

Private Credit February 2024

Five key success factors in the European direct lending market

With traditional lenders continuing to retreat from the market and tailwinds from higher interest rates, private debt is further accelerating its expansion across the continent. Here's Partners Group's guide to what is essential to make the most of this environment.

Introduction

Today, private debt is recognized as an important component in investor portfolios, providing an appealing alternative to more traditional fixed income products. While this trend has been many years in the making, a combination of factors is creating additional tailwinds for the asset class.

In an environment of higher interest rates, the floating rate nature of direct lending is offering investors the potential for attractive double-digit returns and protection against inflation. At the same time, direct lending continues to gain market share, bolstered by the continued retreat from banks, as well as a slowdown in activity from underwriting banks operating in the broadly syndicated loan market.

Having achieved the USD 1.7 trillion mark globally in 2023, private debt assets under management could reach USD 2.8 trillion by 2028¹. In Europe, the asset class is following a similar trajectory. Given these attractive features and the continued growth of the European direct lending space, how can investors make the most of the opportunities the market has to offer? Here, our private credit team presents Partners Group's views.

¹Source: Preqin (2023).

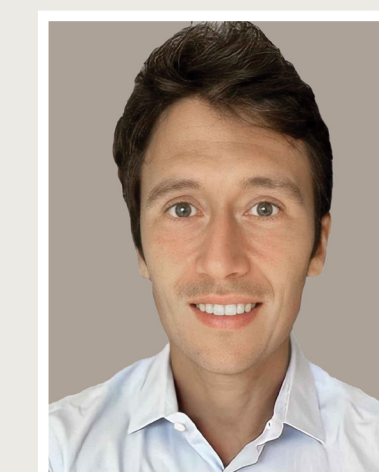
The Authors



Christopher Bone
Partner, Head of
Private Credit
Europe



Carina Spitzkopf
Member of
Management,
DACH, Private
Credit Europe



Maxime Pitel
Member of
Management,
France, Private
Credit Europe

1. Strong roots in local markets

Over the past decade or so, private debt in Europe has grown from a niche form of finance to a significant force in company funding, with direct lending taking the lead. For many of the past ten years, the UK has led the direct lending market, aided by the existence of an established legal framework as well as the earlier retrenchment of banks in middle market lending activities versus other European markets.

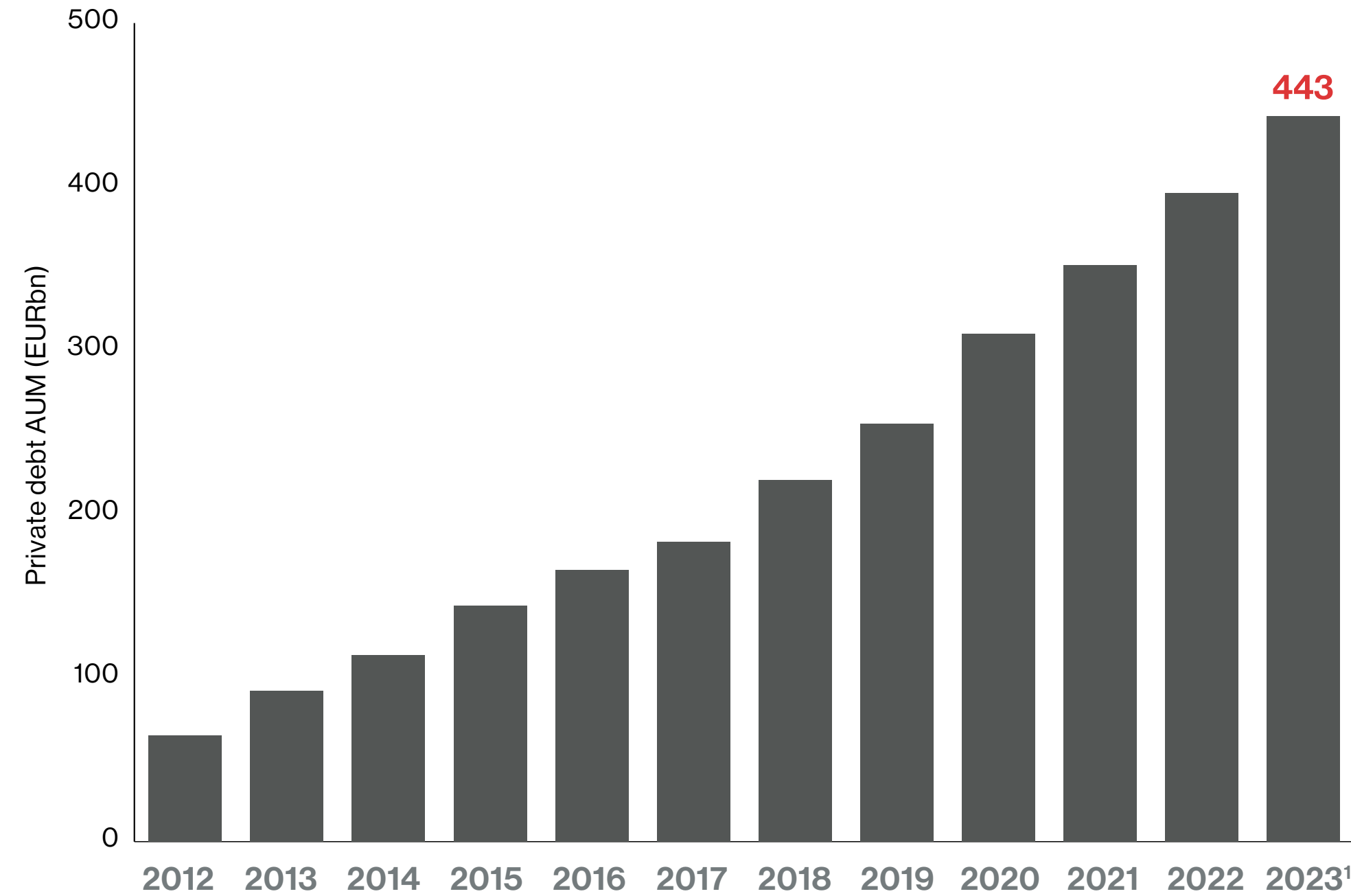
Yet, recent years have seen other countries catch up fast and develop their own direct lending ecosystems. Markets such as France and Germany have grown at a significant rate, while the Benelux and Nordic countries, as well as Southern Europe, have also increased their share of total volumes.

