

## Alternative credit: why overlooking Europe is a mistake

From private debt to distressed and special situations, Europe is fertile ground for investment in alternative credit. It's a region investors can't afford to ignore.

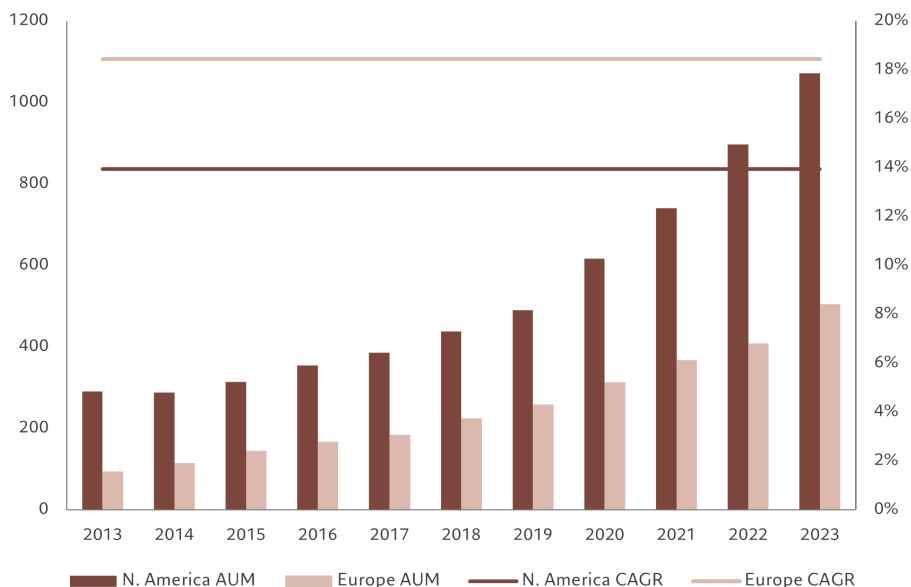
When it comes to investing in listed equities or traditional fixed income instruments, investors routinely take a global approach.

Yet as soon as their focus shifts away from mainstream asset classes, they tend to gravitate to their domestic markets or, more frequently, the US.

Indeed, Europe is often overlooked by American and Asian investors in alternative credit – whether that's in direct lending or distressed and special situations. We believe this is a potentially costly oversight. It is a myth that Europe is still a niche player in alternative fixed income. Its private credit market is growing at faster rate than the US equivalent (see Fig. 1).

Fig. 1 - Growing opportunity

Assets under management (USD bn) and 10-year compound annual growth rate (% , RHS) for private credit markets by region



Source: Preqin. Data covering 31.12.2013-31.12.2023.

Another plus for investors is that Europe isn't oversupplied with lenders, in contrast to the more mature and more saturated US market. This matters because if businesses have fewer funding options, lenders can secure higher yields on any loan they provide, a factor only amplified by Europe's relatively less efficient and less harmonised market.

A simple, aggregated comparison of returns from direct lending over the past five years bears this out: Europe has consistently outperformed the US despite its materially lower base rates. This reflects the more attractive spread achievable in Europe (see Fig. 2).

Digging deeper into Europe's vibrant and even less saturated lower mid-market, senior-secured loans recently originated by Pictet Asset Management's direct lending team, for example, have been made at spreads of over 650 basis points over Euribor.

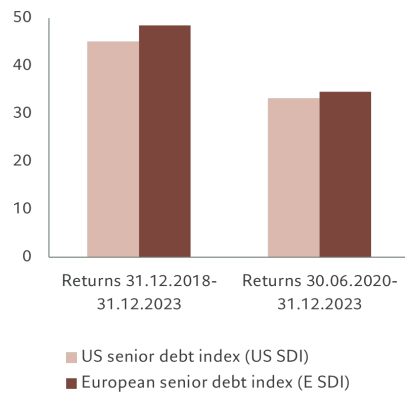
There are other factors that set Europe apart. For a start, Europe's business cycles and socio-economic make-up differ considerably from those of Asia and US. Next year, for example, our economists expect the pace of growth to accelerate in Europe and to slow in the US.

Moreover, Europe is home to a wide range of countries, currencies and industry sectors, presenting opportunities for portfolio diversification – an investment

landscape that is potentially more varied than that of the US or Asia. The possible currency contribution from investing Europe looks appealing. Pictet Asset Management's macroeconomists forecast the euro will appreciate by an average of 1.4 per cent per annum versus the US dollar over the next 5 years, boosting returns for US dollar-based investors, reinforcing the case for an allocation to the region.

Fig. 2 - Superior returns

Returns for senior debt, %



Source: Lincoln International. Data covering period 31.12.2018-31.12.2023.

## Not a level playing field

The diversity of Europe's alternative credit markets means the dispersion of returns across countries and sectors is generally higher than that of the US. This opens up investment opportunities for astute fund managers as they can more easily arbitrage opportunities - across countries, for example - and in doing so build diverse portfolios that are also more resilient over time.

In more liquid credit and leveraged loans, the dispersion creates pricing discrepancies that investors can take advantage of.

