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European Private Debt Investing: Dislocation Creates Opportunity Today

Tristram Leach, Partner, Co-Head of European Credit
Natalia Tsitoura, Partner, Head of European Private Credit

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KEY TAKEAWAYS

Macro-economic headwinds have caused liquidity to dry up in European credit markets, leaving corporate borrowers and private-equity sponsors few options to turn to for financing. But we believe this environment has created an opportunity for private direct lenders to step in and benefit from an attractive opportunity.

In this paper, we provide an in-depth look at this opportunity. Here are the key highlights:

- Europe is facing disruptions from geopolitical tensions, high inflation, economic uncertainty, and tightening monetary conditions—all of which have largely obstructed financing to large, mid, and small borrowers. Combined with secular shifts—such as the retrenchment of banks and the growth of private equity—these conditions can create an opportunity for private lenders to finance companies directly.

- Direct lending differs from traditional means of financing, such as broadly syndicated loans and high-yield bonds. It can offer many borrowers a source of capital with benefits (e.g., customization, flexibility, certainty of closing, speed, and a partnership with the lender). Direct lending also can offer lenders key structural protections and the ability to charge premiums.

- For investors that can allocate portions of their portfolio in illiquid assets, direct lending may provide rising income streams, inflation protection, enhanced diversification, and opportunities for potential alpha compared with traditional fixed-income investments.

- Investors may have underused private credit investments in their portfolios amid more than a decade of low interest rates, but the environment has changed. We believe that European Central Bank (ECB) interest rate hikes, current dislocations in Europe, and subsequent volatility have coalesced to create a compelling entry point today, an opportunity underpinned by the confluence of strong secular changes in favor of private credit.

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Geopolitical concerns, economic events, and central bank actions are causing uncertainty and volatility across global markets and in investors' portfolios. But there are opportunities amidst this storm. Because of the confluence of a variety of forces, we believe that the European private debt market merits closer consideration in the current environment.

Europe is facing severe market headwinds on multiple fronts. First, the Russia-Ukraine war has strained supply chains across a significant portion of the continent, bringing about uncertainty throughout its economy. Second, soaring inflation has forced European central banks to plan extensive rate hikes, which will have a multitude of effects on credit markets and the general health of European economies. Making things worse, the reversal of quantitative easing will likely have significant trickledown effects on assets valuations across Europe. Together, these events have not only impacted total returns across the investment spectrum, but have also shut a significant portion of the primary debt markets in 2022. European high-yield bond issuance tumbled 65.1% in 2022, following a record year in 2021, while leveraged loan volume slumped 44%.[1]

Apollo believes that the confluence of these forces has severely constrained traditional avenues of funding, creating an opportunity for direct lending to corporate borrowers and private-equity sponsors. In our view, private debt can offer investors who are willing to forego some liquidity the opportunity for rising income streams, portfolio diversification beyond that of traditional fixed income, and enhanced risk-adjusted returns. This paper will provide an overview of the European private credit space, assess and qualify the direct lending opportunity in the current environment, and discuss why we believe investors should consider the asset class for their portfolios.

What is direct lending?[2]

Direct lending is the practice of non-bank lenders providing loans directly to corporations and other borrowers, without the use of a bank or other third-party intermediary. Non-bank lenders originate loans themselves to corporate borrowers, providing them with capital for acquisitions, growth, recapitalizations, and other purposes. Borrowers are generally small- and medium-sized enterprises, but they can also be large corporations.

Direct lending has several characteristics that make it attractive for borrowers compared with common avenues of financing, such as broadly syndicated loans and high-yield bonds. The asset class also has key features and benefits that can address weaknesses in traditional fixed income.

With direct lending, the borrower typically negotiates financing with a single lender (or a very small group of lenders) rather than an intermediary working with a large group of underlying creditors as in a syndicated loan. The borrower deals much more closely with a direct lender, giving it more flexibility for developing bespoke financing solutions to address specific needs. Also, working with a direct lender can shift the dynamics of the relationship beyond that of strictly a creditor/lender to more of a partnership. The business model of direct lenders is underwriting loans to hold, which can allow for better access to company management and the ability to conduct more extensive due diligence to structure the loan for better terms and control, especially in the event of borrower underperformance. Direct lenders typically have experience and expertise in loan workouts and recoveries which can help mitigate losses in times of borrower stress.

