Capital at risk. The value of investments and the income from them may fall as well as rise and is not guaranteed. Investors may not get back the full amount invested.

Insight

European Private Debt – A Bright Outlook

January 2022

Does a strong recovery in deal flow and the prospect of protection from rising interest rates reinforce the investment case for private debt? Co-Heads of Pan Europe Private Debt Kirsten Bode and Rafael Torres discuss.

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A Hedge Against Rate Rises and Greater Public Markets Volatility

- Private debt aims to provide higher returns than those available in public debt markets.
- By investing almost exclusively in floating rate instruments, it may protect against the prospect of higher inflation and higher interest rates.
- Private debt seeks to take advantage of providing refuge against the increasing volatility of public markets.

Ongoing bank disintermediation and tighter regulations have resulted in private lenders becoming a fixed part of the lending landscape – a trend we believe is only likely to continue with the introduction of Basel III this month.

With the growth of the asset class has come an increased number of players in the market, yet the lower middle market (companies with €5M-€25M EBITDA) appears to be underserved from a lending perspective.

We believe this segment offers a vast opportunity set (over 100,000 companies in Europe) for lenders with the ability to do the due diligence and work in partnership with these smaller companies on their growth journey.

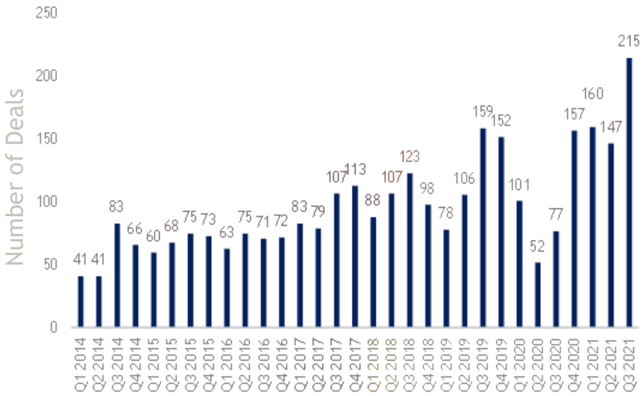
1. Muzinich & Co. views and opinions as of January 2022, and subject to change without notice.

Strong Recovery in Deal Flow

Like all asset classes, the global pandemic had an impact on the private lending market. However, as Fig 1 highlights, this trend has reversed dramatically, and we saw a notable rebound in lending in 2021 as companies began to recover from the economic impact of societal lockdowns.

Q3 2021 produced a record number of deals and the total number of deals for the year to end October has already surpassed 2019's total. [1] Therefore, in our view the asset class is likely to continue to recover strongly from the impact of pandemic.

Fig. 1 – Lending Deals Increasing Post Covid



Source: Deloitte Alternative Lender Deal Tracker Q3 2021, as of 9th December 2021. Latest information available used. For illustrative purposes only.

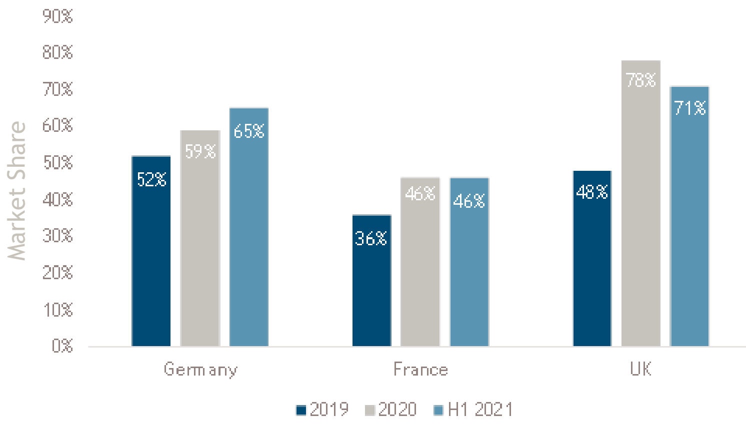
Indeed, the alternative lending market has managed to adapt, and we have seen a flight-to-quality shift by lenders towards more Covid-19 resistant sectors such as healthcare, technology and pharmaceuticals.

This theme has been reflected in our own deal activity, in line with our strict focus on capital preservation. However, we have also sought out interesting opportunities in relatively niche sectors, such as petfood providers, which we believe have strong fundamentals and a very steady underlying growth trend.

Increased Market Share

The alternative lending market has also managed to increase its market share as banks' ability to lend was impacted by, amongst other reasons, their focus on processing government liquidity schemes during the pandemic (Fig. 2).

Fig. 2 European Direct Lending Share of Debt Funds (Senior/Unitranche vs. Banks)

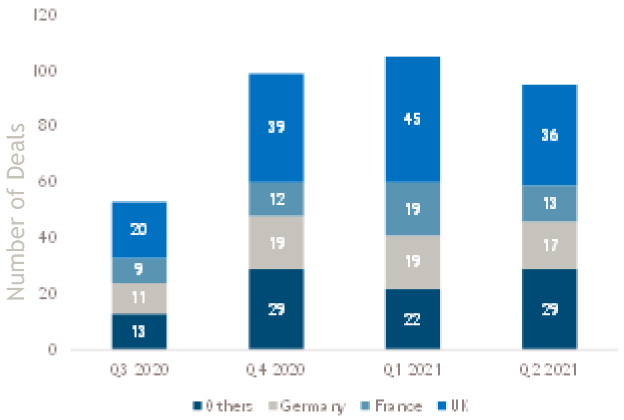


Source: GCA Altium MidCapMonitor H1 2021, as of August 13th, 2021. Most recent data used. For illustrative purposes only.

Furthermore, the number of sponsored unitranche transactions continued to be strong in Q2 2021 (Fig. 3), with 95 unitranche transactions closing during the period. This marks a 121% increase versus Q2 2020, which was the first quarter to be impacted by Covid-19 (43 transactions).

The trend towards add-on acquisitions funded by debt funds also continued in Q2. This was driven by sponsors looking to create additional value through buy-and-build transactions and by strong debt fund appetite for such concepts (whereas banks have limited capacity for bolt-on acquisitions due to regulatory constraints). This data can help allay investor concerns around the ability of private lenders to deploy capital.

Fig. 3 - Sponsored Unitranche Hit New Highs



Source: GCA Altium MidCapMonitor Q2 2021, August 13th, 2021. European Unitranche Financings, (1) No. of deals per quarter. Latest data available. For illustrative purposes only.

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Looking ahead, we believe this strong deal flow trend is only likely to continue, given the improving economic backdrop and lower risks associated with the Covid-19 Omicron variant. In our own portfolios, we will continue to focus on companies within sectors that have managed to avoid the worst of the Covid fallout, or have suffered but have what we believe to be strong underlying fundamentals.

A Partnership Approach Offers Long-Term Benefits

As direct lenders, we work closely with our portfolio companies, and seek out companies interested in growth and expansion. We view ourselves as partners to their business and can customise our lending solutions to fit the specific needs of each borrower. We are also able to integrate ESG considerations, such as disclosures on regulatory compliance or governance, into the terms of the loan agreement. Such resilient relationships with our portfolio companies have already resulted in several repeat transactions, which is beneficial to us as lenders, the borrowers and ultimately our investors.

In addition, with company balance sheets being a mixture of conventional banking solutions and more short-term liquidity mechanics, we believe they will need to refinance to put their debt into a more long-term structure, and direct lenders may be the solution.

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