Goldman Sachs Asset Management

Alternatives

PRIVATE CREDIT'S GLOBAL FOOTPRINT: OPPORTUNITY IN THE MATURING EUROPEAN MARKET

KEY TAKEAWAYS

- Over the last 15 years, private credit has benefitted from a combination of structural tailwinds and increased adoption as borrowers have increasingly sought flexibility in terms and certainty of underwriting without syndication risk.
- Europe remains less crowded than the US, particularly at the larger end of the market where fewer than 5 private credit funds with a geographic investment focus on Europe were closed at or above $10 billion over the last ten years. This presents lenders with opportunities to be more selective as they seek to target the highest quality deals.
- While less mature than the US market, the European private debt market benefits from many of the same tailwinds and has expanded at a faster rate than any other region over the last decade.
- European private lending can be more complicated given the heterogeneous nature of the market, but this complexity can create opportunities for those able to navigate the various cultures, languages, and regulatory regimes.
- Buyouts in Europe have generally used less leverage and larger equity checks than their US counterparts. As a result, after being higher than the US through the wake of the GFC, European default rates have fallen more in line with the US. Large defaults are less frequent in Europe, potentially as a function of a historically less-concentrated market, and interest coverage ratios have consistently held around one turn higher.

THE RISE OF PRIVATE CREDIT

Over the last 15 years, regulatory changes post-GFC (e.g., Basel) have reduced bank lending capacity, leading to an increased need for private capital solutions. During this time, private credit has seen consistent growth and expansion of sub-strategies, with direct lending becoming the largest segment of the market. In addition to structural tailwinds, private credit has seen increased adoption as borrowers have increasingly sought flexibility in terms and certainty in underwriting without syndication risk.

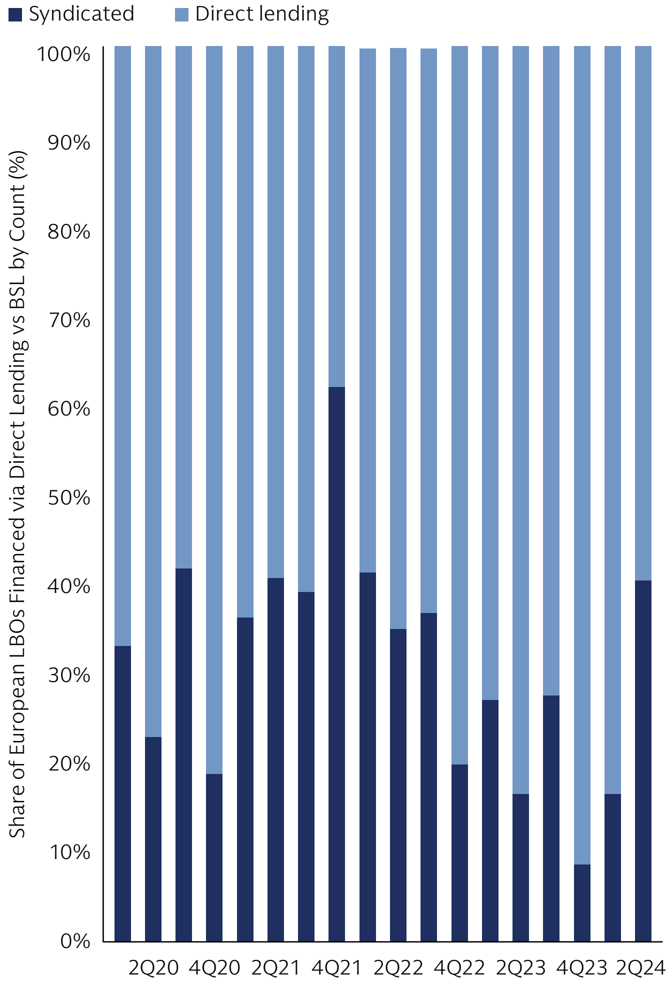
Investors have been increasingly drawn to private credit as it has outperformed versus public credit over a variety of time frames. Aided by several features of the asset class, the yield on private credit has exceeded both high yield and leveraged loans of a similar credit rating. Borrowers – typically private equity financial sponsors – who choose private credit are often willing to pay the yield premium in exchange for greater sophistication, flexibility, customization, speed, and certainty of execution, as well as the ability to evaluate complexity that may impede borrower access to traditional capital sources.