Corporate borrowers that use private debt can avoid the many expenses and burdens inherent in public debt offerings, including those associated with regulatory filings and disclosures, rating-agency processes to obtain credit ratings, and roadshows that are frequently scheduled with limited notice to sell into a supportive market environment. Borrowers can also expect a deal to be completed with more certainty, even in challenging market environments, and with greater speed than with a transaction involving a syndicate of lenders. This is one of the most pronounced benefits of direct lending for borrowers. The broadly syndicated debt markets are highly sensitive to market conditions. This vulnerability of the broadly syndicated loan market has been heightened by the growth of collateralized loan obligations (CLOs), which are major purchasers of leveraged loans. CLOs are subject to limits on lower-rated, particularly CCC-rated or below exposure. Therefore, CLOs' demand for loans is highly sensitive to ratings downgrades, which typically occur during periods of market and macro uncertainty.

Private debt is an asset class within alternative credit that can offer structural protections and potentially compelling benefits. Unlike many types of debt instruments, direct-lending loans have floating-rate coupons that can periodically change. The interest rate on a floating-rate loan comprises

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a base reference rate, such as the Euro Interbank Offered Rate (EURIBOR), plus a spread that considers a borrower's credit quality and time to maturity. In a rising interest rate environment, floating-rate loans can provide investors with rising income streams, as well as protection against inflation.

Private loans tend to rank senior in a corporation's capital structure and are often backed by assets such as a company's plant, property, and equipment. Issuers of private loans are typically first in line to be paid in event of bankruptcy. Private debt can also have strong covenants or terms that the borrower must comply with to avoid being in default. Examples of covenants include requiring the borrower to maintain a certain interest coverage ratio or restrictions taking on additional debt.

Unlike high-yield bonds or syndicated loans that can be traded daily, directly originated loans are illiquid. Direct lenders usually originate loans with the intention of holding them to term. But as compensation for the lack of liquidity, lenders can charge premiums from origination fees and higher spreads compared with syndicated loans and high-yield bonds.

What's the opportunity in European private credit today?

We believe borrowers stand to benefit from a tailored financing solution, as well as certainty of pricing and execution that direct lending can offer, especially at a time when few options are available with traditional public avenues of funding largely closed. The macro and geopolitical headwinds we alluded to earlier in this paper have brought up a cloud of uncertainty over Europe's economy, causing banks and public debt markets to pull back significantly on lending. This dearth of available financing in the public markets has generated a strong opportunity for direct lending as a viable option for companies in need of capital from operational challenges, such as rising costs and supply-chain disruptions, as well as the need to refinance looming walls of maturing debt—which will have to be done at much higher interest rates.

Companies also need funding for acquisitions, while private-equity sponsors need financing to complete leveraged buyouts (LBOs). Amid 2022's challenging conditions, mergers and acquisitions activity dived 41% year over year through the third quarter according to Dealogic. Despite the drought in dealmaking, however, direct lending saw robust activity on the back of dislocated public markets. Deloitte's European deal tracker noted of 617 private debt deals completed through the third quarter of 2022, which was on pace to surpass the 791 deals in all of 2021.

With direct lending one of the few sources of financing amid market dislocations, we have witnessed an increase in borrower size over the past year. According to Apollo's internal research, the average borrowers' earnings before interest, taxes, depreciation, and amortization (EBITDA) has grown to €75 million from €40 million during 2022, as large corporations were unable to tap the public markets and direct lenders continued to gain share in the space. We see that as a positive development for investors in private debt because larger borrowers tend to have more stable and mature business models—in essence higher-quality firms that offer a layer of downside protection for lenders. This phenomenon has resulted in more opportunities and higher-quality deal flow, especially for managers of scale like Apollo.

Lastly, the sharp dislocations experienced in the public markets in 2022 have generated stress among many market participants. Heightened equity volatility and tightening financial conditions have spread across capital markets, creating opportunities to capitalize on the resultant volatility. For more than a decade, many investors have under-allocated to credit given persistently low interest rates. We think the current market environment is changing this situation. We expect that the next 24 months will likely be an attractive environment for credit selection, particularly for lenders who can provide capital dynamically and at scale. As rates rise and spreads widen, we think credit is going to be the most attractive risk-reward trade relative to other asset classes, especially public equities.

We also believe that this opportunity is likely to last for a while, as we think it will take years before bank appetite for financing reverts to 2021 levels. Even if M&A activity remains subdued, we believe that direct lending will continue to take share from bank-funded/syndicated markets. In summary, direct lenders have become an essential viable option for sponsors/borrowers who want to finance acquisitions and/or new LBOs or refinance upcoming debt maturities. We expect this environment to persist, which will likely create more opportunities in the next couple of years.

