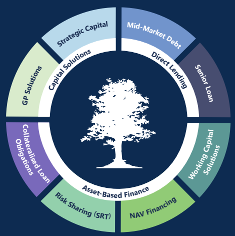


PEMBERTON

Pemberton Viewpoint

June 2025

Why Europe's mid-market has "whatever it takes"

With a major fiscal expansion about to get under way and doubts over the outlook for U.S. assets, we believe investors have strong incentives to reconsider their allocation to Europe. Diversifying into European mid-market direct lending currently represents an attractive option, given these companies' limited exposure to U.S. tariffs.

Note: To date the final shape of U.S. tariff policies remains undecided, this article therefore reflects Pemberton's current understanding of their potential impact to our portfolios.

In Europe, it seems, it takes a crisis to get anything done. In 2012, confidence in the single currency was on the verge of collapse when ECB Chairman Mario Draghi made his pivotal "whatever it takes" speech. Amid doubts over its relationship with the U.S. on security and trade, Europe has once again reached a "whatever it takes" moment.

The results have been dramatic. Shortly after winning the German election on February 23, CDU leader Friedrich Merz declared it was "five minutes to midnight for Europe". Merz then engineered a previously unthinkable change in Germany's constitutional debt brake to allow unlimited borrowing for defence spending. Days later Sweden announced a jump in defence spending from 2.4% of GDP last year to 3.5% by 2030 with others also signalling increases, alongside an €800 billion defence package from the European Commission. Funding is flowing into other sectors too: Germany has announced a €500 billion infrastructure fund, while recent announcements on AI and data centre investments promise further large injections of capital.

The implications for the markets that Pemberton targets are also significant. Amid growing discussion around the future of the American exceptionalism narrative and increasing attention on the potential for dollar depreciation, some investors are beginning to explore whether evolving U.S. defense and trade policies could create new opportunities for Europe to strengthen its global position. Whether or not they are correct, the case for diversification has rarely been stronger.

As they turn their attention to Europe, investors should note that the mid-market European companies in Pemberton's direct lending portfolios are well-insulated from the effects of U.S. tariffs. Fewer than one in ten of them relies on the U.S. for more than 20% of its revenues.

Meanwhile, these companies' domestic markets look set for a major fiscal boost that should accelerate the Continent's economic growth and signal that Europe is committed to deciding its own fate. Just before the U.S. tariff announcement on April 2, Goldman Sachs forecast that Germany's additional spending would lead to a 0.2% increase in the country's GDP growth this year, followed by an extra 0.5% in 2026 and 0.6% in 2027. Goldman also raised its forecast for the Eurozone as a whole.

Against this backdrop, the investment case for Europe is getting appreciably stronger. Even before the major tariff announcement on April 2, equity markets had been signalling a shift of view about the relative attractions of Europe and the U.S.: the STOXX 600 had its best start to the year relative to U.S. equities since 2001.

The Diversification Opportunity

A re-energised European economy likely to benefit from a major fiscal boost offers multiple attractive diversification opportunities. However, for investors seeking stable, floating-rate yield combined with strong capital preservation, we believe European mid-market direct lending stands out. This is especially true for core mid-market strategies that target companies with €15m-€75m of EBITDA.

Businesses of this size, and especially companies in innovation-rich sectors, tend to be directly exposed to improving domestic growth and poised to catch structural tailwinds from developments in AI, the energy transition and healthcare. They are also relatively insulated from tariffs, both because they operate in the services economy and because those that are exporters tend to focus mainly on local European markets. These companies are also relatively small and in the faster-growth phase of their development, with the best set to potentially emerge as the European champions of tomorrow.

