Investing in the European Private Credit Market Today

Taking a Disciplined Approach is the Key to Delivering Attractive Risk-Adjusted Returns

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The trends and dynamics underlying the European private credit market have shifted considerably in the past decade, splitting into two distinct ends of a spectrum. Banks, at one end of the spectrum, have been restricted to holding smaller pieces of debt following the financial crisis. Regulations under Basel III imposed additional capital requirements and heightened underwriting standards on banks, forcing them to simplify and reduce leverage, which has impacted their ability to lend to borrowers. A private equity house considering a €150 million debt funding requirement, for example, may have to seek out as many as 10 banks to source the capital, which creates complexity.

At the other end of the spectrum is the broadly syndicated loan market, which is typically focused on debt packages of €250 million and above. This market is relatively liquid with larger pools of capital providing financing to typically larger companies. As such, there tends to be more competition in this part of the market, which can result in fewer protections for the lender in the form of financial covenants.

In between the two distinct ends of this spectrum is what we see as a gap in the market for direct lenders to fill the shortage of capital. Lenders with the ability and willingness to meet the financing needs of middle-market companies have gained access to a diverse set of investment opportunities with a potential yield premium compared to the broadly syndicated loan market, with enhanced downside protection in place. From a borrower's standpoint, it's also a nice solution because they can lessen complexity and be more efficient by using just one capital provider.

STAY DISCIPLINED AMID STYLE DRIFT

The key, in our view, is to maintain a disciplined approach in this evolving market, which has experienced some style drift. As purchase prices stretch higher and leverage multiples rise, some managers have crept up in the size of transactions they are targeting. This puts them in competition with the broadly syndicated markets, where terms can be less favorable to lenders – including in the form of looser covenants – as borrowers have more financing options. Managers reaching for yield and absolute performance and stretching out of their traditional areas of investment can create additional risk for investors. Maintaining a consistent approach to the size of transactions a manager invests in, through the entire cycle, is an important risk mitigant.

Given the more liquid nature of the broadly syndicated loan market, holders of debt also have the option to sell out if they don't like the structure. In the private market, this is not the case: this is an illiquid asset class – not one you can dynamically change each week or month – so it's crucial to remain disciplined and selective. One aspect of that is ensuring covenants are in place in a transaction to offer structural protection in order to act in a downside situation. This is vital in managing the risk profile of a portfolio.

MAINTAIN STRONG RELATIONSHIPS

Furthermore, in the broadly syndicated market, investors gain access to loans through traditional capital markets, whereas in the private market, managers need to both source and close their investments directly with private equity sponsors and their advisers. Given these nuances of the private market, each manager's portfolio is very different as they access investment opportunities in what has become a bilateral market. The strength and depth of the relationships built by managers over a period of time is what drives access to a broader range of potential transactions. Ultimately, investors must seek managers that fit their risk aspirations. If portfolios are constructed with a lack of discipline, investors may be exposed to a variety of risks, including weak covenant protection, excessive leverage in the portfolio or sub-standard credit underwriting.

At Barings, our approach to investing in European private credit market is built upon a firm-wide commitment to rigorous, bottom-up credit analysis. We have been investing in this asset class in Europe for more than a decade and over time have formed strong partnerships with financial sponsors, intermediaries and portfolio companies. These relationships put us in a position to seek out what we believe are the most attractive risk-adjusted return opportunities for our clients.

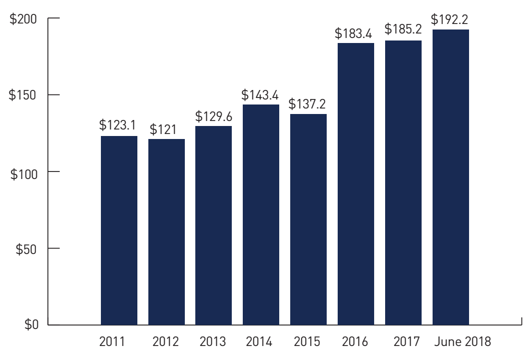
PERFORMANCE THROUGH AN ENTIRE CYCLE

We build well-diversified portfolios of what we assess to be low risk assets that will perform well through an entire cycle, and not just in patches. We're focused on delivering a significant premium to the broadly syndicated loan market through the cycle. Some of our strategies have a similar risk profile to that market, but we aim to deliver a return premium to compensate investors for the illiquid nature of private credit. We avoid chasing additional risk to deliver an absolute return figure, as that would go against our investment philosophy. We also ensure tight financial covenants are part of every deal we invest in, strengthening our position should a downside scenario occur.

In addition, we maintain a broad presence across both public and private markets. When underwriting middle market lending opportunities, we can leverage Barings' large high yield team, for instance, to gain unique and valuable insight into the competitive dynamics of the market and the industries where we invest. This perspective allows us to better understand and price risk, and puts us in position to provide effective solutions across the capital structure, particularly senior debt. At a high level, this scope also gives us the ability to compare valuations and potential returns in the public and private markets to ensure investments in private credit are targeting an appropriate return premium.

Regardless of where we think we are in the current cycle, we adhere unwaveringly to a bottom-up, fundamental approach to deploying capital, focusing on capital preservation, in addition to generating what we believe are appropriate risk-adjusted returns. This has served our clients successfully for more than a decade, through an entire cycle, and we believe we are well-positioned to deliver consistent risk-adjusted returns through this philosophy.

Dry Powder of Buyout Funds in Europe (US$bn)



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