EUROPE: A MARKET OF MANY MARKETS

More Markets, Less Competition

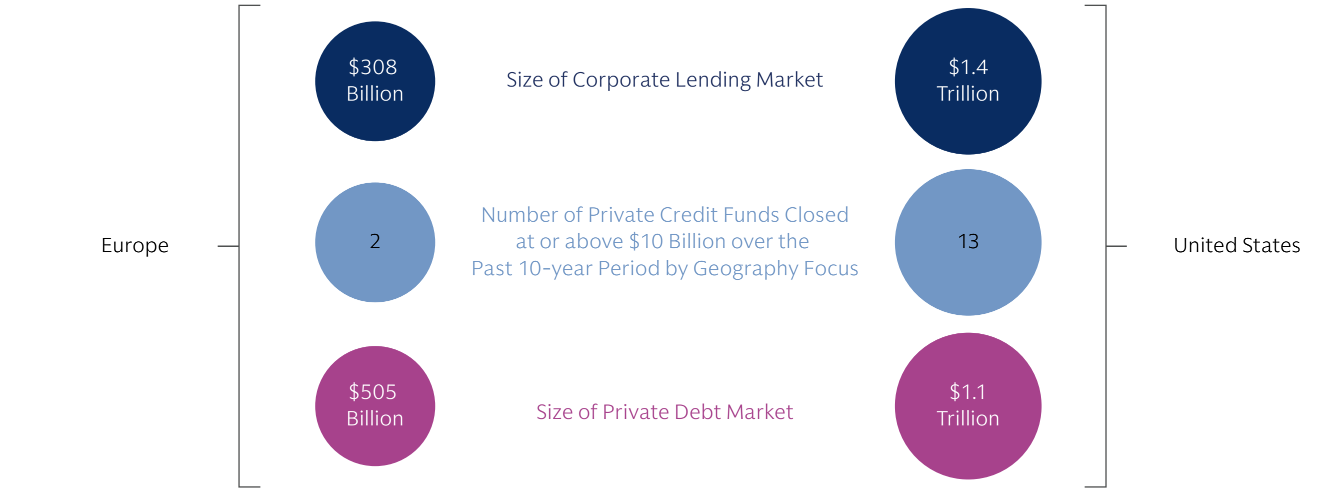
While less mature than the US market, the European private debt market benefits from many of the same tailwinds and has expanded at a faster rate than any other region over the last decade. Despite this rapid expansion, the market is primed for further growth, as the opportunity set is broadening to include larger transactions as more managers achieve scale and fund size growth. Nearly half of direct lending deals in Europe are now €350 million or more, an increase from less than 5% in 2020.[1] Still, Europe remains less crowded than the US, particularly at the larger end of the market where fewer than 5 private credit funds with a geographic investment focus on Europe were closed at or

Direct Lending Has Taken Market Share from BSLs[1]



Source: PitchBook | LCD - Data through June 30, 2024
BSL refers to broadly syndicated loan market; direct-lending count based on deals covered by LCD News

Private Credit Is Dominated By The Rapidly Growing European Market And The More Mature US Market



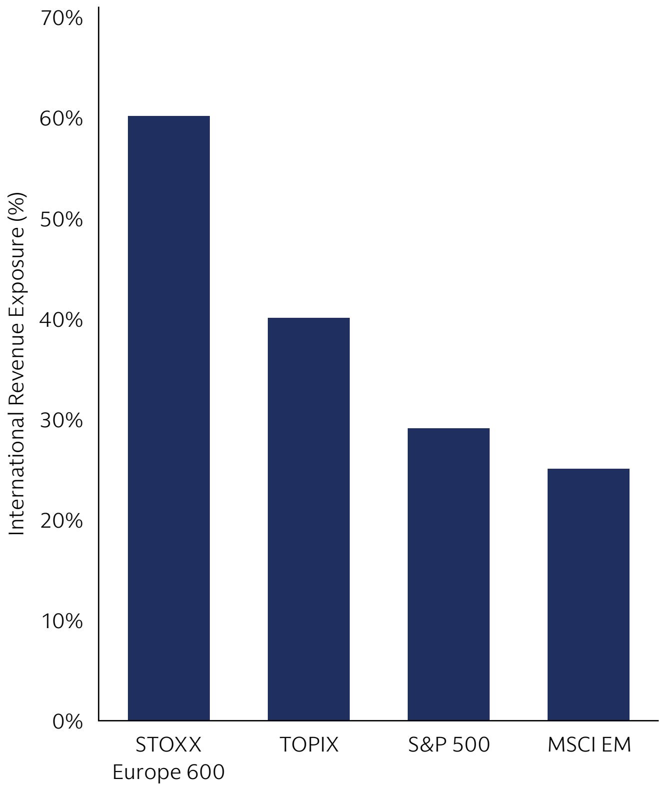
Source: PitchBook, Preqin. As of July 2024.

