The European private debt market environment

During the first half of 2024, there have been several important developments that are impacting the European private debt market favourably.

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Private debt funds account for 50-60% of mid-market lending versus nil 10 years ago, whilst the number of credit institutions in the EU has declined at a 36% CAGR between 2008 and 2021[1].

With sponsors needing to both deploy record amounts of remaining dry powder[2] and return capital to investors before raising successor funds, we have also observed an uptick in exits across Europe, alongside direct lending deal-making that has been largely focused on new acquisition activity.

Primary issuance across the syndicated loan and high-yield bond markets has exhibited an uptick in 2024 following the periods of effective closure in 2022/23[4], however we note that the vast majority of this has been related to refinancing activity for large-cap issuers.

This increase in activity is also true for the Benelux market, where in Q2 2024 the market represented a strong increase compared to Q1 2024. Although banks are showing improved deal activity on the broadly syndicated loan market, the private debt market continues to show an increase in its share of the market, with 77% of completed transactions going the private debt route in Q2 2024[5].

Whilst Arcmont's size and scale has allowed us to operate opportunistically in this segment at times, we remain focused on the core-middle and upper-middle market where we are most able to take advantage of our key strengths.

European private debt's attractive risk-return potential

Arcmont has benefitted from the strong pricing through 2024, with observed European private debt spreads rising to 6.8% as of Q2 2024[7]. This compares favourably with comparable US private debt facilities, which have been typically pricing in the 475-550bps range since the beginning of the year, and the asset class also offers investors a natural inflation hedge[8].

European private debt has also offered investors a volatility hedge – largely due to the long-term, relationship driven, 'locked-up capital' operating model.

We believe that European direct lending can deliver strong returns at a lower risk than the liquid markets, due to the ability to carry out more thorough due diligence, a continued focus on less cyclical industries, stronger investor protections, longer-term funding structures and proactive portfolio monitoring.

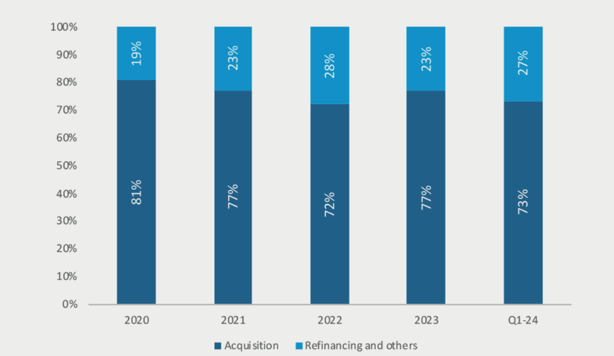
Long-term structural growth factors of European private debt

Since the Global Financial Crisis, the European financing market has been characterised by a transition away from banks in favour of private debt providers.

A further key development in the structure of private debt supply is the increased bifurcation of the market. The market can be segmented into a group of five fund managers with an average of $ 28.9 billion of committed capital, and a 'long tail' of more than 250 lenders who have an average of $ 1.2 billion committed capital[10].

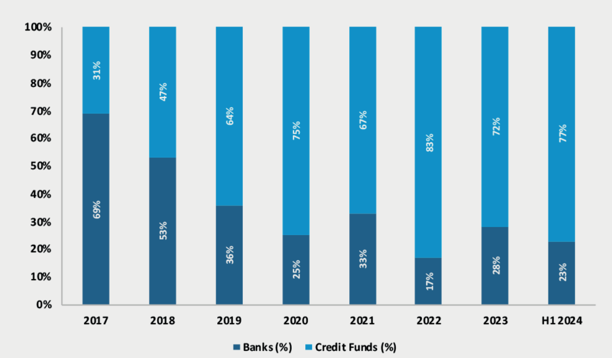
We increasingly observe a small cohort of established managers with the largest funds continuing to lead the broader market, given the benefits accruing to those firms that operate with significant size and scale. These funds are typically

FIGURE 1: DIRECT LENDING FOCUSED ON ACQUISITIONS[3]



Source: Arcmont Asset Management

FIGURE 2: MARKET SHARE IN THE BENELUX MARKET (SENIOR AND UNITRANCHE)[6]



Source: Arcmont Asset Management

FIGURE 3: **FAIR VALUE: DIRECT LENDING SENIOR LOANS VS. LEVERAGED LOAN MARKET – CASE STUDY FOR EUROPE**[9]

Source: Arcmont Asset Management

able to lend to larger, high-quality borrowers, at attractive terms given the limited competition in this part of the market.

