Private credit: Europe versus the US

Estimates suggest the private credit market will double in value over the next 5-years. It's attractions remain as strong as ever: potential inflation protection, diversification, potentially attractive risk-adjusted returns, and volatility reduction. With Europe and the US dominating almost 90% of the market[1], what are the key differences between these regions and where should investors set their focus?

Aramide Ogunlana
Investment Specialist Director, Private Credit
M&G Investments

The private credit market

Within the sub-IG corporate lending market, the more mature $3.5 trillion US market dominates being three times larger than the European market[2]. This differential narrows however within the private credit market where the US is only twice as large[3].

Whilst the overall private credit market could be set to almost double within the next 5-years, Europe could grow faster than the US. In our opinion, this growth will likely come from a narrowing of the disparity between Europe and the US sources of funding. In the US private credit market, almost 80% of lending is provided by capital markets – in Europe this is only 30%[4]. We believe this gap will close with capital markets (private credit) accounting for a larger share of lending.

Europe's likely expansion will provide opportunities for investors seeking to capitalise on the growth opportunity. An enlarged private credit market in Europe offers origination opportunities, in particular for asset managers with a history and proven expertise within local jurisdictions.

Europe: Stronger returns for less risk?

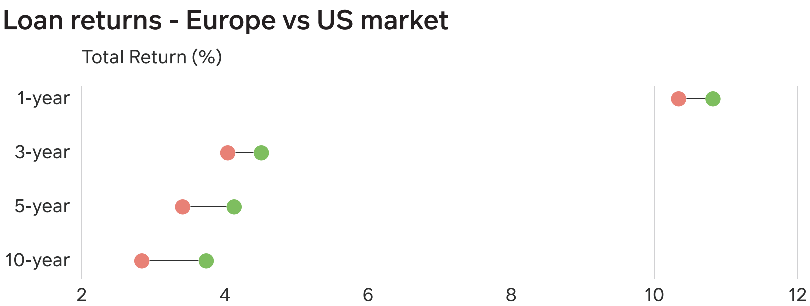
The US market may be more mature, but greater maturity typically affects key risk and return characteristics. With the US being more mature, it is also a more competed market for lenders – there are a greater number of private credit lenders in the US versus Europe. This highly competitive US market typically lowers the yield available for investors:

These lower US margins are coupled to an overall lending environment demonstrating heightened risk characteristics relative to Europe. Indeed, most recently the European market has provided attractive spreads whilst also providing higher interest cover and lower default rates.

Downside protection: The value of collaboration

A distinction between European and US private credit markets are both the legal remedies available and lender characteristics within different European jurisdictions. The Chapter 11 bankruptcy mechanism provides US companies and distressed borrowers a more immediate and formal route to enact work-outs. Europe is characterised by many local restructuring regimes and security jurisdictions, albeit these are by and large more creditor friendly than Chapter 11, but still require greater collaboration between all parties in a workout situation to come to a resolution.

Past performance is not a guide to future performance



* Europe: Credit Suisse Western European Leveraged Loan Index (CS WELLI Index).
** US: Credit Suisse US Leveraged Loan Index (CS US LL Index)
Source: Credit Suisse as at 31 March 2024, hedged to €

Higher quality credit market in Europe

Characteristics	European private credit	US private credit
Interest cover[1]	4.0 – 4.5 x	3.5 – 4.0 x
Default rates[2]	1.1%	1.6%
Recovery rates (3yr average)[3]	75%	67%

[1] Natixis, 'Why Private Debt, June 2003-post GFC data'.
[2] LCD ELLI and US LLI 5-year default rates as at April 2024.
[3] S&P Default, Transition, and Recovery, December 2023.

Multiple jurisdictions makes navigation of the European market more complex. However, this diversity often demands a higher level of expertise by lenders, so specialist knowledge from asset managers is an important capability to have.

The emergence of the European retail investor?

Retail investors are a feature in the US whilst being largely absent in Europe. On the one hand retail participation increases the addressable investor base, on the other, the presence of retail investors likely heightens volatility within US private credit markets.

European retail participation will likely be driven by the growth of European Long Term Investment Funds (ELTIF). The ELTIF provides an accessible, retail-friendly structure allowing individuals to benefit from the same private market opportunities previously the reserve of institutional investors.

The previously discussed growing maturity of the European market, historically higher returns, better credit quality and greater credit opportunities with continued retrenchment in lending by European banks, provides a highly appealing alternative investment choice for individuals, in our opinion.

ESG integration – Europe leading the way

Europe is more advanced, both in terms of ESG integration and disclosure, than the US. Assessment of any risk which might impair the ability of a lender to repay their debt is clearly key. Risks associated with ESG factors can be financial, reputational or regulatory. All can pose a detrimental threat to credit quality and a company's ability to service or repay its debt.

In terms of ESG integration and disclosure standards, Europe is likely to retain an advantage. This is due to the relative ease within Europe for investment managers to make such disclosures. Regulators in Europe often provide templates for asset managers to use which allows data to be presented in a consistent and robust manner.

An issue facing investors across both regions however is the quality and reliability of data. This has been a perennial problem and one which has led many managers to establish their own proprietary research capabilities.

The private credit universe remains a highly attractive choice for investors across both the European and US markets. The more mature and highly competitive US market may be larger, but evidence suggests that the risk is higher, credit quality lower and investors likely to obtain lower risk-adjusted returns relative to Europe. For these reasons, M&G believe that the European private credit market, offering the potential for higher returns with less risk, could be the preferred destination for investors.

For more information on M&G's private markets capabilities, visit mandg.com/institutional

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[1]M&G Investments, 31 December 2023 [2]M&G Investments, 31 December 2023 [3]Preqin, 31 December 2023 [4]Oliver Wyman 'The EU Banking Regulatory Framework, 2023