Private Debt in Europe & the UK

June 2024

This report covers Private Debt in Europe and the UK.

Introduction

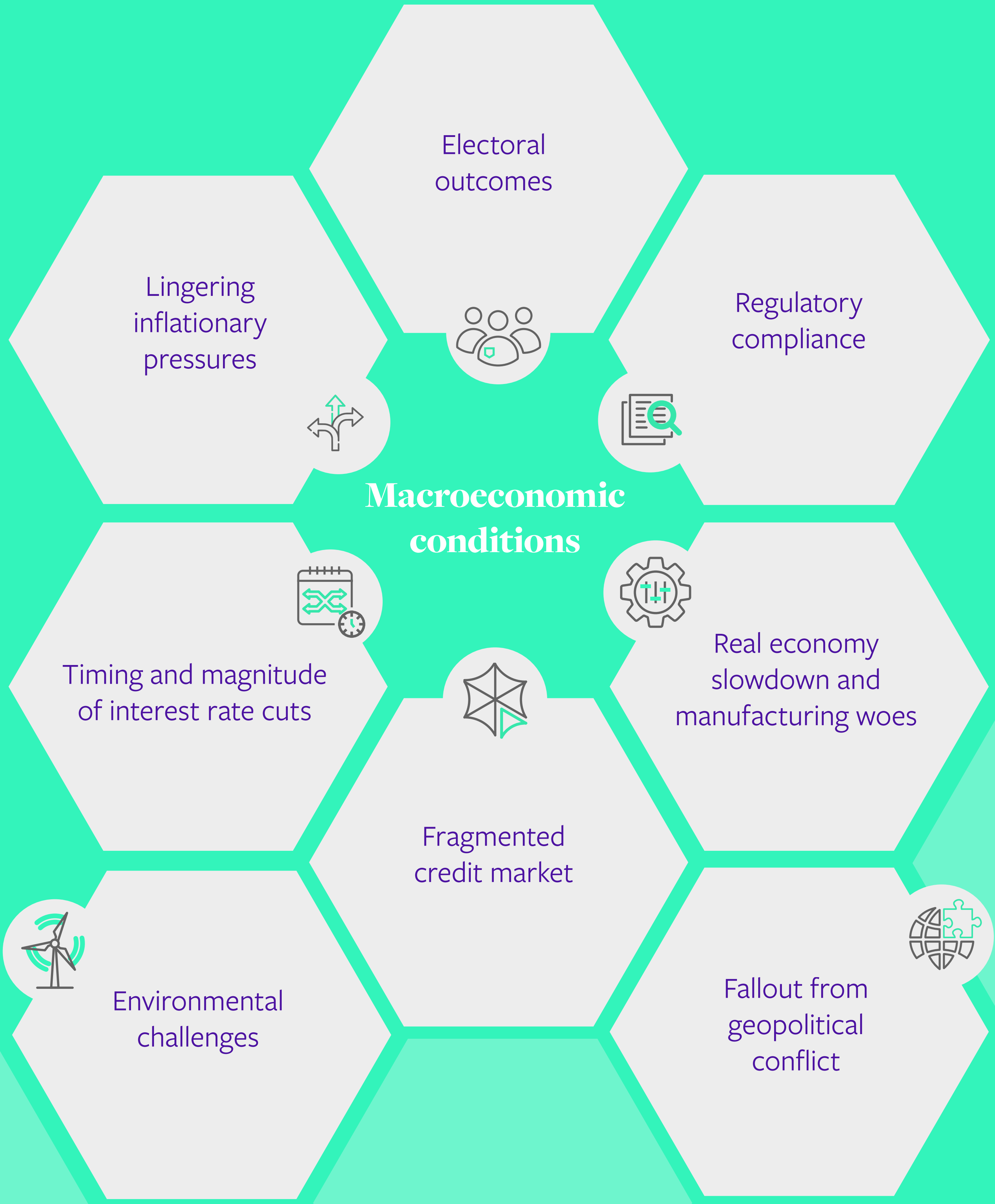
We've witnessed notable macroeconomic shifts, including record-high inflation rates and an aggressive monetary policy tightening campaign across advanced economies over the last 12 months.