This group of managers operates in a more interesting market to the other private debt lenders. The size of the larger market participants means that they are able to benefit from access to a broad and ever-increasing opportunity set[11] – whilst also being comprehensively resourced to manage operational complexity.

More broadly, private debt has successfully demonstrated the ability to offer flexibility and reliability in the provision of debt capital, and in so doing, has become a trusted partner for leading private equity sponsors across Europe[12].

This is relevant given that private equity dry powder – currently sitting at 3.6x the size of the private debt market – suggests material runway of growth exists for the asset class. There are also more than € 25 billion of loans maturing in the European markets over the course of the next two years for which private debt is well placed to refinance.[13]

Conclusion

We retain our firm conviction that European private debt continues to offer investors an attractive risk-return proposition. As such, we have summarised below the five key benefits that European private debt is currently offering to investors:

- Increased deal volumes: 80% of European LBOs have been financed by direct lending in the past two years[14], and whilst liquid markets have reactivated, much of which has been issued is to meet refinancing requirements.
- Typically, lower leverage: Higher interest costs require a prudent and conservative approach to capital structures, a fact reflected in the circa 20% market-wide decline in opening leverage between 2022-23[15].
- Generally improved terms: Private debt managers are typically able to negotiate strong terms given the limited availability of capital from other sources[16].
- High quality borrowers: Private debt has gained increased access to high-quality credits, targeting large, stable businesses operating in defensive sectors.

Whilst the asset class has experienced a period of sustained growth in recent years, we believe private debt's combination of low volatility, portfolio diversification, natural inflation hedge and historic outperformance will continue to be attractive to investors[17]. ■

1 European Banking Federation, EBF Facts & Figures - https://www.ebf.eu/wp-content/uploads/2023/05/Banking-in-Europe-EBF-Facts-and-Figures-2022.-Updated-2023.pdf
2 European direct lending deals by purpose (based on deal count). Source: LCD News Article 'Europe's private credit players adapt to changing financing landscape'
3 Traditional European banks share in mid-market financings (% total deals). Source: Information retrieved from the HL Midcap Monitor Q1 2024.
4 Includes High-Yield and Leveraged Loan Issuance. LCD data as of April 2024
5 Traditional European banks share in mid-market financings (% total deals). Source: Information retrieved from the HL Midcap Monitor Q1 2024
6 Traditional European banks share in mid-market financings (% total deals). Source: Information retrieved from the HL Midcap Monitor Q1 2024
7 Houlihan Lokey Private Performing Credit Index Q2 2024
8 Source: Hamilton Lane – Private Credit Viewpoints 2024
9 Lincoln – EU Senior Direct Lending Index' refers to the quarterly index prepared by Lincoln's Valuation & Opinions Group on a quarterly basis. Quarterly data as of Q1 2024. 2. 'EU leveraged loan market' refers to the S&P European Leveraged Loan Index, which collects the weighted average bid price of European loans monthly. Source: LCD European Leveraged Lending Review: April 2024.
10 Preqin data downloaded November 2023.
11 Source: Statista - Number of credit institutions in the euro area from 2007 to 2023. Accessed September 12, 2024. Significant decrease provides basis for Private Debt future growth
12 Traditional European banks share in mid-market financings (% total deals). Source: Information retrieved from the HL Midcap Monitor Q1 2024
13 OECD data accessed June 2024.
14 LCD research article 'European direct lending heavily concentrated among select funds' as of August 2024.
15 Proskauer 2023 Private Debt Insights report, avg. closing leverage by year.
16 Weighted Average (on invested amounts) of Arcmont's Direct and Senior Portfolios as of September 2024
17 Lincoln International as at Q1 2024. Comparison of Total Return – Lincoln Direct Lending to Morningstar European Leveraged Loan Index.

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PHOTOS: ARCHIVE ARCMONT

SUMMARY

The private debt market continues to show an increase in its share of the total market.

European direct lending can deliver strong returns at a lower risk than the liquid markets.

A small cohort of established managers with the largest funds continue to lead the broader market.

Private debt has successfully demonstrated the ability to offer flexibility and reliability in the provision of debt capital.