November 2024

European Mid-Market Private Credit

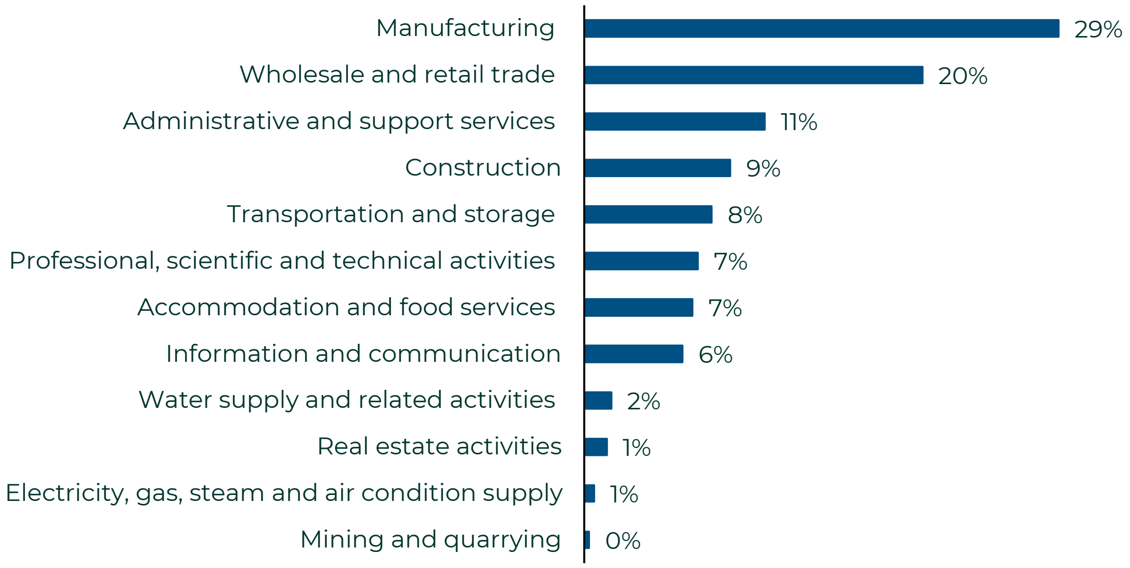
About Atrato

Atrato ("we", "us", "our") is an independent alternatives investment manager, established in 2016. We focus on long term strategies which follow our philosophy of achieving market leading economic, environmental and social returns over the long term.

The European core mid-market in context

Small and medium-size ("SME") enterprises are a key component of Europe's economic engine, including 23 million companies representing 99.8% of non-financial businesses and responsible for approximately two-thirds of all jobs in the region[1]. In this context, the European lending 'core mid-market' (typically defined as companies with 50 to 249 employees) is a key sub-sector with c.226,000 companies across the continent[2].

Figure 1: Industry mix in the European core mid-market space[3]



Excludes figures for the United Kingdom

Historically, core mid-market companies have been serviced by national champion banks and local/regional banks for their financing needs. However, the financing landscape for this market is evolving, leading to a new opportunity set for both borrowers and alternative providers of finance.

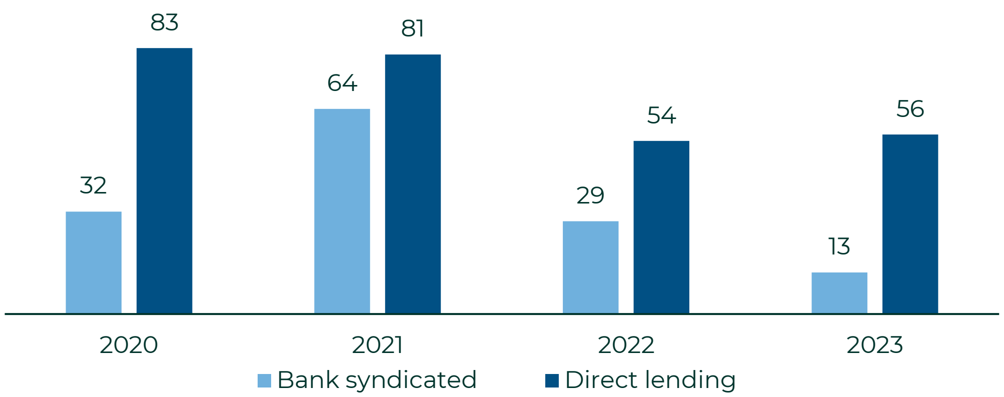
[1] Source: ECB, Small and medium enterprises overview 2022.
[2] Sources: Statista research (18th September 2024) – 190,000 enterprises in the EU excluding UK with 50-249 employees; HMRC Corporate Tax: Research and Development Tax Credits, updated 26th September 2024 – 36,000 enterprises in the UK. Total: 226,000 enterprises.
[3] Sources: Statista research (18th September 2024) – EU Industry mix excluding UK.

