

Bridging the Atlantic: European private credit ascends

Alternative investments

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- The European private credit market, while less known to investors than its US counterpart, has grown to roughly USD 460bn assets under management in 2023 and is set to grow further in the coming years.
- The European private credit market offers elevated yields while maintaining conservative underwriting standards. Selectivity is, however, paramount in the current environment.
- We see good opportunities for Europe-focused investors with a long-term time horizon to diversify and improve income generation with a high-yielding, albeit less liquid, fixed-income alternative.



When investors consider the private credit opportunity, they usually think about the US market. And for good reason—it’s by far the biggest in the world, with nearly USD 1.1tr in assets under management in 2023. But across the Atlantic, there are also opportunities to be found in private credit. Over the past decade, European corporate borrowers have increasingly sought out private debt to power their growth, helping the market grow fourfold since 2015 to roughly USD 460bn assets under management in 2023. And we see good opportunities for Europe-focused investors to diversify and improve income generation with a high-yielding, albeit less liquid, fixed-income alternative.

Like its US counterpart, the European private credit market offers elevated yields. Using leveraged loan data as a proxy, European spreads have historically traded at similar levels to the US, with the gap recently widening to 90bps for European loans (see figure 1). For direct loans, while yields may be less than what can be found in the US, spreads should be higher to compensate for Europe’s less mature, more complex, and diverse market structure, requiring expertise in local jurisdictions. For instance, most European direct loans are underwritten to businesses with EBITDA

ranging from EUR 20–60mn, which is below the US median. The UK represents about 34% of the European market share, followed by France (24%) and Germany (13%), according to Deloitte. New loans are currently originated at lower-double digits, which represents a favorable yield pickup compared to EUR-leveraged loans and high yield.

Figure1: European vs. US leveraged loan spreads



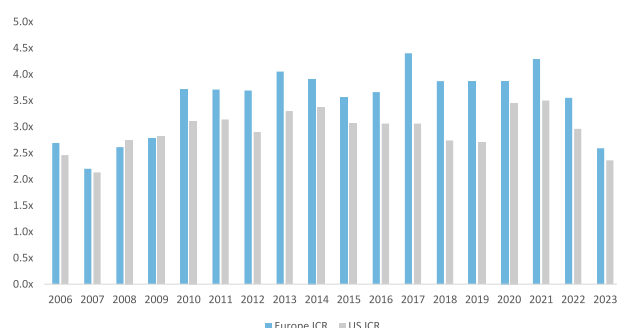
Source: Pitchbook LCD, UBS, March 2023

The smaller size of the market, however, does not mean weaker underwriting standards. In fact, European interest coverage ratios (ICR, or EBITDA/cash interest) have been higher than in the US over the past decade. Coverage ratios did deteriorate—similar to the US—in the past two years as a consequence of the more difficult macroeconomic environment and higher interest rates. But European deals continue to be underwritten with more conservative terms. Using broadly syndicated loan statistics as a proxy, ICRs for newly issued European loans were at 2.59x at end-2023—compared to 2.36x for the US. More conservative underwriting has also driven equity contributions up to around 47%, providing a meaningful cushion in case of defaults.

impact the outcome of a loan. Second, currency uncertainty if not hedged can be a source of volatility in loan portfolios. Third, geopolitical risks have the potential to impact European borrowers more meaningfully than their US counterparts. Other risks—including illiquidity, borrower credit and interest rate risk, as well as risks around the use of leverage—also apply.

Overall, investors based in Europe and with a long-term investment horizon need not look far to find opportunities in private credit to enhance their income generation at the cost of less liquidity—it’s right in their backyard.

Figure 2: Interest coverage ratios for leveraged buyouts in Europe vs. US



Source: Pitchbook LCD, UBS, March 2023

Elevated European Central Bank rates could still put pressure on borrowers, and defaults have been rising since early 2022. For instance, European leveraged loan defaults climbed to 1.9% in January. But as we expect Europe’s economic outlook to stabilize, defaults for leveraged and direct loans should to stay in check—although they may rise a bit from current levels. We note that similar to US private loans, European private loans are senior secured and benefit from strong covenants and strict loan documentation. Recovery rates were around 72% between 2003 and 2022 (S&P Global), levels at which should provide adequate protection on the downside. However, selectivity remains paramount in the current environment.

The European private credit sector should continue to grow in the coming years. The implementation of Basel IV will further increase capital requirements for banking institutions, likely strengthening the role of alternative lenders in the broad European financial system. Meanwhile, the simplification of the ELTIF regulation (ELTIF 2.0) should help ease private markets access to investors.

Investors should be aware of some of the specific risks involving European private credit investing. First, as many managers operate in multiple jurisdictions, changes in the enforcement and regulatory regimes can negatively

Appendix

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