E X P E R T Q & A

The European lower mid-market is home to attractive niche sectors that are decoupled from macroeconomic uncertainty, says Andreas Klein, head of private debt at Pictet Asset Management

The many attractions of the lower mid-market

Q How would you describe the current appetite for private credit among borrowers in Europe's lower mid-market?

Although there has been a significant decline in M&A activity, largely because of the price expectations gap created by macroeconomic uncertainty, there has been an even larger decline in high yield issuance and in the broadly syndicated loan market over the past 24 months.

If you add to that the fact that the banks have been more focused on capitalisation issues on their own balance sheets, there has been a real scarcity of credit supply – we have seen that at both ends of the spectrum, with private credit stepping in to support both bank-underwrites in the larger cap space and bank-holds in the lower cap segment. So, even though it has been a year of lower overall demand, private credit has stepped up and gained significant market share among borrowers as it plugs the liquidity gap.

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The need to plug this gap will only increase in 2024 as we expect more M&A volume to unlock in the next 12 months. The pipeline is growing, in part as the result of a convergence of opinion that inflation and interest rates have now peaked and, while we may not see a period of significant economic growth, it is unlikely we are heading for any deep recession.

The most attractive opportunities we are seeing, and what we have a heavy bias towards, is where strong underlying businesses that are currently unlevered are looking for capital to grow their market position by taking advantage of the low valuation environment and consolidate their space.

Q What makes the lower mid-market attractive versus larger companies?

There is a general perception that smaller is riskier and, while there may be some truth in that, there are certainly many exceptions. We believe the lower mid-market offers many opportunities to fund idiosyncratic, niche businesses that are decoupled from the broader macroeconomic environment.

They do not necessarily experience the same headwinds and drivers tied to things like consumer spending, FX volatility or cross-border trade, whereas the larger you get, the more correlated you tend to be to these and thus the wider economy.

We have found many niche businesses that we believe to be extremely insular in nature. When we overlay that with the characteristics of lower mid-market lending, which are a pricing premium, lower leverage and tighter documentary protections, we find a really attractive risk-return proposition.

Q How are current macro and geopolitical challenges impacting borrowers?

Uncertainty is higher today than it ever has been, and that is down to a combination of geopolitical and macroeconomic issues. We are facing a year of many significant elections around the world, and there are conflicts in both Europe and the Middle East that have the potential to escalate. That makes forecasting demand and costs very difficult for borrowers, particularly given the cost of debt is higher and capital management is absolutely critical for these businesses to manage liquidity.

So, in general it is not an easy environment for borrowers, but the yield curve is tapering. The market appears to see us at the top of the rates and inflation cycle and in a much better position than we were 18 months ago.

There will be some issues for borrowers around the refinancing gap, as there is a maturity wave coming that needs to be refinanced – however, operating performance has been resilient and valuations have been robust. I therefore think lenders will likely come out unscathed, with the equity taking the brunt of the refinancing hit. There are still healthy businesses with broken balance sheets out there and we don't necessarily see the spike in default rates that we might have expected earlier last year.

Q Where do you see the greatest growth opportunities going into 2024, both in terms of sectors and geographies?

For us, because that uncertainty still remains, we are positioning ourselves very much around defensive sectors with lower beta. Those are generally healthcare, education, business services, technology and software. Those are also generally higher margin businesses with limited capex requirements and these therefore have the most free cashflow to absorb any type of volatility. That creates a resilience in the top line and much more resilient assets in terms of serviceability and repayment of debt.

When it comes to geographies, overall I think the European outlook is relatively bleak. The UK economy has seen ever increasing setbacks since Brexit, while Germany is heavily under-invested in energy and infrastructure, creating a fragile outlook. However, our focus on the lower mid-market allows us to be largely insulated from those headwinds and weaknesses, and so for us as a pan-European investor, it is less about picking geographies and more about finding those esoteric opportunities wherever they exist.

Q What should LPs look for when assessing managers active in lower mid-market European direct lending?

Right now, many allocators are really focusing on track record as a determinant of future potential performance and we would really caution against that. First, the track record that many of these managers exhibit is historically based on very different economic and investment environments. Markets have been relatively benign for the past decade, making manager dispersion narrower and track record feel less relevant for the market we are now operating in.

> *"We have found many niche businesses that we believe to be extremely insular in nature"*

Secondly, many managers with long track records will by default have assets in their portfolios that are going to require a lot of bandwidth should they fall into a more distressed scenario. Dealing with these assets prevents management from looking at new investment opportunities as they would otherwise, which isn't great for new investors. So, it is much more important for investors to look at the team, the depth of its origination capacity, the quality of its credit expertise and its ability to manage assets through an entire credit cycle. There is also a noticeable trend in private credit today, with a lot of funds out there with very little differentiation. We have seen scale becoming an increasing factor in private credit, but really large funds often lack a differentiated proposition for underlying investors.

We believe LPs should seek diversification across a range of strategies, with different exposures to different niches. There are (i) not that many managers focused on the lower mid-market and (ii) structurally more smaller companies than larger ones, which provides a very healthy investment environment for GPs in that space to operate in.

Origination is more important than ever today because there is not enough dealflow to absorb the surplus of dry powder in the credit space. Having on-the-ground networks that enable you to source your own proprietary deals is key. ■

For more information on our European Direct Lending strategy, visit assetmanagement.pictet