Each country within Europe has its own market dynamics, regulatory and policy framework and business culture. Add languages to the mix and the picture becomes more complex still.

For example, in France, the growth trajectory of direct lending has been similar to that in the UK – albeit with a lag. The Netherlands, once a bank-dominated market, is now one of the fastest growing direct lending markets in Europe. Private debt is now well established as an alternative and we anticipate it will continue taking share in the coming years.

In Germany, banks still retain a relatively high market share in part because of the historical importance of the country's numerous regional banks in corporate finance. Lending is increasingly shifting to private debt investors, but unlike the UK market, where plain

The European private debt market continues to grow



¹June 2023. Source: Prequin (2023).

vanilla structures tend to dominate, German borrowers often have specific needs that require more bespoke financing packages.

As a case in point, we recently supported a German industrial automation company with a financing solution. The business had significant financing needs outside the term loan supporting the actual sponsor

buyout, such as guarantee facilities which are not as frequent a feature in other jurisdictions. Our team's understanding of the local context meant we were able to support a tailored financing solution for the business to suit its needs.

Getting under the hood to understand these local nuances requires deep-rooted local coverage. With

Christopher Bone
Partner,
Head of
Private
Credit
Europe



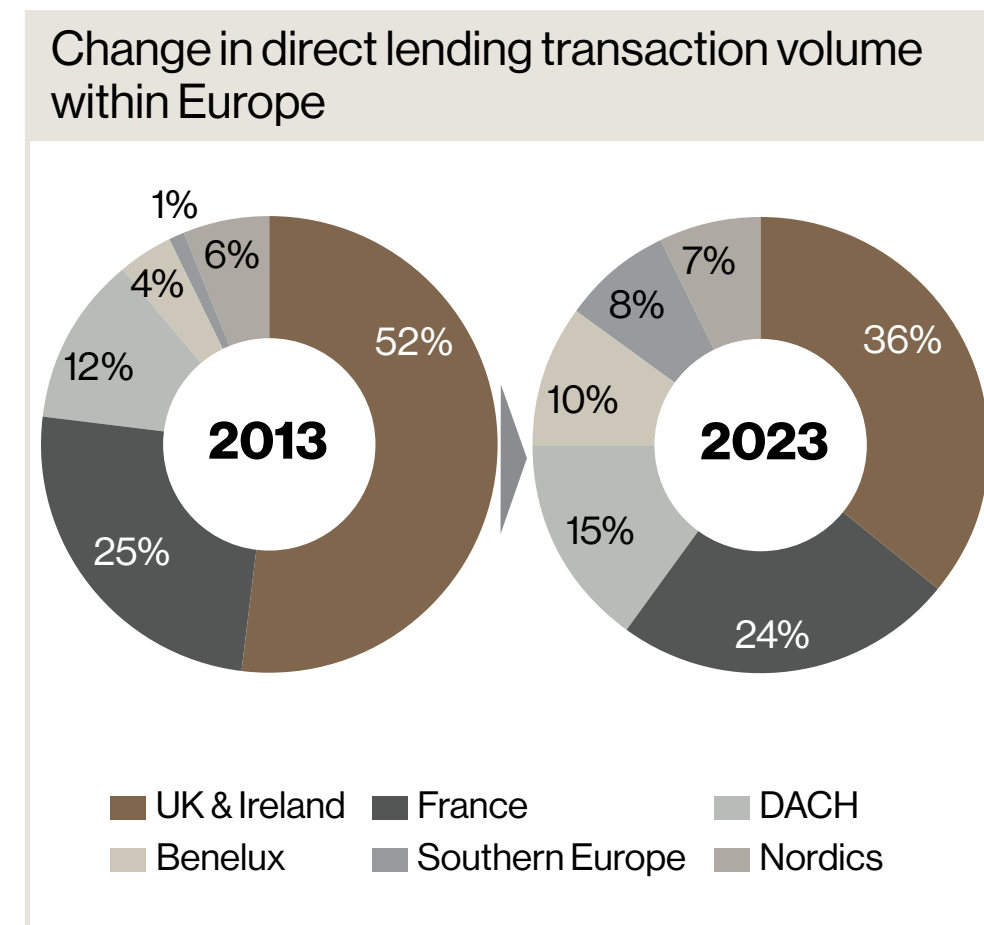
“Private debt has grown from a small, niche part of investor portfolios a decade ago to an established asset class. And while the UK market developed early on, private debt has now penetrated markets across continental Europe, where it provides flexible financing to a range of companies and offers investors a wealth of opportunities.”

With teams covering the main European local markets, Partners Group can identify and source opportunities directly and build strong relationships with borrowers and private equity sponsors.”

teams covering the main European local markets, Partners Group is able to build strong relationships with private equity sponsors and borrowers, which is reflected in our diversified deployment across regions.