Such headwinds have precipitated a global downturn, injecting a considerable degree of uncertainty into markets. Private markets, in turn, have borne significant pressure in light of such headwinds in 2023, albeit with some notable exceptions across strategies and regions.

In 2024, a more optimistic landscape emerges, fuelled by expectations of major central banks implementing rate cuts and inflation stabilising at levels close to target. This optimism sets the stage for a potential resurgence in private market activity. Nevertheless, a broader sense of uncertainty is still expected to linger, driven in part by geopolitical tensions, the prospect of a significant shift in the global political order amid the numerous elections slated for 2024, and persistent macroeconomic challenges.

Against this intricate backdrop, we delve into the examination of how these conditions will influence the outlook for private markets in 2024. Our comprehensive series of reports will scrutinise the prospects for three specific asset classes—private debt, private equity, and real estate—across diverse geographical regions, in light of developments in each region. Accordingly, we provide insights into how investors across various segments can navigate current market dynamics, leveraging opportunities strategically to their advantage.

Macroeconomic overview



Inflation in Europe and the UK has largely seen a disinflationary trend in the second half of 2023, not least due to aggressive monetary tightening campaigns by the European Central Bank (ECB) and the Bank of England (BoE).

Indeed, the latest data at the time of writing show that inflation in the Eurozone and the UK amounted to 2.6% and 4.0%, in February and January, respectively. This is a far cry from the double-digit peaks witnessed in both economies at the tail-end of 2022.

Amidst easing inflationary pressure, the narrative for the two central banks has shifted to rate cuts, and the timing of such rate cuts. Yet, both central banks are exercising caution, amidst upside risks to inflation, not least due to tight labour market conditions and elevated nominal earnings growth, which has the potential to put upward pressure on prices.

As such, while some monetary policy loosening is expected by the middle of the year, interest rates are expected to still remain elevated and not return to pre-pandemic lows in the medium term. Elevated rates are likely to expose financial vulnerabilities for issuers who are finding access to financing restrictions and the cost of service.

Indeed, elevated rates are expected to weigh on the growth prospects for the two economies. Evidence of high borrowing costs biting into economic activity are evident in 2023 full year growth figures, with the Eurozone and UK growing by an estimated 0.4% and 0.1% in the year. The UK entered a technical recession in H2 2023, while the currency bloc avoided one by the narrowest of margins. Looking forward to 2024, growth prospects are expected to improve, albeit only modestly, with Cebr forecasting GDP growth of 0.7% and 1.3% in 2024, for the Eurozone and UK economies, respectively.

Additionally, 2024 is an election year for the UK and various member states in the European Union (EU) which introduces further uncertainties regarding overall policy and regulatory frameworks. Meanwhile, ongoing geopolitical tensions, notably the Russia-Ukraine conflict and conflicts in the Middle East, present further challenges for both markets, with potential implications for the overall economic outlook.

Overview of private credit market

The aftermath of the global financial crisis (GFC) heightened regulations on the banking sector, propelling the expansion of the private credit market.

This market, operating beyond strict banking regulations, emerged as a vital alternative credit source, particularly for risky firms shunned by traditional banks.

The sector's growth is notably underscored by its rapid assets under management (AUM) growth to $1.7 trillion as of mid-2023, from $231 billion in 2008.[1] This surge, despite a general slowdown in fundraising activities across private market asset classes, illustrates the sector's solid foundation and readiness to navigate economic complexities. Indeed, while overall fundraising across private market asset classes saw a 22% decline in 2023, private debt saw a much more modest 13% decrease.[2] Notably, the accumulation of over $500 billion in dry powder globally signifies a potent war chest, ready to be deployed, enabling private debt funds to seize opportunities even in times of high inflation and interest rates.[3]

Navigating fundraising and exit strategies in Europe and the UK amidst prevailing macroeconomic conditions

Assets under management (AUM) in European private credit markets amounted to approximately $460 billion, accounting for 27% of global AUM. While smaller than the US market, growth in the asset class has been much stronger.

