers have done fairly well. ■