Currently, our direct lending strategy sees potential in low beta sectors (those which tend to be less volatile than the overall market, like education or healthcare) and smaller companies with strong market share in 'micro-niches' across Europe. These firms tend to be highly resilient to shifts in the business cycle and leaders in their markets. One of our recent investments is a German manufacturer of 'Made in Germany' high-tech laser heads for medical devices; another is a technology company that develops software for French real estate developers that require energy efficiency certifications. This firm has built a dominant position in its niche market.

The opportunities within Europe's distressed and special situations credit market are equally rich and varied. Our teams have established long positions in select European real estate investment trusts (REITs), which they believe have been trading at unusually cheap levels.

The sector has experienced a tumultuous few years, suffering from mis-steps made when interest rates in Europe were far lower than those in the US. Back then, real estate firms sought to take advantage by borrowing heavily to fund acquisitions; they were given credit ratings that were in many cases at least a notch or higher than they should have been.

When euro zone interest rates began to rise as inflation took hold some of these debt instruments began to decline sharply in price. Many REIT instruments are now trading at stressed or distressed levels. Some of these have fallen to unjustifiably low valuations, offering a cheap way for investors to gain exposure to both residential and commercial sectors of European real estate.

But bond prices can also be too expensive. In European credit markets right now, there are sectors where yields provide insufficient compensation for risk. In some cases this reflects a misunderstanding of deep-rooted problems some firms face. They can also present investment opportunities – establishing short positions in these securities can produce strong returns if prices fall to more realistic levels. Portfolio managers of Pictet Asset Management’s distressed and special situations debt team see such opportunities in a handful of sectors, including chemicals, an industry which has yet to find its footing in the wake of the Russia-Ukraine war. Here, many European firms face significant long-term competitive pressures, with lower cost producers from outside the region threatening their viability.

## Challenges and opportunities

None of this is to say that European markets don't have their own challenges and risks. Some might point to Europe’s relatively lacklustre economic growth in recent years. But, while relative economic performance is crucial for investors deciding on their geographic allocations in listed equities, we believe it is of less relevance for alternative credit markets. Here, bottom-up fundamental analysis is critical to success, and there will always be companies who do well (or badly), whatever the economic weather.

Of greater importance to investment decisions, we believe, is the complex web of national and regional regulations. While in the US all companies follow the Chapter 11 bankruptcy mechanism, in Europe each country has its own restructuring rules which lenders need to navigate, for example when seeking to take or enforce security as a creditor. Our in-house legal team has identified the emergence of a more creditor-friendly environment in some European regimes. This sits in contrast with the US, where so-called “creditor-on-creditor violence”, enabled by typically looser documentation, has historically been far more prevalent. The complex legal tapestry presents risks for the uninitiated but can also be a source of opportunities for experienced distressed investors with local knowledge. A deep network of local restructuring and legal advisors, and hands-on experience of investing throughout the economic cycle are crucial to correctly pricing credit risk and recovery rates.

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Many of those who have overlooked Europe point to the fact that its capital markets are dominated by banks: despite a decline in loan-making over the past decade, euro area’s banking assets are still equivalent to some 290 per cent of GDP, compared to just 120 per cent for the US.

But we expect bank lending will continue to decline in the face of tighter regulation (such as the Basel IV global banking supervisory standards). That opens the door for private debt and other alternative sources of credit to take some of that share and in certain cases to pick up assets or lend at attractive rates. This is particularly the case when it comes to lending to smaller and medium-sized companies, firms which have seen bank funding pared back as European banking groups are now obliged to hold much bigger capital buffers when lending to SMEs. Europe is home to some 23 million small and medium-sized companies, providing nearly two-thirds of its jobs and adding EUR3.4 trillion of economic value a year, so would-be non-bank lenders have plenty of choice over where to deploy capital

Boots on the ground

Navigating such complexity, of course, requires local knowledge and expertise. The recent political uncertainty in France is just one example of why investors must remain nimble. Language barriers, differences in legal systems, divergent local cultures and businesses practices are issues that US markets do not have to grapple with.

Non-European investors seeking to allocate capital to Europe's alternative credit markets should therefore seek out longstanding, proven 'through the cycle' experience and demand on the ground regional presence. These are key success factors to harness the opportunity set.

In summary one thing is clear: including Europe within an investor's alternative credit portfolio – via direct lending, distressed and special situations or credit dislocation strategies – is more than just a diversification play. Due to the unique dynamics of the market landscape, investors risk leaving alpha on the table by overlooking it.

## ALTERNATIVE CREDIT AT PICTET ASSET MANAGEMENT

### European Direct Lending

Our pan-European Direct Lending strategy aims to deliver strong long-term risk-adjusted income to investors by providing senior-secured debt financing for privately-owned, performing lower mid-market companies in Europe (EBITDA of EUR5-15 million). The strategy was launched in 2023 with team members located in London, Paris and Frankfurt.

### Distressed & Special Situations

An absolute return long/short credit and capital structure arbitrage strategy which focuses on financially stressed and distressed companies, predominantly in Europe. Managed by a highly experienced and specialised team led by Galia Velimukhametova, it targets strong net absolute returns across the cycle, leading to low correlation with traditional asset classes.

### Credit Dislocation

A purpose-built 'drawdown' vehicle investing into dislocated corporate credit at the most attractive point in the cycle when prices dislocate from fundamentals. Managed by the same highly experienced Distressed team as above, it can act as a portfolio diversifier and provide attractive directional returns.

Written by



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