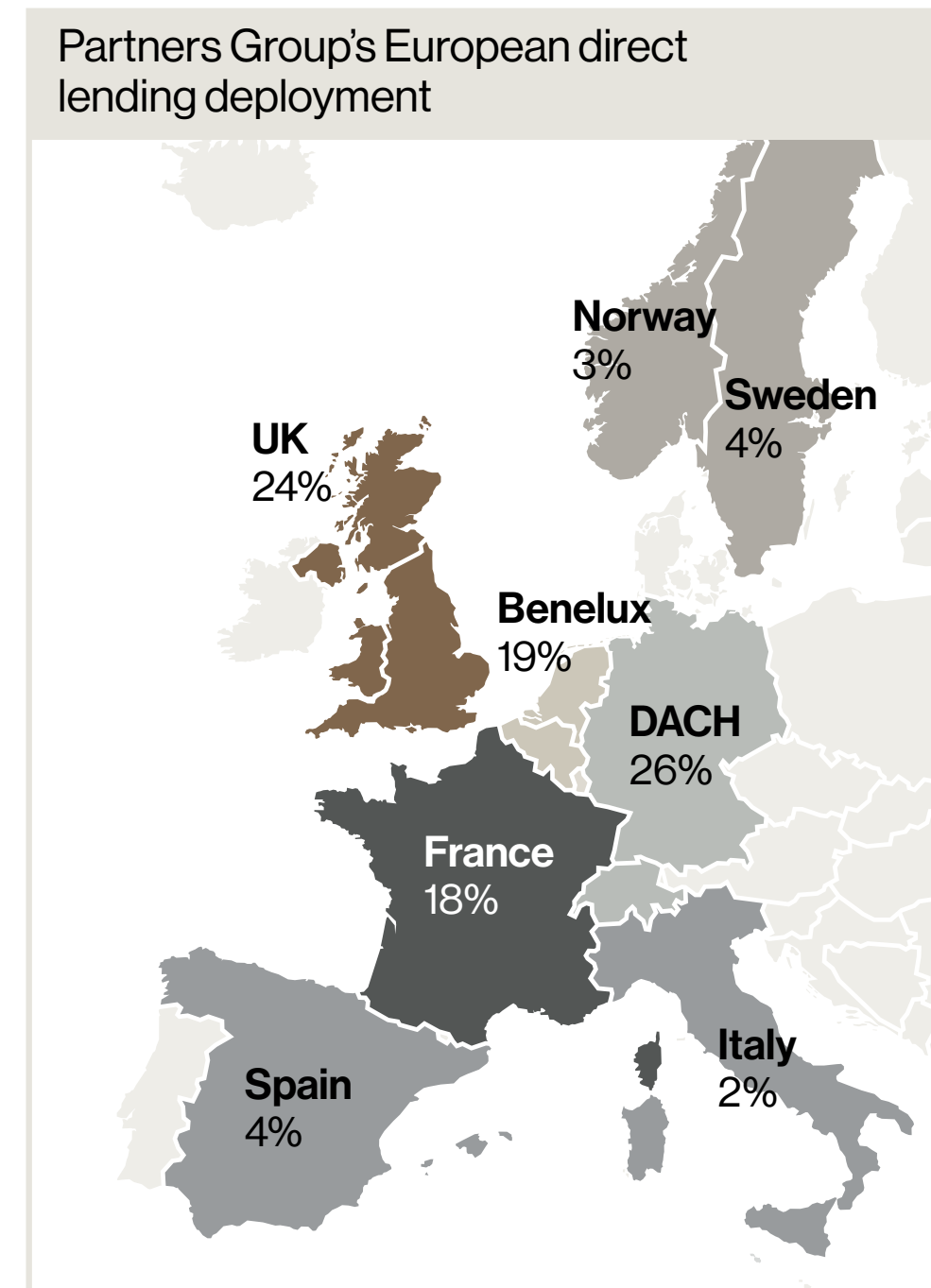
2. Platform-wide coverage to draw upon sector expertise and relationships

The expansion of private debt is fundamentally linked to the growth of private markets, which are taking a central role in financing the real economy. To capture the opportunities being unlocked by this expansion, direct lenders need to deepen their sector knowledge and hone relationships with the private equity managers driving investments.



Sources: Deloitte, Alternative Lender Deal Tracker (Q4 2013), cumulative over the last five quarters; and Deloitte, Private Debt Deal Tracker (H1 2023), cumulative over the last 43 quarters.

This is where we leverage the experience and relationships of our private equity, infrastructure and real estate teams. We source many of our direct lending opportunities through our existing relationships with private equity general partners (GPs) across the Partners Group business. Moreover, our platform has developed in-depth knowledge of the investment themes driving high-potential investment opportunities, and our direct lending team can use those insights when selecting transactions to fund.



Deployment figures for the last two years as for January 2024. Source: Partners Group (2024).

Two recent investments are great examples of these platform advantages. In France, we co-led a direct lending transaction for a cybersecurity and networking IT services player. Cybersecurity is one of the investment themes closely monitored by Partners Group, which means we have sector experts in constant dialogue with the management teams of businesses in the ecosystem. This knowledge was crucial for our debt team to gain comfort about the borrower's business model, the quality of its management team, and the company's potential to benefit from the growth trends in the cybersecurity market.

In another example, we invested as the sole senior lender to a leading data provider for the asset management sector. Our private credit team quickly built conviction around the business due to its value proposition in providing support for mission-critical business decisions, as well as its market leadership, visible cash flows, and diversified blue-chip customer base. Following a competitive process, we were able to convince the sponsor that we were the right lender, because it was clear we understood the business model and its risks and had the ability to support the execution of the next phase of its M&A strategy. Moreover, the sponsor liked the idea of establishing a relationship with a global platform that also operates across real estate, infrastructure and private equity.

USD 2.8trn

Expected global private debt AUM by 2028

Carina Spitzkopf
Member of Management, DACH, Private Credit Europe



“There are nuances in each local market that investors need to understand.

Germany is a case in point. Private debt has taken longer to develop here because the banks were later to retrench from lending and it takes time to establish relationships with borrowers and sponsors' local teams.