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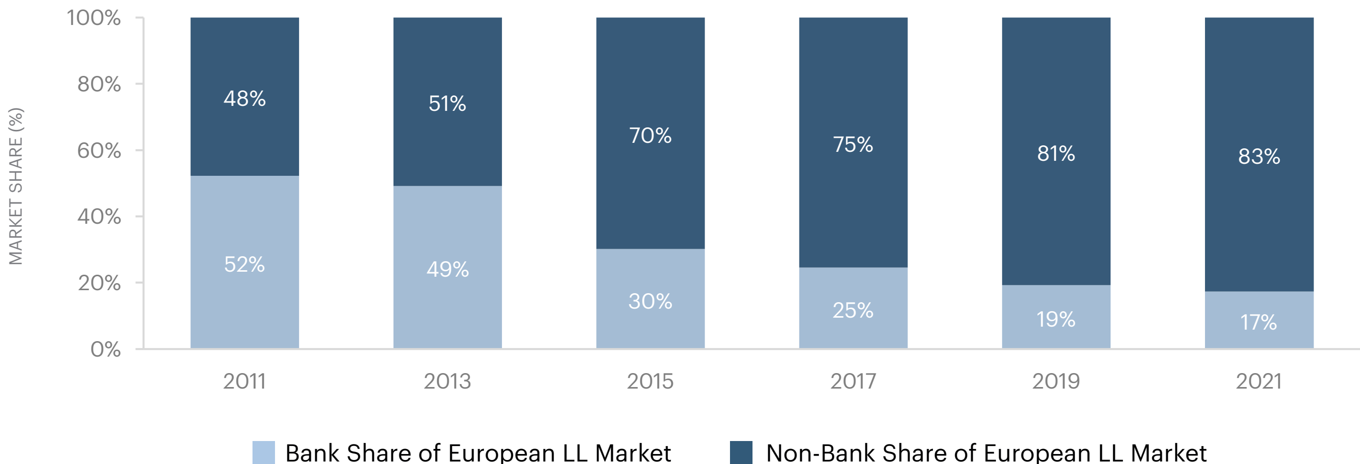
Secular trends are also underpinning the case to invest in European private debt

Banks have traditionally played a larger role in financing companies in Europe than in the US. Thus, the direct lending market in Europe is less mature than its US counterpart, which has roots dating back to Congress' creation of business development companies (BDCs) in 1980 to provide capital to smaller middle-market companies. Europe's direct-lending market emerged from the aftermath of the Great Financial Crisis (GFC), which was a wake-up call not only for European banks but banks around the globe. The GFC uncovered faults in the banking system that allowed for imprudent lending, excessive risk-taking, and the lack of sufficient capital buffers.

But following the crisis, stringent new bank regulations in Europe, such as the Basel III accord, overhauled leveraged lending guidelines, resulting in increased capital requirements, balance-sheet deleveraging, and tighter underwriting standards. Overall, the effects of regulation decreased the aggregate funds available to lend on bank balance sheets. In particular, risk-weighted capital requirements fundamentally changed the bank lending model, and banks shifted from acting as principal investors that originate and hold loans to more of brokers that originate and syndicate loans. Over a 10-year period (2011-2021) European banks' share of the leveraged loan market has been more than cut in half while non-banks have vastly gained market share **(Exhibit 1)**. As a result, institutional and private lenders filled the void, with assets under management in European direct lending surging to €355 billion in 2021 from €57 billion in 2011 **(Exhibit 2)**.

Exhibit 1: Bank's share of European loan markets has fallen sharply

BANK AND NON-BANK SHARE OF EUROPEAN LEVERAGED LOAN MARKET



Source: S&P LCD, data as of March 31, 2022.

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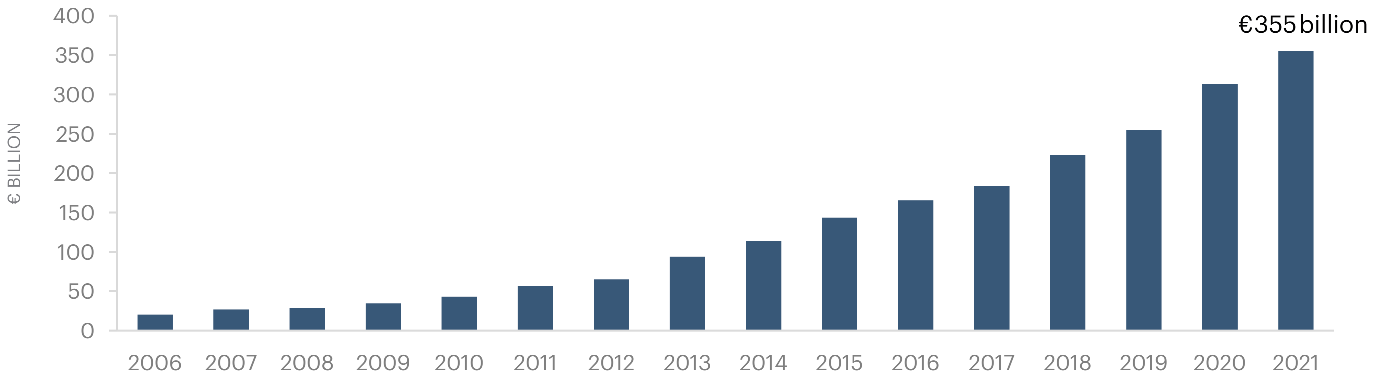
Exhibit 2: European direct lending AUM has grown as private capital replaces receding bank loans

