PICTET
Asset Management

European direct lending in 2025: looking beyond the crowds

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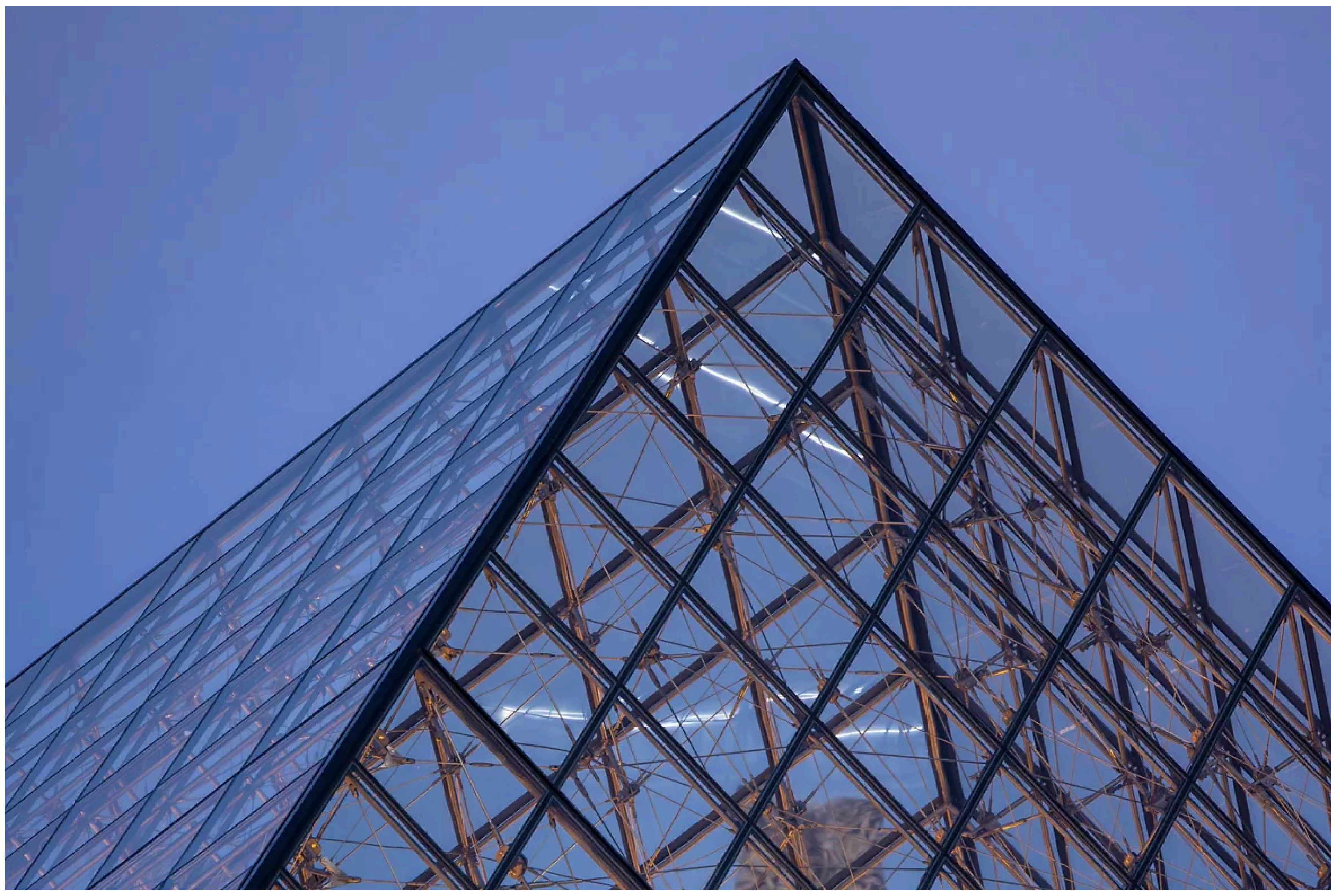
Europe's growing private debt universe presents attractive investment opportunities, particularly in the less crowded lower mid-market.



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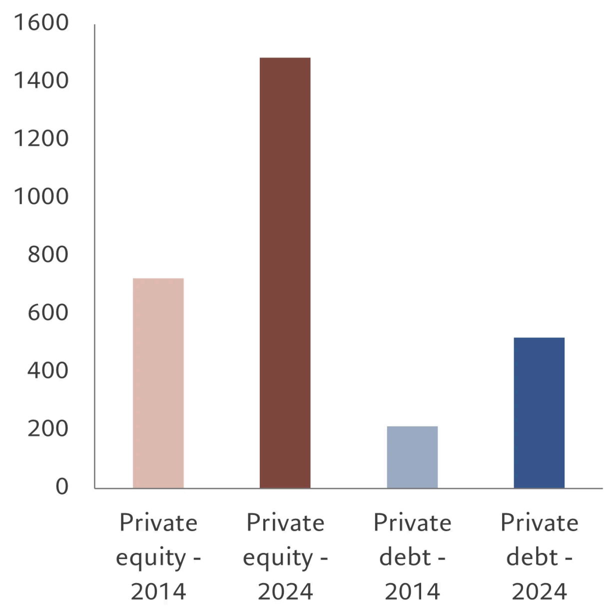
Dealmaking picked up again in European private debt markets in 2024 after a largely subdued period of M&A activity and we expect this to continue in 2025, amid a potentially improving macroeconomic backdrop. This will help supply more deal flow for an asset class where the potential for growth is significant: worth circa EUR400 billion, Europe's private debt market is still a third of the size of the US.