Over the past decade, the European and UK private credit market has expanded at a cumulative annual growth rate of 21%, surpassing the corresponding US rate of 14%.[4] Much of the private credit growth in Europe has been driven by regulatory changes and banking sector consolidation in some European jurisdictions.

The majority of lending activity in the European credit market is concentrated in the UK, which accounted for 27% of direct lending in Europe in 2023. Following closely behind are France and Germany, representing 21% and 16% of the market share, respectively.[5]

However, the prolonged period of elevated rates has placed increased pressure on investment portfolios all across Europe and the UK. With banks scaling back their lending capacity amidst tighter monetary conditions, concerns about the potential for a credit crunch have reignited.

Indeed, private debt fundraising in Europe (including the UK) has seen a drop-off amidst tighter monetary conditions. The total raised in 2023 was $45.5 billion, marking an 18% decrease from the 2019 high of $55.3 billion.[6]

Moreover, many portfolios established before the pandemic are heavily leveraged. In the upcoming three years, significant refinancing requirements are anticipated to arise, largely influenced by the surge in direct lending observed in the immediate post-pandemic period, which has resulted in a notable increase in the amount of debt maturing in the three years to 2026.[7] Indeed, debt obligations in both financial and non-financial sectors throughout Europe, including the UK, are anticipated to rise significantly over this period, from $763 billion in 2024 to a peak of $1,053 billion in 2026.[8]

Additionally, more stringent banking regulations will continue to push banks to manage balance sheets tightly to meet rising capital and liquidity requirements. The combination of the withdrawal of traditional banks from lending, and the impending refinancing wall, and further regulatory enforcement provides an opportunity for private debt funds in Europe and the UK to expand their market share by providing alternative financing options, pushing a structural shift towards private debt more broadly. With a substantial reserve of unallocated capital, estimated at $130 billion, private credit funds are strategically positioned to capitalize on the prevailing market dynamics, despite relatively poor economic growth prospects for the two markets more broadly.

Despite an anticipated relaxation of monetary policy by the ECB and the BoE, interest rates are unlikely to revert to their pre-pandemic levels in the near future. Resultantly, yields are projected to stay elevated, albeit with a slight moderation. This forecasted environment of higher returns adds to the promising outlook for private credit funds, and the private credit market more broadly.

Higher interest rates typically favour private credit, yet they also pose challenges by reducing coverage ratios. In Europe, the interest coverage ratio for buyouts decreased from 4.3x in 2022 to 2.5x in 2023, reflecting a more difficult climate for managing interest expenses.[9] Recent findings suggest that borrowers funded through private credit are more prone to default repeatedly, and typically experience a shorter duration between such defaults, in comparison to borrowers without private credit access.[10] Hence, it is essential to diligently track interest coverage and take pre-emptive actions to minimise default risks, ensuring sustained stability and resilience amidst changing market conditions. Additionally, while yield spreads across European markets have narrowed in recent months, any divergence could necessitate a change in strategy for private credit funds, balancing the pursuit of higher returns with the stability offered by tighter spreads.

Nonetheless, Europe's private credit market is characterised by greater fragmentation compared to that of the US, and a heightened level of bank intermediation in corporate financing. The two factors mean a lack of a unified capital market and a more competitive landscape involving banks for new entrants in the European private credit sector. Consequently, the penetration of private credit in Europe is anticipated to remain subdued in comparison to the US.

An additional notable difference between the two markets is found in their sources of funding. Contrary to the US, where retail investors have the opportunity to engage with the private debt market via Business Development Companies (BDCs), this avenue remains inaccessible to retail investors in Europe. Nevertheless, considering the growth of the retail sector and its investors, facilitating access for these individuals to the European market may yield positive outcomes for this particular asset class.

The region's regulatory framework for this asset category has experienced profound changes.