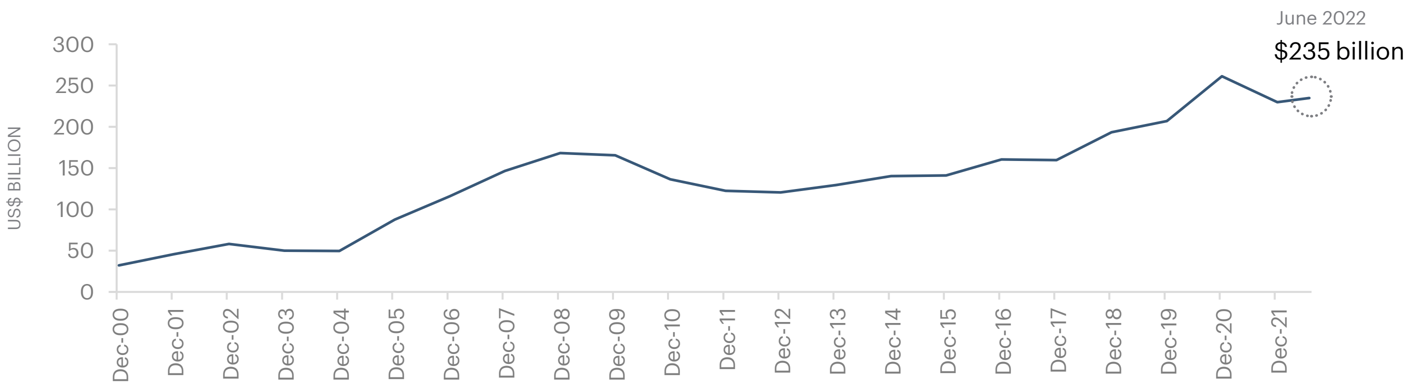


Source: Preqin, data as of December 31, 2021.

Secular growth in sponsor-backed lending, or the practice of providing financing to companies backed by private-equity firms, is another driving force supporting the rise of European direct lending in the long run. Sponsor-backed lending has accounted for a significant portion of private-debt transactions. In 2021, 88% of buyout-related transactions across the UK and rest of Europe involved private-equity sponsors.[3] Sponsor-backed financing can create an additional layer of protection for direct lenders. Private-equity sponsors conduct extensive due diligence when making acquisitions. They may provide operational expertise to enhance the profitability of portfolio companies, as well as deep sector and market insights. They can also play an active role in company management. Ultimately, private-equity sponsors have shared incentives with lenders to see the success of their portfolio companies.

Private-equity managers are typically well capitalized and are in position to step in to help portfolio companies facing challenges. European private-equity managers have near-record levels of dry powder on hand for deployment into portfolio companies in need **(Exhibit 3)**.

Exhibit 3: European equity private-equity managers have plenty of dry powder



Source: Preqin, data as of June 30, 2022.

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Incorporating European private credit into investor portolios

The use of any investment for investor portfolios should take into careful consideration investor goals, risk tolerance, needs, and constraints—European private credit is no different.

Another key consideration is the market environment. For years, major European central banks have used lax monetary policies that kept interest rates low, which essentially provided a tailwind for taking on risky assets such as public-market equities. But for the many reasons we covered earlier in this paper, we believe that investors will need to utilize private-market investments, such as private debt, to generate potential alpha in the long run. We also believe that potential risk-adjusted returns for European direct lending in today's market environment are more favorable than they were just a year ago.

As stated earlier, private debt is not broadly traded, making the asset class an illiquid investment. Ultimately, however, the level of liquidity provided to investors will be dictated by the structure of the investment vehicle that houses the underlying assets. For example, interval funds and non-traded BDCs can offer their investors periodic liquidity even though their portfolio holdings are often illiquid.