The market is now growing strongly and there is still plenty of room for further expansion. But to be successful, lenders need to be able to provide not just direct lending, but also support financing solutions tailored to a company's requirements.”

3. Eyes across the entire mid-market spectrum

Over recent years, the private debt market has opened up across a range of transaction sizes in line with market growth and shifting market conditions. Today, for example, there are opportunities in larger transactions for clubs of direct lenders as the broadly syndicated loan markets have proved to be volatile. We are able to participate in investments of significant size on a selective basis as a control lender. Nevertheless, our key strength lies within the core mid-market, as it offers more consistent and varied opportunities. Here, we can serve as the sole/co-lead lender to a company, and often hold board observer positions.

Targeting businesses with a range of EUR 10-100 million EBITDA, Partners Group can select from a wide array of borrowers across European markets.

We also collect insights from our broadly syndicated loan team, which invests across hundreds of companies. This helps us understand sector dynamics and market trends, which we can apply to our direct lending origination and investment activities.

Having our eyes across the entire mid-market spectrum also allows us to access complementary strategies, such as funding buy-and-build expansions and following our portfolio companies in their growth trajectory.

One of our investments in the software space illustrates this clearly. In 2016, we were the first and sole direct lender to the business, having subsequently seen it go through two buyouts and increase its EBITDA more than tenfold. As we supported the company throughout, we have been in an unparalleled position to provide continued support for its evolving lending needs.

4. Discipline to build resilient portfolios through market cycles

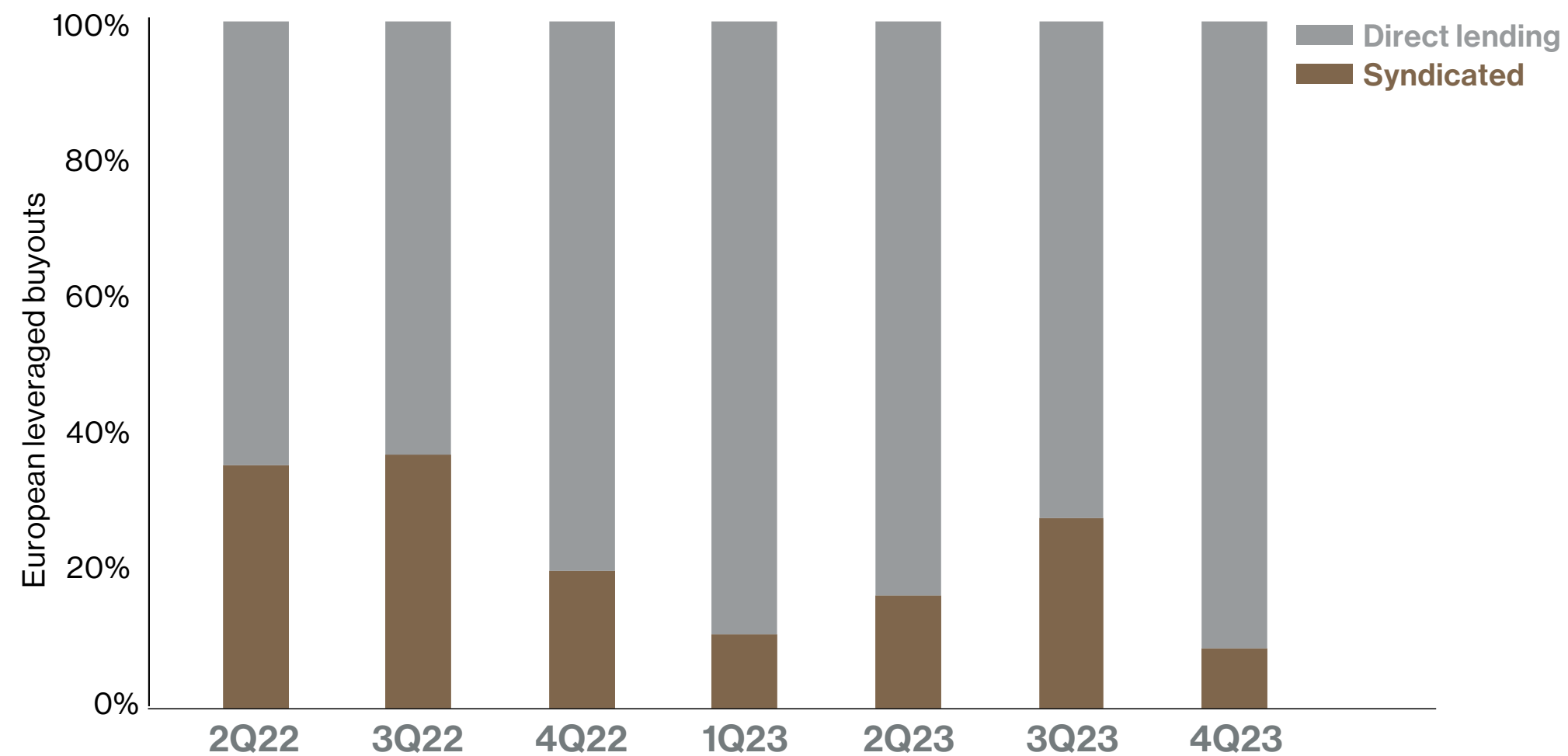
As direct lending continues to expand across Europe, a whole spectrum of new investment opportunities is emerging. Yet, as downside protection is key to private debt, investors need to be highly selective in the types of transactions they pursue and maintain discipline at all times.