above $10 billion over the last ten years. This presents lenders with opportunities to be more selective as they seek to target the highest quality deals.[2]

DIVERSIFICATION ACROSS THE REGION

The European corporate borrower base has diversified revenue streams across both sectors and geographies.[3] Nearly half of private lending in the UK goes to business, professional, and financial services, while technology and healthcare play a larger role in the rest of Europe.[4] In addition to the inherent country diversification within Europe, companies based in Europe tend to have a higher proportion of international revenues than the US, Japan, and emerging markets broadly.[5]

European Companies Have Significant International Exposure



Source: FactSet, Goldman Sachs Global Investment Research, as of December 31, 2023.

While the heterogeneity of the market offers inherent diversification, it also presents challenges in sourcing and executing transactions, as well as managing assets.

Idiosyncrasies Create Barriers, and Opportunities

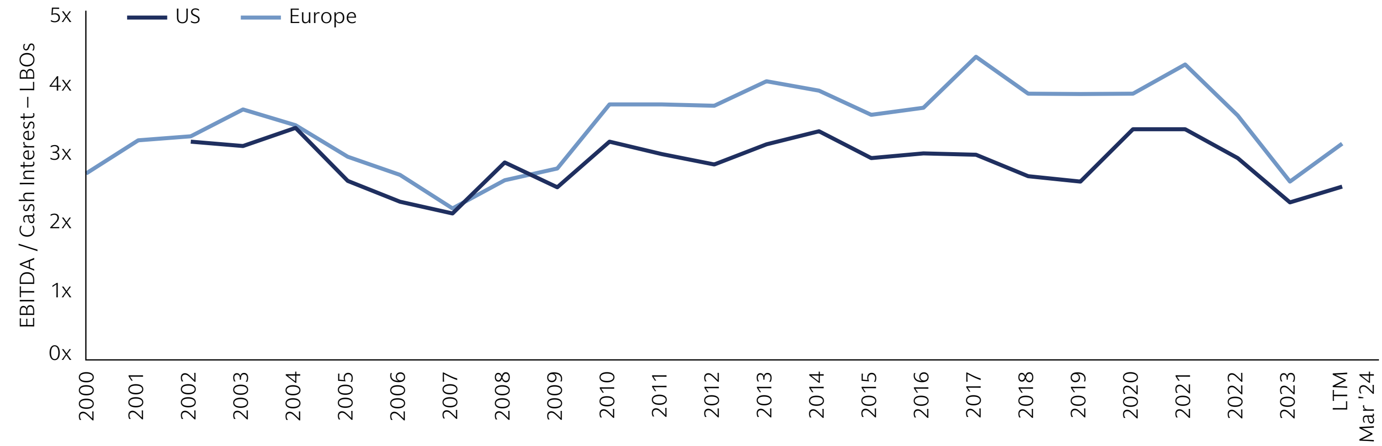
Managers are required to tailor deals to the situation of each individual country – considering different cultures, languages, and relationships, as well as various legal and regulatory environments. Many deals also require multi-currency solutions, given the high percentage of international revenue. These nuances and idiosyncrasies create opportunities for the lenders with local knowledge and expertise to capitalize on their ability to meet a borrower's needs where another lender may not have the ability to do so. Oftentimes, further expansion into foreign markets may be part of the private equity playbook in Europe, potentially requiring complex and bespoke financing to support M&A and organic growth. As a result, many borrowers have been gravitating to the flexibility and certainty of execution offered by direct lenders in Europe.

Investors with deep relationships across countries are also advantaged, as they are more equipped to traverse varying dynamics of the investing landscape from one European country to another. Furthermore, access to locally embedded networks may often be a robust source of deal flow. Compared to the more homogenous US market, this fragmentation in Europe creates more barriers to entry and can strengthen the position of large, scaled lenders in deal negotiations.

EUROPEAN CREDIT FUNDAMENTALS IN A PORTFOLIO

Downside mitigation is paramount in credit investing. With respect to downside risk, European credit may be favorably positioned compared to the US. More than 80% of borrowers in the European private credit market have been sponsor-backed, providing an additional backstop during potential duress, and buyouts in Europe have generally used less leverage and larger

Loans in Europe Tend to Have Higher Interest Coverage Ratios



Source: LCD, as of March 31, 2024.

