EXPERT Q&A

Direct lenders in Europe have gained ground in the absence of syndicated lenders, and are unlikely to look back, says Adam Wheeler, co-head of global private finance at Barings

Structural change in Europe as funds take market share

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Q Given the current macroeconomic landscape, what are the current pressure points for private debt portfolios in Europe? Where are you seeing underperformance or concern from management teams?

Clearly there is a lot of discussion around inflationary pressures flowing through into the real economy, and the impact of higher interest rates.

When I look through our issuers, of which there are almost 100 in Europe and over 350 globally, I have been surprised by how well portfolio companies have held up so far. We don't have a lot of high energy users in our portfolio, so there is not a lot of impact from higher oil and gas prices – but we have certainly seen supply chain issues and wage inflation flowing through. However, where that impact has been felt, companies have generally been able to pass through price increases because demand has remained strong.

The companies that we lend to are generally in more defensive, less cyclical sectors with some pricing power, where demand is still robust. We haven't seen any real margin compression, but as interest rate rises start to bite in the broader economy, we would expect to see some softening of demand and probably some margin compression.

We currently have more equity underneath us than ever before, and that is partly due to the high prices that private equity has been paying for assets. So we have a good cushion. By and large, if you have a high level of diversification across your book at fund level you are going to be okay.

Q How do the challenges differ between syndicated and private markets in times of volatility?

The syndicated loan markets and the high-yield markets remain basically shut at the moment, which means a lot more transactions are coming to the private markets. Private markets as a whole saw an extraordinary number of deals done and dollars deployed in the second quarter of 2022, in both Europe and the US. In Europe in particular, we compete against the banks who remain a large part of the mid-market leveraged finance world, and they have pulled back quite a bit.

So M&A has been relatively strong given the circumstances, and more of that financing has flowed to direct lenders because of the lack of competition from banks. We have recently started to see pricing move up, leverage come down and terms improving to favour lenders.

My view is that this is a structural shift that will not fully reverse, as the direct lending community now has sufficient scale to start doing large transactions by pulling together clubs of direct lenders. That has been happening in the US for some time, and we can expect more of it in Europe. From a borrower perspective, it provides more certainty of execution, which is why we will likely start to see the private markets replacing at least the bottom layer of the syndicated loan market, and potentially more than that.

Q Given your perspective on both the North American and European investment committees, how do the situations in the two regions differ right now?

M&A activity seems to have slowed down faster in North America than it has in Europe, which is surprising given the geopolitical landscape in Europe. We have also started to see pricing move out faster in North America – it does tend to lead the way, with Europe then following suit.

In terms of relative value, Europe is probably slightly better positioned, but there is a much deeper market in North America, where you can get access to transactions in order to deploy capital at scale and build a well-diversified portfolio. The barriers to entry are higher in Europe because a lot of what is done here is done on a sole-lender basis.

Q Despite these challenges, European private credit markets have seen a number of new entrants in the last 12 months. How has this changed competitive landscape impacted the way in which managers win deals?

The asset class keeps on growing and is one of the few asset classes to which LPs, and pension funds in particular, are looking to increase allocations.

In Europe there are a lot of new entrants, but we have seen a consolidation around a small group of lenders. The whole market continues to expand in terms of both the number and size of transactions, but that small group is doing an ever-increasing amount and taking market share. You then have a long tail of people struggling to get dealflow.

In an environment that is uncertain, private equity firms like to transact with people they know they can rely on. So scale, incumbency and deliverability are particularly important right now.

Most of the transactions we do have some sort of proprietary angle, either because the private equity firm has secured a deal that is proprietary, or because they are trying to secure exclusivity in the auction process. In those circumstances, they need to go to a very small group of lenders to get access to a debt facility, and they are focused on deliverability. It is not about a difference of 25 basis points of margin, or giving ground on some of the terms – it is whether they can get there in the timeframe and have a broad structure that works.

"The barriers to entry are higher in Europe"

You have to be one of the handful of lenders that a sponsor wants to work with to get access to that dealflow. Otherwise, you risk getting stuck with auction processes that tend to go to the lowest common denominator.

Q Finally, how would you describe the outlook for European private credit going into 2023?

The outlook is more uncertain in the medium term, so we have to expect a slowdown in deal volumes. I think we will see private equity firms holding onto companies for longer, because it will be more difficult for them to exit at a price they want to achieve, and there will be fewer refinancings because they will be more expensive – meaning firms will hold onto debt for longer.

All of this underscores the importance of being selective about what you do and the types of companies that you lend to. There will be opportunities, because pricing is still attractive, with base rates increasing and ours being a floating rate instrument, and because private equity has so much dry powder. But protecting the downside and not losing any money will always be key.

As we look across the market today, we see value in being senior in the capital structure and conservative in the way we deploy capital. As we come out of the downturn, opportunities may open up further down the capital stack where there is a shortage of capital, and there may be opportunities to get equity-type returns for that, but we are not there yet.

Right now, our pipeline remains robust and we continue to see attractive opportunities across the private-credit landscape. Some of that is down to the structural shift we are seeing in Europe as banks continue to retreat, which suggests that private credit will continue to gain market share through the cycle. ■