At Partners Group, we take a view over the whole three- to five-year hold period. We assess affordability for borrowers using sensitivity modelling and forecasts that include, for example, the potential for prolonged high base rates. When constructing direct lending portfolios we undertake robust due diligence, carefully evaluate the quality of the businesses we back, and seek to invest across a diverse range of assets, sectors and geographies.

We also need to take a view on where in the capital structure we want to be, given the prevailing and future economic environment. Today, our focus is largely on senior debt – this offers the best potential for risk-adjusted returns at a time of economic uncertainty.

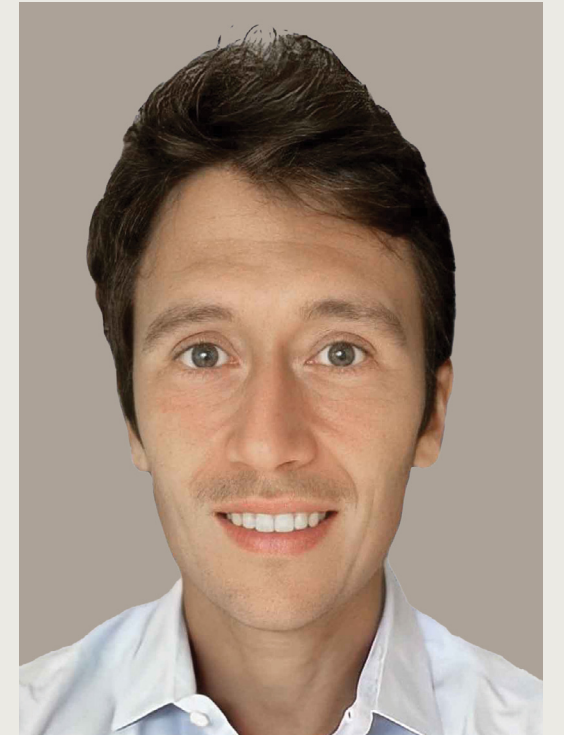
While we emphasise senior debt, there may be space for selective additions to the portfolio in other parts of

Buyout sponsors continue to favor direct lending



Source: S&P LCD (2023).