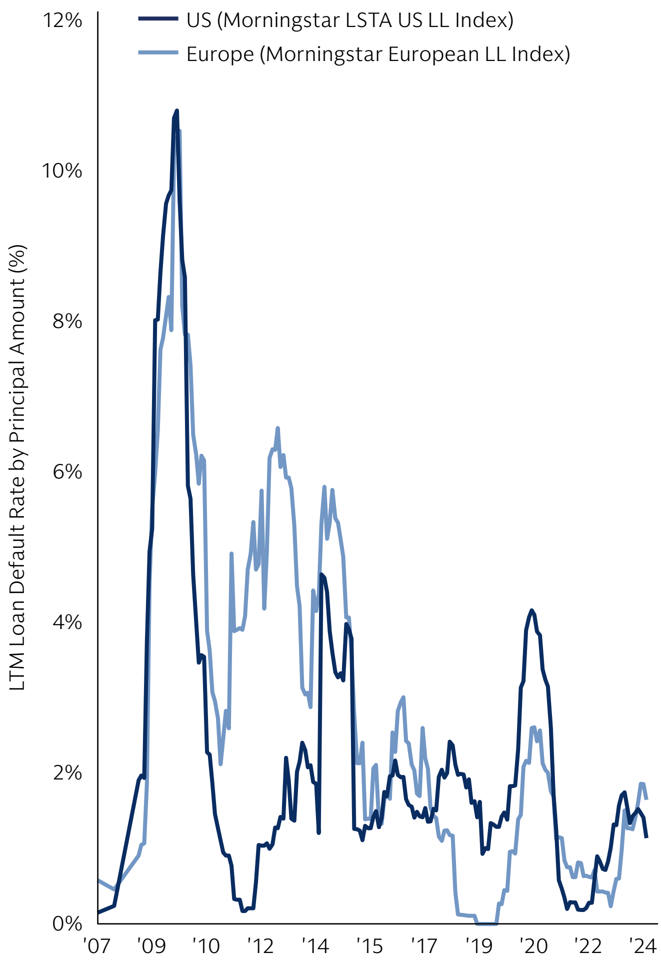
equity checks than their US counterparts.[6] As a result, after being higher than the US through the wake of the GFC, European default rates have fallen more in line with the US. Large defaults are less frequent in Europe, potentially as a function of a historically less-concentrated market, and interest coverage ratios have consistently held around one turn higher than in the US.

Many investors may find additional benefits from European private credit beyond traditional risk/return measures. Those with euro-based liabilities may seek to match with euro-based investments to reduce hedging costs and FX risk. In some countries such as Denmark, Finland, Germany, and Portugal, pension funds are required to cover at least 80% of their liabilities with assets in the same currency.[7] For investors who already have significant domestic exposure, including insurers or those with sizable credit allocations, private credit can provide diversification from commonly held public securities. Investors have historically had fewer options in Europe, but that is beginning to change with the emergence of evergreen structures in the asset class.

THE ROAD AHEAD

European private credit has seen significant growth, but there is room for additional expansion, as the market remains small relative to the private equity activity that it largely supports. Additionally, lenders continue to expand their purview beyond buyouts into other areas, including non-sponsor-backed financing, where borrowers require bespoke solutions. Private lenders are expanding their offering across the capital stack, including investment-grade and asset-backed financing, as well as hybrid capital solutions which have components of both debt and equity. The private market in Europe, and more broadly, are increasingly able to provide an alternative offering for the array of products that can be accessed in public markets and within that, private credit is well-positioned to provide investors with the potential to enhance risk-adjusted returns.

European Default Rates Have Come In-line with the US



Source: LCD, as of March 29, 2024.

1. PitchBook LCD. As of June 30, 2024.
2. Preqin. As of August 2024. Based on latest AUM data available, the US has 23 managers with private credit AUM greater than or equal to $20bn. This contrasts with the European market, where only 5 managers (approximately 0.7% of market) have private credit AUM of over $20bn, and account for approximately 32% of total private credit assets.
3. FactSet, STOXX, Goldman Sachs Global Investment Research
4. Deloitte Private Debt Deal Tracker Spring 2024
5. Bloomberg, FactSet, Goldman Sachs, MSCI, S&P, STOXX, TOPIX and AB
6. PitchBook LCD
7. OECD

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