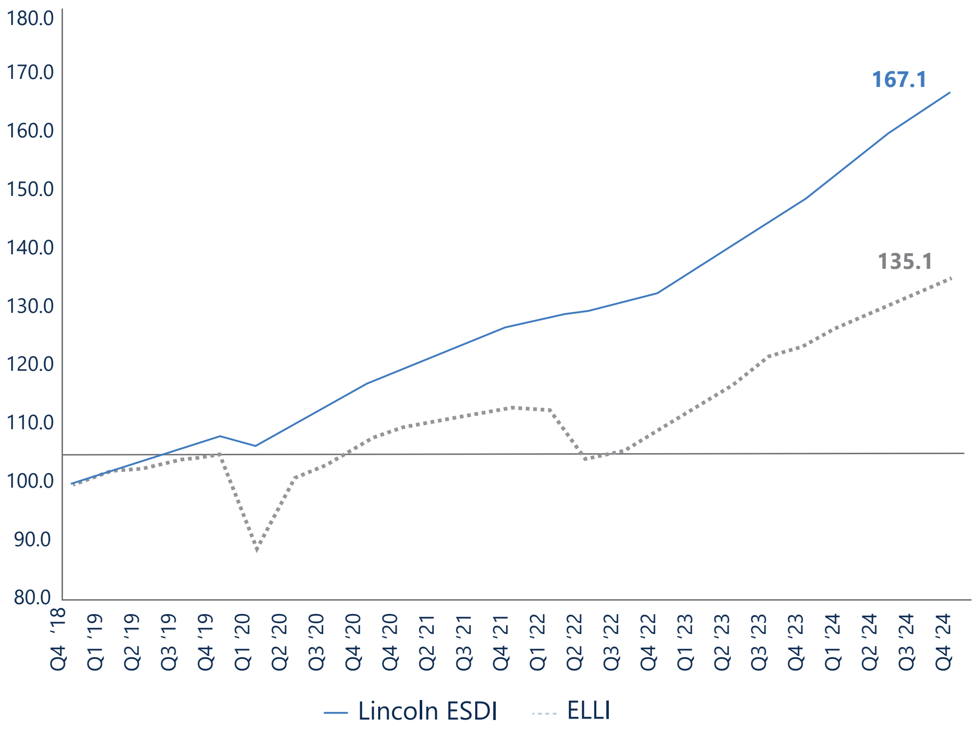
Europe's Mid-Market – Key Attractions

This segment of European credit markets therefore offers investors a series of advantages, both in terms of the characteristics of the asset class and the structure and dynamics of the European direct lending market, as compared to the U.S.

We summarise the most important of these as follows:

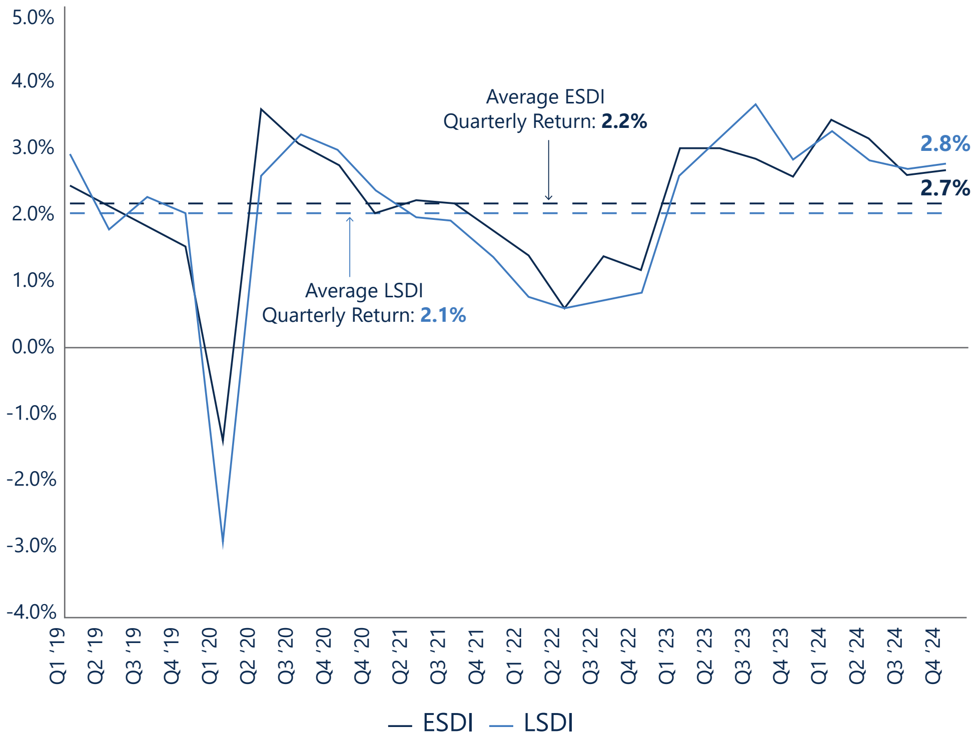
Relative Performance: European senior direct lending has a history of total return outperformance versus both other areas of credit and public equities. Since 2019, total returns from Lincoln's European Senior Debt Index (ESDI), which captures the performance of the direct lending market, have significantly exceeded the broadly syndicated loan market, represented by the Morningstar European Leveraged Loan Index (ELLI).

Comparison of Total Return - Lincoln ESDI to Morningstar ELLI



For illustrative purposes only.
Source: Lincoln International, Q4 2024 Lincoln European Senior Debt Index.