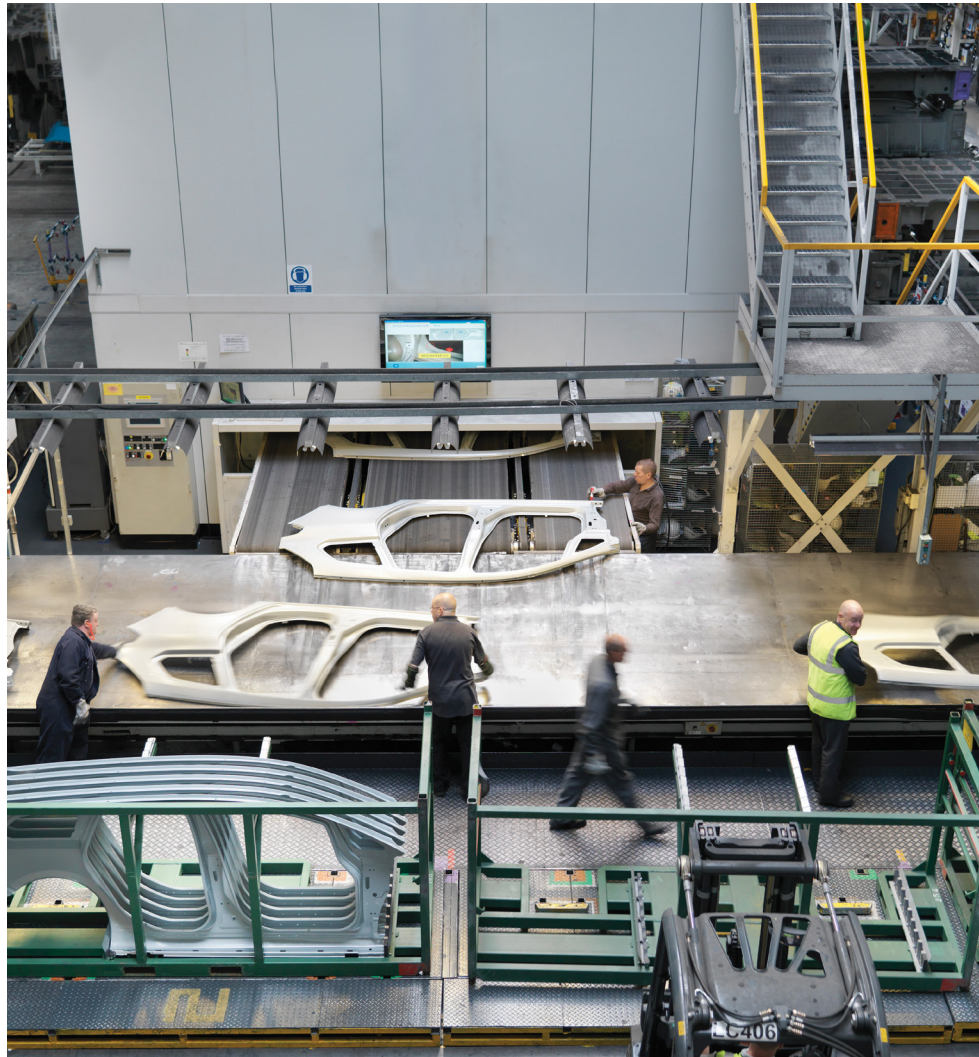
Maxime Pitel
Member of Management,
France, Private Credit Europe



“The Partners Group platform provides a range of advantages.

In transaction sourcing, we can leverage our relationships with private equity GPs on the investment side. We can also tap our platform’s expertise and knowledge on industry and local trends.

In France, we were recently able to draw upon our experts in the cybersecurity sector – one of Partners Group’s thematic areas of investment – to gain comfort about a company and its potential to benefit from market growth trends.”



the capital stack, such as in junior offerings, provided the conditions are right. For example, there may be some opportunity in junior payment-in-kind (PIK) notes and mezzanine in the context of rising interest rates. But given the equity risk this presents, we would approach such areas opportunistically.

5. Focusing on the relevant ESG factors

Over recent years, private debt managers have created environmental, social and governance (ESG) initiatives to encourage borrowers to develop robust policies and practices. One of these is sustainability-linked loans – instruments that incentivize ESG improvements at a company by applying a discount or increase to borrowing costs, depending on their performance against a set of objectives.

We believe it is vital that these initiatives are based on appropriate metrics. Working together with company management teams, we select ESG factors that are relevant as credit risk factors, including business continuation and resilience.

Over three quarters of our European direct lending transactions over the past two years have included ESG margin ratchets. While this is still a nascent area of the market, we have already seen companies in our portfolio improve their ESG profiles.

Our direct lending team is supported in these efforts by the Partners Group platform. The firm's ESG knowledge and expertise feeds into our due diligence and selection processes as well as into how we aim to influence the companies in which we invest.

Partners Group's sustainability-linked loans operating principles

1 Purpose	Improve our portfolio companies' ESG performance and accountability
2 Coverage	Offer ESG margin ratchets for all new investments in Europe
3 Key performance indicators	Define material key performance indicators (KPI) based on company size and sector, with a focus on climate change and diversity and inclusion
4 Margin ratchet	Provide margin incentive to spur achievement of ESG KPIs
5 Material validation	Strive for companies to have third-party assurance
6 Ownership	Define clear ownership of KPIs at every level
7 Training	Educate investment teams on our operating principles

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Media relations contact

media@partnersgroup.com

Client contact

clients@partnersgroup.com