Key drivers for private credit in the core mid-market segment

a. Bank retrenchment

Due to increased bank regulatory capital requirements and the elevated cost of bank 'buffer' capital, it is now inefficient for banks to lend to core mid-market companies. The withdrawal of traditional financial institutions from this sector creates attractive (and less competitive) opportunities for private lenders. The prospect of even tighter bank regulations in the future is likely to compound these challenges for the banking sector.

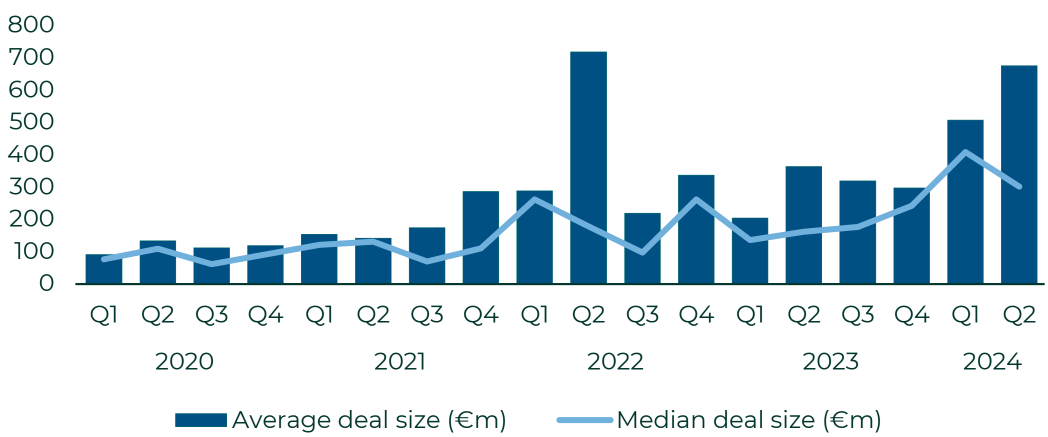
Figure 2: Number of LBOs financed by banks in Europe has materially decreased[4]



b. Larger incumbent private credit funds are targeting bigger transactions

The rapid expansion of private credit funds, coupled with compressed deployment windows, has led to internal pressures to focus on larger lending ticket sizes and hence away from core mid-market borrowers.

Figure 3: Average and median ticket sizes of private credit funds in Europe[4]



[4] Source: PitchBook LCD Research, "Credit Markets Quarterly Wrap" Q2 2024.

The combination of bank retrenchment and a focus on larger ticket sizes by incumbent private credit funds creates a compelling opportunity for core mid-market credit investors, in particular, for those with longer-term liability structures and investment horizons such as those of retirement savings pools.

Lending to core mid-market companies offers attractive relative value...

We believe the core mid-market private credit sub-sector provides the potential for relative value when compared to larger ticket (upper mid-market) direct lending and Broadly Syndicated Loan ("BSL") markets. Given the number of larger private credit funds chasing lending opportunities, documentation standards and pricing remain highly competitive. With less competition in the core mid-market, direct lenders can insist on superior structuring and documentation standards. The sheer number of core mid-market lending opportunities also allow managers to be far more selective in their deal origination.

...and improved risk adjusted returns

Private credit provides solid growth companies with the financial flexibility to pursue their business strategies. As lenders however, the key focus is always on downside cashflow projections and ensuring robust lender protections within the documentation. Meaningful maintenance covenants that closely track the borrowers conservative financing base case are essential. This approach ensures that in cases where the borrower incurs stress or unforeseen difficulties with cash flow, a remedy can be quickly negotiated and implemented, thereby protecting the interests of the lender and the borrower alike.

Typically, there are two to three maintenance covenants to look for in transactions, including net interest cover, leverage, cash available to service debt and where appropriate, a capex covenant. Because target borrowers in this space are usually focused on growth and expansion, stability is an important factor to them and absolute levels of leverage are therefore very conservative when compared to the larger tickets in the upper mid-market and the BSL market. LTV within the core mid-market sector private credit space is moderate at 40% - 50%, providing investors with further downside protections.