Comparison of Quarterly Returns - ESDI to LSDI

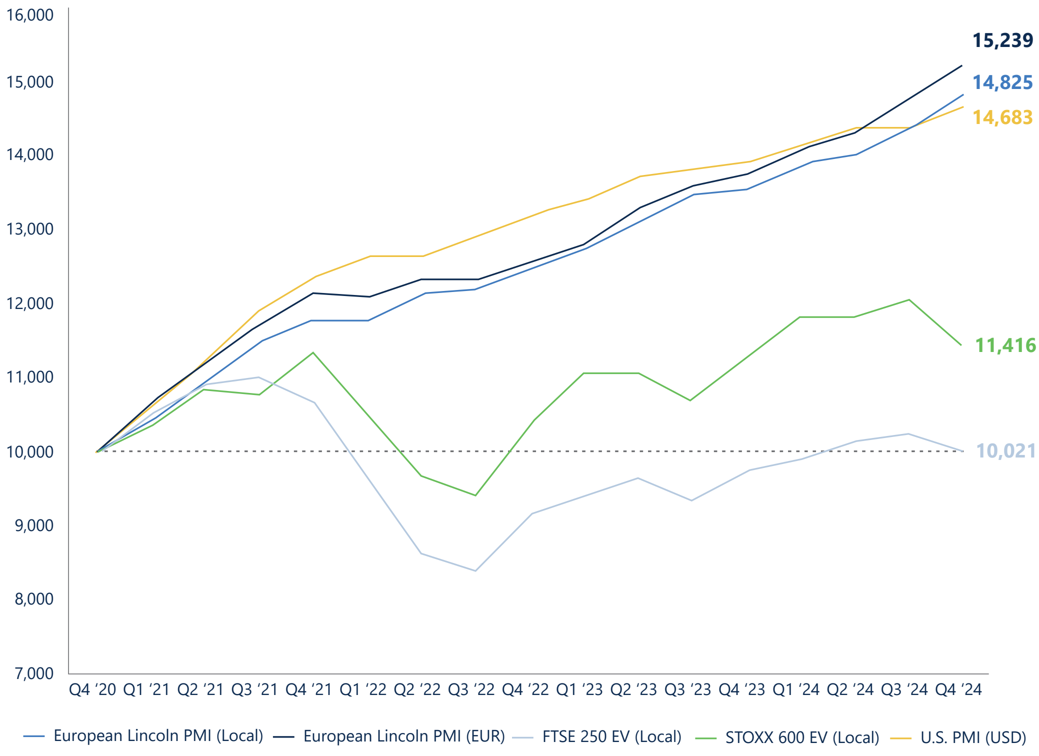


For illustrative purposes only.
Source: Lincoln International, Q4 2024 Lincoln European Senior Debt Index.

Over the past five years, the average return from Lincoln's ESDI has also slightly exceeded the average from its U.S. senior debt index (LSDI) with lower volatility.

The latest update to the European Lincoln Private Markets Index, published in March, also shows that European mid-market private companies, measured by changes in enterprise value (EV), have significantly outperformed European listed companies. The index measures quarterly changes in the EVs of over 250 Europe-based private companies with median EBITDA of around €20-€30 million. Since the end of 2020, it has risen 52%, representing compound annual growth of more than 11% for mid-market private companies versus 3.4% for the STOXX 600 and 0.1% for the FTSE 250 Index. The European PMI has also outperformed its U.S. equivalent over that period.

Private market growth outpaced the public markets due to steadier performance amidst challenging macro-conditions

