EXPERT Q&A

Adam Wheeler, co-head of Barings' global private finance group, discusses the importance of discipline and risk management in today's late-cycle environment

Investing in late-cycle European private credit

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Q What is your view of the private credit landscape overall?

Private credit is very much a global asset class and we see opportunities across the regions where we invest – North America, Europe and Asia-Pacific. That said, the relative value of private debt investments in each region tends to shift over time depending on underlying market characteristics and dynamics.

North America, for instance, is the most mature market, and also the largest and most developed from both a borrower and investor standpoint. Most of the capital in the market comes from non-bank lenders.

In Europe, on the other hand, banks still provide a significant amount of financing for mid-market companies, although the market has evolved considerably over the last decade. Since the financial crisis, regulations have forced European banks to reduce leverage, which has impacted the banks' ability to lend to borrowers and created a gap in the market for direct lenders to fill the shortage of capital.

Asia – specifically Australia, New Zealand, Singapore and Hong Kong – is less developed than Europe, with most financing still provided by banks. The market has started to open up to non-bank lenders and more flexible financing solutions in the last couple of years, but it is still a relatively new, and emerging, opportunity set.

Q As you look across the European private credit market today, where are you seeing opportunities?

Broadly speaking, we can characterise much of the activity in the European markets into two distinct ends of a spectrum. At one end are banks, which have been restricted in the amount of debt they're allowed to hold and in their ability to lend to borrowers. On the other end of the spectrum is the broadly syndicated loan market, a relatively liquid market where large pools of capital are provided to (typically) larger companies.

In between the two ends of this spectrum is what we view as the true mid-market – a 'sweet spot' in terms of debt facilities, where private companies typically have enterprise values of €65-€250 million. This can be an attractive area for private equity sponsors, as it can give them the ability to work with just one capital provider to complete financing. It is also advantageous from an investor's standpoint, as it can provide an opportunity to invest in high-quality companies, but through a private investment that offers a potential yield premium relative to the broadly syndicated loan markets, with greater downside protection.

Traditionally, the UK, France and Germany have been the largest markets in Europe and continue to account for the majority of dealflow. More recently, we have begun to see attractive opportunities outside of these markets, including where the market share of banks continues to decrease. One example of this is in the Benelux region – Belgium, the Netherlands, and Luxembourg – where private equity sponsors are increasingly seeking financing solutions from non-bank lenders. Having traditionally sought the majority of their funding from banks, these sponsors are turning increasingly toward more flexible funding structures.

The Nordic region is another specific opportunity, in our view. Nordic banks – traditionally the market leaders – are unable to hold as much debt in transactions as they did in the past, which has opened the door to managers to compete for deals.

Q Where do you think we are in the credit cycle and what are the implications of that?

We seem to be in the latter stages of an elongated credit cycle, but it's very difficult to predict when things might turn and what that may look like. When considering investing in this environment, we think a disciplined, through-the-cycle approach to the asset class is key.

Rather than chasing high absolute returns and investing in higher-risk transactions, we think there is an opportunity for lenders that are focused on where they see good relative value. Often that means taking a lower yield in return for a stronger credit or structure. Regardless of where we think we are in the credit cycle, it's important to keep in mind that private credit is an illiquid asset class, meaning once you invest, your ability to sell is fairly limited.

Barings' approach to investing

As we consider the private credit markets today and going forward, we believe prudent risk management is key. At Barings, while we continue to seek and uncover attractive opportunities, we are disciplined when it comes to the types of companies that we lend to.

Capital structures and leverage associated with a prospective deal remain paramount to our analysis, in addition to the covenants that we lock into transactions. As part of our risk analysis, we also have a robust environmental, social and governance policy in place.

Ultimately, we don't think in terms of cycles; we build well-diversified portfolios of low-risk assets that we believe will deliver attractive risk-adjusted returns through multiple cycles.

> *"The amount of capital raised in the space has outpaced the supply of M&A volume, meaning there is more capital seeking the same amount of deals"*

We also believe there are certain advantages to investing in sponsored versus non-sponsored deals at this, or any, point in the cycle. For one, sponsored transactions are often stronger on corporate governance. The ability to conduct due diligence also tends to be significantly better, as you often have greater access to information such as company financials.

Q Related to being late in the cycle, are there certain trends or behaviours that have emerged in recent years?

In Europe, one trend we continue to see is increased competition – and in some cases more aggressive behaviour – among market participants. Over the last several years, the amount of capital raised in the space has outpaced the supply of M&A volume; more capital is seeking the same amount of deals.

This increased competition has, in our view, led to some style drift. We have seen some instances in which leverage has been stretched to maintain price, for example. We have also seen some lenders increase the size of the transactions they're targeting, which can put them in direct competition with the broadly syndicated markets.

Tied to this increased appetite for risk across the market, documentation has become a bit looser. Recently, we have seen covenant-lite transactions creep into the higher end of the private mid-market – €40 to €50 million EBITDA businesses.

While covenant-lite isn't broadly bad – it has very different implications in the more liquid broadly syndicated markets, for instance – covenants play an important role in the private markets. Specifically, in the absence of liquidity, covenants can offer structural protection and the ability to act in a downside situation.

Also related to this is the number of new entrants to the European market in recent years. This space can be challenging for new entrants, for a couple of reasons. For one, because it's a bilateral market, a lender needs scale in order to access dealflow. A strong origination network is also critical, particularly for accessing proprietary transactions.

Absent that, the primary way of accessing dealflow is through auction processes and other highly competitive situations. Ultimately, we believe more established managers that have strong partnerships with financial sponsors, intermediaries and portfolio companies are at an advantage. ■