EXPERT Q&A

Higher returns and a broad opportunity set are bolstering the outlook for private debt in Europe, says Pemberton Asset Management's Robert Wartchow, but a consistent, credit first investment approach is critical

A vintage year

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Q How are private credit portfolios currently performing across Europe, and what do LP returns look like?

LPs are benefiting from higher asset level returns. This is a function of market dislocation over the last 24 months, a more pronounced absence of banks from the market and the rate hike cycle implemented by the European Central Bank, the Bank of England and the US Federal Reserve. This is benefiting our current fund vintages, with the average expected gross returns for the assets in our current mid-market fund roughly 12 percent.

That includes assets we put in during recent periods of dislocation and commitments made more recently, with the environment now feeling a little more normalised. Those returns are 200 to 300 basis points above our historical targets, which makes this our highest return vintage to date. It is important to note that we have not changed our investment philosophy to generate those returns. Our credit process has remained disciplined and consistent.

As a result of that consistent approach, the credit metrics in the mid-market fund have remained conservative and, if anything, they are more conservative than they have been historically. The average leverage is around 4.5x EBTIDA, which is towards the bottom end of our historic range, and loan-to-value (LTV) ratios are around 45 percent, which is 5 to 10 percent lower than historical targets. So right now, there is lower leverage, more equity coming in from sponsors and significantly higher returns, which means on a risk-adjusted returns basis this is a really attractive vintage.

We are also seeing similar trends in our two other direct lending strategies, our senior loan fund and our strategic credit fund.

Q How is the current macroeconomic backdrop impacting credit performance and portfolio construction going forward?

Investments committed and allocated to the portfolios in the last 18-24 months have been structured and underwritten with assumptions that reflect the recent macroeconomic headwinds of higher inflation, higher base rates and supply chain inefficiency where relevant to the underlying businesses. We have always included

conservative assumptions and stress scenarios in our modelling, and we will continue to update these assumptions in line with the changing environment.

Our older vintage mid-market funds are performing in line with or better than their original targets. This is driven by a number of factors. In line with our investment approach, virtually all of our portfolio assets are first-lien, senior secured loans structured with conservative cashflow and value cushions.

To the extent that a portfolio company experiences softer performance, they have a good degree of capacity to absorb that and, where needed, we also have covenant protections in place to allow us to take action and/or reprice risk.

Also, the EBITDA growth and deleveraging in our older vintage portfolio companies that occurred prior to the recent increases in inflation and cost of capital created further scope to offset the impact of these higher costs.

At a portfolio level, all of the mid-market fund vintages are generating cash yields of 9 percent or more. With cash yields at these levels, portfolio performance is very resilient. To test this, we have run a number of different stress scenarios on the portfolios. We found that the combination of the cash income, diversification and first-lien nature of the assets means that you need a much higher degree of credit stress and losses than what we are currently expect to have a significant impact on lifetime returns.

"We think sponsors will continue to look first to private credit for M&A financing"

Q What does the opportunity set look like across Europe?

When you look at our overall investment approach, sectors are a key aspect of how we screen opportunities and build portfolios. We have a focus on sectors such as business services, IT services, and financial intermediary services that we think are defensive, have the ability to perform through cycles and will benefit from some of the big picture themes driving private equity investment in Europe.

For example, business services is a broad sector that we have invested in. We find that the strong businesses within this sector have proven track records, flexible cost bases that can easily adjust to changes in the underlying market environment, and low capex requirements.

Many companies in this industry also benefit from the consolidation we are seeing across different sectors in Europe. For example, when two companies merge and combine, there is a need to integrate and update their IT systems, which is a growth driver for the IT services companies we lend to. We see this playing out through the cycle.

Geographically, we believe the majority of opportunities will come from the core markets in Europe of France, Germany and the UK. However, we are also seeing some very interesting opportunities in Benelux, the Nordics and Southern Europe as well, illustrating the benefit of our local office network.

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Most of the lending we do supports an M&A transaction. That could be financing a sponsor on a new buyout or providing incremental financing to a portfolio company that is making an acquisition to build scale. This is quite different to the syndicated market, which is currently driven to a large extent by refinancing activity. We think sponsors will continue to look first to private credit for M&A financing, particularly in the mid-market given the execution certainty, confidentiality and add-on capital direct lenders can provide.

Even with the market-wide M&A slowdown in 2023, we continued to have significantly more investment opportunities than we had capacity to deploy, which allows us to continue to be selective. I expect that to be the case going forward, particularly as market-wide M&A volumes increase, as we are seeing so far in 2024.

Q How do those opportunities vary across different markets? Do certain countries call for different approaches?

Given the nature of the first-lien senior secured financing we provide in the mid-market strategy, there is not a huge degree of variation in our fundamental approach across geographies. There are regional differences around structuring, to make sure that we are complying with relevant local laws and to ensure that we are structuring in a way that protects LP capital to the greatest extent possible. Local market knowledge and experience is essential to do this effectively given the different legal jurisdictions.

Local market experience, presence and expertise is also vital to accessing the most attractive opportunities in each market.

Our highly experienced investment team and professionals on the ground in each of our main markets are key to finding and backing the local champions.

Q Can you explain in what kind of ways you expect demand to grow from non-sponsors?

We have not seen a significant increase in demand from the non-sponsor side of the market, but it is not something that we pursue actively. The main focus of our portfolios across our direct lending platform is on businesses owned by financial sponsors.

We like sponsor shareholders because they invest from funds which can generally provide follow-on equity capital to support portfolio companies when needed, they have broad networks of managers and industry experts that they can call on, and they have been a driver of consolidation. ■

Robert Wartchow is managing director for mid-market debt at Pemberton Asset Management

Q How do you expect the asset class to develop in Europe over the next few years?

The overall opportunity set is growing as a result of industry consolidation, banks continuing to scale back lending to mid-market companies and increased private equity capital raised for Europe. These are long term trends that we do not expect to change any time soon.

As a greater proportion of businesses seek to expand beyond their home markets to operate on more of a pan-European basis, we also see opportunity, as a strategic financing partner, to support existing portfolio companies with additional capital over time.

From an LP perspective, as supported by numerous surveys, we expect to see allocations to private credit continue to expand as well. The absolute and risk-adjusted returns are attractive to LPs. Even if central bank interest rates start coming down over the course of this year, we expect rates to remain elevated for a period of time, which means that returns should continue to be attractive relative to both historical levels and other parts of the credit universe.

The asset class is also maturing and proving the performance that it can generate over time. That is particularly true over the last three to four years, during which the asset class has performed well despite the challenges created by the macroeconomic backdrop. Further, many of the European LPs we speak to still have relatively low allocations to private credit compared with their counterparts in more mature markets like North America.

The wealth channel is also becoming increasingly relevant, and we recently announced an important partnership related to this. We expect all of this to provide further structural growth momentum in Europe, which makes the outlook for European private credit look positive.