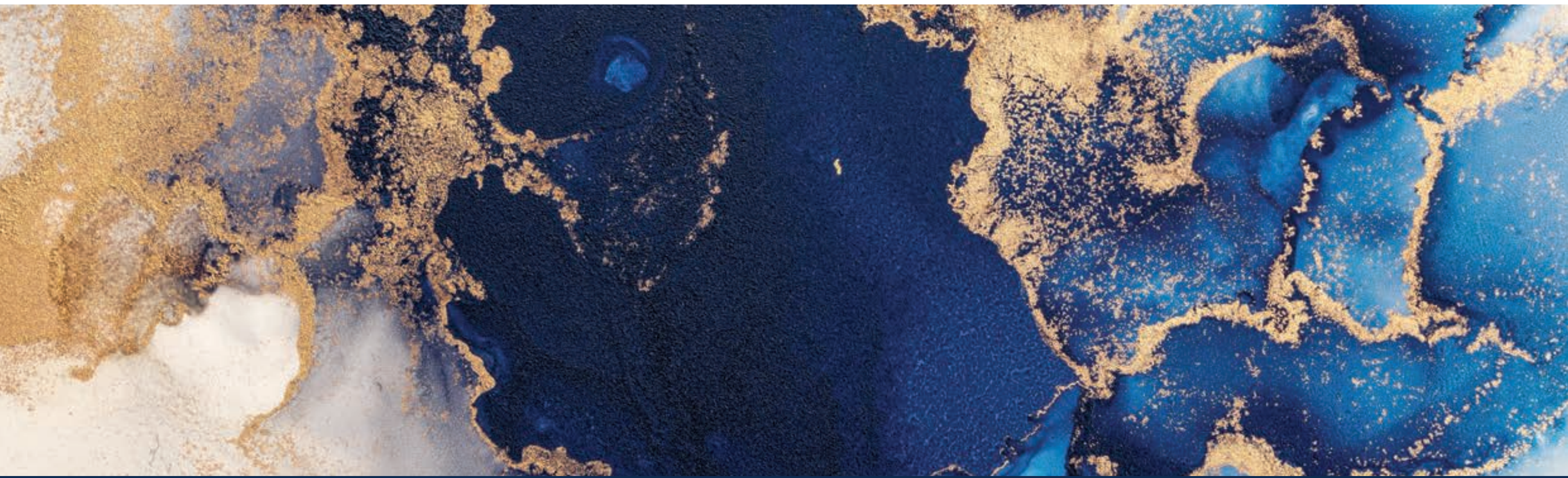


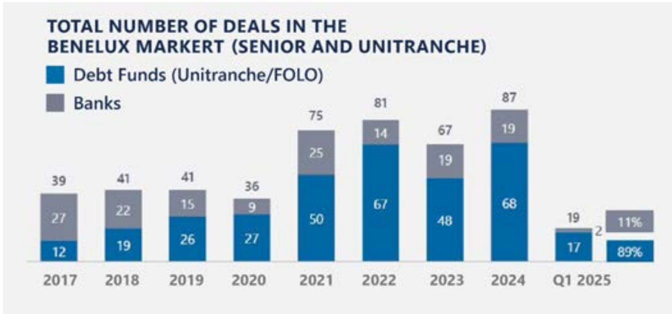
For illustrative purposes only.
Source: Lincoln International, Q4 2024 European Lincoln Private Market Index.

Growth Sensitivity and Downside Protection: Mid-market direct lending is an attractive option for investors targeting stronger growth in Europe. These loans give targeted exposure to Single B-rated borrowers that are typically more closely attuned to the growth outlook than larger and higher-rated credits. In this sense, they offer investors a way to express a positive view of Europe's growth prospects, analogous to the enthusiasm equity investors have demonstrated recently via public markets.

Core European mid-market direct lending strategies combine this growth sensitivity with strong defensive characteristics, notably first lien senior security in the capital structure backed by lender friendly documentation and continuing direct engagement with PE sponsors and management teams.

Stable and Resilient Deal-Flow: The mid-market is far less affected by the sharp slowdown in M&A activity that has hit both the U.S. and European large-cap markets, especially since recent tariff announcements further widened the price gap between buyers and sellers. Classic sources of large-cap deals including public-to-privates, corporate carve outs and secondary buyouts have all shrunk significantly. However, deal flow in the mid-market across major European countries has remained far more consistent in recent years, with no equivalent decline in the number of completed deals.





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Source: Houlihan Lokey, MidCapMonitor, Q1 2025.

A key reason for this is the higher proportion of primary buyouts in the European mid-market, relative both to European large caps and to the U.S. where private equity ownership has been widespread for far longer than in Europe. Pricing of primary buyouts is far less influenced by prevailing acquisition multiples and tends instead to reflect generational planning by controlling families and the need to derisk growth strategies by institutionalising the shareholder register.

Market Maturity and Growth Rate: European mid-market direct lending is less mature than its U.S. equivalent and the companies in this segment are significantly smaller. Europe therefore has strong structural attractions for direct lending, since the market is more concentrated between a smaller number of lenders than in the U.S. and has a higher share of sole-lender deals. The European market's relative immaturity means it can sustain growth rates of 15%-plus per year, far faster than the more mature U.S. market now achieves. The current superior growth rate of Europe's direct lending market versus the U.S. will allow for increasing allocations into the mid-market as investors warm to Europe's prospects. Moreover, ongoing retrenchment by many European banks is expanding the opportunity for direct lenders to finance companies at attractive rates.

Conclusion — A Compelling Way to Access Europe's Improving Growth Outlook

The attractiveness of European mid-market direct lending was well established before the crisis that Europe now faces. This asset class has outperformed syndicated loans and has demonstrated greater resilience in recent deal flow compared to large-cap direct lending.

With a major fiscal boost seemingly about to reach the Eurozone economy, mid-market companies look well-positioned to potentially benefit from accelerating economic growth. This is therefore a highly opportune moment to be seeking exposure. We believe Europe's mid-market companies currently offer an attractive opportunity to diversify allocations into a market with improving growth outlook, while targeting the most growth-sensitive companies in that market. The future looks bright for Europe's mid-market.

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