The launch of the Long-Term Asset Fund (LTAF) by the UK and the European Union's updated European Long-Term Investment Fund (ELTIF) are designed to channel private investments into long-duration, illiquid assets, marking a significant step forward in improving access to private credit, especially for retail investors within the region.

Furthermore, the EU's forthcoming AIFMD regulations, effective from April 2026, introduce more stringent rules for Alternative Investment Funds (AIFs) that provide loans, encompassing leverage caps and requirements for risk retention. However, these regulations also bolster systemic resilience and increase transparency without hampering the flow of capital. Despite the potential for obstacles, these regulatory measures are instrumental in fostering a responsible and transparent private credit environment in the region.

The European private credit market (including the UK), marked by significant growth and potential, stands at a crossroads due to regulatory changes and market dynamics. Despite challenges like market fragmentation and limited retail access, the sector's robust capital reserves and presence as a viable alternative to traditional bank lending amidst prevailing macroeconomic challenges indicate a promising path forward. This juxtaposition of opportunities and obstacles underscores a transformative period for private credit in Europe and the UK, poised for strategic expansion in a shifting financial landscape.

References

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Opportunities for new funds/ emerging trends in Europe and the UK

Degree of opportunity for credit markets posed by macroeconomic conditions

Development	Degree of opportunity for asset class		
Elevated interest rates	**High**	Medium	Low
As the ECB and the BoE plan to ease monetary policies later this year, interest rates, while expected to decrease, are unlikely to return to pre-pandemic lows. This suggests yields will likely remain elevated despite an expected moderation, benefiting private credit funds with increased returns.	✓		
Refinancing needs ahead of debt maturities	**High**	Medium	Low
Debt maturities across Europe, including the UK, covering both financial and non-financial sectors, are set to increase dramatically, rising from $763 billion in 2024 to a peak of $1,053 billion in 2026, according to S&P Global. This significant uptick presents a vital opportunity for the private credit industry to take a leading role in refinancing efforts. Given the current challenging financial environment characterised by historically high interest rates, private credit becomes an attractive option. High interest rates lead to increased costs of funding for refinancing, making traditional financing methods less appealing. The flexibility of private credit and its capacity to tailor financing solutions to specific needs positions it as a preferable alternative amidst growing debt maturities.	✓		
Modest growth outlook for Europe and the UK	High	**Medium**	Low
The European and UK economies have struggled compared to the US in facilitating a soft landing following an aggressive monetary tightening campaign. Improved but still modest growth prospects in 2024, combined with the region's vulnerability to geopolitical conflicts, could potentially worsen credit quality in the region. Despite these challenges, the prevailing conditions of elevated interest rates coupled with sluggish economic expansion present distinct opportunities, particularly within the realm of private credit markets. These markets are poised to serve as an effective alternative, especially in scenarios concerning distressed debt. The heightened yield environment signals potential for superior returns, an aspect that is critically important for investors navigating the complexities of today's financial landscapes.		✓	
Regulation	High	**Medium**	Low
The introduction of the LTAF in the UK and the revision of the EU's European Long-Term Investment Fund (ELTIF) mark significant advancements for the private credit sector, particularly in terms of expanding accessibility to retail investors. These initiatives aim to provide avenues for investors to participate in private credit investments, which were traditionally inaccessible due to regulatory constraints and the illiquidity of the asset class. By enabling retail investors in the region to penetrate the asset class, these regulations level the playing field, empowering the region to compete more effectively with the US market. However, regulations for this asset class are a mixed bag. The EU's AIFMD regulations introduce leverage limits for AIFS originating loans, capped at 300% for closed funds and 175% for open-ended funds, alongside risk retention measures mandating a 5% retention for AIFs originating loans, aimed at mitigating exposure to single borrowers. While funds operating in the UK will not be directly impacted by spill-over effects of these regulations may indirectly impact UK operations. Despite potentially higher leverage caps compared to typical private credit funds, these regulations are proactive measures to mitigate risks within the sector, thereby preventing crisis situations before they arise. In turn, this represents a beneficial step towards fostering a more transparent and accountable private credit landscape within the EU.		✓	

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