The market is also broadening out, with smaller and medium-sized companies increasingly turning to direct lenders for capital as traditional bank financing remains difficult to obtain in some areas. Yet the dynamics and sources of debt financing differ across the different market segments. At the larger end of the universe, direct lending has started to see renewed competition from broadly syndicated loan (BSL) and high yield (HY) markets, creating a glut of capital that has pushed down pricing and diluted terms. Smaller deals, meanwhile, remain largely insulated from such competitive dynamics as the HY and BSL markets are not accessible. Here, direct lending is still the main alternative source of debt financing relative to banks, particularly when it relates to growth or transformational capital. Such contrasting competitive dynamics result in starkly different risk and returns for investors.

Fig. 1 - Competing for deals

Dry powder in private assets - now vs 10 years ago, USD bn



Source: Pitchbook, Q2 2024.

Margin compression: is the tide changing?

Spreads on European direct lending deals have tightened over the last year. Core and upper mid-market segments have seen margins come in by close to 100 basis points since early 2023, dipping below the 600 basis point mark for the first time. We have even seen some deals close in the 450-500 basis points over base range, often without the benefit of covenants.

This comes amid historically elevated levels of dry powder as general partners (GPs) continue to ramp-up fundraising. Private equity and debt funds have a historic USD2 trillion in cash on the sidelines, looking to be deployed (see Fig. 1).[1]

The subdued M&A market has created a real scarcity of debt financing opportunities for funds and a “race to the bottom”, where margins are compressed and terms widened.

Yet in the lower mid-market (LMM) – which we define as companies with earnings before interest, tax, depreciation and amortisation (EBITDA) of up to EUR15 million – the margin compression has been slightly more modest, at around 20 basis points (see Fig. 2). Fewer private credit funds operate in this space and banks’ appetite remains limited due to capital constraints, particularly when it comes to providing any form of undrawn facilities.

Such pricing underscores the growing risk-adjusted return premium on offer to investors in the lower mid-market versus the more traditional large cap market (see Fig. 3). While spreads remain more stable, risk parameters continue to moderate. Leverage, for example, is declining, with more and more deals being closed below four times debt-to-EBITDA and the prevalence of strong covenants is high.

We expect these contrasting dynamics to continue in 2025, with the lower mid-market remaining a superior and more stable source of income and capital preservation.

Fig. 2 - Margin benefits

Evolution of margins by type of deal and LMM premium, bps

Source: KBRA, Q3 2024. Data covering period 01.01.2023-30.09.2024.

Fig. 3 - Risk vs return

Spread per turn of leverage, bps

Source: Pictet Asset Management, Q4 2024; KBRA, Q3 2024.

Opportunities ahead

One of the characteristics which investors value in direct lending is the relatively low default rate. Indeed, while default rates for syndicated loans have crept up to around 6 per cent, those for direct lending remain below 2 per cent on average.[2]

This gap could widen further. Despite European central banks cutting rates in 2024, the potential for residual inflationary pressures means it is still unclear whether the rate reductions will come at the same speed as previous easing cycles. Any slowdown in monetary easing could cause stress in some of the more cyclical and levered corners of credit, such as high yield and leveraged loans.

In the coming year, we expect the lower mid-market segment to benefit from improved economic conditions and a pick up in merger and acquisition activity. However, Europe's economic recovery may prove uneven and the potential for volatility remains.

To mitigate this, we are focusing on lower-beta sectors – ones which tend to be less volatile than the overall market – such as med tech, software and business services. These offer better diversification, more stable income and capital preservation. Conversely, we are avoiding some of the more cyclical segments, such as parts of the industrial and consumer universes. And while most of the market continues to underwrite on a covenant-light basis, our position as a sole lender means we are able to structure more bespoke deals that better protect our investors' capital, notably with quarterly-testing financial maintenance covenants. This approach has meant that we have been – and indeed will be – well protected during periods of volatility as these companies continue to grow their revenues, earnings and free cash flow.

We are often asked about the credit risk in the LMM. Although, as a generalisation, smaller companies can be riskier, we focus on finding businesses which operate in and dominate niche markets, with limited competition and high barriers to entry. Such companies, though small, often exhibit the same defensive qualities as large market leaders, if not better ones.

Crucially, our portfolio is also balanced between sponsored and non-sponsored transactions, adding a further layer of diversification and helping to manage risk while enhancing returns. Our peers often overweight towards the higher-volume, though arguably lower-value, sponsored channel. However, we believe that with the right origination network and capacity the ability to have a meaningful proportion of non-sponsored deals can be a strength.

By offering a differentiated value-add proposition, the lower mid-market has the potential to enhance the overall risk/return profile of a private debt portfolio. It can also complement allocations to, for example, traditional large cap and upper mid-market direct lending, distressed, special situations, and venture debt.

Whether new investors are taking their first steps into the asset class or sophisticated investors are seeking to diversify their existing portfolios in 2025, this niche corner of the market should form a core, strategic allocation in any private credit portfolio.

[1] Pitchbook, 30.06.2024

[2] KBRA DLD, Q3 2024