European private debt can be used as a complement to, or a replacement for, traditional fixed income. The asset class may be attractive to income-oriented investors since it may offer higher yields than investment-grade bonds and other asset classes. Since private debt usually has floating interest rates, investors also have the opportunity for growing income streams as benchmark rates rise.

Having a diversified portfolio, one that is spread across a variety of asset classes in different sectors and industries, is key to reducing the fluctuations that investors experience. Private debt's inherently lower levels of volatility may help "smooth the ride" and shield investors from the damaging effects of "volatility drag"[4] on portfolios' terminal value.

Additionally, investors need to examine the capabilities of the lender or private-debt manager. Size, scale, experience, and expertise are important as European private debt deals are growing larger. Having these attributes can give the manager inherent advantages over its peers. Being able to commit in size can result in the manager having a leadership role in the financing with the ability to drive pricing, terms, and downside protection features in the documentation process. It can also help the manager gain access to borrowers who previously only looked at syndicated bank financing for capital. Additionally, having industry expertise, long-term relationships, and the ability to scale can help win business as companies move from the middle market to the large-cap space. But note that European direct lending is still relatively new, coming about after the GFC as previously mentioned, and thus lacks a long-term track record encompassing multiple cycles that shows which managers truly stand out. We believe that, aside from transitory episodes during the Covid-19 pandemic, the current macro environment will for the first time test the ability of managers to build and manage portfolios in adverse times.

Lastly, environmental, social, and governance (ESG) topics (such as climate change, employee diversity, and labor rights) are becoming ever more important to investors. Private debt managers, particularly those on platforms with size and scale, are also finding ways to incentivize borrowers to improve their sustainability performance. Some have introduced sustainability-linked loans that can adjust borrowing costs by approximately five to 10 basis points if the company meets or fails to meet certain ESG targets.

Conclusion

Disruptions such as the Russia-Ukraine war, rising inflation, and the end of dovish monetary policy are making it hard for European companies to obtain funding from traditional sources, creating a strong opportunity for private lenders to step in. Also, secular trends, including the retrenchment of banks and the growth of private equity, support the opportunity for direct lending in the long run. Apollo believes that direct lending offers significant flexibility and other compelling benefits compared with traditional areas of financing. For investors, direct lending can offer meaningful income and potentially help with portfolio diversification.

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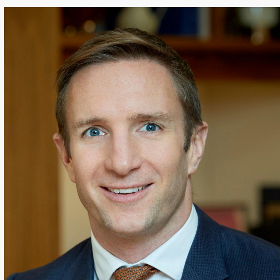
About the authors



Tristram Leach
Partner, Co-Head of European Credit

Tristram Leach is Partner and Co-Head of European Credit at Apollo, where he is responsible for credit investments in Europe. Prior to joining in 2015, Tristram was Partner at Cheyne Capital Management, initially working on the Total Return Credit Fund, and latterly as Portfolio Manager of the Cheyne Long Short Credit Fund.

Tristram graduated from the London School of Economics with a first-class honors degree in Economics and Government.

Natalia Tsitoura
Partner, Head of European Private Credit

Natalia Tsitoura is Partner and Head of European Private Credit at Apollo. Prior to joining in 2020, Natalia was Managing Director at Alcentra in London where she was responsible for originating, structuring and underwriting senior and junior financings for companies across Europe for Alcentra's specialist direct ending and mezzanine team.

Natalia graduated from Loughborough University in Business Studies.

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1. Source: FitchRatings, data for European high-yield bonds are as of January 11, 2023 and European leveraged loans as of January 23, 2023.
2. For the purposes of this white paper, we will use the terms direct lending, private credit, private loans, and private debt interchangeably.
3. Source: Deloitte Alternative Lender Deal Tracker, Spring 2022.
4. "Volatility drag" is traditionally defined as the difference between arithmetic and geometric (or compound) mean returns. For example: Imagine one invests $100 for two years, experiencing a 100% return in year one and a 50% loss in year two. If so, the arithmetic mean return for this investor is 25% [(100% + (-50%)) / 2]. The geometric mean return, however, is zero since the terminal value of the investment is the same as the original investment (no compounding of wealth). Mathematically, geometric returns are always less than or equal to arithmetic returns. That puts portfolio volatility (standard deviation) at odds with compound returns. In other words, the higher the volatility, the higher the hurdle for an investor to compound wealth.

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The Standard & Poor's 500 ("S&P 500") Index is a market-capitalization-weighted index of the 500 largest US publicly traded companies by market value.

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