Current status of the European private credit markets

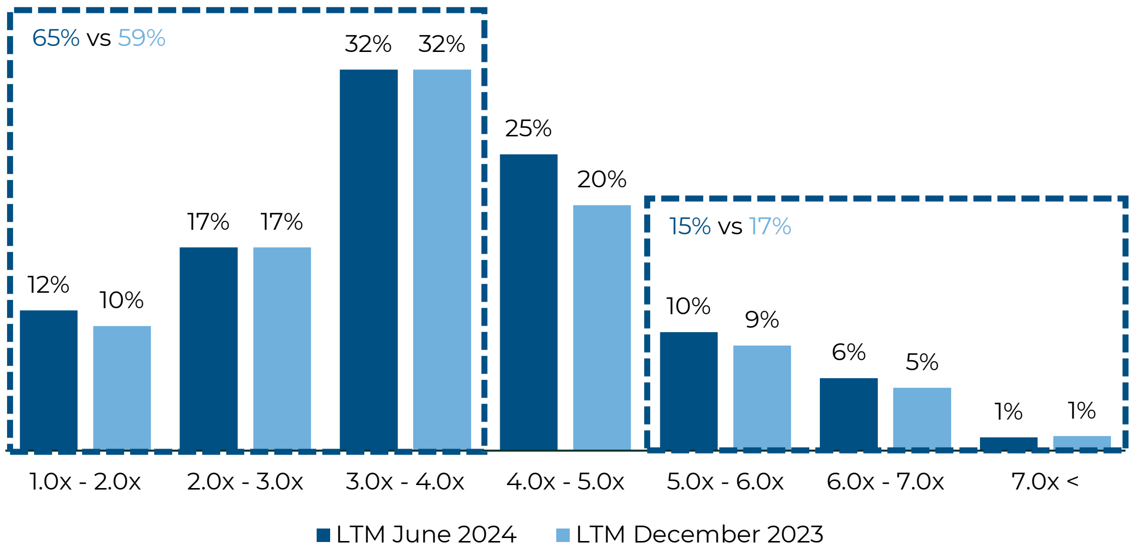
The BSL market, which drives the upper mid-market sector via M&A and disposals, has been active in 2024, in terms of refinancing and repricing deals. This has mostly been driven by technical factors with a significant number of CLO warehouses active in the market. As a result, some larger flow deals are now pricing at E+400bps with no original issue discount (OID), 75bps tighter than last year.

This has rippled into the private credit market, leading to the repricing and refinancing of several private deals. As a result, 2024 has seen strong performance in private credit with significantly more transactions in the market than in 2023.

Direct lending activity in 2024 has so far focused on resilient and cash-generative sectors, with TMT (23%), Business Services (21%) and Healthcare & Life Sciences (15%) accounting for nearly 60% of all deals[5].

Furthermore, leverage levels in the European private credit markets have continued to decline as higher interest rates reduced borrowers' free cashflow and debt service abilities. The average leverage across these sectors declined by approximately 0.5x year-on-year and the proportion of deals with leverage less-than 4.0x rose from 59% to 65%[5]. Deals with leverage above 6.0x declined from 17% in 2023 to 15% in 2024 demonstrating that lenders are unwilling to push leverage in the current higher interest environment[5]. With central banks starting to ease interest rates, we believe it is possible that the reported average leverage will trend higher over the next 12-24 months (although the recent increase in yields may dampen this over the short term).

Figure 4: Leverage levels have decreased[5]



Other trends in 2024 we believe are of note include[5]:

- M&A dominance: M&A driven deals represented 70% of all transactions
- Non-sponsored transactions: non-sponsor deals accounted for 101 of 702 deals, representing only 14% of total private debt deal count
- Subordinated debt structures: comprised 13% of deals - these remain a key feature of the market
- Regional breakdown: the UK is still the largest market with 34% of deals in the last 47 quarters, while Benelux, Spain and Italy remain important and developing regions

[5] Source: Deloitte Deal Tracker Autumn 2024.

Conclusion

The European larger ticket (upper mid-market and BSL) private credit sector is becoming a highly competitive arena. We expect larger ticket lending to increasingly become a cost of capital 'shoot out' ultimately resulting in deteriorating returns and terms for lenders and investors.

Investment timing wise, the current turning point of the interest rate cycle has led commentators to suggest private credit is now a "once in a cycle" investment opportunity. We would strongly believe that it is an opportune time to be deploying capital into private credit. Furthermore, we believe that less competitive core mid-market lending opportunities offer the most attractive risk-adjusted returns within the European Private Credit sector.

However, given the granular nature of core mid-market lending, any successful strategy in this sector will require a highly experienced team, extensive due diligence on each and every borrower and the ability to structure and negotiate complex transactions.

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